# THE ROLES AND CHALLENGES OF INTERNAL AUDITING IN THE BANKING INDUSTRY IN KENYA

BY

LEONA CHEPKORIR

REG.NO: D61/70455/2009

A Management Research Project Submitted in Partial Fulfillment of the Requirements for the Award of a Master in Business Administration Degree, School of Business, University of Nairobi

OCTOBER 2010

## DECLARATION

This research project is my original work and has not been presented to any other institution or university.

Signed ____________ Date 15.11.2010

LEONA CHEPKORIR

REG. NO.: D61/70455/2009

This research project has been submitted for examination with our approval as the university supervisors.

Sign ____________ Date 15/11/2010

Mr. Ondigo Herick Ochieng

Lecturer,

Department of Accounting and Finance,

School of Business,

University of Nairobi

# DEDICATION

I dedicate this work to my family and all those who supported me in the completion of this project.

# ACKNOWLEDGEMENTS

I thank the Almighty God for his guidance and providence which enabled me to undertake this project that was too involving in term of time and resources.

I wish also to express my sincere appreciation to my husband and the entire family for their understanding and support during the project.

I would also like to express my sincere thanks to the supervisor Mr. Ondigo Herick Ochieng for having agreed to supervise this research paper and his patience in reading the drafts and guiding me. without which the research would not have been a reality.

Finally, I would wish to extend my sincere gratitude to all the MBA students, staff, lecturers and the entire University of Nairobi fraternity for changing me from what I was to what I am.

# ABSTRACT

While differences may affect the practice of internal auditing in each environment, conformance with the IIA's International Standards for the Professional Practice of Internal Auditing (Standards) is essential in meeting the responsibilities of internal auditors and the internal audit activity. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. The internal audit activity evaluates risk exposures relating to the organization's governance, operations and information systems. The internal auditors are expected to provide recommendations for improvement in those areas where opportunities or deficiencies are identified.

Faced with this scenario and with the current turbulent business environment, the purpose of this study was to establish the roles of internal auditing and the challenges faced by internal auditors in carrying out these roles. The research design employed in this study was descriptive in nature. The target population in the study was the 43 licensed commercial banks in Kenya. Primary data was collected using a semi-structured questionnaire. The study used the quantitative method of data analysis, that is, mean and mode. To ensure easy analysis, and minimize the margin of errors, questionnaire was coded according to each variable.

Based on the findings, the study concluded that the general roles of internal auditing is to provide guarantee that internal controls are efficient, examining and assessing the banks policies, procedures, manuals and recommending best practices and risk evaluation and management. The study further concludes that the challenges faced by internal auditors on their daily operations were those of realigning skills to address new requirements and implementing the new international professional practices framework (IPPF).

The study recommends that the banks should hire auditors from other fields to introduce new techniques in the bank accounts auditing in order to overcome the challenges encountered by the internal auditors in their operations. The study also recommends that there should be continuous training and development of audit staff, in order to enhance their competence and also there should be acquisition of an audit system in all the banks.

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| | |
|---|---|
| CAE | Chief Audit Executive |
| CEO | Chief Executive Officer |
| CBK | Central Bank of Kenya |
| ERM | Entire Risk Management |
| IAD | Internal Audit Department |
| ICPAK | Institute of Certified Public Accountants |
| IIA | Institute of Internal Auditors |
| IMF | International Monetary Fund |
| ISA | International Standards of Auditing |
| IT | Information Technology |
| NSE | Nairobi Stock Exchange |
| SOE | State Owned Enterprises |
| SOX | Sarbanes Oxley Act |
| USA | United States of America |

# CHAPTER ONE: INTRODUCTION

## 1.1 Background to the Study

Internal auditing is conducted in diverse legal and cultural environments; within organizations that vary in purpose, size, complexity, and structure; and by persons within or outside the organization. While differences may affect the practice of internal auditing in each environment, conformance with the IIA's International Standards for the Professional Practice of Internal Auditing (Standards) is essential in meeting the responsibilities of internal auditors and the internal audit activity.

### 1.1.1 Internal auditing

The IIA (2009) defines internal auditing as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Independence is established by the organizational and reporting structure while objectivity is achieved by an appropriate mind-set.

The internal audit activity evaluates risk exposures relating to the organization's governance, operations and information systems, in relation to; effectiveness and efficiency of operations, reliability and integrity of financial and operational information, safeguarding of assets and compliance with laws, regulations, and contracts. Based on the results of the risk assessment, the internal auditors evaluate the adequacy and effectiveness of how risks are identified and managed in the above areas. They also assess other aspects such as ethics and values within the organization. performance management, communication of risk and control information within the organization in order to facilitate a good governance process (IIA Research Foundation, 2004).

The internal auditors are expected to provide recommendations for improvement in those areas where opportunities or deficiencies are identified. While management is responsible for internal controls, the internal audit activity provides assurance to management and the audit committee that internal controls are effective and working as intended. The internal audit activity is led by the CAE. The CAE delineates the scope of activities, authority, and independence for internal auditing in a written charter that is approved by the audit committee. An effective internal audit activity is a valuable resource for management and the board or its equivalent, and the audit committee due to its understanding of the organization and its culture, operations and risk profile. The objectivity, skills, and knowledge of competent internal auditors can significantly add value to an organization's internal control, risk management, and governance processes. Similarly an effective internal audit activity can provide assurance to other stakeholders such as regulators, employees, providers of finance, and shareholders (IIA Research Foundation, 2004).

The internal auditing profession is guided by the International Standards for the professional practice of Internal Auditing. According to the International Standards for the professional practice of Internal Auditing (2008), the purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the definition of internal auditing, the code of ethics, and the standards. The CAE must periodically review the internal audit charter and present it to senior management and the board for approval.

According to the Basel Committee's internal audit paper (2002), there are four principles of internal audit. First is the permanent function-continuity: states that each bank should have a permanent internal audit function. In fulfilling its duties and responsibilities, senior management should take all necessary measures so that the bank can continuously rely on an adequate internal audit function appropriate to its size and to the nature of its operations. These measures include providing the appropriate resources and staffing to internal audit to achieve its objectives. Second is that an internal audit department should function in accordance with the principles of independence, objectivity and impartiality. Third is professional competence and finally Scope of activity and the organisation of the internal audit department.

### 1.1.2 The Banking Industry in Kenya

The banking industry in Kenya is one of the highly regulated industries and has grown tremendously over the years. The industry is made up of commercial banks and mortgage institutions licensed and regulated pursuant to the provisions of the Banking Act and the Regulations and Prudential Guidelines issued there under. They are the dominant players in the Kenyan Banking system and closer attention is paid to them while conducting off-site and on-site surveillance to ensure that they are in compliance with the laws and regulations. Currently, there are 43 licensed commercial banks and 1 mortgage finance company. Out of the 44 institutions, 31 are locally owned and 13 are foreign owned. The locally owned financial institutions comprise 3 banks with significant shareholding by the Government and State Corporations, 27 commercial banks and 1 mortgage finance institution.5 of the commercial banks are listed in the NSE (CBK Website, 2010).

In the 1980's and early 1990's, several countries in developed, developing and transition economies experienced several banking crisis requiring a major overhaul in the banking systems (IMF,1998). Kenya has experienced banking problems since 1986 culminating in major bank failures following the crisis of 1986-1989, 1993/1994 and 1998. Presently, several developed countries including the USA are experiencing a banking crisis. For example, the Citibank Group alone has written off more than $39 billion losses (Waweru & Kalani, 2009). Brownbridge (1998) argues that the main causes of bank failures are non performing loans caused by insider lending, lending to high risk clients and macroeconomic instability.

The CBK prudential guidelines stipulate the corporate governance guidelines for banks in Kenya. According to the guidelines; shareholders, directors, CEOs and management play key roles in promoting good corporate governance in banks. Chief finance officers and internal auditors are under the management category and are required to be members of the ICPAK.

### 1.2 Problem Statement

Only months before Enron Corp.'s bankruptcy filing in December 2001, the firm was widely regarded as one of the most innovative, fastest growing, and best managed businesses in the USA. Jickling (2002) notes several financial issues that led to the collapse of the American energy company. They include the following; external auditors mistakes, corporate governance issues, accounting issues, pension issues, securities analyst issues and derivative issues. However, nothing was mentioned on the operations management under which internal auditing function falls.

Kimani (2006) observes that many questions were raised by shareholders of Uchumi supermarkets in Kenya when it was declared insolvent. These questions included; reasons for the loss, plans to recover assets looted by past management and whether the company was still solvent. Of such importance was the role of the external auditors. The management was required to justify the retention of Pricewaterhousecoopers as the auditors. Kibet (2008) carried out a survey on the role of internal audit in promoting good corporate governance in SOEs; Kibara (2007) similarly carried out a survey of internal auditors risk management practices in the banking industry in Kenya; Keitany (2000) studied the internal audit control function and its implication for risk assessment by the external auditor and Mugo (1998) conducted a study on the scope of independence of internal auditing in publicly quoted companies in Kenya.

A question is left unanswered as to whether internal auditors should be among the ones to blame when organizations are at the point of collapsing. In the case of Uchumi, the external auditors were mostly accused for failure to alert the public on the financial status of the supermarket. However, according to the ISAs the role of the external auditor is not to unearth frauds and irregularities in organizations but to carry out his work with a skepticism mind and report any if they encounter. They rely on information provided by the management of which internal auditors are part of. The internal auditor should be aware of any irregularities even before the external auditor finds out. This means that the audit committee would have been made aware also through the internal audit reports. There is no local study that has been carried out on what internal auditors perceive as their roles in organizations and the challenges they face as they carry out these roles.

Faced with this scenario and with the current turbulent business environment, a study should be carried out on the roles of an internal auditor and the challenges they face in carrying out these roles. Therefore, this research seeks to carry out a survey on the perceived role and challenges of internal auditors in the banking industry in Kenya.

## 1.3 Objectives of the Study

The general objective of the study was to determine the perceived role and challenges of internal auditing in the banking industry in Kenya. The specific objectives of the study were;

1. To establish the perceived role of internal auditors in organizations.
2. To find out the challenges faced by the internal auditors in performing the perceived roles.

## 1.4 Significance of the Study

This may provide critical information to the various stakeholders in the corporate world.

Management

The study may help management to appreciate the role played by internal auditing function in their organizations and understand the challenges they face in carrying out their roles and help solve them. It may enable them to know whether their investment in strong IAD is worthwhile.

Internal auditors

The internal auditors may understand their role in organisations and the challenges they will face as they carry out these roles.

Academicians

To the academicians and scholars, the study contributes significantly to the internal auditing debate.

Investors

The study may help investors to understand the importance of having an internal audit function in an organization in general before investing in it.

# CHAPTER TWO: LITERATURE REVIEW

## 2.1 Introduction

This chapter presents a review of the literature on the topic of internal audit function as in the previous studies and the gaps to be filled by this research study are also explained.

## 2.2 Theoretical Framework

### 2.2.1 The agency theory

Meckling and Jensen (1976) in their paper on the theory of the firm defined the agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.

The first scholars to propose, explicitly, that a theory of agency be created, and to actually begin its creation, were Stephen Ross and Barry Mitnick, independently and roughly concurrently. Ross is responsible for the origin of the economic theory of agency, and Mitnick for the institutional theory of agency. Ross introduced the study of agency in terms of problems of compensation contracting; agency was seen, in essence, as an incentives problem. Mitnick introduced the now common insight that institutions form around agency, and evolve to deal with agency, in response to the essential imperfection of agency relationships. That is behavior never occurs as it is preferred by the principal because it does not pay to make it perfect. But society creates institutions that attend to these imperfections, managing or buffering them, adapting to them, or becoming chronically distorted by them. Thus, to fully understand agency, we need both streams to see the incentives as well as the institutional structures (Mitnick, 2006).

Fama (1980) proposed that separation of security ownership and control can be explained as an efficient form of economic organization within the "set of contracts" perspective. He set aside the typical presumption that a corporation has owners in any meaningful sense and the concept of the entrepreneur for the purposes of the large modern corporation. Instead, the two functions attributed to the entrepreneur, management and risk bearing, were treated as naturally separate factors within the set of contracts called a firm. He proposed that the firm is disciplined by competition from other firms, which forces the evolution of devices for efficiently monitoring the performance of the entire team and of its individual members. In addition, individual participants in the firm, and in particular its managers, face both the discipline and opportunities provided by the markets for their services, both within and outside of the firm.

Agency theory evolution also owes much to the corporate governance literature, which analyzes the problem of the separation of ownership and control and the role of indirect policing forces in aligning shareholders and management's interests. The contemporary literature identifies three essential indirect policing forces: the labor market discipline, the product market discipline, and the market for corporate control (Padilla, 2003). Fama (1980) in Padilla (2003) argues that one mechanism to mitigate management's opportunistic behavior is the managerial labor market. He argues that manager's career and reputation concerns will alleviate negative incentives. Moreover, Fama argues that career concerns also stimulate competition between the managers inside but also outside the firm, which, in turn, induces a monitoring process between managers to emerge. According to Fama and Jensen (1983) in Fama and Jensen (1998), agency problem is controlled by decision systems that separate the management (initiation and implementation) and control (ratification and monitoring) of important decisions at all levels of the organization. Devices for separating decision management and decision control include; decision hierarchies in which the decision initiatives of lower level agents are passed on to higher level agents, first for ratification and then for monitoring, boards of directors that ratify and monitor the organization's most important decisions and hire, fire, and compensate top-level decision managers, and incentive structures that encourage mutual monitoring among decision agents.

## 2.3 Internal Auditing

The Institute of Internal Auditors defines internal auditing as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. The IIA further defines 'Governance' as 'The combination of processes and structures implemented by the board in order to inform, direct, manage and monitor the activities of the organization toward the achievement of its objectives

Millichap (2002) defined internal auditing as an independent appraisal function established by the management of an organization for the review of the internal control system as a service to the organization. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources.

Independence is established by the organizational and reporting structure while objectivity is achieved by an appropriate mind-set. The internal audit activity evaluates risk exposures relating to the organization's governance, operations and information systems, in relation to; effectiveness and efficiency of operations, reliability and integrity of financial and operational information, safeguarding of assets and compliance with laws, regulations, and contracts. Based on the results of the risk assessment, the internal auditors evaluate the adequacy and effectiveness of how risks are identified and managed in the above areas. They also assess other aspects such as ethics and values within the organization, performance management, communication of risk and control information within the organization in order to facilitate a good governance process (IIA Research Foundation, 2004).

The internal auditors are expected to provide recommendations for improvement in those areas where opportunities or deficiencies are identified. While management is responsible for internal controls, the internal audit activity provides assurance to management and the audit committee that internal controls are effective and working as intended. The internal audit activity is led by the CAE. The CAE delineates the scope of activities, authority, and independence for internal auditing in a written charter that is approved by the audit committee. An effective internal audit activity is a valuable resource for management and the board or its equivalent, and the audit committee due to its understanding of the organization and its culture, operations, and risk profile. The objectivity, skills, and knowledge of competent internal auditors can significantly add value to an organization's internal control, risk management, and governance processes. Similarly an effective internal audit activity can provide assurance to other stakeholders such as regulators, employees, providers of finance, and shareholders (IIA Research Foundation, 2004).

According to the International Standards for the professional practice of Internal Auditing (2008), the purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Definition of Internal Auditing, the Code of Ethics, and the Standards. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

According to the Basel Committee's Internal Audit Paper (2002), the scope of internal audit, from a general point of view, includes the following: the examination and evaluation of the adequacy and effectiveness of the internal control systems; the review of: the application and effectiveness of risk management procedures and risk assessment methodologies, the management and financial information systems, including the electronic information system and electronic banking services, the accuracy and reliability of the accounting records and financial reports, the means of safeguarding assets, the bank's system of assessing its capital in relation to its estimate of risk, and the systems established to ensure compliance with legal and regulatory requirements, codes of conduct and the implementation of policies and procedures, the appraisal of the economy and efficiency of the operations; the testing of both transactions and the functioning of specific internal control procedures; the testing of the reliability and timeliness of the regulatory reporting; and the carrying-out of special investigations.

In attempting to adequately discharge their responsibilities, internal auditors often find themselves in an anomalous position. They report to senior management within the organisation, yet are expected to objectively review management's conduct and effectiveness. The only satisfactory solution to this problem is for internal audit to report primarily and directly to the board and its audit committee rather than to senior management (KPMG, 2003).

### 2.3.1 The role of internal audit

Historically, internal audit has been viewed as a monitoring function, the 'organizational policeman and watchdog' (Morgan, 1979,), tolerated as a necessary component of organizational control but deemed subservient to the achievement of major corporate objectives. An examination of the pressures on internal audit in recent years reveals the struggle to demonstrate that the function can add value.

Keitany (2000) concluded that though the extent of reliance of internal controls is not sensitive to the strength of internal audit departments, companies should not do away with it. This is because as a management tool, it assists management in its day to day operations and not necessarily of relevance to the external auditor. According to Millichap (2002) the following are the roles of an internal auditor: as an appraisal function, that is, to appraise the activities of others and not to perform a specific part of data processing; as a service to an organization by ensuring policies are fulfilled, information required is reliable and complete, assets are safeguarded, internal control system is well designed and works in practice; as an eye of the board within the organization.

According to the Basel Committee's Internal Audit Paper (2002), the scope of internal audit, from a general point of view, includes the following: the examination and evaluation of the adequacy and effectiveness of the internal control systems; the review of: the application and effectiveness of risk management procedures and risk assessment methodologies, the management and financial information systems, including the electronic information system and electronic banking services, the accuracy and reliability of the accounting records and financial reports, the means of safeguarding assets, the bank's system of assessing its capital in relation to its estimate of risk, and the systems established to ensure compliance with legal and regulatory requirements, codes of conduct and the implementation of policies and procedures, the appraisal of the economy and efficiency of the operations; the testing of both transactions and the functioning of specific internal control procedures; the testing of the reliability and timeliness of the regulatory reporting; and the carrying-out of special investigations.

Looking at corporate governance as a whole, that is, the demands, pressure and tasks of the audit committee, management and the board in general, the expectations of the different stakeholders, the position of the internal auditor within the organization, an impact on the workload and the responsibilities of internal audit appears unavoidable. Corporate governance developments both locally and around the world have reaffirmed the board's responsibility for ensuring the effectiveness of their organisation's internal control framework. These developments have highlighted the key role that internal audit can play in supporting the board in ensuring adequate oversight of internal controls and in doing so form an integral part of an organisation's corporate governance framework. The key role of internal audit is to assist the board and/or its audit committee in discharging its governance responsibilities by delivering: An objective evaluation of the existing risk and internal control framework, systematic analysis of business processes and associated controls, reviews of the existence and value of assets, a source of information on major frauds and irregularities, ad hoc reviews of other areas of concern, including unacceptable levels of risk, reviews of the compliance framework and specific compliance issues, reviews of operational and financial performance, recommendations for more effective and efficient use of resources, assessments of the accomplishment of corporate goals and objectives, feedback on adherence to the organisation's values and code of conduct/code of ethics (KPMG, 2003).

The mere definition of internal auditing and the standards drawn up and implemented by the IIA give the internal auditor not just the mandate but the obligation to contribute in any way possible (consulting or assurance) to the evaluation of the corporate governance process (Cattrysse, 2005). The study argues that while traditionally the role of the internal auditor was to help the organization to maintain the system of internal control of its financial statements, a whole range of new opportunities, possibilities and responsibilities present themselves in the wake of corporate governance. He notes that the ultimate challenge for the internal auditor is to find the necessary ways to provide the degree of reasonable assurance expected by all the participants. On other words, the internal auditor needs to become the key 'enabler' in the corporate governance process. Audit committees try to improve their own effectiveness through better and more frequent contacts with the internal auditor who represents one of their most valuable sources of information.

The dual position in which the internal auditor finds himself enables him, as it were, to keep one eye on the direction the company is going in, and the other on every aspect of internal control including rules and regulations, laws and expectations, risk and opportunities. Corporate developments, along with more inquisitive stakeholders and assurance requirements, not only on financial but also on non-financial measurements and reporting, increase the audit workload. Thus the internal auditor becomes 'an integral part' of the corporate governance process. The conviction that the internal auditor plays a valuable role in the 'corporate governance' process is recognized by many organizations of different interest. 'The role of auditors is vital to the corporate governance process. The effectiveness of the board and senior management can be enhanced by recognizing the importance of the audit process and by taking measures that enhance the independence and stature of auditors (Cattryse, 2005).

The internal audit activity evaluates risk exposures relating to the organization's governance, operations and information systems, in relation to; effectiveness and efficiency of operations, reliability and integrity of financial and operational information, safeguarding of assets and compliance with laws, regulations, and contracts. Based on the results of the risk assessment, the internal auditors evaluate the adequacy and effectiveness of how risks are identified and managed in the above areas. They also assess other aspects such as ethics and values within the organization, performance management, communication of risk and control information within the organization in order to facilitate a good governance process (IIA Research Foundation, 2004). The ideal core roles of internal audit department in risk management process as identified in the are; giving assurance on risk management processes, giving assurances that risks are evaluated correctly, evaluating the risk management processes, evaluating the reporting of key risks and finally, reviewing the management of key risks (Kibara, 2007).

## 2.4 Empirical Studies

Several studies on internal auditing have been carried out both locally and globally. Local studies have been done by researchers such as Mugo, Keitany, Kibara, Kibet, Koome and Sigowo. Mugo (1988) in his study aimed to determine the scope and independence of internal audit function in the publicly quoted companies in Kenya. Additionally, the study sought to establish the degree of independence accorded to internal auditors in the same companies. The study used an exploratory research design. The target population was the companies quoted at the NSE as at 31.03.1988. The population was 100% and therefore 55 companies then. Data was collected using a structured questionnaire and analysis done by way of tabulations and percentages. Results of the study indicated that the scope of internal audit is wide enough to cover not only financial/accounting data but also the data from other operations of the organization. Independence from operations in terms of objectivity was found to be quite high unlike in terms of organizational status which was found to be moderately high. The study concluded that the accounting discipline still remained the source of internal audit staff and recommended IT specialists in IADs.

Keitany (2000) in his study 'the internal audit control function and its implication for risk assessment by the external auditor: A case of quoted companies' aimed to establish whether the existence of an adequate internal audit function translates into a strong internal system that can be relied upon by the external auditor. The study adopted an exploratory research design and the population was all companies active in the NSE and their external auditors. The sample was 100% of the population. Primary data was collected using semi structured questionnaires with close ended questions. The data was analyzed using descriptive statistics such as mean, standard deviations and percentages. It was concluded that though the extent of reliance of internal controls is not sensitive to the strength of internal audit departments, companies should not do away with it. This is because as a management tool, it should assist management in its day to day operations and not necessarily of relevance to the external auditor.

Kibara (2007) conducted a survey of internal auditors risk management practices in the banking industry in Kenya. The study sought to establish banking internal auditors' perception of their distinct role in the bank wide ERM process, and whether there was any conflict between internal audit and risk management departments being established to take over the ERM process. Bank internal auditors risk assessment practices in Kenya were also probed. To achieve the objectives set, a survey of involving all heads of internal audit departments in the banking industry in Kenya was conducted. Data analysis was done, and with response rate of 52%, it was concluded that the outcome of the study fairly represented the banking industry internal auditors' practices and perception of risk management. The findings indicated that seven banks out of twenty one (33 %) had not established a separate risk management department. It also emerged that only 14% of the internal auditors could clearly list the distinct role of IAD and those of RMD. For institutions both departments. a conflict was already brewing between IAD and RMD in 29% of the institutions. The conflict centered mainly on lack of clarity on the distinct roles to be played by those two departments in the whole ERM process. The study found that. most banks in Kenya were in process of drafting the ERM process and strategies.

Kibet (2008) in his study ‘a survey on the role of internal audit in promoting good corporate governance in SOEs’ aimed to explore the role and the use of internal audit function in promoting good corporate governance in public sector enterprises and the challenges faced by the internal auditors in SOEs. The study followed an exploratory research design and the population comprised of all SOEs with government equity of over 50% located in Nairobi. A sample of 43 state corporations was selected by way of geographical location and government shareholding. Data collection was by way of questionnaires and the respondents were the heads of internal audit departments. Data collected was analyzed using the SPSS and the output presented in frequency distribution tables, pie and bar charts. The study concluded that internal audit function played a role in corporate governance. The limitations of the study were time constraints and restriction to state owned corporations. Recommendations of further study were effectiveness and contribution of internal audit in promoting corporate governance for companies listed in the NSE. Additionally, a study on the influence of internal audit and audit committee on financial reporting quality was recommended.

Globally, Donaldson and Davis (1991) conducted a study contrasting stewardship theory and agency theory on governance, incentive of the CEO and shareholder return. It sought to examine the effect of CEO duality on shareholder returns. A comparison was done of corporations whose board structure had a dual CEO-chair and where the CEO was independent from the chair. The sample for the study was a convenience sample of 337 US corporations taken from a compensation survey however only 321 firms had complete data and those were included in the sample. The companies covered a wide range of industries such as consumer products, technology, financial services, transportation, services and utilities. The study used a cross-sectional design and examined changes in structure and their effects on changes in shareholder returns. Size data was taken from Standard and Poor's industrial reports and the million dollar directory. The board structure was coded as presence of CEO duality if the top executive was also chair of the board in 1987. The board structure was coded as independent if the board chair was not the CEO. Thus the board structure had a binary code. Shareholder returns were measured by ROE and gain in shareholder wealth.

The results of the research indicated that contrary to agency theory, CEO duality is associated with higher returns to shareholders than is an independent chair of the corporate board. The study also revealed that incentive schemes to CEOs do not secure higher returns to shareholders. In summary the superiority of independent chair board structures and CEO financial incentives on shareholder returns as posited by agency theory was not found on ROE. The positive relationship between CEO duality and shareholder returns posited by stewardship theory was found on ROE. The areas for further research suggested included a research being conducted on board structure and shareholder returns particularly a longitudinal inquiry into cause and effect. A similar study could be conducted which utilizes a more sophisticated market based measure which adjusts for risk. Stewardship theory should also be investigated in strategic management whose premise should not be restricted to the narrow confines of agency and organizational economics.

According to Donaldson and Davis (1991), in a modern corporation, in which share ownership is widely held, managerial actions depart from those required to maximize shareholder returns. Similarly according to Meckling and Jensen (1976), where the principal and the agent are both utility maximizers, the most probable occurrence is that the agent will not always act in the best interests of the principal. Agency theory therefore deals with problems resulting from conflicts of interest that may emerge in contractual relationship when parties are differently informed.

In order for a firm to survive, it needs to control agency problems. These problems arise because contracts are not costlessly written and enforced. Agency costs include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests, plus the residual loss incurred because the cost of full enforcement of contracts exceeds the benefits (Fama and Jensen, 1998). The main objective of agency theory is to explain how different mechanisms can align incentives between contracting parties and minimize costs associated with such problems (Padilla, 2003). Agency theory specifies mechanisms which can reduce agency loss (Eisenhardt, 1989). The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs to limit the aberrant activities of the agent. In some situations the agent expends resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. It is however impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions. The principal and the agent will incur positive monitoring and bonding costs and there will also be an additional cost as a result of divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. This results in "residual loss" (Meckling & Jensen, 1976).

Agency models originally were focusing their attention on explicit incentive mechanisms and, more particularly, the designing of incentive contracts to mitigate agency problems. These models show how principals design or should design contracts to align agent's incentives with their own to reduce agency problems (Padilla, 2003). These would include incentive schemes for managers which reward them financially for maximizing shareholders interest. The schemes typically include for instance plans where senior executives obtain shares perhaps at reduced prices thus aligning financial interest of executives with that of shareholders (Meckling & Jensen, 1976). However these models have limits such that analysis had to go beyond explicit incentive mechanisms (Padilla, 2003). Meckling and Jensen (1976) and Fama and Jensen (1983) addressed the issue of how the principal is able to prevent the agent from maximizing his own self-interest. The solutions proposed involved establishing a 'nexus' of optimal contracts (explicit as well as implicit) between the owners and management of the company. These contracts, also knows as the "internal rules of the game", identify the rights of agents in the organization, performance criteria against which they will be evaluated and the resulting payoff functions they will tend to face.

Krishnan and Visvanathan (2005) in their study sought to address the role of audit committees and auditors in the reporting of internal control deficiencies after the passage of the SOX. The study sample comprised of firms selected from the Compliance week and covered a period from November 15, 2004 till March 1, 2005. Compliance Week reported that 164 firms mentioned internal control issues in their filings with SEC during the sample period. To represent auditor attributes the study examined size of the auditor, tenure, auditor changes, and audit fees. The study found that a higher number of meetings of the audit committee, lesser proportion of "financial experts" in the audit committee, and more auditor changes characterize firms that report weaknesses in their internal controls compared to firms with no weaknesses. Prior restatements of financial statements are also higher for firms not reporting such weaknesses. The results were robust to controlling for a variety of firm characteristics such as complexity of operations, profitability, and growth. It underscored the importance of governance characteristics beyond general firm characteristics in examining the reporting of internal control weaknesses.

Zhang, Zhou and Zhou (2006) in their paper "Audit committee, auditor independence and internal control weaknesses" investigated the relation between audit committee quality, auditor independence, and the disclosure of internal control weaknesses after the enactment of the SOX. The study sample comprised of firms with internal control weaknesses and, based on industry, size, and performance, matched these firms to a sample of control firms without internal control weaknesses. The results of the data analysis suggested that a relation exists between audit committee quality, auditor independence, and internal control weaknesses. The study concluded that Firms are more likely to be identified with an internal control weakness, if their audit committees have less financial expertise or, more specifically, have less accounting financial expertise and non-accounting financial expertise, as well. They are also more likely to be identified with an internal control weakness, if their auditors are more independent. In addition, firms with recent auditor changes are more likely to have internal control weaknesses.

## 2.5 Conclusions from Literature Review

This chapter has provided an overview of internal auditing issues in organizations. Various researches have been carried out by different scholars on internal auditing and its theoretical framework. Mugo (1988) in his study established that the scope of internal audit is wide enough to cover not only financial/accounting data but also the data from other operations of the organization. Independence from operations in terms of objectivity was found to be quite high unlike in terms of organizational status which was found to be moderately high. The study concluded that the accounting discipline still remained the source of internal audit staff and recommended IT specialists in IADs. The study was limited to only small section of Kenyan industrial and commercial sector. A similar research was suggested to done on all companies registered with the registrar of companies' office.

Keitany (2000) concluded that though the extent of reliance of internal controls is not sensitive to the strength of internal audit departments, companies should not do away with it. This is because as a management tool, it should assist management in its day to day operations and not necessarily of relevance to the external auditor. Limitation of the study included the following: the outcome of the study might not have been conclusive as there was a possibility that some quoted companies who responded were not necessarily the ones whom the external auditor reported on; quoted companies that formed part of the analysis all had IADs, however three were excluded due to lack of IADs and finally inherent weaknesses in using questionnaires for data collection purposes. The study suggested areas of further studies; to research on whether internal control systems originating from companies not having IADs are any different from those having such departments; a survey study to establish the fee structure among audit firms for the quoted companies and linking it to the presence and absence of IADs.

Kibara (2007) in his study 'a survey of internal auditor's risk management practices in the banking industry in Kenya' found out that, most banks in Kenya were in process of drafting the ERM process and strategies. Kibet (2008) concluded that internal audit function played a role in corporate governance. The limitations of the study were time constraints, restriction to state owned corporations and having to make prior arrangement sin order to meet the heads of IADs. Recommendations of further study were effectiveness and contribution of internal audit in promoting corporate governance for companies listed in the NSE. Additionally, a study on the influence of internal audit and audit committee on financial reporting quality was recommended

Donaldson and Davis (1991) in his study contrasting stewardship theory and agency theory on governance, incentive of the CEO and shareholder return found out that CEO duality is associated with higher returns to shareholders than is an independent chair of the corporate board. The study suggested that a similar study could be conducted which utilizes a more sophisticated market based measure which adjusts for risk. Stewardship theory could also be investigated in strategic management whose premise should not be restricted to the narrow confines of agency and organizational economics.

The above studies have looked at the scope of independence of internal auditing, internal audit control functions and its implication for risk assessment by the external auditor, the role of internal audit in promoting good corporate governance and the agency theory. The timing of the research is also different. Therefore, the study aims to establish the perceived role of internal auditors and the challenges they face as they carry out their roles. The target industry is the banking industry and study will look at the perceived role and challenges of internal auditors in the banking industry in Kenya.

# CHAPTER THREE: RESEARCH METHODOLOGY

## 3.1 Introduction

This chapter provides a discussion of the research methodology that was used in this study. It discusses the research design especially with respect to the choice of the design. It also discusses the population of study. sample and sampling techniques, data collection methods as well as data analysis and data presentation methods employed in the study.

## 3.2 Research Design

The research design employed in this study was descriptive in nature. Descriptive studies describe characteristics associated with the subject population. Saunders et al (2003) assert that a descriptive research portrays an accurate profile of persons, events or situations. Kimani (2006) notes that a descriptive research collects data from members of a population and helps the researcher get the descriptive existing phenomena by asking individuals about their perceptions, attitudes, behaviour or values. Moreover, it explores the existing status of two or more variables at a given position in time and whether a relationship exists between them: hence most suited in establishing the perceived role and challenges of internal auditing in the banking industry in Kenya.

Both qualitative and quantitative data was collected using a semi-structured questionnaire. The study used a survey based on a case study of the commercial banks in Kenya as listed in the Central Bank of Kenya website. According to Saunders et al (2003), a case study enables the researcher to understand the context of the research and the processes enacted and have considerable ability to generate answers to questions "why" as well as "what" and "how".

### 3.3 Population and sample

According to Cooper and Schindler (2000), a population is the total collection of elements about which we wish to make inferences. The target population in the study was the 43 licensed commercial banks in Kenya as listed in the Central Bank of Kenya website. This is because, most of these banks have their head offices located in Nairobi and therefore was possible to get responses within a reasonable time. The sample that was used in this study is 100 percent of the population which gives a sample of 43. The sample is considered adequate based on Saunders et al (2003) view that, a sample should at a minimum; consist of 30 elements for statistical analysis.

### 3.4 Data collection

Primary data was collected using a semi-structured questionnaire that had been developed by the researcher on the basis of research questions. The questionnaire had three parts; the first part has questions on the general information about the respondent in relation to the case bank, the second part has questions on the general roles of internal auditors in organisations while the third has questions on challenges faced by internal auditors in carrying out their roles organisations. The target respondents were the internal audit managers of the banks. To ensure research quality, different perspectives of validity was checked when designing the semi-structure interview guide for internal auditors of the commercial banks in Kenya. In addition, when analyzing the data, internal and external validity was ensured.

### 3.5 Data Analysis Techniques

Data analysis usually involves reducing accumulated data to a manageable size, developing summaries, looking for patterns, and applying statistical techniques (Cooper and Schindler (2000). The study used the quantitative method of data analysis, that is, mean and mode. To ensure easy analysis, and minimize the margin of errors, questionnaire was coded according to each variable. The raw quantitative data was entered into computers and analyzed using

Statistical Package for Social Sciences (SPSS) version 17 program. Additionally, factor analysis statistical technique was used. The findings of this study were presented by use of charts, and tables in order to convey visual impressions of meanings or to clarify information that may be hidden within the data. A narrative summary of open-ended questions was also provided. Study conclusions were reached based on the summary of the data analysis.

### 3.6 Data Reliability and Validity

Cooper and Schindler (2000) note that pretesting helps not only to discover errors, but also in training the research team and discovering the respondent's reactions to the questions. A pilot study was conducted to pretest the questionnaire in order to identify any ambiguous and unclear questions. This also helps determine its appropriateness of the instrument in obtaining the desired information before administering it to the entire sample. The pilot study was carried out by administering four questionnaires. After making the amendment to the questionnaire in response to the results of the pilot study, these questionnaires were administered to the respondents using drop and pick method.

# CHAPTER FOUR: DATA ANALYSIS AND INTERPRETATIONS

## 4.1 Introduction

This chapter presents analysis of the data found on the perceived role and challenges of internal auditors in the banking industry in Kenya. The data targeted the internal audit managers of the banks of whom majority filled in and returned the questionnaires making a response rate of 81%. This response rate was good and representative and conforms to Mugenda and Mugenda (1999) stipulation that a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent.

## 4.2Demographic Information

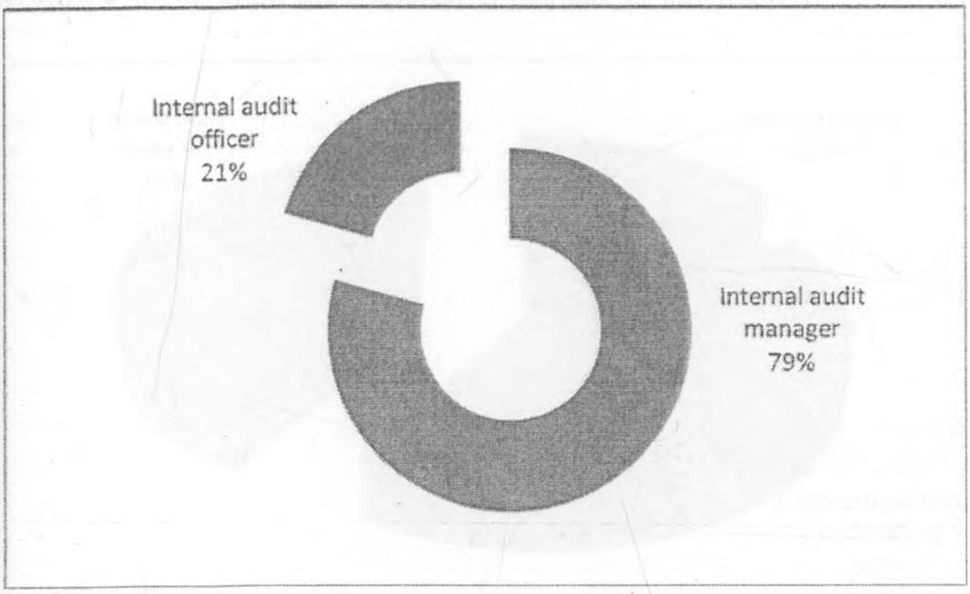
**Table 4.1: Position of the respondent in the organization**

| | Frequency | Percent |
|---|---|---|
| Internal audit manager | 27 | 79.4 |
| Internal audit officer | 7 | 20.6 |
| Total | 34 | 100.0 |

Source: Research findings

The study also sought to establish the respondents' position in the bank. According to the findings, the majority of respondents were internal audit manager as shown by 79.4% of the respondents, while 20.6% of the respondents were internal audit officer. This shows that the respondents were well versed with information on the subject matter of this study given that they were in charge of internal auditing in the banks.

**Figure 4.1: Position of the respondent in the organization**




Source: Research findings

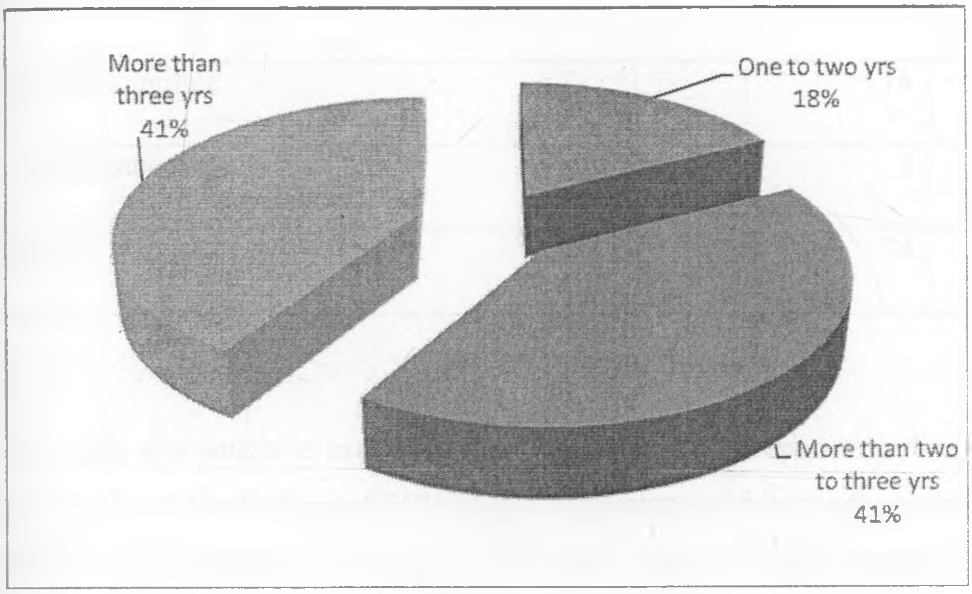
**Table 4.2: Duration the respondent worked for the bank**

| | Frequency | Percent |
|---|---|---|
| One to two yrs | 6 | 17.6 |
| More than two to three yrs | 14 | 41.2 |
| More than three yrs | 14 | 41.2 |
| Total | 34 | 100.0 |

Source: Research findings

The respondents were also required to indicate the number of years that they had been working in their respective banks. From the study. those who had been working at their respective banks for a period of between two to three years and more than three years were represented by 41.2% in each case, while 17.6% of the respondents reported that they had been working in their respective banks for one to two years. This shows that they have been working in the banks for long enough to understand the information required by this study.

**Figure 4.2: Duration the respondent worked for the bank**




Source: Research findings

The study further sought to establish the number of branches that their bank had. According to the study findings, the number of branches ranged from 11-205 with an average of 65 branches. The research also wanted to establish the number of employees work for the bank. From the study findings, the number of employees work for the bank ranged from 300 to above 5000 with an average of 1625 employees per bank. The respondents were also asked to when their internal audit department was established. From the study results, most of the banks were established around 1990 which shows that most of the internal audit departments have operated long enough for maturation of their operations.

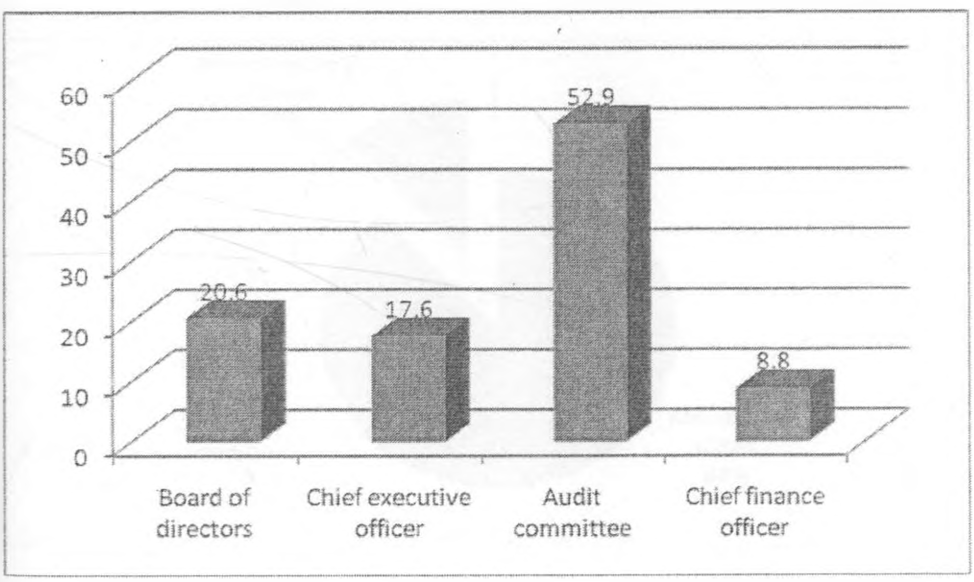
**Table 4.3: Whom internal auditors report to and regularly submit their reports**

| | Frequency | Percent |
|---|---|---|
| Board of directors | 7 | 20.6 |
| Chief executive officer | 6 | 17.6 |
| Audit committee | 18 | 52.9 |
| Chief finance officer | 3 | 8.8 |
| Total | 34 | 100.0 |

Source: Research findings

The study also sought to establish whom internal auditors report to and regularly submit their reports. From the findings, 52.9% of the respondents said it was the audit committee, 20.6% said it was the Board of directors, 17.6% said it was the Chief executive officer while 8.8% of the respondents said the respondents said the respondents said that internal auditors report to and regularly submit their reports to the Chief finance officer.

**Figure 4.3: Whom internal auditors report to and regularly submit their reports**




Source: Research findings

The respondents indicated that the number of staff members in their Internal Audit Department ranged from 5 to 50 with an average of 14 staff members in their Internal Audit Department. On their qualifications, the study established that all the respondents 100% had full accounting qualifications.

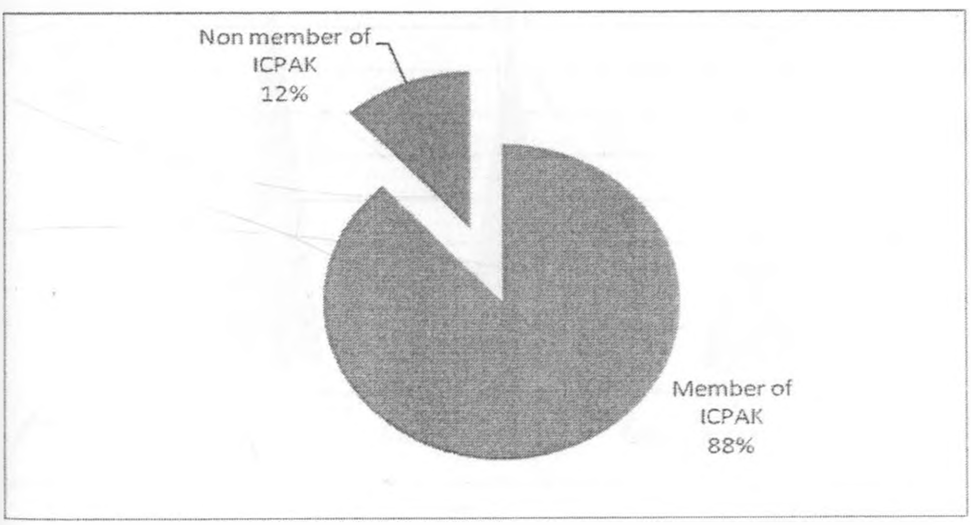
**Table 4.4: Membership of ICPAK**

| | Frequency | Percent |
|---|---|---|
| Member of ICPAK | 30 | 88.2 |
| Non member of ICPAK | 4 | 11.8 |
| Total | 34 | 100.0 |

Source: Research findings

The respondents were also requested to indicate whether they were members of ICPAK. From the results of the study, majority of the respondents (88.2%) indicated that they were member of ICPAK while a small proportion of the respondents as shown by 11.8% said that they were non members.

**Figure 4.4: Membership of ICPAK**




Source: Research findings

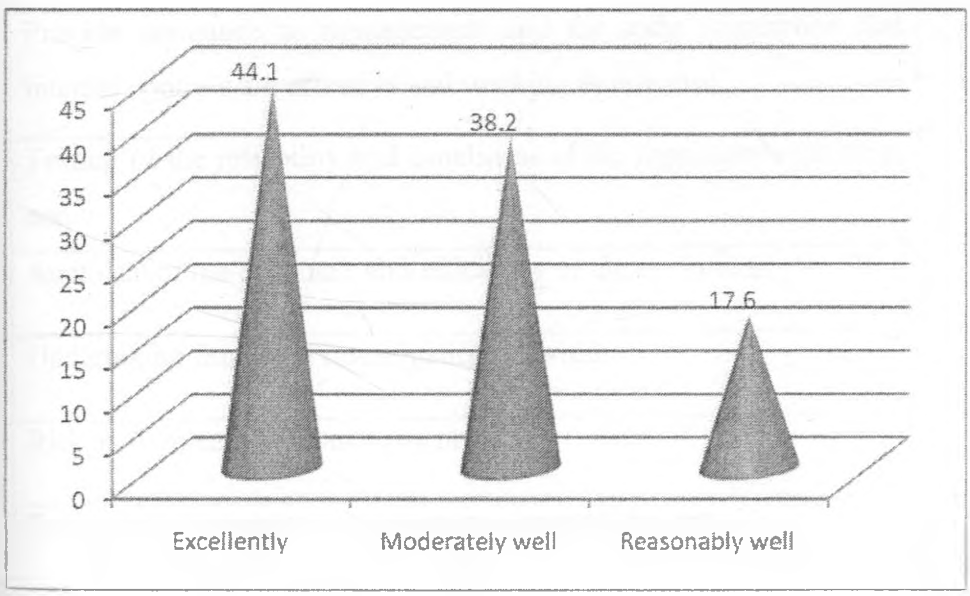
**Table 4.5: Functioning of the internal audit**

| | Frequency | Percent |
|---|---|---|
| Excellently | 15 | 44.1 |
| Moderately well | 13 | 38.2 |
| Reasonably well | 6 | 17.6 |
| Total | 34 | 100.0 |

Source: Research findings

The study also wanted to establish how well the respondents thought the Internal Audit function was currently functioning in their bank. From the responses given, 44.1% of the respondents said the Internal Audit function was excellently functioning, 38.2% said it was moderately well while 17.6% of the respondents said the Internal Audit functions were functioning reasonably well.

**Figure 4.5: Functioning of the internal audit**




Source: Research findings

### 4.3 Roles of internal auditors

**Table 4.6: Extent of agreement with statements regarding the general roles of internal auditors**

| | Mean | Std. Deviation |
|---|---|---|
| Assessing and promoting the adequacy of corporate governance | 3.8529 | 1.07682 |
| Examining and assessing organization policies, procedures, manuals and recommending best practices | 4.5824 | .73915 |
| Testing proper recording of assets, expenditure and the reliability of financial information | 3.9412 | 1.12657 |
| Examining use of organization resources (economy) | 4.0588 | .98292 |
| Examining organizational productivity (efficiency) | 3.7941 | 1.03805 |
| Evaluating the design and effectiveness of internal controls | 4.2647 | 12.13137 |
| Provide recommendations for improvements in those areas where opportunities and deficiencies are identified | 4.2353 | 1.20752 |
| Provide assurance to management and the audit committee that internal controls are effective and working as intended | 4.6471 | .48507 |
| Testing of the reliability and timeliness of the regulatory reporting; and | 3.8824 | 1.09447 |
| Appraisal of the economy and efficiency of the operations; | 3.8529 | .85749 |
| Undertaking fraud and investigation activities | 3.8438 | 1.27278 |
| Risk assessment and management | 4.2647 | .86371 |
| Evaluation of projects and programs accomplishments | 3.7059 | 1.05971 |
| Checking budgetary implementation | 3.8824 | 1.17460 |

Source: Research findings

The study also required the respondents to indicate the extent of agreement with statements regarding the general roles of internal auditors. From the study findings, majority of the respondents strongly agreed that the general roles of internal auditors is to provide assurance to management and the audit committee that internal controls are effective and working as intended as shown by a mean score of 4.6471 and also examining and assessing organization policies, procedures, manuals and recommending best practices shown by a mean score of 4.5824.

Further, majority of the respondents were in agreement that the roles of internal auditors were risk assessment and management shown by a mean score of 4.2647, provide recommendations for improvements in those areas where opportunities and deficiencies are identified shown by a mean score of 4.2353, evaluating the design and effectiveness of internal controls shown by a mean score of 4.2647, examining use of organization resources (economy) shown by a mean score of 4.0588, testing proper recording of assets, expenditure and the reliability of financial information shown by a mean score of 3.9412, checking budgetary implementation and testing of the reliability and timeliness of the regulatory reporting shown by a mean score of 3.8824 in each case, assessing and promoting the adequacy of corporate governance shown by a mean score of 3.8529, appraisal of the economy and efficiency of the operations shown by a mean score of 3.8529, undertaking fraud and investigation activities shown by a mean score of 3.8438, examining organizational productivity (efficiency) shown by a mean score of 3.7941 and evaluation of projects and programs accomplishments shown by a mean score of 3.7059.

## 4.4 Challenges Faced By Internal Auditors in Carrying Out Their Roles

**Table 4.7: Rating of the extent that various challenges are faced by internal auditors when carrying out their roles**

| | Mean | Std. Deviation |
|---|---|---|
| Aligning internal audit coverage to meet new expectations | 3.4118 | 1.39518 |
| Realigning skills to address new requirements. | 4.6941 | 1.29168 |
| Addressing internal auditing role in assessing risk management | 3.6563 | 1.38213 |
| Leveraging technology to achieve greater efficiencies. | 3.2353 | 1.51875 |
| Coping with diminished resources | 3.1176 | 1.24960 |
| Demonstrating value and adding to the bottom line. | 3.3529 | 1.22802 |
| Maintaining stature with the audit committee. | 3.3939 | 1.47774 |
| Developing a continuous focus on risks. | 3.5000 | 1.39805 |
| Maintaining a focus to prevent and detect fraud. | 3.1515 | 1.46033 |
| Implementing the new International Professional Practices Framework (IPPF). | 4.5353 | 1.30405 |
| Insufficient number of audit staff | 3.1471 | 1.23417 |
| Management's reluctance to implement suggested recommendations on noted weaknesses on a timely basis | 3.2353 | 1.32708 |

Source: Research findings

The study also wanted to establish whether the extent that various challenges are faced by internal auditors when carrying out their roles. According to the study, the challenges faced by internal auditors when carrying out their roles on their daily operations to a very great extent were such as realigning skills to address new requirements shown by a mean score of 4.6941 and implementing the new international professional practices framework (IPPF) shown by a mean score of 4.5353.

Majority of the respondents were in agreement to a great extent were addressing internal auditing role in assessing risk management shown by a mean score of 3.6563 and developing a continuous focus on risks shown by a mean score of 3.500 while those that were faced to a moderate extent were aligning internal audit coverage to meet new expectations shown by a mean score of 3.4118, maintaining stature with the audit committee shown by a mean score of 3.3939, demonstrating value and adding to the bottom line shown by a mean score of 3.3529, management's reluctance to implement suggested recommendations on noted weaknesses on a timely basis and leveraging technology to achieve greater efficiencies shown by a mean score of 3.2353, insufficient number of audit staff shown by a mean score of 3.1471 and coping with diminished resources shown by a mean score of 3.1176.

The respondents were therefore requested to state how the challenges can be resolved. From the study, the respondents suggested that the challenges can be resolved by hiring auditors from other fields to introduce new techniques, training audit staff, acquiring an audit system, all staff members to undertake certified internal audit professional qualifications, conducting the audit in an open manner, risks highlighted should be implemented in time, emphasis and implement suggested recommendations on noted weaknesses and risks, employing experienced personnel who are fully qualified to manage their tasks, ensuring the audit team is up to date on issues, more commitment at work.

**Factor Analysis**

**Table 4.8: Communalities**

| | Initial | Extraction |
|---|---|---|
| Assessing and promoting the adequacy of corporate governance | 1.000 | .804 |
| Examining and assessing organization policies | 1.000 | .911 |
| Testing proper recording of assets, expenditure | 1.000 | .852 |
| Examining use of organization resources (economy) | 1.000 | .828 |
| Examining organizational productivity (efficiency) | 1.000 | .890 |
| Evaluating the design and effectiveness of internal controls | 1.000 | .954 |
| Provide recommendations for improvements | 1.000 | .942 |
| Provide assurance to the management and budget committee that internal controls are effective | 1.000 | .933 |
| Testing of the reliability and timeliness of the regulatory reporting | 1.000 | .943 |
| Appraisals of the economy and efficiency of the operations | 1.000 | .950 |
| Undertaking fraud and investigation activities | 1.000 | .743 |
| Risk assessment and management | 1.000 | .962 |
| Evaluation of projects and programs accomplishments | 1.000 | .903 |
| Checking budgetary implementation | 1.000 | .962 |
| Challenges faced by internal auditors-aligning internal audit coverage to meet new expectations | 1.000 | .947 |
| realigning skills to address new requirements | 1.000 | .972 |
| Addressing internal auditing role in assessing risk management | 1.000 | .944 |
| Leveraging technology to achieve greater efficiencies | 1.000 | .927 |
| Coping with diminished resources | 1.000 | .884 |
| Demonstrating value and adding to the bottom line | 1.000 | .939 |
| Maintaining stature with the audit committee | 1.000 | .924 |
| Developing a continuous focus on risk | 1.000 | .965 |
| Maintaining a focus to prevent and detect fraud | 1.000 | .980 |
| Implementing the new International Professional Practices Framework | 1.000 | .878 |
| Insufficient number of audit staff | 1.000 | .877 |
| Management's reluctance to implement suggested recommendations on noted weaknesses on a timely basis | 1.000 | .873 |

Source: Research findings

The above table helps the researcher to estimate the communalities for each variance. This is the proportion of variance that each item has in common with other factors. For example 'role of internal auditors-assessing and promoting the adequacy of corporate governance' has 80.4% communality or shared relationship with other factors. "Maintaining a focus to prevent and detect fraud" had the greatest communality with others of value 98%, while 'undertaking fraud and investigation activities' has the least communality with others of 74.3%.

**Table 4.9: Total Variance Explained**

| Component | Initial Eigenvalues | | | Extraction Sums of Squared Loadings | | | Rotation Sums of Squared Loadings | | |
|---|---|---|---|---|---|---|---|---|---|
| | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % |
| 1 | 8.696 | 33.446 | 33.446 | 8.696 | 33.446 | 33.446 | 7.931 | 30.505 | 30.505 |
| 2 | 7.363 | 28.318 | 61.764 | 7.363 | 28.318 | 61.764 | 7.073 | 27.204 | 57.709 |
| 3 | 2.893 | 11.127 | 72.890 | 2.893 | 11.127 | 72.890 | 3.317 | 12.756 | 70.465 |
| 4 | 2.044 | 7.863 | 80.753 | 2.044 | 7.863 | 80.753 | 2.054 | 7.900 | 78.365 |
| 5 | 1.492 | 5.738 | 86.491 | 1.492 | 5.738 | 86.491 | 1.937 | 7.450 | 85.816 |
| 6 | 1.200 | 4.616 | 91.106 | 1.200 | 4.616 | 91.106 | 1.376 | 5.291 | 91.106 |
| 7 | .707 | 2.718 | 93.824 | | | | | | |
| 8 | .534 | 2.054 | 95.878 | | | | | | |
| 9 | .415 | 1.597 | 97.475 | | | | | | |
| 10 | .253 | .974 | 98.450 | | | | | | |
| 11 | .179 | .687 | 99.137 | | | | | | |
| 12 | .104 | .401 | 99.538 | | | | | | |
| 13 | .068 | .261 | 99.800 | | | | | | |
| 14 | .052 | .200 | 100.000 | | | | | | |
| 15 | .000 | .000 | 100.000 | | | | | | |
| 16 | .000 | .000 | 100.000 | | | | | | |
| 17 | .000 | .000 | 100.000 | | | | | | |
| 18 | .000 | .000 | 100.000 | | | | | | |
| 19 | .000 | .000 | 100.000 | | | | | | |
| 20 | .000 | .000 | 100.000 | | | | | | |
| 21 | .000 | .000 | 100.000 | | | | | | |
| 22 | .000 | .000 | 100.000 | | | | | | |
| 23 | .000 | .000 | 100.000 | | | | | | |
| 24 | .000 | .000 | 100.000 | | | | | | |
| 25 | .000 | .000 | 100.000 | | | | | | |
| 26 | .000 | .000 | 100.000 | | | | | | |

Source: Research findings

In the above table, the researcher used Kaiser Normalization Criterion, which allows for the extraction of components that have an Eigen value greater than 1. The principal component analysis was used and six factors were extracted. As the table shows, these six factors explain 91.1% of the total variation. Factor 1 contributed the highest variation of 30.5%. The contributions decrease as one move from one factor to the other up to factor 6.

**Table 4.10: Rotated Component Matrix**

| | Component | | | | | |
|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 |
| Developing a continuous focus on risk | .973 | | | | | |
| Maintaining a focus to prevent and detect fraud | .939 | | | | | |
| Addressing internal auditing role in assessing risk management | .912 | | | | | |
| Demonstrating value and adding to the bottom line | .911 | | | | | |
| Realigning skills to address new requirements | .889 | | | | | |
| Challenges faced by internal auditors-aligning internal audit coverage to meet new expectations | .869 | | | | | |
| Maintaining stature with the audit committee | .858 | | | | | |
| Leveraging technology to achieve greater efficiencies | .795 | | | | | |
| Coping with diminished resources | .697 | | | .527 | | |
| Insufficient number of audit staff | .574 | | | .570 | | .457 |
| Evaluating the design and effectiveness of internal controls | | -.905 | | | | |
| Testing of the reliability and timeliness of the regulatory reporting | | .863 | | | | |
| Provide recommendations for improvements | | .839 | | | | |
| Checking budgetary implementation | | .809 | | | | |
| Examining organizational productivity (efficiency) | | .780 | | | .454 | |
| Evaluation of projects and programs accomplishments | | .771 | | | | |
| Undertaking fraud and investigation activities | | .767 | | | | |
| Examining use of organization resources (economy) | | .759 | .401 | | | |
| Testing proper recording of assets, expenditure | | .757 | | | | |
| Assessing and promoting the adequacy of corporate governance | | .754 | | | | |
| Risk assessment and management | | | .947 | | | |
| Implementing the new International Professional Practices Framework | | | -.869 | | | |
| Appraisals of the economy and efficiency of the operations | | .500 | .588 | | | .510 |
| Examining and assessing organization policies | | | | -.946 | | |
| Provide assurance to the management and budget committee that internal controls are effective | | | | | .900 | |
| Management's reluctance to implement suggested recommendations on noted weaknesses on a timely basis | .517 | | | | | .631 |

Source: Research findings

The initial component matrix was rotated using Varimax (Variance Maximization) with Kaiser Normalization by suppressing small coefficients of values below 0.4. . The above results allowed the researcher to identify what variables fall under each of the 6 major extracted factors. Each of the 26 variables was looked at and placed to one of the six factors depending on the percentage of variability; it explained the total variability of each factor. A variable is said to belong to a factor to which it explains more variation than any other factor.

From the above table, the individual variables constituting the six factors extracted are summarized and identified below-

**Factor 1:**

Developing a continuous focus on risk

Maintaining a focus to prevent and detect fraud

Addressing internal auditing role in assessing risk management

Demonstrating value and adding to the bottom line

Realigning skills to address new requirements

Challenges faced by internal auditors-aligning internal audit coverage to meet new expectations

Maintaining stature with the audit committee

Leveraging technology to achieve greater efficiencies

Coping with diminished resources

Insufficient number of audit staff

**Factor 2:**

Evaluating the design and effectiveness of internal controls

Testing of the reliability and timeliness of the regulatory reporting

Provide recommendations for improvements

Checking budgetary implementation

Examining organizational productivity (efficiency)

Evaluation of projects and programs accomplishments

Undertaking fraud and investigation activities

Examining use of organization resources (economy)

Testing proper recording of assets, expenditure

Assessing and promoting the adequacy of corporate governance

**Factor 3:**

Risk assessment and management

Implementing the new International Professional Practices Framework

Appraisals of the economy and efficiency of the operations\

**Factor 4:**

Examining and assessing organization policies

**Factor 5:**

Provide assurance to the management and budget committee that internal controls are effective

**Factor 6:**

Management's reluctance to implement suggested recommendations on noted weaknesses on a timely basis

# CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

## 5.1 Introduction

The chapter presents a summary of the data findings on the perceived role and challenges of internal auditors in the banking industry in Kenya. The summary of findings is structured based on the specific objectives of the study. From the analysis and data collected, the following discussions, conclusions and recommendations were made. The recommendations were based on the objectives of the study.

## 5.2 Summary of Findings

The study found that most of the respondents had been working at their respective banks for a period of between two to three years and more than three years showing that they have been working in the banks for long enough to understand the information required by this study. The internal auditors report to and regularly submit their reports to the audit committee. All had full accounting qualifications and majority were member of ICPAK. The Internal Audit function in the banks was excellently functioning.

The study further established that that the general roles of internal auditors is to provide assurance to management and the audit committee that internal controls are effective and working as intended, examining and assessing organization policies, procedures, manuals and recommending best practices, risk assessment and management, provide recommendations for improvements in those areas where opportunities and deficiencies are identified, evaluating the design and effectiveness of internal controls, examining use of organization resources (economy), testing proper recording of assets, expenditure and the reliability of financial information, checking budgetary implementation and testing of the reliability and timeliness of the regulatory reporting, assessing and promoting the adequacy of corporate governance, appraisal of the economy and efficiency of the operations, undertaking fraud and investigation activities, examining organizational productivity (efficiency) and evaluation of projects and programs accomplishments.

The challenges faced by internal auditors when carrying out their roles on their daily operations were such as realigning skills to address new requirements. implementing the new international professional practices framework (IPPF), internal auditing role in assessing risk management and developing a continuous focus on risks.

## 5.3 Conclusion

Based on the findings, the study concludes that the general roles of internal auditors is to provide guarantee that internal controls are efficient, examining and assessing the banks policies, procedures, manuals and recommending best practices, risk evaluation and management and giving recommendations for improvements in those areas where prospects and dearth are identified.

The study further concludes that the challenges faced by internal auditors on their daily operations were those of realigning skills to address new requirements, implementing the new international professional practices framework (IPPF) and the challenge of developing a uninterrupted focus on risks.

## 5.4 Recommendations

The study recommends that the banks should hire auditors from other fields to introduce new techniques in the bank accounts auditing in order to overcome the challenges encountered by the internal auditors in their operations.

The study also recommends that there should be continuous training and development audit staff, in order to enhance their competence and also there should be acquisition of an audit system in all the banks. The study also recommends that all staff members should undertake certified internal audit professional qualifications and the audit should be conducted in an open manner. The risks highlighted should be implemented in time in order to avoid backlogs in the audit departments.

The banks should also employ experienced personnel who are fully qualified to manage their tasks and the management at the banks should also ensure that the audit team is up to date on the current issues.

## 5.5 Limitations of the Study

A limitation for the purpose of this research was regarded as a factor that was present and contributed to the researcher getting either inadequate information or responses or if otherwise the response given would have been totally different from what the researcher expected.

The main limitations of this study were; Some respondents refused to fill in the questionnaires. Further some respondents decided to withhold information which they considered sensitive and classified. This reduced the probability of reaching a more conclusive study. However, conclusions were made with this response rate.

The small size of the sample could have limited confidence in the results and this might limit generalizations to other situations.

Most of the respondents were busy throughout and had to continuously be reminded and even persuaded to provide the required information. Time- Due to official duties time was a major concern.

Fear and victimization by respondents is also likely to limit the study some employees may be unwilling to divulge information for fear of victimization by their superiors and finally slow pace of respondents shall also limit the study.

## 5.6 Recommendation for Further Studies

The researcher suggests that a similar study should be done focusing on other industries in Kenya. This is because different industries apply different strategy options and thus the role and the challenges of internal auditors are different from those of the banking sector. Secondly, a study can be carried out on the possible solutions to the challenges faced by internal auditors in organizations in Kenya. Further studies should also be done on the factors that influence the efficiency and effectiveness of internal auditors in the public sector whose functions are stipulated by the central government.

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# APPENDIX I: LETTER OF INTRODUCTION

LEONA CHEPKORIR

THE UNIVERSITY OF NAIROBI

P.O. BOX 30197

NAIROBI

Tel: 0720333055

Dear Respondent,

I am a Masters of Business Administration (MBA) Student of the University of Nairobi.

As a partial requirement of the coursework assessment, I am required to submit a research project report on some management problem. My research topic is: Perceived role and challenges of internal auditors in the banking industry in Kenya.

I would highly appreciate if you could kindly spare some time to complete the questionnaire attached.

The results of the report will be used solely for academic purposes and will be treated with utmost confidence.

Thank you in advance,

Yours faithfully,

Leona Chepkorir,

Herick O. Ondigo

Lecturer, School of Business, University of Nairobi

Supervisor

## APPENDIX II: LIST OF COMMERCIAL BANKS IN KENYA

1. African Banking Corporation Ltd.
2. Bank of Africa Kenya Ltd.
3. Bank of Baroda (K) Ltd.
4. Bank of India
5. Barclays Bank of Kenya Ltd.
6. CFC Stanbic Bank Ltd.
7. Charterhouse Bank Ltd - UNDER - STATUTORY MANAGEMENT
8. Chase Bank (K) Ltd.
9. Citibank N.A Kenya
10. Commercial Bank of Africa Ltd.
11. Consolidated Bank of Kenya Ltd.
12. Co-operative Bank of Kenya Ltd.
13. Credit Bank Ltd.
14. Development Bank of Kenya Ltd.
15. Diamond Trust Bank (K) Ltd.
16. Dubai Bank Kenya Ltd.
17. Ecobank Kenya Ltd
18. Equatorial Commercial Bank Ltd.
19. Equity Bank Ltd.
20. Family Bank Ltd
21. Fidelity Commercial Bank Ltd
22. Fina Bank Ltd
23. First community Bank Limited
24. Giro Commercial Bank Ltd.

25. Guardian Bank Ltd
26. Gulf African Bank Limited
27. Habib Bank A.G Zurich
28. Habib Bank Ltd.
29. Imperial Bank Ltd
30. I & M Bank Ltd
31. Jamii Bora Bank Ltd.
32. Kenya Commercial Bank Ltd
33. K-Rep Bank Ltd
34. Middle East Bank (K) Ltd
35. National Bank of Kenya Ltd
36. NIC Bank Ltd
37. Oriental Commercial Bank Ltd
38. Paramount Universal Bank Ltd
39. Prime Bank Ltd
40. Standard Chartered Bank (K) Ltd
41. Trans-National Bank Ltd
42. Victoria Commercial Bank Ltd
43. UBA Kenya Bank Ltd.

## APPENDIX III: QUESTIONNAIRE

PERCEIVED ROLE AND CHALLENGES OF INTERNAL AUDITORS IN THE BANKING INDUSTRY IN KENYA

### PART A: DEMOGRAPHICS

Kindly answer the following questions by ticking (√) against your preferred choice (s).

1. Please indicate your position in the organization
    a) Internal Audit Manager
    b) Internal Audit Officer
    c) Other? Please specify.........................................................................
2. How long have you worked for the bank?
    a) Less than 1 year
    b) 1-2 years
    c) 2-3 years
    d) More than 3 years
3. How many branches does your bank have? ............................................................
4. How many employees work for the bank?...................................................................
5. When was your internal audit department established?..................................................
6. Whom do the internal audit department report to and regularly submit their reports?
    a) Board of Directors
    b) Chief Executive Officer
    c) Audit committee
    d) Chief Finance Officer
    e) Other? Please specify.....................................................................
7. How many members of staff are in your Internal Audit Department?...........................
8. What are their qualifications?
    a) Full Accounting qualifications...........................................................
    No accounting qualification.........................................................................

b) Member of ICPAK...............................................................................

Non member of ICPAK.........................................................................

9. How well do you think the Internal Audit function is currently functioning in your bank?

a) Excellently

b) Moderately well

c) Reasonably well

d) Poorly

**Part B: ROLES OF INTERNAL AUDITORS**

What are your views on the following statements regarding the general roles of internal auditors? *(Circle the number closest to your view)*

| | Agree | | | Disagree | |
|---|---|---|---|---|---|
| a) Assessing and promoting the adequacy of corporate governance | 5 | 4 | 3 | 2 | 1 |
| b) Examining and assessing organization policies, procedures, manuals and recommending best practices | 5 | 4 | 3 | 2 | 1 |
| c) Testing proper recording of assets, expenditure and the reliability of financial information | 5 | 4 | 3 | 2 | 1 |
| d) Examining use of organization resources (economy) | 5 | 4 | 3 | 2 | 1 |
| e) Examining organizational productivity (efficiency) | 5 | 4 | 3 | 2 | 1 |
| f) Evaluating the design and effectiveness of internal controls | 5 | 4 | 3 | 2 | 1 |
| g) Provide recommendations for improvements in those areas where opportunities and deficiencies are identified | 5 | 4 | 3 | 2 | 1 |
| h) Provide assurance to management and the audit committee that internal controls are effective and working as intended | 5 | 4 | 3 | 2 | 1 |
| i) Testing of the reliability and timeliness of the regulatory reporting | 5 | 4 | 3 | 2 | 1 |
| j) Appraisal of the economy and efficiency of the operations; | 5 | 4 | 3 | 2 | 1 |
| k) Undertaking fraud and investigation activities | 5 | 4 | 3 | 2 | 1 |
| l) Risk assessment and management | 5 | 4 | 3 | 2 | 1 |
| m) Evaluation of projects and programs accomplishments | 5 | 4 | 3 | 2 | 1 |
| n) Checking budgetary implementation | 5 | 4 | 3 | 2 | 1 |
| o) Any other? Please specify ..................................... | 5 | 4 | 3 | 2 | 1 |

**Part C: CHALLENGES FACED BY INTERNAL AUDITORS IN CARRYING OUT THEIR ROLES**

1. Based on your daily operations, please rate the extent of the following challenges faced by internal auditors when carrying out their roles. (Circle the number closest to your view)

| | Agree | | | Disagree | |
|---|---|---|---|---|---|
| a) Aligning internal audit coverage to meet new expectations | 5 | 4 | 3 | 2 | 1 |
| b) Realigning skills to address new requirements. | 5 | 4 | 3 | 2 | 1 |
| c) Addressing internal auditing role in assessing risk management | 5 | 4 | 3 | 2 | 1 |
| d) Leveraging technology to achieve greater efficiencies. | 5 | 4 | 3 | 2 | 1 |
| e) Coping with diminished resources | 5 | 4 | 3 | 2 | 1 |
| f) Demonstrating value and adding to the bottom line. | 5 | 4 | 3 | 2 | 1 |
| g) Maintaining stature with the audit committee. | 5 | 4 | 3 | 2 | 1 |
| h) Developing a continuous focus on risks. | 5 | 4 | 3 | 2 | 1 |
| i) Maintaining a focus to prevent and detect fraud. | 5 | 4 | 3 | 2 | 1 |
| j) Implementing the new International Professional Practices Framework (IPPF). | 5 | 4 | 3 | 2 | 1 |
| k) Insufficient number of audit staff | 5 | 4 | 3 | 2 | 1 |
| l) Management's reluctance to implement suggested recommendations on noted weaknesses on a timely basis | 5 | 4 | 3 | 2 | 1 |
| m) Any other? Please specify ...................................... | 5 | 4 | 3 | 2 | 1 |

**2.** In your opinion, how can the challenges be resolved?

..........................................................................................................

..........................................................................................................

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Thank you, for your responses