



**Internal Audit: Reporting Relationship  
in  
Ethiopian Public Enterprises**

**For The Partial Fulfillment Of  
MSC. In Accounting and Finance**

*By*

**Samuel Mulugeta**

*Advisor*

**Gebremedihne Gebrehiwot**

**Addis Ababa University  
Faculty of Business and Economics  
Department of accounting  
June 2008**

**Addis Ababa**

**Declaration**

I, Samuel Mulugeta declare that, this paper prepared for the partial fulfillment of the requirements for MSC. Degree in Accounting and Finance entitled “internal Audit: Reporting Relationship in Ethiopian Public Enterprises” is prepared with my own effort. I have made it independently with the close advice and guidance of my advisor.

Samuel Mulugeta

-----

-----

Signature -----

Date -----

## **Certification**

This is to certify that Ato Samuel Muligeta has carried out this research work on the topic entitled **“Internal Audit: reporting Relationship in Ethiopian Public enterprises”** under my supervision. This work is original in nature and it is sufficient for submission for the partial fulfillment for the award of MSc. in Accounting and Finance.

Gebremedhin Gebrehiwot

Signature -----

Date -----

ADDIS ABABA UNIVERSITY  
FACULTY OF BUSINESS AND ECONOMICS  
ACCOUNTING AND FINANCE (MSC PROGRAM)

# Internal Audit: Reporting Relationship In Ethiopian Public Enterprises

By  
**Samuel Mulugeta**

Advised by:

Name -----

Signature -----

Date -----

Examined by:

1. Name----- Signature----- Date-----

2. Name----- Signature----- Date-----

3. Name----- Signature----- Date-----

## **Acknowledgements**

I am truly indebted to God for giving me the potential, courage and determination to complete my studies in general and this project in particular.

I am also very thankful to my supervisor, Ato Gebremedhin Gebrehiwot, for all his assistance and willingness to share his knowledge and experiences with me. This small piece of appreciation can not fully convey my heartfelt gratitude towards him.

Finally, I would also like to thank my friends, Adana Diro and Fitsum Gezahegne for copy editing this project.

## Abbreviations:

A.A.A- American Accounting Association

C.M.S- Construction Material supply

C.B.B- Construction & Business Bank

C.E.O- Chief Executive Officer

C.F.O- Chief Financial Officer

C.I.A- Certified Internal Auditors

C.E.A- Chief Executive Auditor

E.I.C Ethiopian Insurance Corporation

E.S.L- Ethiopian Shipping Lines

E.E.P.C.O- Ethiopian electric and Power Corporation

I.A- Internal Auditor

IIA- Institute of Internal Auditors

IIARF- Institute of Internal Auditors Research Foundation

M.O.F.E.D- Ministry of Finance and Economic Development

P.E.S.A- Public Enterprise Supervising Authority

T.A.C- Tikur Abay Construction

Z.S.R.F- Zequala Steel Rolling Factory

# Table of Content

## Chapter one: Introduction

1.1. Background of the study	1
1.2. Statement of the Problem	2
1.3. Research Questions	4
1.4. Objectives of the study	5
1.5. Hypothesis	5
1.6. Significance of the Study	6
1.7. Scope and limitation of the study	6
1.8 Methodology	7
1.9. Analysis Method	9

## Chapter two: Literature Review

2.1 Internal Audit – Historical background	10
2.1.1. Evolution of Auditing	10
2.2.2. The development of internal audit in Ethiopia	11
2.2. Analysis of internal audit reporting Structure	13
2.3. Reporting relationship and internal audit scope	19
2.4. Reporting relationship and independency	25
2.5. Reporting relationship with Audit Committee	28
2.6. Corporate governance and reporting relationship	33

## **Chapter three: Data Presentation and analysis**

3.1. Data Gathering_____	35
3.2. Empirical results and discussion_____	
_____37	
3.2.1. Introduction_____	37
3.2. 2. Internal audit reporting relationship_____	
_____39	
3.2.2.1. Internal audit reporting responsibility_____	39
3.2.2.2. Benefits and Risks of the current reporting line_____	
_____42	
3.2.2.3. The availability and clarity of audit charter_____	
_____43	
3.2.2.4. The clarity of IA charter_____	44
3.2.3. Reporting relationship Vs scope of internal audit_____	
_____45	
3.2.3.1. Relationship between reporting relationship and scope of IA	
_____45	
3.2.3.2. The current scope of internal auditors_____	46
3.2.3.3. Size and quality of internal audit staff_____	46

3.2.4. Reporting relationship Vs independency of internal audit_____	
_____48	
3.2.4.1. Conducive environment to promote independence_____	
_____48	
3.2.5. Reporting relationship Vs IA contribution for good governance____	
_____48	
3.2.5.1. Reporting relationship contribution for good governance_	
_____48	
3.2.5.2. Management and employee understanding the role of	
IA for good governance_____	50
3.2.6. The effect of reporting relationship on management correction action__	
50	
3.2.6.1. Conflict of interest with the management_____	
_____50	

#### **Chapter four: Conclusions and recommendations**

4.1. Conclusions_____	52
4.2. Recommendations_____	55
References _____	58

#### **Annexes**

Appendix one: Questioner

Appendix two: Response summery

Appendix three: Comment on Sarah Johnson, CFO.com

Appendix four: Audit Committee directives for Ethiopian Public Enterprises

Appendix five: Internal Audit Directive for Ethiopian Public Enterprises

Appendix six: Directive for internal audit plan for the year 2008/2009 for

Ethiopian Public Enterprises

## Charts

Chart 1: Functional Reporting Responsibilities

Chart 2: Administrative Reporting Responsibilities

Chart 3: The reason for the existence of internal audit function

Chart 4: Functional reporting relationship

Chart 5: Benefits of the current reporting relationship

Chart 6: Risks of the current reporting relationship

Chart 7: The clarity of IA charter

Chart 8: IA reporting relationship Vs scope

Chart 9: The size of IA staff

Chart 10: The quality of IA staff

Chart 11: Independence Vs reporting relationship

Chart 12: IA reporting relationship Vs good governance

Chart 13: IA reporting relationship Vs Conflict of interest with the management

### Tables

Table 1: Sample Public Enterprises

Table 2: Primarily (administrative) reporting responsibility of internal audit

Table 3: Responding rate

Table 4: Internal audit reporting structure in Ethiopian public enterprises

### Graphs

Graph1: Respondents' educational background

Graph2: Respondents' work experience

Graph3: The role of IA to address the very purpose for which it is established

Graph 4: The major challenges of internal audit

Graph 5 The availability of audit charter

Graph.6 Scope of internal auditors

Graph.7 Boards/ audited committee contribution to good governance

Graph8. Management and employee IA support for good governance

### Figure

Figure 1: The Relationship between Reporting Level and IA Scope

## Chapter one

### Introduction

#### **1.1. Background of the study**

Today, several forces have led to a quiet revolution in internal audit. Democracy requires government to be accountable in its use of public money and in providing effective, efficient, and economical service delivery. Ever larger and more complex systems require greater competencies, thus internal audit has had to become ever more professional. (Cecilia Nordin Van Gansberghe, 2003.)

Reporting relationships of internal auditing has changed and developed together with the progress of internal auditing. At the beginning reporting lines of internal auditors went to the accounting level and external auditors, who saw internal auditors mainly as assistant in financial audits. Accordingly as functions and roles of internal auditing expanded, changed and shifted more to management oriented matters than accounting matters, reporting lines have also been transformed and currently in many countries internal audit reporting have also been transformed. Internal audit reporting lines ideally classified in to administrative and functional, the chief audit executive should report functionally to the board or audit committee and administratively to the chief executive officer of the organization. (Rolandas Rupsys, 2005.)

In addition, the development in internal audit profession brings change in the scope and the reporting relationship with internal audit customers. Initially the major role of internal auditing focused on an accounting oriented function that has been gradually transformed into management oriented profession. Previously internal auditors were seen just as an assistant of accountants and

an external auditor but recently internal audit is certainly is considered an independent profession, which is playing a significant role in the management of organizations.

Besides, Independence of auditors have always been a sensitive issue, especially for internal auditor in which the internal auditor expected to be independent, while he/she is the employees of the organization, above all, not clearly organized structure or reporting line make the problem more complicated.

Moreover, the emergence of the concept corporate governance and audit committee brings change in the reporting relationship of internal auditors. In many countries internal audit required to report functionally to audit committee and it is also play key role to assist the board and/or its audit committee in discharging their governance responsibility.

The main purpose of this project is to conduct a survey study through analyzing the reporting structure of internal audit, and identify the correlation of internal audit scope, independency, good governance and audit committee with internal audit reporting relationship in relevant with Ethiopian Public Enterprises and make recommendations on this particular concern.

## **1.2. Statement of the Problem**

Internal audit is facing many challenges, some of the challenges identified by the Ministry of Finance and Development, in Internal Audit Manual are: lack of expertise leading to trivial auditing findings, lack of opportunity for professional development, repetitive audit routines which staffed members can predict, being assigned to tasked such as accounting and pre-control of expenditures with the internal auditor subsequently have to audit (conflict of interest) , inability to insist on getting significant information because fears of losing promotion opportunities and job security

(lack of independence), wrong perception of the audit function and auditors by the staff of the public body.

The above-mentioned problems can be classified into two categories with some overlapping. First, the competency of internal auditor that leads to trivial audit finding, lack of professional development, repetitive audit work, and non-value added internal audit report. Second, structural problem (reporting relationship) in the form of assigned task that impair the auditor independency, and fear of losing promotion, job security , and wrong perception about internal auditors as fault-finders and their task as policing rather than auditing.

Above all, vague reporting relationship brings: -

- Poorly motivated and frustrated internal audit staff because of limited scope of audit
- Lack of independence
- Weak organizational governance
- Internal auditor can also suffer from low status that leads to inefficient and ineffective internal audit work

### **1.3. Research Questions**

The study will try to answer the following research questions.

1. To whom the internal audit unit report in Ethiopia public enterprises?
2. Does the current reporting relationship of Public enterprises actually or potentially impair the internal auditor's independency?
3. Are the public enterprises internal audit purpose, authority and responsibility formally defined in the internal audit manual or charter?
4. Does the reporting relationship in Ethiopian public enterprises promote the role of internal auditors in good governance?
5. What is the level of management or the employee awareness about the role of internal auditing?
6. How is the educational qualification and professional experiences of internal auditors?
7. Are the internal auditors satisfied with the management response for audit findings?
8. What are the major activates or scope of Ethiopian public enterprises internal auditors?

#### **1.4. Objectives of the study**

The study tries to analyze the reporting line of internal audit and investigate its relationship with internal audit scope, independency, good governance and audit committee, furthermore conduct a survey study on selected Ethiopian public enterprises and recommend possible ways to cope up the problems identified from the research result, so that to promote the image of internal audit profession. Specifically the researcher plans:

- To Investigate the reporting line of internal audit unit in Ethiopian Public enterprises, and its actual or potential effect on internal auditor's independency
- To assess the quality of public enterprises internal audit unit
- To look in to the responsiveness for corrective action from the management  
(Conflict of interest)
- To examine whether managers or employees of those organizations have proper understanding and knowledge of internal audit role in good governance
- To recommend alternative solutions for the actual problems that will be identified by this research

#### **1.5. Hypothesis**

The preliminary study, observations made by the researcher, and different previous researches on this subject show reporting lines of internal audit activity are not always organized and practice as they should be ideally (theoretically). In addition, it has direct impact on audit scope, independency, and internal audit contribution for good governance that negatively affect the effectiveness of internal audit.

## **1.6. Significance of the Study**

The researcher believes that the result of this research project would have the following significances.

- This project paper could be used as an initiation for those who are interested to conduct a detailed and comprehensive study regarding the internal audit in Ethiopian Public enterprises.
- It will enable the governing body, specifically the managements, the higher responsible body, and audit committee of selected public enterprises, to be aware of the importance use of internal audit, and gives insight how they use the internal audit service most efficiency.

## **1.7. Scope and limitation of the study**

The researcher believes that the findings of this study would have been more productive if it has been conducted on all governments and non-governments organizations in Ethiopia. However, due to time and financial constraints, it is out of the reach of the researcher to incorporate all in this study. Due to this, the project is limited to 12 randomly selected organizations from non-budgetary government organizations (Public Enterprises).

## 1.8 Methodology

This research uses both stratified and random sampling method. First the public enterprises was divided into four sectors as shown in table one, then the non-budgetary organizations (public enterprises) were grouped in different strata according to their sector, and three organizations are randomly selected from the public enterprise in the sector

No	Sectors	Selected public enterprises
1	Financial Sector	Construction & Business Bank
2		Commercial Bank of Ethiopia
3		Ethiopian National Insurance
4	Construction Sector	Tikur Abay Construction
5		Construction Material Supply
6		Batu Construction
7	Transportation, Communication and Power	Ethiopian Shipping Lines
8		Ethiopian Electric and Power Corporation
9		Ethiopian Telecommunication Corp.
No	Sectors	Selected organizations

10	Manufacturing	Zequala Steel Rolling Factory
11		Aday Ababa Yearn Share cop.
12		Yekatit Paper Convert

*Table one: sample public enterprises*

The researcher will use both primary and secondary sources of data.

**Primary data** was obtained through structured questionnaires, as well as the over all observation of the researcher. Questionnaires will be distributed to the internal auditors, and internal audit services users (i.e. managements) in the selected public enterprises.

**Secondary data** sources were the selected:

- Articles
- Journals
- Internal audit manuals
- Websites and other documents that are related to the topic under study

## **1.9. Analysis Method**

Both quantitative and qualitative data analysis method were used. First the data were collected through the questionnaires and analyzed by using spreadsheet for descriptive statistics and qualitative method of analysis is employed for feedbacks obtained using open-ended questions then graphs, tables and charts were used to present the research findings.

## **Chapter two**

### **Literature Review**

#### **2.1 Internal Audit - Historical background**

##### **2.1.1. Evolution of Auditing**

The history of auditing started as man's awareness of the need to safeguard state and personal property that has been inferred from the records of a Mesopotamian civilization going back as early as 3500 BC. These records, involving financial transactions displayed various markings, which may be construed as a system of verification, internal controls and separation of duties. (Cecilia Nordin Van Gansberghe, 2003.). Ancient Rome employed the "hearing of accounts", where one official would compare his records with those of another, entails an application of both separation of duties and verification practice, hearing of accounts, which gave rise to the term "audit", from the Latin "Audire", to listen.

In the medieval period, Industrial Revolution in Europe, changed the role of auditing that went beyond hearing of accounts to include verification of accounting records and associated supporting documentation

Since Second World War internal audit, has evolved rapidly from the primarily function, which is concerned with financial and accounting matters to the one that addresses the entire range of operation activities. Internal audit profession has advanced primarily as consequences of; the increase size and decentralization of organization, the greater complexity of their operations, and the resulting need for means of monitoring their numerous activities, various government

organizations are expected to have an internal auditing function and an audit committee composed of non management directors. (Irvinn Gliem, 2000)

### **2.2.2. The development of internal audit in Ethiopia**

An Internal Auditing function has existed for quite a long time in Ethiopia; however, it got legal recognition in late 1980s. The internal Auditing function started in the budgetary public sector as part of internal control. However the latter part of the 1940s witnessed the establishment of Internal Audit functions in the Ministry of National Defense, Ministry of Education, and Ministry of Finance. It was also at this time that the Internal Auditing units began to sprout in non-budgetary public sector (Public enterprise) like Ethiopian Highway Authority, Ethiopian Airlines, Ethiopian Telecommunication, and financial sector that formed the modern layer of the National Economy (Lemma Argaw, Dec 2000)

Internal Auditing in Ethiopia obtained legal recognition for the first time in 1987 through Proclamation No. 13/1987. This proclamation empowered Office of Auditor General (O.A.G) to direct the Internal Auditors of Government Offices and Public Enterprises in three aspects that are whether accounting records are properly maintained and reliable, whether the assets of the ministries and enterprises are adequately safeguarded and properly maintained; and whether policies and procedures laid down by top officials/management are complied with that implies less attention was given to operational audit as a service to management.( Lemma Argaw, Dec 2000)

In 1994 the civil service reform program organized a task team that was formed by Prime Minister to assess and review the performance of Civil Service and come with the following findings: absence of Internal Audit functions in some of the Ministries and Public enterprises, internal auditors devoted most of their times and efforts on pre-audit, internal auditors neither have the skills needed nor working manuals.

On July 1, 1997 the Financial Administration Regulations No. 17/1997 was issued in which the responsibility of internal audit function was transferred from the Office of the Auditor General to the Ministry of Regulation set out the responsibilities of the Minister of Finance to develop and maintain appropriate standards of work and conduct for application throughout all the public bodies internal audit function and after this financial regulations almost all public bodies established Internal Audit Services; almost all public bodies discontinued pre-audit or pre-checking.(Wolderuphael W. Giorgis, 2000)

In 1998 the Ministry of Finance issued an Operational Audit Manual to strength the Audit function in the Public bodies. According to this manual internal audit services are made to report to the top persons of the organizations.

In May 2007 policy directive was issued to further strengthen the Internal Audit service function in the public bodies, however, the legal basis laid down by both in the Regulations of Council of Ministers and the Ministry of Finance Directive is applicable only to internal auditing under the auspices of Public bodies and does not apply to public enterprises and the private sector, but recently Public Enterprises Supervising Authority has issued policy directive for establishment of audit committees in all public enterprises and an audit manual to maintain uniformity of audit work in all public enterprises (Appendixes 4 and 5)

Generally, the history of internal auditing in Ethiopia dated back to the 1940s just about the time the profession was also evolving in Europe and in the United States. Although, the prologue of internal auditing in our country counts half a century and all the above endeavors has made to the development of internal audit in Ethiopia there are challenges that hinders or slows the speedy growth of internal audit. (Lemma Argaw, Dec 2000.)

In this chapter we try to analysis the reporting structure of internal audit, looking in to the relationship between reporting relationship and internal audit scope explain how independency

could be impeded by reporting relationship, elucidate the relationship between corporate governance and reporting relationship, and finally discuss internal audit relationship with audit committee

## **2.2. Analysis of internal audit reporting Structure**

Theoretically, the Chief Audit Executive should report functionally to the board or audit committee and administratively to the chief executive officer of the organization and functional reporting line for the internal audit function is the ultimate source of independence and authority (Rolandas Rupsys, 2005). Report functionally means that the governing authority would approve the overall charter of the internal audit function, approve the internal audit risk assessment and related audit plan, receive communication from the C.A.E on the results of the internal audit activities or other matters that the C.A.E determines are necessary, private meeting with the C.A.E without management present, approve all decisions regarding the appointment or the removal of the C.A.E, approve the annual compensation and salary adjustment of the C.A.E, and make appropriate inquiries of the management and the C.A.E to determine whether there are scopes or budgetary limitation that impede the internal audit function to execute its responsibility. On the other hand administrative reporting is the reporting relationship within the organization's management structure that facilitates the day-to-day operation of the internal audit function it is typically includes, budgeting and management accounting, human resource administration including personal evaluations and composition, internal communication and information flow, administration of the organization's internal policies and procedures (Irvin N. Gleim, 2002).

However, different research results show that theoretical approach usually is not always implemented practically. For instance as the survey of the chief audit executives made by the IIA for 2003 shows, functional reporting lines of the internal audit activity sometimes deviate from the ideal or theoretical reporting relationship.

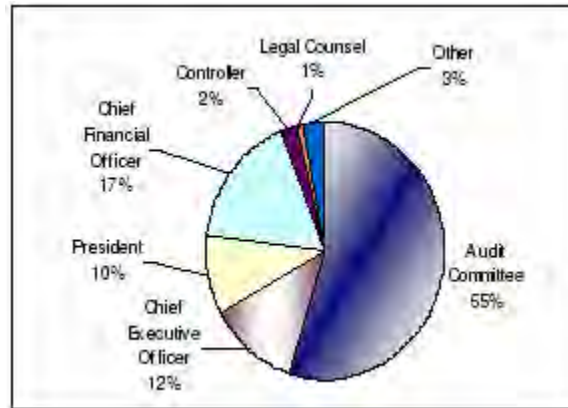


Chart 1: Functional Reporting Responsibilities  
 (Source: the IIA Research Foundation, 2003)

According to the above figure, 55 percent of respondents functionally report to the audit committee, and 22 percent of respondents have answered that they report to the president or Chief Executive Officer. However 23 percent of the respondents’ reporting relationship is not in accordance with the theoretical fundamentals.

At the same time about 50 percent of respondents answered that administratively they report to the Chief Financial Officer. Only 33 percent of respondents administratively report to the C.E.O or president. Ideally the Chief Audit Executive should report functionally to the C.E.O.

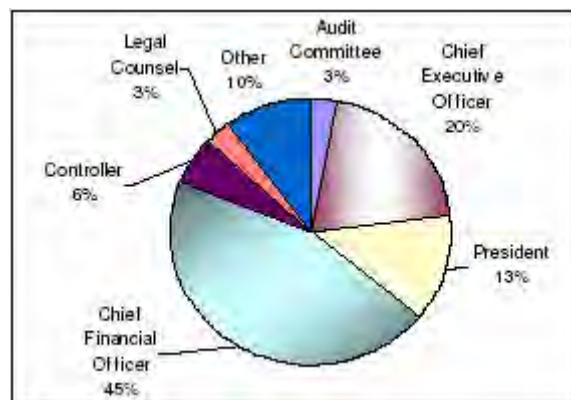


Chart 2: Administrative Reporting Responsibilities  
 (Source: the IIA Research Foundation, 2003)

From the above figure we can infer that administrative reporting lines in practice are not always organized by the theoretical assumptions. (Rolandas Rupsys, 2005) argues that the reason that empirical data deviates from theoretical fundamentals is the traditional concerns of internal auditing, means when internal auditors primary concern more on accounting and financial issues rather than on managerial matters. The argument may be right when the organizational structure permits the internal auditor to report to the C.E.O and the C.E.A fails to do so.

Another research conducted by Michael J. Barrett and Victor Z. Brink in 1980 to evaluate Reporting responsibilities of internal auditors, also shows the same result as the above research. Researchers use the term primarily reporting responsibility and supplemental reporting responsibility instead of administrative reporting responsibility and functional reporting responsibility respectively. The data is collected from 395 public and business organizations. Internal auditors were asked to identify the person to whom they had primary reporting responsibility and the results are shown in the following table

Board of director/ audit committee	8%
Chief executive officer-President	18%
Vice president - finance	41%
Controller (chief financial officer)	23%
Other	10%

*Table 1: primarily (administrative) reporting responsibility of internal audit*

Source: *Evaluating Internal/External audit Service and Relationship* page30

This research shows that most internal auditing departments primarily report to chief financial officers, and the research accounts, supplemental (functional) reporting responsibility of most organizations is to the boards of directors usually through their audit committees, however, most respondents said that they reported most frequently when asked by the boards, and the respondents are satisfied to report to audit committee so that they believe it promotes high recognition for internal audit profession (Michael J. Barrett and Victor Z. Brink, 1980). From this finding we can conclude that formally defined reporting responsibilities and reporting functionally to audit committee and/ or board are very important for the recognition of internal audit profession, so that it places internal audit department in the highest level of the organization.

Organizational structures for internal audit function vary among countries. Miekatrien Sterck and Geert Bouckaert conducted a study on six organization of economic co-operation and development countries- Australia, Canada, Netherlands, Sweden, the United Kingdom and United States the study which was part of broader international comparative research with the particular concern of public internal audit department that is conducted between 2002 and 2005 for the ministry of the Flemish community, Belgium, examined the internal audit organizations and internal control systems in the central and federal governments of these six countries after analyzing government reports and legislation and conducting interviews with civil servants and government experts the research group found numerous similarities in internal audit mandates, the types of services provided by internal audit, its organizational structure and human resources challenges. The research result is presented as follows:

The organization of the internal audit function has three forms. First, some countries have a single internal audit unit responsible for auditing all central government departments and agencies like in Canada where the comptroller General's Office provides audit services to small departments and agencies. Second, internal audit units situated at the entity level as in Australia, United Kingdom

and United States. Third, the hybrid of these two scenarios for instance, in Sweden there is one internal audit unit covers the Prime Minister's Office, the Ministries, and the Office for Administrative Affairs, and the large Swedish agencies have their own separate internal audit organizations.

As the researchers examined in all six countries the head of internal auditing is supposed to report to the head of the department or agency that ensure independency. However, senior management is not always as interested in internal audit results. For example, according to the Auditor General of Canada, "the lack of support from senior management has prevented internal audit groups from contributing as much as they could." (Miekatrien Sterck and Geert Bouckaert, 2006)

We argue that even if countries have a right to design the internal audit structure that can work for their context central office unit is needed that is responsible for developing and coordinating internal audit policies at country level specifically for public sectors to uphold the independency of internal audit unit that is located at the entity level.

Another research conducted by IIA Research Department, which sent an electronic survey to all its members illustrate the relationship between job satisfaction and reporting relationship. The result explains overall 88 percent were satisfied with their level of access to the audit committee or board of directors. 12 percent said their reporting relationships did jeopardize their independence and that they had tried to resolve this issue, without success, with their audit committee, senior management, or both (IIA Research Department, 2003) that makes internal auditors dissatisfied with their work that implies a direct relationship between IA job satisfaction with level of IA in the organization (internal audit reporting relationship)

In the article posted on CFO.com by Sarah Johnson to answer the question "should Internal Audit Report to the CFO? Moody's recommends that the chief internal auditor report to the CEO and the audit committee, not the CFO." (Sarah Johnson, 2003). Eighteen people posted their comment on

this article and the full comment is attached in the appendix part of this project (Appendix 3), but the main ideas are summarized as follows: Some agrees that the answer is depending on the role or scope of internal audit. Others respond that internal audit should report to C.E.O in order to foster independency of internal auditor in fact and appearance and to promote the level of respect for the internal audit team. The remaining believes internal audit should only report to the board appointed audit committee so that to raise the level of professional responsibility and the stature of internal audit profession. We analyze that many of the comments are ignoring the dual reporting responsibility of internal audit that is administrative and functional, however, the result at least implies internal audit needs clear structure that promote the profession and independency of internal audit.

### **2.3. Reporting relationship and internal audit scope**

Reporting relationships of internal auditing has changed and developed together with the progress of internal audit discipline. At the beginning (when internal auditors mostly were dealing with accounting and financial issues) reporting lines of internal auditors went to the accounting level and external auditors, who saw internal auditors mainly as assistant in financial audits. Accordingly as functions and roles of internal auditing expanded, changed and shifted more to management oriented matters than accounting matters, reporting lines have also been transformed. Moreover, if at the beginning reporting lines of internal auditing were generally simple and straightforward; together with changed functions of internal audit they have made a shift to more complex and difficult relationships. (Rolandas Rupsys, 2005)

The change in internal auditing scope is best seen in the definition of internal auditing adopted by The Institute of Internal Auditors.

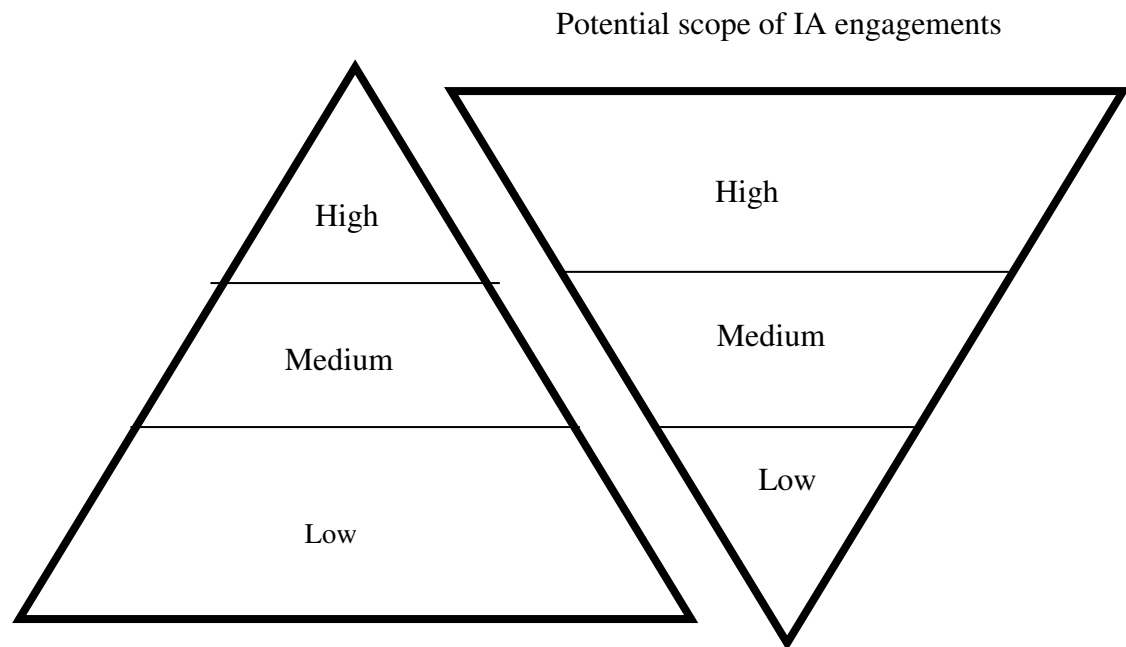
*Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. (Irvin Gliem, 2000)*

This definition recognizes two major pillars of internal audit that are the scope of internal auditors and constituencies or customers of internal auditors. The scope of internal auditors is to provide independent, objective assurance and consulting activity, so that to add value to the organizations in the course of evaluate and improve the effectiveness of risk management, control, and governance processes. At the same time, it recognizes that there are many different constituencies for internal audit services that are: Senior management, who are interested on the accomplishment of the objective of the organization, operational management they focuses on the value added services of internal auditors for the improvement of organization's operations, and audit committees and the board of directors their center of attention are the effectiveness of risk management, control, and governance processes. (IIA Research Department, 2003)

The question that should be raised at this juncture is how internal audit serve these different constituents? And how should be the reporting relationship with those constituents? Because there

will be potential conflicts and demands from the various customers, for instance audit committees are primarily interested in assurance services regarding risk and control, operational management is primarily concerned with consultative help regarding the efficiency of operations and adequacy of control mechanisms, senior management is concerned with both consultative advice and assurances regarding risk and control. However, there may be overlap (i.e. operational management may desire assurance about the effectiveness of controls that has implemented to control the operations for which it is responsible. Audit committees may want consultation regarding risk assessment and control processes.)

According to A.A.A (American Accounting Association) analyses on independency and objectivity framework for internal auditors, the above mentioned expansion of internal audit scope and constituents is correlated with the organizational status of the internal audit unit. When there is high-level reporting, the scope of potential engagements is less limiting; when there is lower-level reporting, the reporting universe (i.e. the population of users who could benefit from the audit reports) becomes more limited. This concept is illustrated in Figure 3 as a direct relationship between organizational status and the potential scope of engagements. The traditional pyramid on the left represents increasing organizational status and reporting level for the internal audit unit as one goes from the base to the top. The inverted pyramid on the right represents the potential scope of engagements that can be undertaken given the organization status of the internal audit unit. The potential scope is greatest with high-level reporting and narrowest with low-level reporting activities. (IIARF, 2001)



Organizational level to which IA Reports

*Figure 1: The Relationship between Reporting Level and IA Scope*

*Source: independency and objectivity: a framework for internal auditors*

The above pyramid shows that whenever the expectation from internal audit report or the increase in the scope of internal audit leads to the adjustment in the level of internal audit status in the organization into the highest level.

Ten years ago, internal audit might have seen as an adjunct of external audit, or as a box-ticking, fault-finding function that provided nothing much in the way of constructive value. But attitudes have changed, people have changed their minds about what internal audit can deliver and a lot of internal audit's customers are educated about internal audit profession role and scope (Richmond, Dec 2006) this connote the scope and the service expected from internal auditor internal audit is changing significantly in a short period of time as the scope of internal audit changes.

Many articles have been written about the change in internal audit scope: The article by Prof. Johannes Kinfu on the title “The Upstream and Down Stream of Internal Audit” explains internal audit has been evolving from downstream of internal audit that focuses on the origins of transaction recording and balancing in to the upper management task and becoming tool of management for planning, organizing, and control (upward stream of internal audit.) and this evolution demand the interlocking capacities in order to effectively perform its’ role, which are: advisory capacity, implementative capacity. Reporting capacity, and routine testing responsibility and the article concludes that these capacities and responsibilities definitely enlarge the internal audit role and function ever wider, demanding more extensive knowledge and not specialization in traditional fields.( Prof. Johannes Kinfu, 2000)

Rolandas Rupsys put in plain words about internal audit activity in the organization and broad range of internal audit functions, which are assessment of internal controls, operational audits, compliance audits, fraud investigations, partial or full participation in financial audits, providing an independent assessment on risk management, control, and governance processes of the organization. (Rolandas Rupsys, 2005)

Moreover, new companies act places greater emphasis on non-financial reporting, and internal auditors should be well placed in the organization to make sure the businesses get the most from this change of emphasis positioned to help businesses manage the risks and take advantage of business opportunities. Internal audit, with its traditional focus on financial data and reporting systems, may be wary of addressing this new area, so the internal auditors should stepping out of their comfort zone to satisfy this demand of the organizations. (Richard Porter and Jon Hauck, March 2007), so the scope of internal audit is not only narrow- focusing on financial compliance and internal.

Generally, in the past, internal auditors were taken as fault finders and intruders and their contributions were measured the number of frauds they detect in the course of their audits. They were also seen as specialists in negative reporting, focusing on what is wrong within an organization and discovering other's mistakes. The passage of time has shown some dramatic changes on the image of internal auditing. Gradually internal auditing has changed from a "watch dog" to a "help dog". In other words, the image of internal auditors has changed from feared policemen more and more as internal consultants and as valued employees who understand the problems of management and are capable of providing the needed controls and problem solving skills (Wolderuphael W. Giorgis, December 2000). However, the question from our country prospective is that, is the scope of internal auditor changed from the protective functions, such as audit balance sheet accounts, the routine verification of the financial transactions, accuracy of calculations, and adequacy of physical custody in to evaluating and improving the effectiveness of the risk management processes, control processes and governance processes?

Above all, the competency of auditor determines the scope and the quality of audit work performed in the organization. Competency is measured in terms of academic level, experience, skill and the effort of staff to continue professional development. Competency determines the efficiency of the auditor setting a systematic and disciplinary approach to evaluate and improve the effectiveness of the risk management, control and governance processes and add value to the organization. In addition the audit activity must have sufficient funding relative to the size of its audit scope because budget impacts the audit activity's capacity to carry out its duties (Zelege Belay, April 2005).

In conclusion, the reporting relationship, audit scope, competency of the internal auditor, and sufficient budget for internal audit are interrelated factors that positively or negatively affect the efficacy and effectiveness of internal audit function.

## **2.4. Reporting relationship and independency**

Independence and objectivity are often treated synonymously; however, according to Webster's dictionary defines independence as the quality or state of being independent. Independent, in turn, is defined as being not dependent, not subject to the control of others, not subordinate, and not requiring or relying on something or someone else. Also, to be independent is defined as not looking to others for one's opinions or for the guidance of conduct and not being biased by others. Objectivity, on the other hand, is defined as an existing independence of mind, relating to an object, as it is itself, and also as expressing or involving the use of facts without distortions by personal feelings or prejudice. In comparing the two concepts, it becomes clear that even if one is lacking independence (I.e., dependent subject to the control of others, subordinate, and requiring or relying on someone else.), it is still possible for one to be objective in the sense of relating to an object as it is itself or expressing or involving the use of facts without distortion by personal feeling or prejudices. (IIARF, 2001)

The organizational structure of the internal audit unit poses a practical constraint or a limit on the independency and/or objectivity of internal auditor. For example, if the internal audit unit is situated in the finance's department with the director of internal auditing reporting directly to the CFO, it is difficult, if not impossible, for internal auditor to objectively evaluate the performance of peer offices under the controller. In general the higher the reporting level, greeter the independency and/ or objectivity of internal auditors. (IIARF, 2001)

Obviously, in today's modernized system of audit and control the auditor frequently plays an important advisory role which may jeopardize his or her independence, auditors may find themselves too involved in consultancy. For example, in the United Kingdom internal audit units play an important role in supporting the accounting officer, however, if the internal auditors are too involved in developing the internal control systems it may become more difficult to maintain independence when auditing these systems. Additionally, some internal audit units do not have a direct reporting line to the head of the department or agency which may compromise their independence. (Miekatrien Sterck and Geert Bouckaert, 2006)

So far we can see that reporting relationship is one of the factors, which affect the independence of internal audit. However, what are the key measures that will ensure that the reporting lines support and enable the effectiveness and independence of internal audit function. Institute of internal auditors suggests the following main measures regardless of the reporting relationship the organization choose (IIA, practical advisory, 2002). The measures are summarized as follows:

- The head of internal audit should meet privately with the board/ audit committee without the presence of management. This will reinforce the independence and direct nature of the reporting relationship
- The board/ audit committee should have the final authority to review and approve the annual audit plan and all major changes to the plan.

- The board/ audit committee should review the performance of the head of internal audit and the overall internal audit function at least once a year, as well as approve the compensation level for the head of internal audit
- The charter for the internal audit function should clearly articulate both the functional and administrative reporting lines for the function as well as its principal activities
- The reporting line should be to someone with sufficient authority to provide internal audit with sufficient support to accomplish its day-to-day activities
- The reporting line should facilitate open and direct communication with the CEO, the senior executive group and line management
- The reporting line should enable adequate and timely information flow, so that internal audit receives adequate communications and information concerning the activities, plans and business initiatives of the organization
- Budgetary control and consideration imposed by the administrative reporting line should not impede internal audit in the process of auditing

## **2.5. Reporting relationship with Audit Committee**

In relation to the emergence of the concept corporate governance a marked increase in audit committee activity is occurring around the world, primarily driven by rules and recommendations issued in response to local corporate crises. Audit committees' involvement in overseeing internal auditing, risk management activities and the effectiveness of internal control is clearly expected and explicitly stated in many countries' rules. We are going to review the experience of twelve countries

that are: Australia, Canada, China, Germany, Hong Kong, Mexico, Netherlands, Russia, United Kingdom, South Africa, and Ethiopia respectively (Curtis C. Verschoor, 2001)

In Australia Corporate Governance Council of the Australian Stock Exchange (ASX) issued (“Principles of Good Corporate Governance and Best Practice Recommendations”) in 2003. This document recommends that audit committees be composed of non executive directors accountable to the board, a majority of whom are independent, and that the audit committee's role include, among other things, assessing the performance and objectivity of the internal audit function; reviewing results of risk management and internal compliance and control systems; and assessing whether external reporting is consistent with audit committee members' information and knowledge and is adequate for shareholder needs.

Canadian Securities Administrators issued rules to improve investor confidence in early 2004. The rules mandate independent audit committees, require written committee charters, authorize audit committees to communicate directly with internal auditing and accountable to the board.

The China Securities Regulatory Commission requires at least one third of board members to be independent directors, and its rules provide for the optional appointment of an audit committee. If an audit committee is established, a majority of it's members must be independent, and at least one independent director must be an accounting expert. The committee's principal responsibilities should include supervision of the internal audit function.

In Germany the Transparency and Disclosure Act was passed in July 2002 requiring companies' bylaw to publish an annual statement of compliance or noncompliance with the code's recommendations. The code recommends the establishment of audit committees that would be accountable to the board to deal with issues of accounting, auditing, and risk management.

The Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited and The Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock

Exchange of Hong Kong Limited require listed companies to establish an audit committee composed of non executive directors, a majority of whom are independent. The audit committee should have clear terms of reference, including oversight of the financial reporting system and internal control procedures.

The Mexican Securities and Banking Commission recommend that all public companies adopt its Code of Best Practices, which recommends the size, role, and responsibilities of the audit committee. Among those responsibilities are assisting the board in reviewing financial information for external reporting and helping to oversee internal control systems and to evaluate their effectiveness.

In Netherlands the Dutch Corporate Governance Code, issued in 2003, recommends practices for the supervisory board and the audit committee. The supervisory board should supervise the operation of the internal risk management and control system. The corporate governance code recommends that audit committees be established and fulfill an oversight role with regard to the responsibilities and functioning of internal auditing and the organization's compliance with recommendations and observations.

In Russia Corporate Behavior Code was developed in April 2002 recommended the establishment of an audit committee for purposes of implementing and monitoring controls over an organization's financial and business activities, the code also recommends that the audit committee consist solely of independent directors.

In United Kingdom Combined Code on Corporate Governance, issued in 2003, advise audit committees to monitor and review the effectiveness of the internal audit function including reviewing internal auditing remit, appointing or terminating the head of internal auditing, and meeting privately with the head of internal auditing at least annually.

In South Africa a report on Corporate Governance, issued in 2002, focuses on board and audit committee practices and the conduct to improve governance. The role, function, and reporting requirements of internal auditing are specifically covered. Audit committees are required to concur in the appointment and dismissal of the internal audit head and accountable to the board. And, the report recommends that internal audit plans be based on risk assessment as well as on issues highlighted by the audit committee and senior management.

In Ethiopia Public Enterprises Supervising Authority issued directive n<sup>o</sup>–002/97 for the establishment audit committee that explains the accountability, responsibility and authority of audit committee, which are resolving conflicts between auditors (internal or/and external) with the management concerning the audit report; evaluate the objectivity and the independency of internal and/ or auditors when they execute their duty; the audit committee is accountable to Public Enterprises Supervisory Authority.

(E.P.E.S.A., Audit committee directive, 2003)

To summarize, two main points are mentioned in all countries practice that are the composition of audit committee and the role of audit committee. First, almost all counties have the same approach that the audit committee should be non executive independent directors, and some deemed one of the independent directors must be an accounting expert. The roles of audit committee are assessing the performance and objectivity of the IAF, reviewing results of risk management and internal compliance and control systems, assessing whether external reporting is consistent with audit committee members' information and knowledge and is adequate for shareholder needs, oversight of the financial reporting system and internal control procedures, assisting the board in reviewing financial information for external reporting and helping to oversee internal control systems and to

evaluate their effectiveness, oversight the organization's compliance with recommendations and observations, monitor and review the effectiveness of the internal audit function including reviewing internal auditing remit, appointing or terminating the head of internal auditing, and meeting privately with the head of internal audit department, resolve conflicts between auditors (internal or/and external) with the management concerning the audit report; evaluate the objectivity and the independency of internal and/ or external auditors when they execute their duty.

Our main concern is that internal auditors are functionally report to audit committee, who has the above mentioned role, so how internal auditors should work with audit committee. A research conducted by Catherine L. Bromilow, Barbara L. Berlin, and Richard J. Anderson that included face to-face interviews with more than 50 prominent audit committee chairs, corporate governance thought leaders, and C.A.E from around the world, as well as surveys of audit committee chairs and C.A.E in the United States. The final report identifies four key activities C.A.E. can undertake to strengthen internal audit and audit committee relationships.

First, Pursue ongoing communication with the audit committee chair, 59% of the C.A.E responding to the survey indicates the communication and interaction with the audit committee increased significantly. Additionally, as indicated by audit committee chairs and C.A.E. interviewed recognize that audit committees function best when they have open, candid and frequent communication with internal auditors.

Second, build audit committee awareness of risks and business issues, as revealed through interviews with audit committee chairs, risk awareness ensuring a thorough understanding of the complete set of key risks that the company faces- is a growing priority of many committees.

Third, expand or formalize audit committee training according to many of the audit committee chair interviewed, they formalize training plans at the beginning of their annual planning cycle identifying the continuing education topics they wish to cover during the year and how they'll obtain such knowledge. Audit committees look to formal conferences, in-house boardroom education, and allocating specific sessions at audit committee meetings to provide training needs.

Finally, facilitate Greater Interaction with the Audit Committee, interviews conducted with audit committee chairs indicate savvy Chief Audit Executives are taking steps to provide audit committee member with broader exposure to internal audit manger and staff.

## **2.6. Corporate governance and reporting relationship**

Recent events have highlighted the critical role of board of directors in promoting good governance. In particular, boards are being charged with ultimate responsibility for the effectiveness of their organization's internal control systems, and internal audit function plays a key role in assisting the board to discharge its governing responsibility. (KPMG, 2003)

The key role of internal audit is to assist the board and/or its audit committee in discharging their governance responsibility by delivering an objective evaluation of the existing risk and internal control framework, systematic analysis of business process and associate controls, reviews of the existence and value of assets, a source of information on major frauds and irregularities, ad hoc

review of other areas of concern, including unacceptable levels of risk, review of the compliance framework and specific compliance issues, review of operational and financial performance, recommendations for more effective and efficient use of resources, assessment of the accomplishment of corporate goals and objectives, feedback on adherence to the organization's value and code of conduct/ code of ethics.

However, in attempting to adequately discharge their responsibilities, internal auditors often find themselves in an anomalous position. They report to senior management within the organization, yet are expected to objectively review management's conduct and effectiveness. The only satisfactory solution to this problem is for internal audit to report primarily and directly to the board and/or its audit committee rather than to senior management.

## Chapter Three

### Data Presentation and Analysis

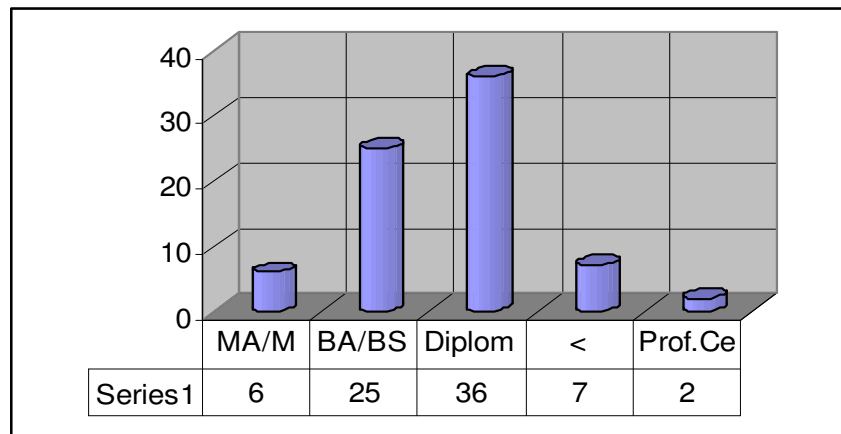
#### 3.1. Data Gathering

A survey has been carried out using the attached questionnaire (Annex1) with the goal of assessing internal audit reporting relationship and its impact on IA scope, independency, audit committee, and good corporate governance in Ethiopian public enterprises. Structured questionnaires were sent to 105 internal auditors at different positions also to internal audit service users in the selected public enterprises that are listed in table two. As shown below, 72% of them have responded:

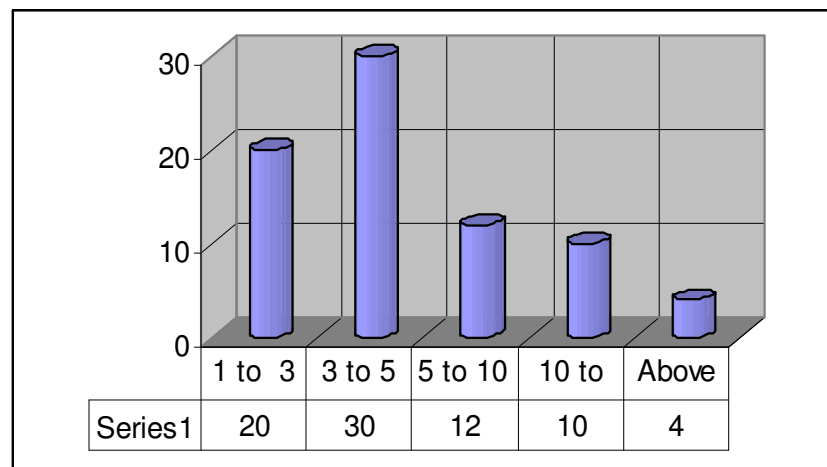
No	Sectors	Selected organizations	Sample Population	Response
		<i>Public Enterprises</i>		
1	Financial Sector	Construction & Business Bank	10	8
2		Commercial Bank of Ethiopia	10	6
3		Ethiopian National Insurance	10	9
4	Construction Sector	Tikur Abay Construction	10	6
5		Construction Material Supply	5	3
6		Batu Construction	10	8
7	Transportation, Communication and Power	Ethiopian Shipping Lines	10	8
8		Ethiopian Electric and Power Corporation	10	9
9		Ethiopian Telecommunication Corp.	10	7
10	Manufacturing	Zequala Steel Rolling Factory	5	3
11		Aday Ababa Yearn Share cop.	10	6
12		Yekatit Paper Convert	5	3
		<b>Total</b>	<b>105</b>	<b>76</b>
<i>Total response rate</i>			<b>72%</b>	

*Table 2: responding rate*

The respondents are assistance internal auditors, internal auditors (financial and performance), audit team leaders, assistance audit supervisors; audit supervisors, audit division head and some financial officers, general managers, and member of audit committee. Most of the respondents have an educational background of accounting with diploma and BA and have three to five years of work experience as internal auditor.



*Graph1: respondents' educational background*



*Grap2: respondents' work experience*

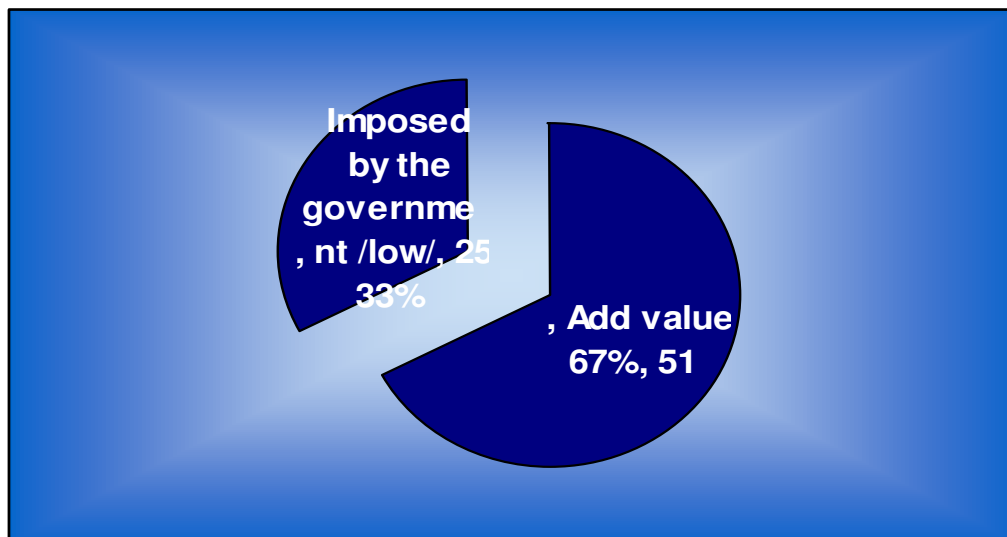
## 3.2. Empirical Results and Discussion

### 3.2.1. Introduction

Recent trends show that governments which strive for democracy demonstrate some degree of accountability in the use of public money and increase their efficiency for delivery of services.

Larger and more complex systems demand greater competency and professionalism from internal auditing, and scarce resources must be deployed more efficiently to minimize and manage risk.

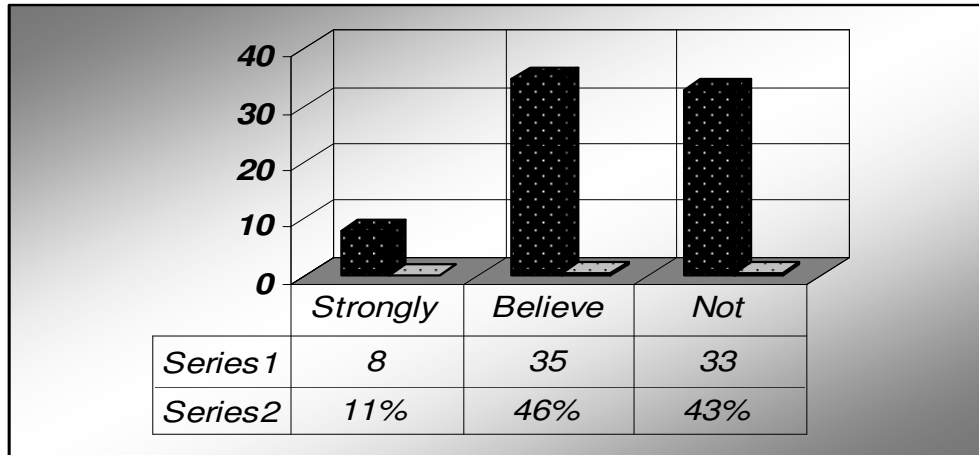
Internal audit departments of all selected Ethiopian public enterprises, were established with the primary purpose of adding value to the organizations or established by governments' imposition by law. As shown in the following chart, 67% of the respondents believe that internal audit adds value to the organization that they work for.



*Chart 3: The reason for the existence of internal audit function*

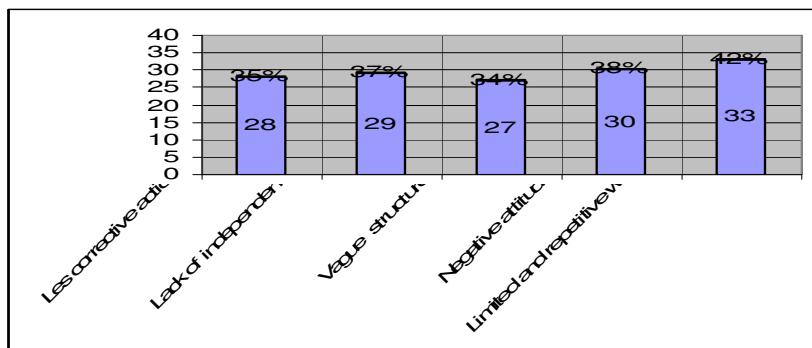
However, although the majority of the respondents agree internal audit adds value to the organization, 43% of them think that this very objective has not been met. These shares of respondents believe that a lot needs to be done for the achievement of this objective of value to the

organizations, by providing systematic and disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.



Grap3: The role of IA to address the very purpose for which it is established

Although, internal audit is expected to meet the above mentioned objectives, it is facing challenges like less management corrective action for IA report, lack of independence, vague internal audit structure, negative attitude towards internal audit, and limited & repetitive audit work as described in graph 4, and this project work covers these issues directly and/ or indirectly.



Graph 4: The major challenges of internal audit

Above all, to meet its responsibilities, as mentioned earlier in the literature review part, the IAF should have a clearly defined reporting relationship that has an impact on the internal audit scope,

independency, good governance and management response for corrective action for internal audit report.

The empirical data is analyzed using spreadsheet and is presented under annex 2 and discussion is made in the following section.

### **3.2. 2. Internal audit reporting relationship**

#### **3.2.2.1. Internal Audit Reporting Responsibility**

It has long been the recommendation of many researches reviewed in chapter two that the chief audit executive (CAE) should report directly or functionally to the audit committee, board of directors, or other appropriate governing authority, and administratively to the chief executive officer (CEO) of the organization. In this context, direct or functional reporting means that the governing authority would set the direction and approve the policies of the internal auditing activities and administrative reporting includes the administrative units facilitates the day-to-day operation of the internal audit activity.

The majority of CAE's in the Ethiopian public enterprises included in this research report directly to the board, audit committee or its equivalent, and administratively to the general manger

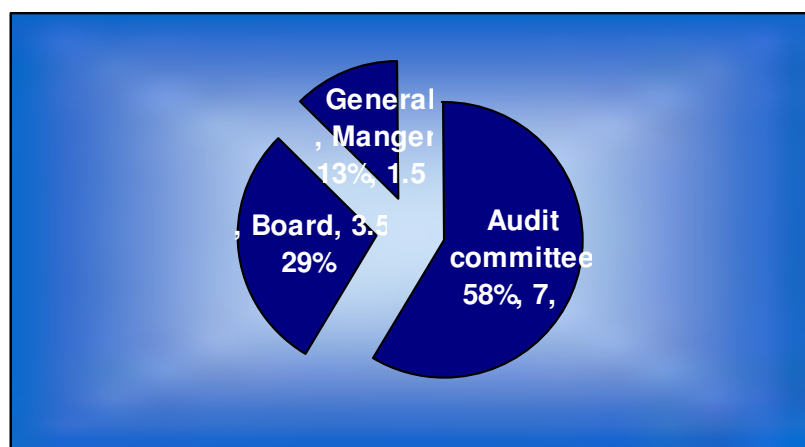
No	Sectors	Selected organizations	Functional Reporting	Administrative Reporting
		<i>Public Enterprises</i>		
1	Financial Sector	Construction & Business Bank	Board	General Manager
2		Commercial Bank of Ethiopia	Audit committee	General Manager
3		Ethiopian National Insurance	Board	General Manager
4	Construction Sector	Tikur Abay Construction	Audit committee	General Manager
5		Construction Material Supply	Audit committee	General Manager
6		Batu Construction	Audit committee	General Manager
7	Transportation, Communication and Power	Ethiopian Shipping Lines	Audit committee	General Manager
8		Ethiopian Electric and Power Corporation	Board	General Manager
9		Ethiopian Telecommunication Corp.	Board, (Zone & regional IA to General Manger)	General Manager
10	Manufacturing	Zequala Steel Rolling Factory	General Manager	General Manager
11		Aday Ababa Yearn Share cop.	Audit committee	General Manager
12		Yekatit Paper Convert	Audit committee	General Manager

*Table 3: Internal audit reporting structure in Ethiopian public enterprises*

From the research result presented in the above table, public enterprises that are under the direct supervision of Ethiopian Public Enterprise Supervisory Authority that are: Tikur Abay Construction, Construction Material Supply, Batu Construction, Ethiopian Shipping Lines, Yekatit Paper Convert, and Aday Ababa Yearn Share company do report functionally to the audit committee and they are governed by internal audit manual and audit committee directive issued by Ethiopian Public Enterprise Supervisory Authority (Annex 4 and 5).

From the Financial sector, CBE's head of internal audit reports to the organization's audit committee, and CBB and ENI report to the board, but it is noted that ENI is in the process of establishing an audit committee.

In the case of ETC, at the head office level, the functional reporting line is quarterly summarized and reports are to the board; whereas a detailed report is to be given to the chief executive officer. However, in the zonal and regional levels the reporting relationship is towards the General Manger. The same is true for ZSRF where the reporting relationship is directly to the top management. Generally the functional reporting relationship of the selected Ethiopian public enterprises is about 58% to the audit committee, 29% to the board and 13% to the general manger, as shown in the following chart

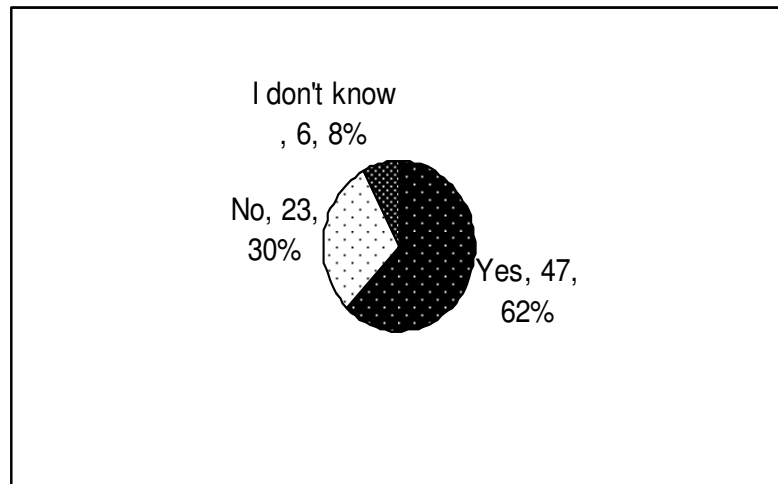


*Chart 4: Functional reporting relationship*

Keeping in mind the above facts about functional reporting line, administratively all the selected public enterprises report to the general mangers. According to a research conducted by IIA in 2003, as already is discussed in the literature review part, it is noted that administrative reporting lines in practice are not always organized by the theoretical assumptions. Nevertheless, in the cases of the selected Ethiopian public enterprises the administrative reporting line is in accordance with the theoretical foundation. As it is presented in table 3

### 3.2.2.2. Benefits and Risks Arising as a Result of the Current Reporting Line

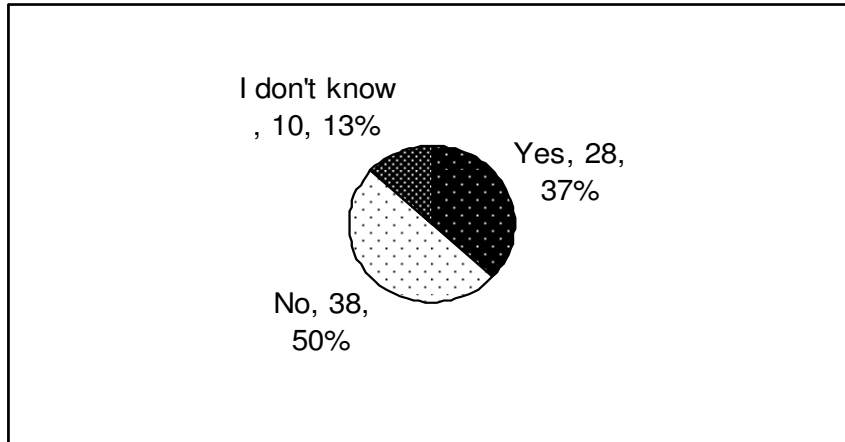
According to this survey, approximately ten public enterprises are reporting to their boards or audit committees. 62% of the respondents believe that the current reporting relationship brings about the following advantages



*Chart 5: Benefits of the current reporting relationship*

The first advantage is that it increases the internal audit work scope in the way that IA will be able to transcend all departments without fear of limitation of scope. The second advantage is that it increases the reliability of IA report. This is because the board and the audit committee know that the information they receive from IA reflects a true description and has not been “watered-down” or filtered by management. And the third and prominent advantage is that it obviously fosters IA independence.

On the other side, 37% of the respondents perceive there are risks in the current reporting line



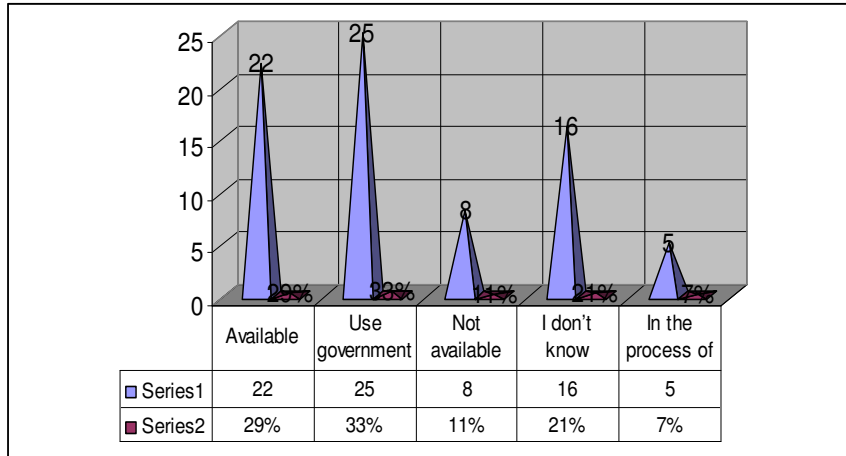
*Chart 6: risks of the current reporting relationship*

The internal audit and the users of its services face the following risks.

1. IA may be seen as “outside” the management structure,
2. The board members are ministers having several other responsibilities, so they do not allocate sufficient time to deal with the oversight of the internal auditing function.
3. And finally, it potentially restricts the ability of the CEO to use internal audit as a tool to reinforce internal control.

### 3.2.2.3. The Availability of Audit Charter

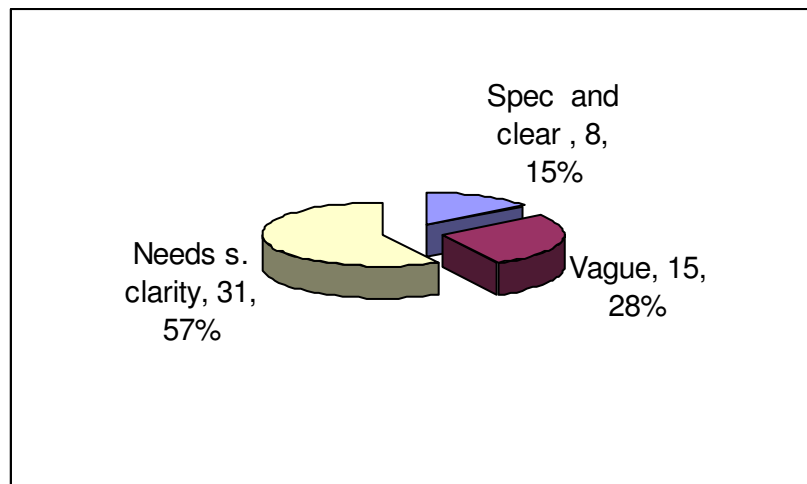
Being one of the very essential elements of internal auditing, audit charter needs to be available and clearly understood by the people in action. In other words, the audit charter’s purpose, authority and responsibility of the internal audit activity, and its reporting relationship should be formally defined and effectively communicated. Nonetheless, 11% of the respondents reply that there is no audit charter and 20% answered that they have no information about the availability of audit charter in their organizations. This implies that, if available, the audit charter is not effectively communicated in those organizations.



*Graph 5 the availability of audit charter*

#### 3.2.2.4. The Clarity of IA Charter

Assuming that audit charter is available, only 15% of the respondents believe that the audit charter is clear enough. Nevertheless, as we can see from the chart below, 28% and 57% of the respondents reply it is vague and/ or need clarity.



*Chart 7: The clarity of IA charter*

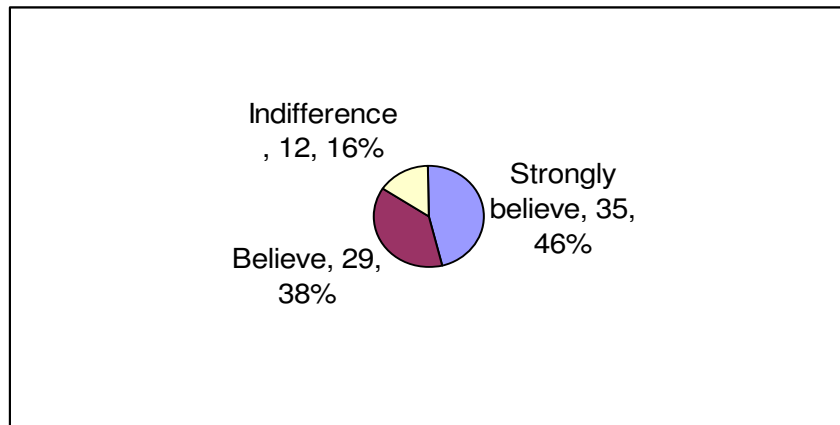
For instance, Article 5.17 of Public Enterprises Audit Committee Directive which was issued by Ethiopian Public Enterprise Supervisory Authority can be taken as a mere example. This article states about the authority and responsibility of audit committee and is highly debatable while evaluated in relation with the reporting structure. The article gives superior authority to the audit

committee to evaluate the board on how effectively it plans and leads the enterprises, and report this to Public Enterprise Supervisory Authority on quarterly basis. Moreover article 5.1 affirms an audit committee is established for the purpose of supporting the board.

### 3.3.2.3. Reporting Relationship Vs Scope of Internal Audit

#### 3.2.3.1. Relationship between Internal Audit Reporting Relationship and Scope of IA

Researches reviewed in chapter two indicate the direct relationship between organizational status and the scope of internal audit. Similarly, the result of this survey indicates that 46% and 38% of the respondents strongly believe or believe respectively on the direct relationship between internal audit scope and reporting relationship.



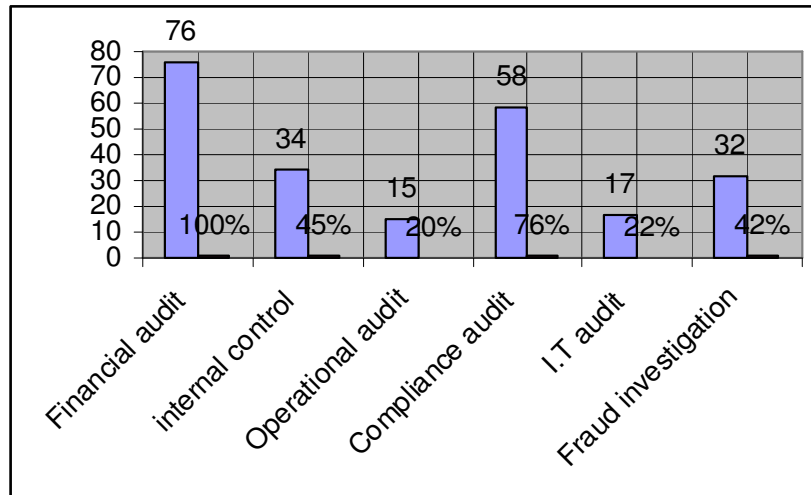
*Chart 8: IA reporting relationship Vs scope*

#### 3.2.3.2. The Current Scope of Internal Auditors

Graph six clearly indicate that, the activities of IAF are more of traditional type that emphasize on verification of accounts, compliance, internal control and a little on fraud investigation.

However, it is noted that Public Enterprise Supervisory Authority sent a directive for public enterprises that give guidance on how internal auditors shall prepare their audit plan for next year

(i.e. 2008/2009) in which the scope of internal audit is expected to include both assurance and consulting service (Appendix4).



Graph.6 scope of internal auditors

### 3.2.3.3. Size and Quality of Internal Audit Staff

To enhance the scope of internal audit, the internal audit department should have been strengthened in respect of size and/ or quality. In terms of size, 37% of the respondents reply that the internal audit staff size is not sufficient and other 13% believe the size of internal audit staff is very low as indicated in the chart below:

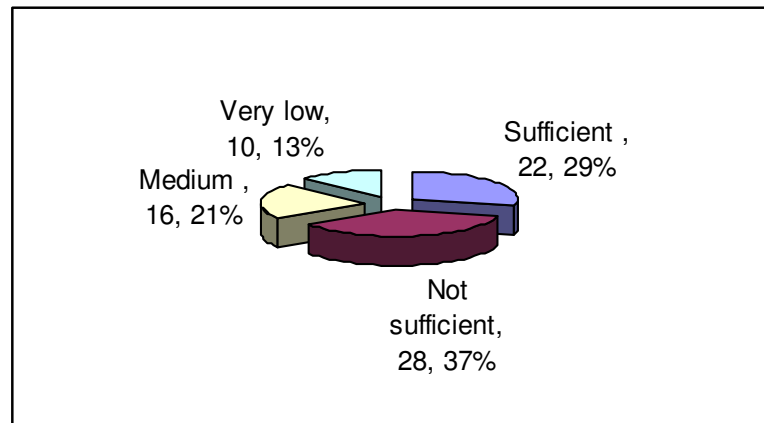
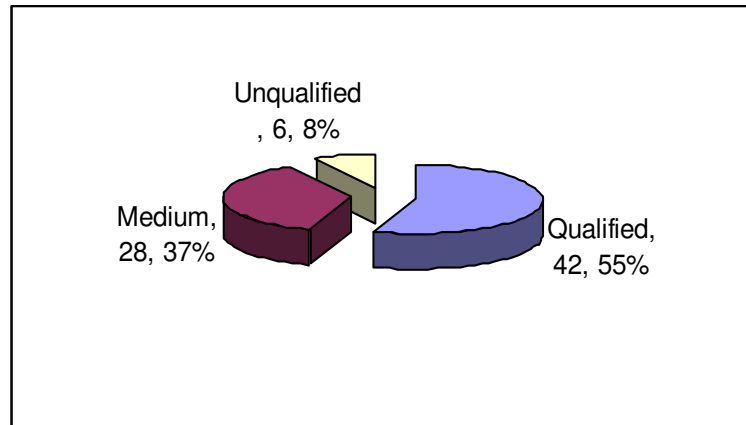


Chart 9: the size of IA staff

Beyond the above fact, many respondents believe that the medium quality of internal audit promises the possibility of improving internal audit staff. This directly contributes to the increase in the internal audit scope and related with the internal audit reporting relationship.

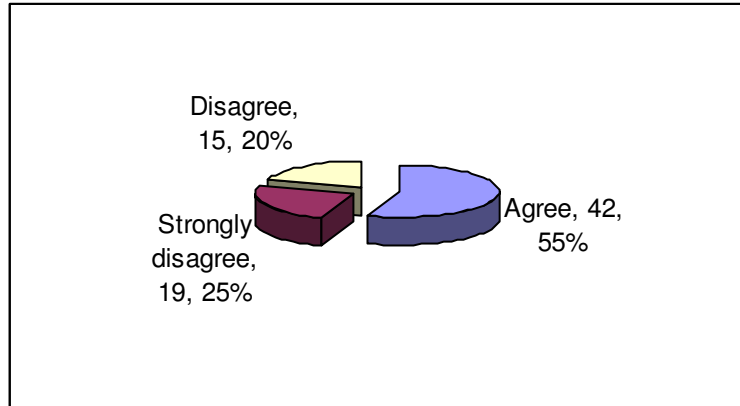


*Chart 10: The quality of IA staff*

### **3.2.4. Reporting Relationship Vs Independency of Internal Audit**

#### **3.2.4.1. Conducive Environment to Promote Independency**

A total of 55 % of the respondents believe that the current internal audit structure promotes independency. Other respondents, 25% and 20% strongly disagree and disagree respectively that the current organizational reporting relationship promotes the internal auditors' independency; specifically the functional reporting relationship with the general manager puts the internal auditors' independency at danger.

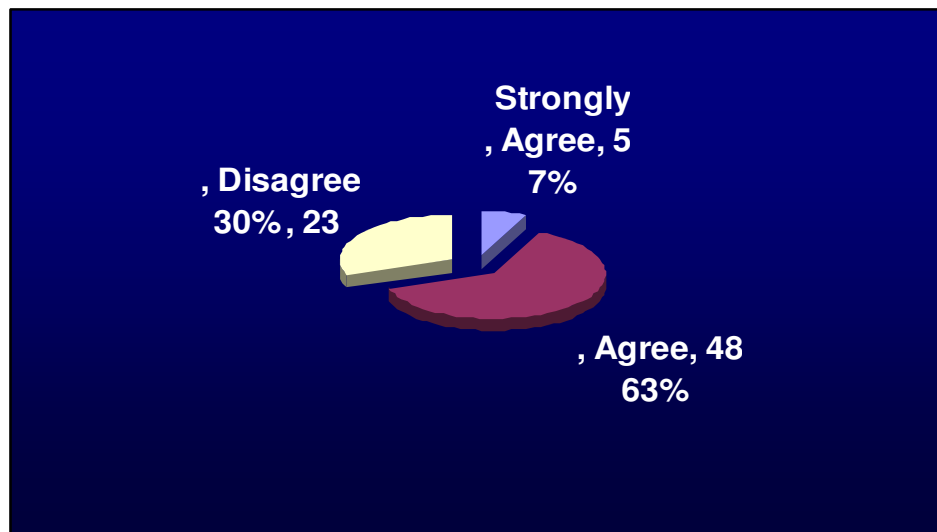


*Chart 11: independence Vs reporting relationship*

### 3.2.5. Reporting Relationship Vs IA Contribution for Good Governance

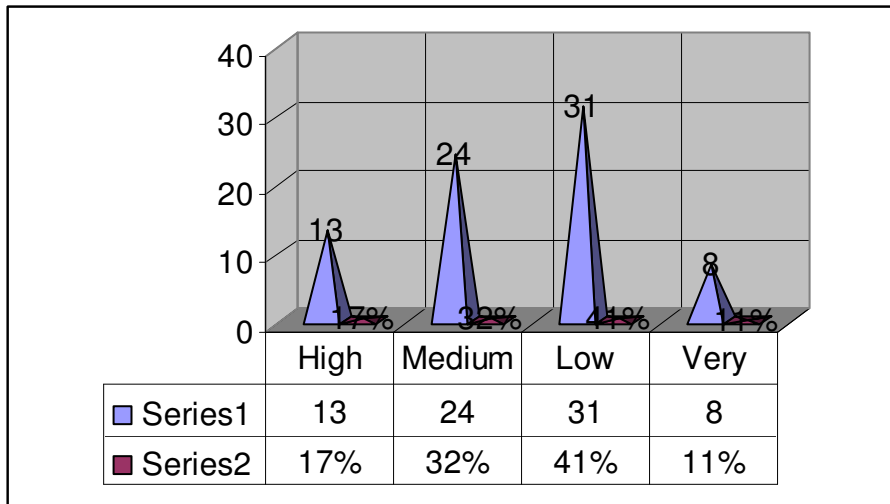
#### 3.2.5.1. Reporting Line of IAF to Promote Internal Audit in Discharging its Role in Good Governance

70% of the response asserts that the current structure of internal audit has sufficiently contributed for good governance as it was expected. However, 30% of the respondents disagree with this, as shown in the chart below.



*Chart 12: IA reporting relationship Vs good governance*

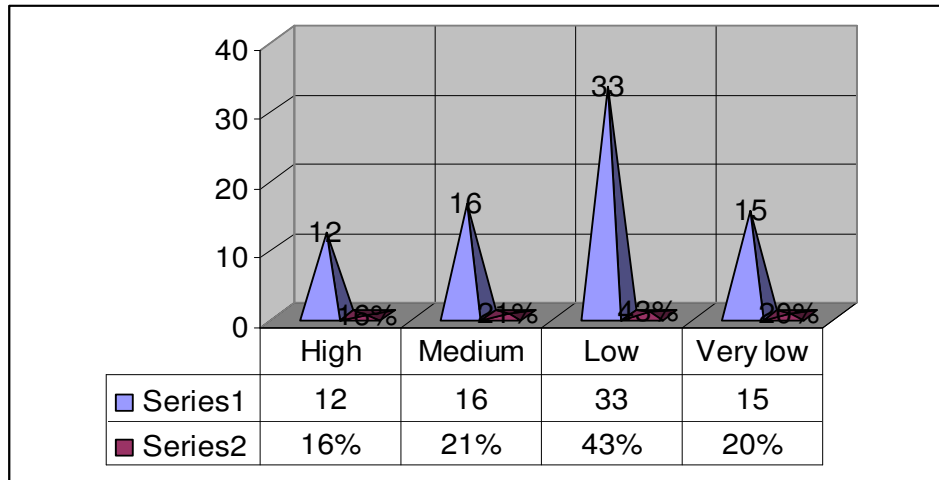
In principle, the board members and /or audit committee should support internal auditors to discharge its good governance role. In other words, the governing body should give attention to strengthen and support the internal audit function to bring about good governance. However, 41% and 11% the respondents think that the boards and/or audit committees are contributing at a low and very low level respectively as shown in the following graph.



*Graph.7 boards/ audited committee contribution to good governance*

### 3.2.5.2. Management and Other Organs of the System Support, Understand and Appreciate the Role of Internal Audit Function in Good Governance

In order to exercise good governance, both the management and employees shall understand and appreciate role of the internal audit. Despite this, however, in the real situation 43% and 20% of the respondents perceive their understanding is very low and low. Moreover, internal auditors are distinguished as negative tinkers, fault finders, low potential and qualified staffs in their organizations.

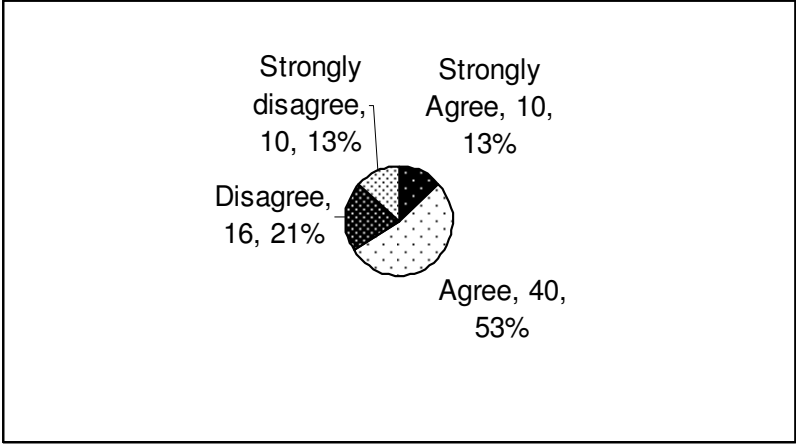


*Graph8. management and employee IA support for good governance*

### **3.2.6. The Effect of Reporting Relationship on Management Correction Action for Internal Audit Report.**

#### **3.2.6.1. Conflict of Interest with the Management**

13% and 53% of the respondents strongly agree and agree on the existence of conflict of interest in internal audit reporting line. The main reason for this is that whenever the internal audit finds out corrective actions, the management involves directly or indirectly and then the report goes to this management unit as well. The corrective action, therefore, falls in danger so that the findings may be filtered by management.



*Chart 13 IA reporting relationship Vs Conflict of interest with the management*

## Chapter four

### Conclusions and Recommendations

#### **4.1. Conclusions**

According to the theoretical fundamentals of internal audit discipline, ideally the Chief Audit Executive should report functionally to the board or audit committee and administratively to the chief executive officer of the organization. Researches conducted by, Institute of Internal Audit (IIA) and Michael J. Barrett and Victor Z. Brink in 1980, which are discussed in chapter two, show functional reporting lines of the internal audit activity sometimes deviate from the ideal or theoretical reporting relationship and the administrative reporting line is not always designed and followed as it is in the theoretical assumptions.

This survey also shows the functional reporting lines in practice are not always organized according to the theoretical assumptions, particularly in ETC (i.e. at zonal and regional level) and Zequala Steel Rolling Factory. However, the administrative reporting line is always designed and according to the theoretical assumptions in the selected Ethiopian Public enterprises. Hence, this result shows the reverse from the previous researches discussed in chapter two.

Although, 58% and 29% of the selected public enterprises report to the audit committee and to the board respectively, they are facing challenges like, internal audit has been seen as outside the management structure (outsider), and board members are ministers who have several other responsibilities so that they do not have sufficient time to deal with the oversight of the internal audit function.

The concept of audit committee is new that has emerged in relation with the introduction of corporate governance concept. Seven out of the twelve selected Ethiopian Public enterprises have tried implementing it very early. Even if the attempt is much appreciated, the structure and/ or the responsibilities of the audit committee need some kind of revision. This is mainly because this survey clearly signifies that the audit committees are directly accountable to Ethiopian Public Enterprise Supervisory Authority. Furthermore, one of its responsibilities is evaluating the performance of the board that leads to conflict of interest between audit committee and the board.

The Ethiopian public enterprises internal audit scope is more limited on the verification of financial transaction (Financial audit), compliance audit, assessments of internal control, and fraud investigation. In other words, The Ethiopian Public enterprises internal auditors' are primary concerned on accounting and financial issues rather than on managerial matters. However, the directive issued by the Public Enterprise Supervisory Authority that gives guidance on how the internal auditors should prepare their audit plan for the year 2008/2009 demands the internal auditors to plan for giving both assurance and consulting services. This in turn, implies the need for increasing the internal audit scope. In other words, putting the internal auditors in the higher reporting position calls for the enhancement of internal audit work scope.

Weak or not clearly defined reporting structure puts the independency of internal auditors in danger, and when the auditors' independence is impeded, the audit work becomes non-value adding activity. Independence is a sensitive issue for auditors particularly for internal auditors in which he/she is the employee of the organization and demanded to be independent. In this complex situation, vague reporting relationship makes the problem worst.

We can therefore, conclude that internal audit is one of the key cornerstones of effective good corporate governance by providing assurance on the risk management, control, and governance process within an organization. However, 70% of the respondents noted that the current structure of internal audit is sufficient to contribute for good governance, internal audit needs understanding and support from the board and/or the audit committee, management and employees so as to play their good governance role effectively that directly or indirectly benefits the specific organization and the country at large.

## 4.2. Recommendations

Functional reporting lines of the internal audit function in ETC (i.e. at zonal and regional level) and Zequala Steel Rolling Factory deviate from the ideal or theoretical reporting relationship and brings negative impact on the internal audit scope, independency, contribution for good governance and management response for corrective action for internal audit report. Thus, ETC (i.e. at zonal and regional level) and Zequala Steel Rolling Factory is recommended to change the internal audit reporting structure.

The reporting line of ETC Zonal and regional internal audit is directly accountable to the Zonal and regional managements and the copy of the report is to be sent to the head office, which puts independence of the auditor in danger. Therefore, the reporting relationship can be adjusted as the reporting relationship at zonal or regional internal audit goes to the internal audit division head of ETC at the head office level and the copy to zonal or regional management, and the internal audit division summarizes the report and accumulated with the head office audit report and directly report to the board.

In the case of Zequala Steel Rolling Factory the internal audit department is organized by two internal auditors at internal audit service level, but no audit division head. Thus the audit scope of internal auditor work is very limited and the reporting responsibility is to the management level, so the organization should strengthen the internal audit department in terms of the size and quality of staff and the reporting relationship should be made to the board.

As the literature review of countries experiences on audit committee is found that in many countries like Australia, Canada, Germany, Mexico, Netherlands, Russia, and South Africa. audit committee is accountable to the board and their main responsibilities are assessing the performance and objectivity of the IAF, assisting the board in reviewing financial information for external reporting and helping to oversee internal control systems, and oversight the organization's compliance with recommendations and observations. In Ethiopian public enterprises case the audit committee is responsible to evaluate the board, and audit committee is directly accountable to Public Enterprise Supervisory Authority according to article 5.17. However, the main role of audit committee should be assisting or helping the board to carry out their oversight role effectively. Hence it is recommended that the accountability of audit committee change into the board and avoid the responsibility of audit committee to evaluate the board.

Even if the functional reporting line to the board is efficient to foster their independence, 37% of the respondents reply that they are facing tremendous challenge because the board members are ministers and high ranking officials that have no time to give attention to the internal audit function. So, it would be one of the solutions to establish the audit committee. To establish audit committee we can follow two alternatives considering the resource and the internal and external environment of the organization. The first option to establish an audit committee at organizational level in which the audit committee can work a lot for the specific organization, or audit committee can be established at the sector level; for instance the financial sector may establish one or more audit committee.

Moreover, internal audit staffs in public enterprises have to be strengthened in size and quality. To strengthen the quality of internal audit service, sufficient fund should be allocated and professional trainings should be arranged. In addition to that, internal auditors should function together at the national level and should maintain and develop their profession. For its practicality, at least the Institute of Internal Auditors- Ethiopian Chapter was established and different professional certification programs are facilitated through the association like CIA (Certified Internal Auditor). And this institute or a similar kind of forum can be used to exchange experiences, and enhances their professional capacity

## References

- American accounting association, Independence and objectivity-A frame work for Internal Auditors, IARF Florida America, 2001.
- Cecilia Nordin Van Gansberghe, Internal Audit Finding: its place in public finance Management., New York, 2003
- Catherine L. Bromiliw. Berlin. J. Anderson, Internal Auditor, Working with audit Committees, December 2005, Pp 52-58
- Curtis C. Verschoor. Audit Committee Briefing, IARF Florida America, 2001
- Irvinn Gliem, Definition of Internal Auditing, Exposure draft January 1999.
- Joan Pastir, Conflict Management and Negotiation skills for Internal auditors, IARF, florida America, 2007.
- Kathrine S. Eckhart. Windener, Johnson, Internal Auditor, Governance in public sector, June 2001, Pp52-55
- Louis braiotta. Jr. John. Audit Committee Hand Book, 3rd Ed. Wiley and sons Inc. New York USA, 1999
- Lema argaw, proceedings inaugural ceremony of IIA-EC, The State of intenal Auditing in Ethiopia The Way Forward to Professionalism, December 200, pp21-37
- Lawrence B. Sawyer, The Practice of Modern Internal Auditing, 4<sup>th</sup> ed. IIA inc, 1996, USA.
- Miekatrien Sterck. Geer Bouckaert. Internal Auditor, International Audit Trends in Public Sector, august 2006, Pp49-53
- National Commission, Fraudulent financial Reporting, IARF, Florida America, 1987.
- Prof. Johannes Kenfu, IIA-EC, The Upstream and the Downstream of internal audit, pp15-17 December 200, Addis Ababa, Ethiopia.

- Richard M. Steninger, Catherine L. Bromilow, Corporate Governance and the Board-What works best, Florida, USA, 200
- Rolandas Rupsys, The Analysis of Reporting Lines, 2005
- Sally F Cutler, Designing and Writing Message- Based Audit Reporting, IIARF, Florida America, 2001
- Wolderuphael W. Giorgis, Proceedings inaugural ceremony of IIA-EC, The Development and Growth of Internal Auditing, December 2000, pp38-59
- Wanda A. Wallace. Thomas white. Internal Auditor's role in Management Reporting on Internal control, IIARF, Florida America, 1994.
- Zeleke Belay, Internal Audit Function to Promote Good Governance in Ethiopian Public Sector, Ethiopia, 2005

#### Major visited Web-sites

- <http://www.theii>
- [http://www.aicpa.org/audcommctr/guidance\\_resources/ia\\_and\\_audit\\_cmte/15.htm](http://www.aicpa.org/audcommctr/guidance_resources/ia_and_audit_cmte/15.htm)
- <http://www.theiia.org/theiia/about-the-profession/internal-audit-faqs/?i=1081>
- <http://www5.cfo.com/article.cfm/8045574?f=related>
- <http://businessfinancemag.com/article/new-directions-internal-audit-0418>
- <http://businessfinancemag.com/article/new-directions-internal-audit-0418>
- [http://goliath.ecnext.com/coms2/gi\\_0199-6288563/A-solid-reporting-line-internal.html](http://goliath.ecnext.com/coms2/gi_0199-6288563/A-solid-reporting-line-internal.html)

**Addis Ababa University**

**School of Post Graduate Students**

**Department of Accounting and Finance**

**Part one: General information**

1. Name of your organization \_\_\_\_\_
2. Your position in the organization \_\_\_\_\_
3. Educational background
  - MSC and above in accounting
  - BA in accounting
  - Diploma in accounting
  - Below diploma in accounting
  - Certified like CIA (Certified internal auditor), ACCA, other \_\_\_\_\_
  - Other than accounting qualification: please specify \_\_\_\_\_
4. work experience as an internal auditor
  - 1- 3 years
  - Between 3-5 years
  - Between 5-10 years
  - Between 10-20 years
  - > 20 years

## Part two: Introduction

5. Why the internal audit function exists in your organization?

Add value to the organization

Imposed by the government /low/

Other, please specify \_\_\_\_\_

6. Do you believe that the existing role the internal audit is playing sufficient enough to address the very purpose for which it is established?

Strongly Believe

Believe .

Indifference

Not believe

7. What are the major challenges observed so far in the internal audit functions in your organization?

---

---

---

### Part three: internal audit reporting relationship.

8. To whom does the internal audit department report in your organization?

Board / Audit committee     General Manger

President                       Finance Department Head

Other, please specify \_\_\_\_\_

9. Dose the existing situation pose an issue of reporting related problem?

Yes                       No                       Don't Know

10. What are the risks arising as a result of the current reporting line in your organization?

---

---

---

11. Do you believe the need for changing the current reporting responsibility of internal audit?

Strongly believe

Believe

Indifference

Not believe

12. If “strongly believe or believe”, what is the reason and purpose of changing the current reporting responsibility of internal audit?

---

---

---

13. In your opinion to whom should internal audit report?

- Board / Audit committee     General Manger  
 President                       Finance Department Head  
 Outsourcing the internal audit service  
 To the shareholders             No recommendations

Other, please specify \_\_\_\_\_

14. If the above reporting line (suggested in number 8) is applied in your organization, what would be the benefits of internal audit department?

---

---

---

15. If the above reporting line (suggested in number 8) applies in your organization, what would be the challenges of internal audit department?

---

---

---

16. The reporting line of internal audit should be established or defined clearly in the internal audit charter. Do you have audit charter?

- Yes                                       Use government manual     No

In the process of preparation

17. If you have audit charter, is the reporting line of internal audit clearly defined?

Specifically and clearly defined

Needs some clarity

Vague and not understandable

Note applicable

18. If the audit charter is not clearly define the reporting line, what are your comments for improvement?

---

---

---

#### **Part four: reporting relationship Vs scope of internal audit**

19. Do you believe that an increase or decrease in internal audit scope brings an increase or decrease in the level of reporting status respectively?

Strongly Believe

Believe

Indifference

Not believe

20. Which of the following represent the scope of work for internal audit in your organization?

(Please mark each boxes as much as it is applicable)

Verification of financial transaction (Financial audit)

Assessing and promoting the adequacy of corporate governance

Assessment of internal control

Evaluates projects/ programs accomplishments (effectiveness)

- Operational audit
- Compliance audit
- Assessment of organizational risk
- Fraud investigation
- Information system audit

Other areas if any \_\_\_\_\_  
\_\_\_\_\_

21. Do you think that the organization's audit department or divisions has progressed in terms of:-

i. Number of staff

- Unnecessary number of staff
- Sufficient
- Not sufficient
- Medium
- Very low
- Almost no

ii. Appropriately qualified staff

- Highly qualified
- Qualified
- Medium
- Unqualified

## Part five: reporting relationship Vs independency of internal audit

22. Do you agree that the environment in which the internal audit operates is conducive to promote independence in your organization?

- Strongly Agree
- Agree
- Disagree
- Strongly disagree

23. Explain the reason for your agreement?

---

---

---

24. While the audit function performs its duty, do you believe that, it is free to any transaction or area of interest for audit?

- Strongly Believe
- Believe
- Indifference
- Not believe

## Part six: - reporting relationship Vs IA contribution for good governance

25. Do you believe that the current reporting line of internal audit functions in your organization promotes internal audit to discharge its role in good governance?

- Strongly Agree
- Agree
-

Disagree

Strongly disagree

26. If “strongly agree or agree” how?

---

---

---

27. If “disagree or strongly disagree” why?

---

---

---

28. To what extent the board members curious to strengthen and support the internal audit function to bring about good governance?

Very high     Medium     Very low

High     Low

29. To what extent the management and other organs of the system support, understand and appreciate the role of internal audit function in good governance?

Very high     Medium     Very low

High     Low

**Part seven: The effect of reporting relationship on management correction action for internal audit report.**

30. Do you agree that the current reporting relationship create conflict of interest with the management?

- Strongly Agree
- Agree
- Disagree
- Strongly disagree

31. If “agree or strongly agree” in what way?

---

---

---

32. What do you suggest to solve this conflict of interest (if any)?

---

---

---

33. Anything to add?

---

---

---

---

Thank you