

**INTERNAL AUDIT OUTSOURCING AND QUALITY OF AUDIT OF SMALL
MEDIUM ENTERPRISES (SMEs) IN LAGOS STATE**

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ADP12/13/H/2804

**A THESIS SUBMITTED TO THE DEPARTMENT OF MANAGEMENT AND
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THE AWARD OF THE DEGREE OF MASTER OF SCIENCE
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CERTIFICATION

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DEDICATION

This research project is dedicated to the Almighty God, the Fountain of knowledge and wisdom.

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ABSTRACT

The study determined the extent to which SMEs outsource internal audit functions in Lagos State and assessed the factors influencing the outsourcing of internal audit functions among SMEs in the state. These were with a view to providing information on the impact of outsourcing internal audit functions on the audit quality of the SMEs.

The study employed primary data. The population for the study consisted of 300 registered SME owners in Lagos State in accordance with Lagos Business Directory (2013). Data on variables such as asset specificity, environmental uncertainty, audit cost, quality of audit and outsourcing of internal audit function were sourced through the administration of structured questionnaire on 170 respondents. Data obtained were analysed using percentages and chi-square method.

The result from the study indicated that the extent of adoption of outsourcing internal audit functions among SMEs was very high (62%). It further revealed that compliance with established policies (59%), application of internal control systems (59%) and special investigation (50%) were wholly outsourced by SMEs. Internal audit functions were mostly outsourced on yearly basis as indicated by the result. The major factors identified as influencing internal audit outsourcing among respondents were asset specificity ($x=3.35$, $p>0.05$), environmental uncertainty ($x=3.53$, $p>0.05$) and cost of auditing ($x=3.4$, $p>0.05$) mean value. Furthermore, the result showed that outsourcing of internal audit function by SMEs had significant impact on the audit quality ($F=3.719$, $p<0.05$).

This study concluded that outsourcing of internal audit functions had a significant impact on the audit quality of SMEs in Lagos State. Also, internal audit outsourcing promotes independence of audit in small and medium scale companies.

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CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

Small and Medium Sized Enterprises (SMEs) significantly contribute to employment and the gross domestic product (GDP) in emerging economies (Ale-Ebrahim, Ahmed and Taha, 2010; Devi and Samujh 2010). Many claim that the growth of emerging economies significantly depends on the performance of SMEs (Ale - Ebrahim *et al.*, 2010; Zohari, 2008; Bayati and Taghavi, 2007). For example, in developing countries, SMEs help to bring stability to the national economy and help buffer the shocks that came with the boom and burst of economic cycles (Ale - Ebrahim *et al.*, 2010), because SMEs make up the most part of manufacturing enterprises (Zohari, 2008; Bayati and Taghavi, 2007). For example, Iranian SMEs employed more than 63 percent of total Iranian manpower in the industrial sector which in total, represents 99.9 percent of all firms in Iran (Zohari, 2008).

Micro, Small and Medium Enterprises (MSMEs) are recognized, all over the world, as the engine of growth in any development oriented economy. Due to their inherent labour intensive production processes, they also provide a viable platform for job creation. All over the developed world, the contribution of MSMEs to GDP averages about 47 per cent. However, in Nigeria, MSMEs account for only 10 per cent of our GDP. As reported by the Small Medium Enterprises Development Agency of Nigeria (SMEDAN), there are about 17.3 million MSMEs in Nigeria compared to the over 40 million MSMEs in Indonesia, whose population is only a

little greater than Nigeria (Jonathan 2014). Some of the reasons adduced for this disparity are limited access to finance, low technology, poor infrastructure and lack of market access.

SMEs play an important role in a nation's economy. In Malaysia, it represents the largest percentage of economic formations at 99.2 percent. This contributes 32 percent to Gross Domestic Products (GDP), 56.4 percent to total workforce and 19 percent to total exports of the country (SMECORP 2013).

In Nigeria, SMEs contributed over 70 percent of national industrial employment represents about 90 percent of the industrial sector, in terms of the number of enterprises. But the SMEs development only accounted for 10 percent of manufacturing output and a meager 5 percent of gross domestic product (GDP) in 2008 (Ogundele, 2010). Over the years, SMEs in Nigeria have been an avenue for job creation and empowerment of citizens providing about 70 percent of all job opportunities and also for wealth formation (Dauda and Akingbade 2010).

Indeed, SMEs in emerging economies are a major part of the industrial economies and their survival and development (growth) is an important issue (Ale-Ebrahim *et al.*, 2010; Zohari, 2008).

To further increase the generative capacity of SMEs, outsourcing can be implemented. It is evident that outsourcing can be an important activity that SMEs can adapt enhance their competitiveness. In this context, this thesis examines the factors affecting internal audit outsourcing and the impact of such outsourcing on the quality of audit in an emerging economy like Nigeria. This chapter provides an overview of the study. Internal audit has been defined as a strategy that helps in preserving and maintaining the resources or asset which facilitates the invention of the reliable accounting information that leads to better decision making during

organizational changes due to the global rivalry and overcapacity such as their non-core functions (Ebaid, 2011; Schneider, 2008). Currently, internal audit has been developed in order to incorporate operational auditing, risk assessment, Information Technology (IT) assurance services and other aspects (Spekle, 2007). Internal auditing has benefited particular organizations by taking a systematic and disciplined approach to evaluate and improve the effectiveness of the risk management, control and governance processes (Barac & Motubatse, 2009; Caplan, Janvrin & Kurtenbach, 2007).

The concept of Small Scale Enterprises has been defined variously by many individuals and institutions using various yardsticks such as number of employees, volume of sale, value of assets, or the volume of deposit in banks (Ademola, Samuel and Ifedolapo 2012). The National Economic Reconstruction Fund (NERF) defined small and medium enterprises as projects to be financed by the firm should have a total fixed asset cost (including land) of not more than N10million. The Federal Ministry of Industry (in respect of small scale industries credit scheme) sees small scale industry as any manufacturing, processing or service industry with capital investment not exceeding N150,000 in machinery and equipment alone. According to Atijosan (1998), a small business is any manufacturing, processing or servicing industry that satisfies any or all of the following conditions:

- (i) Capital, but excluding cost of land and not exceeding N750,000
- (ii) Staff strength not exceeding 50 persons and wholly Nigerian owned
- (iii) A manufacturing, processing or servicing industry, exceeding the units of investment stated is relatively small compared to prevalent size of plant and the technology is fairly labour intensive.

According to Ademola et al, (2012), Small scale enterprises are catalysts for world's economic growth and development which have dominated the industrial sector of both developed and underdeveloped countries. Aruwa (2006) believes that Nigeria's industrial sector is dominated by Small and Medium Scale Enterprises (SMEs) which account for 90%

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