

# Relationship of Internal Audit Functions to Governance of Local Government Units

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## Abstract

The study determined the relationship between internal audit functions and governance in Local Government Units (LGUs) in Metro Manila, Philippines. The data were gathered from 510 employees of LGUs using stratified sampling. Majority (359 or 70.6%) of the respondents belonged to 31-50 years old; majority of them worked in finance (181 or 35.5%) and in social service provider department (179 or 35.1%) and were managers (44 or 8.6%), supervisors (188 or 36.9%), and in clerical position (278 or 54.5%). Results of the study revealed that the internal audit functions of the Internal Audit Units of the LGUs were very good. However, the respondents perceived that the internal audit units seldom retain an independent outlook in presenting their suggestions. The overall status of governance of LGUs included in the study was very good although they sometimes spend more than what they earned. Loans from private institutions are sometimes obtained. Further results revealed that all the dimensions of governance, i.e., financial management and reporting, delivery of basic services, legal compliance, and internal government were perceived very good but the respondents were most satisfied on financial management and reporting. There was a strong positive relationship of internal audit functions to governance. The findings showed that the predictors of governance included consulting services, assurance services, and age.

Keywords: internal audit functions, governance, Local Government Units

## I. Introduction

Governance is the process by which the organization and its stakeholders gain assurance that activities are conducted in accordance with broad organizational policies, and that accountability is established. (Jubb, Topple, Schelluch, Rittenberg, & Schweiger, 2008). It refers to the political, economical, social, and technological links in different countries (Hamilton & Webster, 2009), that diminution or elimination of state-enforced restrictions on exchanges across borders and the increasingly integrated and complex global system of production and exchange that has emerged as a result (Palmer, 2002). Governance brings about rapid changes in technology and communication. It also provides opportunities for new markets and other developments not only internationally but also locally.

Governance is a major concern of private and government institutions because of the quickening pace of globalization and the significant decline in economic activity brought about by the recent financial crisis. The financial and economic crisis that started in 2008 led to a

significant loss of trust in government (OECD, 2013).

As a result, economies have become more complex which in turn complicates governance. Best practices, new concepts, tools and measurements are needed to ensure that any government or organization will be able to cope with these changes. Hence, the topic on governance is on top of the reform agenda conducted by governments, different concerned institutions, and individuals.

A study made by Standard and Poor's Rating Services on the current situation of the Philippine Local Government Units (LGUs) reveals the following: there is basic to poor levels of financial management in most areas when compared to the global's best practices although some evidence of intermediate practice has started to surface; transparency is quite poor and is helped somewhat by publicly available audited reports though often with significant qualifications; there are underdeveloped information systems and planning tools; weak link between strategic goals and expenditure allocations (Okorotchenko, 2009).

In addition, the data taken from the Department of Budget and Management (DBM) as presented by Gera (2008) reveal that the Internal Revenue Allotment (IRA) given to LGUs keeps increasing in relation to the total national budget which is from 6.88% in 1992 to 16.33% in 2006. Furthermore, the IRA remains to be the major source of revenues for the LGUs. He presented a data from the Commission on Audit (COA) where only 34.6% is generated from local revenues in 2006 while 63.1% comes from the IRA and 2.3% from other external receipts. The data revealed further that there was also a decrease in the local revenues which is 35.7% in 2005, the IRA at 62.1% and the receipts from other external sources at 2.2%.

The above scenario indicates that the goal of Republic Act 7160 to give more freedom to LGUs to self-generate their own revenues has not been achieved and the opportunities presented by globalization have not been captured.

Belay (2007) states that a wellperforming internal audit function is one of the strongest means to monitor and promote good governance system in an organization. As a result, in many countries, internal audit function receives increasing attention as an important component of government financial management and as a tool for improving the performance of the government sector.

Furthermore, Asare (2009) mentions that a well configured internal audit function can play a vital role in the governance and accountability process of public sector institutions through their assessments on the effectiveness of key organizational controls, governance and risk management processes. This would lead to the examination of what an internal audit function is and how it relates to governance.

This situation puts pressure on the LGUs to examine and enhance their system of governance for them not to burden the national government and consequently to obtain support from the people. There is a need therefore for some concepts or tools on which to evaluate the problems and to find solutions for them.

#### Overview of the Study

If the data provided by the COA and the DBM suggests that there was a problem on governance and Tantuico (1994) also states that

there was a problem on internal audit functions, then it would be worthwhile to research on it to prove whether there is relationship between internal audit functions and governance as hinted by Belay (2007) and Asare (2009). Furthermore, this study sought to answer how respondents perceive the internal audit functions in terms of assurance services and consultancy services, the status of governance (in terms of financial management and reporting internal management). The study further determined the significant predictors of governance. The effects of age, functional group, position, and locality on the relationship between the internal audit functions and governance were also determined in this study.

## II. Methods

### Samples and Sampling Design

The respondents of the study were 510 employees of LGUs who belong to the age group 41-50 years old (197 or (38.6%) and 31-40 years old (180 (35.3, mostly came from the finance group comprising 181 personnel or 35.5% of the total respondents, followed by the social service provider composed of 179 respondents or 35.1%, the personnel and IT division with 78 respondents or 15.3%, the legal and procurement division having 43 respondents or 4.8%, and 29 of the respondents or 5.7% came from other divisions. The clerical personnel also dominated the composition of the respondents wherein there were 278 of them or 54.5%, supervisors or specialists came next with respondents of 188 or 36.9% and there were 44 respondents or 8.6% who were in the managerial position.

A great proportion of the respondents (27.8%) came from the City of Manila. These respondents were chosen using stratified sampling.

### Instrumentation

The questionnaire consisted of three parts, namely: 1) the demographic of the respondents; 2) the perception of the respondents on internal audit functions, and 3) the status of governance. The 5-point Likert scale was used to determine the perception of the respondents towards their internal audit functions and the status of governance. The following scale was used: (5) always; (4) often; (3) sometimes; (2) seldom; and (1) never with the corresponding of interpretation

of Excellent, Very Good, Fair, Poor, Very Poor, respectively. The questionnaire was content validated by nine experts holding doctorate degrees with specialization mostly in the field of business administration, public administration and education. Some items were revised or deleted based on the comments and suggestions of the experts. Pilot study was conducted to establish internal consistency. This was done to ensure that responses are not too varied across time periods (Hair, Black, Babin, Anderson, & Tatham, 2006). (Hair et al., 2006, p. 137). The Cronbach alpha reliability was computed. The reliability results ranged from .92 to .97 for the variables assurance services (.94), consulting services (.97), financial management and reporting (.90), delivery of basic services (.92), legal compliance (.92), and internal management (.92) Statistical Treatment of Data The data gathered was analyzed through the Statistical Packages for Social Sciences (SPSS) computer software program. Frequency count and percentages, correlation analysis using Pearson's product-moment correlation and multiple regressions to determine the relationship between internal audit functions and governance.

### III. Results

#### Internal Audit Functions

The descriptive statistics of internal audit functions as measured by assurance services and consultancy services is presented in Table 1. The employees perceived that all assurance services items asked were often carried out and were rated *very good* by the respondents. The items of internal audit functions that were rated the highest are "the collection process of local taxes is efficient" (M=4.38,SD=.98), and "the collection of revenues is timely" (M=4.23, SD=.96) while respondents gave the lowest rating on two items of assurance services which were sometimes practiced: "loans are obtained from private institutions to finance its projects (mean=3.25, SD=1.15)" and "the government spends more than what it has earned (mean=2.74, SD = 1.22)".

Table 1

#### Internal Audit Functions of LGUs

Internal Audit Mean(M) SD VI  
Functions

Assurance Services	3.81	.95	Very Good
Consulting Services	3.71	.95	Very Good

SD- Standard deviation

VI- Very good

The consulting services were perceived to be *very good* according to the respondents. Most of the practices under consulting services were also often performed; such as advic on how to use City's funds, how to prevent from paying penalties due to non-compliance to regulation, how to safeguard the City's properties, how to cope with the changes in the local government environment, and how to set up criteria for measuring overall performance except that the respondents feel that the internal audit units *seldom* retain an independent outlook in presenting their suggestions. This practice was considered *poor* by the respondents. The three items that were *often practiced* and were interpreted *very good* are "advises on improving the City's uses of funds", "Advises to prevent the City from paying penalties due to possible non-compliance to regulations", and "Advises the City Government on how to safeguard the City properties". Indeed, consulting services is perceived to be *very good* according to the respondents (mean=3.68, SD =.83).

#### Governance Practices of Local Government Units

The governance practices of LGUs were identified as financial management and reporting, delivery of basic services, legal compliance, and internal management. All these governance practices were perceived to be *very good* by the respondents with a mean ranging from 3.81 to 4.05.

On financial management and reporting, the result shows that two items "the collection process of local taxes is efficient" (M=4.38, SD=.98) and "the collection of revenues is timely"(M=4.23, SD=.96) received the highest mean rating from the respondents, while they gave the lowest mean rating on items "loans are obtained from private institutions to finance the project" (M=3.25, SD = 1.15) and "the government spends more than what it has earned" (M=2.74, SD=1.22). These two items were *sometimes* practiced among LGUs.

The second dimension of governance practices was on the delivery of basic services. The Local Government Code took effect in 1992 which devolved to the Local Government Units (LGUs) the responsibility for the delivery of various aspects of basic services such as health, education and social welfare services among others. These were earlier under the responsibility of the national government. The respondents were then asked how they perceived these services were delivered. The results revealed that the delivery of basic services among LGUs was perceived to be *very good* by the respondents. Examples of the items which garnered the highest mean ratings are: “Health services are well delivered” ( $M=4.2647$ ,  $SD=.92$ ) and “Education is one of the priority programs of the City Government” ( $M=4.21$ ,  $SD=.99$ ) The item “Health service providers are updated with the latest medical technology” received the lowest mean rating ( $M=3.86$ ,  $SD=1.14$ ) but still perceived to be *very good*.

The legal compliance as the third dimension of governance was perceived to be *very good* which means that the employees of LGUs are

compliant to Civil Service regulations, environment, government auditing rules, code of ethics, procurement practices, and other laws, rules and regulations in their respective work units.

The last dimension of governance for this study is internal management. Like the other three dimensions, the respondents perceived that the internal management practices of LGUs was *very good* as manifested by the mean rating of 3.90 ( $SD =.68$ ). Some of the internal management practices that are *often* practiced by LGUs are: promotes cooperation among groups, provides more efficient services to the public through computerization, promotes teamwork through projects, sees to it that computer data are well secured, employees are given freedom to decide, and projects are well coordinated with the National Government for funding.

Of all the indicators of governance practices, the respondents in this study rated the delivery of basic services as *Very good*, which received the highest mean rating among the four indicators. This means that the respondents were best satisfied in the execution of this function compared to the other four.

Table 2  
Governance Practices

Governance	Mean(M)	SD	VI
1. Financial Management and reporting	3.81	.67	Very Good
2. Delivery of Basic Services	4.05	.85	Very Good
3. Legal Compliance	3.99	.86	Very Good
4. Internal Management	3.97	.83	Very Good
Over all			

SD- Standard deviation  
VI- Very good

#### Correlation Between Internal Audit Functions Aand Governance

The results in Table 3 revealed that internal audit functions and governance practices are positively correlated ( $r = .77$ ). The variance accounted for ( $r^2$ ) by the internal audit functions to the

Table 3. Correlation bBetween Internal Audit Functions and Governance Practices

Variables	FMR	DBS	LC	IM	OA
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governance practices is 59.29% . In the same manner, their dimensions are also correlated. These results imply that if internal audit functions are carried out well, the better will be the governance practices among LGUs.

Assurance services	.63**	.50**	.52**	.47**	.73**
Consulting Services	.65**	.51**	.53**	.49**	.75**
Internal audit functions	.67**	.53**	.53**	.50**	.77**

\*\*Sig at .01

Table 4 shows the regression analysis that presents the significant predictors of governance practices. The results also present the total variance accounted for of at .612 or 61.2% by the three variables that entered the regression. The 61.2% is allocated for consulting services (.557 or 55.7%), assurance services (.043 or 4.3%), and age (.012 or 1.2%). Table 4 also presents the Beta coefficients (B) of consulting services (B = .319), assurance services (B = .254), and age (B = .083)

which indicates that for each unit increase in the measure of consulting services, assurance services and age, the score of governance will increase by 0.319, .254 and 0.083, respectively. If governance practices would be written as GOV, consulting services as CS, assurance services as AS, and age as AG, the regression equation that would predict the value of governance would be written as follows:  $GOV = 1.540 + .319CS + .254AS + .083AG$ .

Table 4  
Table 4: Regression Analysis for Governance

Model	B	Beta	R Square Change	Sig.
Constant	1.54	0.94		0.000
Consult	.319 <sup>a</sup>	0.34	.557	0.002
Assuran	0.254 <sup>b</sup>	0.34	.043	0.029
Age	.083 <sup>c</sup>	.021	.012	
R = .612	R <sup>2</sup> = .3745			

- a. Predictors: Consulting services
- b. Predictors: Assurance services
- c. Predictors: (Constant), Assurance services, Assurance services, Age

#### IV. DISCUSSION

##### I. Internal Audit Functions

Internal Audit Unit mostly conducts financial audits while the review on compliance to procurement law is given least priority when compared to the other assurance practices in this study. It also reveals that other assurance services such as computer audit and operations or systems audit were also provided. This situation could be supported by the statement of Fraser (n.d.)

pointing out that from a concern with low-level financial audit, internal auditors have progressed to systems audit and involvement with economy, efficiency, and effectiveness to their contemporary focus on enterprise risk management. He also said that the traditional role of internal auditors in connection with financial auditing gave them an initial knowledge base with which to get involved with risk management. Financial auditing is concerned with the risk of

financial misstatement.

The result reveals that financial consulting tops the lists of services delivered by the Internal Audit Unit and followed by compliance consulting. Other consulting services were also practiced often which means that the Internal Audit Units are providing various consulting services. The overall mean of 3.70 (SD =.95) indicated that most consulting services are practically perceived to be very good when taken as a whole. The various consultancy services being delivered by the respective IAU could be rationalized by what Hass, Abdolmohammadi, & Burbany (2006) Hass et al., (2006) found out that there has been a paradigm shift in the activities performed by internal auditors. He stated that the increasing complexity of business transactions, a more dynamic regulatory environment and significant advances in information technology have resulted in opportunities and the challenges for internal auditors. These situations have advanced the focus of internal auditing from the traditional financial assurance services to other services including consulting.

However, the IAU is perceived to be poor in retaining an independent outlook in presenting their suggestions. This is supported by the study conducted by what Simmons (1995), which The study concluded that for the most part, internal auditors who participated in the study believe that performing consulting services carries a relatively high risk of jeopardizing independence. Further, it was determined in the study that 53% of the participants believed that providing consulting services poses a risk of getting involved with internal organizational politics, a risk of political exposure, or a risk of negative political pressure from within the organization.

## II. Governance

Two practices under financial reporting and management were perceived being carried out sometimes although all other items were often practiced. One of the two practices is that loans are obtained from private institutions to finance its their projects. The limited borrowing from private institutions can be supported by the report of Okorotchenko (2009) that local and regional

governments can borrow in local currency only and are subject to a debt-servicing limit as a proportion of their regular income. She further wrote that, in local currency, LGUs tend to borrow from government-owned banks, but they generally have low credit standings with banks. She added that only a small number/amount of local bonds has been issued so far and all of them are guaranteed by the Local Government Unit Guarantee Corporation.

The government was spending more than what it has earned. This could be backed up by Gera (2008) that the Internal Revenue Allotment (IRA) remains the main source of revenue of the LGUs (63.1%) and another small percentage (2.2%) comes from external sources. Hence, their local revenue is only about 35.7%.

## III. Relationship Between Internal Audit Functions and Governance Practices

The result gives clear evidence that the internal audit functions have a relationship with governance. The relationship can be substantiated by what Asare (2009) said that a well-configured internal audit function can play a vital role in the governance and accountability process of public sector institutions through their assessments on the effectiveness of key organizational controls, governance and risk management processes. Also, Belay (2007) stated that a well performing internal audit function is one of the strongest means to monitor and promote good governance system in an organization.

## IV. Predictors of Governance Practices

In this study the internal audit functions in terms of assurance and consulting services and age are significant predictors of governance practices among LGUs. Considering all these predictors to governance, consulting services emerged as the best predictor with the largest variance accounted for to the governance practices. These findings imply that the consistent implementation of good internal audit practices increases financial management and reporting, delivery of basic services, legal compliance, and internal management. Also, age significantly contributed

to the improvement of governance. Further, the finance group significantly improved financial management and reporting while the social service providers significantly add value to the delivery of basic services.

The study reveals that very few employers had the view that 'older workers' as less productive. In fact, age seems to be a significant advantage in many white-collar jobs. A clear majority said that older managers and professionals were "more productive". Two areas in which employers see value of the older worker is in a) having excellent knowledge of procedures and understanding of job aspects and b) ability to interact with all customers. This is one evidence that the older the worker, the more he/she will contribute to the improvement of internal management(O'Connor, 2006).This could be justified by the empirical research of Lucas (as cited in Howell, Buttigieg, & Webber, 2006) Howell et al., (2006) which found older workers to be more reliable, careful, responsible, stable, and better communicators. He also said that hiring older employees results in lower recruitment and training costs, lower turnover, higher profitability, more experienced workers, higher organizational commitment and quality of service. Age could then be a factor for the improvement of governance because of these values possessed by the older workers. Furthermore, Howell et al. (2006) added that workers who are 50 years old and above are more creative than their younger counterpart. Because of their experiences, older people feel more empowered to suggest new ideas for job development; whereas, younger workers have little experience in their jobs and have some fears taking risks.

#### V. Conclusions

Based on the findings of the study, the following conclusions were drawn: The internal audit functions as practiced by the Internal Audit Units of several Local Governments Units (LGUs) in Metro Manila are very good. However, the internal audit units seldom retain an independent outlook in presenting their suggestions under consulting services.

The status of governance of the LGUs under study

is very good. However, improvements should be made under financial management and reporting because the result of the study reveals that the LGUs spend more than what it has earned and loans are sometimes obtained from private institutions. This suggests a problem in the way LGUs manage their finances, and possibly in the way the financial results were reported, including the integrity of such financial statements. Internal audit functions and governance are moderately related. Both dimensions of internal audit functions influence each of the individual dimensions of governance practices of LGUs. This implies a better internal audit functions for an improved governance practices. The internal audit functions in terms of consulting services had a great contribution to the improvement of the governance practices.

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