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**ASSESSING THE EFFECT OF CORPORATE GOVERNANCE  
ON INEPENDENCE OF INTERNAL AUDIT FUNCTION, *case  
study based on Private commercial Banks of Ethiopia***

**BY**

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(EMBA-PROGRAM)**

**ASSESSING THE EFFECT OF CORPORATE GOVERNANCE  
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CASE STUDY BASED ON PRIVATE COMMERCIAL  
BANKS OF ETHIOPIA**

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**JUNE 2015**

**DECLARATION**

I hereby declare that this thesis is the result of my own original work and that no part of it has been presented for another degree in this university or elsewhere.

Meseret Wondim Bizuneh

Signature.....Date.....

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## DEDICATION

*This thesis is dedicated to my late beloved mother Alemush Zegeye who had never failed to bring me up to this level of manhood from ELEVEN years of age without the help of my father whom I lost when I was ELEVEN years old.*

*Hope your soul is in heaven, but I owe you forever...*

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## **ABBREVIATIONS AND ACRONYMS**

ACCSA	Addis Ababa Chamber of Commerce and Sectoral Associations
ACCA	Association of Chartered Certified Accounts
AICPA	American Institute of Certified Public Accountants
BCBS	Basel Committee on Banking Supervision
CBB	Construction and Business Bank
CBE	Commercial Bank of Ethiopia
CEO	Chief Executive Officer
CIA	Chief Internal Auditors
CGS	Corporate Governance Setting
ECIIA	European Confederation of Institute of Internal Auditors
EAC	Effectiveness of Audit Committee
GAAP	Generally Accepted Accounting Principles
ICAEW	Institute of Chartered Accountants in England & Wales
IIA	Institute of Internal Auditors
IIARF	Institute of Internal Auditors Research Foundation
IIAF	Independence of Internal Audit Function
ISSAI	The International Standards of Supreme Audit Institutions
ISPPIA	International Standards for Professional Practice for Internal Auditing
INTOSAI	International Organization of Supreme Audit Institutions issues the International Standards of Supreme Audit Institutions, ISSAIs
IOSCO	International Organization of Securities Commission
MOFED	Ministry of Finance and Economic Development

NBE	National Bank of Ethiopia
OECD	Organization for economic Cooperation and Development
POI	Perception of Internal Audit
RQ	Research Question
RI	Research Issue
SMS	Senior Management Support
SPPIA	Standards for the Professional Practice of Internal Auditing

## **ABSTRACT**

*The concept of internal audit independence has not been reviewed in the past more so among commercial banks. Therefore, this study has sought to establish how the independence of internal audit is affected by various corporate governance factors among commercial banks in Ethiopia.*

*Data was collected using structured questionnaires distributed to all internal audit department managers, heads of audit and inspection division and risk and compliance officers/managers of the 16 private commercial banks in Ethiopia. Data collected was analyzed by descriptive statistics aided by SPSS version 20 data analysis tool. A regression model was then used to analyze the relationship between internal audit independence and level of corporate governance factors within a test of significance of 95% confidence level.*

*The study revealed that there is positive linear relationship between independence of Internal audit function and the corporate governance factors; corporate governance setting (CGS, senior management support (SMS), Effectiveness of audit committee (EAC)) and Perception of Internal audit independence (POI) among private commercial banks in Ethiopia.*

*From the findings, the study recommends that private bank executives and board of directors to carefully consider the direction and effect of corporate governance factors on independence of internal audit function. Management of private commercial banks should also update themselves with the **corporate governance factors** that affect independence of internal audit function to get best /value adding service out of their banks' internal audit function.*

**KEY WORDS:** *corporate governance, senior management, independence, internal audit, perception, audit committee effectiveness.*

## CHAPTER ONE

### INTRODUCTION

#### 1.1 General Background of the Study

(Radu & Ramona 2013) discussed that during the last decade, new approaches of the corporate governance, totally confirmed the board's responsibility for ensuring effectiveness of their organization's internal control framework. These theories stressed the key role that internal audit can play in supporting the board in ensuring adequate oversight of internal controls and in doing so form an integral part of an organization's corporate governance framework. The key role of internal audit is to assist the board and/or its audit committee in discharging its governance responsibilities.

The Institute of Internal Auditors IIA (2004) defines Internal Auditing as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. Internal auditors are employees of the organization and work exclusively for the organization. They assist staff of an organization in performing their responsibilities by furnishing them with analyses, appraisals, recommendations, and counsel. A widely accepted definition of internal audit published by the Institute of Internal Auditors (IIA) is "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

Hemraj (2003) as cited by Sandberg (2012) explained the term 'independence' as "an expression of professional integrity of the individual. Independence requires avoidance of situations which would tend to impair objectivity or permit personal bias to influence delicate judgment".

As cited by Mahma (2009) corporate governance concerns with the way a company is operated and directed and in particular encompasses the operations of the board and audit committee, as well as the overall control and risk management framework (Association of Chartered Certified Accountants, 2005, p.71).

By providing unbiased, objective assessment of whether the corporate resources are responsively and effectively managed to achieve intended results, auditors help achieve accountability and integrity, improve operations, and instill confidence among stakeholders (Deloitte on Africa Collection: Special Edition 2012). This study focuses on independence of internal audit function in the context of Ethiopian private commercial banks. The study will try to establish relationship between corporate governance and internal audit function through the governance mechanisms. The study will primarily focus on assessing the effect of corporate governance on independence of internal audit function.

The rationale for assessing the effect of corporate governance on internal auditors' ethical decision making stems from recent suggestions that corporate governance is comprised four cornerstones: the audit committee, management, external audit and internal audit (IIA, 2003; Gramling et al, 2004; Adamec et al., 2005).

## **1.2 Statement of the Problem**

Admassu & Asayehgn (2014) discussed that banking industry in Ethiopia is in a rudimentary and fragile state. It is small, relatively undeveloped, closed and characterized by a large share of state ownership. The state- owned commercial banks account for nearly two-thirds of the banking sector assets. However, the contribution of the private banking is showing growth. The banking industry unlike other sectors is tightly controlled one and corporate governance framework is highly dictated by the National Bank of Ethiopia (NBE).

While there is strong evidence that **independence** of internal audit is very important corporate governance tool, in most organizations the corporate governance systems are not designed in such a way that internal audit can maintain its independence and add value to the organization.

Ethiopian private banks have not been without these corporate governance shortcomings. This study has assessed whether the corporate governance affects independence of internal audit function of private commercial banks in Ethiopia.

### **1.3 Objective of the Study**

#### **1.3.1 General objective**

General objective of this study is to assess the effect of Corporate Governance on the independence of internal audit function, which is very important attribute for the internal audit function to carry out its duties and responsibilities as, stated in the (Institute of internal auditors IIA) definition.

#### **1.3.2 Specific objectives**

A specific objective of this study is to determine how each corporate governance factors: Corporate Governance setting (CGS), Effectiveness of Audit Committee (EAC), Senior Management support (SMS) and perception of Internal Audit (POI) affect the independence of the internal audit functions in Ethiopian private commercial banks.

To this end, the following guiding research question (RQ) and research issues (RI) are pursued.

**RQ:** How does corporate governance affect independence of internal audit function?

RI1: How does existing corporate governance setting affect independence of internal audit function?

RI2: How does the perception of internal audit independence (independence of mind & appearance) affect the independence of internal audit function?

RI3: How does effectiveness of audit committee affect the independence of internal audit function?

RI4: How does the senior management support as corporate governance mechanism affect independence of internal audit function?

### **1.4 Significance of the Study**

The study will establish enhanced understanding of the relationship between the corporate governance and independence of internal audit function and how corporate governance factors affect independence of the internal audit function. The study has expounded the importance of corporate governance setting, effectiveness of audit committee, senior management support and Perception of internal audit independence as corporate governance mechanisms to enhance the independence of internal audit function, which in turn affects its value adding capacity.

The study documents important findings on the corporate governance practices in Ethiopian banking industry that may affect internal audit independence for future exploration. The study highlighted appropriate theories underpinning the internal audit independence including the agency theory and stakeholder theory.

The study establishes theoretical foundation on the relationship between corporate Governance mechanism and independence of internal audit function in the context of Ethiopia.

## **1.5 Scope and Limitation of the Study**

### **1.5.1 Area Limitation**

The study was carried out in private commercial banks and data were collected at their head offices in Addis Ababa. The study however, excludes any details about external audit function. This study is limited to exploring whether governance factors; Corporate Governance setting, Senior Management Support, Effectiveness of Audit Committee and Perception of Independence have effect independence of internal audit function

### **1.5.2 Subject Limitation**

The study focused on the effect of corporate governance on independence of internal audit function. Effectiveness of audit committee, Perception of internal audit, senior management support and corporate governance setting as corporate governance factors as independent variables and independence of internal audit function as dependent variable.

## **1.6 Structure of the Thesis**

This thesis has five chapters. Chapter **one** introduces the background of the study by providing the background information, statement of problem, objective of the study, the research question, scope of the study and significance of the study high lights of the methodology and limitation of the study.

Chapter **two** deals with a review of the relevant literature on the related topics while, chapter **three** outlines the methodology and tools used in the study. Chapter **four** provides the interpretation and analysis of findings. Chapter **five** deals with summary, conclusions and recommendations.

## CHAPTER TWO

### LITERATURE REVIEW

#### 2.1 Introduction

It is generally accepted that the correlation between internal auditing and corporate governance affects all kinds of economic activity and that the perceived implications and consequences of this interaction have changed considerably in the recent years. Internal auditing and corporate governance have now become a matter of major public concern. In this concept, international guidelines perceive that effective cooperation of corporate governance and internal auditing improves performance, and is a source of competitive advantage. The contribution of internal auditing to corporate governance is depicted via demarcating the relationship between internal audit and key elements of corporate governance. It is also a fact that the Board of Directors has been recognized as the key player in corporate governance by regulators and governance committees around the world (US Congress, 2002; ASX, 2003, *Drogalas, Gotzamani & Tampakoudis 2010*)

This chapter presents review of literature related to independence of internal audit function and corporate governance. It consists of general overview about internal audit function, corporate governance and effect of corporate governance on independence of internal audit function. In general, this chapter attempts to synthesize existing empirical research in the area of internal audit independence and corporate governance and ends up by summarizing the review and identifying the gap in the existing literature.

#### 2.2 Definition and Theory of Internal Audit

As cited by Drogalas (2010) historically, internal audit has been considered as a monitoring function, the “organizational policeman and watchdog” (Morgan, 1979) and is tolerated as a necessary component of organizational control but deemed subservient to the achievement of major corporate objectives. However, Institute of Internal Auditors, IIA, (1991); Taylor and Glezen, 1991; Konrath, (1996) defines internal auditing as “an independent appraisal function, established within an organization to examine and evaluate its activities as a service to the organization”. By measuring and evaluating the effectiveness of organizational controls, internal

auditing, itself, is an important managerial control device (Carmichael et al., 1996), which is directly linked to the organizational structure and the general rules of the business (Cai, 1997).

The new definition of internal auditing focus on corporate governance especially the board of directors; this definition emphasizes internal audit's role in aiding the entity to achieve its objectives. Because of the fact that the board of directors is ultimately responsible for the entity's accomplishment of its objectives, the internal auditor's contribution is providing information to that group (Colbert, 2002). Apart from the above, internal audit's role is crucial in assisting the board of directors in its governance self-assessment. (Drogalas, Gotzamani & Tampakoudis 2010)

### **2.3 Independence of Internal Audit Function**

Wahid AbuAzza (2012) discussed that the concept of independence is generally used to mean the ability of the auditor to be fair and objective in his/ her review and appraisal and not to be under undue pressure from any party to the extent that this could bias his /her opinion. The IIA's Standards for Professional Practice of Internal Auditing glossary) defines independence of internal auditors as:

*'The freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement ,functional and organizational levels'(Institute of Internal Auditors 2011b)'*

Independence of IA has been identified by the IIA, the American Institute of Certified Public Accountants (AICPA) and others as crucial to the viability of the IA function. The IIA has issued a number of attribute standards under which the IIA explored the issue of independence in the ISPPIA, more specifically, the Standard 1100 Independence and Objectivity. This standard states the internal audit activity should be independent in performing their work'. The standard 1100 states:

*'Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner'(Institute of Internal Auditors 2011d)'*

To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels. (IIA Guide 1100)

It is still an on-going discussion on the reporting roles for the internal audit function. Some authors suggest that in order to secure internal auditor's independence it is best to give the entire reporting role to the audit committee (Abbott et al., 2012; Haron et al., 2012), but IIA's definition includes consulting and adding value because internal auditors can help the organization to reach the goals (Ali" and Rusjan, 2009).

Guideline on internal audit in banking business by Barclays Simpson consultants states that to maintain complete independence, Internal Audit should not be responsible for performing or authorizing any of the day-to-day tasks, which enable the bank to operate. Nor is it directly responsible for the implementation of any new initiatives, even where these arise because of audit recommendations. Internal Audit should however, be prepared to offer advice, cooperation and practical assistance to line management whenever possible. [http:// www.barlaysimpson.com](http://www.barlaysimpson.com) (15/2/2015)

The IIA (1999) for definition of internal auditing saying, "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes" is now familiar and well accepted.

This definition highlights the independence and objectivity of internal auditing with respect to both assurance services and consulting. Independence and objectivity are closely related and are sometimes used within the IIA Standards in a somewhat circular manner. Indeed, the IIA (2001) acknowledges that the terms have been used interchangeably and with a lack of clarity. However, the Glossary to the IIA Standards distinguishes between the two concepts in the following way:

**“Independence:** – The freedom from conditions that threaten objectivity or the appearance of objectivity.

**“Objectivity:** – An unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Objectivity requires internal auditors not to subordinate their judgment on audit matters to that of others.”

**(a) Independence of Mind**

The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

**(b) Independence in Appearance**

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that affirms, or a member of the audit team’s, integrity, objectivity or professional skepticism has been compromised. (Canadian Perspectives-Auditor Independence Discussion Paper September2012).

Basel Committee on Banking Supervision (BCBS) on the internal audit function in banks Principle 2 states as follows:

*“The bank’s internal audit function must be independent of the audited activities, which requires the internal audit function to have sufficient standing and authority within the bank, thereby enabling internal auditors to carry out their assignments with objectivity.”*

Independence of internal auditors is regarded as a critical attribute to providing credibility to the auditor and to the effectiveness of internal audit function. Internal audit has to maintain a high degree of independence in order to achieve its objectives effectively and make an effect on organization's management (Cheung and Qiang 1997). Independence can be considered from the perspective of autonomy. Internal auditors are said to be independent if they carry out their work freely and objectively without fear or having to subordinate their judgment to management or others on audit matters; (Mary 2007)

The importance of the auditor's independence and impartiality has been controversial in recent years when several auditing scandal was revealed. This resulted in stricter guidelines on how the financial statements should be prepared; for example: the Sarbanes-Oxely Act, which was a result of the Enron's collapse. (Healy et al. 2003, Beth Arnold, Paul de Lange; 2004)

The head of internal audit function should therefore be responsible to an officer whose authority is sufficient to assure a broad range of audit coverage and adequate consideration of and effective action on the audit findings and recommendations (Chun, 1997). This will be achieved if the internal auditor administratively reports to the Chief Executive and functionally to the audit committee, where it exists, or to the Board (Tarr, 2002, Mary, 2007)

To ensure objectivity, internal auditors should not develop and install procedures, prepare records or engage in any other activity that they would normally review or assess which could be construed to compromise their Independence (II A, 2000).

## **2.4 Objective and Function of Internal Audit**

According to Association of Chartered Certified Accountants (2005 p. 77), the internal audit function is responsible for evaluating, and commenting on the effectiveness of risk management, control and corporate governance process.

Jenny Stewart & Nava Subramaniam, (2008) cites the IIA (1999) for definition of internal auditing saying, "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes" is now familiar and well accepted.

As cited by Mahama (2009), Tawiah (2006, p. 38) sees the objectives of internal auditing as being part of its definition. He defined internal auditing, as "systematic and objective appraisal by

internal auditors of the diverse operations and controls within an organization to determine whether:

- *Financial and operating information is accurate and reliable*
- *Risks to the enterprise are identified and minimized*
- *External regulations and acceptable policies and procedures are followed,*
- *Satisfactory standards are met,*
- *Resources are used efficiently and economically, and*
- *The organization's objectives are effectively achieved*

all are for the purpose of assisting members of the organization in the effective discharge of their responsibilities”.

Diane and John (2000) identified the functions of internal auditing to include internal control; review of budgetary control and management information systems; compliance with policies, plans, procedures, laws and regulations; operational and 'value for money' audits; and special audits or investigations (Mahama 2009).

Principle 13 of the Basel Committee on internal audit function states that internal audit function can be explained using the three lines of defense model.

**Table 2.1 Basel Committee view on status of internal audit**

<b>Line of defense</b>	<b>Examples</b>	<b>Approach</b>
First line	Front Office, any client-facing activity	Transaction-based, ongoing
Second line	Risk Management, Compliance, Legal, Human Resources, Finance, Operations, and Technology	Risk-based, ongoing or periodic
Third line	Internal Audit	Risk-based, periodic

**Source:** BCBS-the internal audit function in banks 2012

## **2.5 The Need for Independence of Internal Audit Function**

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, 2008)

Prior research on auditor independence and objectivity has been undertaken predominantly in the context of external audit. However, in more recent years, there has been heightened interest in issues associated with the independence and objectivity of internal audit. However, studies by Travis P. Holt (2009) in the context of internal audit emphasize the need for Information asymmetry and governance transparency by citing the scholarly recommendations of Jensen and Meckling (1976) model in agency relationship between the managers of a firm and the shareholders of a firm.

There are inherent problems (e.g., moral hazard and information asymmetry) in contractual relationship between managers and shareholders because the managers of the firm have inside information and may not always make decisions that are most advantageous for the firm shareholders (e.g., Jensen and Meckling 1976; Eisenhardt 1989). As a result, shareholders and rule-making bodies implement corporate governance mechanisms to monitor firm activities to ensure that the managers of a firm are acting as proper stewards of firm assets. These accounting, auditing and governance mechanisms are a critical part of the capital markets system (Travis P. Holt 2009; P 7.)

Principle 13 of the Basel committee on Bank supervision, (2012) states that internal audit function should independently assess the effectiveness and efficiency of the internal control, risk management and governance systems and processes created by the business units and support functions and provide assurance on these systems and processes. (BCBS 2012)

The International Standards of Supreme Audit Institutions (ISSAI) with respect to internal audit independence in public sector states that whatever the form of government changes or not, Independence and objectivity are vital to ensure that stakeholders view the audit works are

performed, the results are credible, factual and unbiased. The nature of internal auditing and the role of providing unbiased and accurate information and the use of public resources and services delivered require the internal audit activity to perform their duties without restrictions free from interference or pressures from the organization being reviewed or the area under audit. ([http://www/intosai.org](http://www.intosai.org) April 8, 2015).

Principle 10 of Basel Committee on bank supervision on internal audit states that the internal audit function provides independent assurance to the board and supports board and senior management in promoting an effective governance process and the long-term soundness of the bank. The internal audit function should have a clear mandate, be accountable to the board, be independent of the audited activities and have sufficient standing, skills, resources and authority within the bank (BCBS, the internal audit function in banks, 2014).

## **2.6 Internal Audit in Banking Business**

Barclays and Simpson Recruitment Consultants on introduction of internal audit in banking explained the roles and responsibilities of bank internal audit as a department, independent of line management, whose prime responsibility is to review the quality and effectiveness of the controls within the banks to manage and mitigate risk and protect the assets of the bank. In performing this work, internal audit provides recommendations and advice to management on matters requiring attention. ([www.barclaysimpson.com](http://www.barclaysimpson.com) March 25, 2015)

Internal audit will normally produce an annual plan of work to be performed, concentrating on areas of higher risk. Structured timetables and work programs (e.g. audit programs) will then be designed for each assignment. At the end of each review, an audit report will normally be prepared for senior management attention and action. Ad hoc assignments may also be performed at the request of senior management where problems or irregularities require further investigation. Further, there are real advantages in ongoing internal audit involvement in major projects, including systems developments. In this way audit concerns can be addressed up-front and action taken before the problem becomes too entrenched (Basel Committee report 2012)

According to Basel Committee report (2012), each bank should have a permanent internal audit function in order to fulfill its duties and responsibilities. The senior management should take all necessary measures so that the bank can continuously rely on an adequate internal audit function appropriate to its size and to the nature of its operations. These measures include providing the appropriate resources and staffing to internal audit (Ondieki 2013)

Basel Committee on Banking Supervision on internal audit function in banks December 2012 page 7 provides the internal audit function to evaluate:

- Effectiveness and efficiency of operations;
- Reliability, effectiveness and integrity of management information systems and Processes (including relevance, accuracy and comprehensiveness);
- Monitoring of compliance with laws and regulations, including any requirements from supervisors (see the following sub-section for more details); and
- Safeguarding of assets.

As stated in the Institute of Internal Auditors Research Foundation (IIARF) the Statement of Responsibilities of Internal Auditing noted, “The scope of internal auditing encompasses the examination and evaluation of the adequacy and effectiveness of the organization’s system of internal control and the quality of performance in carrying out assigned responsibilities.”

However, the Institute of Internal Auditors Research Foundation assumes the expanded responsibilities and skill stating, “auditors of the 21st century must be prepared to ‘audit’ virtually every operations (including control systems), performance, information and information systems, legal compliance, financial statements, fraud, environmental reporting and performance, and quality.

As quoted by Kristina Karmanova (2013) the importance of internal audit function within the organization can also be justified with the fact that a strong internal audit function is a deterrent to financial reporting irregularity in the presence of unambiguous potential GAAP (i.e. Generally Accepted Accounting Principles) violation (Arel et al., 2012).

## **2.7 Definition and Theory of Corporate Governance**

A generally accepted definition does not exist, so I will refer to some descriptions of the concept of corporate governance. Using the wording of the Toronto Stock Exchange, annex II “Corporate Governance is the process and structure used to direct and manage the business and affairs of the corporations with the objective of enhancing shareholder value, which includes ensuring the financial viability of the business. The process and structure define the division of power and establish mechanisms for achieving accountability among shareholders, the board and management.”

Organization for Economic Co-operation and Development (OECD) principles states that there is no single model of good corporate governance. However, work carried out in both OECD and non-OECD countries and within the Organization has identified some common elements that underlie good corporate governance. The Principles are non-binding and do not aim at detailed prescriptions for national legislation. Rather, they seek to identify objectives and suggest various means for achieving them. Their purpose is to serve as a reference point. They can be used by policy makers as they examine and develop the legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices (OECD 2004, P 14)

The Organization for Economic Co-operation and Development (OECD) states: “Corporate governance comprehends that structure of relationships and corresponding responsibilities among a core groups consisting of shareholders, board members and managers designed to best foster the competitive performance required to achieve the corporation’s primary objective.” (PRINCIPLES OF AUDITING Second edition published by Pearson Education Limited 2005).

In the context of banking business, Basel Committee on Banking Supervision, Corporate Governance principles for banks states that effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. Banks serve a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth. Banks’ safety and soundness are key to financial stability, and the manner in which they conduct their business is central to economic health. Governance

weaknesses at banks that play a significant role in the financial system can result in the transmission of problems across the banking sector and the economy as a whole. (Basel Committee Guideline for Banking Supervision 2014).

## **2.8 Corporate Governance in Ethiopia**

Fekadu Petros (2010) as cited by Hussein Ahmed Tura underlined the growing separation between ownership and control in Ethiopia and he provided some empirical evidence in this regard. Relying on the data and literature on corporate governance, he discussed the deficiency of the Commercial Code in protecting the rights of minority shareholders in the context of publicly held companies. He raises crucial issues such as: “what power does the board have? Who is it accountable to? How is it organized? What are its standards of liability?” among others. In his book titled ‘Ethiopian Company Law’ (2011), Fekadu further addresses most of the issues in corporate governance related to board of directors (Hussein Ahmed Tura, 2012).

Tewodros Meheret (2011) discussed the legal regime applicable to governance of share companies in Ethiopia. He explored the theoretical background and legal framework of corporate governance and examined the rules of governance in light of available standards. In particular, he discussed the structural choices, appointment and removal, powers, duties and responsibilities, remuneration, and the working methods and mechanism for controlling the boards of directors. Tewodros stated, “a share company is managed by its board which is composed of directors appointed by the general meeting of shareholders.”

(Hussein Ahmed Tura 2012) further enlightened that there are a number of companies that are being formed by sale of shares to the wider public unlike most share companies in the past, which were formed among founders. The emergence of publicly held share companies in Ethiopia give rise to a multitude of issues on corporate governance.

Typically, ownership separates from the control of dispersed shareholders and goes into the hands of few managers, which in turn creates the principal-agent relationship. In such situations, agents (managers) may misappropriate the principals’ (shareholders’) investments as they have more information and knowledge than the shareholders do. Where there exist few block holders in

share companies, minority shareholders could be exploited in the hands of such block holders (Hussein Ahmed Tura 2012)

(Hussein Ahmed Tura 2012) concluded that the agency problems that could occur between dispersed shareholders and managers and/or bloc holders of share companies in Ethiopia, have necessitated good corporate governance laws and institutions.

## **2.9 Overview of Banking Industry in Ethiopia**

The banking industry differs fundamentally from other industries in any country. An apparent area of variation is in the products and services it provides. Banks mainly deal with the liquid and largely risky assets of business, cash and cash equivalents. Two key differences distinguish the governance of banks from that of non-financial firms. The first is that banks have many more stakeholders than non-financial firms. The second is that the business of banks is opaque and complex and can shift rather quickly. (Hamid Mehran Alan Morrison June 2011).

Banks lie at the heart of the world's financial system. They represent the source we often visit to find a loan to purchase a home or automobile, start a new business, or finance a college education etc. (Peter and Sylvia, 2008).

For the fact that the banks have differences in the scale, diversity, complexity and geographical coverage, each bank is adopting different management structures. Of particular significance is the functioning of the internal audit unit in the various banks. Each bank is subject to different degrees and types of risks. The internal audit function is therefore tailored in such a way as to manage the risk exposure of the banks (Mahama, 2009)

As discussed by (Admassu Bezabeh and Asayehgn Desta 2014) banking history in Ethiopia like any share companies has passed through several stages of state systems. Banking institutions have been springing up in all corners of the country during the past few years of Ethiopia's economic history private commercial banks being introduced into the country.

The banking sector in Ethiopia has been dominated by the state-owned Commercial Bank of Ethiopia (CBE). The level of financial intermediation in Ethiopia was low in part due to the public's lack of confidence in the banking sector. This in turn is due to a very weak supervisory framework, dominant state ownership, and its widespread lending directed by the National Bank of Ethiopia (NBE) (Admasu Bezabeh & Asayegn Desta, 2014).

At present, the boom of the new private banks has been set back due to the raise of capital requirements from Birr 75 million to 500million (NBE Directive SBB/50/2011). However, the contribution of the existing 16 private banks is still substantial for the economy, which was under the central command for more than 17 years and where dependence on private banking as financial intermediation was unknown. The economic contribution of private and government banks is more clarified in the following table:

**Table 2.2: Government bank versus private bank comparison of economic contribution in terms of deposit and loans & advances as June30, 2014.**

	Banks	Deposit in millions	%age	Loans & advances
Government banks	CBE	193,200	66.5%	89,665
	CBB	5,078	1.7%	2408
16 Private banks		92,662	31.8%	53,685
Total Industry		290,930	100%	145,759

**Source:** Data from Zemen Bank Research Unit; Computation by the researcher

Study conducted by Global center for cooperative security September 2014 confirmed that compared to most countries, Ethiopia has taken a cautious approach toward the liberalization of its banking industry. For all intents and purposes, its industry is closed and generally less developed than its regional peers (Report by GCCS 2014)

## **2.10 Corporate Governance in Private Banks of Ethiopia**

According to Hussein Ahmed Tura, (2012) the Voluntary Code of Corporate Governance for Ethiopia” was adopted on 3 June 2011 under the patronage of AACCSA the adoption of the Code, without doubt, can be taken as a good step towards introducing standards of good corporate governance in Ethiopia in a detailed and comprehensive manner. The industry comprises one state-owned development bank and 18 commercial banks, two of which are state-owned, including the dominant Commercial Bank of Ethiopia (CBE), with assets accounting for approximately 70 percent of the industry’s total holdings.

The National Bank of Ethiopia (NBE) as the country’s central bank was first established in 1963. On May 1991, a new Monetary and Banking Proclamation No.83/1994 was enacted and reorganized the bank according to the market-based economic policy so that it could foster monetary stability, a sound financial system and such other credit and exchange conditions conducive to the growth of the country’s economy (Ayele, A.G 2013).

Ayele A.G (2013) further discussed that implementing good corporate governance practices in the banking sector clearly facilitates the NBE’s most important goal of fostering monetary stability and a sound financial system in the country. Moreover, in order to give teeth to the powers of the NBE, the law has empowered it to supervise compliance of rules by banks through onsite and off-site supervision mechanisms and to impose various sanctions on a non complying bank.

As stated by Hussein Ahmed Tura (2012), the definition of ‘corporate governance’ is not provided under the Ethiopian company law. For the purpose of this study, it is thus important to adopt a working definition for corporate governance as a system of rules and institutions that determine the control and direction of a company and that define relations among the company’s primary participants including board of directors, managers, shareholders and other stakeholders. This combines the narrow and broad definitions and it considers corporate governance as a system of rules and institutions which determine the control and direction of a company. It recognizes not only shareholders but also stakeholders that should be involved in the governance of share companies.

*Besides the Commercial Code, 1960), states that banking operations in Ethiopia are governed by first established by the Monetary and banking proclamation in July 1963 and changed following regime change of 1974 and monetary and Banking proclamation of No.99/1976 changed in 1974 as the Banking Proclamation . After the Downfall of Dergue regime in 1991, a new Monetary and Banking proclamation No.83/1994 was enacted, Finally in 2008 anew proclamation gave full power to national bank of Ethiopia(NBE) as a central bank, National Bank of Ethiopia establishment proclamation No. 591/2008. Moreover, Banking Business Proclamation No.592/2008 was also enacted to regulate the banking business in Ethiopia.(Proclamation No.591/2008 and Proclamation No.592/2008 of August 2008)*

In the latest development, National Bank of Ethiopia (NBE) has issued draft corporate Governance directive which is termed as National Bank of Ethiopia (NBE) directive No SBB/--/2014 on Corporate Governance for Banks/Insurers/Micro Finance Institutions . The draft directive defines corporate governance as a means the process and structure used to direct and manage the business and affairs of a bank/an insurer/a microfinance institution towards enhancing business prosperity and corporate accountability with ultimate objectives of realizing long term shareholders value and other stakeholders' interest.”

### **2.11 Relationship between Independence of Internal Audit Function and Corporate Governance**

The Institute of Internal Auditors Research Foundation (IIARF) (2013) stresses that for the internal audit function to raise its organizational stature, it was critical that it forge a strong relationship with “those charged with organizational governance,” and communicates directly to the audit committee. There is much evidence today that such a reporting relationship is being widely viewed as a best practice in the most progressive corporations committed to enhancing governance structure and processes. Principle 13 of the Basel Committee on internal audit function explains internal audit function as third line of defense next to other operational and risk management controls.

However, (Njeru M.Edwin, 2011) in his thesis study has put that an internal audit function could be viewed as a first line of defense against inadequate organization governance and financial reporting. With appropriate support from the board and audit committee, the internal audit is in

the best position to gather intelligence on inappropriate accounting practices, inadequate internal controls and ineffective corporate governance (Zekele, 2007). It is therefore an integral and necessary part of an effective corporate governance framework. Alongside the board, executive management and external audit, internal audit is one of the cornerstones of good corporate governance.

Institute of Internal Auditors (2011) for organizational independence to be effectively achieved the chief audit executive reports functionally to the board. (Hermanson and rittenberg, 2003) from the Institute of Internal Auditors Research Foundation describes that monitoring, assessing, and analyzing organizational risks and controls; and reviewing and confirming information and compliance with policies, procedures, and laws. Working in partnership with management, internal auditors provide the board, the audit committee, and executive management assurance that risks are held the organization's corporate governance is strong and effective. When there is room for improvement anywhere within the organization, the internal auditors make recommendations for enhancing processes, policies, and procedures (Hermanson and Rittenberg, 2003) The literatures here above indicate the existence of relationship between internal audit function and corporate governance factors of the organizations.

## **2.12 Theories Underpinning the Internal Audit and Corporate Governance**

### **2.12.1 Agency Theory**

Agency theory, a premise often associated with Jensen and Meckling (1976), was first predicated by Alchian and Demsetz (1972) who emphasized that activities of firms governed by the role of contracts to facilitate voluntary exchange. Agency theory explains how best to organize relationships in which one party (principal) determines the work, which another party (agent) performs. Agency problems are created when the shareholders (principals) hire managers (agents) to make decisions that are in the best interests of the shareholders. These theoretical postulations continue that in general people are self interested and will therefore have conflicts of interest in any cooperative endeavors (Jensen, 1994) (Arnold and Lange, 2004)

In the context of internal audit, (Institute of Chartered Accountants in England & Wales December 2005) states the role of audit in agency relationship as a mechanism to align the interest of various differing motivations and information asymmetries that lead to concern about the reliability of information, which effects on the level of trust that principals will have in their agents. Audit provides an independent check on the work of agents and of the information provided by an agent, which helps to maintain confidence and trust ([www.icaew.co.uk/auditquality](http://www.icaew.co.uk/auditquality) February 24, 2015)

According to agency theory, the demand for internal auditing arises due to the contractual principal-agent relationship between owners and management of the firm. Each party in this relationship takes steps to protect its interests and to signal that the other party's interests are promoted. The theory explains that internal auditing and other internal control mechanisms as voluntarily introduced by management to signal to shareholders that the former is properly discharging the goal of maximizing shareholders' wealth (Jensen & Meckling, 1976). Management also voluntarily seeks external auditing to provide independent assurance on financial reports prepared by management for shareholder's use. Nonetheless, from an internal audit research perspective, this theory suffers from a key epistemological shortcoming emanating from the limitations of the theory's neoclassical economic foundation.

Mihret et al., (2010). argue that the theories are based on the notion that competitive markets underpin the contracts underlying the agency relationship. This assumption is problematic from internal audit research perspective, because the demand for internal auditing is not market-driven. Unlike external audit reports which serve to address the information asymmetry problem in the context of the firm's relationships with external parties (Healy & Palepu, 2001), internal audit reports are available neither to the market nor shareholders. Thus, an alternative perspective is needed that enables understanding the role of internal auditing by considering a holistic view of the firm's internal and external accountability relations.

### **2.12.2 Stakeholder Theory**

Stakeholder theory is relevant to this discussion as it considers the stakeholder view of organizations and embraces stakeholder analysis, stakeholder management and stakeholder

activism. It can be used to understand how organizations work, the various interests and ability of stakeholders to influence and how organizations can manage their stakeholders.

The stakeholder concept has grown in popularity in recent years but there is much discussion among academics about what it means, resulting in a multitude of stakeholder theories.. The organization itself should be thought of as a grouping of stakeholders and the purpose of the organization should be to manage their interests, needs and viewpoints' (Friedman and Miles, 2006, p1).(Institute of Chartered Accountants in England and Wales 2008; www.auditqualityforum.com, February 24, 2015 )

In the context of this research, the Ethiopian private banking business as indicated in the draft corporate governance directive, the governance process involves multitude of stakeholders with different interests, which include minority shareholders, directors, employees and senior management. The internal audit independence therefore is crucial to provide relevant and reliable information and the corporate governance. The need for information asymmetry among the various stakeholders will call for the independence of the internal audit function.

### **2.13 Corporate Governance Factors Affecting Independence of Internal Audit Function**

According to (Stewart, Jenny and O'Leary, Conor 2007), one of the cornerstones of corporate governance theory is internal auditors are expected to work with audit committees, boards and senior management to help set the right “tone at the top”. They also help to ensure that ethical behavior flows down through the ranks to lower level employees (IIA, 2003; Brown et al., 2003; Bailey et al., 2003).

#### **2.13.1 Corporate Governance Setting**

The International Standards of Supreme Audit Institutions (ISSAI), the Institute of Internal Auditors (the IIA) and International Standards for the Professional Practice of Internal Auditing (Standards), have presented general terms to allow adoption in different national contexts with the understanding that implementation will be governed by the environment in which the internal audit activity carries out their responsibilities and in accordance with the applicable laws and

regulations. The IIA's Standards are universal and are intended to apply to all members of the internal audit profession.

The IIA's Standards and Code of Ethics recognize the importance of internal auditor maintaining their independence and objectivity when performing their work, irrespective of whether the internal auditors are engaged in public or private sector audits. In addition, the IIA Standards advocate a strong system of internal control that is monitored by a well-resourced internal audit activity as a fundamental feature of good governance. In the public sector, a strong system of governance is essential in ensuring adequate service delivery to the public at large. Legislative requirements to establish an internal audit activity helps protect the funding and independence of the internal audit activity and recognize internal audit as an important function in the public sector. Finally, adequate legal protection of internal auditor independence, in particular under civil service law, is an important element of a legislative framework. (<http://www.intosai.org>; April 15 2015)

Mihret, James & Mula 2012 indicated that there is still lack of well developed internal audit standards to guide and govern the relationship with the corporate governance. The Government of Ethiopia has emphasized internal auditing in the country post 1991 (Mihret, Mula & James 2009) as well. The Ethiopian Prime Minister established in 1994 a taskforce to propose recommendations to upgrade internal audit in government offices.

They also discussed the recommendations of the taskforce that had become basis for legal backing which was granted to internal audit by issuing the Councils of Ministers Financial Administration Regulation (CMFAR) (Federal Government of Ethiopia 1996) which provided the Ministry of Finance and Economic Development (MoFED) with the responsibility to monitor and regulate internal audit in the public sector and to develop an internal audit manual for use by all internal audit departments of public bodies. (Mihret, James & Mula 2012)

With respect to the bank internal audit, Basel Committee on banks supervision on Internal audit function, Principle 2 states that the bank's internal audit function must be independent of the audited activities, which requires the internal audit function to have sufficient standing and

authority within the bank, thereby enabling internal auditors to carry out their assignments with objectivity.

Therefore, this research will be designed to assess the effect of corporate governance settings such as Governance guidelines if any, External compliance requirements and internal bank policy requirements for the independence of internal audit function in the context of Ethiopian private banks.

### **2.13.2 Senior Management Support**

A study conducted by Mathose (2013) indicated that the majority of employees perceived the internal audit department to have the support of senior management, which is in line with the Standards for the Professional Practice of Internal Auditing (SPPIA). More high-level employees had a perception that internal audit had the support of management than the employees on lower levels. In reality, internal audit does have the support of senior management, yet the majority of employees perceived internal audit to be not independent. Therefore, it would seem that in the eyes of employees, senior management support does not enhance internal audit's independence.

According to a new survey by Thomson Reuters, internal audit practitioners globally report that more visible and vocal support for the internal audit function is needed from senior management within their organizations as the changing demands of today's regulatory and risk environment are putting them under increasing pressure to do more with less. (<http://thomsonreuters.com> April15, 2015)

For the professional development of employees, Hepworth & Noel (2002) argued that staffing professional employees increase effectiveness of internal auditing, and that an internal auditor should pursue continual professional development by seeking membership at professional auditor and accountant associations both nationally and internationally and obtain world-class accreditation, All in all, this will help improving effectiveness of the internal auditing process. On the other hand, Shahreri (1999) advised recruiting competent and well-qualified staff to support internal auditing activities and departments. (*Seif Obeid ALshbiel & Hussein Ali AL-Zeaud 2012*)

The research in this area focused on identifying the factors that potentially influence independence and assessing their effect upon internal audit independence. These include Response to findings, Training and Development Support and Recruitment and Training of internal auditors. All these were tested within Ethiopian private banks through this research.

### **2.13.3 Effectiveness of Audit Committee as Corporate Governance Tool**

Study by Ramadili & Karbhari (2009) indicates that audit committee could significantly safeguard auditor independence if members are truly independent, knowledgeable and are committed to improve good governance without fear and favor. There is an urgent need for the committee to go beyond procedural compliance, which address issues on good governance, internal control structure over financial reporting, internal audit issues and the role of the head of accounting and finance division with internal audit (monitoring) division (Ramadili & Karbhari 2009)

An effective audit committee should strengthen the position of the internal audit function by providing an independent and supportive environment where the chief internal auditor (CIA) can raise matters affecting management (Braiotta, 1999; Goodwin and Yeo, 2001; Goodwin, 2004).

One of the essential elements in determining the effectiveness of internal audit is the reporting structure, which requires direct reporting to the audit committee (Krishnamoorthy, 2008; Owolabi & Dada, 2011).

As quoted by Mu'azu Saidu Badara & Siti Zabedah Saidin June (2014); recent concern over the audit committees as one of the mechanisms of corporate governance has received tremendous attention especially when considering audit committee members. Constituting people with high caliber that have some degree of independence, qualification, experience and knowledge as indicated by (Alkdai & Hanefah, 2012; Nimer et al, 2012; wolabi & Dada, 2011; Quigley 2012, Owolabi and Dada (2011) revealed that effective audit committee will definitely enhance reliable, dependable, effective and efficient corporate governance; this is because its establishment in the corporate governance has led to reduction of corporate ineffectiveness (Mu'azu Saidu Badara & Siti Zabedah Saidin June 2014).

Audit Committee has the responsibilities of measuring performance of the internal audit function, appointment and dismissal of the heads of internal audit, recommending the appointment and dismissal of external auditors, support and promote the audit function within various organizations such as independence and objectivity (Davies, 2009).

BCBS (2012) states the main areas of responsibility of the audit committee with respect to bank internal audit function as:

- a. monitoring and reviewing the effectiveness of the bank's internal audit function;
- b. approving the internal audit plan, scope, cycle (if any) and budget;
- c. reviewing and discussing internal audit reports;
- d. ensuring that the internal audit function maintains open communication with senior management, external auditors, the supervisory authority, and the audit committee;
- e. reviewing discoveries of fraud and violations of laws and regulations as raised by the head of the internal audit function;
- f. approving the audit charter and the code of ethics of the internal audit function;
- g. approving, or recommending to the board for its approval, the annual remuneration of the internal audit function as a whole, including the head of the internal audit function;
- h. reviewing the assessment by senior management of the head of the internal audit function and of the key internal auditors; and
- i. Approving, or recommending to the board for its approval, the appointment, reappointment or removal of the head of the internal audit function and the key internal auditors.

This research assessed how effective is audit committee as corporate governance tool affects the independence of internal audit function. This was tested on the data collected within Ethiopian private commercial banks.

#### **2.13.4 Perception of Independence (Mind and Appearance)**

As quoted by Mathose (2013) 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' (Paape, 2007).

The IFAC distinguishes between independence of mind and independence in appearance (Quick & Warming-Rasmussen, 2005:138). The appearance of independence is an important facet of the regulation of auditor independence (Geiger et al., 2002). The importance of auditor independence, both actual and as perceived by others, has been widely recognized both in theory and by regulators (Geiger et al. 1999:3) (Mathose, 2013)

As Quoted by Mathose (2013), independence of mind is defined as the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism. Independence in appearance is defined as the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would reasonably conclude that the integrity, objectivity or professional skepticism of an internal audit function was compromised (Quick & Warming-Rasmussen, 2005:138). It was indicated concluded that the area of the perceived independence of internal audit is relatively unexplored compared to the perceived independence of external audit.

This research focused upon identifying the factors that potentially influence independence, and assessing their effect upon perceived independence, since independence in fact is unobservable (Beattie et al., 1999:2). In essence, there are a number of independence aspects that had to be tested in this research. These include the freedom of internal audit to determine its own scope, the reporting structure (arrangements) of internal audit and the role conflict in its work with the management. All these aspects were tested on the data collected within Ethiopian private commercial banks through this research.

#### **2.14 Special Nature of Bank Corporate Governance**

Research Department of International Monetary Fund July 24, 2013 indicates that banks play an important role in the allocation of capital for productive uses. If banks are well managed and allocate capital to their most productive use, this contributes to growth (Levine 2005).

Because of the opaque nature of banks and heavy government regulation, corporate governance works differently in the banking sector. Banks are generally more opaque than nonfinancial firms are and evidence suggests that informational asymmetries are larger in banks than in other sectors. The true value of a bank's loan portfolio is not readily observable and can be hidden for long periods. Moreover, banks can change the risky nature of their assets more quickly; they can hide problems by extending loans to clients that cannot service previous debt obligations. (Ayele, A.G. 2013)

Ayele A.G further elaborated that the unique nature of the banking firm requires the legal protection of depositors equally as that of shareholders. For this reason, the government provides explicit deposit insurance and the implicit guarantee of bailing out of large banks to avoid bankruptcies and hence maintain financial system stability to this end, independent auditor verification is needed.

### **2.15 Regulatory Framework in Ethiopian Banking Industry**

The government issued Proclamation No. 591/2008 dated August 11, 2008, in order to increase the autonomy of the National Bank of Ethiopia, which among other things clarified the role of the National Bank as the regulator and supervisor of the banking sector. Despite improvements in the regulatory framework, the supervisory capacity of the National Bank of Ethiopia remained weak largely due to an acute shortage of qualified banking supervisors. In recent years however, the NBE has made a concerted effort to develop its capabilities over time. Consequently, the public has gained greater confidence in the banking sector, which has led to strong growth in financial intermediation from levels that it was among the lowest in Africa (Admassu & Asayehgn 2014)

Among the global guidelines, further initiatives are set by the Basel Committee, which views banking supervision from two perspectives; First, sectoral "good practices" must be indicated, taking into account the specificities of the banks. General rules intended to improve corporate governance in banks were updated by the current version of the document which contains 14 rules in 6 areas Basel committee for banking supervision. (BCBS, 2010, October):

- supervisory board practices,

- senior management,
- risk management and internal control,
- compensation policy,
- complex or opaque corporate structures,
- Disclosure of information and transparency.

Its extension BCBS December, 2011 has also set guidelines for the internal audit function in banks, the institution of the supervisory board, the supervisory assessment of the internal audit function.

Revised Bank Risk Management Guidelines of National Bank of Ethiopia Bank Supervision Directorate May 2010 asserts the need for board and senior management to ensure that internal audit reviews the credit risk, liquidity risk, interest rate risk management system on an on-going basis.

## **2.16 Summary and Gap in the Existing Literature**

The board of directors has been recognized as the key player in corporate governance by regulators and governance committees around the world (Cadbury Committee, 1992; United States (US) Congress, 2002; Australian Stock Exchange Corporate Governance Council, 2003). As a sub-committee of the board, the audit committee, in particular, plays an important role in enhancing the quality of financial reporting (McMullen and Raghunandan, 1996; Davidson et al., 2005). An effective audit committee should also strengthen the position of the internal audit function by providing an independent and supportive environment where the chief internal auditor (CIA) can raise matters affecting management (Braiotta, 1999; Goodwin and Yeo, 2001; Goodwin, 2004)

Thuweba Ndunge Kimotho, (2014) has studied factors affecting independence of internal audit such as limitation of scope, reporting structure and the involvement of internal audit in managerial activities. With respect to reporting structure, it is recommended that internal audit should report directly to the audit committee.

Basel committee on Bank supervision on Internal audit (2012) requires internal audit to perform various duties and without any limitations from electronic information to testing of reliability and timeliness of regulatory reporting and carrying out of special investigations.

There are various literatures discussing the relationship of internal audit and independence and the corporate governance. IIA (2003) discusses consideration of the ethical decision of internal auditors that the ethical decisions depend on the corporate governance framework which determines the relationship of four cornerstones; the audit committee, senior management, Internal audit and external audit.

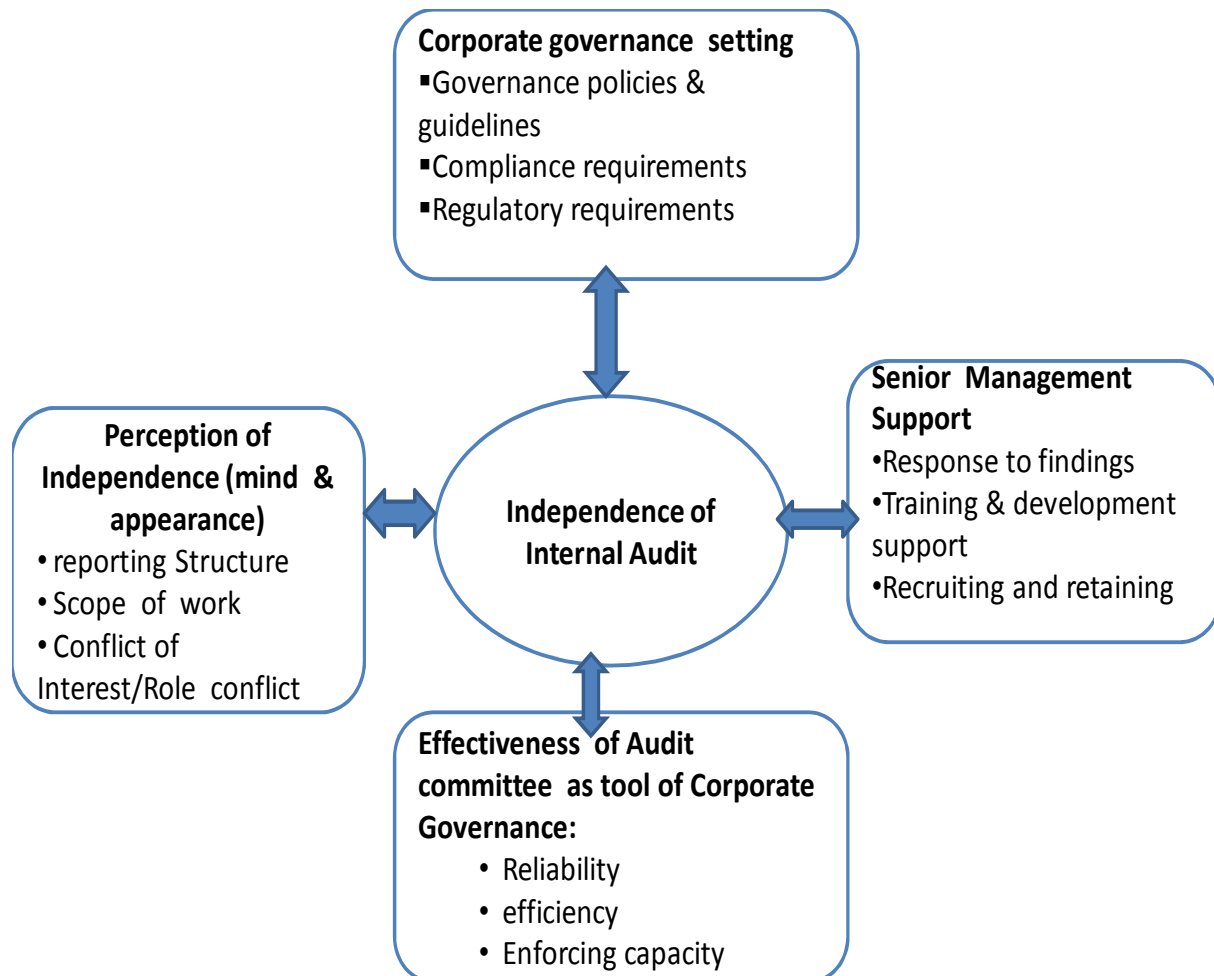
Moreover, Theofenoes & Karagrorgos et.al (2010) further mentioned that the effectiveness of audit committee in terms of support it provides the internal audit function by providing independent support environment and review effectiveness of internal audit function.

Terdpaopong & Miheret, (2012) also revealed that the independence of internal audit in Ethiopian government ministries was clearly stated in the manual issued by Ministry of Finance and Economic Development (MOFED) in 2004. In their study based on Ethiopian context and interview with directors Internal audit function, ( Terdpaopong & Miheret, 2012) also indicated that only Banks and insurances are required by regulatory body NBE to maintain internal audit function.

While there are studies in such areas as effectiveness of internal audit function, the role of internal audit on corporate governance (KPMG 2008), (Carl Gabrini 2013) and Factors Affecting Internal Audit Independence Thuweba Ndunge Kimotho, (2014). In the studies discussed, there seems to be interrelationship and interdependence between corporate governance and independence of internal audit function. However, there is dearth of empirical study that examines the effect of corporate governance on independence of internal audit function.

## 2.17 The Conceptual Framework

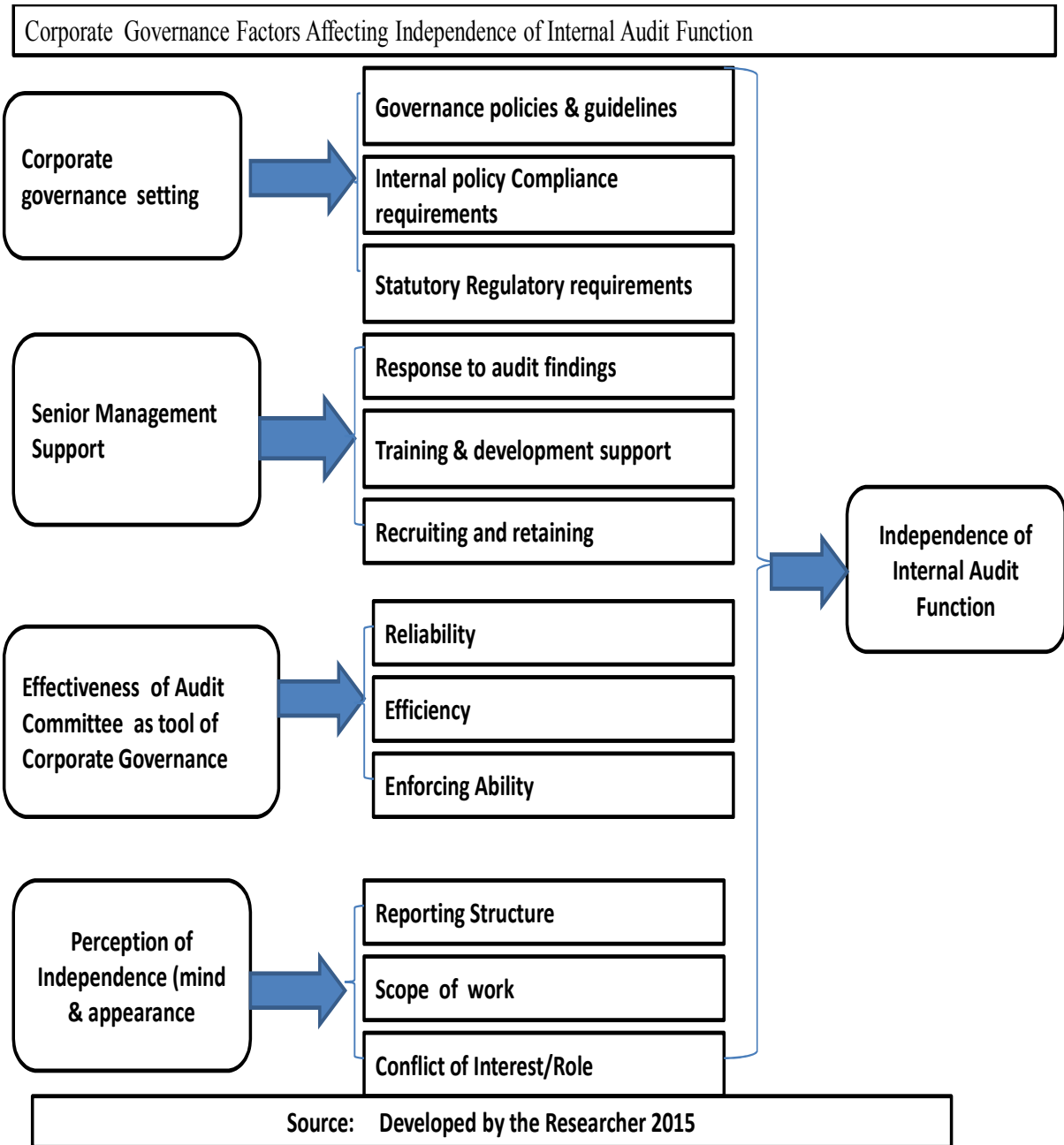
### 2.17.1 The Conceptual Framework Between Corporate Governance Factors and the Independence of Internal Audit Function



Source : Developed from preliminary literature review

Based on the literatures cited the above conceptual frame work indicates that there are interdependence between the corporate governance factors and the independence of internal audit function.

### 2.17.2 Conceptual Framework between the Dependent and Independent Variables



Based on the literatures cited, the above conceptual frame work indicates that how each of the corporate governance factors affect the interdependence the internal audit function.

## **CHAPTER THREE**

### **RESEARCH MEHODLOGY**

#### **3.1 Introduction**

This chapter contains a discussion of the approach used in carrying out the research. The areas covered include the population, sample and sampling technique, data collection instruments, type of data collected and sources, administration of the questionnaires, method of analysis and scope and limitation. The survey was conducted with the objective of evaluating the extent to which the independence of internal audit function is affected by corporate governance factors in the private commercial banks of Ethiopia.

#### **3.2 The Population**

The population of the research comprises all managers of internal audit department, heads of inspection and audit divisions and Risk managers. All sixteen private banks were targeted for the study.

Moreover, the questionnaires were also served to the bank supervision directorate of the national bank of Ethiopia (NBE) specifically to private bank desk officers to solicit information on regulatory input on internal audit independence in private commercial banks.

#### **3.3 Sample and Sampling Technique**

The researcher used the purposive sampling. At present, there are sixteen private commercial banks in Ethiopia; each having one internal audit department as one unit. Thus, structured questionnaires were served to all internal audit managers of private banks and the heads of inspection and audit divisions as is in most of the banks. The questionnaires were also served to the risk managers as key informants who have relation with the governance issues and users of the internal audit reports.

Therefore, 64 questionnaires were distributed to private commercial bank manager and 10 questionnaires were administered to National Bank of Ethiopia (NBE) bank supervision

directorate managers and desk offers; total of 74 questionnaires were distributed to collect primary data.

### **3.4 Data Collection Instruments**

The questionnaires were adopted and designed based on those used by Institute of Internal auditors (IIA) Chicago chapter March 24, 2003, for the survey study on ‘Internal Audit Independence and Corporate Governance’

However, the questions were adapted for the respondents to rate the extent to which they agree or disagree on a five point likert scale with the following ratings. **Strongly agree, Agree, Neutral, Disagree** and **Strongly Disagree**. On this scale score of 5 or 4 indicates that the item is perceived to be essential while a score of 3 or 2 indicate that the item is perceived to be fairly important, but not essential, while a score of 1 indicates that the item could be disregarded for being unimportant.

Fikru Fantahun had also used these questionnaires in his thesis research of 2012 citing that the questionnaires were structured based on those used by Iyoha and Faboyede (2011), and Sharif (2010).

The questionnaires containing six parts comprising general information about the respondents, independence of internal audit function, corporate governance setting, perception on independence of internal audit function, Effectiveness of audit committee, and senior management support were administered to the internal audit managers, risk managers, heads of audit and inspection divisions or equivalent. Sixty four (64) questionnaires were administered in all sixteen (16) private banks. The other ten questionnaires with the same content were administered to National Bank of Ethiopia (NBE) desk officers to the private banks with the objective to solicit and balance regulatory view on the same questions.

### **3.5 Type of Data and Sources**

Survey was conducted by collecting mainly primary data, through questionnaires, from key informants of the private banks. Secondary data was included in the study through references to authoritative books and web pages, which include relevant literature such as newsletters, textbooks, standards for the professional practice of internal auditing and ethics for internal auditors by the Institute of Internal Auditors (IIA).

### **3.6 Administration of Questionnaires**

The questionnaires were served to the respondents personally. This has provided me the opportunity to respond to whatever preliminary questions the respondents raised before filling in the questionnaires. The distribution of the questionnaires took 4 days. The administration of the questionnaires therefore took a period of twenty (20) days.

### **3.7 Formulation of Hypothesis**

The following hypotheses were tested during the Research study:

**H<sub>0</sub>**: corporate governance setting does not have effect on independence of internal audit.

**H<sub>a</sub>**: corporate governance setting has effect on independence of internal audit.

**H<sub>0</sub>**: Senior management support does not have effect on independence of internal audit.

**H<sub>a</sub>**: Senior management support has effect on independence of internal audit.

**H<sub>0</sub>**: Effectiveness of audit committee does not have effect on independence of internal audit.

**H<sub>a</sub>**: Effectiveness of audit committee has effect on independence of internal audit.

**H<sub>0</sub>**: Perception of independence does not have effect on independence of internal audit.

**H<sub>a</sub>**: Perception of independence has effect on independence of internal audit.

### 3.8 Data Analysis and Presentation

The primary data obtained from the questionnaire was summarized and analyzed by using descriptive statistics such as proportions, percentages, means and frequency distributions tables. Data was analyzed using Statistical Package for Social Sciences (SPSS Version 20.0) program. The analysis employed regression model to analyze the relationship between internal audit independence and level of effect of corporate governance factors within the private commercial banks within a test of significance of 95% confidence level.

#### 3.8.1 Conceptual Model

The following conceptual model was adopted in the study where Independence of Internal audit Function (IIAF) is a function of Corporate Governance Setting (CGS), Senior Management Support (SMS), Effectiveness of Audit Committee (EAC) and Perception of Independence (POI):

$$\text{IIAF} = f(\text{CGS, SMS, EAC, POI})\text{-----}(1)$$

Where;

IIAF = Independence of Internal Audit Function;

CGS = Corporate Governance Setting;

SMS = Senior Management Support;

EAC = Efficiency of Audit Committee;

POI = Perception of Independence

#### 3.8.2 Analytical Model

The following regression model was used to perform data analysis

$$Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \epsilon$$

Y= Represents the dependent variable that measure level of corporate governance factors' influence. To minimize multi-co linearity effect, the dependent variable Y is determined based on the average score for main independent variables

X= represents Independent variable that measure the independence of the internal Function,

X is determined based on the average score to be determined as follows:

$$AFS = \left( \frac{\text{Total score of each Factor}}{\text{Maximum possible score obtainable by each factor}} \right) \times 100$$

Where: AFS = Average Factor Score.

$$\text{IIAF} = \beta_0 + \beta_1 (\text{CGS}) + \beta_2 (\text{SMS}) + \beta_3 (\text{EAC}) + \beta_4 (\text{POI}) + \varepsilon \text{-----(2)}$$

Corporate Governance Setting (CGS), Senior Management Support (SMS), Effectiveness of Audit Committee (EAC) and Perception of Independence (POI) were measured using average factor scores determined for each factor.

Finally, the degree of relationship between the two variables that is internal audit independence (Y) and level of influence by corporate governance factors (X) will be established by calculating the correlation coefficient (r) and determination

## **CHAPTER FOUR**

### **DATA ANALYSIS AND INTERPRETATIONS**

#### **4.1 Introduction**

This chapter discusses the interpretation and presentation of the findings obtained from the data analysis. Descriptive and inferential statistics have been used to discuss the findings of the study. The study targeted a sample size of 74 respondents from which all the respondents filled in and returned the questionnaires making a response rate of 100%. This response rate was satisfactory to make conclusions for the study.

#### **4.2 Data Presentation**

##### **4.2.1 Demographic Information and Data Characteristics (Appendix II)**

The researcher sought to determine the gender of the respondents and therefore requested the respondent to indicate their gender. The study found that majority of the respondents as shown by 85.5 % was males whereas; 13.5% of the respondents were females. This is an indication that both genders were involved in this study. As the sample considers only the job position held in the bank, the finding of the study did not suffer from gender bias.

The researcher requested the respondents to indicate their age category and findings obtained from the table 4.2 indicate that 31.1% of the of the respondents have indicated that they were aged between 25 and 34 years, 56.8 % of the of the respondents indicated they were aged between 35 and 44 years, 10.8% of the respondents indicated were aged between 44 to 54 years, whereas 1.4% of the respondents indicated that they were aged above 55 years.

The researcher requested the respondents to indicate their highest level of education. From the findings, it was established that 71.6% of the respondent indicated their highest education level as degree, 27% of the respondents indicated their highest level of education as masters. This is an indication that most of the respondents focused in this study had university degree as their highest level of education.

The researcher requested respondents to indicate the number of years they served the particular bank and the findings of the study established that 2.7% of the respondents indicated they had worked for a period of less than 1 year, 31.7% of the respondents indicated that they had worked for a period ranging between 1 to 5 years, 40.5% of the respondents indicated that they had worked for a period ranging from 6 to 10 years, and 25.7% of the respondents had served for more than 10 years. This implies that majority of the respondents had served for a considerable period which indicates that most of the respondents had vast knowledge and experience which could be relied upon by this study

#### 4.2.2 Independence of Internal Audit Function

The respondents were asked to express the extent to which they agree on the need, value and credibility of the services provided by independent internal audit function. The response to this general questions is summarized and displayed as follows:

**Table4.1: Response about independence of internal audit function.**

About independence of(IIAF)	Frequency	Percent	Valid Percent
SDA	0	0	0
DA	0	0	0
NEU	11	14.9	14.9
AG	39	52.7	52.7
SAG	24	32.4	32.4
Total	74	100.0	100.0

Source: SPSS analyzed questionnaire May 2015

From the findings above table, we note that there were no responses with strongly disagree-SDA and disagree DA, 14.9% indicated NEU- neutral, 52.7% of the respondents indicated AG-agree whereas 32.4% of the respondents indicated SAG-strongly agree. This implies that most of the respondents agree on the need, value and credibility for independence of internal audit function is necessary in private banks of Ethiopia to a greater extent.

#### 4.2.3 Effect of Corporate Governance setting on independence of Internal Audit Function

**Table 4.2: Extent to which corporate governance setting affect independence of internal audit function.**

##### AV.CGS

Extent of Response	Frequency	Percent	Valid Percent
SDA	0	0	0
DA	5	6.8	6.8
NEU	33	44.6	44.6
AG	24	32.4	32.4
SAG	12	16.2	16.2
Total	74	100.0	100.0

**Source:** SPSS analyzed questionnaire May 2015

The researcher sought to establish the extent to which corporate governance setting (CGS) affects independence of internal audit function in private commercial banks of Ethiopia. From the findings, there were no responses with strongly disagree-SDA, 44.6% indicated (moderate) NEU-neutral, 32.4% of the respondents indicated AG-agree whereas 16.2% of the respondents indicated SAG-strongly agree. This implies that corporate governance setting (CGS) affects independence of internal audit function in commercial banks of Ethiopia to a great extent.

#### 4.2.4 Effect of Senior Management Support on Independence of Internal Audit Function

**Table 4.3: Extent to which senior management support factors affect independence of internal audit function**

##### AV.SMS

Responses	Frequency	Percent	Valid Percent
SDA	0	0	0
DA	1	1.4	1.4
NEU	23	31.1	31.1
AG	38	51.4	51.4
SAG	12	16.2	16.2
Total	74	100.0	100.0

**Source:** SPSS analyzed questionnaire; May, 2015

The researcher sought to establish the extent to which senior management support (SMS) affects independence of internal audit function in private commercial banks of Ethiopia. From the findings there were no responses with strongly disagree-SDA, 31.1% indicated (moderate) NEU-neutral, 51.4% of the respondents indicated AG-agree whereas 16.2% of the respondents indicated SAG-strongly agree. This implies that senior management support affects independence of internal audit function in commercial banks of Ethiopia to a great extent.

#### 4.2.5 Effect of Audit Committee Effectiveness on Independence of Internal Audit Function

**Table 4.4: Extent to which effectiveness of audit committee affects independence of internal audit function.**

AV.EAC

Responses	Frequency	Percent	Valid Percent
SDA	0	0	0
DA	0	0	0
NEU	16	21.6	21.6
AG	42	56.8	56.8
SAG	16	21.6	21.6
Total	74	100.0	100.0

**Source:** SPSS analyzed questionnaire; May, 2015

The researcher sought to establish the extent to which effectiveness of audit committee affect the independence of internal audit function of private commercial banks in Ethiopia. From the findings, that there were no responses with strongly disagree- SDA and disagree-DA, 21.6% indicated NEU-neutral o a great extent, 56.8% of the respondents indicated to a AG-agree whereas 21.6% of the respondents indicated SAG-strongly agree. This implies that effectiveness of audit committee affects the independence of internal audit function in private commercial banks in Ethiopia to a great extent.

#### 4.2.6 Effect of perception on Internal Audit on Independence Internal Audit function

**Table 4.5: Extent to which perception of internal audit affects independence of internal audit function.**

AV.POI

Responses	Frequency	Percent	Valid Percent
SDA	0	0	0
DA	0	0	0
NEU	22	29.7	29.7
AG	40	54.1	54.1
SAG	12	16.2	16.2
Total	74	100.0	100.0

Source: SPSS analyzed questionnaire May 2015

The researcher sought to establish the extent to which perception of internal audit independence affects the independence of internal audit function in private commercial banks of Ethiopia. From the findings that there were no responses with strongly disagree- SDA and disagree DA, 29.7% indicated NEU-neutral, 54.1% of the respondents indicated Ad-agree whereas 16.2 % of the respondents indicated SAG-strongly agree. This implies that perception of internal audit independence affects the Independence of Internal Audit Function in private commercial banks of Ethiopia to a great extent.

#### 4.3 Relationship between Independence of Internal Audit function and Corporate Governance

This study has attempted to establish the relationship between internal audit independence and corporate governance factors. The results of this analysis are as follows:

### 4.3.1 Pearson Correlation

**Table 4.6: The relationship between dependent and independent variables  
Correlations**

		AV.IIAF	AV.CG S	AV.POI	AV.EAC	AV.SMS
Pearson Correla tion	AV.IIAF	1.000	.374	.390	.402	.441
	AV.CGS	.374	1.000	-.005	.294	.036
	AV.POI	.390	-.005	1.000	.031	.354
	AV.EAC	.402	.294	.031	1.000	.088
	AV.SMS	.441	.036	.354	.088	1.000

**Source:** SPSS analyzed questionnaire; May, 2015

Pearson Correlation/ Correlation Coefficient (r) measure how well the regression equation truly represents the set of data. The quantity r, called the linear correlation coefficient, measures the strength and the direction of a linear relationship between two variables. The value of r is such that  $-1 < r < +1$ . The + and – signs are used for positive linear correlations and negative linear correlations, respectively. Positive correlation: If x and y have a strong positive linear correlation, r is close to +1. An r value of exactly +1 indicates a perfect positive fit.

Positive values indicate a relationship between x and y variables such that as values for x increase, values for y also increase. Negative correlation: If x and y have a strong negative linear correlation, r is close to -1. An r value of exactly -1 indicates a perfect negative fit. Negative values indicate a relationship between x and y such that as values for x increase, values for y decrease. No correlation: If there is no linear correlation or a weak linear correlation, r is close to zero.

A value near zero means that there is a random, nonlinear relationship between the two variables. The correlation factors in the above table indicate that all are above zero and below one. This in turn indicates that there is linear correlation between independent variables, the corporate governance factors and the dependent variable, independence of internal audit function.

### 4.3.2 Significance of Correlation

**Table 4.7: Significance of correlation between dependent and independent variables**

		Correlations				
		AV.IIAF	AV.CGS	AV.POI	AV.EAC	AV.SMS
	Pearson Correlation	1	.326**	.468**	.352**	.388**
AV.IIAF	Sig. (2-tailed)		.005	.000	.002	.001
	N	74	74	74	74	74
	Pearson Correlation	.326**	1	.130	.310**	.080
AV.CGS	Sig. (2-tailed)	.005		.270	.007	.496
	N	74	74	74	74	74
	Pearson Correlation	.468**	.130	1	.106	.432**
AV.POI	Sig. (2-tailed)	.000	.270		.367	.000
	N	74	74	74	74	74
	Pearson Correlation	.352**	.310**	.106	1	.236*
AV.EAC	Sig. (2-tailed)	.002	.007	.367		.043
	N	74	74	74	74	74
	Pearson Correlation	.388**	.080	.432**	.236*	1
AV.SMS	Sig. (2-tailed)	.001	.496	.000	.043	
	N	74	74	74	74	74

\*\* . Correlation is significant at the 0.05 level (2-tailed).

\* . Correlation is significant at the 0.01 level (2-tailed).

**Source:** SPSS analyzed questionnaire; May, 2015

The correlation between dependent and independent variables is significant as indicated by double asterisk (\*\*) for two- tailed test at 0.05 level of significance.

### 4.3.3 Regression Analysis

**Table 4.8: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.680a	.462	.431	.505	.462	14.838	4	69	.000

- a. Predictors: (Constant), AV.SMS, AV.CGS, AV.EAC, AV.POI
- b. Dependent Variable: AV.IIAF

**Source:** SPSS analyzed questionnaire; May, 2015

From the findings in the above table, the value of adjusted R squared (co-efficient of determination) was 0.431 an indication that there was variation of 43.1% on independence of internal audit function(IIAF) due to changes in corporate governance setting (CGS) senior management support (SMS), effectiveness of audit committee (EAC) and perception of internal audit independence(POI). This shows that 43.1% changes in average factor score of internal audit independence could be accounted for by changes in average factor scores of corporate governance setting (CGS) senior management support (SMS), effectiveness of audit committee (EAC) and perception of internal audit independence (POI).

The study also established that there is strong positive relationship between independence of internal audit function(IIAF) and corporate governance setting(CGS) senior management support (SMS), effectiveness of audit committee (EAC ) and perception of internal audit independence(POI) shown by correlation coefficient of 0.462.

**Table 4.9: Relationship between Internal Audit Independence and Corporate Governance factors**

*Coefficients a*

<i>Model</i>	<i>Unstandardized Coefficients</i>		<i>Standardized Coefficients</i>	<i>t</i>	<i>Sig.</i>	<i>95.0% Confidence Interval for B</i>		<i>Collinearity Statistics</i>	
	<i>B</i>	<i>Std. Error</i>	<i>Beta</i>			<i>Lower Bound</i>	<i>Upper Bound</i>	<i>Tolerance</i>	<i>VIF</i>
<i>AV.CGS</i>	.223	.073	.281	3.045	.003	.077	.369	.875	1.143
<i>AV.POI</i>	.274	.094	.273	2.897	.005	.085	.462	.908 .869	1.102
<i>AV.EAC</i>	.287	.094	.283	3.060	.003	.100	.474		1.151
<i>AV.SMS</i>	.292	.089	.309	3.268	.002	.114	.470		

*a. Dependent Variable: AV.IIAF*

*Source: SPSS analyzed questionnaire; May, 2015*

**The established regression equation was:**

$$Y=0.055 + 0.223CGS + 0.287EAC + 0.292MS + 0.274POI$$

From the regression equation, the study revealed that holding corporate governance setting, perception of audit independence, effectiveness of audit committee and senior management support to a constant zero, independence of internal audit in private commercial banks would stand at 0.055. A unit increase in average factor score of corporate governance setting (CGS) would lead to increase in average factor score of independence of internal audit function by a factor of .281, a unit increase in average factor score of senior management support (SMS) would lead to increase in average factor score in independence of internal audit function by a factor 0.309 a unit increase in average factor scores perception of internal audit independence (POI) would lead to increase in average factor score independence of internal audit function (IIAF) by a

factors of 0.273 and further unit increase in average factor score of effectiveness of audit committee (EAC) would lead to increase in average factor score independence of internal audit function (IIAF) by a factor of 0.283.

#### 4.3.4 Hypothesis Testing

**Table 4.10: Significance Test of the Regression Line ANOVA<sup>a</sup>**

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	15.129	4	3.782	14.838	.000 <sup>b</sup>
Residual	17.587	69	.255		
Total	32.716	73			

a. Dependent Variable: AV.IIAF

b. Predictors: (Constant), AV.CGS, AV.POI, AV.EAC, AV.SMS

**Source:** SPSS analyzed questionnaire; May, 2015

F- Value 14.838 is significant where level of significance is indication of the overall significance of the relationship between the dependent and independent variable.

After analyzing the data and applying the multiple correlation and regression method, researcher has applied some other tests for testing of hypothesis. The hypotheses developed by the researcher were:

#### Hypothesis I

**H<sub>0</sub>:** corporate governance setting does not have effect on independence of internal audit.

**H<sub>a</sub>:** corporate governance setting has effect on independence of internal audit.

The calculated value of t-value for n-2 (df) for corporate governance setting (CGS) is 3.045; whereas, the critical value for at 0.05 confidence level from the table is 1.99. Thus the test leads us to reject the null hypothesis and accept the alternative hypothesis indicating that corporate

governance settings(CGS) in private commercial banks of Ethiopia has effect on independence of internal audit function .

## **Hypothesis II**

**H0:** Senior management support does not have effect on independence of internal audit.

**Ha:** Senior management support has effect on independence of internal audit.

The calculated value of t-value for n-2 (df) for senior management support (SMS)) is 3.268; whereas, the critical value for at 0.05 confidence level from the table is 1.99. Thus, the test leads us to reject the null hypothesis and accept the alternative hypothesis indicating that senior management support (SMS) in private commercial banks of Ethiopia has effect on independence of internal audit function.

## **Hypothesis III**

**H0:** Effectiveness of audit committee: does not have effect on independence of internal audit.

**Ha:** Effectiveness of audit committee has effect on independence of internal audit.

The calculated t-value for n-2 (df) for effectiveness of audit committee (EAC) is 3.060; whereas, the critical value for at 0.05 confidence level from the table is 1.99. Thus, the test leads us to reject the null hypothesis and accept the alternative hypothesis indicating that effectiveness of audit committee (EAC) in private commercial banks of Ethiopia has effect on independence of internal audit function.

## **Hypothesis IV**

**H0:** Perception of independence does not have effect on independence of internal audit.

**Ha:** Perception of independence has effect on independence of internal audit.

The calculated value of t-value for n-2 (df) for perception of internal audit (POI) is 3.060; whereas, the critical value for at 0.05; because it is a 2-tailed test. In this case n = 34 (34 banks)

thus  $n-2 = 72$ . With  $\alpha = 0.05$  we have  $\alpha/2 = 0.025$ . Therefore the t- critical value from t- distribution table was  $t = 1.99$ . The comparison of the two values of t gave the following results:  $t\text{-calculated} > t\text{-critical}$  and thus reject  $H_0$ . This meant that the intercept was significant in the regression model.

Thus, the test leads us to reject the null hypotheses and accept the alternative hypothesis indicating that perception of audit independence (POI) in private commercial banks of Ethiopia has effect on independence of internal audit function.

## CHAPTER FIVE

### SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

#### 5.1 Summary

As quoted by Bhavik M. (2012), corporate governance is a wide subject and like any other field, definition and effective practice of good corporate governance is largely affected by the size of the economy, differences in the legal, regulatory, institutional, financial and political framework, status of the capital market and stakeholders' perceptions etc. However, irrespective of the differences, the importance and the inherent meaning remains the same across the world.

Organizations for Economic Cooperation and Development [OECD's] definition and principles on corporate governance has been accepted by most of the countries in the world including the multilateral organizations like the World Bank Group, the United Nations, the Basel Committee for Banking Supervision, the International Organization of Securities and Commission [IOSCO], the Asian Development Bank , Islamic Financial Services

The importance of internal audit independence is also demonstrated in the growing demand for high value and credibility of its service in all organizations and in the rapid growth of its professional organization, the IIA. However, researchers have paid little attention to this function and the relationship it was with the corporate governance.

The aim of this study was to establish the extent to which corporate governance affects independence of internal audit function of private commercial banks in Ethiopia. The source of information was primary data collected from a sample of 74 respondents collected from 16 private commercial banks which respondents were picked.

##### 5.1.1 Summary of Descriptive Analysis

The study has been conducted by taking purposive sample of internal audit managers, heads of inspection & audit divisions and risk and compliance officers or managers as specified in the

research methodology. From the descriptive statistic of the analysis the study involved both male and female genders without any gender bias as it is based on the job positions held in 16 private commercial banks of Ethiopia.

From the statistics, majorities of the respondents were under age categories between 35 and 54 indicating that they have enough experience to provide information about independence of internal audit and corporate governance in Ethiopian private banks.

From the statistics, 72% of the respondents were degree holders where as 27% are MA holders in educational status indicating that most of the respondents focused in this study have university degree as their highest level of education.

From the statistics, 40.5% of the respondents had worked for a period ranging from 6 to 10 years, 25.7% of the respondents had served for more than 10 years. This implies that majority of the respondents had served for a considerable period which indicates that most of the respondents had vast knowledge and experience which could be relied upon by this study.

From the statistical **table 4.1** from the findings 14.9% indicated NEU- neutral, 52.7% of the respondents indicated to AG- agree whereas 32.4% of the respondents indicated SAG-strongly agree. This implies that most of the respondents agree on the need for independence of internal audit function is necessary in private banks of Ethiopia.

From the statistical **table 4.2**, from the findings, 44.6% indicated (moderate) NEU-neutral, 32.4% of the respondents indicated AG-agree whereas 16.2% of the respondents indicated SAG-strongly agree. This implies that corporate governance setting (CGS) affects independence of internal audit function in commercial banks of Ethiopia to a great extent.

From the findings of the statistical **table 4.3**, 31.1% indicated (moderate) NEU-neutral, 51.4% of the respondents indicated AG-agree whereas 16.2% of the respondents indicated SAG-strongly agree. This implies that senior management support affects independence of internal audit function in commercial banks of Ethiopia to a great extent.

From the statistical **table 4.4**, 21.6% indicated NEU-neutral o a great extent, 56.8% of the respondents indicated to a AG-agree whereas 21.6% of the respondents indicated SAG-strongly agree. This implies that effectiveness of audit committee affects the independence of internal audit function in private commercial banks in Ethiopia to a great extent.

From the statistical **table 4.5**, 29.7% indicated NEU-neutral, 54.1% of the respondents indicated Ad-agree whereas 16.2 % of the respondents indicated SAG-strongly agree. This implies that perception of internal audit independence affects the Independence of Internal Audit Function in private commercial banks of Ethiopia to a great extent.

### **5.1.2 Summary of Regression Analysis and Hypothesis Testing**

From the regression **table 4.6**, the value of adjusted R squared (co-efficient of determination) was 0.431 an indication that there was variation of 43.1% on dependent variable, independence of internal audit function(IIAF) due to changes in corporate governance setting (CGS) senior management support (SMS), effectiveness of audit committee (EAC) and perception of internal audit independence(POI). This shows that 43.1% changes in average factor score of internal audit independence could be accounted for by changes in average factor scores of corporate governance setting (CGS) senior management support (SMS), effectiveness of audit committee (EAC) and perception of internal audit independence (POI). Though limited variable (four) factor model the model has high explanatory power as it explains 43.1% while other 56.9% is explained by variables other than used by researcher.

Both overall significance F-test and individual significance- tests have indicated that there is strong cause and effect relationship between the dependent variable, independence of internal audit function and independent variables, corporate governance factors.

Although there are no hard and fast rules about what value of the VIF should cause concern, Myers (1990) suggests that a value of 10 is a good value at which to worry. What's more, if the average VIF is greater than 1, then multicollinearity may be biasing the regression model Bowerman & O'Connell, (1990). Related to the VIF is the tolerance statistic, which is its

reciprocal (1/VIF). As such, values below 0.1 from the **table 4.8**, Multi-collinearity test of the model is in line with the suggestion indicated proving the strength of the model utilized.

From the analysis of the data the model indicated that there is positive linear relationship between the dependent variable, Independence of internal audit function (IIAF) and independent variables, corporate governance setting (CGS), senior management support (SMS), effectiveness of)audit committee (EAC) and perception of internal audit independence (POI).

## **5.2 Conclusion**

The study revealed that there was variation on independence of internal audit function due to changes in corporate governance factors, corporate governance setting, and senior management support, effectiveness of audit committee and perception of internal audit independence. This shows that changes in independence of internal audit function of private commercial banks of Ethiopia could be accounted for by changes in stated corporate governance factors.

The study also established that there was a strong positive relationship between independence of internal audit function of private commercial banks and the corporate governance factors, corporate governance setting (CGS), senior management support (SMS), effectiveness of audit committee (EAC) and perception of internal audit independence (POI).

Therefore, bank governance agents such as executives and board of directors should understand that none or minimal existence of corporate governance factors such as proper governance setting, senior management support, effectiveness of audit committee and perception of independence would reduce the independence of internal audit function, which in turn is important attribute for its value adding capacity in organizations. Hence, there is a need for executives and board of directors to carefully consider the direction and effect of corporate governance factors on independence of internal audit function

### **5.3 Recommendations**

There is need for the independence of internal audit for value and credibility of its service. Therefore, the management of private commercial banks should update themselves with the corporate governance factors that affect independence of internal audit function to get best service out of their banks' internal audit function.

The private commercial banks should organize seminars and workshops whereby experts in internal audit and corporate governance would train effect of these **corporate governance factors** on independence of internal audit function frequently internally or externally so that the management is aware of the corporate governance settings such as governance policies and guidelines, compliance requirements and regulatory requirements.

The audit committee of the private commercial banks should enhance its effectiveness, efficiency reliability and enforcing capacity while communicating, supervising and reviewing the work of internal audit function so that independence of internal audit function is maintained.

Senior management of private commercial banks should provide support for internal audit function through expediting the response to audit findings, training and development of internal audit staff, and recruiting training of internal audit staff so that internal audit is maintaining its independence.

### **5.4 Limitations of the Study**

In attaining its objective, the study was limited only to private Commercial banks from which only four respondents were picked from each. This is due to the nature of the study, which requires involving only those individuals which the researcher believed to have knowledge of corroborate governance and independence of internal audit function. These according to researcher are managers of internal audit function and their immediate supervisors and the bank's risk and compliance department managers (officers).

Some of the respondents were suspicious about the study, regarded some information as confidential and some time is wasted to convince the scope of the study.

The study was also limited to the degree of precision of the data obtained from the respective respondents.

The study was also limited to establish how corporate governance affects independence of internal audit function in private commercial banks of Ethiopia.

The method used is descriptive research design whereby the variables cannot be controlled by the researcher. The study used questionnaire as the instrument for collecting data. This is because time for the data collection was limited to only one week.

## **5.5 Recommendation for Further Studies**

This research recommends a similar study to be done but include government owned commercial banks and government ministries.

There is need for a study to be conducted to determine the challenges facing internal audit in commercial banks, this will help in enhancing the internal audit in the commercial banks in Ethiopia and thus positively affecting value and credibility of their service.

There is need for a study to be conducted on the roles and challenges of internal auditing in the banking industry in Ethiopia

The study recommends reciprocated in-depth study be done on effect of internal audit on corporate governance of private commercial banks and other institutions in order to further reveal interdependence.

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## APPENDIX II

### Statistical Data Analysis Figure and Tables

#### Gender of the Respondents

Gender	Frequency	Percent	Valid Percent
MALE	64	86.5	86.5
FEMAL	10	13.5	13.5
Total	74	100.0	100.0

Source: SPSS analyzed questionnaire May 2015

#### Age Distribution of the Respondents

Age Ranges	Frequency	Percent	Valid Percent
25-34	23	31.1	31.1
35-44	42	56.8	56.8
45-54	8	10.8	10.8
>55	1	1.4	1.4
Total	74	100.0	100.0

Source: SPSS analyzed questionnaire May, 2015

#### Education Level Respondents

Education Level	Frequency	Percent	Valid Percent
DIP	1	1.4	1.4
BA	53	71.6	71.6
MA	20	27.0	27.0
Total	74	100.0	100.0

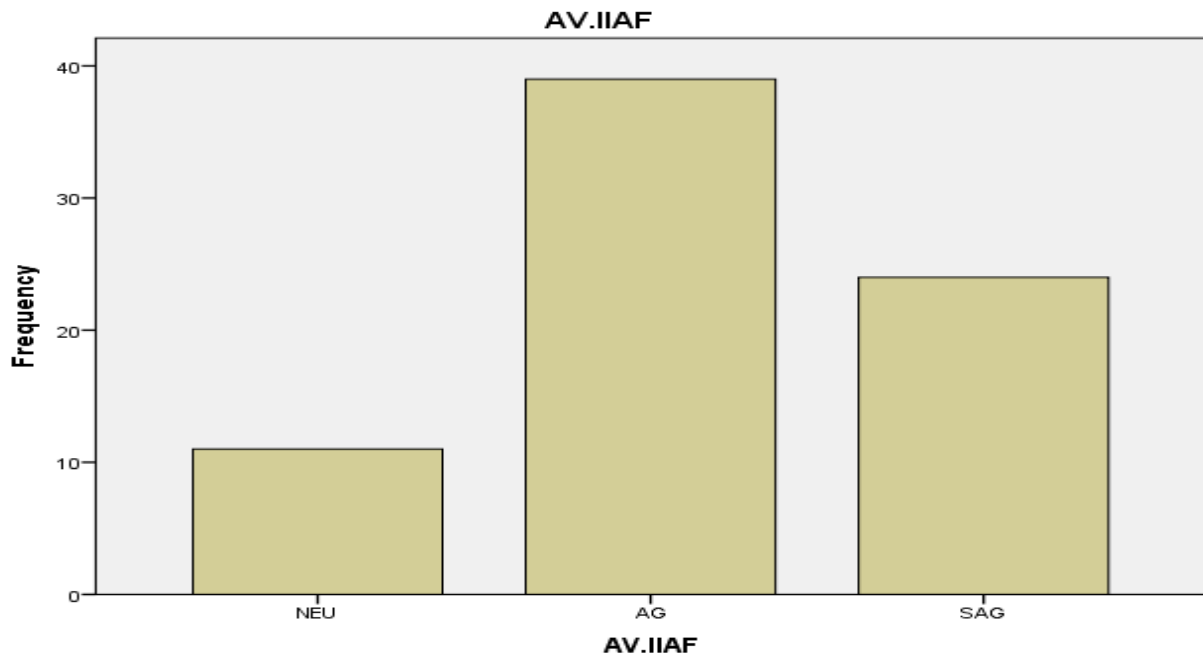
Source: SPSS analyzed questionnaire May 2015

**Period of Service Years of service in the Bank**

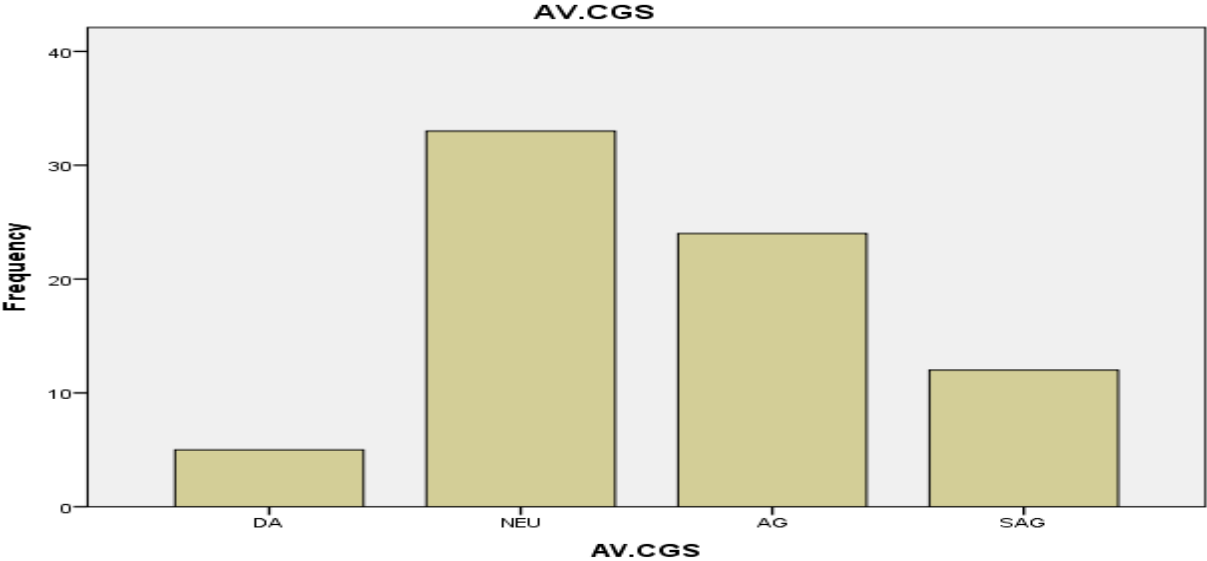
Years of Experience(EXP)	Frequency	Percent	Valid Percent
<1	2	2.7	2.7
1-5	23	31.1	31.1
6-10	30	40.5	40.5
>10	19	25.7	25.7
Total	74	100.0	100.0

Source: SPSS analyzed questionnaire May 2015

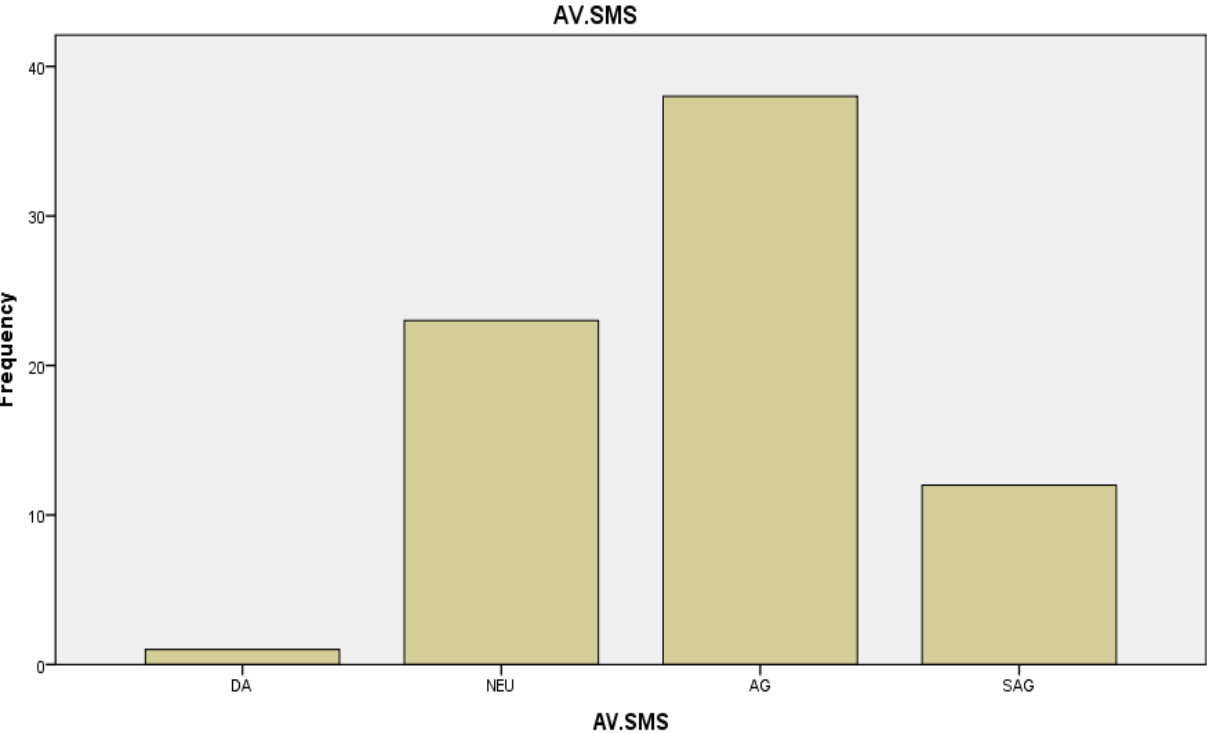
**Figure 1: Response factor score on independence of internal audit function**



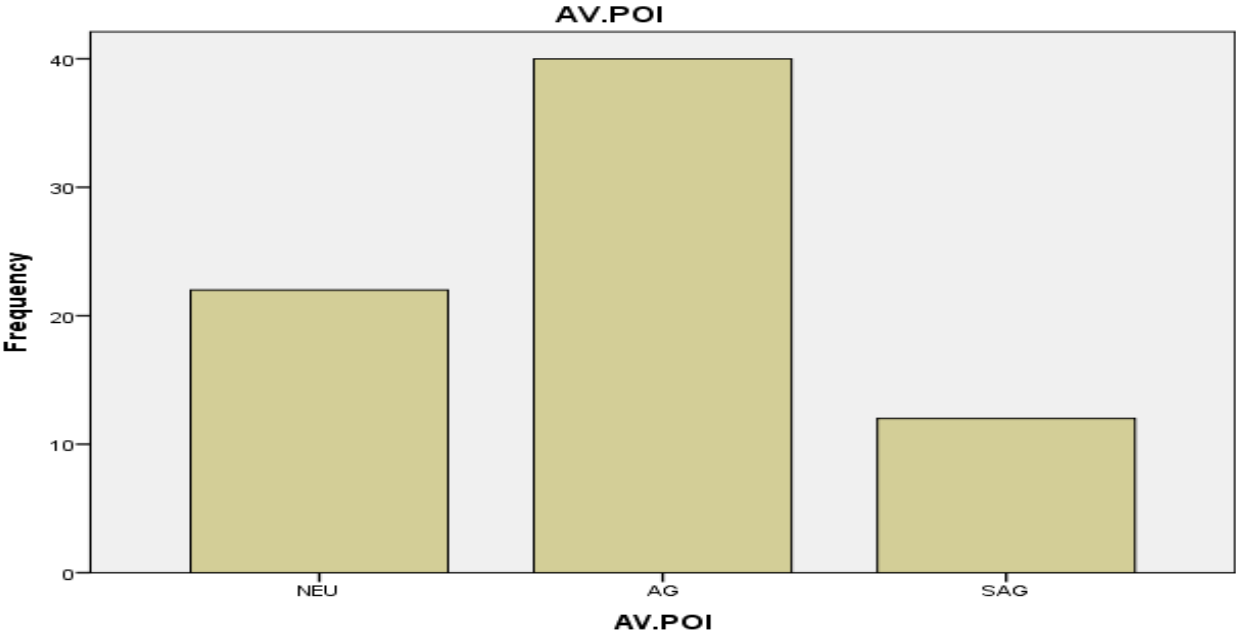
**Figure.2: Average response factor score on effect of corporate governance setting factors on independence of internal audit function**



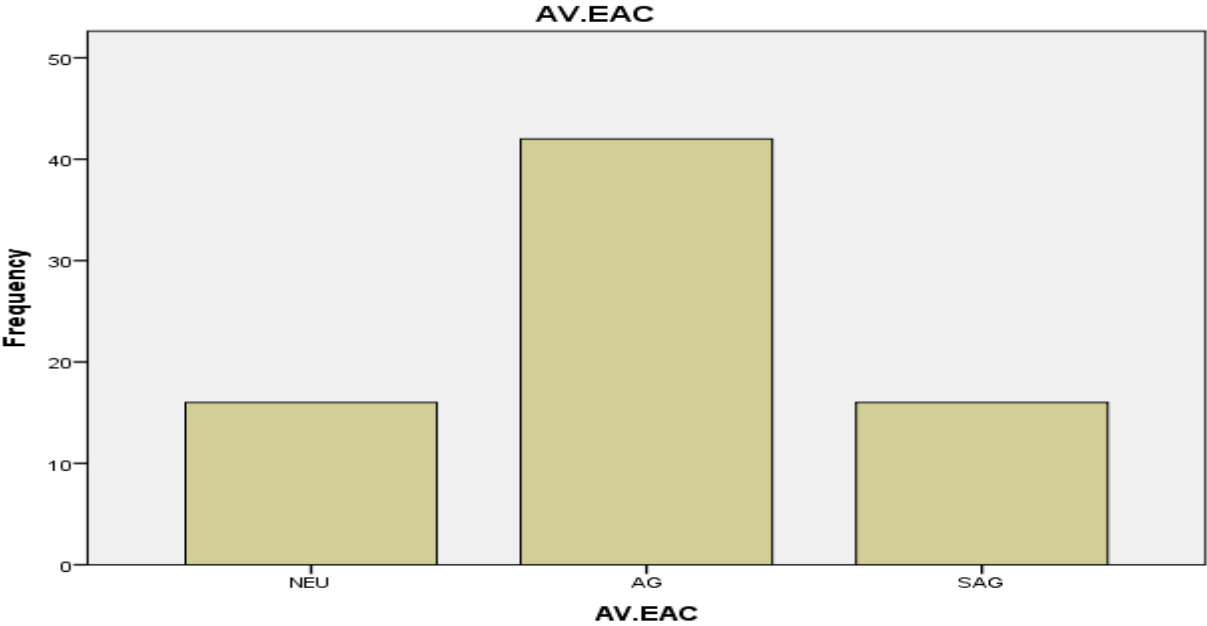
**Figure3: Average response factor score on effect of senior management support on independence of internal audit function.**



**Figure 4: Average response factor score effect of audit committee effectiveness on independence of internal audit function**



**Figure 5: Average response factor score on effect of audit committee effectiveness on independence of internal audit function.**



## List of all private banks in Ethiopia

No.	Name of Private Banks
1	Awash International Bank S.C
2	Dashen Bank S.C
3	NIB Bank
4	Wogagen Bank S.C
5	Bank of Abyssynia S.C
6	United Bank S.C
7	Lion Bank S.C
8	Buna International Bank.S.C
9	Cooperative Bank of Oromia S.C
10	Oromia International Bank S.C
11	Debub Global bank S,c
12	Zemen Bank S.C
13	Abay Bank S.C
14	Berhane bank S.C
15	Enate Bank S.C
16	Addis International bank S.C