

## **Internal Audit and Financial Performance of Micro Finance Banks in Nigeria**

**Arzizeh Tiesieh Tapang & Oti Ibiam**

Department of Accounting, College of Management Sciences,

Michael Okpara University of Agriculture Umudike,

P.M.B. 7267 Umuahia, Abia State – Nigeria,

E-mail: [arzizeh@gmail.com](mailto:arzizeh@gmail.com); [prince.ibiam@gmail.com](mailto:prince.ibiam@gmail.com)

Tel: +234 (0) 8032737920; +234 (0) 7060608569

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### **Abstract**

*The study examined internal audit and financial performance of micro finance banks in Nigeria. The study made use of the ex-post facto research design and data collected from both primary and secondary sources were analysed using the ordinary least square technique. The results revealed that the regression parameters estimated coefficient has a positive sign and is therefore consistent with our a-priori expectation. The consequence of this symbol is that internal audit proxy by value of fraud favorably impacts the related variables Return on Asset, Profit Margin and Return on Equity. The research also showed that the relationship between value of fraud and the different dependent variables of Return on Asset, Profit Margin and Return on Equity is very strong. The study concludes that in order to ensure successful fraud prevention and control in micro-finance banks, bank management should ensure that internal audit is well understood and developed in all departments to match that of micro-finance banks. It is recommended that to ensure internal audit is time-tested, only qualified and experienced accountants should be appointed head of the internal audit department of micro-finance banks. External auditors should be well paid to maintain their honesty in the performance of their duties. Management should ensure that the internal audit provides the prospective auditors with a visual presentation and prepares booklets and brochures explaining the internal audit function. External checks, such as manual assessments, should be integrated into the banking system to facilitate entry processes in order to secure timely facilities, help minimize delays and serve as protection against possible collusion.*

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**Keywords:** *Internal audit, Profit margin, Return on assets, Return on equity, Value of fraud*

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## INTRODUCTION

In business and economic theory, the industrial revolution has some catalytic impacts. This leads to the shift of focus from widening territorial boundaries to economic development in most organizations (Ejiofor, 1981). In addition to providing support and simply providing a conducive environment for business activities, management is also active in fraud prevention and control along with others. Such business activities contribute to the collapse of departmental organizational structure such as payroll, development, advertising, department of employees, etc. This agency strongly promotes efficient coordination and monitoring, making it necessary to recognize the level of results in performing delegated duties, testing organizational record manipulation and consistency, etc. Although the department's operations have been investigated, bribery and misappropriation also exist. Holiws (1995), notes that, at that time, internal audit had its functions but due to the huge growth of most companies, an effective and efficient internal audit department was required. In most organizations, the position of the department of internal audit has grown tremendously. Such development requires broad institutional spreads and the need to ensure that corporate practices and basic accounting standards are followed in all facets of the company (Ajayi, 1991).

Okezie (2004) opined that internal auditing is administrative supervision with the responsibility of maintaining the implementation and follow-up of company policies on check-mating fraud and prevention. An autonomous assessment role set up within an entity to monitor and assess its operations and report to the appropriate authority. An organization's administration cannot be familiar with every part of the organization. The internal audit department becomes the primary means of controlling the organization's activities as the 'watch dog' of other regulations developed by the government. It involves checks and balances, monitoring and avoidance of theft, embezzlement, misappropriation of funds; this is performed among others by the department of internal audit. Brown and Howard (1975) believed that several cases of vandalism, bribery, misappropriation of corporate funds and theft of property have been recorded to be in the order of the day in most organizations, especially in the banking sector. Therefore, internal auditing becomes a method of monitoring implemented by managers in business organizations to improve record accuracy and reliability. Internal audit deals with the measurement and correction of the subordinates' performance in order to achieve organizational goals with maximum efficiency and at minimum cost.

Problems such as misappropriation of public funds, bribery, and embezzlement evasion may occur in an entity where internal auditing does not exist. Because of this issue, the organization's and the financial institution's money could be split into those at the receiving end defraying. The problem of fraud in the banking industry is caused by lack

of knowledge between employee ambition and organizational target, little or insufficient employee expertise with respect to their assigned role, lack of training and lack of internal control system. Internal control measures would be used to curb or eliminate these errors. Internal audit, which is an important component of internal control, will check the fraud activities of other departments or employees if properly used. The study's main objective is to examine internal audit and financial performance of micro-finance banks in Nigeria.

## **LITERATURE REVIEW**

### **Concept of internal auditing**

Millchamp (1986) defined internal auditing as an independent appraisal of activities within an organization for the view of operations as a source to management it is a management control which functions by measuring and evaluating the effectiveness of other control. This means that an internal auditor should be independent of any manipulations or distractions from the managements activities or others, thereby enabling him to determine whether the management policies are being adhered by the several department in the organization if and whenever there is any deviation policies, the internal auditors check it. Howard (1989) in his own contribution states that “The internal auditors is an employee of the business engaged in the work on behalf of the organization, although the nature of his work require that should be given an element of independence while engaged in it”. This means that the internal auditor is engaged as a staff of the organization but should be given a level of independence. The institute of internal auditors (IIA) defined internal auditing as the independence appraisal of activity within an organization for the review of accounting, financial and other operations as a basis for protective and constructive services to the management. The management of internal auditor here is independent personnel of the organization who appraises the activities of the department and proper, economic efficient and effective use of resources.

### **Historical background of internal auditing**

Auditing has been performed at least since the fifteenth century. The exact origin of audits of financial report is in dispute but it is known that as early as the fifteen century, auditors were called on to ensure the absence of fraud in the records kept by the Steward of Wealthy household estates. In England Stewards were appointed by great land owners to manage their land for them. Today, most business is operated by limited companies, which are owned by their shareholders and manager by direct appointment by the shareholders. Development of auditing has occurred in the last century. Since the shareholders delegate management to the board of directors. The accounts of the company are shown periodically to the shareholders so that they may see the financial position of the company. The shareholders, in order to verify the accuracy and truth of the statement,

now appoint auditors who investigate and inform them of the genuineness of the accounts presented by managements. The shareholders are then satisfied that the account presented shows an objective view of the company's operations.

According to Okezie (2004) internal auditing began as a one-man basic function that consisted primarily of performing independence verification of bills before payment over the years. Internal auditing has evolved to the appraisal of the efficiency and effectiveness of all phases of a company's operations, both financial and otherwise. These changes have led to the formation of internal auditing departments, senior management status for the director, manager of the internal auditors' functions, and reporting responsibilities directly to the board of directors or its audit committee.

Internal audit may be an alternative control techniques and its overall objective is to assist all members of management in the effective discharge of their responsibilities by furnishing them with objective analysis appraisal recommendation and pertinent comments concerning with any phases of business activities; whereas he can be of services to the management, and should be involved in such activities as reviewing and appraising the soundness adequacy and application of accounting financial and operating control ascertaining the extent of compliance with established policies, plans and procedures, ascertain the extent to which company assets were accounted for and safeguarding against loses of all kinds, ascertaining the reliability of accounting and appraising the quality of performance in carrying out assigned responsibility (Institute of Internal Auditing, 1957).

### **Function of internal audit**

The major function of an internal audit is to act as a management tools for effective control. Robert and David (1988) states that, internal auditors have to carry out evidence gathering, according to them, the evidence gathering field work can best be described in terms, as application of the practical audit method.

### **Components of good internal audit**

An internal audit department, according to Debtosh (1993) is a section established in an organization by management in order to carry out internal audit function. Certain elements are pertinent in a good internal audit department: Totality, Independence: Objective, Expertise, and Utility.

### **Types of internal audit**

An internal audit department may be asked by management to look into any aspect of the organization. The safeguarding of the assets can be judged by checking a large number of transactions. This is by carry out a large number of substantive tests. As system audits also utilized substantive test, there is sometimes confusion between transactions and

system audit. The difference is that system audit uses some substantive test (the number texts). It is therefore possible that a system audit may at an early stage discover that no reliance can be placed on internal controls, and so turn to pure substantive testing, that it switches back and become a transaction audit. A management audit would focus attention on the managers themselves, whereas an administrative audit would look at the organizations structure and regular routine, unlike the financial audit of a company by its external auditors.

### **Independence of internal auditors**

Arkin (1963) observed that, internal auditors like external auditors, hold independence as a goal. As noted by Gupta (1993) an internal auditor can only be as effective as the management want him to be. However, if an internal auditor has to effectively perform his duties, he should be independent of the activities that he audits. In the case of a company, he should submit periodic reports to the board or to the audit committee highlighting significant audit finding. In summary, the concept of audit and the concept of independence are the turn bodies of the same coin, as pointed out by Wottle (1982). An independent auditor should be in a better position to produce objective and reliable reports opinions upon which the users of such reports make their decisions.

### **Internal control and internal check**

Kwame (1992) defines internal control as ‘the plan for an organization and all the methods and procedures adopted by management of an entity which assist in achieving management objectives, of ensuring as a far as practicable the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of fraud and error, the accuracy competency of the accounting records and the timely preparation of reliable financial information. The system of internal control extends beyond those matters which relate directly to the functions of the accounting system. This is clear that, internal control is the whole system of control of which internal check and internal auditing are two important constituents. Internal check, according to Awoyemi (1987) can be defined as a system of instituting checks on the day to day transaction which operate continuously as part of the routine system whereby the work of one person is proved independently, or is complementary to the work of another. The objective brings the early detection of fraud or errors. The objective of such an allocation has an exclusive control over any transaction or a group of transactions. Thus, a fraud cannot take place unless there is collusion between two or more parties. Apart from the complementary methods, it involves prompt and independent verification of an individual work by prescribing, cross checking and cross reconciliation as a part of the operational procedure itself. Gupta (1993) states that internal check are in-build in the system itself and takes place concurrently with the execution of the

transaction, whereas internal auditing is a distinct function which is carried out after the transaction as taken place. In essence, internal audit functions of appraising and reviewing operations and records, is today a major factor that established the quality of an organizations internal control.

### **Internal audit report**

On completion of the audit in an organizational unit, the internal auditors draft a report. This report, according to Means and Larson (1973) should contain recommendations on specific steps for operational personnel to implement better controls, prevent errors and improve profits. The report should also include rotation of major changes in operations implemented. This draft report is then forwarded to the audit of the company's board of directors, or to the members of top management in direct control of internal audit. Management or managers and employees of the unit then meet and discuss the deficiencies reported by the internal auditors and take corrective actions. After submitting their final report, the internal auditors may later reinvestigate the affected units and determine the nature and efficiency of corrective actions undertaken by the units, management and employees.

The reporting stages as reported by Roberson and Dan's (1988) is the internal auditor's responsibility to capture managements and individual attention. To be effective, a report cannot be unduly long, tedious, technical or laden with minutes. It must be accurate, concise, clear and timely. Unlike external audit reports, internal audit reports are usually considered 'open' with a formal written reply to the recommended audited unit or department. This reply which would also go to the same people as the audit report, so as the audit committee would indicate recommendations to be implemented which were considered not necessary. Only after the written response is received, is the audit considered close.

## **THEORETICAL FRAMEWORK**

### **Auditor monitoring strength and reputation theory**

De Angelo (1981) argued that a critical attribute to understanding the influence of the audit on financial statement information is related to the ability of the auditor to modify his report when he discovered a breach in the financial statement of a client and the probability that the modification would take place. The probability of reporting the breach is contingent upon auditor's independence. According to the theory, independence is a crucial attribute of the audit since the primary force-giving rise to the demand for auditing is the existing of conflict of interest between providers and users of financial information. The auditors degree of competence and independence relates to the component of audit quality referred to as auditor monitoring strength. From another perspective, auditor reputation is often used synonymously with audit quality. This theory establishes that

auditor's reputation and auditor monitoring strength are the two major components of audit quality.

Auditor monitoring strength influences information quality by improving fineness, reducing noise and reducing bias. It minimizes the difference between a client's reported economic circumstances of the client. Auditor reputation impacts information credibility or how reliable the information is perceived to be. It relates to market perception of auditor competence and objectivity. Reputation is likely viewed as a firm wide characteristic that is consistent across audit engagement, whereas auditor monitoring strength may vary with audit engagements. This theory is applicable in Nigeria as most firms (small, medium and large scale) would prefer to engage auditors with brand name for their reputation and reports; and perceived as having high quality even if there is low monitoring strength as in the case of AP and Andersen LLP in Nigeria in 2000.

### **Agency theory**

The agency theory holds that the demand for audit has been motivated by the need to manage agency conflict. Accordingly, in an agency setting, information asymmetry between a principal (Stakeholder) and an agent (Management) creates a moral hazard problem which is the concern that an agent will pursue his/ her own self-interest at the expense of the principal (Jensen & Meckling, 1976; Watts & Zimmerman, 1983). Agency theory predicts that agents and principals will recognize that it can be mutually beneficial to reduce the moral hazard and will devise arrangement to align their self-interest. One such arrangement is the independent audit, which provides a monitoring device designed to improve information about client performance and reduce information asymmetry. The greater the agency conflict between managers and stakeholder, the greater the agency costs, and the greater the demand for audit identified as high quality (or of high perceived quality) (Palmrose, 1984; Francis & Wilson, 1988; Defond, 1992; Crawell et al, 1995; Asuquo, 2011, Asuquo, 2012; Tapang, Bessong & Ujah, 2015; Tapang, Bassey & Bessong, 2012; Bassey & Tapang, 2012; Bessong & Tapang, 2012; Asuquo, Akpan, & Tapang, 2012). De Angelo (1981) argues that auditors should specialize in supplying a certain level of audit quality. Therefore, if a client wishes to change audit quality, they must change auditors. Relying on various theoretical and analytical arguments (De Angelo 1981; Dopuch and Simonc, 1982; Titman and Truman, 1986; Beaty, 1989; Ingwe, Bessong & Uwanade, 2013) most agency related audit quality research assumes that larger (brand name) auditors provide great monitoring strength and that this results in higher information quality and credibility.

### **The deep pocket theory**

Simunic (1980) posits that a positive related is assumed to assist between audit quality and audit fees. Most researchers theorized that if larger firms are charging higher fees, it

reflects the higher quality of their audit services. The theory proposes that the increased hours provided by brand name auditors reflect greater productive activities (evidence acquisition) in providing higher levels of assurance (higher quality to clients). The theory raises a questionable issue thus; are fee premium due to monopolistic behavior of branch auditors or evidence of greater monitoring efforts?

The deep pocket theory also impact on issues relating to low-balling which is the pricing of internal audits significantly below cost and how this affect the supply of audit quality ad audit fees (AICPA, 1978). The theorists argued that low balling could lead to true and budget pressures as well as make difficult for auditors to refuse accounting concession because of the threat of termination. This could impair auditor independence and contribute to lower quality audits (Lee and Gu, 1998); Kanodia & Mukherji, 1994; De Angelo, 1981).

The practice of auditing in Nigeria has significantly been affected by this theory. This is no more so since, the brand name audit firms in the country would charge high fees and commit high level of resources and may not render such higher services. From another perspective in Nigeria, low balling has become a common practice especially for small audit firms who will under price audit engagement to ensure that they are able to maintain their earnings and operate their firms.

### **EMPIRICAL REVIEW**

Peursem (2019), a study undertaken in New Zealand, internal auditors were required to evaluate the importance of their functions in connection with audit engagements. The findings of the study were true professions exist although it does not dominate auditors with high level of experience and are in public practice have significant influence over the management. Additionally, if the auditors have accountancy training, their influence level is high due to the fact that they are members of accountancy professional bodies. These findings are supported by Coopers and Craig (1983), Cooper et al. (1966) and Gramling (1997), who had portrayed reservations over the effectiveness of the role of internal auditors. Peursem conducted a follow up study in New Zealand to determine whether the auditor influences his role. This involved checking on internal auditors' objectivity while working with the management so as to be able to report on their performance. The findings of the study were that for those internal auditors who best balanced their role, they had external professional status and their organizations had both formal and informal communication network. Sunday (2017) conducted a study on internal audit function and corporate governance. The study established that there is a positive relationship between quality of internal audit function and quality of corporate governance. Makoju (2019) noted that bureaucracy and sluggishness of government employees has resulted to the inadequate performance of state corporations. The issue of high incidences of fraud and government staff employment being inclined to political

affiliation rather than ability to perform was also found to have contributed to the inadequate financial performance.

Dwivedi (2019) however, mentions other financial measures to include value of long-term investment, financial soundness, and use of corporate assets. John and Morris (2019) mentions accounting based performance using three indicators: return on assets, return on equity, and return on sales. Each measure is calculated by dividing net income by total assets, total common equity, and total net sales, respectively. Mawanda (2018) conducted a research on effects of internal control systems on financial performance in institution of higher learning Uganda. In his study he investigated and sought to establish the relationship between internal control systems and financial performance in an Institution of higher learning in Uganda. Internal controls were looked at from the perspective of Control Environment, Internal Audit and Control Activities whereas Financial performance focused on Liquidity, Accountability and Reporting as the measures of Financial performance. The Researcher set out to establish the causes of persistent poor financial performance from the perspective of internal controls. The study established a significant relationship between internal control system and financial performance. The investigation recommends competence profiling in the Internal Audit department which should be based on what the University expects the internal audit to do and what appropriate number staff would be required to do this job. The study therefore acknowledged role of internal audit department to establish internal controls which have an effects on the financial performance of organizations.

## **METHODOLOGY**

Study design is a structure or program that is used as a model for the compilation and review of study data. Research design, according to Nwana (2011), is the structuring of research aimed at identifying variables and relationships with each other. Nevertheless, the study made use of the ex-post facto research method as this would contribute to the study's goal of directing the researcher in his attempt to produce evidence to test the theory needed and answer question. The analyst took into account the essence of the research work and led the researcher in his attempt to produce evidence to test the proposed theory and address research questions. The study population covers the entire Nigerian micro-finance sector. The sampled micro finance banks are in line with the works of Balsley and Clover (1988) quoted in Tapang, Bessong and Ujah (2015); Tapang, Bassey and Bessong (2012); Bassey and Tapang (2012) suggesting that the use of 10 percent of the sample size is normal in research studies, since the sample size of 10 percent of the universe has been shown to be more than sufficient in research projects. Ogolo (1996) also as quoted in Tapang, Bessong and Ujah (2015); Tapang, et al. (2012); Bassey and Tapang (2012) corroborate this by noting that, where a population is identified, at least 10% of the population represents a sample that can be investigated.

### Model Specification

A simple linear panel regression model was adapted from the work of John and Morris (2019) as follows.

$$ROA_{it} = \beta_0 + \beta_1 VOF_{it} + \varepsilon_i \text{-----} 1$$

$$ROE_{it} = \beta_0 + \beta_1 VOF_{it} + \varepsilon_i \text{-----} 2$$

$$PM_{it} = \beta_0 + \beta_1 VOF_{it} + \varepsilon_i \text{-----} 3$$

Where:

ROA = Return on Assets

ROE = Return on Assets

PM = Profit Margin

VOF = Value of Fraud

$\beta_0$  = Unknown constant to be estimated

$\beta_1$  = Unknown coefficient to be estimated

it = Cross Section (i) and Time (t)

$\varepsilon_i$  = Error term

### FINDINGS

The study's empirical results revealed that the regression parameters estimated coefficient has a positive sign and is therefore consistent with our a-priori expectation. The consequence of this symbol is that internal audit proxy by value of fraud favorably impacts the related variables Return on Asset (ROA), Profit Margin (PM) and Return on Equity (ROE). The research also showed that the relationship between internal audit (value of fraud) and the different dependent variables of Return on Asset (ROA), Profit Margin (PM) and Return on Equity (ROE) is very strong.

### CONCLUSION/RECOMMENDATIONS

Based on the findings of this report, it can be inferred that, in order to ensure successful fraud prevention and control in micro-finance banks, bank management should ensure that internal audit is well understood and developed in all departments to match that of micro-finance banks.

Based on the findings of this study, the following were recommended.

- 1) In order to ensure that the internal audit is time-tested, only qualified and experienced accountants should be appointed head of the internal audit department of micro-finance banks.
- 2) External auditors should be well paid to maintain their honesty in the performance of their duties.

- 3) Management should ensure that the internal audit provides the prospective auditors with a visual presentation and prepares booklets and brochures explaining the internal audit function.
- 4) External checks, such as manual assessments, should be integrated into the banking system to facilitate entry processes in order to secure timely facilities, help minimize delays and serve as protection against possible collusion.
- 5) The bank's internal control system should be enabled to prevent or detect fraud when it has not matured. There is also a need to tighten the banks' security system. in order to match that of commercial banks in all micro-finance institutions.

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