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Corporate Governance in Nigerian Banking Sector and Relevance of Internal Auditors

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Abstract

The importance of corporate governance in ensuring dependable financial reports and deterring fraud in banking sector cannot be overemphasised. Internal control framework is the direct responsibility of the board of directors and audit committee. This governance responsibility is discharged through the assistance of internal auditors.
This paper attempts to examine the relevance of internal auditors in Nigerian banking sector in the light of recent negative corporate governance experiences.
A semi-structured interview is conducted with 23 internal auditors in nine of the currently existing 24 banks. The sample is conveniently chosen to cover both the old and new generation banks. The Interview was structured around 10 questions drawn from Literature, internal audit manual of 2 banks, corporate governance manual of central bank of Nigeria and that of Security and Exchange Commission. The interviews were conducted in the premises of the chosen banks in Lagos and took approximately 25 minutes to complete each.
Reflecting on personal experiences, internal auditors indicate a wide range of views suggesting why there was existence of weak corporate governance and resultant capital erosion in some of the banks. Majority of Internal auditors consider management as most crucial driver of corporate governance. This is inconsistent with agency theory's prescription which puts the board before management to protect stakeholder's interest.
This paper presents clear implications for practice and research.

Keywords:
Corporate governance, internal auditors, agency theory, internal control, audit committee
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1.0 Introduction

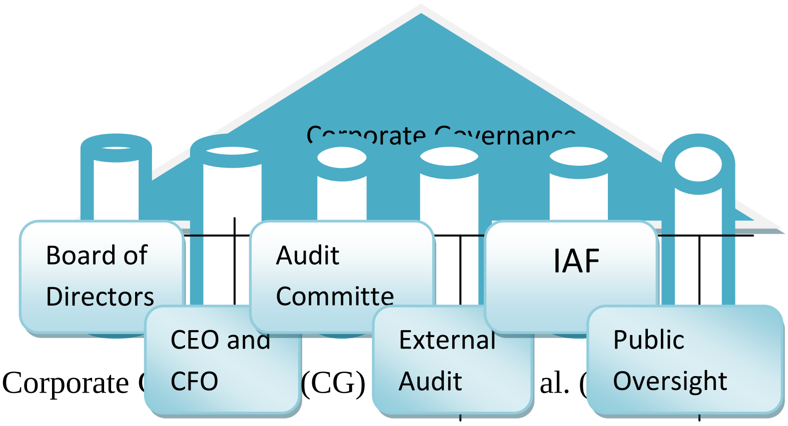
In response to recent corporate failure across the world corporate governance has enjoyed considerable focus both in practice and academic research (Levitt 1998; Arthur Levitt 1999; Brown 1999; Beasley, Carcello and Hermanson 1999; De Zoort and Salterio 2001; Cohen et al. 2002) However, the relationship between Internal Audit Function (IAF) and Corporate Governance (CG) issues in developing countries enjoyed very little patronage in academic literatures.

Corporate Governance has no rigid definition. The perception of CG depends on which side of the prism one is focusing on. The description of CG given by the Organisation for Economic Co-Operation and Development (OECD) appears to be somewhat embracing for this study.

.... as a key element in improving economic efficiency which involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. ....provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and shareholders. (OECD, 1999. P11)

Internal control framework is the direct responsibility of the board of directors and audit committee. This governance responsibility is discharged through the assistance of internal auditors. One of the most controversial issues in practice and academic literature is the reporting line of IAF. In a survey carried out in 2003 about half of the respondents in Belgium, Greece, Ireland, United Kingdom and Spain report directly to Audit Committee whereas in some other countries the total is far less (Paape et al 2003). In recognition of the importance of business risk assessment and control to CG, many commentators have recommended that IAF should report directly to the audit committee (IIA 2003; Hopwood et al. 2008; CBN 2009; SEC 2009). The purpose of this requirement "is for the audit committee to serve as an independent check on top management and to independently ensure quality internal control processes and compliance. (Hopwood et al. 2008, P274).

IAF can therefore be considered as one of the six pillars of CG apart from board of directors, CEO or CFO, Audit Committee, External Auditors, and Public Oversight Organisations represented in Nigeria by Central Bank of Nigeria (CBN), Nigeria Deposit Insurance Corporation (NDIC) and Security and Exchange Commission (SEC). The board of directors have critical role to play in showcasing good corporate governance.



Six pillars of Corporate ((CG) al. (

The satisfactory discharge of the board and its audit committee's responsibilities rested squarely on effective internal audit function.

2.0 Nigeria business environment and corporate governance

There are a number of developments within Nigeria business environment in the recent time that may have direct or indirect impact on corporate governance. Most of the reforms carried out by various governments were aimed at opening up the Nigeria economy to the outside world in order to provide enabling environment for Nigeria to compete in the global economy.

For instance, in 1995 the Nigeria Enterprises Promotion Decree (NEPD) which hitherto restricted foreign ownership of shares in certain businesses was repealed and replaced with Nigerian Investment Promotion Commission Decree (NIPCD) which by far is more foreign investors friendly. The resultant effect of this was an increase in foreign investment flow and expansion of existing businesses including banks.

Furthermore in 1995 foreign exchange control in Nigeria was also deregulated. The restricted exchange regime was replaced with a very flexible exchange rules which allow private individuals to operate 'bureau de change' for exchanging foreign currencies to local one and vice versa. This is contained in Foreign Exchange (Monitoring & Miscellaneous Provision) Decree of 1995. The law also allows individuals and companies to hold domiciliary accounts in Nigeria banks where foreign currencies can be saved and withdraw without restrictions.

The most important reform that impacted corporate governance is privatisation which commenced in 1988. Most government controlled corporations were sold out to core investors. By 1999 fifty seven (57) government corporations were already privatised. Ownership changed hand from government controlled to individual investors (Ahunwan 2002)

Privatisation engendered reforms in the capital market. The activities in the Lagos stock exchanged more than double. Most companies including banks have unimpeded access to funds from capital market. Unexpectedly, most chief executive officers are saddled with funds management problems.

The Bank consolidation reform carried out by the central bank of Nigeria has not been without success. The number of banks reduced to twenty four from 95 before consolidation. With the minimum capital raised to 25billion Naira, Nigerian banks have enough liquidity to compete globally.

All these reforms brought with it obvious problems of corporate governance in the sense that most of the banks still operate the same management structure before the capitalisation with the chief executive officer holding substantial equity and power even at board level.

Evidence that all is not well with Nigeria banking sector's corporate governance process can be found in the recent EFCC cases against some bank executives. A good example is oceanic bank where the former CEO Cecelia Ibru pleaded guilty to three of 25 counts charge of fraud and mismanagement in 2009. She was sentenced to 6 months in prison for fraud and ordered to hand over $1.2bn or (£786m) in cash and assets. (Punch News paper 2009).

Also former CEO bank PHB accused of fraud involving £320million of depositors' funds. Others are executive chairman of Afribank fraud involving £220million and CEO of Intercontinental bank of £108 million. (EFCC, 2010)These are all huge amount of money which could not have been possible without lapses in internal control and corporate governance. As a matter of expediency, the CBN sacked the management and board of 5 banks replacing them with selected new officials to protect the depositors' funds.

3.0 Research questions

In order to access the extent to which Internal auditors consider corporate governance in planning their work and how the governance structure affects assessment of risk and control factors, the following research questions are adapted from Cohen et al (2002).

3.1 Research question 1 (RQ1)

What aspect(s) of the corporate structure do you think of when you are asked about corporate governance as internal auditor?

3.2 Research Question 2 (RQ2)

To what extent do you consider corporate governance in the planning and conduct of internal audit?

3.3 Research Question 3 (RQ3)

How effective do you think the audit committee has been in discharging their oversight function when compared with the board or management?

3.4 Research Question 4 (RQ4)

What are your views regarding the changing role of corporate governance in the internal audit process over time?

3.5 Research question 5 (RQ5)

How do you think the kind of Management fraud experienced in some banks in the recent years can be averted in future?

3.6 Research Question 6 (RQ6)

What role is internal auditor expected to play to strengthen corporate governance in near future?

4.0 Method

This study employs exploratory, semi-structured interview approach to address the research questions. Face to face interviews were conducted with 23 internal auditors in Nigeria banking industries (10 senior audit managers, 6 audit managers, 7 audit officers with average of 7; 4 and 2 years of auditing experience. The choice of varying staff categories is deliberate to obtain individual's views and assessment of relevance of internal audit process to corporate governance which may vary with staff level. Nine of the twenty four banks were selected for convenience but the sample size covered the 'four old banks' going by their total market capitalisation and five of 'new generation' banks. The Interview was structured around 6 questions drawn from Literature, internal audit manual of 2 banks, corporate governance manual of central bank of Nigeria and that of Security and Exchange Commission. The interviews were conducted in the premises of the chosen banks in Lagos and took approximately 25 minutes to complete each.

The researcher made use of former students and professional colleagues to gain access to internal auditors in the selected banks. All the banks are listed in the Lagos Stock Exchange.

The subjects were informed that the purpose of the interview is to access the relevance of internal auditors to governance process and that their views will be held in confidence. They were allowed to make comments as they deem right even when they seem to have deviated from the main question (Hirst and Koonce 1996).

The interviews were audio taped to ensure accuracy and completeness and were later transcribed by the researcher. The findings are based on the comments and reconciled responses obtained.

5.0 Findings

5.1 Aspect(s) of the corporate structure internal auditors think of when asked about corporate governance? (RQ1)

The purpose of the first research question is to explore the perception and understanding of the internal auditors about CG and to see which aspect of Corporate Governance they think is more important reasoning from the practical roles they play in their various banks. Unexpectedly, respondents described their perception of Corporate Governance within the conceptual framework of top management (88 percent), board of directors (70 percent), regulatory authorities (65 percent) and audit committee (45 percent). Respondents rated top management as most important CG mechanism (88 percent). One of the Chief Internal Auditors Interviewed noted that "CG tone is set from the top by the management because top management provides ethical colouration........ in any case, even though it is the board that can fire the head of internal audit here, the CEO controls and influences the board decisions. So he is capable of firing any internal auditor who does not do his biddings." This position is consistent with the view that top management influences corporate governance than any other mechanism but inconsistent with the agency theory which recommended the board and the audit committee to serve as a means of independent overseers of management actions in order to protect the shareholders' interest.

It is of interest to note that majority of participants (65 percent) viewed CG as a regulatory mechanism. This is consistent with agency (monitoring) perspective. This looks conflicting with the initial view but consistent with the result of Cohen et al., which found that those "governing" cannot be separated from the ones "being governed" since top management may avoid "being governed" by deliberately picking an ineffectual board. Internal auditors seem to understand that they are to complement the audit committee in fulfilling important objective of governance by instituting effective monitoring mechanism for management so as to enhance shareholders value but it is the management who will create the enabling environment. This further underlines the notion or presumption that CEO or Top management is by far the strongest mechanism or pillar of the corporate governance.

5.2 Do you consider corporate governance in the planning and conduct of internal audit? (RQ2)

The second research question evaluates the extent of internal auditors' consideration of CG in the planning and conduct of internal audit. Majority of respondents (96 percent) indicated that they use corporate governance guidelines provided by the Central Bank of Nigeria (CBN) and Security and Exchange Commission (SEC) (98 percent in the audit planning stage; 60 percent in the field-testing stage and 45 percent in the review stage).
Expectedly IAs across different levels makes use of CG guidelines provided by the regulatory authorities in order to meet up with regulatory requirements. This is consistent with the notion that public oversight organisations (e.g CBN, SEC) are important mechanism (pillar) of corporate governance. However one Senior Internal auditor has a caveat "The understanding of corporate governance in planning audit depends largely on the credibility of management and the independence of audit committee..." This view further suggests that the level of compliance with CG code is affected by internal auditor's independence.

5.3 Internal auditors' view on effectiveness of audit committee in discharging their oversight function over management?(RQ3)

The third research question accesses the effectiveness of audit committee in discharging their oversight function. Most participants (85 percent) felt the audit committees are not effective. They suggested various reasons. Lack of basic accounting and financial knowledge (78 percent); Manipulation by top Chief Executive Officers to impair their independence (62 percent); Inability to hold regular meetings (55 percent) . One participant have this comment to make “Most of the time members of the audit committee lack experience on financial matters and are incapable of resolving contentious financial issues with management” When asked if internal auditors hold meetings with audit committee to discuss and resolve contentious issues, 75 percent of the participants says two to three meetings were held during the last year. The major items discussed are significant audit issues (75 percent); audit plans (62 percent); significant disagreement with management (35 percent). Another participant commented thus “Most of the issues discussed are just mere formality and no further mention of it again .... even those obvious issues that need to be resolved are often pushed under carpet”

These findings and comment are consistent with Blue Ribbon Committee (BRC) 1999; Ramsay 2001; and Abbott et al 2001. For instance, Abbott et al (2001) found that independence of members and frequency of meetings are associated with possibility of financial reporting misstatement. Furthermore Menon and Williams 1994; Collier and Gregory 1999; Beasley and Salterio 2001 found that the audit committee’s effectiveness is related to the composition of the entire board.

5.4 Internal auditors’ views regarding the changing role of internal audit function in corporate governance over time (RQ 4)

The fourth research question accesses the view of internal auditors regarding the changing role of IAF in corporate governance process. Most participants (98 percent) are of the opinion that corporate governance is an important driver for changing role of internal audit function. One participant is of the view that “internal auditors are now more concerned in strengthening corporate governance much more than auditing individual transaction and control”. Most participants (72 percent) are of the view that IAs will be more involved in advisory/consultancy services in future. 65 percent of the participants believes that weaknesses in corporate governance signpost possible incidence of fraud. This is consistent with the findings of KPMG 1999 and Beasley et al. 1999.

On the question of appropriate training on corporate governance to meet up with changing role of IAF most participants (98 percent) are of the view that more training are needed not only for internal auditors but all involved in CG processes.

5.5 How do you think the kind of Management fraud experienced in some banks in the recent years can be averted in future and how can CG process be improved (RQ 5 and RQ 6)

The fifth and sixth research questions access how IAs can improve CG process in reducing fraud level in financial institutions. Most of the participants (95 percent) are of the view that red flag will be easier when there is a strong board. This is consistent with consideration of governance from a strict agency perspective. A strong and credible board is more likely to appoint a credible audit committee.

Furthermore 60 percent of the participants believe that the use of ICT to audit transaction and monitor internal control will be more effective in reporting exceptional items appropriately as Management cannot blame computer for “reporting” their misdeed. ICT tools and techniques improve corporate governance process. This is consistent with the findings of Omoteso et al. (2007).

On the question of cooperation with external auditors in preventing and detecting fraud most participants (90 percent) agree that cooperation with external auditor is very useful. For instance one participant is of the view that “...sometimes some of control breaches committed by CEO are better reported to external auditors. This is necessary to avoid direct conflict with management. The external auditor is in a more vantage position to deal with such breaches."

All participants (100 percent) are of the view that all those involve in the CG mechanism should be well trained in CG code of practice.

6.0 Final Discussion

Internal auditing function is one of the pillars of corporate governance. IAF as one of the pillars of CG is capable of cooperating with other CG mechanism in improving governance process. Despite the ever increasing focus on corporate governance in both developed and developing countries there has been surprisingly little research efforts on how internal auditors view the CG and other CG pillars such as Board; external auditors; public oversight organisations; chief executive officer(management) and audit committee. This study addresses these issues by using interview approach to obtain evidence of internal auditors' experiences.

Consistent with prior research (COSO 1992; Cohen et al 2002) an issue that emerged in this study is that effective governance cannot be dissociated with top management credibility and attitude. This has implication for future research as Cohen et al (2002: p 588) put it "The agency perspective alone, with its emphasis on independence of the board and audit committee from the management, may be insufficient to fully understand the role and impact of corporate government"

Prior auditing research focused on isolated corporate governance mechanism i.e the board and audit committee, future study is needed to explore the interrelationships between the six pillars of corporate governance.

An obvious limitation of the current study is that the participants were asked to respond on the basis of their general experiences. This may provide a rich data set but also places limitation on sample size. Furthermore this study could have benefited more if longitudinal approach had been adopted gathering data over a defined length of time since attitude and experience changes with time.

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