

**EFFECT OF RISK BASED AUDIT ON FINANCIAL PERFORMANCE OF
DEPOSIT TAKING MICROFINANCE INSTITUTIONS IN KENYA**

BY

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DECLARATION

This research project is my original work and has not been submitted for presentation for the award of a degree in any other university or institution of higher learning.

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This research project has been submitted for presentation with my approval as the student's supervisor.

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DEDICATION

This project is dedicated to my parents who taught me that the best kind of knowledge to have is that which is learned for its own sake. To my classmates Alexander Mwangi Kagira and Margaret Ruguru Mwangi whom we have journeyed together.

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ABSTRACT

The purpose of the study is to trace the effect of risk-based audit on financial performance of DTMFIs in Kenya. Correlation research design was adopted in the investigation in which quantity data was collected and analysed in order to describe the specific phenomenon in its current trends, current events and linkages between different factors at the current time. The population of 6 deposit taking Microfinance is small therefore the study carried out a census survey of all the Microfinance Deposit Taking Institutions in Kenya.

Primary data was collected through a questionnaire which was quantitative in nature. A total of 36 credit officers, branch managers and operation manager auditors at the six Deposit taking microfinance Institutions in Kenya were asked to respond to a questionnaire. Inferential statistic regression and correlation was used to establish the effect of risk based audit on financial performance of DTMFIs.

The findings show that there is a positive effect of Risk Based Audit on financial performance of Deposit Taking Microfinance Institutions in Kenya. The study concluded that risk based audit practices adoption enables detection of risks on time and concentrate on high risk areas, hence enhancing financial performance. The study recommends that management in deposit taking microfinance institutions in Kenya should adopt effective risk based audit practices such as risk assessment, risk management, annual risk based planning, internal auditing standards and internal auditing staffing to enhance financial performance.

TABLE OF CONTENTS

DECLARATION.....	ii
DEDICATION.....	iii
ACKNOWLEDGEMENT.....	iv
ABSTRACT.....	v
TABLE OF CONTENTS	1
LIST OF TABLES	3
LIST OF ABBREVIATION.....	4
CHAPTER ONE	5
INTRODUCTION.....	5
1.1 Background of the Study.....	5
1.1.1 Risk Based Audit	8
1.1.2 Financial Performance of DTMs	9
1.1.3 Risk Based Audit and Financial Performance	11
1.1.4 Deposit Taking Microfinance Institutions in Kenya.....	13
1.2 Research Problem	14
1.3 Objectives of the Study	16
1.4 Value of the Study	16
CHAPTER TWO	18
LITERATURE REVIEW	18
2.1 Introduction.....	18
2.2 Theoretical review.....	18
2.2.1 Stakeholder Theory.....	18
2.2.2 Agency Theory.....	19
2.2.3 Transaction Cost Theory.....	21
2.3 Empirical review	22
2.4 Risk Based audit practices	29
2.4.1 Risk Management	29
2.4.2 Annual Risk Based Planning	30
2.4.3 Internal Auditing Standards	31
2.4.4 Internal Auditing capacity.....	32
2.5 Financial Performance	33
2.6 Conclusion	34
CHAPTER THREE	35
RESEARCH DESIGN AND METHODOLOGY	35
3.1 Introduction.....	35
3.2 Research design.....	35

3.3 Population of the Study	35
3.4 Sample Sampling Technique.....	36
3.5 Data collection	36
3.6 Data analysis.....	36
3.7 Validity and reliability.....	38
CHAPTER FOUR.....	39
DATA ANALYSIS AND PRESENTATION.....	39
4.1 Introduction.....	39
4.2 Data Presentation.....	39
4.2.1 Current designation.....	39
4.2.2 Respondents Working period.....	40
4.2.3 Inherent risk assessment effect on the financial performance of DTMF's ..	40
4.2.4 Impact of risk based audit on financial performance.....	41
4.2.5 Factors influencing judgments of risk in DTMF	42
4.2.6 Managing of risks on financial performance in DTMF	43
4.2.7 Effect of managing of risks on financial performance in DTMF	44
4.2.8 Effect of annual audit planning on financial performance of DTMF	45
4.2.9 Risk factors that relate to DTMF affect financial performance.....	45
4.2.10 Auditing code effect on the financial performance of DTMF	46
4.2.11 Auditing standards effect on the financial performance of DTMF.....	46
4.2.12 Risk based audit practices influence on return on assets of DTMF	47
4.2.13 Regression Analysis.....	48
4.3 Summary and interpretation of findings	51
CHAPTER FIVE	55
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS	55
5.1 Summary.....	55
5.2 Conclusions.....	56
5.3 Policy Recommendations.....	57
5.4 Limitations of the Study	58
5.5 Suggestions for further studies	59
REFERENCES.....	60
APPENDICES	65
Appendix I: Questionnaire.....	65
Appendix II: Deposit Taking Microfinance Institutions in Kenya	69

LIST OF TABLES

Table 4. 1: Current Designation of Respondents	39
Table 4. 2: Respondents working period	40
Table 4. 3: Whether inherent risk assessment affect financial performance at DTMF	40
Table 4. 4: Rating the risk assessments effects financial performance at DTMF.....	41
Table 4. 5: Factors influencing judgments of risk in your DTMF	42
Table 4. 6: Influence of Managing of risks on financial performance in DTMF	43
Table 4. 7: Risk based audit on the influence of financial performance in your DTMF	44
Table 4. 8: Whether annual audit planning affects return on asset in the DTMF	45
Table 4. 9: Factors that relate to DTMF affect financial performance	45
Table 4. 10: Whether auditing code affect return on assets in DTMF	46
Table 4. 11: Rating the extent to which auditing standards affect the ROA in DTMF	46
Table 4. 12: Rating risk based audit practices influence on return on assets of DTMF	47
Table 4. 13: Model Summary	49
Table 4. 14: ANOVA (B).....	49
Table 4. 15: Coefficient Matrix(b).....	50

LIST OF ABBREVIATION

DTMFIs	-	Deposit Taking Micro Finance Institutions
DTMF	-	Deposit Taking Micro Finance Institutions
IA	-	Internal Audit
IAC	-	Internal Audit Capacity
IIA	-	Institute of Internal Auditors
IR	-	Inherent Risk
MDTI	-	Microfinance Deposit Taking Institutions
OECD	-	Organization for Economic Co-operation and Development
RBA	-	Risk Based Audit
RBIA	-	Risk Based Internal Audit
RMD	-	Risk Management Department
ROA	-	Return on Asset
ROE	-	Return on Equity
ROI	-	Return on Investment
SPSS	-	Statistical Package for Social Science

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Risk Based Auditing could improve the precision of financial statement information by issuing qualified opinions to firms with unreliable financial statements. Auditors enable investors to screen out such firms (Gibson, 2003). Uncertainty regarding the association between the focus of voluntary corporate governance guidelines and risk management and internal control activities in practice has created a research gap in this area. Beekes and Brown (2006) refer to company responses to such voluntary guidelines as a rich area for research. The impact of risk based audit has been found to mitigate the occurrence of risks through enhancing quality financial reporting, minimizing losses and eventually improving bank financial performance (Vafeas, 1999). Well run microfinance institutions (MFIs) make better use of scarce funds by providing better financial services and reaching more poor clients. Although the literature on microfinance is significant and growing, very few studies explore the relationship between MFI performance and mechanisms of outside control. So far, studies have focused mainly on the role of innovative lending practices designed to improving outreach and sustainability, and on the impact that MFIs have on borrowers (Aghion and Morduch, 2000).

The aims of this risk-based approach are to assess and identify the high-risk areas, while at the same time, the auditor is minimising the risk of negligence (Griffiths, 2006). This can therefore speed the audit work and help to allocate specialists to specific areas of the audit. However, this process can cause more time to be spent on the audit and raise costs, thus not making economic sense. Unfortunately, another problem faced by auditors when

adopting the risk-based approach is when identifying high-risk areas. Auditors must decide what evidence is required and in how much detail (Commonwealth of Australia, 2004). Risk based audit can be an effective external mechanism because it signals to potential investors and donors whether the manager complied with the accounting practices and did not misrepresent financial information. Quality of risk audit also matters as evidence suggests that it is usually driven by active stakeholders (Ashbaugh and Warfield, 2003). In addition, there is evidence that firms who voluntarily adopt the International Accounting Standards or US Generally Accepted Accounting Practices (GAAP) have lower cost of debt (Leutz and Verrecchia, 2000).

The degree of MFI transparency helps impose market discipline because more transparent MFIs would attract more investors, creditors, and donors. Beekes and Brown (2006), indicated that risk-based supervision is implemented in microcredit unions by developing an understanding of the institution tailoring the audit and supervisory plan to meet the feature of the MFI and adjusting that plan on an ongoing basis as circumstances change. Through increased emphasis on planning and monitoring, supervisory activities can focus on the significant risks to the institution and related supervisory concerns. Given the technological and market developments within the Microcredit sector in developing countries and the speed with which an institution's financial condition and risk profile can be managed to improve financial performance (Leutz and Verrecchia, 2000).

Increased concerns regarding corporate accountability in various developed nations have been associated with the need for appropriate Risk Based Audit which involves internal

control systems (Beekes and Brown, 2006). For organizations to gain competitive advantage firms in developing countries like Kenya required to improve corporate governance to promote governance and accountability for the purposes of attracting capital, gain sustainability and curb vice such as corruption. An internal audit function could be viewed as a first line defense against inadequate corporate governance and financial reporting. With appropriate support from the Board of Directors' Audit Committee, the internal audit staff is in the best position to gather intelligence on inappropriate accounting practices, inadequate internal controls, and ineffective corporate governance (Vafeas, 1999).

In recent years in Kenya , with the maturing of the microfinance industry, there has been increase in large numbers of deposit taking microfinance institutions (MFIs).The formal market of microfinance is influenced by the process in which informal MFIs convert into formalized or regulated financial institutions which are referred to as Deposit Taking Microfinance Intitutions. This usually requires fresh capital from outside investors, regulatory approval by local banking authorities and improved governance plus internal controls. The transformation process allows DTMFIs to mobilize client deposits as an additional source of refinance and offer additional non-credit products and improve on profitability (Frank, 2008). Furthermore, with the transformation and growth of their assets, MFIs increase on govermenance and accountability due to increase exposure to risks and need for controls as improved accessibility of funds and financial management as well as product diversification which allows them to broaden their outreach and serve more clients. The financial crisis in Micro credit institutions is to a large extent attributable to excessive risk-taking by financial institutions. Given that corporate

governance is essentially a mechanism for addressing agency problems and controlling risk within the financial firm, Deposit Taking MFIs emphasized the role of effective risk based auditing practices in managing risks (CBK, 2010).

1.1.1 Risk Based Audit

Risk based audit (RBA) is a term derived from the Institute of International Audit (IIA) research foundation based in the USA (IIA, 2004). In 1999, the board of directors of IIA voted to approve a new definition of internal auditing and a new Professional Practice Framework (PPF). The board through deliberation came to a conclusion that a significant gap existed between available guidance and current practice of internal auditing, and that a new framework was needed to carry the profession into the 21st century (IIA, 2004). In pre-audit, management abdicated their responsibilities to internal audits; there were no audit reports and no review of the system by management. On the other hand, systems audit was passive and reactive control based audit with no involvement of management in audit planning. Therefore, for internal audit to be effective and efficient, RBA was introduced (IIA, 2004).

It is a process, an approach, a methodology and an attitude of mind rolled into one. The simplest way to think about risk-based audit conceptually is to audit the things that really matter to your organisations. Risk based audit (RBA) is a term derived from the Institute of International Audit (IIA) research foundation based in the USA (IIA, 2004). The board through deliberation came to a conclusion that a significant gap existed between available guidance and current practice of internal auditing, and that a new framework was needed to carry the profession into the 21st century (IIA, 2004). Ideally, RBA is a paradigm shift

from traditional approach of pre-auditing or transactional audit to systems audit and finally to RBA (IIA, 2004).

1.1.2 Financial Performance of DTMs

Financial performance is a measure of a financial institution's policies and operations in monetary terms. It is a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. There are many different ways to measure a bank's financial performance. This may be reflected in the firm's return on investment, return on assets, value added, among others and is a subjective measure of how a firm can use assets from its primary mode of business and generate revenues. According to Mishkin (2007), the financial industry, like other industries is in business to earn profits by selling its products. To maximize the profits, financial institutions develop new products to satisfy their own needs as well as those of their customers; in other words, innovation-which can be extremely beneficial to the economy- is driven by the desire to get (or stay) rich. This view of the innovation process leads to the following simple analysis: A change in the financial environment will stimulate a search by financial institutions for innovations that are likely to be profitable.

The share of the loan portfolio (as a percentage of total assets) devoted to financing income-generating activities for microenterprises and, possibly, VSEs and SMEs must be above 70% of the total balance sheet. This ratio indicates that the MFI is focusing on its core business which is its most profitable activity (Farrington & Abrams, 2002). The main area of expertise of a MFI remains its sound knowledge of its clients; when it moves away from this, it takes a risk and causes provisions to put pressure on its

profitability. The cost of financial resources (equity, debts, and deposits) must be optimized by trying to give priority to deposits, which are often the cheapest resources. If this is not possible, a MFI should optimize the debt/equity leverage effect in order to avoid financing growth exclusively at the exorbitant cost of accrued income.

Indeed, in this case it can only achieve a sufficient level of net income by charging high rates, which in turn will raise the level of equity so as to boost growth or at least not to curb it. The weight of the return on capital – dividends – must be a specific focus. It will be more difficult to bear if the debt/equity ratio is not optimized (Fehr & Hishigsuren, 2004). Operating expenses, which by nature are high, must be controlled (de Sousa-Shields & Frankiewicz, 2004). Each MFI could begin by analysing the sensitivity of ROE to the overall effective rate (OER) which includes all the direct costs relating to the loan charged to its clients so that the shareholders can be aware of the leeway they have to adjust the rate charged to the client more accurately in line with their profitability strategy. Moreover, it would seem that benchmarks are required for MFIs' levels of ROE. The comparison with the banking sector is enlightening, but can only be made in the case of mature MFIs that have been profitable for several years and have an activity that has reached a certain critical size (Cohen, 2003).

All of these criteria must of course be analysed in the light of the local economic context. But any inefficiency relating to one of them will put a strain on the profitability of a MFI. Once the performance of the institution has been analysed and optimized, the next step is to look at the other factor which has a decisive effect on the rates charged the MFI's profitability target. It is set by the shareholders and must meet both their own profitability targets and also the institution's need to strengthen the equity of the structure (Farrington

& Abrams, 2002). To survive in the new economic environment, financial institutions have to research and develop new products and services that would meet customer needs and prove profitable, a process referred to as financial engineering. The financial innovation that occurs suggests that there are three basic types of financial innovation: responses to changes in demand conditions, responses to changes in supply conditions, and avoidance of regulations (Ball and Shivakumar 2004).

1.1.3 Risk Based Audit and Financial Performance

Deposit taking MFIs access to grant funding and other safety-net protections may increase incentives for internal audit control of risk shifting or lax risk management, potentially increasing the agency costs of outside debt (Counts, 2005). The enactment and endorsement of Deposit Taking Microfinance Institutions Act (The Microfinance Act 2006) by the parliament gave birth to Microfinance Deposit Taking Institutions which are allowed to mobilize and intermediate savings from the depositors (Mutua 2003). Microfinance institutions world over have been identified as critical institutions to nations quest for solutions to the development challenge (CGAP, 2002). An effort to modernize and uplift operations of microfinance institutions gave rise to Deposit Taking Microfinance which is regulated under MFI Act 2006 by Central Bank of Kenya (CBK, 2006).

The Microfinance Act 2006 of Kenya, seeks to streamline the operation of the MFIs in Kenya, addresses licensing provisions, and sets minimum capital requirements and minimum liquid assets, submission of accounts to the Central Bank, supervision by the Central Bank, and limits on loan and credit facilities. The licensed deposit taking MFIs accepts public funds and contributes to poverty alleviation while in compliance with the

required financial sector safety and soundness. Empirical research has investigated the existence or extent of internal auditing from risk or governance perspectives. Goodwin-Stewart and Kent (2006) use an agency framework to explore firm characteristics associated with the existence of internal audit function from risk management, control and governance perspectives influence, accountability and enhance provision of financial statement thereby influencing financial performance in financial institutions (CBK, 2011).

The empirical findings by Al-Tamimi (2002) and Al-Mazrooei (2007) highlighted that UAE banks are efficient in risk based auditing. Drzik (1995) found out that Bank Administration Risk based audit Survey showed that large banks in the US had made substantial progress in their financial performance. Comprehensive risk based auditing influence effective financial reporting activities and influencing profit and loss sharing in the source of funds especially investment account holders as explained by Sundararajan (2007, pp.36-35). He concludes that the application of risk based audit particularly for credit and overall banking risks is important for Banks.

There is a generally accepted relationship between risk and return, that is, the higher the risk the higher the expected return. Therefore, traditional measures of bank performance have measured both risks and returns. The increasing competition in the national and international banking markets, the change over towards monetary unions and the new technological innovations herald major changes in banking environment, and challenge all banks to make timely preparations in order to enter into new competitive financial environment. (Spathis, and Doumpos, 2002) investigated the effectiveness of commercial banks based on their assets size. They used in their study a multi criteria methodology to

classify Greek banks according to the return and operation factors, and to show the differences of the bank's profitability and efficiency between small and large banks. The study seeks to establish the relationship between riskbased audit and financial performance in DTMFIs in Kenya.

1.1.4 Deposit Taking Microfinance Institutions in Kenya

The enactment or endorsement of Microfinance deposit taking institutions Act (MDI ACT) by the parliament of Microfinance Act 2006 gave birth to Microfinance Deposit Taking Institutions (MDIs) which are allowed to mobilize and intermediate savings from the depositors (Mutua 2003). Microfinance institutions (MFIs) world over have been identified as critical institutions to nations quest for solutions to the development challenge (CGAP, 2002). An effort to modernize and uplift operations of microfinance institutions gives rise to Microfinance Deposit Taking Institutions (MDIs) which are regulated under MDI Act 2006 by Central Bank of Kenya (CBK, 2006). According to ADB (2000) and Otero and Maria (2002), the implementation of the policy was deemed important for savings mobilization and proper management of public deposits by implementing basic minimum level of prudential regulations. Mutua,(2003) argues that prudential requirements enable MDIs to manage resources properly which ultimately improves the efficiency and loan costs.

The Microfinance Act 2006 of Kenya, seeking to streamline the operation of the MFIs in Kenya, addresses licensing provisions, minimum capital requirements and minimum liquid assets, submission of accounts to the Central Bank, supervision by the Central Bank, and limits on loan and credit facilities. The licensed MFIs called the deposit taking

MFIs are licensed to accept public funds, contribute to poverty alleviation and at the same time comply with the requirements of financial sector safety and soundness. The Deposit taking MFIs are regulated under the Bill to provide savings, credit, and other financial services to MSEs and to low-income households in both rural and urban areas.

The Government of Kenya recognizes that greater access to, and sustainable flow of financial services, particularly credit, to the low-income households and MSEs is critical to poverty alleviation. Therefore, an appropriate policy, legal and regulatory framework to promote a viable and sustainable system of microfinance in the country has been developed via the proposed Deposit Taking Micro Finance. There are six Deposit Taking MFIs which include Faulu Kenya DTM Limited, Kenya Women Finance Trust DTM Limited (**now Kenya Women Holdings Limited**) REMUDTMLimited, SMEP DTM Limited, UWEZO DTM Limited and Century DTM Limited. All these DTMs have their Headquarters in Nairobi.

1.2 Research Problem

As the microfinance industry grows and matures, the competition for donations and customers, as well as the presence of for-profit firms has made the impact of market discipline even more pronounced. Recent study found that about 90 percent of the one billion dollars that funded Deposit taking microfinance initiatives came from public money, mainly from taxpayers in the developed countries (CGAP, 2004). Effective risk based auditing improve corporate performance due to improved ownership, managerial control and risk management. Empirical research has investigated the existence or extent of use of internal auditing in risk management. Goodwin-Stewart and Kent (2006) use an

agency framework to explore firm characteristics associated with the existence of internal audit role in risk management, risk control and governance perspectives influencing financial performance in financial institutions.

Chen (2003) investigated the relationship between Risk Based Internal Audit and corporate governance structures. It was found that there existed a significant positive relationship between the level of RBIA used and corporate governance board size. The findings of this study indicated a significant negative correlation existed, suggesting that a small board size seems to be more effective, and is more likely to use RBIA, as a complementary mechanism. Krishnan, (2005) carried out an empirical analysis on the role of risk based audit on internal corporate governance and found that the higher level of independent directors and supervisors employ higher percentage of RBIA for monitoring of risk management. Finally, the result indicated that financial institutions use a relatively high level of RBIA when there was a higher level of shareholdings held by institutional shareholders and internal auditors' technical competence are higher. An effective risk based audit by Deposit taking MFIs highly dependent both on the implementation of adequate corporate governance and on the risk based audit with focus in improving firm profitability (Katz 1998). In Kenya, MDFIS operate in an institutional environment where internal auditing is a statutory requirement.

Despite all of the recent attention focused on RBA, research on the existence or extent of this sector in general in financial Institutions has been scanty. Local studies on impact of risk based audit on financial performance in regulated microfinance institutions are scanty with a few done focusing on effects of risk management of financial performance of MFIs. For instance, Keitany (2000) studied the internal audit control function and its

implication for risk assessment by the external auditor and found that extent of reliance of internal controls was not sensitive to the strength of internal audit departments; companies should not do away with it. Ndwiga (2010) carried out a study on impact of credit risk management on financial performance of Microfinance institutions in Kenya. Despite the influence of risk based audit on financial performance in organization, studies on risk based audit on financial performance of MDFIS in Kenya has been neglected. The study will seek to answer the following question what is the impact of risk based audit practice on financial performance of Microfinance Deposit Taking Institutions in Kenya?

1.3 Objectives of the Study

The research objective of this study will be

- i. To determine the risk based audit practices adopted by Deposit taking microfinance Institutions
- ii. To determine the effects of risk-based audit practices on financial performance of Deposit Taking Microfinance Institutions in Kenya.

1.4 Value of the Study

This study is paramount in that it will enable directors and management appreciate the importance of risk based audit practices and assist them in rating their level of compliance against those of their competitors or the entire market, and in determining whether risk based audit practices improve Microfinance Deposit Taking Institutions financial performance. The study will help shareholders know the various mechanisms through which they can exercise their control. Potential investors will also benefit as they

will be able to determine banks that are properly governed in making their investment decisions to improve Microfinance Deposit Taking Institutions financial performance

The government in the developing policy papers, policy making regarding risk based audit and its effects on financial performance of Microfinance Deposit Taking Institutions in Kenya. The policy maker will know how well to incorporate the sector effectively to ensure its full participation.

The academicians who will be furnished with relevant information regarding the relationship between risk based audit and financial performance in the Deposit Taking Microfinance Institutions. The study will contribute to the general body of knowledge and form a basis for further research.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter summarizes the information from other researchers who have carried out their research in the same field of study. Specific emphasis has been put on the major issues in risk based audit practices on the financial performance of Deposit taking MFIs in Kenya. The specific areas covered here are theoretical orientation, empirical review and summary of the literature.

2.2 Theoretical review

2.2.1 Stakeholder Theory

Stakeholder theory takes into account of a wider group of constituents rather than focusing on shareholders. A consequence of focusing on shareholders is that the enhancement of shareholders' value is paramount whereas when a wider stakeholder group such as employees, providers of credit, customers, suppliers, government and the local community is taken into account the overriding focus on shareholder value becomes less self evident. Nonetheless many companies do strive to maximize shareholders value whilst at the same time trying to take into account the interests of the wider stakeholder group. One rationale for effectively privileging shareholders over other stakeholders is that they are recipients of the residual free cash flow (being the profits remaining once other stakeholders such as loan creditors, have been paid). This means that the shareholders have vested interest in trying to ensure that resources are used to maximum effect, which in turn should be to the benefit of the society.

Risk-based auditing derives largely from models that assume that inherent risk (IR) and control risk (CR) are distinct concepts and that IR arises from attributes of the audit environment that are completely independent of attributes that determine the level of control risk. Operationalizing the distinction between IR and CR has however, proved troublesome as the literature review below indicates. There appears to be little consensus regarding attributes that may identify IR and there is little published evidence regarding how IR is considered by practitioners. Also, it is not yet clear neither does it make good logical sense to try to separate IR and CR in the manner demanded by standard setters (DeFond et al.,2000).

Assessing the risk of material misstatement at the financial statement level as well as at the planning stage, adds to and clarifies the direction on performing a combined assessment of inherent, and control risk, leaving the ability for the auditor to assess other risk factors in an audit (McCord, 2002). This approach to auditing has also changed the view of substantive procedures performed by auditors. For example, the use of statistical sampling has significantly reduced, but remains an important part of auditor's substantive procedures in financial institutions to achieve efficient and effective control of risks. Sherer and Turley (1998) suggest that in order to improve the risk-based approach, ways must be identified in which auditors' judgement of inherent risk and control risk can become more accurate and consistent.

2.2.2 Agency Theory

A significant body of work has built up in this area within the context of the principal-agent framework. The work of Jensen and Mecklin (1976) in particular and of Fama and Jensen (1983) are important. Agency theory identifies the agency relationship where one

party, the principal, delegates work to another party, the agent. The agency relationship can have a number of disadvantages relating to the opportunism or self interest of the agent: For example, the agent may not act in the best interests of the principal, or the agent may act only partially in the best interests of the principal. There can be a number of dimensions to this including for example, the agency misusing his power for pecuniary or other advantage ,and the agent not taking appropriate risks in pursuance of the principals interests because he (the agent) views those risks as not being appropriate and the principal may have different attitudes to risks. There is also the problem of information asymmetry whereby the principal and the agent have access to different levels of information; in practice this means that the principal is at a disadvantage because the agent has more information.

In the context of financial institutions and issues of corporate control, agency theory view corporate governance mechanisms especially the board of directors, as being an essential monitoring device to try to ensure that any problems that may be brought about by the principal-agent relationship, are minimized. The costs resulting from managers misusing their position, as well as the costs of monitoring and disciplining those to try to prevent abuse have been called ‘agency costs’. Much of agency theory, as related to financial institutions is set in the context of the separation of ownership and control as described in the work of Berle and Pears(1932). In this context, the agents are the managers and the principals are the shareholders, and this is the most important commonly cited agency relationship in the corporate governance context.

2.2.3 Transaction Cost Theory

Transaction cost economics (TCE) as expounded by the work of Williamson (1975, 1984) is often viewed as closely related to agency theory. Transaction cost economics views the firm as a governance structure whereas the agency theory views the firm as a nexus of contracts. Essentially, the latter means that there is a connected group or series of contracts amongst the various players, arising because it is seemingly impossible to have a contract that perfectly aligns the interests of principal and agents in a corporate control situation.

As firms grow in size, whether caused by the desire to achieve economies of scale, or by technological advances, or by the fact that natural monopolies have evolved, they have increasingly required more capital which needs to be raised from the capital markets and wider shareholder base needed to be established. The problem of the separation of ownership and control and the resultant corporate governance issues have thus arisen. Coase (1937) examines the rationale for the firm's existence in the context of a framework of the effectiveness of internal as opposed to external contracting. He states "the operation of a market costs something and by forming an organization and allowing some authority (an entrepreneur) to direct the resources, certain marketing costs are saved". The entrepreneur has to carry out his function at less cost, taking into account the fact that he may get factors of production at a lower price than the market transactions which he supersedes. Williamson (1984) builds on the earlier work of Coase, and provides a justification for the growth of larger firms and conglomerates, which

essentially provide their own internal capital market. He states that the costs of any misaligned actions may be reduced by judicious choice of governance structure rather than merely realigning incentives and pricing them out.

2.3 Empirical review

Chen, (2003) investigated the relationship between corporate governance and risk-taking behavior in Taiwanese Banking Industry. The sample consisted of all the 39 domestic banks, and of the 39 surveys mailed, 24 completed responses were returned for a response rate of 61.54%. Of the 24 survey responses, 13 (54.1%) of the credit unions report that more than 60% of their internal audit activities are risk oriented. It was found that 8 of 24 (33.3%) respondents indicated that they use a relatively high level of RBIA, about 61%-80%, while 6 (25%) of the domestic banks report that about 21%-40% of their internal audit work are risk-based (Sarens and de Beelde, 2006).

Liebesman (2004) strongly advocates that ISO 9000 and ISO 14000 can be used to reduce risks with compliance with the Sarbanes-Oxley Act (SOX, 2002): Because of SOX, the CEOs and CFOs of public companies must certify their financial statements, and each year they must certify the effectiveness of their systems of internal controls mandated by the law. Top management needs to obtain better information about the effectiveness of their organizations. Quality and environmental people should be at the table when the internal financial auditors develop their reports to top management and the board of directors (Verschoor, 2002).

Boot *et al.* (2004) argue that the mechanism of CreditWatch allows the rating agency to interact with the firms it rates and write an implicit contract with the management of a

firm that is under a threat of having its credit rating changed. This allows for a “deal” between the firm and the credit rating agency where the firm commits to take actions to mitigate possible deterioration in rating. The rating and the implicit contract are incentive compatible provided that a group (that is, possible investors) conditions its financing decision on the rating. The insights from this model are relevant to microfinance rating where some rating agencies such as M-CRIL provide rating that is valid only for certain period of time and thus, donors and investors are more likely to act on it.

Millichamp, (2002) study on the impact of microfinance rating agencies and their ability to serve as an effective mechanism of external control is timely and important especially in view of recent attempts to support the industry. As MFIs main objective is serving the poor, the emphasis on outreach is also important. MFI rating agencies do not rate exclusively on debt; instead, microfinance rating agencies develop methodologies that focus on the overall performance of the organization in terms of both outreach and sustainability. Thus, studies on the impact of rating in microfinance should account for the impact of rating on MFI outreach.

In 1999, the Institute of Internal Auditors (IIA) promulgated a new definition of internal auditing which identifying an assurance and consulting role for internal audit, highlighting the changing focus and the expansion scope of internal auditing into risk management, corporate governance, and adding value (Jenny 2004). The new definition emphasizes that internal audit function can add value to the organization in terms of risk management and corporate governance, and RBIA is an approach that can help to meet these requirements (IIA 2003). This approach is consistent with Turnbull’s broader approach to internal control as Turnbull implies that high level, risk-based internal audit

functions are *sine qua non* an essential action in risk management in financial institutions (Fraser and Henry 2007). A Survey was designed to gather information on the current use of RBIA in banking industry. The questionnaire was developed based on the Standards for the Professional Practice of Internal Auditing (IIA 2004) and the Implementation Rules for Bank Internal Audit and Internal Control System (FSC 2007), and includes four parts, part one asked about current status of the bank's risk management; part two requests for the definition of RBIA activity in audit charter and technical competence of internal auditors; part three investigates the performance of RBIA in relation to audit planning, nature of work and communication; and part four inquire about basic information of the Microfinance Institutions

Linbo Fan (2004) examined efficiency versus risk in large domestic USA credit Unions. He found that profit efficiency is sensitive to credit risk and insolvency risk but not to liquidity risk or to the mix of loan products. HoHahm (2004) conducted an empirical study on interest rate and exchange rate exposures of banking institutions in pre-crisis Korea. Results indicated that Korean commercial credit Unions and merchant banking corporations had been significantly exposed to both interest rate and exchange rate risks, and that the subsequent profitability of commercial credit Unions was significantly associated with the degree of pre-crisis exposure. The results also indicated that the Korean case highlights the importance of upgrading financial supervision and risk management practices as a precondition for successful financial liberalization.

According to AMFIs (2011), K-Rep implemented a credit risk program that brought employees Back to Basics," which reemphasized the fundamental principles of microfinance and its commitment to the micro entrepreneur. K-Rep lowered the

maximum initial loan size from \$431 to \$238, this reduced the rate of increase of subsequent loans, and shortened loan terms. In addition, K-Rep enhanced management's supervision of credit officers, and increased the amount and frequency of loan portfolio monitoring. These changes returned the focus to the original target population and discouraged the participation of higher income clients. By the end of 1998, K-Rep had delinquency under control and reduced its portfolio risk ratio to 8.8 percent (Kim and Santomero, 1993). In this regards there is need to carry out the study to establish the relationship between credit risk management practices and the performance of the Deposit Taking Microfinance Institutions in Kenya. K-Rep implemented a credit risk program that brought employees "Back to Basics," which reemphasized the fundamental principles of microfinance and its commitment to the micro entrepreneur after experiencing poor performance in loans portfolio quality that diminished from 5.0% to 18.3% (AMFIs, 2011)

Funding growth through core deposits has become largely a thing of the past. The advent of nonbank competition and the rise of third-party funding means that community credit Unions now operate in a dynamic funding market, which requires the use of more sophisticated liquidity risk management practices. Industry experts point to many different underlying causes for the demise of growth in deposits, such as the increased financial sophistication of the public, demographic shifts, the rise of nonbank competitors offering a whole wave of alternative investment products, new delivery systems such as the Internet, and competition from credit unions and insurance companies.

Kibara (2007) in his study on a survey of internal auditors risk management practices in the banking industry in Kenya found out that, most banks in Kenya were in process of

drafting the Early Rate Mode process and strategies. Kibet (2008) concluded that internal audit function played a role in corporate governance. The limitations of the study were time constraints, restriction to state owned corporations and having to make prior arrangement in order to meet the heads of IADs. Recommendations of further study were effectiveness and contribution of internal audit in promoting corporate governance for companies listed in the NSE. Additionally, a study on the influence of internal audit and audit committee on financial reporting quality was recommended

The Sarbanes-Oxley Act of 2002 has also contributed to the growth of internal auditing. "Internal auditors have enjoyed increased prominence, higher salaries, and a greater public appreciation for the role that internal auditing can play in a well-governed organization (Hermanson, 2006)." In particular, companies are using internal auditors to strengthen and evaluate their internal control systems to comply with the internal controls provisions of Sarbanes-Oxley. A 2003 survey by The Institute of Internal Auditors indicated that 20% of companies included in the Fortune 1,000 did not yet have internal audit departments but 50% of the Fortune 1,000 companies planned to increase their internal audit staffs to comply with Sarbanes-Oxley (Harrington, 2004). A later survey of 117 chief audit executives of public companies subject to the provisions of Sarbanes-Oxley indicated that 111 reported their companies increased internal audit budgets from 2002 to 2005 (Kaplan & Schultz, 2006). Of these 111, 32% increased internal audit budgets by more than 50%. Another survey of 402 companies reports that more than half of them increased internal audit resources as a result of Sarbanes-Oxley, with 15% indicating more than a 50% increase (PricewaterhouseCoopers, 2006).

The empirical findings by Al-Tamimi (2002) and Al-Mazrooei (2007) highlighted that UAE banks are efficient in risk based auditing. Drzik (1995) found out that Bank Administration Risk based audit Survey showed that large banks in the US had made substantial progress in their financial performance. Comprehensive risk base auditing influence effective financial reporting activities and influencing profit and loss sharing in the source of funds especially investment account holders as explained by Sundararajan (2007, pp.36-35). He concludes that the application of risk based audit particularly for credit and overall banking risks is important for Banks.

The presence of real options based flexibilities should enhance effective risk management practices that diminish earnings volatility and thereby reduce the costs associated with potential financial distress (Andersen, 2008). To this extent, an organization is able to manage risks imposed by dynamic global conditions potential under investment problems would be reduced resulting in higher earnings (Froot, Scharfstein and Stein, 1994). Hence, risk based audit can be extended to include a real options perspective where firms are able to develop opportunities and claims on the future that can be evaluated based on assumptions about underlying risk factors (Leiblein, 2003).

Transparency, disclosure and trust, which constitute the integral part of corporate governance, can provide pressure for improved financial performance. Financial performance, present and prospective is a benchmark for investment. The Mckinsey Quarterly surveys suggest that institutional investors will pay as much as 28% more for the shares of well governed companies in emerging markets (Mark, 2000). According to the corporate governance survey 2002, carried out by the Kuala Lumpur stock exchange and accounting firm Price Water House Coopers (PWC), the majority of investors in

Malaysia are prepared to pay 20% premium for companies with superior corporate governance practices.

Prior research has examined the effect of corporate governance on auditors' decisions (judgments). Cohen and Hanno (2000) find that management control philosophy and corporate governance structure affect auditors' pre-planning (client acceptance) and planning (extent and timing of testing) judgments; specifically, auditors were more willing to recommend client acceptance and more likely to reduce substantive tests in the presence of a stronger corporate governance or management control philosophy. Bedard and Johnstone (2004) examined auditors' assessments of planning and pricing decisions related to earnings manipulation risk and corporate governance risk, and showed that auditors plan increased effort and interest rates for clients with earnings manipulation risk. The positive relation between earnings manipulation risk and interest rates are greater for clients that have heightened corporate governance risk. Lee *et al.* (2004) found that an independent audit committee and board members who are concerned about incurring legal liability and harming reputation support external auditors in accomplishing their assurance duties.

Yatimet *al.* (2006), examined the relationship between corporate governance and audit fees, finding that external audit fees are positively and significantly associated with good audit committees. Cohen *et al.* (2007) examined the effect of the role of the board of directors in monitoring management (agency role) and/or the role of the board in helping to formulate corporate strategies (resource dependence role) on the auditors' planning judgments, and showed that auditors respond to the role of the board when making judgments with respect to control risk assessments and the planned scope of audit tests.

The way management and control are organized affects the company's performance and its long run competitiveness. It determines the conditions for access to capital markets and the degree of investors' confidence (Brownbridge, 2007).

2.4 Risk Based audit practices

2.4.1 Risk Management

Risk management dictates that as long as the demand for liquidity from depositors and borrowers is not too highly correlated, the intermediary should pool these two classes of customers together to conserve on its need to hold costly liquid assets the buffer against unexpected deposit withdrawals and loan take downs. Liquidity risk management is entering a new and much more demanding era.

Stakeholders now compete to participate in corporate governance to seek power in organizations by asserting their own conceptions of risk and how it should be managed, and a focus on risk management has become central to this competition since it defines the accountability of the management of the organization (Spira and Page 2003). This is consistent with Hay and Knechels' (2004) argument that the demand for auditing is a function of the set of risks faced by individual stakeholders in an organization and the set of control mechanisms available for mitigating those risks. Therefore, internal auditing's risk management orientation has given the audit function increased credibility across the enterprise and greater acceptance by management (Beumer 2006).

Risk based audit is a sound risk management strategy which improve business risk management (Fatemi and Glaum, 2000). It is not just about avoiding or minimizing losses, but about dealing positively with opportunities. It is a powerful tool for public sector managers (Drzik, 2000). Good risk management is based on a well-planned,

logical, comprehensive and documented strategy. This strategy provides general policy guidance, and plans and procedures that can be used as part of the organization's everyday work to manage risk (OECD, 2005).

The Risk Based Internal Auditing (RBIA) approach involves management to a far greater extent. The risks to be covered in audits will exist in all parts of the organization and audits will therefore involve managers in departments never visited before (Millichamp, 2002). Many risks will be very significant to the organization and the discussion of their controls will involve more senior managers and directors than might be involved in traditional finance orientated audits (Al-Tamimi, 2002). RBIA emphasizes management's responsibility for managing risks. Audits will involve more discussion with managers about their risks and their responses to them. There will be an initial meeting with managers, possibly involving a risk workshop to examine risks in greater depth, and contact throughout the audit to discuss issues (Schnatterly, 2001).

2.4.2 Annual Risk Based Planning

In most organizations' internal audit offices do not develop a strategic plan, the exercise of which would have enabled the audit staff to evaluate risk and identify high-risk areas that deserve audit attention. It could also have been an exercise by which the head of internal audit ensures the appropriateness of resources by projecting requirements in a timely fashion thus enhancing good governance (Wade, 2002). Proper planning enables accomplishment of a large number of audits in a given period by improving efficiency. In some cases the numbers of the audit engagements are completed in the budgeted time and the number of actual audits performed in a period is usually less than the number of audits stated in the annual audit plan (Sanda, Milkailu and Garba, 2005). This is usually

caused by adhoc audit assignments by the management and urgent requests by external parties. Adhoc audit assignments signify the relevance of internal audit to management (Van Gansberghe, 2005), and reflect positively on audit effectiveness and also in good governance. The supply side argument suggests that during the audit planning stage, auditors assess corporate governance risk and plan procedures or charge risk premiums based on their assessment (Karapetrovic, 1999).

According to Davidson et al. (2005), an auditor's duty is to give a fair and true view of a client's set of company accounts, but auditors cannot guarantee that the company accounts are entirely free of errors and irregularities. Therefore, in their audit planning, auditors must identify and assess the risk that they need to discover. If an item is discovered, auditors must consider the context and presentation of the item and then decide whether it affects the true and fair view of the company accounts. The Statements of Auditing Standards, SAS 220, states that 'Auditors should consider materiality and its relationship with audit risk when conducting an audit' (O'Regan, 2002).

2.4.3 Internal Auditing Standards

The principles of good governance transparency and accountability, fairness and equity, efficiency and effectiveness, respect for the rule of law and high standards of ethical behaviour represent the basis upon which to build effective risk management in banking institutions (OECD, 2005). For Risk Based Audit (RBA) to provide good governance in public sector they must embrace the International Auditing standards that guide the internal audit ethics of work and maintain professional auditing standards.

As organizations grow in size and complexity, effective risk management becomes increasingly problematic (Fraser and Henry 2007). Previous study on internal auditing linked to the cost versus benefit gained by institutions (Goodwin-Stewart and Kent 2006). Carcello, *et al.* (2005) asserts that increased organizational complexity would result in greater risk and companies facing higher risk will increase their organizational monitoring. In addition, from transaction cost perspective, larger firms have opportunities to gain economies of scale from investment in the fixed costs of internal auditing (Carey *et al.* 2006).

2.4.4 Internal Auditing capacity

Investments in internal auditing have been effective, as companies with internal audit staffs are less prone to financial fraud than companies without internal auditing. Coram *et al.* (2008) find that organizations with internal audit staffs are more likely than those without internal auditing to detect and self-report occurrences of fraud. The number and magnitude of errors requiring adjustment by the external auditors have been found to be substantially lower for entities that had an internal audit department compared to those that did not have an internal audit department, (Wallace and Kreutzfeldt, 1991). The internal audit function is important because it adds value and therefore reduces detected errors (Goodwin and Kent, 2004).

The IIA's standard, 1210 on proficiency of the auditor require that the internal auditors possess the knowledge, skills and other competencies needed to perform their responsibilities (IIA, 1999). The auditors' should be interested in attending courses for the purpose of gaining professional qualification, such as for certification as an internal auditor and the employer can provide financial support. Since, internal audit work

requires knowledge and experience on a wide range of systems and operations, it is imperative to deploy auditors with extensive professional skills and to upgrade their skills through continuing professional training and development. Given the high level of staffing with temporary employees, the difficulty of recruitment and retention of auditors with the right technical proficiency is evident. Krishnan (2005) revealed that the auditors view the office as given insufficient attention in terms of staffing. Continuous skill upgrading is another dimension that deserves attention so as to achieve a high level of technical proficiency. Therefore, audit quality is arguably a function of extensive staff expertise; reasonableness of the scope of service; and effective planning, execution and communication of internal audits.

2.5 Financial Performance

The financial industry, like other industries is in business to earn profits by selling its products. To maximize the profits, financial institutions develop new products to satisfy their own needs as well as those of their customers; in other words, innovation-which can be extremely beneficial to the economy- is driven by the desire to get (or stay) rich. This view of the innovation process leads to the following simple analysis: A change in the financial environment will stimulate a search by financial institutions for innovations that are likely to be profitable (Mishkin, 2007).

MFIs earn financial revenue from loans and other financial services in the form of interest fees, penalties, and commissions. Financial revenue also includes income from other financial assets, such as investment income. An MFI's financial activities also generate various expenses, from general operating expenses and the cost of borrowing to provisioning for the potential loss from defaulted loans. Profitable institutions earn a

positive net income that is operating income exceeds total expenses). For the purpose of this review and to account for the institutional scale of operations, financial revenue and expense indicators as well as returns are compared against the institution's assets. Efficient institutions minimize costs of delivering services. The efficiency of an MFI can be calculated in various ways; this study analyses costs per borrower and costs per saver as indicators of efficiency.

2.6 Conclusion

This study seeks to establish the effect of RBA on financial performance of Microfinance Deposit Taking Institutions in Kenya. To understand the impact of RBA on financial performance of the DTMFIs, this study will examine whether the use of RBA practices such as risk management, risk assessment, annual risk planning, and audit staffing affects financial performance of the DTMFIs. RBA is seen as the process and structure used to direct and manage the business affairs of the DTMFIs towards enhancing credit unions prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interest of other stakeholders. RBA is linked to financial performance of financial institutions. The study therefore seeks to investigate the effect of RBA on financial performance of Microfinance Deposit Taking Institutions in Kenya

CHAPTER THREE

RESEARCH DESIGN AND METHODOLOGY

3.1 Introduction

This chapter presented the research design and methodology that was used to carry out the research. It presented the research design, the population, sampling, data collection and data analysis.

3.2 Research design

Research design refers to the way the study is designed, that is the method used to carry out the research (Mugenda and Mugenda (2003). Correlation research design was adopted in the investigation in which quantity data was collected and analysed in order to describe the specific phenomenon in its current trends, current events and linkages between different factors at the current time. Correlated research design was chosen because it enabled the researcher to establish the impact of risk based audit on financial performance of Microfinance Deposit Taking Institutions in Kenya. It was used to obtain information concerning the current status of the effects of risk-based audit on financial performance of Microfinance Deposit Taking Institutions in Kenya.

3.3 Population of the Study

The target population for the proposed study was all the Deposit Taking Microfinance Institutions in Kenya operating in Kenya. These include six (6) Microfinance Deposit Taking Institutions in Kenya which have been in operation for the last 5 years from 2007 to 2012 as indicated in the Appendix II. This was because the population According to

Cooper and Schindler, (2008) is a well-defined or set of people, services, elements, and events, group of things or households that are being investigated.

3.4 Sample Sampling Technique

The population of 6 deposit taking Microfinance was small therefore the study carried out a census survey of all the Microfinance Deposit Taking Institutions in Kenya. Census survey is used where all the items under study are investigated and is applicable where the population is so small that selecting a sample would be meaningless as indicated by Mugenda and mugenda, (2003).

3.5 Data collection

A questionnaire was used to collect primary data which was quantitative in nature. Primary data was collected using semi-structured questionnaires. The questionnaires was administered using drop and pick method. The questionnaires was used because it allowed the respondents who were credit managers, branch managers and operations managers to give their responses in a free environment and helped the researcher gather information that would not have been given out had interviews been used. Secondary data was collected from the Deposit taking MFIs annual financial statements.

3.6 Data analysis

The collected data was thoroughly examined and checked for completeness and comprehensibility, coded and tabulated to analyse quantitative data using Statistical Package for Social Science (SPSS version 17). Tables were used for further representation of the data for easy understanding and analysis. Inferential statistic

regression and correlation was used to establish the effects of risk based audit on financial performance in DTMFIs.

Regression analysis was applied to cross check the conclusion reached in the first approach. A regression model relating each of the four risk based audit practices to value of the bank as proxied by Tobin's Q and Book-to-market ratio was specified. To test the relationship between the percentages RBA practices and Deposit Taking Microfinance Financial performance, Tobin model was used in data analysis, which is a regression technique suited to analyze limited (censored) dependent variables (Spekle' *et al.* 2007). The return on assets (ROA) percentage indicated the financial performance measure of the DTMFIs. The response on RBA practices was measured by computing indices based on the responses that were derived from the Likert-Scaled questions. The relationship equation is represented in the linear equation below.

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \epsilon$$

Where

Y= Return on Assets

α = Constant Term

β_1 = Beta coefficients

X_1 = Risk Management

X_2 = Annual Risk Based Planning

X_3 = Internal Auditing Standards

X_4 = Internal audit Capacity

ϵ = standard error

Financial Performance is measured by financial sustainability. Financial sustainability is measured by return on assets (*ROA*). Establishing the impact of risk based audit is important because proponents of transformation of MFIs into regulated institution have argued that regulated MFIs could reach more borrowers as their leverage opportunities improve.

The response on RBA practices were measured by computing indices based on the responses derived from the Likert-Scaled questions. Thus, a positive coefficient would indicate an inclining role risk based auditing, and a negative link would indicate moral hazards, that is, managers slack off once previous year financial statements have been certified.

3.7 Validity and reliability

Piloting was carried out to test the validity and reliability of the instruments. Validity indicates that degree to which the instrument measures the constructs under investigation (Mugenda and Mugenda, 2003). There are three types of validity test which include content, criterion and related construct validity. This study used content validity because it measures the degree to which the sample of the items represents the content that the test is designed to measure.

A pilot study was conducted by the study taking some questionnaires to the staff in DTMFIs in Nairobi which were filled by 10 respondents at random. From this pilot study the study was able to detect questions that needed editing and those that were ambiguous. The final questionnaire was then printed and used to collect data required by the study.

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION

4.1 Introduction

This chapter presents the results and findings of the study based on the research questions. The findings were given based on the objectives of the study as explored using specific questions in the questionnaire. A total of 36 auditors at the six Deposit taking microfinance Institutions in Kenya were asked to respond to a questionnaire on effect of risk based audit practices on financial performance of Microfinance Deposit Taking Institutions in Kenya. Of the 36 expected respondents, 32 responded in time for data analysis. This represented 88.88% of the total respondents. This rate was considered appropriate based with Mugenda&Mugenda (2003) who indicated that respondents of 50%, 60% and 70% response rate was sufficient for a study.

4.2 Data Presentation

4.2.1 Current designation

Table 4. 1: Current Designation of Respondents

	Frequency	Percent
Credit Manager	17	53
Branch Manager	10	31
Operations Manager	5	16
Total	32	100

On respondent's designation, 53% of the respondents were credit managers, 31% of the respondents were branch managers and 16% of the respondents were operation managers.

This implied the information on effects of risk based audit on performance of Deposit taking Microfinance Institutions was collected from relevant parties.

4.2.2 Respondents Working period

Table 4. 2: Respondents working period

Working period	Frequency	Percent
1-5 years	8	24
6-10 years	14	45
11-15 years	10	31
Total	32	100

The study sought to know the number of years respondents had been working in the Microfinance. From the findings, 45%, 31% and 24% of the respondents had been working in the Deposit taking microfinance Institutions for 6 – 10 years, 11 – 15 years and for 1 – 5 years respectively. This clearly indicated that the respondents were in a position of offering valid information on effects of risk based audit on financial performance of the Deposit Taking MFIs based on their experience after working in the institution for more than six years.

4.2.3 Inherent risk assessment effect on the financial performance of DTMF's

Table 4. 3: Whether inherent risk assessment affect financial performance at DTMF

	Frequency	Percentages
Yes	26	81
No	6	19
Total	32	100

This study sought to know whether inherent risk assessment affects financial performance in deposit taking microfinance Institutions. From the findings, 81% of the respondents

indicated that inherent risk assessment affects financial performance in deposit taking microfinance institutions in Kenya while 19% of the respondent indicated that inherent risk assessment does not affect financial performance in Deposit Taking Microfinance Institutions in Kenya. This implied that inherent risk assessment affects financial performance in Deposit Taking Microfinance Institutions greatly.

4.2.4 Impact of risk based audit on financial performance

Table 4. 4: Rating the risk assessment effects of financial performance in DTMF

Risk assessments	Average extent	Great extent	Very great extent	Total	Mean	Std deviation
Consideration of risk assessment in the detection of errors	3	12	17	32	4.65	0.50
The auditors understanding of the DTMF's risk	3	7	22	32	4.59	0.53
Difficult and costly to assess risks at the DTMF	0	7	23	32	4.67	0.67
The auditor's involvement of management in risk evaluation process	6	12	14	32	4.73	0.71
The auditors identification of changes that have influence on financial performance at DTMF	0	18	14	32	4.70	0.63
Auditors recognition of work environment in risk assessment	8	8	16	32	4.47	0.40

Table 4.4 shows the response on rating the risk assessment effects on financial performance in DTMFIs. From the findings, majority of the respondents indicated that the auditor's involvement of management in risk evaluation process, the auditors understanding of the DTMF's risk and the auditors identification of changes that have influence on financial performance at DTMF have an effect to a very great extent as indicated by a mean 4.73 and 4.70 with a standard deviation of 0.71 and 0.63. Some of the

respondents indicated that difficult and costly to assess risks at the DTMF, consideration of risk assessment in the detection of errors, the auditors understanding of the DTMF's risk affects financial performance at DTMF to a great extent as indicated by a mean of 4.67, 4.65 and 4.59 with standard deviation of 0.67, 0.50 and 0.53. Most of the respondents indicated that auditor's recognition of work environment in risk assessment affects financial performance at DTMF to a moderate extent as indicated by a mean of 4.47 with standard deviation of 0.40.

4.2.5 Factors influencing judgments of risk in DTMF

Table 4. 5: Factors influencing judgments of risk in DTMF

	Mean	Std deviation
Effective controls	4.71	0.76
Lack of adequate funds	4.44	0.53
The complexity of operations	4.43	0.42
The quality of personnel in internal audit	4.64	0.79

Table 4.5 present the respondents response on the extent to which the given factors influence judgments of risk at the deposit taking microfinance institutions in Kenya were significant. From the findings, majority of the respondents indicated that effective controls and quality of personnel in internal audit were very significant in influencing judgments of risk at the deposit taking microfinance institutions in Kenya as indicated by a mean of 4.71 and 4.64 with standard deviation of 0.76 and 0.79. The study further found that some of the respondent indicated that lack of adequate funds and the complexity of operations were significant in influencing judgments of risk at deposit taking microfinance institutions in Kenya as indicated by a mean of 4.44 and 4.43 with

standard deviation of 0.53 and 0.42. This concurred with Al-Tamimi, (2002) who found that many risks will be very significant to the organization and the discussion of their controls will involve more senior managers and directors than might be involved in traditional finance orientated audits.

4.2.6 Managing of risks on financial performance in DTMF

Table 4. 6: Influence of Managing of risks on financial performance in DTMF

	Frequency	Percent
Yes	31	98
No	1	2
Total	32	100

The figure 4.6 indicates the respondents response on the extent to which they agreed with the given statement concerning the managing of risks being one of the major factors that influence deposit taking microfinance institutions in Kenya. From the findings, 98% of the respondents agreed that managing of risks influence deposit taking microfinance institutions in Kenya while 2% indicated that managing of risks does not influence deposit taking microfinance institutions in Kenya. This concurred with Millichamp, (2002) who found that the risks to be covered in audits will exist in all parts of the organization and audits will therefore involve managers in departments never visited before. This implied that the Risk Based Internal Auditing (RBIA) approach involves management to a far greater extent.

4.2.7 Effect of managing of risks on financial performance in DTMF

Table 4.7: Risk based audit on the influence of financial performance in your DTMF

Risk Based Services	Very significant	Significant	Neutral	Mean	Std. deviation
Risk Based Audit Reporting time	8	14	10	4.19	0.41
Assessment of risks	11	10	11	4.05	0.33
Risk Based audit Annual plans with the Management	2	4	26	4.93	0.71
Auditing process	4	7	21	4.68	0.55
Action audit queries on time	6	4	22	4.67	0.61
Implementation of audit recommendation by the Management	5	11	16	4.28	0.45
Adequate auditing staff	2	7	23	4.78	0.64

The study sought to find out the extent to which the given risk based audit services were significant in influencing financial performance in deposit taking microfinance institutions in Kenya. From the findings, majority of the respondents indicated that risk based audit annual plans with the management, adequate auditing staff, auditing process and action audit queries on time were significant in influencing financial performance in deposit taking microfinance institutions in Kenya as indicated by a mean of 4.93, 4.78, 4.68 and 4.67 with standard deviation of 0.71, 0.64, 0.55 and 0.61. Some of the respondents indicated that implementation of audit recommendation by the management, risk based audit reporting time and assessment of risks were significant in influencing financial performance in deposit taking microfinance institutions in Kenya as indicated by a mean of 4.28, 4.19 and 4.05 with standard deviation of 0.45, 0.41 and 0.33.

4.2.8 Effect of annual audit planning on financial performance of DTMF

Table 4. 8: Whether annual audit planning affects return on asset in the DTMF

	Frequency	Percent
Yes	31	98
No	1	2
Total	32	100

The study sought to know whether annual audit planning affect return on asset at the DTMF in Kenya. From the findings, 98% of the respondents indicated that annual audit planning at the DTMF in Kenya affected the financial performance. Respondents further stated that in some cases the numbers of the audit engagements are completed in the budgeted time and the number of actual audits performed in a period is usually less than the number of audits stated in the annual audit plan. This concurred with Sanda, Milkailu and Garba, (2005) proper planning enables accomplishment of a large number of audits in a given period by improving efficiency.

4.2.9 Risk factors that relate to DTMF affect financial performance

Table 4. 9: Risk factors that relate to DTMF affect financial performance

	Mean	St Dev
Disclosures about financial risk and risk management	4.56	0.67
Disclosures about compliance risk and risk management	4.91	0.87
Disclosures about environmental and safety risk and risk management	4.74	0.63
Disclosures about technology risk and risk management	4.63	0.59
Internal process risk and risk management	4.46	0.45
Change management risk and risk management	4.11	0.39

The study sought to know the extent the given factors affect DTMF's financial performance. From the findings, majority of the respondents indicated that disclosures about compliance risk and risk management, disclosures about environmental and safety

risk and risk management, disclosures about technology risk and risk management and disclosures about financial risk and risk management affected the deposit taking microfinance institutions financial performance to a very great extent as indicated by a mean of 4.91, 4.74, 4.63 and 4.56 with standard deviation of 0.87, 0.63, 0.59 and 0.67.

4.2.10 Auditing code effect on the financial performance ofDTMF

Table 4. 10: Whether auditing code affect return on assets in DTMF

Responses	Frequency	Percent
Yes	32	100
Total	32	100

The respondents of this study were required to indicate whether auditing codes affect return on assets in the deposit taking microfinance institutions in Kenya. From the findings, all the respondents indicated that the auditing codes affected return on assets in deposit taking microfinance institutions. The findings were in line with Jackson, (2005), who stated that the aim of the audit codes is to improve the quality and effectiveness of audits by substantially changing audit practice.

4.2.11 Auditing standards effect on the financial performance of DTMF

Table 4. 11: Rating the extent to which auditing standards affect the ROA in DTMF

	Very great extent	Great extent	Average extent	Mean	St Dev
Auditors technical and professional skills	2	8	22	4.63	0.59
Auditors Readiness to embrace change	4	13	15	4.56	0.67
Quality audit reports	3	3	27	4.91	0.87

Quality criteria to measure internal auditors performance	4	10	18	4.74	0.63
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The study sought to know the extent to which auditing standards affect the DTMF financial performance. From the findings, majority of the respondents indicated that quality audit reports, quality criteria to measure internal auditors performance, auditors technical and professional skills and auditors readiness to embrace change auditing standards affected the deposit taking microfinance institutions financial performance to a very great extent as indicated by a mean of 4.91, 4.74, 4.63 and 4.56 with standard deviation of 0.87, 0.63, 0.59 and 0.67.

4.2.12 Risk based audit practices influence on return on assets of DTMF

Table 4. 12: Rating risk based audit practices influence on return on assets of DTMF

	Very great extent	Great extent	Average extent	Mean	Std deviation
Active and independent audit committee	4	6	22	4.63	0.66
Independent directors	4	17	10	4.32	0.39
Management's ownership interest	0	15	17	4.26	0.43
Financial management and compliance with accepted audit standards	3	10	19	4.67	0.59
Limited auditors in the DTMF	2	2	28	4.90	0.95
Proficiency of the internal auditor	0	15	17	4.65	0.54
Audit planning	1	3	28	4.73	0.63
Effective internal audit staff	0	5	27	4.72	0.69

The study sought to investigate the extent to which DTMFIs financial performance is influenced by the given measures. From the findings, majority of the respondents indicated that limited auditors in the DTMF, audit planning, effective internal audit staff,

financial management and compliance with accepted audit standards, proficiency of the internal auditor and active and independent audit committee influenced DTMF's financial performance to a very great extent as indicated by a mean of 4.90, 4.73, 4.72, 4.67, 4.65 and 4.63 with a standard deviation of 0.95, 0.63, 0.69, 0.59, 0.54 and 0.66. The study further found that most of the respondents indicated that independent directors and management's ownership interest measures influenced DTMF's financial performance to a great extent as indicated by a mean of 4.32 and 4.26 with standard deviation of 0.39 and 0.43.

4.2.13 Regression Analysis

A multivariate regression model was applied to test of relationship between the RBA practices and the financial performance of deposit taking microfinance institutions in Kenya. The logistic regression used in this model was

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \epsilon$$

Where

Y= Return on Assets

α = Constant Term

β = Beta coefficients

X_1 = Risk Management

X_2 = Annual Risk Based Planning

X_3 = Internal Auditing Standards

X_4 = Internal audit Capacity

ϵ = Standard errors

Model Summary

Table 4. 13: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.877(a)	.685	.674	.19456	.945	719.412	46	234	0.01(a)

A Predictors: (Constant), Risk Management, Annual Risk Based Planning, Internal Auditing Standards and Internal audit Capacity

B Dependent Variable: Return on Assets

From the table above, the value of adjusted R^2 (Coefficient of determination) is 0.674. This implies that, there was a variation of 67.4% of return on asset, varied with variation in factors influencing financial performance at deposit taking microfinance institutions in Kenya which were risk management, annual risk based planning, internal auditing standards and internal audit capacity at a confidence level of 99.95%. The unexplained variation could be attributed to other factors not included in the model as well as random factors.

Table 4.14 ANOVA (B)

Model		Sum of Squares	df	Mean Square	F	Sig. Change
1	Regression	37.421	46	8.124	719.412	0.01(a)
	Residual	6.987	234	.039		
	Total	62.264	264			

A Predictors: (Constant), Risk Management, Annual Risk Based Planning, Internal Auditing Standards and Internal audit Capacity

B Dependent Variable: Return on Assets

The strength of variation of the predictor values influence the financial performance of deposit taking microfinance institutions in Kenya variable at 0.01 significant levels.

Table 4.15: Coefficient Matrix (b)

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig. change
		B	Std. Error	Beta		
1	(Constant)	4.000	.346		3.126	0.01
	Risk Management	0.637	.129	.1254	3.451	0.04
	Annual Risk Based Planning	0.546	.233	-.2477	.0042	0.01
	Internal Auditing Standards	0.443	.194	.3188	.0121	0.03
	Internal audit Capacity	0.537	.147	.1248	1.472	0.02

A Predictors: (Constant), Risk Management, Annual Risk Based Planning, Internal Auditing Standards and Internal audit Capacity

B Dependent Variable: Return on Assets

$$Y = 4.000 + 0.637X_1 + 0.546X_2 + 0.491X_3 + 0.267X_4$$

Where X_1 = Risk Management, X_2 = Annual Risk Based Planning, X_3 = Internal Auditing Standards and X_4 = Internal audit Capacity

From the above regression model, it was found that return on asset in deposit taking microfinance institutions would be at 4.000 holding risk management, annual risk based planning, internal auditing standards and internal audit capacity constant. A unit increase in effective risk management would lead to increase in return on asset in deposit taking microfinance institutions financial performance by factor of 0.637 with a P Value of 0.04, a unit increase in annual risk based planning would lead to increase in return on asset in

financial performance by factor of 0.546 with a P Value of 0.01, a unit increase in internal auditing standards would lead to increase in return on asset by a factor of 0.443 with a P Value of 0.03 while a unit increase in internal audit capacity would lead to increase in return on asset in deposit taking microfinance institutions by factor of 0.537 with a P Value of 0.02.

There existed a positive relationship between return on asset and risk based audit factors influencing financial performance in deposit taking microfinance institutions in Kenya clearly indicating that effective risk management, annual risk based planning, internal auditing standards and internal audit capacity influence financial performance as they were statistically significant with a P-Value of 0.04, 0.01, 0.03 and 0.02 at 95% confidence level.

4.3 Summary and interpretation of findings

The study found that effective controls and quality of personnel in internal audit were very significant in influencing judgments of risk at the deposit taking microfinance institutions in Kenya as indicated by a mean of 4.71 and 4.64 .The study found that lack of adequate funds and the complexity of operations were significant in influencing judgments of risk at deposit taking microfinance institutions in Kenya.This concurred with Al-Tamimi, (2002) who found that many risks will be very significant to the organization and the discussion of their controls will involve more senior managers and directors than might be involved in traditional finance orientated audits.

From the findings, risk based audit annual plans with the management, adequate auditing staff, auditing process and action audit queries on time were significant in

influencing financial performance in DTMFIs in Kenya as indicated by a mean of 4.93, 4.78, 4.68 and 4.67. The findings indicated that implementation of audit recommendation by the management, risk based audit reporting time and assessment of risks were significant in influencing financial performance of DTMFIs in Kenya as indicated by a mean of 4.28, 4.19 and 4.05.

From the findings, audit planning, effective internal audit staff, financial management and compliance with accepted audit standards, proficiency of the internal auditor and active and independent audit committee influenced DTMFIs financial performance to a very great extent as indicated by a mean of 4.90, 4.73, 4.72, 4.67, 4.65 and 4.63. The study further found that independent directors and management's ownership interest measures influenced DTMF's financial performance to a great extent as indicated by a mean of 4.32 and 4.26. O'Regan, (2002) noted that the Statements of Auditing Standards, SAS 220, states that 'Auditors should consider materiality and its relationship with audit risk when conducting an audit'.

From the findings, the study established that auditor's involvement of management in risk evaluation process, the auditors understanding of the DTMFs risk, the auditor's identification of changes that have influence on financial performance at DTMFs. Difficult and costly risks assessment, consideration of risk assessment in the detection of errors the auditors understanding of the DTMFs risk affects financial performance. Effective controls and quality of personnel in internal audit were very significant in influencing judgments of risk and lack of adequate funds and the complexity of operations were significant in influencing judgments of risk at deposit taking microfinance institutions in Kenya. Risk based audit annual plans with the management,

adequate auditing staff, auditing process and action audit queries on time were significant in influencing financial performance in deposit taking microfinance institutions. This concurred with Mishkin, (2007) who found that MFIs earn financial revenue from loans and other financial services in the form of interest fees, penalties, and commissions. Financial revenue also includes income from other financial assets, such as investment income.

The study established that annual audit planning at the DTMFs in Kenya affected the financial performance. Respondents further stated that In some cases the numbers of the audit engagements are completed in the budgeted time and the number of actual audits performed in a period is usually less than the number of audits stated in the annual audit plan. Disclosures about compliance risk and risk management, disclosures about environmental and safety risk and risk management, disclosures about technology risk and risk management and disclosures about financial risk and risk management affected the DTMFIs financial performance. Auditing codes affected return on assets in deposit taking microfinance institutions. The findings were in line with Jackson, (2005), who stated that the aim of the audit codes is to improve the quality and effectiveness of audits by substantially changing audit practice. Quality audit reports, quality criteria to measure internal auditors performance, auditors technical and professional skills and auditors readiness to embrace change auditing standards affected the DTMFIs financial performance.

The study found that a unit increase in effective risk management would lead to increase in return on asset in deposit taking microfinance institutions financial performance by factor of 0.637, a unit increase in annual risk based planning would lead to increase in

return on asset in financial performance by factor of 0.546, a unit increase in internal auditing standards would lead to increase in return on asset in by factor of 0.443 while a unit increase in internal audit capacity would lead to increase in return on asset of DTMFIs by factor of 0.537 .

There existed a positive relationship between return on asset and risk based audit factors influencing financial performance of DTMFIs in Kenya clearly indicating that effective risk management, annual risk based planning, internal auditing standards and internal audit capacity influence financial performance as they were statistically significant with a P-Value of 0.04, 0.01, 0.03 and 0.02 at 95% confidence level. The findings were similar to that of Maiteka (2010) who found that there existed a strong and positive relationship between risks based audit and corporate governance in public sectors with an adjusted 0.783 indicating that the risk based audit explain 78.3 % of the variability in the corporate public corporate governance enhancing public service delivery. This shows a strong correlation between the independent variables and the dependent variable. This implied that the risk management, annual risk based planning, internal auditing standards and internal audit capacity influence return on assets in DTMFIs in Kenya. The findings concurred with Lee *et al.* (2004) who found a positive relation between earnings manipulation risk and interest rates are greater for clients that have heightened corporate governance risk.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The objective of the study was to determine the effect of risk-based audit on financial performance in DTMFIs in Kenya. The study addressed risk based audit practices which included risk management, Risk based audit annual planning, internal audit standards and auditing capacity. This study adopted Correlation research design for it describes the specific phenomenon in its current trends, current events and linkages between different factors at the current time. The target population for the study constituted of 36 respondents who were Credit managers, Branch managers, Operation managers and auditors at DTMFIs in Kenya. The study administered the questionnaires which included structured and unstructured questions to all the respondents. Descriptive statistics such as mean, standard deviation and frequency distribution were used to analyze the data. Data presentation was done by the use of tables for ease of understanding and interpretation. The study sought to fill the knowledge gap by establishing the effect of risk based audit on financial performance of DTMFIs in Kenya.

The study established that there existed a positive relationship between return on asset and risk based audit factors influencing financial performance in DTMFIs in Kenya clearly indicating that effective risk management, annual risk based planning, internal auditing standards and internal audit capacity influence financial performance as they were statistically significant with a P-Value of 0.04, 0.01, 0.03 and 0.02 at 95% confidence level.

5.2 Conclusions

The study established that risk based internal auditing through risk assessment, risk management, annual risk based planning, internal auditing standards and internal auditing staffing when enhanced enable the firm to detect risks on time, thus enhancing financial performance. The study revealed that risk based audit helps management in assessing the risks and recommend corrective measures for improvement. Auditors understanding of the DTMF's risk, Consideration of risk assessment in the detection of errors, auditors recognition of work environment in risk assessment, auditor's involvement of management in risk evaluation process and auditors identification of changes that have influence on financial performance at DTMF's have an effect on financial performance of DTMFs in Kenya.

From the findings, implementation of audit recommendation is still the prerogative of management and enhances the financial performance. This study also advises that for any risk based audit to improve the financial performance of DTMFs, embracing International Auditing Standards guides, the internal audit ethics of work and maintaining professional auditing standard is important. Compliance to the annual audit planning can create transparency and accountability in the DTMFs hence influence return on asset. Quality audit reports and criteria to measure internal auditor's performance, auditor's technical, professional skills and readiness to embrace change in auditing standards influence financial performance.

The study concluded that risk based audit practices are essential since they have an effect on the financial performance of DTMFs greatly.

5.3 Policy Recommendations

From the findings and conclusions the study recommends that risk based internal audit should be enhanced through adoption of better risk assessment, internal auditing standards, annual risk based planning and internal auditing staffing practices so as to achieve success in financial performance in deposit taking microfinance institutions in Kenya.

The study recommends that management of deposit taking microfinance institutions in Kenya should emphasize on auditors understanding of the risk based audit, risk assessment in the detection of errors, work environment in risk assessment, involvement of management in risk evaluation process and identification of changes in order to effectively control and improve the quality of personnel in internal audit, ensure adequate funds and the complexity of operations in the financial performance.

Management in deposit taking microfinance institutions in Kenya should bear the responsibility defining effective implementation of audit recommendation, risk based audit annual plans, reception of risk based audit reports in time and adequate resources for risk based audit to enhance transparency and accountability through improved efficiency, accuracy, completeness, timeliness, convenience and clarity.

The study also recommends that management of DTMFIs in Kenya need to develop and retain adequate quality professionals in order to ensure quality audit reports, internal auditor's performance, technical, professional skills, readiness to embrace change auditing standards and proficiency of the internal auditor required knowledge, skills, and other competencies needed to perform individual responsibilities.

Finally, the study recommends that management of deposit taking microfinance institutions should adopt effective risk based audit practices such as risk assessment, risk management, annual risk based planning, internal auditing standards and internal auditing staffing to enhance effective and efficient performance in the DTMF's in Kenya.

5.4 Limitations of the Study

The main limitation of study was inability to include more organizations. This study concentrated only on DTMFIs that have been in existence for at least five years 2007 to 2012. The study would have covered more institutions across all sectors so as to provide a more broad based analysis. However, resource constraints placed this limitation.

The study also faced challenge of time resource, limiting the study from collecting information for the study particularly where the respondents delayed in filling the questionnaire and travelling for collection of the the filled questionnaire.

The study also faced a limitation where it proved difficult to obtain the signed copies of the institutions' financial statements. The management was hesitant to reveal such information. The researcher followed up to ensure data was collected without further delays.

The study also faced a limitation whereby some respondents were found to be uncooperative because of the sensity of information required for the study. Thus the researcher had to explain to the respondents that the information they provided was to be held confidential and would be used for academic purposes only.

5.5 Suggestions for further studies

This study determined the impact of risk based audit practice on financial performance of Microfinance Deposit Taking Institutions in Kenya.

A further study should be carried out to determine challenges affecting implementation of risk-based audit practices in Deposit taking Microfinance institutions in Kenya.

A further study should be carried out to determine impact of risk based audit on profitability of Microfinance institution in Kenya.

The study further recommends that further study should be carried to determine relationship between risks based audit and financial performance in DTMF's.

The study recommends that a further study should be carried out to investigate the challenges of risk-based audit on financial performance in regulated SACCOs under SASRA in Kenya. A study should also be carried out to determine challenges affecting implementation of risk-based audit practices of SACCO's in Kenya.

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APPENDICES

Appendix I: Questionnaire

1. What is your current designation within the DTMFI?
 Credit Manager () Branch Manager ()
 Operations Manager () Others (please specify.....)
2. How many years have you been in the Microfinance you work in?
 1 – 5 years () 6 – 10 years () 11 – 15 years ()
 16 – 20 years () 21 years and above ()
3. Does an inherent risk assessment affect financial performance at your DTMF
 A) Yes []
 B) No []
4. In your opinion to what extent do the following factors on risk assessments affect financial performance for DTMF?

	Very great extent	Great extent	Average extent	Low extent	Very low extent
Consideration of risk assessment in the detection of errors.					
The auditors understanding of the DTMF's risk					
Difficult and costly to assess risks at the DTMF.					
The auditor's involvement of management in risk evaluation process.					
The auditors identification of changes that have influence on financial performance at DTMF					
Auditors recognition of work environment in risk assessment					

5. How significant are the following factors in influencing judgments of risk in your DTMF? Where 1-Not Significant , 2 Slightly Significant, 3 Moderately significant, 4 significant and 5- very Significant)

	Very significant	Significant	Moderately significant	Slightly significant	Not Significant
Effective controls					
Lack of adequate funds					
The complexity of operations					
The quality of personnel in internal audit					

6. Does managing of risks influence financial performance in your DTMF?

A) Yes []

B) No []

7. In your opinion to what extent do the following risk based audit practices influence the financial performance in your DTMF?

Risk Based Services	Very significant	Significant	Neutral	Less Significant	Not Significant
Risk Based Audit Reporting time					
Assessment of risks					
Risk Based audit Annual plans with the Management					
Auditing process					
Action audit queries on time					
Implementation of audit recommendation by the Management					
Adequate auditing staff					

8. Does DTMF annual audit planning affect return on asset in your DTMF?

A) Yes []

B) No []

9. To what extent do the following factors that relate to DTMF affect financial performance? Use a scale of 1 to 5 where: 1 = No extent at all; 2 = Low extent; 3 = Moderate extent; 4 = Great extent; 5 = A very great extent

	5	4	3	2	1
Disclosures about financial risk and risk management					
Disclosures about compliance risk and risk management					
Disclosures about environmental and safety risk and risk management					
Disclosures about technology risk and risk management.					
Internal process risk and risk management.					
Change management risk and risk management.					

10. Does auditing code affect return on assets in your DTMF?

- A) Yes []
B) No []

11. To what extent do the following auditing standards affect the return on assets in your DTMF?

	Very great extent	Great extent	Average extent	Low extent	Very low extent
Auditors technical and professional skills					
Auditors Readiness to embrace change					
Quality audit reports					
Quality criteria to measure internal auditors performance					

12. To what extent do the following set of risk based audit practices influence return on assets of DTMF. 1 = very low extent; 2 = low extent; 3 average extent; 4 = Great extent; 5 = very great extent.

	Very great extent	Great extent	Average extent	Low extent	Very low extent
Active and independent audit committee					
Independent directors					
Management's ownership interest					
Financial management and compliance with accepted audit standards					
Limited auditors in the DTMF					
Proficiency of the internal auditor					
Audit planning					
Effective internal audit staff					
Risk assessment					
Risk management					

Appendix II: Deposit Taking Microfinance Institutions in Kenya

1. Faulu Kenya DTM Limited
2. Kenya Women Finance Trust DTM Limited
3. Remu DTM Limited
4. SMEP Deposit Taking Microfinance Limited
5. UWEZO Deposit Taking Microfinance Limited
6. Century Deposit Taking Microfinance