

# **A SURVEY ON THE ROLE OF INTERNAL AUDIT IN PROMOTING GOOD CORPORATE GOVERNANCE IN STATE OWNED ENTERPRISES //**

**BY:**

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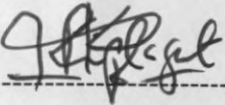


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## Declaration

This project is my original work and has not been submitted for a degree in any other university.

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## Dedication

This Research Project is dedicated to my dear wife Jane Jepkorir and my son Caleb Kimutai Kiplagat for their unfailing love, care, support, understanding and encouragement during this long period of search of knowledge and study.

Finally wish to express my dedication on this piece of work to my mother for making a lot of sacrifices, efforts and painful experiences she underwent in nurturing me and my siblings so that we may a better life and future. She has been a pillar of strength to the family at all times.

May God shower you all with His blessings in the journey that life is.

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## Abstract

There has been growing recognition in recent years of the importance of corporate governance in ensuring sound financial reporting and deterring fraud. Well performing internal audit function is one of the strongest means to monitor and promote good corporate in state owned enterprises. As a result, in many organizations it has received an increasing attention not only as an important component of prudent financial management but as a tool for improving the performance of public sector organizations and as a monitoring device.

The purpose of this was to establish the role of internal audit in promoting good corporate governance in state owned enterprises. The study used exploratory research and primary data was collected via a questionnaire. The population comprised of all state owned enterprises headquartered in Nairobi. Twenty nine responses were received representing sixty seven percent of the sample size.

A majority of state owned enterprises have set up internal audit departments and established audit committees. The study found that to enhance the independence of the internal audit function, it should report to the board or the audit committee and that internal audit staff be dismissed after the approval of the audit committee. The main activity of internal audit is evaluating the adequacy of internal controls, providing assurance about the achievement of the organization's objectives with regard to reliability of financial reporting and compliance to applicable laws and regulations. Key challenges facing internal audit functions is the insufficient number of audit staff, management reluctance to implement suggested recommendations and the inadequate technical resources and skilled personnel in the audit of computerized systems. Major achievements reported by respondents include reductions of organization's costs, minimal cases of frauds and strengthening of internal controls.

The study concluded that internal audit function plays a significant role in enhancing good corporate governance. The Board and management should offer the necessary support, appreciate the increasing status and role of internal audit in promoting good corporate governance practices.

## **Abbreviation of Acronyms**

AC	Audit Committee
BOD	Board of Directors
CAE	Chief Audit Executive
CEO	Chief Executive Officer
CACG	Commonwealth Association of Corporate Governance
CMA	Capital Markets Authority
ECIIA	European Commission of Institute of Internal Auditors
GDP	Gross Domestic Product
GOK	Government of Kenya
IAG	Internal Auditor General
IAF	Internal Audit Function
ICPAK	Institute of Certified Public Accountants of Kenya
IIA	Institute of Internal Auditors
IS	Information Systems
ISA	International Standards on Auditing
ISC	Inspectorate of State Corporations
NYSE	New Yoke Stock Exchange
OECD	Organization of Economic development
PSCGT	Private Sector Corporate Governance Trust
PIC	Public Investment Committee
SOE	State Owned Enterprises
SCAC	State Corporations Advisory Committee
SEC	Security Exchange Commission
UK	United Kingdom
USA	United States of America



## CHAPTER 1.0: INTRODUCTION

### 1.1 Background

Corporate Governance has in the recent past moved up sharply on the global agenda following numerous corporate financial scandals and the ensuing business failures that have cost investors billions of shillings and devastated the lives of millions of employees who had invested their savings in these companies. These corporate frauds following in the footsteps of the Asian financial crisis of the late 1990s are epitomized by Enron, WorldCom, Global Crossing and Tyco in the USA as well as Vivendi, Parmalat and others in Europe. These scandals have shaken investors' confidence to the core and called into question the honesty and integrity among Corporate Boards and Executive Management (KPMG, 2004).

These recent events have therefore highlighted the critical role of Boards of Directors in promoting good corporate governance. In particular, Boards are being charged with ultimate responsibility for the effectiveness of their organizations' internal control systems. An effective Internal Audit function plays a key role in assisting the Board to discharge its corporate governance responsibilities. Yet how does the Board and its Audit Committee satisfy itself that Internal Audit is functioning effectively and efficiently? (Sarens, 2007).

Corporate governance developments both in Kenya and internationally have reaffirmed the Boards' responsibility for ensuring the effectiveness of their organizations' 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 organization's corporate governance framework.

In this period of financial reporting failures and increased regulatory scrutiny, the internal auditor group has an exceptional opportunity to contribute towards improving both financial reporting integrity and corporate governance. The company's board and management must reaffirm or improve internal audit's independence and scope of inquiry.

### 1.1.1 Internal Audit

The Institute of Internal Auditors (IIA, 2004) offers the following definition on internal auditing:

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes”. This definition is designed to embrace the expanding role of internal audit which has evolved from a narrow focus on control to include risk management and corporate governance and also encapsulates the scope and challenges for modern internal audit. An internal audit function that meets this definition is uniquely positioned to support the board, the audit committee, and executive management as an essential component of their governance mechanisms (ECIIA, 2005). Consequently, a significant opportunity for internal auditing has emerged to demonstrate its potential to add value and to break away from its historical characterization as “organizational policeman and watchdog” (Morgan, 1979). In other words, expertise and knowledge of risk management and internal control become a source of power for internal auditing to advance and play an important assurance and advisory role within the contemporary governance environment.

From the above definition, internal audit function has had a corporate governance role in many organizations as early as the 1940s (Moeller, 2004), and that role has evolved over time. The nature of internal audit activity today typically includes risk assessment, control assurance, and compliance work, all of which map directly into corporate governance (Hermanson and Rittenberg, 2003). International Standards on Auditing (ISA) require those charged with governance of any entity to have oversight responsibility of systems for monitoring risk, financial control and compliance with the law. The standards encourages auditors to seek the views of those charged with governance on the adequacy of accounting and internal control systems in place to prevent and detect fraud, to determine risk of fraud and error, and the competence and integrity of management (ISA 240). Further, ISA 315 defines internal control as the process designed and effected by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entity’s objectives

with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. It follows that internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives.

An Internal Audit function could be viewed as a “first line defense “ against inadequate organizational governance and financial reporting. With appropriate support from the Board of Directors’ and Audit Committees, the internal audit staff is in the best position to gather intelligence on inappropriate accounting practices, inadequate internal controls and ineffective corporate governance (Zelege, 2007). It is therefore an integral and necessary part of an effective corporate governance framework. Alongside the Board, executive management and external audit, internal audit is one of the cornerstones of good corporate governance.

In attempting to adequately discharge their responsibilities, however, internal auditors often find themselves in anomalous positions. They report to senior management within the organization, yet they 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 senior management.

### **1.1.2 Agency Problem**

Jensen and Meckling (1976) define the agency relationship as a contract under which one party (the principal) engages another party (the agent) to perform some service on their behalf. Agency problem arises as a result of separation of ownership from control and it takes two forms: one is the conflict of interest between shareholders and management and the other is the conflict between shareholders and debt holders. The shareholders through the board delegate the day to day decision making to the managers or agents. Managers are charged with using and controlling the economic resources of the firm. However, managers may not always act in the best interest of the shareholder due to partly adverse selection and moral hazards. Shareholders must therefore monitor managers to ensure they live up to the provisions of their shareholders (Goddard et al., 2000).

Power (2000) argued that agency theory is based on the notion that the delegation of material responsibilities by the principal to professional managers requires the presence of mechanisms that either align the interest of principals and agents or monitor the performance of managers to ensure that they use their knowledge and the firm's resources to generate the highest possible return for the principal. More specifically the agency theory suggests that the best option for owners is to design contracts that align manager/owner interest. Agency theory is concerned with aligning the interest of owners and management and is based on the perception that there is an inherent conflict between a firm and its management.

To guard against management failures, Modoveanu (2001) suggests that shareholders should enact ratification, monitoring and sanctioning mechanisms. These mechanisms are for validating the decisions of the agents of giving financial approval or veto for an initiative or actionable plan of the agent. Power (2002) observed that the primary means of monitoring is via the annual accounts whose reliability is enhanced by the audit report. However, accounts may be inadequate for monitoring purpose due to information asymmetry. Managers who have more information than the shareholders or auditors (external) produce the accounts and they may be unwilling to disclose private information for fear that it may be used against them. The nature of the audit is such that omissions or distortions may not be detected or reported to shareholders. In addition monitoring involves costs which the shareholders may not be willing to bear. Therefore, to monitor management, shareholders have traditionally relied in the Board of Directors and Audit Committees.

Various corporate governance mechanisms can be used to monitor management's behaviour and these include board of directors, an effective audit committee and both internal and external audit. The management is accountable to the board which in turn reports to the shareholders. It therefore the responsibility of board charged with governance of the entity to ensure, through oversight of management, that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Active oversight by those charged with governance can help reinforce management's commitment to creating a culture of honesty and ethical behavior. Internal



Audit assists the Board of an organization discharge its corporate governance responsibilities and Anderson (1993) argues that internal audit is a substitute mechanism for monitoring by the board.

OECD provides in its guidelines that State Owned Enterprises should develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the Board and to the Audit Committee or the equivalent company organ to mitigate against the agency problem. The internal auditing function as part of the corporate governance structure plays an increasingly important role in monitoring the internal control system of the company and its financial reporting systems (Khas, 1999). The demand for good corporate governance now equally applies to the public sector as well as the private sector. Accordingly, the public sector management must give equal attention to the processes and governance mechanisms of their institutions (Balderston, 1974). Internal auditing was identified as one of the key participants to promote good governance in the corporate sector (Kadir, 2000); hence, management in the public sector organizations should realize the importance of the internal audit function in their institutions. Moreover, J. Kinfu (2006) has also noted that one of the strongest means to monitor ethics and governance in government institutions can be through the audit function. These statements clearly indicate the contribution that IAF can have towards enhancing government efforts in effective public sector governance.

### **1.1.3 State Owned Enterprises (SOE's)**

SOEs generally known as parastals are partially or fully government owned and controlled companies. There are approximately 120 SOEs in Kenya employing over 200,000 persons. SOEs are established under the State Corporations Act Cap.446 and other Acts of Parliament. As defined in the State Corporations Act, SOEs encompasses all state owned enterprises whether established by the Companies Act or other statute. All SOEs unless exempted from the State Corporations Act under Section 2(Vii) of the Act, fall under the ambit of the State Corporations Act Cap 446 which came into existence in 1986. This Act is therefore the supreme legal document relating to management and control of state corporations.

The primary objective of the parastals according to a study carried out by IEA (1994) was a desire to take hold of the economy, promote a Kenyan entrepreneurial class and earn a share of

the profits otherwise received by the private sector. Orengo (2000) reinforced the importance of SOEs when he noted that the government loses approximately 45 billion shillings every year through theft, over-invoicing, payment of goods and services that are never delivered and other financial leakages (Orengo, 2000). Between 1987 and 1993 financial years, a total of Kshs.8.5 billion was injected into some 18 SOEs (IEA, 1994). These capital injections arose out of internal management problems, characterized by corruption, excessive interference in management by the political wing of government and poor planning and budgeting.

SOEs contribution to the nation's economic development as often fallen short of expectations: output growth has been sluggish, quality and productivity levels have been low, and the sector has imposed heavy financial and managerial burdens on government and therefore the need to closely monitor their performance through appropriate audit processes.

## **1.2 Statement of the Research Problem**

Democracy requires a government to be accountable in its use of public funds and in providing effective, efficient and economical service delivery. Efficient management and quality of governance at all levels in SOEs is seen as one of the ways of creating wealth and employment in a nation. Without investment, public sector corporations will stagnate and collapse. If business enterprises do not prosper, there will be no economic growth, no employment, no taxes paid and invariably the country will not develop. It is important, therefore, for SOEs to be well governed and managed so that they can attract investments, create jobs and wealth and remain viable, sustainable and competitive in the global market place.

The crisis in the public sector has often been associated with poor management (Ikiara, 2000). Central to the management of SOEs is the issue of good corporate governance. There has been public outcry since the 1990s due to massive financial scandals and frauds in the public sector such as Rural Development Fund, the Kisumu Molasses project, the Turkwell Gorge Multi-purpose Project and the Goldernberg Export Compensation Scheme which was the subject of a commission of inquiry. Others collapsed completely, namely; Kenya Cooperative Creameries and Kenya Meat Commission which have since been revived. The Anglo Leasing, has been

one of the most recent major financial scandals. Major frauds perpetrated in public institutions continued to feature in the reports of the Controller and Auditor General, the official government auditor and the reports of both the Public Accounts and the Public Investments committees of Parliament. A recent probe report on Kenya Power and Lighting Company suggested corporate mischief of Enron proportions.

One will be tempted to ask: "Why didn't the internal auditor blow the whistle?" This is because an internal audit function could be viewed as a "first defense" against inadequate corporate governance and financial reporting (Zekele, 2007). The internal audit function has been described as the "window into the whole company" (Tapestry Networks, 2004) and thus serves as the "eyes and ears of management" (Sawyer, 1973). An internal audit function with this type of access throughout the organization is in a unique position to serve as a valued resource to the other three corporate governance parties. Vallario (2003) observed that for governance to benefit the varied stakeholders of an organization, the internal audit function must be an integral component of the network of parties having corporate governance responsibilities. Further, according to Faulkner (2006), "when things go wrong and there is a corporate collapse, the question raised is where were the auditors?". The internal audit staff is in the best position to gather intelligence on improprieties and ineffective corporate governance and there is significant public interest in greater responsibility being placed upon internal auditors.

Corporate governance concerns in public sector enterprises have not been adequately addressed. Top management positions in the public sector have, if not in most cases, been awarded based on political patronage and not on merit or efficiency (Ikiara, 2000). It is often recognized that an internal audit department should be able to provide independent and objective opinions on the organization's operations. It will report regularly these to the Board, audit committees and management.

Whereas a number of prior research studies on corporate governance (Jebet, 2000; Gakuo, 2001; Mwangi, 2002; Wangombe, 2003 ; ) have concentrated on corporate governance practices in various sectors, only a few have emphasized on audit: Audit Committees and



Corporate Governance (Riro, 2005) and The Perceived Role of the External Auditor in Corporate Governance (Mutiga, 2006). Further, prior internal audit research in other countries has explored objectivity issues (Brody and Lowe, 2000; Brody and Kaplan, 1996), the relationship between internal and external auditors (Felix et al., 2001; Carey et al., 2000) and some recent studies have explored the relationship between internal audit and the audit committees (Goodwin, 2003; Raghunandan et al., 2001).

No research study, however, has been undertaken examining the role of the internal audit in promoting good corporate governance or/and factors that prompt and influence corporations to create an internal audit function, both in the public or private sector. This research study, therefore, sought to investigate the role and the extent of the contributions to good corporate governance practices in the public sector by the internal audit function in Kenya. It also sought to narrow the existing gap by answering the question: What role do the internal audit function play in promoting sound corporate governance practices in the public sector?

The results of the study make important contribution to this growing body of literature and document the use of internal audit in the public sector for enhancing good governance practices. The limited use of the internal audit function by the public sector has important practical implications for sound corporate governance.

### **1.3 Objectives of the Study**

The purpose of the research study was 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 audit function in SOE's.

### **1.4 Research Questions**

To assess the primary objectives of the study, the following research questions guided the study:

1. What is the internal auditor's role in promoting corporate governance?
2. What are the challenges faced by the internal audit department in promoting good corporate governance?

3. What kind of safeguards need to be built into the IAF to ensure that internal auditing meet its external governance responsibilities in Kenyan State Owned Enterprises?
4. Why some State Owned Enterprises had not established internal audit department?

These were interesting research questions in view of the well-published corporate collapses which have focused global attention on corporate governance and the need to strengthen internal controls.

### **1.5 Importance of the Study**

The findings of this research study are important in further refining the scope of the internal audit function in the public sector enterprises, especially so to the policy makers concerned with regulation governing the internal audit function; and enabling those charged with the responsibility in the management of public affairs that the management systems in place have adequate internal controls to promote transparency, accountability and in enhancing good corporate governance mechanisms..

Others to benefit from the study includes:-

#### **Academicians and Researchers:**

The highlighting of the importance and effectiveness of the internal audit function in promoting corporate governance is of value to them. This is because they are interested in establishing whether internal audit function adds value to the accuracy of financial statements and reporting disclosures of institutions in the public sector, and may use the findings as references in further relevant studies.

#### **Donors and the General Public:**

The donors and the public should be made aware of the importance of corporate governance and the internal monitoring mechanisms that the public administration has instituted to ensure public funds are utilized for the intended purposes. Internal auditors are the watchdogs to the operations of management and, therefore, their independent and effectiveness are of great importance to the donors and the public.

## **Internal Audit Managers**

The research findings are useful to managers of internal audit departments as the results make them appreciate their role and place in promoting good governance practices and be an eye opener for performance improvement.

## **CHAPTER 2.0: LITERATURE REVIEW**

### **2.1 Introduction**

Most of the debate concerning corporate governance lies on the issue of reconciling the different interests at play in both the public and private sector. The problem is evident in the trade-off between management and control and can only be resolved by an efficient system of internal and external checks and balances.

#### **2.1.1 Corporate Governance**

The current preoccupation with corporate governance can be pinpointed at two events: The East Asian crisis of 1997 that saw the economies of Thailand, Indonesia, South Korea, Malaysia and the Philippines severely affected by the exit of foreign capital after property assets collapsed. The lack of corporate governance mechanisms in these countries highlighted the weaknesses of the institutions in their economies. The second event was the American corporate crises of 2001 to 2002 which saw the collapse of two big corporations: Enron and WorldCom, and the ensuing scandals and collapses in other corporations such as Arthur Andersen, Global Crossing and Tyco in the USA.

Shleifer and Vishny (1997) defined corporate governance as “deals with the ways in which suppliers to corporations assure themselves of getting a return on their investment. How to the suppliers of finance get managers to return some of the profits to them? How to they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers”.

The OECD (1999) defines corporate governance as “a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently”. This definition bears similarity with that given in the Cadbury Report (1992) which provides that corporate governance is the system by which companies are directed and controlled.

Within the Kenyan environment corporate governance has been addressed by both the Private Sector Corporate Governance Trust (PSCGT) and Capital Markets Authority (CMA). Corporate Governance “refers to the manner in which the power of a corporation is exercised in the stewardship of the corporation’s total portfolio of assets and resources with the objective of maintaining and increasing shareholder value and satisfaction of other stakeholders in the context of its corporate mission. It is concerned with creating a balance between economic and social goals and between individual and communal goals while encouraging efficient use of resources, accountability in the use of power and stewardship and as far as possible to align the interests of individuals, corporations and society” (PSCGT, 2002). The CMA issued guidelines on Corporate Governance Practices by Public Listed Companies in Kenya (2002) state that “good corporate governance practices must be nurtured and encouraged to evolve as a matter of best practice but certain aspects of operation in a body corporate must of necessity require minimum standards of good governance”

Governance is concerned with the processes, systems, practices and procedures, formal and informal rules that govern institutions, the manner in which these rules and regulations are applied and followed, the relationships that these rules and regulations determine or create, and the nature of those relationships. Essentially, governance addresses the leadership role in the institutional framework.

Corporate failures and scandals have necessitated the demand for reforms and for better regulations particularly on governance issues. In the UK, a number of issues in the early 1990’s notably the collapse of the Maxwell business empire, stimulated discussions and debate about structures for controlling executive power (Power, 20002). A code of best practice was developed by a committee chaired by Sir Adrian Cadbury, “the Cadbury Code”. In the US as a result of high profile allegations of financial statements fraud and lack of responsible corporate governance of high profile companies (e.g. Enron, Global Crossing and World Corn) has shaped the ever increasing attention on corporate governance in general including internal audit in particular. The fall of the above companies has raised concerns regarding the lack of vigilant oversight functions such as Board of Directors (BOD), management, audit committees and internal auditors in effectively overseeing financial reporting process and auditing



functions within an entity. As a result a number of commissions and committees have been established to address corporate governance and the US provided the lead by establishing the Treadways Commission, Blue Ribbon Commission and the enactment of the Sarbanes-Oxley Act of 2002 into law whose major provisions was the requirement for the establishment of the Internal Audit Function (IAF) in companies.

### **2.1.2 Importance of Corporate Governance**

According to OECD (2005), governance can improve access for emerging market companies to global portfolio equity. Evidence indicates that well-governed companies receive higher market valuations. Improving corporate governance will also increase all other capital flows to companies in developing countries: from domestic and global capital, equity and debt for public securities markets and private companies' sources.

Companies that demonstrate good corporate governance have easier access to the world's capital markets and boosts investor confidence (PriceWaterHouseCoopers, 1997). Improved governance structures help ensure quality decision making, encourage effective succession planning for senior management and enhance the long term prosperity of the company independence its sources of finance.

Good corporate governance aims at the increased profitability and efficiency of business enterprises and their ability to create wealth for shareholders, increased employment opportunities with better terms for workers and increased benefits to shareholders. The transparency, accountability and probity of business enterprises make them as acceptable as caring, responsible, honest and legitimate wealth creating organs of society. The credibility of business enterprises enhances their capacity to attract investment in an internationally competitive environment. The enhanced legitimacy, responsibility and responsiveness of business enterprises within the economy and improved relationship with their various stakeholders comprising shareholders, managers, employees, customers, supplies and communities, providers of finance and the environment enhance their market standing, image and reputation (PSCGT, 2002).

As far as the public sector is concerned, efficient use of resources and accountability strengths in the stewardship of these resources, improved management and service delivery contribute to improving peoples' lives. Effective governance is essential for building confidence in public sector enterprises, which is itself necessary if they are to be effective in meeting their objectives. Further, proper corporate governance precludes corruption (PSCGT, 2002). As noted by the Centre for Corporate Governance (2006), good governance ensures managers and corporate boards are accountable for their actions and decisions and they will be more responsive to societal and shareholders needs. At the very least this promotes the common good. The multilateral and donor agencies insist on good corporate governance so as to avoid reputation risk, which is avoiding being associated with companies with poor corporate governance. Reputation risk is particularly serious where shareholders and equity investors stand to lose from governance abuses (OECD, 2005).

Public attention through higher profile corporate scandals and collapses has forced governments, regulators and boards of corporations to carefully reconsider fundamental issues of corporate governance as essential for public economic interest. In addition, the volatility and instability experienced in emerging markets in recent times has drawn attention to the implications of corrupt practices and maladministration in national and international financial systems and on public expenditure.

## **2.2 Role of Internal Audit**

The roots of internal auditing lie in the financial control area, as shown in IIA's Statement of Responsibilities of Internal Auditing issued in 1947. It was charged with the task of measuring and evaluating the effectiveness of different types of control and evaluating the correctness of financial transactions. The objective of the function was to assist members of the organization in the effective discharge of their responsibilities (Rittenberg and Covaleski, 1997; Bou-Raad, 2000).

Hass and Burnaby (2006) noted that organizations have encountered rapid changes in economic complexity, expanded regulatory requirements, and technological advancement in recent years. These changes have given the internal audit function (IAF) a set of expanded



opportunities to support management, provide services to other organizational functions, and generate direct reporting links to the audit committee.

Chapman and Anderson (2000) argue that the inclusion of assurance and consulting services in the new definition of internal auditing results in internal auditing becoming a proactive, consumer focused activity concerned with the important issues of control, risk management and governance. The definition specifically states that IAF is designed to add value and improve on organization's operations. The IIA standards indicate examples of assurance engagements as financial, performance, compliance, system security and diligent audits. Consulting activities include conducting internal control training, providing advice to management about the control concern in new systems, drafting policies and participating in quality teams. These are all value-added activities and contribute to organizational success and strategic achievement.

A study by Cooper et al. (1989) that aimed at determining the state of internal audit practice in Hong Kong found that 45.6% of Chief Executive Officers (CEO) saw the main role of internal audit as being an independent appraisal of the internal control system; 21.6% perceived internal audit's main role as an independent review of the efficient operation of the organization; and 19.2% were more concerned with proper safeguarding of assets and preventing and detecting fraud and error. The internal audit managers saw their main role as financial auditing and internal control reviews representing up to 50% of the activity in 94% of the internal audit departments that responded to the survey. Similarly, a research aimed to provide a profile of internal audit and to address a number of issues including the role and scope; and the future role of internal audit work was carried out in Australia in 1990s. In respect of the role and scope of internal audit, the findings were that the CEOs appeared to place great emphasis on the audit of financial areas, and yet most internal auditors were by then concentrating on operational areas. The major area of audit coverage as acknowledged by 66% of CEOs was accounting and finance. This high expectation of coverage in accounting and finance was reinforced by their strong perception of internal audit as an independent appraisal of the internal control system. This study also revealed that only 40% of internal audit managers spent between 30% and 80% of their time on financial auditing, while almost

another 40% spent only 10-30% of their time on financial auditing. The future role of internal audit was seen as expanding beyond the traditional boundaries within which internal audit was often constrained. The survey disclosed that the CEOs (61%) envisaged an expansion in the need for independent reviews of the operational efficiency of their organizations. Further, 34% of the CEOs believed in the emergence of greater internal audit emphasis in independent evaluations of the effectiveness of management, and the use of internal audit as an internal consultant to management.

The Government Financial Regulations and Procedures (1989) provides that the main objective of internal auditing is to assist all levels of management in the effective discharge of their responsibilities through the submission of reports on their examination, which contain unbiased, dispassionate and factual analyses of their operations and, when justified appropriate action oriented recommendations for corrective action. Achieving this objective will usually involve the review and evaluation of the adequacy, soundness and applicability of accounting, financial and other operating controls; the effectiveness and economy of these controls; the extent of compliance with established policies, plans and procedures; the extent of compliance with legislative mandates and restrictions embodied in the laws governing various government programmes; the extent to which government assets are accounted for and safeguarded from the losses of all kinds; and the adequacy and reliability of financial reports and other accounting data emanating from the accounting unit.

The scope of internal auditing is presently limited to the above mentioned tasks but will in future be extended to all government operations, activities and related management controls, in the interest of providing maximum service to the responsible managerial officials. Today internal auditing functions are generally geared towards assessing and advising on risk management, control and governance processes in ministries, department and districts. Its objective is to provide quality assurance and consulting services designed to add value to Government

### **2.2.1 Internal Audit Charter**

The Internal Audit activity charter is the formal document that specifies the internal auditors' authority and responsibilities. The charter is important to management, the people being

audited, and the audit staff. The endorsement of the Internal Audit activity charter by IIA underscores the importance of the internal audit function in organizations operations. There should be continued cooperation from management as internal auditors fulfill their important responsibility to the corporation (IIA Manual, 2002).

Performance Standards describe the nature of internal audit activities and provide quality criteria against which the performance of these services can be measured. Performance Standard 2130 on Governance states that “the internal audit activity should contribute to the organization's governance process by evaluating and improving the process through which; values and goals are established and communicated, the accomplishment of goals is monitored, accountability is ensured, and values are preserved. It further provides that internal auditors should review operations and programs to ensure consistency with organizational values and consulting engagement objectives should be consistent with the overall values and goals of the organization. (Standards for the Professional Practice of Internal Auditing, 2000).

Previously the authority and responsibility of internal audit was derived from sub-sections 2 and 3 of section 4 of the Exchequer and Audit Act Cap 412. This sections state that: “the Permanent Secretary to the Treasury, or any officer in the Treasury authorized by him, shall be entitled to inspect all offices and to have access to all official books, documents and other records as may be necessary for the exercise of the powers and duties of the Treasury under this Act. The Treasury shall so superintend the expenditure of public moneys as to ensure proper arrangements for accounting to the National Assembly for such expenditures are made” (Exchequer and Audit Act cap 412).

Internal Audit Function is an independent review function set up within the Civil Service and is governed by the Government Financial Management Act 2004 section 9(1) (c) as a service to all levels of management. The Internal Auditor General is responsible for effective review of all aspects of risk management and control throughout the Civil Service of the Republic of Kenya as stipulated in the Exchequer and Audit Act Cap 412, sub-section 2 and 3 of section 4. Currently, the internal audit function is centralized under the Internal Auditor General’s Office (IAG) under the Ministry of Finance. Under this arrangement, internal audit staff belongs to

the Internal Auditor General's Office, and they are posted to the individual government ministries they audit and report to the IAG.

In order to clarify the position of internal audit and to provide guidance for its operations, a number of policy documents have been developed including the Charter for Audit Committees, Charter for Internal Audit, Internal Audit Guidelines and Ethical Guidelines for Internal Auditors. An Internal Audit Manual and Guidelines for the adoption of the Standards for the Professional Practice of Internal Auditing are currently being developed. Furthermore, in order to ensure independence of the internal audit function in line with best practice, the head of internal audit unit, under the decentralized set-up, shall functionally report to the accounting officer but have direct access to the Audit Committee. The duties and responsibilities of the audit committees are specified in the Treasury Circular No. 16/2005 published in October 2005.

The reforms in the Government's financial management systems have implied a change from the traditional role of internal audit to a more proactive and independent role based on international standards and best practice. The changes have conferred new responsibilities on the internal auditing function such as review of IT systems controls and evaluation of effectiveness of public financial management programmes, and orientation towards risk-based auditing. Accordingly, there is an urgent need to build capacity of the internal audit function by means of upgrading the skills and knowledge of the internal audit staff, updating of the internal audit methodology and policies and procedures and auditing in a computerized environment. In addition, there is need to appropriately manage the process of decentralizing the internal audit function.

Key achievements towards the strengthening of the Internal Audit Function (IAF) in government was the enactment of the Government Financial Management Act in December 2004 which clarifies the role of accounting officers and treasury functions and more importantly, formally enshrines the office of the Internal Auditor General. These changes should enhance transparency and accountability in the management and expenditure of public funds.



The Kenya Consultative Group Meeting held with donors in April 2005, Kenyan development partners welcomed the appointment of the Internal Auditor General as dedicated coordinator for public financial management reforms and expressed hope that this would facilitate the elaboration of a sector-wide support programme to be built around government action plans and ensure public funds are used with integrity and transparency.

Andy Wynne (2001) concluded that the internal audit units in the federal ministries of Nigeria have a direct line to the permanent secretary in their respective ministry. However, their independence is preserved, as it is the Accountant-General in the Ministry of Finance that controls their transfer rather than their home ministry. In addition, the head of each internal audit unit is required to report to the Accountant-General each quarter on the work they have undertaken and their main findings. However, their scope could still be restricted, as it is the permanent secretary in their ministries that endorses their annual plan.

### **2.2.2 Internal Auditor Independence**

The Research Committee of the Institute of Chartered Accountants in Scotland (1993) claimed that one of the criticisms made of internal auditors is that they are not independent of the executives. Cipfa (1990) defined independence as the internal auditor having independence in terms of organizational status and personal objectivity, which permits the proper performance of their duties. The professional internal auditor must have independence to fulfill his professional obligation, to render a free, unbiased, unrestricted opinion, and to report matters as they are, rather than as some executives would like to them to do (Sawyer, 1988). Independence permits internal auditors to perform their work freely and objectively. Vanasco (1996) noted that without independence, the desired results of internal auditing cannot be realized. He also concluded that the role of the internal auditor requires unrestricted independence in order to perform a variety of duties for the organization they serve. For internal auditors, practical independence needs to be constituted through the organizational and reporting status of the internal audit department.

Standard on internal auditing reiterate the importance of maintaining the auditors' independence. Attribute Standard 1100 on Independence and Objectivity provides that the internal audit activity should be independent, and internal auditors should be objective in

performing their work. Further, Attribute Standard 1110 on Organizational Independence explains that the Chief Audit Executive (CAE) should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. Also Attribute Standard 1110.A1 explains that internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results (IIA Manual, 2000).

A study by Gordon and Fischer (1996) provide mixed results concerning the degree of independence experienced by internal auditors. The most affirmative evidence of independence was reflected in those auditors who are hired by the board of directors, have a written authority for unrestricted access to records and regularly meet with the board. These are all informal indicators of evidence; informal indicators may be more important. One informal way that the internal auditor's work can be influenced is through the board and administration's perceptions of the quality of the internal auditor's work. Further, a survey Azad (1992) concluded that reporting to the audit committee was the most important for improving the independence of IAF.

Internal auditors should have an impartial, unbiased attitude and avoid conflicts of interest. If independence or objectivity is impaired in fact or appearance, the details of the impairment should be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment. Internal auditors should refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an auditor provides assurance services for an activity for which the auditor had responsibility within the previous year.

### **2.3 Internal Audit and Governance**

The primary representatives of the organization's stakeholders are viewed as the four cornerstones of corporate governance, and these includes the audit committee, board of directors, executive management, external auditors and the internal audit function. Moeller (2004) notes that the internal audit function has had a corporate governance role in many organizations as early as the 1940s and that the role has evolved overtime. The Institute of Internal Auditors (IIA, 2003), bears similar observations by naming internal audit function as

one of the four cornerstones in good corporate alongside the board, the executive management and external audit. The institute argues that with the right positioning in an organization and with competent professional staff and leadership, an internal audit function will provide independent and objective opinion on the organization's operations and report these regularly to the board, audit committee and management.

The internal auditing function as part of the corporate governance structure plays an increasingly important role in monitoring the internal control system of the company and its financial reporting systems (Khas, 1999). The demand for good corporate governance now equally applies to the public sector as well as the private sector. Accordingly, the public sector management must give equal attention to the processes and governance mechanisms of their institutions (Balderston, 1974). Internal auditing was identified as one of the key participants to promote good governance in the corporate sector (Kadir, 2000); hence, management in the public sector should realize the importance of the internal audit function in their institutions.

Drucker (1975) observed that to ensure institutions derive the most benefit from internal auditing, it is essential that the governing body should formally establish an internal auditing department, an audit committee of the governing body should oversee the coordination of internal and external audit operations; and internal auditors in the internal auditing department should report to an official who will ensure the deficiencies are promptly considered and corrective actions taken.

Andy (2002) notes that because of corruption and misconduct by high ranking government officials, inappropriate use of resources and the abuse of executive authority, there have been increased public interest, and concern for, the processes by which the government is accountable to the citizens for its decisions and actions. He further observes that there is increased demand that taxes be properly expended and the community receive value for money. The modern role of the government auditor as a member of the management control team should be reviewed and redefined so as to reinforce the accountability of government to the public as a whole.



Hespenheide (2003), on the renewed interest in auditing, observes that internal audit units are now being challenged by audit committees and the chief executive to not only prove their value but to play a larger role in overall corporate governance. He notes that internal audit has a significant role to play in a company's demonstration of good corporate governance and that effective internal audit functions embraces a broad concept of risk assessment focusing on monitoring financial and operational controls and compliance.

The Government Internal Audit Council of Canada, in its paper, *The Role of Auditing in Public Sector Governance* states that; “government internal auditing is a cornerstone of good public sector governance. By providing unbiased, objective assessments of whether public resources are responsibly and effectively managed to achieve intended results, auditors help government organizations achieve accountability and integrity, improve operations and instill confidence among citizens and stakeholders. An effective public sector internal audit function strengthens governance by materially increasing citizens' ability to hold government accountable. Auditors perform an especially important function in those aspects of governance that are crucial in the public sector for promoting credibility, equity, and appropriate behaviour of government officials, while reducing the risk of public corruption.”

Hermanson and Rittenberg (2003) argue that as a result of the nature of internal audit activity today typically includes risk assessment, control assurance and compliance work all of which map directly into corporate governance. The corporate governance role of the IAF will likely take an increased role given the new requirements imposed under Treasury Circular No 16/2005 dated 4<sup>th</sup> October, 2005.

The IAF has been described as the “window into the whole company” (Tapestry Networks, 2004) and thus serves as the “eyes and ears of management” (Sawyer, 1973). An IAF with this type of access throughout the company, it is in a unique position to serve as a valued resource to the other three corporate governance parties.

In analyzing the evolution of internal audit practices, Gupta and Ray (1992) clearly noticed an extension of the audit examination into activities that were previously not audited. They

indicated a shift from examining financial records and fraud investigation towards more internal control evaluations, operational auditing and the provision of recommendations for future action. According to Allot (1996), the contemporary internal auditor must determine whether the organization plans and activities have been carried out efficiently and effectively. In addition, he or she comments on whether organizational objectives, as set by management, have been achieved. The “new” internal auditor is an indispensable management assistant that would be subjected to increased interaction with other line functions and outside groups. When suggesting possible solutions and improvement, internal auditors try to work in a more proactive ways (Thevenin, 1997).

The increased regulatory demands for accountability following the well-known corporate scandals that have shaken the worldwide business environment including the Kenyan public sector in the last decade, have brought government’s risk management and internal controls systems into public policy debates on corporate governance. Many national and international corporate governance guidelines, including recent incentives taken by the European Commission (2003) and the Capital Markets Authority (2002), clearly demand that boards of directors and executive management adhere to sound risk management, and demonstrate publicly that they are in control of their organizations. More specifically, Accounting Officers in government ministries and departments are responsible for ensuring that appropriate systems of risk management, internal control systems and audit committees are in place. In addition, audit committees are often established to assist in carrying out these growing monitoring responsibilities with respect to control in the broadest sense. Subsequently, Accounting Officers must be the first to identify and evaluate the risks faced by their organizations, and second, to design, operate and monitor a suitable system of internal control which implements the policies adopted by the government.

By stating that internal auditing should evaluate and contribute to the improvement of the risk management, control and governance, the IIA formally recognizes the assurance and consulting role of internal auditing in corporate governance, and thereby, reflects existing practice: “Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps organizations

accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes” (IIA, 2004). An internal audit function that meets this definition is uniquely positioned to support the board, the audit committee and executive management as an essential component of their governance mechanisms (ECIIA, 2005). Consequently, a significant opportunity for the internal auditing has emerged to demonstrate its potential to add value and break away from its historical characterization as “organizational policemen and watchdog” (Morgan, 1979). In other words, expertise and knowledge of risk management and internal controls has become a source of power for internal auditing to advance and play an important assurance and advisory role within the contemporary governance environment.

Jocelyn Thompson, Auditor General of Trinidad and Tobago, while presenting a paper on ‘Accountability and Audit’ at a *Regional Public Expenditure Management Conference held in Port of Spain, Trinidad, in February 2003* noted that an internal audit function plays a significant monitoring role in the accountability process and that top management is responsible for ensuring that as far as possible, the internal audit function, while carried out by the organization’s employees, is free from restrictions that could limit its scope. It is mandatory, therefore, that the internal auditor be responsible only to senior management to preserve the independence of the internal auditor from influences by the personnel subject to internal audit. She further, observed that, “internal auditing must not be confined to financial transactions. In the final analysis, it assists the organization through its fact-finding, judgmental evaluation followed by recommendations, and follow-up action. The internal auditor can also assist line management by ensuring that adequate financial and management controls have been implemented and are operating effectively or by identifying weaknesses in the system and recommending remedial actions, where necessary”.

The Commonwealth Association for Corporate Governance (CACG, 2005) guidelines require the board to regularly review processes and procedures to ensure the effectiveness of its internal systems of control, so that its decision-making capability and the accuracy of its reporting and financial results are maintained at a high level at all times. The guidelines state that ‘the board should implement a formal internal audit function. An audit committee should

be established to keep under review the scope and effectiveness of the audit and its cost efficiencies. The board should make sure that access between itself and the corporation's internal and external auditors is open and constructive. It should be satisfied that the scope of the audit is adequate, and that management and the internal auditors have co-operated fully''.

Mutiga (2006) in his study which sought to determine the role of the external auditors in corporate governance indicated that the independence of the auditor is critical in enhancing corporate governance. His findings highlighted that adherence to professional ethics, avoidance of conflicts of interest on the part of the auditor, existence of a supportive body (ICPAK), legislation and judiciary and creating awareness through which an auditor can discuss freely with shareholders any reservation or misgivings they might have in carrying out their audit, could enhance the independence of the auditor and enhance corporate governance. On the inclusion of corporate governance issues on the audit report, he noted the following: "52% of those interviewed were of the opinion that such a paragraph enhance transparency and accountability to the shareholders from an independent source. However, 45% of the respondents felt that such a paragraph was not necessary as auditors do not review compliance with control guidelines. They argued that this is the work of regulators. Further, they were of the opinion that corporate governance encompasses the whole entity operations, financial and otherwise, and this would therefore not be adequately covered in the audit report. They were of the opinion that such a report should be specially called for may be on a rotational basis and by a special team and not the auditor''.

#### **2.4 Internal Auditing and the Agency Costs**

Defond (1992) noted that internal auditing may also serve as a monitoring response to agency costs and Adams (1994) observed that relatively few studies have used agency theory to explain the importance of internal auditing. Agency theory postulates that a company consists of a nexus of contracts between the owners of economic resources (the principals-taxpayers) and managers (the agents-government officials) who are charged with using and controlling those resources (Jensen and Meckling, 1976). The public sector represents a principal-agent relationship, the government officials acting as the principal's agents who must periodically account to the principal for their use and stewardship of resources and the extent to which the public's objectives have been accomplished. The audit function reduces the risks inherent in



the principal-agent relationship. The principal relies on the auditor to provide an independent, objective evaluation of the accuracy of the agent's accounting and to report on whether the agent uses the resources in accordance with the principal's wishes. Agency theory is based on the idea that agents have self-seeking motives; hence they are likely to take opportunity to act against the interest of the owners of the company. Jensen and Meckling (1976) and Wallace (1980) refer to this as the moral hazard dilemma and moral problem respectively.

Sherer and Kent (1983) and Watts (1988) suggest that internal auditing is a bonding cost borne by agents to satisfy the principals' demands for accountability made by external participants especially shareholders. The cost of internal auditing can be judged to be monitoring cost which is incurred by the principals to protect their economic interests. Agency theory contends that internal auditing, like other intervention mechanisms like financial reporting and external auditing, helps to maintain cost-efficient contracting between owners and managers. Adams (1994) illustrates that agency theory helps to explain the existence of internal auditing in companies but also help to explain an important characteristic of the internal audit function, namely its size. It is assumed that the more information asymmetry, the greater the need for monitoring to reduce this information asymmetry, resulting in a larger internal audit function. In a larger internal audit function, there will be more staff, representing a more diverse range of skills and competences that will be able to reduce a greater range of information asymmetry problems. Further, the scope of the internal audit function covered would be greater in a larger function than in a smaller function (Mat Zain et al., 2006). It is assumed that a larger internal audit function has a broader scope of work and is able to cover more areas where (potential) information asymmetries exist. Internal auditing can be considered as a basic monitoring mechanism to reduce the information asymmetry resulting from the separation of ownership and control (Francis and Wilson, 1988; Defond, 1992). This separation is considered as the basic principle behind the demand for corporate governance, which confirms the growing importance of internal auditing's monitoring role in contemporary corporate governance (Carcello et al., 2005b).

From the foregoing it is apparent that agency theory can help explain the existence of internal audit, the nature of internal audit function and the particular approach adopted by internal



auditors to their work. In this respect, it is considered that an agency-theory perspective to the internal audit will have substantive benefits for both academicians and practitioners.

## **2.5 The Relationship between Management and Internal Audit**

Internal Audit is an integral part of the financial structure in government and is an independent appraisal function within government institutions for the review of activities as well as a service to all levels of management. The Blue Ribbon Committee (1999) stated that the quality of financial reporting can only be achieved through open and candid communication and close working relationships among the company's board, management, internal audit and external audit. The success of the internal audit in fulfilling their appraisal function depends on their working relationships with other participants of corporate governance. Cohen, Krishnamorthy and Wright, (2002) in their study observed that the inclusion of management as one of the cornerstones of corporate governance recognizes the strong influence of management in setting the overall tone for governance.

A recent study by Van Peurse (2005) found that internal audits are conducted in an environment of close and, sometimes, dependent associations with management, which makes their independence from management structurally at risk. She found that those who seem to be able to meet their own expectations are also those who most carefully balance the sometimes conflicting interests of their own profession. Essentially, a key issue is that internal audit would assume whatever position that is in the best interests of their employer and would be reluctant to counter management, irrespective of the consequences as noted by Van Peurse, (2004).

Sarens and De Beelde (2006) argue that a professional internal audit activity supplements senior management's actions, by providing independent and objective assurance on the effectiveness of the organization's governance process, how well it manages all kinds of risks, and whether internal audit processes are operating as required, to mitigate risks to acceptable levels. Furthermore, they note that IA play a key role in monitoring a company's risk profile, identifying areas of improvement and supporting management by providing them with consulting services geared towards establishment of sound risk management processes and facilitating their effort to improve the system of internal control and any implications to the

change in that system. They concluded that the enhanced attention to corporate governance and fraud cases within organizations have contributed to the increased appreciation of internal audit.

Sarens (2007) noted that senior management wants internal audit to compensate for the loss of control they experience resulting from increased organizational complexity. Senior management expects internal audit to fulfill a supporting role in the monitoring and improvement of risk management and internal control, and wants them to monitor the corporate culture. Further, management expect internal audit to be a training ground for future managers.

The definition of internal auditing provided by IIA includes references both to assurance and to consulting activities directed at the governance, risk management and internal control processes. Consequently, an internal audit activity that fulfils this definition is uniquely positioned to support the board and management as an essential component of their governance mechanisms (ECIIA, 2005). Moreover, Carcello *et al.* (2005) found indications that effective oversight, sound internal controls and the importance assigned to internal auditing by management has increased due to enhanced focus on corporate governance. They also note that senior management's expectations of the IAF have changed in profound ways. Additionally, it has been found that an expectations gap arises when audit customers (including senior management) do not recognize the value of the IAF. In order to function effectively, internal auditors and the customers of audit services should possess a similar understanding of what makes internal auditing a value-adding activity. Failure to reach this understanding could result in the perception that internal audit is simply an obstacle to achieving organizational objectives. This can result in underutilized audit services and ignored audit recommendations as observed by Flesher & Zanzig (2000).

It is clear that different levels of management, including senior management, should commit to providing prompt responses to recommendations from IA, to monitoring the implementation action plans, and to keeping IA informed of plans, of changes to the risk and internal control profile of the organization, and of major changes to the organization's policies and procedures.

## 2.6 Audit Committees and Internal audit Function

The concept of an audit committee was first proposed by the Securities and Exchange Commission (SEC) in 1940 in the USA, following the McKesson and Robbins case (Vanasco, 1994). However, it was not until the 1960s and 1970s that any significant progress was made. In fact in 1974, the New York Stock Exchange (NYSE) stated that a strong audit committee could stimulate improvements in financial reporting and control and strengthen the credibility of corporate reports. In 1978, the NYSE required the establishment of audit committees composed of independent directors for its listed companies. Since then, the establishment of audit committees has escalated worldwide. Development has varied from country to country and has been largely attributed to the large number of business failures and corporate malpractice (Goddard and Masters, 2000). In the United Kingdom (UK), the Cadbury Committee (1992) was established in response to high profile corporate failures such as Polly Peck and BCCI (Laing and Weir, 1999). In Canada, the collapse of Atlantic Acceptance Corporation Limited in the 1960s propelled the adoption of audit committees (Vinten, 1998).

Historically, the audit committee has had oversight responsibility of management's external financial reporting. Glassman (2004) noted that the role of the AC has expanded today to also include ensuring robust internal controls and overseeing internal auditor activities. Audit committees are looking at ways to better discharge their responsibilities for overseeing the organization, and are increasingly relying on the IAF as one of the primary resources to assist in their responsibilities for ensuring quality corporate governance (KPMG ACI, 2003; McHugh and Raghunandan, 1994). Hermanson (2002) also observed that increased expectations of audit committees will result in enhanced relationships between the IAF and the audit committee.

Goodwin and Yeo (2001) were of the view that an effective audit committee can strengthen the position of the internal audit function by acting as an independent forum for internal auditors to raise matters affecting management. At the same time, internal audit can be of considerable assistance to the audit committee in "its oversight reporting, risk management and control (Bishop, 2001). In particular, internal audit can help overcome the problem of information asymmetry which inevitably exists because an independent audit committee does not have direct access to the same level of information as management. Professional governance

guidance, standards, and best practices highlight the importance of a quality relationship between the audit committee and the IAF (e.g., IIA, 2003c, 2004; KPMG ACI 2003). The listing rules for the NYSE require that an entity maintain an IAF and that the IAF is expected to interact with the audit committee by providing the committee with ongoing assessments of the company's risk management processes and system of internal control (SEC, 2003). Further, standards promulgated by the IIA suggest a relationship between the IAF and the audit committee such that the IAF reports to the audit committee and that the IAF provides the committee with appropriate information (IIA, 2003).

In addition to IAF assisting the audit committee in discharging its corporate governance responsibilities, a quality relationship between the IAF and the audit committee also works towards providing the IAF with an appropriate environment and support system for carrying out its own governance related activities such as risk assessment, control assurance and compliance work. An effective audit committee uplifts the status of the IAF, which, in turn, assists the audit committee in ensuring quality reporting by management (Beasley, Carcello, Hermanson, and Lapedes, 2000; McHugh and Raghunandan, 1994).

In the Public Sector, audit committees were established through Treasury Circular No. AG/3/080(61) of 8<sup>th</sup> August 2000 which provided the mandate and the guidelines to be followed when setting up the State Corporations audit committees. However, concerns were raised regarding the adequacy of the guidelines in this circular particularly on the appointment and composition of the membership which had hindered the audit committees from being effective due to lack of independence and objectivity. In order to enhance oversight, governance, accountability and transparency in SOEs', the government decided to enforce establishment and strengthen audit committees in all state corporations through Treasury Circular No. 16/2005 of 4<sup>th</sup> October 2005. Through this circular all Chief Executive Officers of state corporations were required to establish audit committees and to ensure they were fully operational.

The circular provides the mandate of the audit committees to include: assisting the CEOs' in enhancing internal controls in order to improve efficiency, transparency and accountability; reviewing audit issues raised by both internal and external auditors; resolving unsettled and



unimplemented Public Investment Committees' (PIC) recommendations; enhancing communication between management, internal and external audit and fostering an effective internal audit function.

The Head of the Internal Audit Function is required to provide the audit committee with a progress report summarizing the following: work performed compared to work planned; key issues emerging from internal audit work done; status of management response to audit findings and recommendations; changes to annual work plans; and any limitation in resources that may affect the implementation of internal audit work (Treasury Circular No. 16/2005). Audit Committees have the overall responsibility for independent in-depth review of the framework of internal control and of the internal audit process. This therefore brings into focus the working relationships of the two bodies.

## **2.7 Internal Versus External Audit**

As noted by Ratcliffe (2003), the relationship between internal and external auditors has recently taken on increased importance with today's corporate governance requirements. The IAF's relationship with the external auditor is one of a longstanding tradition (Thurston, 1949). In today's environment, the roles of the two audit groups have become potentially more aligned, which has resulted in a deeper relationship between the two audit groups (Tapestry Networks, 2004).

One of the important corporate governance goals is quality reporting by management. The annual audit completed by the external auditors is specifically directed towards that goal. Professional auditing standards discuss the resource role that the IAF can provide to the external auditors in completing the annual external audit (SAS No. 65, AICPA 1991; AS 2, PCAOB, 2004). The IAF's work may affect the nature, timing, and extent of the annual audit work, including procedures the external auditor performs when obtaining an understanding of the entity's internal control, when assessing risk, and when gathering substantive evidence. In performing the audit, the external auditor may rely on work already performed by the IAF and request direct assistance from the IAF such as a specific request for the IAF to complete some aspect of the external auditor's work. Similarly, AS No. 2 [PCAOB, 2004] provides



opportunities for the external auditor to rely on internal control work performed by the company's IAF.

In the public sector, the external auditor (Controller and Auditor General) is not an employee of the State Corporation. His/her appointment is provided under Sections 105 of the Constitution of Kenya. The Public Audit Act (2003) Section 36 states that the duties of the Controller and Auditor General are “to satisfy himself that all reasonable precautions have been taken to safeguard the collection of revenue, the receipt, custody, issue and proper use of property; that the applicable law has been complied with; and that all money, other than money that has been appropriated by Parliament, has been dealt with in accordance with proper authority”. The internal auditor performs many duties, among them being the continuous implementation and evaluations of internal control systems. The Controller and Auditor assesses to what extent he can rely on the work of the internal auditor in conducting his audit (KENAO Financial Manual, 2006). The Cadbury Committee (1992) recommended that the external auditor should access the company’s internal control system and determine whether it can be relied upon.

## **2.8 State Owned Enterprises**

State Corporations (State-Owned Enterprises) are established under different statutes which include the Companies Act, Cap.486, State Corporations Act Cap.446 and other Acts of Parliament. As defined in the State Corporations Act, State-Owned Enterprises (SOE) encompasses all state owned enterprises whether established by the Companies Act or other statute. All SOEs unless exempted from the State Corporations Act under Section 2(Vii) of the Act, fall under the ambit of the State Corporations Act Cap 446 which came into existence in 1986. This Act is therefore the supreme legal document relating to management and control of state corporations. It prescribes rules and regulations on how state corporations are to be governed; and this includes:

- Provisions for corporate governance of state corporations,
- Provisions for control of finances of state corporations,
- Provisions for supervision of the management of state corporations, and
- Provision for accountability.

## **2.9 Regulatory, Control and Supervisory Framework**

The Government controls and regulates the operations, management and overall performance of state corporations through a composite framework of agencies spread across the wide spectrum of Government. Some of these agencies are involved in formulation and development of policies others in supervising and enforcing compliance with the regulations and laid down procedures, while others are involved in the continuous monitoring of performance. A brief description of each of these agencies includes:-

### **2.9.1 Office of the President**

Section 23(1) of the Constitution of Kenya vests the President of Kenya with executive authority of Government of Kenya. It states, "*The executive authority of the Government of Kenya shall vest in the President and, subject to this constitution, may be exercised by him either directly or through officers subordinate to him*". State-owned enterprises are accountable to the state through the Government. The President commands enormous authority in the governance of these corporations. Some of the powers vested with the President in the management of state corporations includes the establishment of state corporations, assigning ministerial responsibility for a state corporation, appointment of chairpersons of boards of state corporations, giving directions of a general or specific nature to boards of state corporations and revocation of the appointment of members of the boards of state corporations and constitution of a new board (Constitution of Kenya, 1992). Further, the Office of the President is the umbrella body which formulates and issues general policy direction to state corporations through the respective parent ministries.

### **2.9.2 State Corporations Advisory Committee (SCAC)**

The State Corporations Advisory Committee (SCAC) was set up in 1986 under section 26 of the State Corporations Act, Cap.446. The functions of the Committee are succinctly spelt out in section 27 of the State Corporations Act as follows and includes to review and investigate the affairs of state corporations and make such recommendations to the president as it may deem necessary and where necessary, advise on the appointment, removal or transfer of officers and staff of state corporations and the secondment of public officers to state corporations, the terms and conditions of any appointment, removal, transfer or secondment. The committee has also to be consulted on the approval of terms and condition of service for the staff and Chief Executive Officer (CEO) of a state corporation, the establishment of Committees of the Board

and also specifies the scales of sitting allowances or other remuneration payable to the members of the Board. The Committee therefore has wide ranging responsibilities in policy development and general management of state corporations.

### **2.9.3 Inspectorate of State Corporations (ISC)**

This is an important government advisory and supervisory agency. ISC is established under section 18 of the State Corporations Act to advise the government on all matters affecting the effective running of state corporations, to report periodically to the minister on management practices within any state corporation and to report to the Controller and Auditor-General any cases where funds appropriated by parliament are not being applied for the purpose for which they were appropriated.

The overall goal of ISC is to assist the government to improve performance, profits and generation of overall resources of SOE's through regular appraising, evaluating and monitoring the performance of SOE's in light of their mandates specified in the legal instruments under which they were constituted. It is therefore expected to ensure that state corporations are managed in accordance with sound management principles which reflect accountability and transparency.

### **2.9.4 Ministry of Finance (Treasury)**

Treasury is the government agency entrusted with the responsibility of making and overseeing government investments in state corporations, hence the official government shareholder in state corporations. Treasury participation in the governance of state corporations is exercised through participation in the board of a state corporation, approval of the annual estimates of the state corporation's revenue and expenditure as well as capital budgets and prescribing conditions and guidelines for borrowing or investing money by a state corporation. External borrowing by state corporations is guaranteed and regulated by the Treasury. Treasury is therefore the arm through which government controls and regulates its investment in state corporations by ensuring prudent financial management.

### **2.9.5 Parent Ministries**

A state corporation has a parent ministry, connoting the dependence of the corporation on the ministry which directs its affairs. Section 4 of the State Corporations Act stipulates that, "*The President shall assign ministerial responsibility for any state corporation and matters relating*

*thereto to the Vice-President and the several ministries as the president may by directions in writing determine*". Government directives to state corporations are communicated through respective parent ministries. Ministries are expected to be fully responsible and accountable for the proper, effective and efficient management of all state corporations falling under them.

### **2.9.6 Controller and Auditor-General**

Section 12 of the Public Audit Act 2003 provides each state corporation shall prepare and submit for audit accounts to the Controller and Auditor-General, who shall certify the results of the examination and audit. The controller and Auditor-General is therefore a watchdog of the public who are the owners of state corporations and has a statutory obligation of reporting to the shareholders (the public) through the Public Investment Committee of the National Assembly.

### **2.9.7 Public Investments Committee (PIC)**

The Public Investments Committee is a select Standing Committee of the National Assembly established pursuant to standing order No. 148(5), whose functions are to examine the reports and accounts of the public investments, to examine the reports, if any, of the Controller and Auditor-General on the public investments and to examine, in the context of the autonomy and efficiency of the public investments, whether the affairs of the public investments, are being managed in accordance with sound business principles and prudent commercial practices ( Government Financial Regulations and Procedures, 1989). Section 15 (2) of the state corporations Act stipulates that, *"The Chief Executive of a state corporation may be summoned by the Public Investments Committee to answer on behalf of the Board any question(s) arising from the report submitted to that Committee by the Controller and Auditor General.*

### **2.9.8 The National Assembly**

The role of Parliament in the governance of state corporations is similar to that of shareholders in a public limited company; the only difference being that parliament does not hold an annual general meeting to exercise the powers of a shareholder such as appointing and dismissing directors, declaration of dividends and appointing auditors. When the accounts of a state corporation are laid before the National Assembly, members of parliament as the legal representatives of the owners (public) of state corporations have the right to scrutinise the report and accounts of a state corporation and demand from the responsible Minister, any



explanation they deem fit on issues relating to the overall management of a state corporation and holding ministers accountable for the proper management of public investments in state corporations.

From the foregoing, it is clear that the public who are the defacto shareholders in state corporations have no direct authority over state corporations. Their right is exercised through their representatives in Parliament.

## **2.10 Governance Principles and Practices**

Corporate governance in SOEs is premised on the principle of stewardship. They are managed by a Board of Directors appointed by the government. A particular problem of governance in state-owned enterprises is that government delegates its responsibilities and authority to a Minister, thus acting an interface between the shareholder and the Board. This can result in the relationship between the responsible Minister and the Board being personality driven and vulnerable to political agenda which may not be in the best interest of the corporation.

The existence of parliament, ministers, Boards and CEOs creates an elaborate set of relationships in the governance of state-owned enterprises. The following is a review of the principles and practices of governance in state-owned enterprises in Kenya:-.

### **2.10.1 Powers of parliament**

Parliament passes legislation which underpins the operations of state-owned enterprises including their functions and powers. The enactment of the State Corporations Act to make provision for the establishment of state corporations, for control and regulation of state corporations and for connected purposes was a milestone in the corporate governance of state-owned enterprises (PSCGT, 2001).

Under Section 99 of the Constitution of Kenya, all public funds paid out of the consolidated fund must be authorised by parliament. The Share Capital and other Exchequer funds provided to state corporations by the state must have parliament's authorisation. Parliament, therefore, has a responsibility to ensure that the affairs of state-owned enterprises are being managed in accordance with sound business principles and prudent commercial practices for public good. By law, Parliament has also a responsibility to receive dividends or return on behalf of the public who are the investors.



Parliament has entrusted the government with the shareholding of state-owned enterprises in trust on behalf of the public. The public has a right through parliament to question the extent of accountability and transparency in the manner in which the government has exercised the trust bestowed upon it by the public. Parliament thus has an important accountability role in reviewing the performance of state-owned enterprises.

### **2.10.2 Minister(s)**

According to the State Corporations Act, the minister is vested with the responsibility of ensuring proper and efficient management of state corporations falling under his purview. The minister commands powers to appoint directors of a state corporation, to approve annual budgets, grant authority to incur expenditure outside the approved annual budget, grant approval to dispose assets where such disposal was not taken into account in the budget, approve dividends to be paid to the consolidated fund, approve terms and conditions of service for the staff and CEO and to give consent to a state corporation to borrow money in Kenya or elsewhere.

### **2.10.3 Board of Directors**

The top governing organ in state corporations is referred to variously as Board of Directors, Board of Management or Board of Governors, a parlance which depends largely on the legal instrument establishing a state corporation. Section 2 of the State Corporations Act defines a Board as: “----- the body or person, by whatever name called, carrying out or empowered to carry out functions relating to the overall direction and management of a state corporation”.

Section 15 of the State Corporations Act, Cap.446 stipulates that: “A Board shall be responsible for the proper management of the affairs of a state corporation and shall be accountable for the monies, the financial business and the management of a state corporation”. Therefore, the Board of a state corporation ideally expected to play the role of steering the corporation towards attainment of its objectives as outlined in its enabling legislation.

Every corporation should be headed by an effective Board which should exercise leadership, enterprise, integrity and judgment in directing the corporation so as to achieve continuing prosperity and to act in the best interest of the enterprise in a manner based on transparency, accountability and responsibility. The Board is responsible for determining and approving

corporate strategy and guidance and oversight to the Chief Executive and management. It is responsible for approving and reviewing the overall business strategies, significant policies and structures of the organization.

The State Corporation Act clearly states that the Board shall be responsible for the proper management of the affairs of a state corporation. Under the State Corporations (Performance Contracting) Regulations, 2004, the Board of state corporations are required to sign performance contracts with the parent ministry which shall be countersigned by the Treasury every last month of the financial year in order to become effective on the first month of the financial year. The purpose of the performance contracting is to reward Board members and employees of state corporations whose performance achievements agreed targets and sanction Boards members and employees whose performance is below the agreed targets.

### **Conclusion**

As can be noted from the literature, corporate governance framework in state-owned enterprises is very complex. The respective powers, roles and responsibilities of parliament, ministers, boards and Chief Executive officers tend to result in greater management complexity in terms of stewardship and accountability than in the norm in the private sector. There is therefore need to rationalize the governance framework of state owned enterprises to ensure effective corporate governance.

Internal auditors have seen their role evolve from performing traditional audit functions to focusing on adding value to the organization and its scope has expanded too much broader spectrum of activities. Increasingly, internal auditors are looked upon as service providers such that their continued existence is dependent on adding value to the organization. New emphasis is being placed on adding continuous value through the prevention of problems and identification of risks (Auditwire, 2000). There is also a relatively focus on risk management, control, and corporate governance as the internal audit role goes beyond accounting roles to both understanding and evaluating the effectiveness of controls in managing business risk. Further, more internal auditors have been challenged to not only work on problems but also work with management to recommend solutions (Rittenberg, 2000).

The breadth and depth of work performed by internal auditors can be seen in the recent definition of internal auditing adopted by the Institute of Internal auditors (IIA, 2000): This new definition puts IA into both the assurance and consulting arena. The concept of 'assurance' implies that the profession can add value by providing assessment of the reliability of the data and operations in specific organizational settings. This concept includes all the traditional audit areas as well as new forms of assurance involving control and risk management issues. Internal auditor's cultural shift from a policing activity to a function that contributes positively to the organization needs to be nurtured and well managed.

The existence of Parliament, Accounting Officers, Audit Committees, Internal Audit and the Controller and Auditor General creates an elaborate set of relationships in the governance of public affairs and public resources in the government. The respective powers, roles and responsibilities of each party tend to result in greater management complexity in terms of stewardship and accountability than is the norm in the private sector. Furthermore, the very nature of public entities with their often broad objectives, variable and complex benefits and society-wide impact, distinguish management of public affairs from management of most private sector entities; where the overriding obligation is to maximise the organisations' value, including dividends to shareholders.

The study therefore will seek to test the extent to which the responsibility and authority of corporate governance rests with internal audit by specifically assessing its role in corporate governance.

## CHAPTER 3.0: RESEARCH DESIGN AND METHODOLOGY

### 3.1 Introduction

This chapter sets to explain the research design, population of interest, source of data, and the techniques that were used data analysis.

### 3.2 Research Design

The type of research design used in this study was exploratory. This is mainly because the focus of the research study was to gain understanding, insights and familiarity of the role of internal auditors in state owned enterprises in promoting governance. Similar studies that have successfully used this research design include Riro (2005), Mutiga (2006) and Wambua (2006).

### 3.2 The Population

The population for this study comprised all state owned enterprises with government equity of over 50% located in Nairobi. There were one hundred and eleven as shown below. These state corporations are either directly or indirectly regulated by the various regulatory boards or operated by the parent ministries.

**Table3.1: Classification of State Owned Enterprises**

SECTOR	NO. OF STATE OWNED ENTERPRISES
Commercial	39
Regulatory	31
Research Institutions	11
Educational and Training	14
Regional Development Authorities	8
Social Service	8
<b>TOTAL</b>	<b>111</b>

*Source: Department of Government Investment and Public Enterprises, Ministry of Finance, July 2007*

### 3.3 The sample

The researcher had proposed to study a total of 43 State Corporations. The sample was selected by way of geographical location and GoK shareholding. SOEs operating and headquartered in Nairobi were chosen because of time, budgetary constraints and proximity. The Corporations



were then stratified into 2 main strata for purposes of sampling. The first strata consisted of corporations in which the government has 100% ownership and the second strata were made up of those corporations in which the government has controlling interest of 51% to 99%. The study then drew 50% of the corporations from each stratum to add to the researcher's sample as shown below. However, only twenty nine of the forty three organizations in the sample responded to the questionnaire, which represent a response rate of 67.4%. The responses were analyzed in order to achieve the objectives of this study.

**Table 3.2: Sample Chosen**

<b>GoK shareholding</b>	<b>NO. of SOEs</b>	<b>Sample (50%)</b>
100% Ownership	81	40
51 – 99% Ownership	6	3
<b>TOTAL</b>	<b>87</b>	<b>43</b>

*Source: Internal audit questionnaire*

**3.4 Data Collection**

This research study utilized primary data that was collected by way of a questionnaire. The questionnaire was sent to and administered by heads of internal audit departments of state owned enterprises. The questionnaire consisted of both closed and open ended questions and was administered by a drop and pick latter method. Such questions were preferred because they provided an opportunity for in-depth probing of issues. A standardized questionnaire was developed to allow comparison of results amongst the various corporations. This method of data collection was considered appropriate because the information sought in the study was not publicly available and heads of internal audit were in a good position to provide answers to the questions posed in the survey instrument. The drop and pick approach was considered an appropriate method for the study because it gave the respondents time to fill the questionnaire and allow the researcher an opportunity to review the questionnaire before picking it to ensure completeness of responses.

**3.5 Data Analysis**

Data collected was validated, coded and checked for any coding errors and omissions. Thereafter, it was run through the Statistical Package for Social Sciences (SPSS). The output



from the data analysis was tabulated and represented in frequency distribution tables, pie and bar charts and summarized by calculating averages and/or percentage frequencies for clear presentations of the research findings. This facilitated quick and easy exploration of data to help identify the most prominent factors that influence internal auditors in their role of promoting governance.

### **3.6 Summary**

The problem under investigation is social in nature and therefore the qualitative approach in research was used. This approach facilitated a deeper and better understanding of the role of the internal auditor in promoting corporate governance. According to Mugenda and Mugenda (1999), qualitative in research is increasingly being used to address social and economic problems in recent years. He notes that qualitative approach is slowly gaining acceptance by scholars in Africa because of its effectiveness in addressing social issues. By using qualitative methods researchers are able to collect data and explain a phenomenon more deeply and exhaustively.

## CHAPTER 4.0: DATA ANALYSIS AND FINDINGS

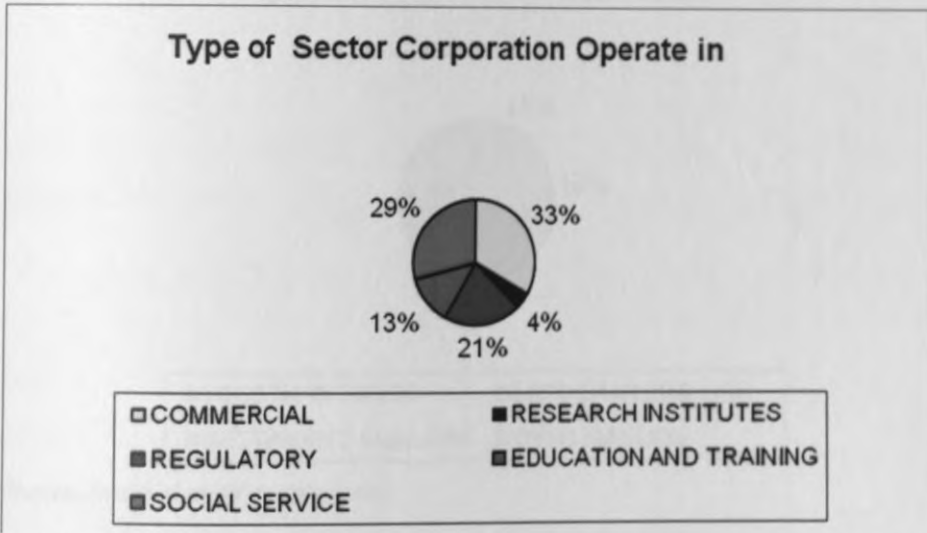
### 4.1 Introduction

This chapter sets to give a detailed analysis of the data collected. Data was collected using the internal audit questionnaire. Data collected was coded, validated and analysed in order for the research questions to achieve the objectives of the study.

### 4.1 General information about the Respondents

The state owned enterprises fall into five sectors; namely commercial, regulatory, research institutions, educational and training, regional development authorities and social service. Figure 4.1 shows that that the respondents were somewhat evenly distributed across the different subdivisions of SOEs.

Figure 4.1: State Corporations by Sectors



Source: Internal audit questionnaire

Table 4.1 present data on the number of respondents having internal audits. It can be seen that 24(82.8%) of the 29 respondents have established internal audits in their organizations. In this study only five respondents indicated the absence of internal audit units in their organizations, representing 17.2% of the respondents. Two respondents indicated that IAF had not been established in their organizations owing to their small sizes, minimal financial operations and the cost implication of setting up such a function. The other three respondents indicated that they had outsourced the internal audit services but they have intentions of establishing the internal audit function within their organizational structures.

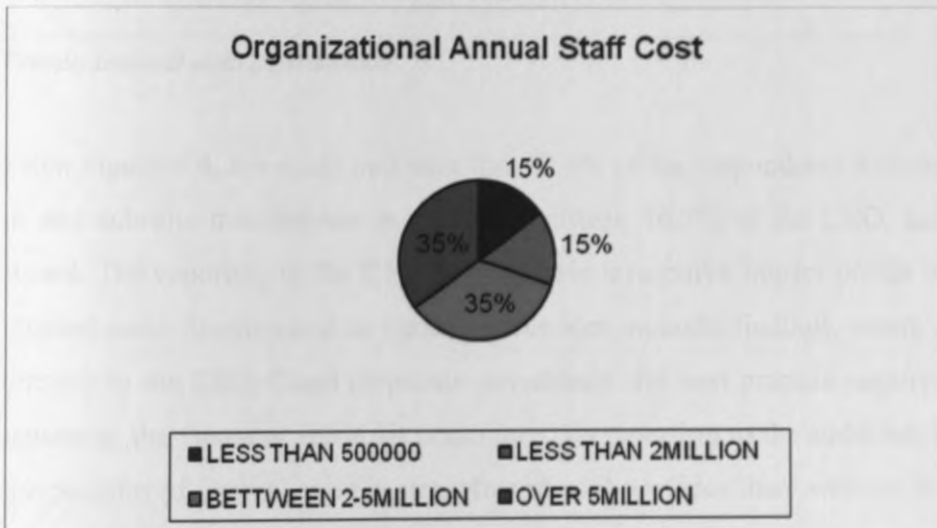
**Table 4.1: Organizations with Internal Audit Departments**

Responses	No. of Respondents	Percentage (%)
Yes	24	82.8
No	5	17.2
Total	29	100

Source: Internal audit questionnaire

Of the respondents with internal audit units, 86% indicated that their IAD were established before year 2000, when the government directed for the establishment of audit committees in the public service. Figure 4.2 show that 30% of the respondents have funding of less than two million shillings and below. There is need for organizations to appreciate the role of internal audit in achieving their overall organizational objectives by providing adequate funding.

**Figure 4.2: Annual Internal Audit Staff Costs**

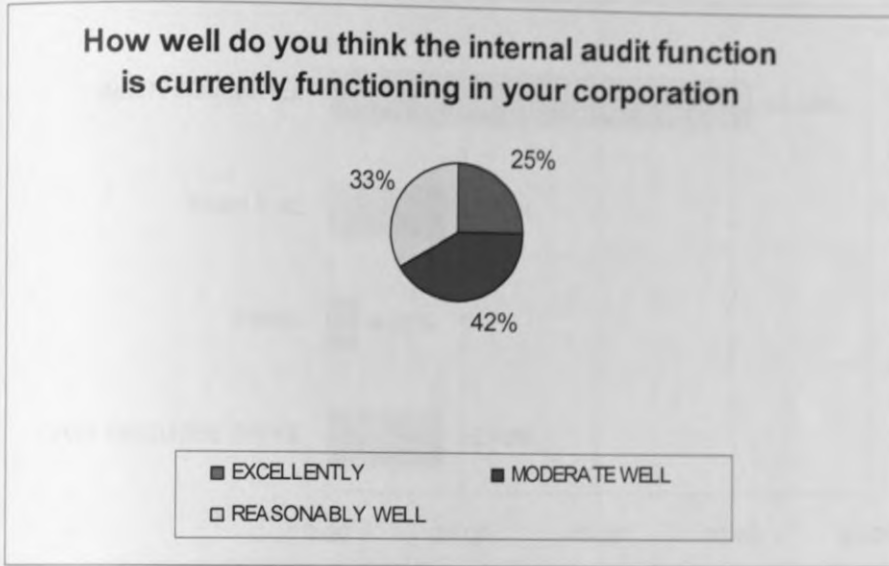


Source: Internal audit questionnaire

#### 4.2 Functioning and Reporting of Internal Audits

As shown in Figure 4.3, 25% of the respondents are functioning excellently, 42% are functioning moderately well while the remaining 33% are functioning reasonably well. This is an indication that internal audit departments in state owned enterprises are working relatively well in assisting their organizations to achieve their set objectives.

**Figure 4.3: Functioning of Internal Audit**



Source: Internal audit questionnaire

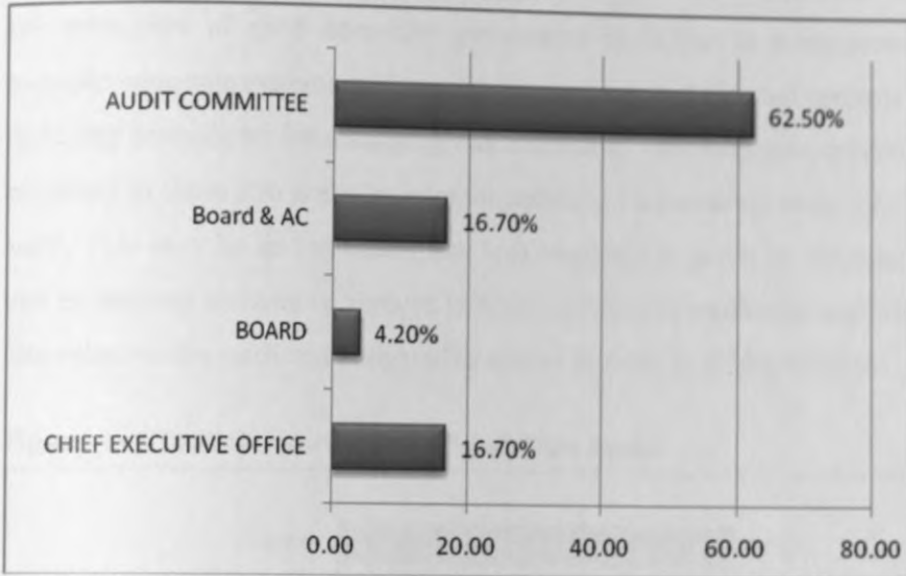
From Figure 4.4, the study indicates that 62.5% of the respondents with internal audits report to and submits their reports to audit committees, 16.7% to the CEO, and only 4.2% to the Board. The reporting to the CEO by may have a negative impact on the independence of the internal audit function and on candid discussions on audit findings, where the function reports directly to the CEO. Good corporate governance and best practice requires that internal audit reports to the Board or the audit committee. By reporting to the audit committee or the board, the position of internal audit is strengthened as it provides them with an independent forum to raise sensitive matters touching on management.

### 4.3 Time spent on tasks performed by Internal Auditors

Figure 4.5 show that 70% of the respondents spent 35 to 75 percent of their time performing pre-audit work. Only 15% of the respondents indicated that they are not involved in pre-audit assignments. By not participating in pre-audit assignments, internal audit objectivity and neutrality is enhanced. The involvement of internal auditors in pre audit work would not enable them too fully act as an advisor and consultant to management and other sections or departments in the organization as they may be considered to be part of the system they are required to evaluate and review.

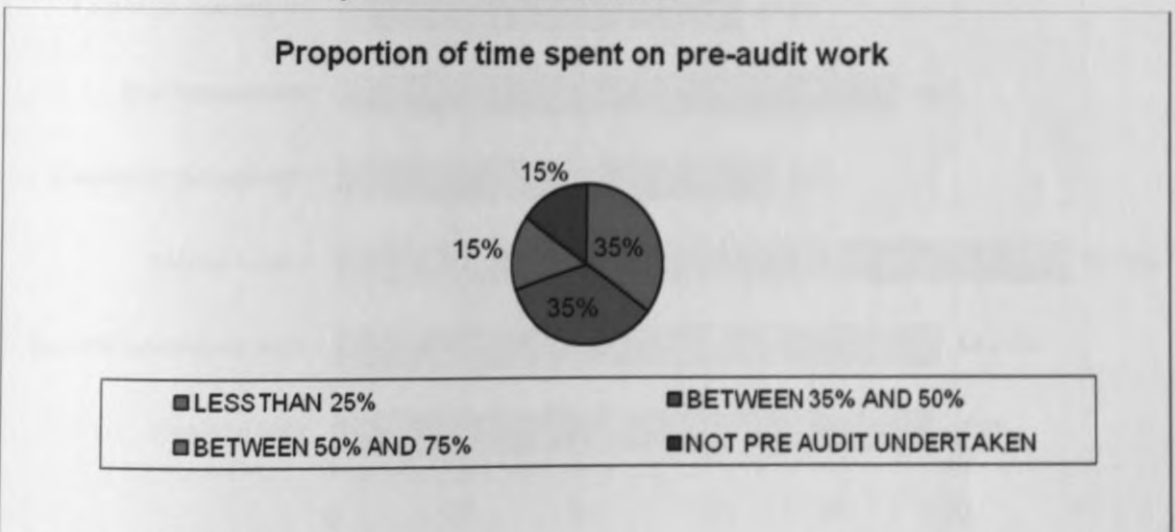


**Figure 4.4: Reporting of Internal Audit**



Source: Internal audit questionnaire

**Figure 4.5: % of Time spent on Pre Audit Work**

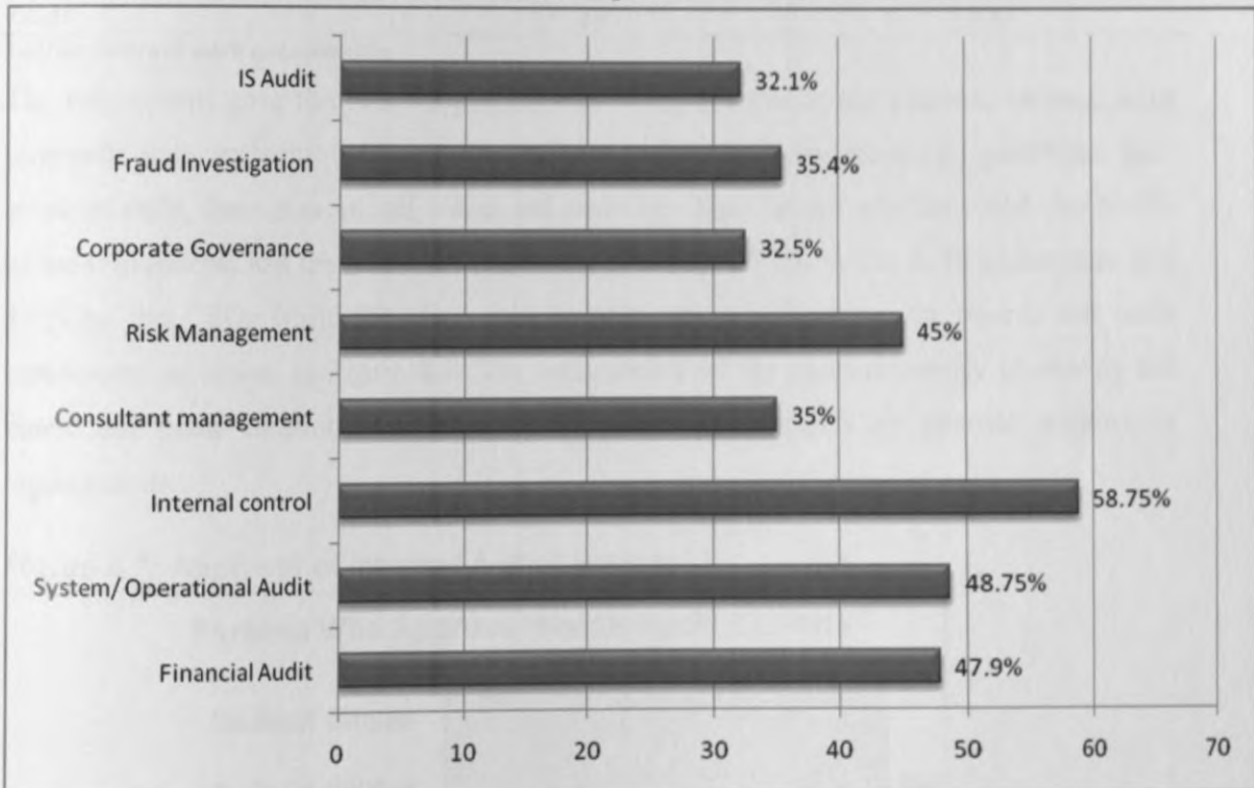


Source: Internal audit questionnaire

As shown in Figure 4.6, reviewing and evaluating internal controls takes a larger portion of the internal auditors' time. This illustrates that the main role of internal audit is to make independent appraisals of the internal control systems and provide assurance that an organization's main business risks are being managed and that its internal control framework is operating effectively. Majority of the respondents, therefore, considered internal controls as the most important internal audit objectives in their corporations as they spent 58.75% of their time in this area. It follows that internal controls are designed and implanted to address

identified business risks that threaten the achievement of any of these objectives. One of the key principles of good corporate governance in SOEs' is a requirement for the BOD to maintain adequate systems of financial management and internal controls over the corporation, including procedures for managing risk and fraud. This perhaps explains why there is a lot of emphasis in these two areas by internal auditors. Respondents spent 32.1% of their time on IS audit. This may be an indication that less emphasis is given to this area or reluctance on the part of internal auditors to venture in areas outside the traditional auditing. However, it might also relate to the restricted budget allocated to internal audit departments.

**Figure 4.6: Tasks Performed as a % of Time Spent**



*Source: internal audit questionnaire*

#### 4.4 Internal Audit Charter

Table 4.2 indicates that 17 (70.8%) of the respondents with internal audit units have developed internal audit charters for the effective functioning of the internal audit function. 12.5% of the respondents were in the process of developing them while 16.7% had no internal audit charters. An internal audit charter empowers the IAF and typically provides internal audit to have full, free and effective access to all records, documents and employees of the organization and for

internal audit to have direct access to chairman of the audit committee. It sets out the reporting lines and establishes the independence status of the internal audit function and its personnel. The respondents with no audit charters could be an indication that they are not functioning optimally and hence not assisting the board in exercising leadership in directing the corporation in a transparent, accountable and responsible manner.

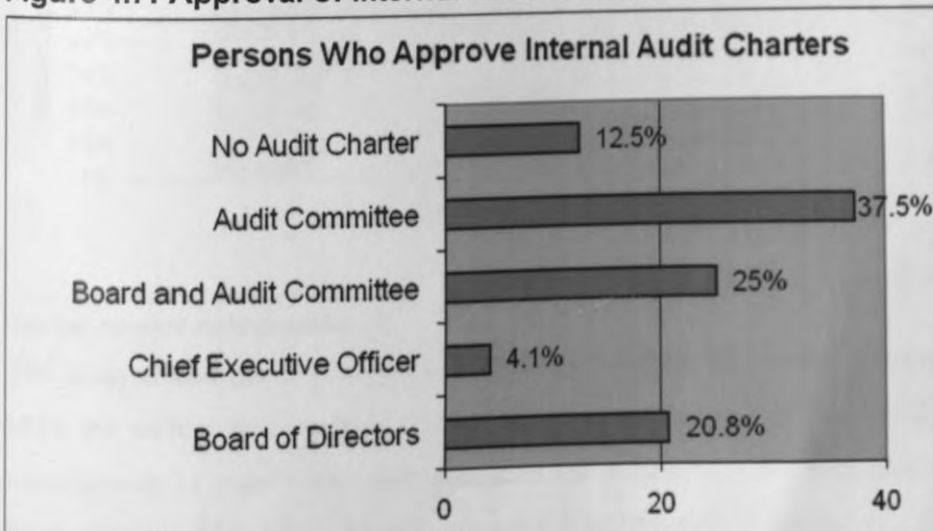
**Table 4.2: Written Internal Audit Charters**

Responses	No. of respondents	Percentage (%)
Yes	17	70.8
No	4	16.7
Being formulated	3	12.5
Total	24	100

*Source: Internal audit questionnaire*

The respondents gave the following matters as being covered in the charters; internal audit responsibilities, authority for access to records and information, independence guidelines, their scope of audit, their mission and vision and reporting. The findings also indicated that 20.8% of the respondents had their charters approved by boards, 37.5% by the audit committees and 4.1% by the CEOs while 25% had their charters approved both by the boards and audit committees as shown in Figure 4.7. The endorsement of the internal activity charter by the board and audit committee underscores the importance played by internal auditors in organizations.

**Figure 4.7: Approval of Internal Audit Charters**

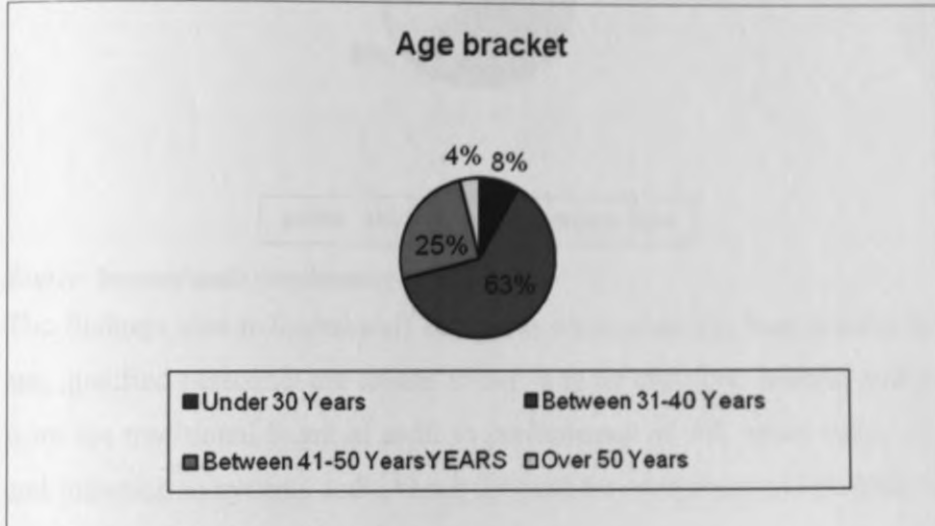


*Source: Internal audit questionnaire*

#### 4.5 Profiles of Heads of Internal Audits Units in State Owned Enterprises

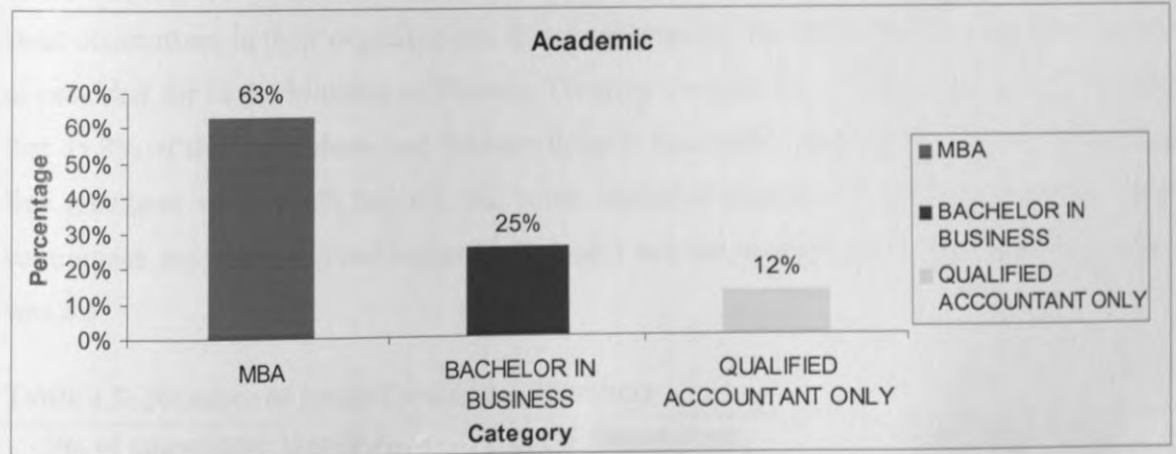
Majority heads of internal audits were within the age bracket of 31 to 40 years (63%) with the majority having masters' degrees in business administration (63%) and qualified Certified Public Accountants (80%) with 12% only being qualified public accountants.

Figure 4.8: Age Profiles of Respondents



Source: Internal audit questionnaire

Figure 4.9: Educational Levels of Respondents

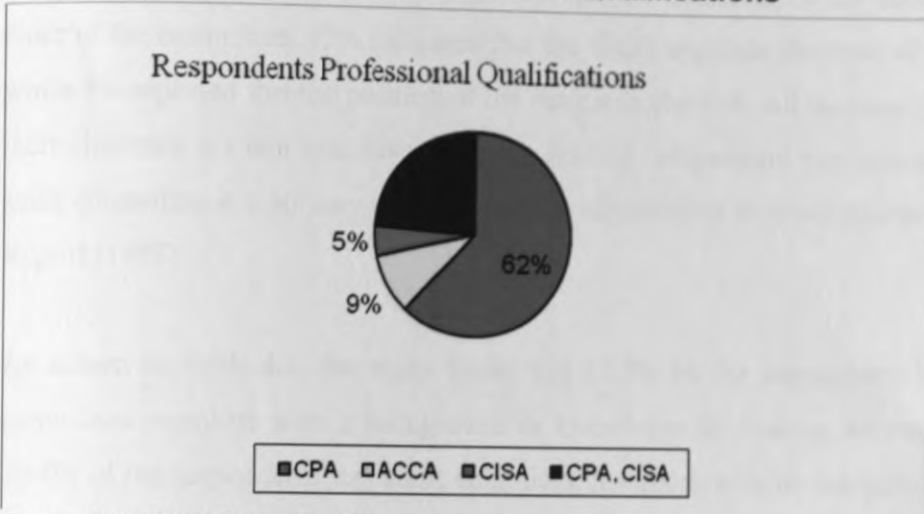


Source: Internal audit questionnaire

The study found out that a majority of the respondents had auditing experience (86%). Thus, IAFs are well manned with trained and competent heads that enables the boards and senior management to place reasonable assurance and reliance on the work and recommendations of internal audit. 67% of the respondents were members of ICPA (K).



**Figure 4.10: Respondents Professional Qualifications**



*Source: Internal audit questionnaire*

The findings also indicated staff structures were relatively lean in most SOEs. Adequate staff and qualified personnel are crucial if IAF is to be effective. Internal auditing has moved away from the traditional financial audit to performance of risk based audit, value for money audit and information systems audit, hence the need for competent and qualified staff.

#### **4.6 Composition and membership of Audit Committees**

Of the 24 respondents with Internal Audit Units, 95.8% of the respondents indicated they have audit committees in their organizations. It is a requirement for SOEs to have audit committees as provided for in the Ministry of Finance, Treasury Circular No. 16/2005. Table 4.3 indicates that 45.8% of the respondents had between three to four audit committee members, 33.3% had five members while 8.4% had six and seven members respectively. In this study, all audit committees are appointed and report to the board and the average membership per committee was 4.5.

**Table 4.3: Number of Audit Committee Members**

No. of committee Members	No. of respondents	Percentage (%)
3	3	12.5
4	8	33.3
5	8	33.3
6	2	8.4
7	2	8.4
0	1	4.2
Total	24	100

*Source: Internal audit questionnaire*

2 respondents, representing 10% indicated that the members of the committee appoints the chair of the committee, 85% indicated that the BOD appoints the chair of the audit committee while 5% reported that the position of the chair was elective. All the respondents indicated that their chairmen are non executive directors. Having independent non executive members in the audit committee is a primary and fundamental requirement that was addressed in the Treadway Report (1987).

As shown in Table 4.4, the study found that 37.5% of the respondents had two of its audit committee members with a background or knowledge in finance, accounting or audit while 20.8% of the respondents had audit committee members with no background or knowledge in accounting and auditing. Audit committee members' knowledge and experience relating to accounting and finance have been regarded as an important dimension affecting audit committee effectiveness. This knowledge is important because many oversight judgements are subjective and such knowledge will help in discerning internal auditors' review of financial decisions. Organizations whose committee members lack financial knowledge and experience are likely to make sub-optimal decisions in primary oversight areas such as the implications of accounting policy changes on financial reports. Audit committee members with the requisite financial knowledge and experience are more likely to ask the 'right' questions and more easily detect any misinformation or incongruity in the financial reports.

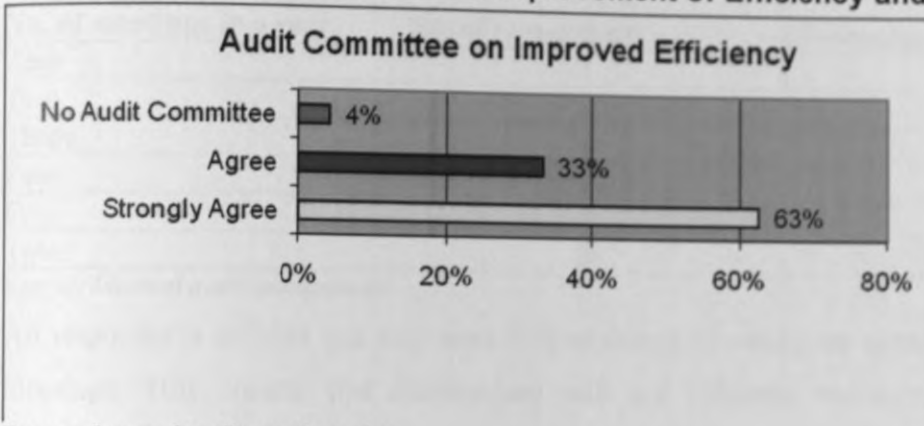
**Table 4.4: Audit Committee Members' Knowledge in Finance and Audit.**

No. of Committee Members	No. of Respondents	Percentage (%)
0	5	20.8%
1	4	17.7
2	9	37.5
3	3	12.5
4	2	8.3
5	1	4.2
Total	20	100

*Source: Internal audit questionnaire*

As indicated in Figure 4.11, 63% of the respondents strongly agreed that audit committees have improved the efficiency and effectiveness of internal audits while 33% disagreed. Given that internal audit one of the key responsibilities of the AC, this can be an indicator that most ACs are achieving their objectives.

**Figure 4.11: Audit Committee on Improvement of Efficiency and Effectiveness**



*Source: Internal audit questionnaire*

The status of the internal audit unit has significant implications for its effectiveness. The greater the independence of the internal auditors including freedom from management pressure, the greater the likelihood that internal auditors can remain objective and free from bias.

#### **4.7 Frequency, length and privacy of audit committee meetings with internal auditors**

Treasury Circular No. 16/2005 requires audit committees to meet at least four times a year. In this study, 58.3% of the respondents comply with the Treasury provision. The other respondents have their audit committees meeting three times per year (25%), 8.3% meet twice a year, another 4.2% meet 5 times per year while 4.2% do not meet at all.

The committee meets with the head of internal audit on average 3.5 times per year. The average length of these meetings is 2.4 hours. While frequency and length of meetings are not necessarily related to the effectiveness of the meetings, they do give some indication of the importance that the committee places on its dealings with internal audit function. The study also reports that 75% of the time, respondents meet privately with the audit committee without management being present, while 25% do not. Privacy of meetings with the heads of internal audit is an important way of strengthening the independence of the internal audit function as it facilitates an open forum to discuss issues of concern that may reflect adversely on management. This study also shows that audit committees with accounting and audit knowledge have more private meetings with the internal auditors and their meetings tend to be longer compared to those with no auditing or accounting backgrounds.

**Table 4.5: Number of Audit Committee Meetings**

No. of meetings in a year	No. of respondents	Percentage (%)
Zero	1	4.2
Two	2	8.3
Three	6	25
Four	14	58.3
Five	1	4.2
Total	24	100

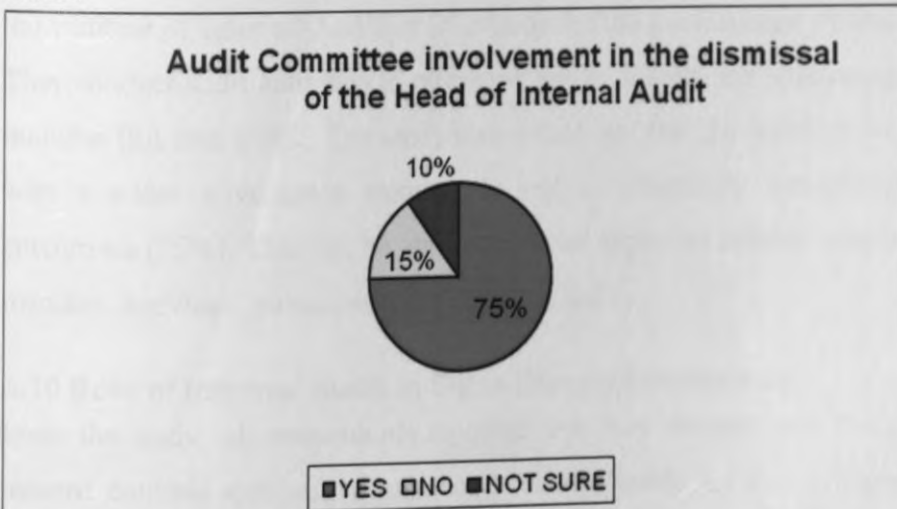
Source: Internal audit questionnaire

All respondents indicated that they were fully in charge of setting the agenda of the committee meetings. This ensures that management will not influence the committee agenda and deliberations. Frequent meetings enable the AC to remain informed, knowledgeable and also provide opportunities to explore and undertake in-depth discussions on ways to improve an organisation's financial reporting system.

#### 4.8 Dismissal of the Head of Internal Audit

Figure 5.7 shows in 75% of the cases, audit committees were involved in the dismissal decisions of the head of internal audit in public sector organizations. Only 15% of the respondents reported that audit committees do not participate in the dismissal of the head of internal audit while 10% were not sure. This low participation may lead to less empowerment of the internal audit function in some organizations.

**Figure 4.12: Audit Committee Involvement in the Dismissal of Head of Internal Audit**



Source: Internal audit questionnaire



#### **4.9 Organizational Independence of Internal Audit**

For internal audit to be effective, it must be independent and especially resist influence from the CEOs. The internal auditor should poses independence in terms of organizational status and personal objectivity. 75% of the respondents indicated that they were independent of management. All the respondents were unanimous that being independent of management was key in facilitating prompt reporting to the audit committee on adverse issues touching on management and any significant deficiencies and material weaknesses in a timely manner.

From the respondents, it was found that the IAF is strategically positioned (85%) in the organization structure to enable the department fulfil its responsibilities. The current structure of internal audit seems sound to promote objectivity, consistency and business understanding in SOEs. However, the respondents strongly feel that the current organizational status does not allow them to report when officials in the organization abused their powers against public interest (48%), lose their integrity and honesty (52%), and withhold key information to stakeholders and the public (62%). Respondents pointed out this because in the current set up there is no law that protects internal auditors for being whistle blowers or for encouraging them to report management to law enforcement and anti corruption agencies.

95% of the internal auditors in all SOEs are free to choose any transaction or area of interest for audit. All the respondents were cognisant of International Standards on Auditing (ISA) and the Institute of Internal Auditors Standards for the Professional Practice of Internal Auditing. They conduct audit activities in reference and in accordance with recognized standards, which includes ISA and IFRS. The study also found that that the mission and role of IAF is defined with a wider governance framework and is effectively communicated in public sector enterprises (75%). This can be attributed to he approved internal audit charters that define the mandate, activities, powers and duties of the IAF.

#### **4.10 Role of Internal Audit in State Owned Enterprises**

From the study, all respondents reported that they evaluate the design and effectiveness of internal controls and test compliance with applicable laws and regulations relating to their organizations. Other functions performed by the respondents' include are assessing and promoting the adequacy of corporate governance (83.3%), examining and assessing

organizational policies, procedures and manuals and recommending best practices (91.7%), testing proper recording of assets, expenditure and the reliability of financial information (95.8%), examining use of organizational resources (economy) (91.7%), risk assessment and management (79.2%). Only 58.3% of the respondents indicated that they were involved in the evaluation of projects and programs.

It is apparent that the main role of internal audit lies in the finance area. This study also envisages the expanded role of the internal audit function beyond the traditional boundaries it has often been confined in.

**Table 4.6: Role of Internal Audit on Performance**

<b>INTERNAL AUDIT ROLE</b>	<b>% of Strongly Agreed</b>	<b>Mean</b>
Internal Audit provides relevant information in making decisions on financial matters	41.7	4.08
The Audit Committee (if any) is more proactive and involved in the work of IA	29.2	3.96
Internal Audits are usually performed with emphasis on the Risks and Controls	54.2	4.29
Recommendations made by Internal Audit are usually considered and implemented by the organization.	33.3	3.96
Internal Audit needs the support of management in order to be effective in its work.	75	4.65

*Source: Internal audit questionnaire*

On the role of internal audit on performance in SOEs, it can be seen from Table 4.6 above that 75% of the respondents strongly agreed that internal audit needs the support of management in order to be effective in its work. Support of top management is of necessity crucial for internal auditors to enhance good corporate governance. However, only 33.3% of the respondents indicated that management consider and implement their recommendations. This calls for more support of the function by the Board and reporting to a higher institutionalized committee of the Board.

In this study 22 respondents (91.7%) reported that they are involved in advising management on the adequacy of existing corporate governance structures and on the design and implementation of internal control systems. 87.5% advice management on the effectiveness of risk management. Other respondents however indicated that they are involved in advising

management on project management (45.8%) and program evaluation and management (41.2%). These scenarios clearly indicate that the activities of IAF have gained prominence by addressing broader management and governance issues in addition to the traditional emphasis on financial reporting and compliance to applicable laws and regulations.

#### 4.11 Role of Internal Audit Function in Corporate Governance

Table 4.7 shows that 37.5% of the respondents strongly agreed that internal audit function is regarded by the board and senior management to play a significant role in enhancing corporate governance practices. 62.5% strongly agreed that internal audit would like to be more involved with the board and the audit committee in governance issues. 75% of the respondents said that to be effective on governance issues and processes, internal audit must be provided with sufficient status in the organization. The mean of 3.75 indicates that on average most respondents strongly agreed that internal audits plays significant roles in enhancing corporate governance in State Owned Enterprises.

**Table 4.7: Extent of Agreement as to the Role of Internal Audit Function**

Extent of agreement as role of Internal Audit	% of Strongly Agree	Mean
Internal Audit is regarded by the Board and senior management to play a significant role in enhancing good corporate governance practices.	37.5	3.75
The internal Audit would like to be more actively involved with the Board and Audit Committee (if any) in governance issues.	62.5	4.25
In order to be effective on governance issues and processes, the internal audit must be provided with sufficient status in the organization.	75	4.375
Internal Audit should be an integral part of the governance process by providing reliable information to key management.	79	4.33

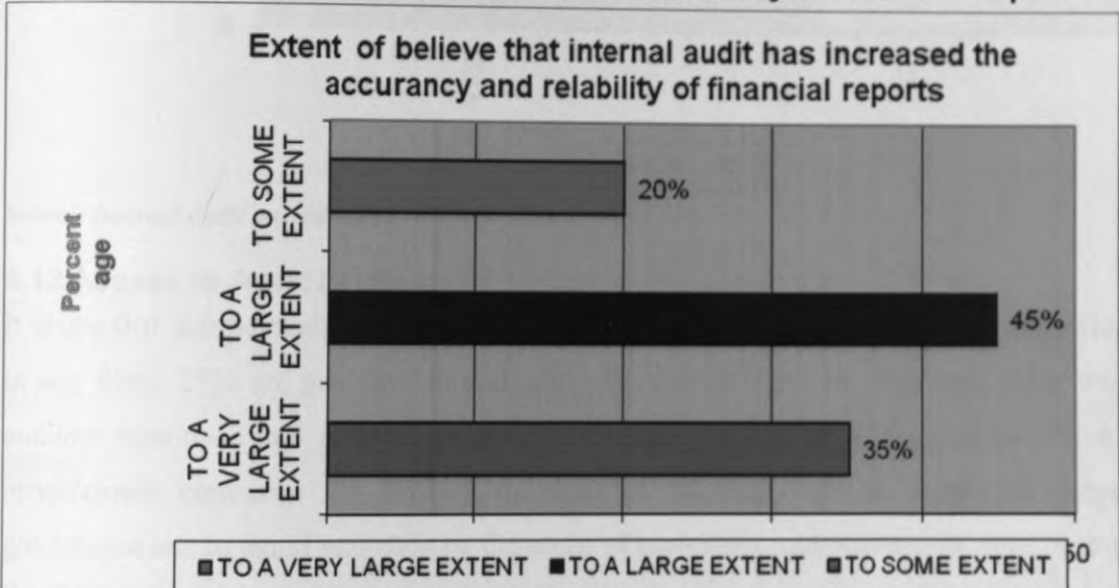
*Source: Internal audit questionnaire*

Most respondents considered internal audit to play a significant role in enhancing corporate governance by providing reasonable assurance to management and the Board that internal controls as functioning as designed and weaknesses reported on a timely basis. They also provide consulting services and undertaking risk management. Respondents also indicated that internal audit alone is not a sufficient tool of corporate governance.

#### 4.12 Extent to which Internal Audit has increased the Accuracy and Reliability of Financial Reports

Figure 4.13 show that 35% of the respondents believe that the internal audit function had increased the reliability of the financial reports to a very large extent. 45% indicated that the IAF had increased the reliability to a large extent while 20% believed that the IAF had increased the accuracy and reliability of the financial statements to some extent.

**Figure 4.13: Internal Audit on Accuracy and Reliability of Financial Reports**

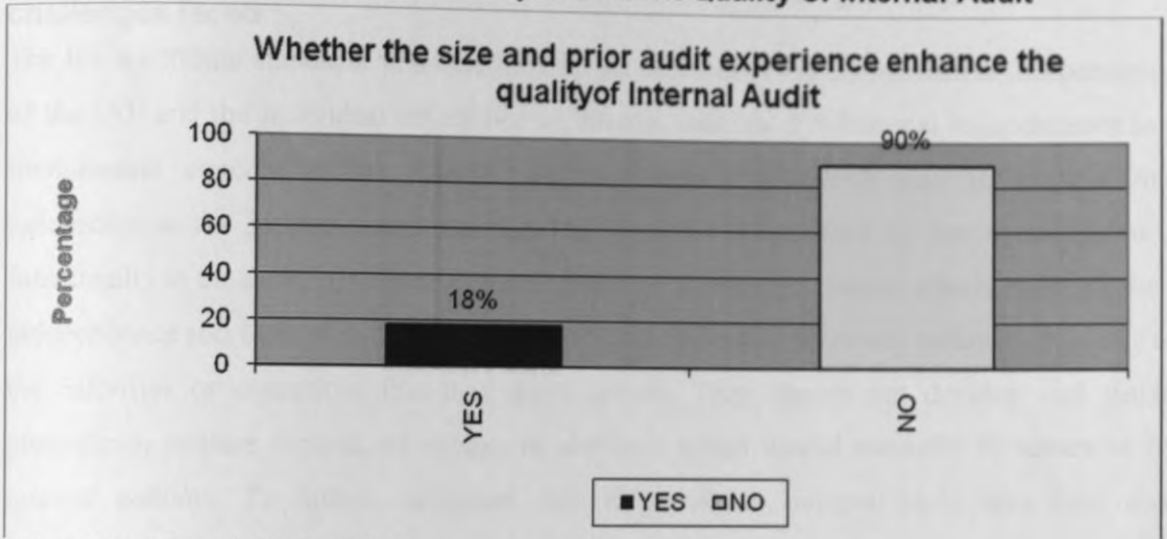


Source: Internal audit questionnaire

From Figure 4.14, 90% of the respondents are of the view that the size of the IAF and prior audit experience of audit staff enhance the quality of IAF and its work while 10% did not. Only sixteen percent (33%) of the respondents do not believe that corrective action is usually taken as a result of audit findings or weaknesses pointed out and identified by IAF. 67% of the respondents indicated that corrective measures are normally taken to address the areas of weakness they have highlighted. Some respondents added that, auditing is done and findings reported just for the purpose of formality. Almost all heads of IA monitor and follow up the implementations of audit findings based on rectification during the audit process of the following year. This is also done by having an agreed time table of implementation, regular reviews and reports on the status of implementation with the concerned audited departments.



**Figure 4.14 Size and Prior Audit Experience on Quality of Internal Audit**

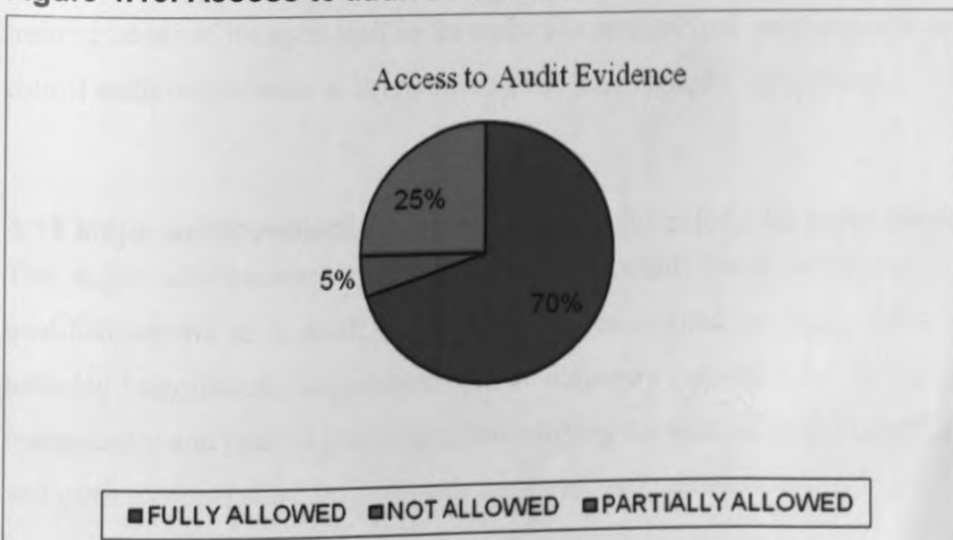


Source: Internal audit questionnaire

### 4.13 Access to Audit Evidence

It seems that internal auditors are seventy percent (70%) fully allowed to access audit evidence in any form, 25% are partially allowed while 5% are not allowed. However, some internal auditors mentioned that, in some situations it is difficult to find board minutes for review and procurement contracts. To enhance the role of internal audit in promoting corporate governance and to avoid limitation on the scope of audit work, authorization should be granted for full and complete access to any of the organization's records, physical properties and personnel relevant to an audit engagement.

**Figure 4.15: Access to audit Evidence**



#### **4.14 Mechanisms to safeguard the independence of Internal Audit and challenges faced**

The IIA's attribute standards stress the importance of both the organizational independence of the IAF and the individual objectivity of internal auditors. Professional independence is a fundamental concept to the internal auditors. Most respondents said to achieve this independence the internal audit function has been institutionalized by having it reporting functionally to the audit committee of the Board, have developed charters clearly restating their independence and internal auditors not having direct responsibility or any authority over any of the activities or operations that they have review. They should not develop and install procedures, prepare records, or engage in activities which would normally be reviewed by internal auditors. To further, safeguard their independence, internal audit have their own developed budgets.

#### **4.15 Major achievements of internal auditors in State Owned Enterprises**

Most respondents indicated that the major challenges facing internal auditors as insufficient number of audit staff, management reluctance or failure to implement suggested recommendations on noted control weaknesses, limitation in training and knowledge in the audit of computerized businesses processes as a result of the rapid technological advances that have been embraced by organizations in order to be more efficient and reduce costs, inability to access certain confidential information that is required for audit purpose and heads of internal audits being placed low in rank as compared to others heads of departments and minimal involvement in risk based audits. This therefore calls for organizations to address training needs of its audit staff in the audit of computerized environments and a more proactive role of audit committees in strengthening the internal audit departments.

#### **4.16 Major achievements of internal audit functions in state owned enterprises**

The major achievements cited by most respondents were reductions in fraud, costs and qualified reports as a result of strengthening of internal controls. Other achievements cited included significant improvements in corporate governance practices, improved risk management and control processes, demystifying the internal audit function as a policing entity and getting cooperation from other departments and members of staff.

# **CHAPTER 5.0: SUMMARY, DISCUSSIONS, RECOMMENDATIONS, LIMITATIONS AND DIRECTION FOR FURTHER RESEARCH**

## **5.1 Introduction**

This study set out to answer the following research questions:

1. What is the internal auditor's role in promoting corporate governance?
2. What are the challenges faced by the internal audit department in promoting good corporate governance?
3. What kinds of mechanisms are there to safeguard the independence of the internal audit function in Kenyan State Owned Enterprises?

This chapter gives a summary of the findings, discussions, recommendations, limitations and direction for further research.

## **5.2 Summary of findings**

### **5.2.1 Operations of Internal Audit**

From the analysis, it was observed that most organizations (82.8%) had established internal audits. In this study only 5 respondents (17.2%) had not set up internal audit units in their organizations. Neither the type of sector nor the size of a SOE was seen to be a determinant of whether a SOE has established an internal audit or not. The study found out that only 35% of respondents had annual staff costs of over five million per year. Those with annual staff costs of less than two shillings and below were 30%.

In this study 33% of the respondents were functioning excellently indicating that internal audit functions are working relatively well in assisting organizations achieve their objectives. 62.5% of internal audits departments report and submit their reports to the audit committee greatly enhancing their independence and status in the organization. Only 16.7% report to the chief executive officer which may have a negative impact on the candid discussions on adverse audit findings. Only 15% of the respondents reported that they are not involved in pre-audit work while 85% were involved in varying proportions. By being involved in pre-audit assignments, internal audit objectivity and neutrality is impaired. A majority of the respondents spent 58.75% of their audit time evaluating internal controls and they spent 32.5% of their time on corporate governance issues.

Of the 24 respondents with internal audits, 70.8% had developed internal audit activity charters. There is a lot of literature on the need for internal audit charters. The key is that every organization that has an internal should develop a tailor made charter in line with the Institute of Internal Auditors guidelines and that the charter should be reviewed and updated annually. The fact the 70.8% of the respondents have domesticated their own charters, underscores the importance of internal audit functions in organizations. The findings also indicated that 37.5% of the respondents had their charters approved by the audit committee while 20.8% had their charters approved by the board. The endorsement of the internal audit charter by the board and audit committee underscores the import role that is played by internal auditors in organizations.

Of the 24 respondents with internal audits, 95.8% indicated that they have audit committees. The audit committee meets with the internal audit on average 3.5 times per year. The average length of these meetings is 2.4 hours. 45.8% of the respondents indicated they have membership of 3 to 4 committee members. Only 33.3% of the respondents meet the four minimum number of committee members required by Treasury and CMA guidelines with the average number of members being 4.5 per committee. A majority of the respondents (85%) indicated that the chair of the audit committee is appointed by the board and which increase their independence from management. 55.2% of the respondents had a least two committee members with knowledge in finance, accounting and audit so to be effective in their roles. On perception, 63% of the respondents strongly agreed that audit committees have improved the efficiency and effectiveness of internal audits. This can be an indication that most audit committees are achieving their objectives.

This study also reports that a majority of internal auditors heads (75%) meet privately with the audit committee without management presence. Privacy of meetings with heads of internal audit could act as fulcrum of strengthening the independence of the internal audit function.

### **5.2.2 Internal Auditor Independence**

For internal audit to be effective, it must be independent and resist management influence. 75% of the respondents reported that they were independent of management and were unanimous that being independent of management was key in facilitating prompt reporting to the audit committee on adverse audit queries touching on management. In terms of organizational status,



a majority (85%) of internal audit functions were found to be strategically positioned in their organizations structures to enable them fulfil their responsibilities. 95% of the respondents were free to choose any transaction or area of interest for audit. To further provide independence to the internal audit function, 70% of the respondents were fully allowed to access audit evidence or information in any form.

### **5.2.3 Profiles of Heads of Internal Audit**

Most of the heads of internal audit function (64%) were within the age bracket of 31-40 years with bachelors' degree in business and were certified public accountants. Majority of them also had greater experience in auditing (86%). The internal audit staff structures in many organizations were lean but majority were qualified accountants. The study found that all respondents strongly agreed that, for internal audit to add value to governance process, there should be good working relationships, independence, awareness and professionalism. It was also indicated that there in need for recognition in the organization and involvement with the board and management in governance matters. A few (37.5%), however, strongly agreed that the board and top management regard them as having significant role in enhancing good corporate governance. Over 75% of the respodents strongly agreed also that in order to be effective on governance issues and processes, the internal audit must be provided with sufficient status in the organization.

## 5.3 Discussions

### 5.3.1 Operations of Internal Audit

In this study a majority of respondents had established internal audit departments. It seems SOEs listed on the NSE and those not listed are observing the CMA (2002) guidelines which require the board of directors to establish an internal audit function that is independent. Literature has a lot on the membership and meetings of audit committees. The findings of this study show that membership of audit committees varied between 3 to 5 members and provide support for findings from PriceWaterHouseCoopers (1999) and the recommendations for best practice by BRC (1999). A study by Philmore (2006) in Barbados show similar results where membership varied between 3 and 4 members. In this study the average number of meetings is 3.5 per year where each meeting takes an average of 2.4 hours. Literature has it that formal meetings are at least 4 and sometimes up to 12 times per year. PriceWaterHouseCoopers (1999) found that audit committees among European companies met on average 3 to 4 times in a year. The results also compares favourably with those of prior studies where the number of meetings ranged from 3.03 for Canadian audit committees to 3.3 for the US and Singapore committees (Goodwin and Yeo, 2001). It is apparent that the audit committees in SOEs are doing well when it comes to the number of meetings and membership.

In view of the complex accounting and auditing issues faced by audit committees, it was expected in this study that ACs in SOEs would have at least two members of the committee with some degree of financial knowledge. The Public Oversight Board (1993) suggests that the effectiveness of the AC is primarily affected by the expertise of its members in the area of accounting, financial reporting, internal controls and auditing. The findings of the study show that 55.2% of the respondents had at least two committee members with knowledge in finance, accounting and audit. Though the finding somewhat meets the BRC (1999) recommendation that an effective AC should comprise at least three members, all of whom should have the ability to read and understand financial statements and be financially literate and at least one of who should have accounting or financial management expertise, none of the respondents' audit committee members met this requirement. This is recognised as being relevant to public service organizations' audit committees and they should embrace this requirement as such expertise is regarded as important if the audit committee is to effectively carry out its

responsibilities of overseeing the work of both internal and external auditors.. be so to be effective in their roles

There is agreement that members of the audit committee should be independent of management to be able to be effective. A study by Gao (1991) found out that half of the 40 surveyed audit committees of large US banks perceived that their audit committees had no members with expertise in assigned accounting, auditing and banking and law oversight domains. In this study, 20.8% of the respondents indicated that their committees lacked financial knowledge and experience and are likely to make sub-optimal decisions in oversight areas such as the implications of accounting policies changes on financial reports.

### **5.3.2 Role of Internal Audit in Promoting Corporate Governance**

From the study, 37.5% of the respondents indicated that Internal Audit is regarded by the Board and senior management to play a significant role in enhancing good corporate governance practices. Respondents also reported that they played a role in promoting good corporate governance in their organizations by assessing and ensuring internal controls are functioning as designed, ensuring that their organizational policies and procedures are adhered to, and providing reasonable assurance about the achievement of the organization's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. All these work performed by internal audit map directing to good governance practices.

Literature lends support to the findings of this study. Moeller (2204) notes that internal audit function has had a corporate governance role in many organizations as early as the 1940s and that the role has evolved over time. Vallario (2003) observed that for governance to benefit the varied stakeholders of an organization, the internal audit function must be an integral component of the network of parties having corporate governance responsibilities. Further, Sawyer (1973) who has been described as the father of internal audit, described the IAF as the window into the company and that it serves as the eyes and ears of management. He noted that an IAF with this type of access throughout the company is in a unique position to serve as a value resource and enhance corporate governance.

Executive management and the Board need to lend tangible support to the IAF and developing a corporate culture and value systems that are inculcated to employees and observed in the organization. The support of internal audit should also emanate from other government agencies such as the Internal Auditor General, Controller and Auditor General Offices' and the Inspectorate of State Corporations.

### **5.3.3 Dismissal of Head of Internal Audit**

75% of the respondents reported that audit committees participate in the dismissal of the head of internal audit. This high involvement of the audit committee in terminating the audit services of heads of internal audit have positive signals on the independence of the internal audit function, making it difficult for management to dismiss the managers of internal audit for raising adverse and sensitive audit queries.

This finding provides support to a Singapore study (Goodwin and Yeo, 2001) where 72% of the audit committees were involved in terminating employment contracts of chief audit executives. It also compares to 48% in a Canadian study by Scarbrough et al., (1998). This study also supports the CMA (2002) guidelines on corporate governance for companies listed at the NSE that require approval for any appointment or termination of senior staff members of the internal audit function to be sanctioned by the audit committee and that it should be informed of resignations of internal audit staff members. It also calls for the committee to provide the resigning staff an opportunity to submit reasons for resignation. It is argued that when the AC is involved in key decisions such as termination of the head of internal audit contract, there will be greater empowerment of the IAF. In other words, management influence over the internal audit function decreases and consequently internal auditors would feel confident in undertaking audit investigation. These are important roles of the audit committees because it ensures the independence and avoids arbitrary sacking of the head of IAF.

### **5.3.4 Mechanisms to safeguard the independence of Internal Audit Function**

Most respondents indicated to have achieved independence by having IAF reporting functionally to the audit committee of the Board, developing activity charters that clearly states its independence and ensuring internal auditors do not have a direct responsibility or any authority over any of the activities or operations that they review. The respondents also



reported that the involvement of the Board or audit committee on the dismissal of the head of internal audit and submitting their reports to the committee has had positive impact on safeguarding their independence. 75% of the respondents reported that they were independent of management and 95% were free to choose any area of interest for audit. To further provide independence to the internal audit function, 70% of the respondents were fully allowed to access audit evidence or information in any form.

A lot of literature supports the independence of the internal audit function. Vanasco (1996) observed that the professional internal auditor must have independence to fulfill his professional obligation, to render a free, unbiased, unrestricted opinion, and to report matters as they are, rather than as some executives would like to them to do. Independence permits internal auditors to perform their work freely and objectively. He also noted that without independence, the desired results of internal auditing cannot be realized. He concluded that the role of the internal auditor requires unrestricted independence in order to perform a variety of duties for the organization they serve. A study by Gordon and Fischer (1996) provide mixed results concerning the degree of independence experienced by internal auditors. They noted that the most affirmative evidence of independence was reflected in those auditors who are hired by the board of directors, have a written authority for unrestricted access to records and regularly meet with the board. Further, a survey Azad (1992) concluded that reporting to the audit committee was the most important for improving the independence of IAF.

Sarens (2007) noted that if the hiring or firing authority is vested with the audit committee but senior management continue to have authority over the budget and evaluation of IAD, the IA will remain highly dependent upon the CEO and /or chief finance officer. For internal auditors, practical independence needs to be institutionalized through the organizational and reporting status of the internal audit function. The limited amount of funding allocated to the internal audit as indicated in this study, may restrict the scope of their audit activities.

### **5.3.5 Challenges facing Internal Audit Departments**

Most respondents indicated that the major challenges facing internal auditor units in SOEs is the insufficient number of audit staff. Other key challenges being faced are management reluctance or failure to implement suggested recommendations on noted control weaknesses on a timely basis. A study carried out in Ethiopia by Zeleke (2007) bear similarities to the findings in this study. For the organization he surveyed, 60% lacked sufficient staff while 64% of his respondents believed that corrective action was not taken based on audit findings. For internal audit to be effective, it needs to be well resourced so as to meet the demands of the audit process. The quality of the internal audit function in terms of competence and professionalism will enhance audit work quality. An internal audit that is well staffed, the scope of audit work coverage will be greater and it will be composed of staff with varying audit experiences thus being in possession of more competencies in discharging their responsibilities.

32.1% of the respondents indicated that they were involved in IS audit. This is key challenge as result of inadequate capacity, skills, knowledge and relevant training in the audit of computerized systems. These IT systems have been as a result of the rapid technological advances that have been embraced by organizations in order to be more efficient and reduce costs. This result is consistent with a study by Zamzulaila (2006) who found that 33% of private institutions in Malaysia cover IS audit. He concluded that this indicated less emphasis was being given to this area due to lack of technical resources and skilled personnel or alternatively could have been reluctance on the part of internal auditors to venture in areas outside the traditional auditing. This, therefore, calls for SOEs to heavily invest in its audit staff with the necessary training to equip them with skills and knowledge required for the audit of this emerging high risk area. Information System security is important so as to ensure confidentiality and availability to authorized persons only. Respondents also cited their inability to access certain confidential information that is required for audit purpose and heads of internal audits being placed low in rank as compared to others heads of departments and minimal involvement in risk based audits. All this calls for audit committees in organizations to address training needs of its audit staff in the audit of computerized environments and to play a more proactive role of in strengthening the internal audit departments.

### **5.3.6 Achievements of Internal Audits in State Owned Enterprises**

In this study, the major achievements of internal audits has been the establishment by management and the board to establish audit committees enabling the function to have a functional reporting line by having a direct communication with the audit committees, hence ensuring that the audit issues raised are attended to promptly which enhances its independence. Other major achievements reported by respondents include reductions of organization's costs, minimal cases of frauds and strengthening of internal controls, all which map to good corporate governance. The presence of internal audits units in organizations has also increased the reliability of the financial statements to a very large extent.

### **5.3 Conclusion**

The objective of the study was to survey on the role of internal audit in promoting good corporate governance in State Owned Enterprises. The findings indicate that internal audit function contribute to the promotion of good corporate governance. Corporate governance is about promoting fair, efficient and transparent administration of corporations to meet its established and defined objectives. It is about promoting systems and structures of operating and controlling operations with a view to achieving long term strategic goals that satisfy the owners, suppliers, customers and financiers while complying with legal and regulatory and meeting environmental and society needs and an efficient process of value creating and value adding ( PSCGT, 2002).

Good corporate governance practices require that organizations and their boards establish audit committees. Audit committees ensure that the internal audit function has the independence, profile, resources and professionalism it needs to operate effectively. According to this study, majority of SOEs have established audit committees and internal audit charters, which defines the purpose, authority and responsibilities of the internal audit function. A board that works closely with its internal audit function will have access to fresh and independent perspective on some of the issues that really matter to the business. An internal audit function that reports to the CEO of the organization is denied the independence it needs for advising and appraising management actions.

The study adds to the growing body of literature concerned with linkages between various corporate governance mechanisms. From a practical perspective, the study provides feedback to government policy makers on the need for policies that support and enhance the link between the audit committee and their internal audit function. The results also support the current debate on the appointment of independent audit committee members and the need for members to be knowledgeable in accounting, auditing and finance. Issues of appropriately resourcing the internal audit function are also important to improve internal audit participation in the financial reporting process.

#### **5.4 Limitations of the study**

This research study attempts to assess the effectiveness of the internal audit function in promoting good corporate governance in State Owned Enterprises. For this reason, the study is limited and the findings can not be said to be equally applicable to the private sector, not for profit and publicly listed organizations. The questionnaire tailored for this study was administered by internal audit heads and as such prior arrangements had to be made with the respondents. Further, some of the respondents considered the study as confidential hence their reluctant and non cooperation in responding to the questionnaire submitted. Others had to seek authority from the Chief Executives resulting to the delays in this study.

Time was a constraint and this study focused only on SOEs headquartered in Nairobi.

#### **5.5 Recommendations**

The study observed that only 37.5% of the respondents strongly agreed that they were being regarded by the board and senior management to have significant role in enhancing good corporate governance and also respondents indicated they spent 32.5% of their time on governance issues. It is recommended that the board and management of organizations should appreciate the increasing status and importance of internal audit in corporate governance. The study found that 16.7% of the respondents report to Chief Executive Officers. It is recommended that internal audit functions should report functionally to the Board or the audit committee of the Board so as enhance its independence, objectivity and professionalism and not to the Chief Executive Officers was reported in the study.



Many State Owned Enterprises have embraced the use of Information Technology to automate their business processes for efficiency and cost reduction, some of which are so complex. However, only 5% of the respondents have the necessary competencies and audit skills required in this area. The IAF must embrace technology, understand it, and be able to effectively audit the process and use it as an audit tool. It is recommended that organizations should build capacity and increase internal audit training budgets specifically for information systems audit so that knowledge of IT, IT auditing and the current trends drive the working of the IAF in SOEs.

Lastly, the Board of Management of all State Owned Enterprises should be required to publicly disclose an assessment of the effectiveness of internal controls within their organisations. Further, they should be required to establish and maintain an independent, adequately resourced and competently staffed Internal Audit Function to provide management and the audit committee with ongoing assessment of the organisation's risk management, control and governance. In the absence of internal audit, the Board should be required to disclose this in the organisation's annual report why the function is not in place.

### **5.6 Direction for further research**

Findings of this study suggest opportunities for further research. For example, a similar research may be directed to the effectiveness and contribution of internal audit in promoting good corporate governance practices for companies listed on Nairobi Stock Exchange, Non Governmental Organizations and Private Companies. This will enable conclusive and comprehensive conclusions to be made about the role of internal audit in enhancing good governance practices. Additionally there are some encouraging findings regarding the reduced likelihood of financial reporting problems when internal audit are more active and independent. However, much more need to be discovered about the internal audit and audit committee influence on financial reporting quality.

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## APPENDIXES

### APPENDIX A: List of Respondents

1. Kenya Tourist Board
2. Tea Board of Kenya
3. National Aids Control Council
4. Kenya Broadcasting Corporation
5. Kenya Wildlife Service
6. Consolidated Bank of Kenya
7. Communication Commission of Kenya
8. National Hospital Insurance Fund
9. Postal Corporation of Kenya
10. Higher Education Loans Board
11. National Social Security Fund
12. Coffee Development Fund
13. Kenya Revenue Authority
14. University of Nairobi
15. Kenya Investment Authority
16. Kenya Medical Research Institute
17. National Housing Corporation
18. Agricultural Finance Corporation
19. Kenya National Library Services
20. Kenya Re-Insurance Corporation
21. Kenya National Trading Corporation
22. Kenya National Examination Council
23. Post Office Savings Bank
24. Kenya Roads Board
25. Kenya Tourist Development Corporation
26. Retirement Benefits Authority Kenya National Hospital
27. Bomas of Kenya
28. Capital Markets Authority
29. Kenyatta National Hospital



## APPENDIX B: Internal Audit Questionnaire

I am a student at the University of Nairobi pursuing a post graduate degree course in Business Administration (MBA). In partial fulfillment of the postgraduate degree programme, I am undertaking a research study on the *Role of Internal Audit in Promoting Good Corporate Governance in State Owned Enterprises*.

I shall be grateful if you kindly devote a little of your time by responding to the questions posed in this study as per the questionnaire. The information and responses required is purely for academic purposes and your response will be treated with utmost confidentiality and purposefully for this study.

If you would like to receive a copy of the findings of this research study, please indicate your Email address in here: -----

With best regards,

**Paul K. Kiplagat Kibet.**

1. Name of your Corporation:----- Headquarters:-----

2. What type of sector does your Corporation operate in? (Please Tick).

- Commercial  Regulatory  
 Research Institutes  Education and Training  
 Regional Development Authorities  Social Service

3. Does your corporation have an Internal Audit Department? (Please Tick)

- YES  NO

4. If yes, when was it established in your Corporation? ----- (Indicate Year).

5. If your Corporation does not have an Internal Audit Function, please give reasons.

-----  
-----  
6. If no, who performs the functions of Internal Audit? (Please specify). -----

7. To whom does the Internal Audit Function report to and regularly submit their reports to?

- Chief Executive Office                       Board     Chief Finance Officer  
 Audit Committee                               Others (Please specify)

8. How well do you think the Internal Audit Function is currently functioning in your Corporation?

- Excellently  
 Moderately well  
 Reasonably well  
 Poorly

9. Which of the following audit functions are performed by the Internal Audit Department (IAD) in your Corporation? *Tick each box as much it is applicable to your organization.*

- Assessing and promoting the adequacy of corporate governance.  
 Examining and assessing organizational policies, procedures and manuals and recommending best practices.  
 Testing proper recording of assets, expenditure and the reliability of financial information.  
 Examining use of organizational resources (Economy).  
 Examining organizational productivity (Efficiency).  
 Testing compliance with laws and regulations.  
 Evaluating the design and effectiveness of Internal Controls.  
 Undertaking fraud and investigation activities.  
 Risk assessment and management.  
 Evaluation of projects and programs accomplishments.  
 Checking budgetary implementation.

10. What proportion of time would you estimate Internal Audit Function spends on performing pre-audits of transactions or other work relating to execution of transactions? (Please tick).

- Less than 25%                       Between 50% and 75%  
 Between 35% and 50%         More than 75%

11. Excluding pre-auditing work, indicate what type of activity takes the largest proportion of Internal Audit Function's time in performing the following tasks in your Corporation? [Use a scale of one (1) to ten (10), with 1 representing the lowest point and 10 the highest to rank].

- Financial or finance related audit                       Risk Management  
 Systems/Operational audit                                       Corporate Governance issues  
 Evaluation of Internal Controls                               Fraud Investigation  
 Consultant to management                                       IS audit

12. What was your Corporation's Internal Audit Department annual staff cost in Kenyan Shillings for the financial year ended 2007/2008? (Please tick).

- A. Less than 500,000.                      C. Between 2-5 million  
 B. Less than 2 million                      D. Over 5 million

13. How many officers are in the Internal Audit Department? ----- (Indicate Number).

- Chief Internal Auditors                       Senior Auditors  
 Auditor I     Auditor II  
 Audit Assistants                                       Support Staff

F. Others (Please specify)-----

14. What are the qualifications of your Internal Audit staff in numbers? The columns show academic qualifications and the rows professionalism.

Qualification	'O' Level	'A' level	First Degree	Second Degree
CPA (K)				
CPA II				
CPA I				
KATC				
CISA				
Others specify				

15. Does the position occupied by your department (IAD) in the overall Corporation's structure permit the department to accomplish its audit responsibilities?

Yes

NO

16. Does your Corporation have an Internal Audit Charter? (Please Tick)

YES

NO

17. If 'NO', do you think your organization should have it? -----

18. What are the matters/issues covered in the Audit Charter?  
-----  
-----

19. Who approves the Internal Audit Charter? (Please Tick).

Board of Directors

Chief Executive Officer

Chief Finance Officer

Audit Committee

Others (Please specify) -----

20. What is your age bracket? (Please Tick)

Under 30 years

Between 31-40 years

Between 41-50 years

Over 50 years

21. What is your academic or educational level?

PhD

Qualified Accountant Only

MBA

Other Qualifications (Please specify) -----

Bachelor in Business

College graduate

22. What professional qualifications do you hold?

CPA

CISA





32. To whom does the Audit Committee report to?----- (Please Indicate).

33. Do what extent do you agree that having an Audit Committee in your Corporation has improved the efficiency and effectiveness of Internal Audit Function? (Please Tick).

- Strongly Agree.       Agree.  
 Disagree.             Strongly disagree.

34. Do what extent do you agree to the Audit Committee members' knowledge level with respect to accounting and auditing issues is: (Please tick).

- Excellent     Very Good     Good     Below-par                       Poor

35. Do you meet privately with the Audit Committee without the Corporation's management presence?                       Yes                       No

36. How many times do you and the IAD meet the Audit Committee in a year and how long do such meetings normally take (in minutes)?

Frequency of meetings: -----

Length of the meetings: -----

37. Is the Audit Committee involved in the approval prior to the dismissal of the Head of Internal Audit? (Please explain)                       Yes                       No

38. Does the Internal Audit Function have the ability to report to relevant Government Authorities if it found that (Please indicate 'Yes' or 'No')?

- Officials in the Corporation abused their power against public interest?  
 Organization officials lose integrity and honesty?  
 Key management officials withhold key information to stockholders and the public?  
 Management fail to disclosure material matters in the financial statements?  
 Management override internal controls?  
 Management involvement in fraud and embezzlement?

39. Are Internal Auditors free to choose any transaction or area of interest for audit?

Yes      No

40. Do you conduct audit activities in reference and in accordance with recognized standards?

Yes      No

41. If yes, please specify the standards: -----  
-----

42. Is the mission and role of Internal Audit Function well defined within a wider governance framework and effectively communicated?

Yes       No

43. For each of the following questions indicate 'Yes' or 'No'.

QUESTION STATEMENT	RESPONSE
Is the IAD sufficiently staffed?	
Does the organization's IAD possess appropriately qualified staff?	
Are the organization's salary levels sufficient to attract and retain auditors with the requisite professional skills and qualifications?	
Are Internal Auditors tasks defined on the basis of prior risk assessment?	
Does the IAD have authority to seek assistance of experts during the audit process if required?	
Are Internal Audits performed on the basis of annual plans?	
Is the IAD adequately resourced with the appropriate technology to enhance the provision of audit services?	

44. To what extent do you agree with the following statements on Internal Audit Function within your Corporation? *(The scale ranges from strongly agree to strongly disagree. Please insert the values attached to each extent after the question posed).*

RATINGS	Strongly agree	Agree	Indifferent	Disagree	Strongly Agree
SCALE	5	4	3	2	1

INTERNAL AUDIT ROLE	SCORE
Internal Audit provides relevant information in making decisions on financial	

matters	
The Audit Committee (if any) is more proactive and involved in the work of IA	
Internal Audits are usually performed with emphasis on the Risks and Controls	
Internal Audit is able to influence key management decisions on matters within its expertise.	
Recommendations made by Internal Audit are usually considered and implemented by the organization.	
Internal Audit needs the support of management in order to be effective in its work.	
Internal Audit staff keeps themselves uprest with current developments in auditing and accounting matters.	
The Internal Audit Department has upgraded itself on a range of skills to meet future requirements.	
Internal Audit cannot be effective without the right culture and ethical standards in the organization	
The Head of IAF spends a significant amount of time in providing training and mentoring the IA staff.	
The organization's management supports the IAF role and is strategically positive to contribute to the long term interest of the organization and performance.	

45. Do internal Audit task provide management with advice on means of reducing cost, improving efficiency and effectiveness? (Please tick).

Yes                       No                       Don't Know

46. If yes, please tick from the following possible advisory roles of the internal audit to management applicable to your Corporation.

- Good Governance
- Designing and implementing internal control systems
- Information systems development, acquisition and operation
- Accountability
- Ethical practices and anticorruption programs
- Sound business processes
- project management
- Effective risk assessment
- Program evaluation and management

Other areas, if any -----

47. To what extent do you agree with the following as the role of Internal Audit Function?  
*(The scale ranges from strongly agree to strongly disagree. Please insert the values attached*





To some extent

Not at all

53. Do the size of the Internal Audit Function and prior audit experience of your audit staff in your Corporation enhance the quality of Internal Audit Function and its work?

Yes

No

54. Do you feel that corrective measures are usually taken as a result of weaknesses pointed out by the Internal Audit Function?

Yes

No

55. Does the Head of the Internal Audit monitor and follow-up action taken by management to the recommendations made by the Internal Audit function?

Yes

No

56. If 'yes', how are such actions and its results monitored and assessed? -----  
-----

57. What mechanisms are in place to ensure there are safeguards for the Internal Audit independence? -----  
-----

58. What challenges/limitations to the Internal Audit Function face in your Corporation?-----  
-----  
-----

59. Are internal Auditors allowed to access all the documents, accounting records, explanations and information they require in the performance of the audit work?

Fully allowed

Not allowed

Partially allowed

60. What have been the major achievements of IAD in your Corporation?  
.....  
.....