University of Southern Queensland

ANTECEDENTS AND ORGANIZATIONAL PERFORMANCE
IMPLICATION OF INTERNAL AUDIT EFFECTIVENESS: EVIDENCE
FROM ETHIOPIA

A dissertation submitted by

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Dedication

This dissertation is dedicated to my late sister, Melkamie Getie.
Summary

The literature suggests that the dynamics prevailing in an internal audit (IA) milieu possibly influence internal audit effectiveness. Besides organizational attributes that appear to influence IA effectiveness, other factors grounded in country context could influence IA effectiveness in developing countries. A study of IA practice as embedded in its broader context and identification of factors that enhance or inhibit its effectiveness could enable understanding IA’s potential to support organizational performance and thereby assist national economic development. A few prior studies attempted to examine contextual influences on IA practices. The association of IA effectiveness with company performance, however, appears unexplored as yet. Using a combination of quantitative and qualitative research methods, this study examines IA practices in selected Ethiopian Government ministries, State-owned enterprises, and private companies. It aims to identify country- and organization-level influences on IA effectiveness from an institutional theory perspective. It then explores the association between internal audit effectiveness and company performance using Marx’s theory of the circuit of industrial capital.

Results of canonical analysis suggest that IA effectiveness, as measured by IA proficiency, IA independence and objectivity, scope of IA work, quality of IA planning and execution, and quality of IA reporting and follow up, is significantly associated with a set of organization-level context factors. These factors are organizational category, organizational size, organizational policies authorizing IA, organizational risk exposure, auditee cooperation, and internal-external audit linkages. IA proficiency, scope of IA work and IA planning and execution appear to be higher in organizations where organizational policy authorizing IA is clearly defined and organizational risk exposure and internal-external audit linkages are stronger. Furthermore, Kruskal-Wallis tests show that IA proficiency and IA independence and objectivity are highest for State-owned enterprises followed by ministries and private companies. Spearman’s correlation test results suggest that the association between IA effectiveness and company performance (as measured by return on assets) was not statistically significant. A hypothesized moderating
effect of management attention to internal audit recommendations on this association was also not statistically significant. This lack of support for the hypothesis is possibly explained by the relatively small sample used (for this hypothesis). Another potential reason is that the relatively young age of internal audit in Ethiopia could not help capture the possible positive association. Furthermore, the use of a single proxy measure of company performance (i.e., ROA) may not be sufficient to capture the contributions of effective IA to several dimensions of company performance. Survey results were then enriched through interviews with selected internal audit directors and leaders of three professional associations in Ethiopia as well as reviews of documentary evidence.

Overall, the results portray the State’s contribution to the development of IA through coercive isomorphic pressures. These pressures are largely attributable to Government involvement in economic activity and its regulatory roles. Government’s role in setting the overall scene of accountability mechanisms in government organizations appears to have contributed to IA adoption in Ethiopian organizations. The State also serves as a nexus for IA and international sources of normative pressure for IA development. Nevertheless, organization-level factors, i.e., top management support for IA, extent of risk exposure, company connection with the international business environment, IA’s information technology advancement, and IA leadership demeanour tend to be linked with IA effectiveness to a greater extent than the contributing factors for IA adoption. In conclusion, country- and organizational-level contextual dynamics appear to influence IA effectiveness. In this process, government coercive pressures foster IA adoption while largely normative and mimetic pressures advance IA effectiveness by building upon the coercive inputs. Government coercive pressures also tend to transform into a normative pressure over time.

The study contributes to the IA literature and practice in several ways. First, it conceptualizes internal audit effectiveness as a multi-dimensional construct by measuring IA effectiveness in terms of its components rather than the hitherto dominant approach of using an aggregate measure or a proxy variable. Conceptualization of IA effectiveness as a multi-dimensional construct enabled
employing analytical approach of canonical analysis. This approach helps examine the nature of the relationships between context factors and specific dimensions of IA effectiveness. Canonical analysis also helps consider the interrelationships among the different dimensions of IA effectiveness.

Second, it is one of the few recent attempts to statistically test the relationships of IA effectiveness with its contextual influences. By formulating and testing such hypotheses, the study has attempted to identify major organization-level factors that tend to enhance or inhibit IA effectiveness. It also extends IA studies under institutional theory by considering a broader set of factors influencing IA practice and their possible interplay. Furthermore, it illustrates how the coercive, mimetic and normative isomorphic pressures interrelate and how this influences both IA adoption and IA effectiveness. This is considered an extension to existing literature because prior studies employed institutional theory largely to explain IA development at a national level by considering patterns of IA adoption by companies. Third, it contributes to the limited literature that employed Marx’s theory of the circuit of industrial capital in accounting in general and IA research in particular. Specifically, the study extends IA theory by developing hypotheses on the relationship between IA effectiveness and organizational performance.

Fourth, prior IA research has largely been on the empirical context of developed economies. Thus, some of the findings of this study could be considered additional insights to the literature emanating from the empirical setting of a developing country. Finally, the study is expected to inform government policy makers, boards of directors, managers, Global as well as national IIA institutes, transnational corporations engaged in business in developing countries, and international financial institutions that provide funds in different arrangements to developing countries including Ethiopia. It does this in two ways. Firstly, being a study on a developing economy setting, it helps enhance understanding of the global configuration of the internal audit profession. Thus, it enables figuring out the current state of internal audit in Ethiopia vis-à-vis the profession’s global status. This could then be extrapolated into the role of internal audit in the control
and governance mosaic of developing economies. Secondly, it highlights major factors that enhance or inhibit internal audit effectiveness. Thus it informs stakeholders on key priorities for the development of IA as a profession as well as its advancement as a key function in organizations.
Certification of Dissertation

I certify that the ideas contained in this dissertation are entirely my own, except where otherwise acknowledged. I also certify that the work is original and has not been submitted for any other award.

________________________
Signature of Candidate
12 March 2010
Date

ENDORSEMENT

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Signature of Supervisor
12 March 2010
Date

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Signature of Supervisor
12 March 2010
Date
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List of symbols

\( \rho \)  Spearman’s rho
\( r_s \)  Spearman’s Rank order correlation
\( r_c \)  Canonical correlation
\( R^2 \)  Pooled squared canonical correlation
\( \chi^2 \)  Chi-Square
List of acronyms and abbreviations

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>ACCA</td>
<td>Association of Chartered Certified Accountants</td>
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<td>ANOVA</td>
<td>Analysis of Variance</td>
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<tr>
<td>ASC</td>
<td>Audit Service Corporation</td>
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<td>ASE</td>
<td>Accounting Society in Ethiopia</td>
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<tr>
<td>CIA</td>
<td>Certified Internal Auditor</td>
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<tr>
<td>CPD</td>
<td>Continuing Professional Development</td>
</tr>
<tr>
<td>ETB</td>
<td>Ethiopian Birr (the Ethiopian Currency)</td>
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<tr>
<td>ECSAFA</td>
<td>Eastern, Central, and South African federation of Accountants</td>
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<tr>
<td>EPAAA</td>
<td>Ethiopian Professional Association of Accountants and Auditors</td>
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<tr>
<td>EAFA</td>
<td>Ethiopian Accounting and Finance Association</td>
</tr>
<tr>
<td>FDRE</td>
<td>Federal Democratic Republic of Ethiopia</td>
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<tr>
<td>IFAC</td>
<td>International Federation of Accountants</td>
</tr>
<tr>
<td>IA</td>
<td>Internal Audit</td>
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<tr>
<td>IIA</td>
<td>Institute of Internal Auditors</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>MoFED</td>
<td>Ministry of Finance and Economic Development</td>
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<td>MoTI</td>
<td>Ministry of Trade and Industry</td>
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<td>OFAG</td>
<td>Office of the Federal Auditor General</td>
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<td>PPESA</td>
<td>Privatization and Public Enterprises Supervisory Authority</td>
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<tr>
<td>ROA</td>
<td>Return on Assets</td>
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<td>ROCE</td>
<td>Return on Capital Employed</td>
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<td>ROSC</td>
<td>Reports on Observance of Standards and Codes</td>
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<td>SOA</td>
<td>Sarbanes-Oxley Act</td>
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<td>SPPIA</td>
<td>Standards on the professional practice of internal auditing</td>
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<tr>
<td>WB</td>
<td>World Bank</td>
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<td>WPE</td>
<td>Workers Party of Ethiopia</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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