

**THE RELATIONSHIP BETWEEN INTERNAL AUDIT  
INDEPENDENCE AND CORPORATE GOVERNANCE AMONG  
COMMERCIAL BANKS IN KENYA**

**By**

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## **Declaration**

This Research Project is my original work and has not been presented in any other University.

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## **Dedication**

I dedicate this project to my wife Faith Njoki and my daughter Shiphrah Mwende for the overwhelming support and encouragement that they gave me.

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## **Abbreviations and Acronyms**

ABC	African Banking Corporation
ALCO	Assets and Liabilities Committee
ANOVA	Analysis of Variance
BFID	Banking Fraud Investigation Department
CAE	Chief Audit Executive
CBK	Central Bank of Kenya
CEO	Chief Executive Officer
CFO	Chief Finance Officer
CMA	Capital Market Authority
Df	Degrees of Freedom
IIA	Institute of Internal Auditors
ICPAK	Institute of Certified Public Accountants of Kenya
KCB	Kenya Commercial Bank
MBA	Master of Business Administration
NSE	Nairobi Stock Exchange
SACCO	Savings and Credit Cooperatives
SPSS	Statistical Packages for the Social Sciences
UBA	United Bank of Africa
USA	United State of America

## **Abstract**

Internal audit is a subject that has been studied by scholars on various aspects. Some of the main areas of focus have been: the audit board committee function; risk management and internal audit; internal audit and organizational performance and the evolving trends within internal audit function. However, the concept of internal audit independence has not been reviewed in the past more so among commercial banks. Therefore this study sought to establish the independence of internal audit and how it relates to corporate governance among commercial banks in Kenya.

Data was collected using a structured questionnaire distributed to all the 43 commercial banks in Kenya as at 31/12/2012. It was further analyzed by the use of descriptive statistics aided by SPSS data analysis tool and for each of the commercial bank a level of internal audit independence and a level of corporate governance was determined. A regression model was then used to analyze the relationship between internal audit independence and corporate governance within a test of significance of 95% confidence level.

The study found out that there was indeed a threat to internal audit independence since the Chief Executive Officer (CEO) had powers in most banks to approve the internal audit budget, determine the compensation of the Chief Audit Executive (CAE) as well as hire and fire the CAE. The study further found out that there was a strong linear relationship between internal audit independence and corporate governance among commercial banks in Kenya. This implies that in policy and practice there are gaps in relation to internal audit independence that needs to be addressed by management.

# CHAPTER ONE: INTRODUCTION

## 1.1 Background

The Institute of Internal Auditors (2011) promotes the internal audit function as an independent function that provides value added assurance and consulting services. Through this extended role the function has been promoted as the cornerstone upon which effective corporate governance is built. KPMG (2004) notes that corporate governance is a major debate in the world due to the numerous corporate financial scandals and the ensuing business failures. These corporate frauds following in the footsteps of the Asian financial crisis of the late 1990's are epitomized by the Enron, Worldcom, Global Crossing and Tyco in the USA as well as Vivendi, Parmalat and others in Europe. These scandals have shaken investors confidence to the core and called into question the honesty and integrity among corporate board and executive management.

These unfortunate events have therefore highlighted the critical role of board of directors in promoting good corporate governance. In particular boards are being charged with ultimate responsibility for the effectiveness of their organizations internal controls systems. An effective internal audit function plays a key role in assisting the board to discharge its responsibility, but its audit committee must satisfies itself that internal audit is functioning effectively and efficiently (Sarens, 2007).

Internal auditor's independence from the board of directors is of great importance to shareholders and is seen as a key factor in helping to deliver audit quality. However, an

audit necessitates a close working relationship with the board of directors of a company. The fostering of this close working relationship has led (and continues to lead) shareholders to question the perceived and actual independence of auditors and to demand tougher controls and standards over independence to protect them (Fama, 2006).

As far as independence and objectivity are concerned, auditors need to be conscious of threats to objectivity and apply suitable safeguards where necessary. Reputation is a key factor in promoting trust and auditor independence and is an important quality that shareholders look for. Auditors have an important incentive to maintain independence to protect their reputation and thereby help them to retain and win audits (Goodwin and Yeo, 2001).

### **1.1.1 Internal Audit Independence**

Institute of Internal Auditors (2011) defines Internal Auditing as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, controls and governance processes.

Gunther and Moore (2002) notes internal auditing is conducted in diverse legal and cultural environment within organization that varies in purpose, size, complexity and structure; and by persons within or outside the organization. While differences may affect the practice of internal auditing in each environment, conformance with the

Institute of Internal Auditors (IIA) international standards for the professional practice of internal auditing is essential in meeting the responsibilities of internal auditors and the audit activity. Central Bank of Kenya (2006) has further emphasized that the board of directors shall set up an effective internal audit department, staffed with qualified personal to perform internal audit functions, covering the traditional function of financial audit as well as the function of management audit.

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

Basel committee's (2012) principles for enhancing corporate governance states that bank should have an internal audit function with sufficient authority, stature, independence, resources and access to the board of directors. Independent, competent and qualified internal auditors are vital to sound corporate governance. The committee further summarized the principles into three groups that is principles relating to: the supervisory assessment of the internal audit function; the relationship of the supervisory authority

with the internal audit function and finally the supervisory expectation related to the internal audit function.

### **1.1.2 Corporate Governance**

Cadbury (1992) describes corporate governance as the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and auditors and to satisfy themselves that an appropriate governance structure is in place. In addition Evans, Evans, and Loh (2002) further defines corporate governance as rules governing board structure, managers and boards incentive compensation, decision rights by the board and the chief executive officer (CEO), succession of the board and CEO share holding voting, debt/equity finance decisions as well as disclosure during takeovers.

According to Power (2000), corporate failure and scandals have necessitated the demand for reforms and for better regulations particularly on governance issues. In United Kingdom, a number of issues in the early 1990's notably the collapse of the Maxwell business empire stimulated discussions and debate about structures for controlling executive power. PriceWaterhouseCoopers (1997) states that companies that demonstrate good corporate governance have easier access to world's capital markets and boosts investors confidence.

Macey and O'ttara (2001) argues that a broader view of corporate governance should be adopted in banking institution. This is because of the peculiar contractual form that corporate governance mechanisms for banks seek to protect depositors and shareholders.

Thomson and Jain (2006) added by stating that a good working relationship between the board of directors, management and other stakeholders in a given bank would result in increased efficiency, throughput and profits.

In conclusion as pointed out by Bowen et al. (2004) ignoring corporate governance therefore can lead to doubtful inferences on firm's performance. This is concurrent with the remarks of Bain and Band (1996) who points out that companies and other enterprises with a professional and positive attitude to governance are stronger and have a greater record of achievement.

### **1.1.3 Internal Audit Independence and Corporate Governance**

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

Hermanson and Rittenberg (2003) states that the nature of internal audit activity today typically includes risk management, control governance and compliance work all of which map directly into corporate governance. Khas (1999) argues that the internal auditing functions as part of the corporate governance structure plays an increasingly

important role in monitoring the internal control system of the company and its financial reporting systems. Moreover, Kinfu (2006) notes that one of the strongest means to monitor ethics and governance in institutions can be through an internal audit function. These statements clearly indicate the contribution that internal audit function has towards enhancing effective and good corporate governance in commercial banks in Kenya.

Chapman and Anderson (2000) argues that the inclusion of assurance and consultancy in the definition of internal auditing results in internal auditing becoming a proactive consumer focused activity concerned with the important issues of control, risk management and governance. Hass and Burnaby (2006) further notes that organizations have encountered a rapid change in the economic complexity, expanded regulatory requirements and technological advancement. These changes have given internal audit function a set of expanded opportunities to support management provide services to other organizational functions and generate direct reporting links to the audit committee.

Ramamoorthi (2003) indicates that overtime there has been a massive shift in focus to one that promotes and supports effective organizational governance. Ruud (2003) further notes that in today's business environment the internal audit function has become a major support function for management, the audit committee, the board of directors and other stakeholders. Morgan (1979) consequently notes a significant opportunity for internal auditing has emerged to demonstrate its potential to add value and to break away from historical characteristic as organizational policemen and watchdog.

#### **1.1.4 Commercial Banks in Kenya**

Commercial banks in Kenya are licensed and regulated under the Banking Act Cap 488 and prudential regulations issued by the central bank of Kenya from time to time. As at 31<sup>st</sup> December 2012 there were 43 commercial banks in Kenya and 1 mortgage financial company. Out of the 44 institutions, 31 are locally owned and 13 foreign owned. The locally owned financial institution comprises 3 banks with significant government shareholding and 28 privately owned. The foreign owned financial institutions comprises of 9 locally incorporated foreign banks and 4 branches of foreign banks. 5 of the commercial banks in Kenya are listed in the NSE (Central Bank of Kenya, 2012).

Commercial banks play an important role in any economy since they offer support to financial solutions. In the last decade there has been a drastic change in the banking industry ranging from expanded regulations, technology advancement, stiff competition and the ever changing customer preference. Investment in more robust banking systems, agency banking, mobile and internet banking and cheque truncation are some of the new innovation facing the industry today. This has had a great impact in the banking industry since more and more people can access financial services and at the same time exposing the banks to cyber crimes. Further the licensing more foreign based banks and upgrading of microfinance institutions to take in deposits has introduced some turbulence within the industry as evidenced by stiff and rough competition for customers (CBK Bank Supervision, 2011).

Central Bank of Kenya (2012) issued new prudential guidelines and risk management guidelines which were to be effective in January 2013 applicable to all commercial banks in Kenya. These guidelines have introduced new measure which the management must comply with or face penalties. Kenya Law Reports (2012) clearly indicates that the government overtime has enacted new regulations which have their share of implications on commercial banks, for example the new Land Act and amendment to the Traffic Act introduces more stringent measures in relation to charging, transferring and disposal of land and motor vehicles yet these are the mostly preferred collaterals by banks. From the above it is evident that the banking industry in Kenya is under pressure from the environment and therefore this study tries to focus on how internal audit and corporate governance comes in.

## **1.2 Research Problem**

Corporate governance according to the Central Bank of Kenya involves the manner in which the business and affairs of an institution are governed by its board and senior management and provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the institution and its shareholders, facilitate effective monitoring and define how an institution sets corporate objectives, runs the day to day operations of the business and protects the interests of depositors and other creditors (Central Bank of Kenya, 2012).

Mwaura (2007) notes that in Kenya a number of problems relating to corporate governance have been identified, these problems range from errors, mistakes to outright fraud. The origin of the problem ranges from concentrated ownership, weak incentives, poor protection of minority shareholders, to weak information standards. BFID (2011) highlights that in 2011 fourth quarter alone a total of Kshs 137 Million was defrauded in Kenyan banks out of which Kshs 50 Million was through insider dealings. This begs the question as to whether the management had put in place effective monitoring mechanisms which includes setting up an effective, independent internal audit function.

The spotlight has only recently been placed on the independence of auditors and there is little in the literature as yet to suggest how they are responding to it (Brody and Lowe, 2000). Audit committees particularly those that include directors assist the internal auditors in this regard as their presence and involvement are seen to enhance auditor's independence (Spira and Page, 2003; Vanasco, 1996; Goodwin and Yeo, 2001). In order to be in a position to be 'heard' having an independent audit committee may help. Bariff (2003) underlines the way in which the internal audit function can maintain independence from management by noting the following quote from a PricewaterhouseCoopers report which states that internal audit department needs to ensure an organizational posture which allows them to operate successfully and concentrate on strategic issues. This means both the independence and mandate to deal with significant strategic business risks and issues. If inappropriately positioned within the company, internal audit deals with tactical issues and is viewed only at that level. In appropriate positioning can also raise serious concerns about the overall independence of the internal audit function.

A number of studies have been conducted in relation to corporate governance and Internal audit for example: Murithi (2011) studied the relationship between corporate governance practices and financial performance of investment banks in Kenya; Cherono (2011) looked at the impact of CMA corporate governance code on the financial performance of commercial banks in Kenya; Nyakoe (2010) studied the relationship between corporate governance and risk management practices among commercial banks in Kenya; Sigowo (2009) examined the role of internal audit in promoting good corporate governance in SACCO's and Murithi (2009) studied the role of internal auditor in enterprise wide risk management for listed companies in Kenya under Industrial and Allied Sectors. In Canada, Maigant and Zeghal (2000) looked at the motives, composition, selection and frequency of audit committee meeting, audit committee relationships with internal and external auditors and its broader role.

Though there are not many studies as far as the relationship between internal audit independence and corporate governance is concern, hence the empirical gap that the present study sought to bridge. Given the growing role of the internal audit in contemporary corporate governance, independence has gained renewed attention. The tension resulting from the pressure to provide value added services while maintaining independence prompts my research objective which is to analyze whether internal audit functions in practice are operating independently in line with theoretical best practice guidelines. This study thus sought to answer the following research question: what is the relationship between internal audit independence and corporate governance among commercial banks in Kenya?

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

The objectives of the study are:

- 1) To determine the independence of internal audit in commercial banks in Kenya.
- 2) To establish the relationship between internal audit independence and corporate governance among commercial banks in Kenya.

### **1.4 Value of the Study**

The study is of value to the following groups:

In theory, the study finding is important to scholars and researchers by adding to the body of existing knowledge on internal audit. The study also gives recommendation for further researchable areas which will be useful in furthering the understanding of internal audit function and corporate governance.

In practice, the study is of value to: the management who are able to appreciate the importance of an independent internal audit function in their organization; the internal auditors who through this study be in a position to appreciate their role in promoting good corporate governance in commercial bank and finally to the institute of internal auditors which is in a position to have more insight on how the internal audit function is executing its mandate in the banks. This informs on skills and knowledge gaps inherent within the function and hence provides workable solutions.

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

This chapter presents a review of the literature on the topic of internal audit function from previous studies and the gap to be closed by this study. The chapter is organized as follows: first a review of theories in relation to internal auditing. Then a review of the empirical studies and finally determine the relationship between variables that is internal audit independence and corporate governance.

### **2.2 Theoretical Framework**

The theories discussed here are agency theory and stewardship theory.

#### **2.2.1 Agency Theory**

Meckling and Jensen (1976) define agency relationship as a contract under which one or more person(s) (the principal) engages another person (agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. Watts and Zimmerman (1986) argues that agency theory in its purest form also assumes that individuals will take into account all available information, rationally and instantly, to make decisions. Assumptions of an efficient market can be relaxed to explain the importance of accounting practices and contracting services. In an imperfect market where principals cannot know everything at any one point in time, emphasizes the need to incur agency costs as a means of monitoring. This involves contracting accountants and auditors.

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

Sheret and Kent (1983) and Watts (1988) suggest that internal auditing is a bonding cost borne by agents to satisfy the principal’s demand for accountability made by external participants especially shareholders. The cost of internal auditing can be judged to be monitoring cost which is incurred by the principals to protect their economic interests. Agency theory contends that internal auditing like other intervention mechanism like financial reporting and external auditing helps to maintain cost efficient contracting between owners and managers.

Adam (1994) uses agency theory to mark the internal audit department as an important monitoring body that enables management to evaluate possible information asymmetry

between principal and agent. He assumes that management sees internal audit as a mechanism to supervise external auditors and control costs. Further he questions why some companies have internal audit while others don't and he assumes that more complex organizations are more likely to have it than the less complex. It is assumed that the more information asymmetry the greater the need for monitoring to reduce this information asymmetry resulting in a larger internal audit function. In a large internal audit function there will be more staff representing a more diverse range of skills and competences that will be able to reduce a greater range of information asymmetry problems. Further the scope of the internal audit function covered would be greater in a larger function than a small function. It is further assumed that a larger internal audit function has a broader scope of work and is able to cover more areas where information asymmetry exists. Carcello, Hermanson and Raghunandan (2005) asserts that this separation is considered as the basic principle behind the demand for corporate governance which forms the growing importance of internal audit monitoring role in contemporary corporate governance.

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

### **2.2.2 Stewardship Theory**

Stewardship theory has its roots from psychology and sociology and is defined by Davis, Schoorman and Donaldson (1997) as "a steward protects and maximizes shareholders wealth through firm performance, because by so doing, the steward's utility functions

are maximized". In this perspective, stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders. Unlike agency theory, stewardship theory stresses not on the perspective of individualism (Donaldson and Davis, 1991), but rather on the role of top management being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained.

Agyris (1973) argues that while agency theory looks at an employee or people as an economic being, which suppresses an individual's own aspirations, on the other hand Donaldson and Davis (1991) argues that stewardship theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust. It stresses on the position of employees or executives to act more autonomously so that the shareholders' returns are maximized. Indeed, Fama (1980) contend that executives and directors are also managing their careers in order to be seen as effective stewards of their organization, whilst, Shleifer and Vishny (1997) claims that managers return finance to investors to establish a good reputation so that that can re-enter the market for future finance.

Davis et al. (1997) and Tosi et al. (2003) notes that the involvement-oriented, participative management philosophy espoused by the stewardship theory automatically reduces the need for strict internal control mechanisms to curb governance challenges and agency costs, part of which is the involvement of internal audit in an organization.

Meckling and Jensen (1994) further states the cost incurred to curb agency problems (reducing information asymmetries and accompanying moral hazards) is less when owners directly participate in the management of the firm as there is a natural alignment of owner managers' interest with growth opportunities and risk. This alignment reduces their incentive to be opportunistic and hence owner managed firms have little to guard against the governance challenges.

It follows from the above that stewardship theory unlike agency theory is a complete contrast and doesn't emphasize on the need to incur monitoring or agency cost which includes establishing an internal audit function. Nevertheless Donaldson and Davis (1991) further notes that returns are improved by having both of these theories combined rather than separated which implies that management must strike a balance.

### **2.3 Internal Audit Independence and Corporate Governance**

From the review of literature above we have learnt the vital role of internal audit function in any organization corporate governance. This study therefore sought to extend further to find out whether an independent internal audit function guarantees indeed good corporate governance in commercial banks in Kenya. Institute of Internal Auditors (2011) defines independence as the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. Threats to independence must be managed at the individual auditor, engagement, functional and organizational levels.

Institute of Internal Auditors (2011) for organizational independence to be effectively achieved the chief audit executive reports functionally to the board. Examples of functional reporting to the board involve the board to: approving the internal audit charter; approving risk based internal audit plan; receiving communication from the CAE on the internal audit activities performance relative to the plan; and approving decision regarding the appointment and removal of the CAE. Internal auditors must have impartial, unbiased attitude and avoid any conflict of interest. If independence or objectivity is impaired in fact or appearance the details of the impairment must be disclosed to appropriate parties. The determination of appropriate parties to which he details of an impairment to independence or objectivity must be disclosed dependent upon the expectation of the internal audit activity's and the CAE's responsibilities to senior management and the board's as described in the internal audit charter.

Cohen et al. (2002) recognizes that management has a strong influence in setting the overall tone for governance. Claybrook (2004) argues that upper management has the broadest influence on stakeholders and that management influences operations as well as board of directors and even the audit function. Nagy and Cenker (2002) confirms this by noting that management and not internal auditors, ultimately determines the orientation of the internal audit functions. This is supported by Brody and Lowe (2002), who assert that the internal audit function sometimes is requested by management to assist it in advisory roles, such as in acquisitions, mergers and system development and implementation. Bou-Raad (2000) further supports this by suggesting that more can be

accomplished with the internal audit function by reviewing and providing advice to management regarding business objectives.

Sarens and Debeelde (2006) confirms that management requires the internal audit function to take on an extended role to compensate for loss of control resulting from increased organizational complexity. In addition their study results infer that internal auditors are expected to safeguard culture through personal contacts with people in the field. Drent (2002) notes that executive and line management by utilizing the internal audit function for these various extended roles do not always appreciate the need for independence. He further argues that in the minds of many executives and managers' internal auditors' work for them and that reporting to the audit committee merely is a formality to satisfy corporate governance requirements. It is in this area that the impairment of the internal audit function's independence poses a threat. Van Gansberghe (2005) suggests that this dilemma is expressed by the argument that the internal audit function must add value to management while at the same time not become its servant and faithfully report on the status to the board or some other equivalent governing body.

## **2.4 Empirical Studies**

Various studies have been carried out in the past focusing on the different aspects of internal audit and corporate governance in organization and they were very critical in guiding these study. Examples are:

Soh and Martinov (2009) aimed at finding out the relationship and interaction between the audit committee and the internal audit function. A qualitative approach using semi structured interviews was employed to investigate the perception of 6 audit committee chairs and 6 chief internal audit executives representing a number of industries from the top 150 Australia Stock Exchange listed companies and 1 large public sector entity. The results of the study suggested that there was a greater appreciation for the importance of mutual reliance and a strong relationship between the audit committee and the internal audit function. The quality of individuals in key roles within each function as well as personal attributes and values of members were also perceived to be critical for the effectiveness of each mechanism and in ensuring a strong functional relationship between both. Lastly the finding presented a level of diversity in the participation in and practice of performance evaluation of both the audit committee and internal audit function.

McGimpsey et al. (1992) set out to determine how internal audit is adapting in a changing management culture. They sampled 40 governments and private sectors organization in Canada and United States of America. Information was collected through interviews and review of documentary evidence. The results of the study were: audits are becoming more cost effective by being risk driven; for internal audit to be effective senior management must clearly signal to the rest of the organization its supports for internal audit; Internal audit practices was moving away from merely reporting control deficiencies to management and finally internal audit function had adapted technology to aid in continuous monitoring of the organization data online.

Ndimitu (2011) aimed at establishing the relationship between internal audit and effective management in Embu water and sanitation company ltd. Primary data was collected from staffs in the different levels as per the organization structure using a questionnaire and secondary data included cost of internal audit from the payment cash book and salaries journals. The data was analysed using SPSS tool and the following conclusion was noted: with commitment to integrity and accountability, internal auditing provides value to governing bodies and senior management as an objective source of independent advice. A fact that ensures proper processes are followed in generating and safeguarding the organization's wealth.

Murithi (2009) set out to survey the role of internal audit in enterprise risk management for quoted companies under the industrial and allied sector listed at the NSE. The sample comprised of all 18 listed companies under the Industrial and Allied Sectors with the NSE as at 31<sup>st</sup> December 2008. The data was collected through a questionnaire to the internal audit department and where the function was outsourced it was distributed to the outsourced consultant. Data analysis was through descriptive statistics. The conclusion was that the internal auditors were well aware of their core roles in risk management but it was further discovered internal audit function were spending a lot of time in risk management beyond their mandate due to lack of a specialized risk department in the organization.

Sigowo (2009) aimed at exploring the role of internal audit function in promoting good corporate governance in SACCO's. The sample comprised of 20 SACCO's operating

within Nairobi selected randomly. The population however was 4,200 SACCO's operating in Kenya. Data was analyzed using SPSS and the following conclusion were made: the independence of the audit function was guaranteed since there were audit committee at the Board level; the internal audit function spent around 36% of their time in doing corporate governance test, assessing internal controls, risk management and ensuring compliance and finally it was noted that internal audit function was being involved in pre-auditing tasks hence limiting their effectiveness.

## **2.5 Summary of the Literature Review**

From the theories highlighted in this chapter it is clear that the agency theory supports the concept of internal audit as a necessary function to check on corporate governance and top management on behalf of shareholders. However, the stewardship theory gives a different view that it is expected that top management be conversant with their roles and that they are good stewards in ensuring shareholder interests are met. From previous research studies it is clear that interrelationships between the management, audit committee and internal audit function connote the level of corporate governance in organizations. It is also noted that internal audit supports management in review of internal controls adequacy and risk management. The review also tackled the challenges within internal audit in promoting effective corporate governance for example inadequate reporting lines and tone at the top. It is therefore apparent from literature that the independence of internal audit in relation to commercial banks has not been studied in depth in the past. Hence this study seeks to bridge the gap and find out if internal audit functions are independent and if there is a relationship between internal audit independence and corporate governance among commercial banks in Kenya.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

This chapter sets to explain the research design, population of interest, sample size and sampling method, data collection and analysis method.

### **3.2 Research Design**

The research design was descriptive. Descriptive research is the process of collecting data in order to answer questions concerning the current status of the subject under study. Saunders et al. (2003) assert that a descriptive research portrays an accurate profile of persons, events or situations. Moreover, it explores the existing status of two or more variables at a given position in time and whether a relationship exists between them, hence the most suited for this study.

### **3.3 Population and Sample Size of the Study**

The population comprised of 43 commercial banks in Kenya as at 31<sup>st</sup> December 2012 (See **Appendix 3**) and therefore a census study was carried out due to the small size of the population.

### **3.4 Data Collection Methods**

Primary data was collected using semi structured questionnaire (See **Appendix 2**). The target respondent was internal audit managers in commercial banks in Kenya. The questionnaire was administered by drop and pick later method. The questionnaire had three parts: part one focused on general information about the bank and internal audit function, part two focused on independence of the internal audit function and part three

touched on the internal audit and corporate governance as per the governing regulations from CBK.

### 3.5 Data Analysis Techniques

The primary data obtained from the questionnaire was summarized and analyzed by the use of descriptive statistics such as proportions, percentages, means and frequency distributions tables. A regression model was used to analyze the relationship between internal audit independent and level of corporate governance within commercial banks within a test of significance of 95% confidence level as follows;

$$Y = \beta_0 + \beta_1 X + \varepsilon$$

$\beta_0$  = is the independent variable representing the autonomous part of the model.

$\beta_1$  = is the coefficient of the independent variable.

$\varepsilon$  = is the error term representing all factor not captured in the analytical model.

$Y$  = Represents the dependent variable that measure level of corporate governance.

This was determined for each individual bank by evaluating its main board and the audit board committee on the following parameters using the regression model below.

$$Y = \sum_{n=1}^{22} (t_n) + \varepsilon$$

$\varepsilon$  = is the error term representing all factor not captured in the analytical model.

- t<sub>1</sub>** = There is no shareholder with more than 5% stake forms part of executive directorship or is a senior management;
- t<sub>2</sub>** = The main board at least constitutes not less than 5 members;
- t<sub>3</sub>** = The number of non executive directors is at least three fifth;
- t<sub>4</sub>** = The board chairman is a non executive director;
- t<sub>5</sub>** = CBK approvals are sought before the board of directors assumes office;
- t<sub>6</sub>** = The board meets at least four times in a financial year;
- t<sub>7</sub>** = Every member of the board attends at least three fifth of the board meeting in a financial year;
- t<sub>8</sub>** = The board approves the strategic plan of the bank;
- t<sub>9</sub>** = The board has established an independent board audit committee;
- t<sub>10</sub>** = The chairman of the audit committee is a non executive director;
- t<sub>11</sub>** = The board has set up an effective internal audit department;
- t<sub>12</sub>** = The board has set up an independent compliance function;
- t<sub>13</sub>** = The board reviews the compliance policy to check for variances;
- t<sub>14</sub>** = The board maintains adequate capital base in line with the various guidelines;
- t<sub>15</sub>** = The board reviews the various audit reports and CBK inspection report;
- t<sub>16</sub>** = The board appoints, dismisses and defines the duties of senior management;
- t<sub>17</sub>** = The directors are informed on a regular basis the performance of the bank;

$t_{18}$  = The directors carry out regular review to assess its effectiveness;

$t_{19}$  = The board has set up a credit committee to oversee lending process;

$t_{20}$  = The board has set up ALCO committee to oversee the mix of assets and liabilities of the bank;

$t_{21}$  = The board has established and risk management committee to ensure quality, integrity and reliability of the risk management process;

$t_{22}$  = The chief finance officer (head of finance) and the chief audit executive (head of audit) are members of ICPAK.

$X$  = represents Independent variable that measure the independence of the internal audit function. This was determined for each individual bank by evaluating its key processes within the internal audit function using the regression model below.

$$X = \sum_{n=1}^8 (g_n) + \varepsilon$$

$\varepsilon$  = is the error term representing all factor not captured in the analytical model.

$g_1$  = The internal audit charter is approved by the audit board committee;

$g_2$  = The salary/compensation of the head of audit is determined by the audit board committee;

$g_3$  = The audit board committee has the full mandate to hire and fire the head of audit;

**g<sub>4</sub>** = The annual internal audit budget is approved by the chief executive officer;

**g<sub>5</sub>** = The annual internal audit plan is approved by the audit board committee;

**g<sub>6</sub>** = The internal audit function reports functionally to the audit board committee;

**g<sub>7</sub>** = The internal audit function reports administratively to the chief executive officer;

**g<sub>8</sub>** = The internal audit function annual progress review is done by the audit board committee.

Finally the degree of relationship between the two variables that is internal audit independence (X) and level of corporate governance (Y) was established by calculating the correlation coefficient (r).

## **CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION**

### **4.1 Introduction**

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

### **4.2 Sample Characteristic**

The study required the respondents to state their job title within the internal audit functions. According to the findings 65% of the respondents were Head of Department, 24% were Senior Managers within the internal audit function and 11% were Internal Audit Officers. This has been summarized in table 4.1 below.

**Table 4.1: Position Held by the Respondents within Internal Audit Function**

	<b>Frequency</b>	<b>Percent</b>
<b>Head of Department</b>	22	65
<b>Senior Manager</b>	8	24
<b>Audit Officer</b>	4	11
	<b>34</b>	<b>100</b>

Source: Analyzed Questionnaire.

The study sought to establish whether the majority shareholders for the various commercial banks in Kenya were either locals or foreigners. The finding was that out of the 34 respondents 74% of the banks were locally owned while 26% of the banks were foreign owned as shown by table 4.2 below.

**Table 4.2: Majority Shareholder in various Commercial Banks in Kenya**

	<b>Frequency</b>	<b>Percent</b>
<b>Locally Owned</b>	25	74
<b>Foreign Owned</b>	9	26
	<b>34</b>	<b>100</b>

Source: Analyzed Questionnaire

The respondents were also required to indicate the number of years that they had worked within the internal audit function. From the study the period worked ranged between two year and 15 years. This implied that the respondents were well versed with the internal audit activities and functions. This has been further analyzed in table 4.3 below.

**Table 4.3: Number of Years worked within the Internal Audit Function**

<b>Years Worked</b>	<b>Frequency</b>	<b>Percent</b>
<b>0 – 2</b>	5	15
<b>3 – 5</b>	9	26
<b>Above 5 Years</b>	20	59
	<b>34</b>	<b>100</b>

Source: Analyzed Questionnaire

The study also found out that the number of branches ranged from a minimum of 3 to a maximum of 177. To further determine if there was any relationship between the number of internal audit staff and the number of branches the bank had, the Pearson Correlation/ Correlation Coefficient ( $r$ ) was computed between the two variables. The value of ( $r$ ) which always lies between -1 and +1 is interpreted as follows; if the value of ( $r$ ) is close to -1 then the relationship is negative (inverse relationship), if the value of ( $r$ ) is close to +1 then the relationships is positive (direct relationship), if the value of ( $r$ ) is 0

then it means that there is a random, nonlinear relationship between the two variables. With this in mind therefore an analysis was done between number of internal audit staff and number of branches using the SPSS data analysis tool and the value of ( $r$ ) was found to be 0.956. It's therefore follows that there is a strong linear positive relationship between the two variables. This is as shown in table 4.4 below.

**Table 4.4: Relationship between Number of Audit Staff and Number of Branches.**

		<b>Number of Staff in Audit</b>	<b>Number of Branches</b>
<b>Number of Staff in Audit</b>	Pearson Correlation	1	0.956**
	Sig. (2-tailed)		.000
	N	34	34
<b>Number of Branches</b>	Pearson Correlation	0.956**	1
	Sig. (2-tailed)	.000	
	N	34	34
**. Correlation is significant at the 0.05 level (2-tailed).			

Source: Analyzed Questionnaire

In terms of bank size with reverence to shareholders equity it was found out that 38% of banks had a shareholder equity that was below Kshs 2 Billion and 62% of the banks had shareholders equity above Kshs 2 Billion as shown in table 4.5 below.

**Table 4.5: Size of the Banks with reverence to Shareholders Equity**

	<b>Frequency</b>	<b>Percent</b>
<b>Below 2 Billion</b>	13	38
<b>2 Billion and Above</b>	23	62
	<b>34</b>	<b>100</b>

Source: Analyzed Questionnaire

### 4.3 Independence of Internal Audit Function

The respondents were asked to state whether it was common for internal auditors to move to other functions within the bank. It was found out that 21% of the responded indicated that this was common. This means that most of the banks surveyed 79% don't move internal auditors to other functions within the bank. Further the respondents were asked if they had an internal audit charter and 85% of the respondents confirmed that they had an audit charter in place. These results are summarized and presented in table 4.6 below.

**Table 4.6: Movement of Auditors and Presence of Audit Charter**

	<b>Frequency</b>	<b>Percent</b>
<b>Movement of Internal Auditors to other functions</b>	7	21%
<b>Internal Audit functions with an Audit Charter</b>	29	85%

Source: Analyzed Questionnaire

The respondents were asked to state where the internal audit reports functionally. The results showed that internal audit function in all the banks reported functionally to the audit committee. The result also showed that all the internal audit function reported administratively to the chief executive officer (CEO). It was also noted that as regards setting of compensation for the head of internal audit this was done by the Audit Board Committee in 24% of the banks; 65% by the CEO while 11% of the banks this function was carried out by other functions that is the Chief Finance Officer and Human Resources. These results are summarized in table 4.7 below.

**Table 4.7: Responsibility to Compensate Head of Audit**

	<b>Frequency</b>	<b>Percent</b>
<b>Audit Board Committee</b>	8	24
<b>Chief Executive Officer</b>	22	65
<b>Chief Finance Officer</b>	2	5.5
<b>Human Resources</b>	2	5.5
	<b>34</b>	<b>100</b>

Source: Analyzed Questionnaire

The study found out that on who hires and fires the head of internal audit in commercial banks in Kenya it was the responsibility of the audit board committee in 38% of the banks and in 62% of the banks it was done by the CEO. Thus in most of the banks the CEOs can hire and fire the head of audit. These results are analyzed in table 4.8 below.

**Table 4.8: Responsibility to Hire and Fire Head of Audit**

	<b>Frequency</b>	<b>Percent</b>
<b>Audit Board Committee</b>	13	38
<b>Chief Executive Officer</b>	21	62
	<b>34</b>	<b>100</b>

Source: Analyzed Questionnaire

The study found out that the responsibility to approve internal audit charter lied with the audit board committee in commercial banks. Further the annual audit plan and the review of internal audit activities was the responsibility of the audit board committee. In addition the study found out that the approval of the internal audit budget was done by the CEO in 59% of the banks; 26% by audit board committee while in 15% of the banks it was been done by the chief finance officer. This shows that the CEO's were

responsible for approving internal audit function budget in most of the banks. This is summarized in table 4.9 below.

**Table 4.9: Responsibility to Approval of Internal Audit Budget**

	<b>Frequency</b>	<b>Percent</b>
<b>Audit Board Committee</b>	9	26
<b>Chief Executive Officer</b>	20	59
<b>Chief Finance Officer</b>	5	15
	<b>34</b>	<b>100</b>

Source: Analyzed Questionnaire

#### **4.4 Corporate Governance**

The study found that in all the banks there was no situation where a shareholder with more than 5% shareholding was participating fully in the day to day running of the bank. It was also noted that the main board in all the banks constituted at least 5 members with all their chairpersons been non executive directors and three fifth of the members been non executive directors. Further it was noted that the board assumes office after the Central Banks of Kenya gives an approval acknowledging their appointments.

It was also noted that the main board had put in place an audit board committee with a non executive chairman and an internal audit function in all the banks. Further the study found out that the main board meets at least four times in a financial year with every board member attending at least 75% of the scheduled meeting within a financial year. The study also revealed that in 71% of the banks the board had put in place a

compliance function while in 88% of the banks they had put in place and Asset and Liabilities board Committees (ALCO). This is summarized in the table 4.10 below.

**Table 4.10: Proportion of Banks with Compliance Function and ALCO Board Committee**

	<b>Frequency</b>	<b>Percent</b>
<b>Number of Banks with Compliance Function</b>	24	71%
<b>Number of Banks with an ALCO board Committees</b>	30	88%

Source: Analyzed Questionnaire

The study also found out that the role of approving the bank’s strategic plan was the responsibility of the main board in all commercial banks in Kenya. Further it was found out that it was only in 29% of the banks where the board was conducting a board review aimed at assess skills mix, experience and other qualities. This implied that the main board skill evaluations and performance appraisal was not common in commercial banks.

It was also noted that in all the banks the main board was very keen to maintain capital base in line with the Banking Act, review Central Banks Inspection reports and audit reports and provide a way forward and they are always informed on the banks performance and business condition. The study found out the main board reviewed regularly the compliance policy in an effort to assess the management of risk only in 76% of the banks in Kenya. On the other hand the responsibility to appoint, dismiss and define the duties of senior management rested with the mains board in 85% of the banks.

The study also found out that the in all the banks the chief audit executive and chief finance officer were both members of the ICPAK. Further the board had established a credit committee to aid in review of the quality of the loan book but it was only in 76% of the banks where the board had established a risk management board committee meant to ensure quality and integrity of risk management process.

#### **4.5 Relationship between Internal Audit independence and Corporate Governance.**

The study sought to establish the relationship between internal audit independence and corporate. The results of this analysis are as follows.

##### **4.5.1 Pearson Correlation**

Pearson Correlation/ Correlation Coefficient ( $r$ ) measure how well the regression equation truly represents the set of data. The quantity  $r$ , called the linear correlation coefficient, measures the strength and the direction of a linear relationship between two variables. The value of  $r$  is such that  $-1 \leq r \leq +1$ . The + and – signs are used for positive linear correlations and negative linear correlations, respectively. Positive correlation: If  $x$  and  $y$  have a strong positive linear correlation,  $r$  is close to +1. An  $r$  value of exactly +1 indicates a perfect positive fit. Positive values indicate a relationship between  $x$  and  $y$  variables such that as values for  $x$  increase, values for  $y$  also increase. Negative correlation: If  $x$  and  $y$  have a strong negative linear correlation,  $r$  is close to -1. An  $r$  value of exactly -1 indicates a perfect negative fit. Negative values indicate a relationship between  $x$  and  $y$  such that as values for  $x$  increase, values for  $y$  decrease. No correlation: If there is no linear correlation or a weak linear correlation,  $r$  is close to

0. A value near zero means that there is a random, nonlinear relationship between the two variables.

A computation of the correlation coefficient  $r$  was therefore done between internal audit independence and corporate governance and was found to be 0.603. This meant that the relationship is positive since the value of  $r$  is close to +1. These results are detailed in the table 4.11 below.

**Table 4.11: Relationship between Internal Audit Independence and Corporate Governance.**

		<b>Internal Audit Independence</b>	<b>Corporate Governance</b>
<b>Internal Audit Independence</b>	Pearson Correlation	1	0.603**
	Sig. (2-tailed)		.000
	N	34	34
<b>Corporate Governance</b>	Pearson Correlation	0.603**	1
	Sig. (2-tailed)	.000	
	N	34	34
**. Correlation is significant at the 0.05 level (2-tailed).			

Source: Analyzed Questionnaire

Coefficient of determination,  $r^2$  was further computed since its gives the proportion of the variance (fluctuation) of one variable that is predictable from the other variable. It is a measure that allows one to determine how certain one can be in making predictions from a certain model/graph. The coefficient of determination is the ratio of the explained variation to the total variation. The coefficient of determination is such that  $0 \leq r^2 \leq 1$ , and denotes the strength of the linear association between  $x$  and  $y$ . The coefficient of determination represents the percent of the data that is the closest to the line of best

fit. This was found out as  $r = 0.603$ , then  $r^2 = 0.364$ , which meant that 36.4% of the total variation in  $y$  corporate governance could be explained by the linear relationship between  $x$  internal audit independence and  $y$  corporate governance. The other 63.6% of the total variation in  $y$  corporate governance is explained by other factors which were not part of this study.

#### 4.5.2 Model Summary and Testing the Significance of Regression Coefficient

At 95% confidence level that is at 5% level of significance and sample data of 34 banks the results of individual bank in relation to internal audit independence and corporate governance was analyzed using SPSS data analysis tool and the constant coefficient for the regression model that is

$$Y = \beta_0 + \beta_1 X + \varepsilon$$

were obtained as detailed in table 4.12 below

**Table 4.12: Coefficient of the Regression Analysis**

Coefficients						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig. (p-value)
		B	Std. Error	Beta		
1	(Constant)	16.887	0.734		22.992	.000
	Internal Audit Independence	0.532	0.124	0.603	4.280	.000

a. Dependent Variable: Corporate governance

Source: Analyzed Questionnaire

Where  $\beta_0 = 16.887$  and  $\beta_1 = 0.532$

The results above were based on a sample since not all banks responded it was therefore important to generalize the results to the population. Therefore the intercept  $B_0$  and coefficient of independent variable  $B_1$  were tested for significance with an aim to find out if the relationship found actually exist in the population or is the result due to sampling error. The specific test used was a t-test to test if  $B_1$  is different from 0. Since  $B_1$  would be the slope of the regression line in the population, it makes sense to test to see if it is different from zero. If it is zero, then the slope is 0, meaning if the relationship graphed between X and Y then one would end up with a horizontal (flat) line. This means there is no linear relationship between the two variables. This also means that the regression line calculated is useless in explaining or predicting the dependent variable. The test is as follows;

Hypotheses:  $H_0: B_1 = 0$ ,  $H_1: B_1 \neq 0$

Critical value: A t-value based on n-2 degrees of freedom (df). Also divide alpha which is  $\alpha = 0.05$  by 2 because it is a 2-tailed test. In this case  $n = 34$  (34 banks) thus  $n-2 = 32$ .

With  $\alpha = 0.05$  we have  $\alpha/2 = 0.025$ . Therefore the t- critical value from t-distribution table was  $t = 2.042$ .

Calculated Value of t: This is from the results of SPSS table 12 above was  $t = 4.280$ .

The comparison of the two values of t gave the following results:  $t\text{-calculated} > t\text{-critical}$  i.e.  $4.280 > 2.042$  and thus reject  $H_0$ . This meant that the slope for the regression model

was significant and hence the coefficient for independent variable could be used to predict the value of Y that is corporate governance.

This same test is significance was repeated for the  $B_0$  to test the significance of the y-intercept of the regression model as follows;

Hypotheses:  $H_0: B_0 = 0$ ,  $H_1: B_0 \neq 0$

Critical value: A t-value based on n-2 degrees of freedom. Also divide alpha which is  $\alpha = 0.05$  by 2 because it is a 2-tailed test. In this case  $n = 34$  (34 banks) thus  $n-2 = 32$ . With  $\alpha = 0.05$  we have  $\alpha/2 = 0.025$ . Therefore the t- critical value from t-distribution table was  $t = 2.042$ .

Calculated Value of t: This is from the results of SPSS table 12 above was  $t = 22.992$ .

The comparison of the two values of t gave the following results:  $t\text{-calculated} > t\text{-critical}$  and thus reject  $H_0$ . This meant that the intercept was significant in the regression model.

Thus the regression model is as follows;

$$Y = 16.887 + 0.532X$$

#### **4.5.3 Testing the Significance of the Regression Line**

Using the data collected, the ANOVA table was constructed to determine whether there was a regression relationship between corporate governance (Y) and internal audit independence (X). This is as shown in table 4.13 below.

**Table 4.13: Significance Test of the Regression Line**

ANOVA <sup>a</sup>						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	18.886	1	18.886	18.316	.000 <sup>b</sup>
	Residual	32.996	32	1.031		
	Total	51.882	33			
a. Dependent Variable: Corporate governance						
b. Predictors: (Constant), Internal Audit Independence						

Source: Analyzed Questionnaire

This analysis was conducted using the F – Test where the F – calculated obtained from the table 13 above is compared to the F – critical from the F- distribution tables as follows;

Hypotheses:  $H_0$ : There is no significant regression relationship, i.e.  $B_1 = 0$ .

$H_1$ : There is a significant regression relationship, i.e.  $B_1 \neq 0$ .

Critical F-Value:  $F(\text{numerator. df, denominator. df}) = F(1, 32)$  at  $\alpha = 0.05 = 4.1709$

Calculated F-Value: from the ANOVA table above = 18.316

Compare: F-calculated larger than F-critical thus reject the  $H_0$

Conclusion: There is a regression (linear) relationship between corporate governance and internal audit independence. This further implies that at 95% confidence level it is possible to predict a level of corporate governance with a given level of internal audit independence. Hence the model fits the purposes.

#### 4.5.4 Comparison between Foreign Owned Banks and Locally Owned Banks.

A further analysis was conducted between the locally owned banks and foreign owned banks to determine how different is internal audit independence and corporate governance in the two set up. The results are analyzed in tables 4.14 and 4.15 below.

**Table 4.14: A Statistical Analysis on Banks Ownership**

Group Statistics					
	Who are Major Share Holders	N	Mean	Std. Deviation	Std. Error Mean
Internal Audit Independence	Foreign	9	5.1111	1.26930	0.42310
	Local	25	5.9600	1.42829	0.28566
Corporate Governance	Foreign	9	19.5556	1.13039	0.37680
	Local	25	20.0800	1.28841	0.25768

Source: Analyzed Questionnaire

**Table 4.15: Independent Samples Test between Locally Owned Banks and Foreign Owned Banks.**

		t-test for Equality of Means						
		t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
							Lower	Upper
Internal Audit Independence	Equal variances assumed	-1.571	32	0.126	-0.84889	0.54043	-1.94971	0.25193
	Equal variances not assumed	-1.663	15.857	0.116	-0.84889	0.51050	-1.93190	0.23412

Corporate Governance	Equal variances assumed	-1.079	32	0.289	-0.52444	0.48621	-1.51483	0.46594
	Equal variances not assumed	-1.149	16.062	0.267	-0.52444	0.45648	-1.49184	0.44295

Source: Analyzed Questionnaire

The independent-samples t-test (or independent t-test) compares the means between two unrelated groups on the same continuous, dependent variable. In this study a comparison between internal audit independence mean and corporate governance mean for locally owned banks and foreign owned banks was determine to find out if there was any statistical significant difference.

It is expected that if the Sig (2-Tailed) value is greater than 0.05 then one can conclude that there is no statistically significant difference between the two conditions. Then if the Sig (2-Tailed) value is less than or equal to 0.05 one can conclude that there is a statistically significant difference between the two conditions.

Hence in view of that for internal audit independence the value of Sig (2-Tailed) as read from table 4.15 above was 0.126 which was greater than 0.05. This implied that there was no statistical significant difference between the means for locally owned bank and foreign owned banks as far as internal audit independence is concern. In conclusion there is no difference between independence of internal audit function in locally owned banks and foreign owned banks.

Further in relation to corporate governance the value of Sig (2-Tailed) as read from table 4.15 above was 0.289 which was greater than 0.05. Hence there was no statistical significant difference between the means for locally owned bank and foreign owned banks as far as levels of corporate governance are concern. In conclusion there is no difference between the levels of corporate governance in locally owned banks and foreign owned banks.

#### **4.5.5 Relationship between Shareholder Equity (Size) and Corporate Governance.**

The study also sought to find out if there was any statistical relationship between the shareholders equity (size of the bank) and levels of corporate governance. However, from the literature review it was very clear that CBK set guidelines for all banks and on a regular basis they visit the institutions to assess if they are in conformance with the laid down guidelines on corporate governance. An analysis between the two variables was done and the correlation coefficient ( $r$ ) was found to be 0.046 between the two variables as shown in table 4.16 below. This meant that since the value of ( $r$ ) was close to zero  $r \approx 0$  then there was a random, nonlinear relationship between the two variables. Hence in conclusion the size of the bank is not related to the way the banks are governed. This is well in line with the literature review where corporate governance among commercial banks is CBK business. This is detailed in table 4.16 below.

**Table 4.16: Correlation Coefficient between Shareholders Equity (Size) and Corporate Governance.**

		Corporate Governance	Shareholder Equity (Capital)
Corporate Governance	Pearson Correlation	1	0.046
	Sig. (2-tailed)		0.796
	N	34	34
Shareholder Equity (Capital)	Pearson Correlation	0.046	1
	Sig. (2-tailed)	0.796	
	N	34	34

\*\* . Correlation is significant at the 0.05 level (2-tailed).

Source: Analyzed Questionnaire

#### **4.6 Summary and Discussion**

The study found out that the internal auditors in all the banks functionally reported to the audit board committee and administratively to the CEO. This was consistent with the recommendation of the institute of internal auditors. Christopher, Serans & Leugn (2009) in a study in Australia had found that with respect to the relationship with the audit committee significant threats identified included chief audit executive not reporting functionally to the audit committee.

The study found that it was not common practice in 79% of the banks for internal auditors to move to other functions within the bank. This was not consistent with Goodwin and Yeo (2001) who found out that the internal audit function was been used as management training ground was widespread in Singapore.

The study found that responsibility to approve internal audit function budget rested on the CEO in 59% of the banks. This was very consistent with the Christopher, Serans & Leugn (2009) who analyzed the independence of the internal audit function through its relationship with management and audit committee in Australia found that having the CEO and CFO approve the internal audit function budget was one of the threats to independence. Further the salary/ compensation of the head of internal audit was in 65% of the banks done by the CEO. This was inconsistent with the IIA guidelines and was big threat to independence of the internal audit function.

The study further found out the main board skill review and assessment of its effectiveness was been done in 29% of the banks. This meant that the performance of many board functions was not been assessed which was a big threat to corporate governance and in contravention with the central bank prudential guidelines.

The study also found out that there was a strong relationship between internal audit independence and corporate governance among commercial banks in Kenya. It was further found out that 36% variation in levels of corporate governance can be explained by internal audit independence. The study found out there was no statistical between locally owned banks and foreign owned banks as far as internal audit independence and corporate governance. Further the number of internal audit staff was directly related to the number of branches the bank had.

## **CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATION**

### **5.1 Introduction**

This chapter presents the summary of the study, discussions, conclusions and recommendation. This chapter also presents suggestions for further studies.

### **5.2 Summary of Findings**

The study found that the internal auditors in all the banks functionally reports to the audit board committee and administratively they report to the CEO. The study also found out that in 15% of the banks the internal audit didn't have an audit charter in place. The study also found that the salary for the head of internal audit was been determined by the CEO in 65% of the banks which was threat to audit independence.

The study found that the responsibility to approve the internal audit function budget rested on the CEO in 59% of the banks. In addition the responsibility to hire and fire the head of internal audit was done by the CEO in 65% of the banks. The study further found that it was not common in 71% of the banks in Kenya for the main board to conduct a performance appraisal, skills analysis and experience checks. The study also found that the main board had put in place a compliance function in 71% of the banks and an asset and liabilities board committee in 88% of the banks.

The regression results showed internal audit independence influenced 36.4% of the variance in corporate governance as shown by the coefficient of determination  $R^2$ . The

analysis of the regression constants that is  $B_0$  and  $B_1$  found out the there exist a linear relationship between corporate governance and internal audit independence. Further it was found out the there was no significant statistical difference between locally owned banks and foreign owned banks as far as internal audit independence and corporate governance is concern. The study also found out there was a direct positive relationship between the number of auditors a bank had and the number of branches.

### **5.3 Conclusion and Recommendation**

The study concludes that there is threat to internal audit independence in some commercial banks. For instance: where the heads of internal audit are hired and fired by the CEO, their salaries been determined by the CEO and the approval of the audit budget is being done by the CEO.

The study concludes that the main board hardly reviews their performance and skills in commercial banks. The main board on the other hand has formed several board committees like the audit board committee, the ALCO committee and the risk management committee as per the CBK guidelines.

The study concludes that there is no difference between locally owned banks and foreign owned banks in relations to internal audit independence and corporate governance. There is a positive relationship between internal audit independence and corporate governance in banks and that internal audit is a vital component of good governance.

Consequently, there is an urgent need to create sufficient awareness on these issues; this should be championed by the regulators, the accounting and auditing professional if there is to be greater understanding of the importance of a strong audit board committee and strengthening the independence of the auditors. Further there is need to create awareness among the board members on the need to conduct performance reviews, sharpen their skills through training and workshops and peer to peer review with other board members from other banks. That way governance among commercial banks would be enhanced and audit independence guarantee as well.

#### **5.4 Limitation of the Study**

As with most empirical studies this researches is not perfect and has various limitations therefore findings from the study should be used with caution to the extent of the following limitations.

The study target was a census of all the 43 commercial banks but only 34 responses were received. Therefore the sample size in this study may be adjusted to be small. To this extent the results may suffer from small sample bias.

The study was essentially a cross sectional study that examines a phenomenon at a particular point in time. This may not give a complete picture of the phenomenon studied. Thus a longitudinal study would have better captured the changes in the investigated phenomena over a long period of time.

The study relied on a questionnaire to collect data and therefore I relied wholly on the feedback the respondents gave. It was difficult to verify how objective the respondent was while completing the questionnaire. Hence the data collected was assumed to be free and fair and it was a true representation of what was on the ground.

The study focused on commercial banks in Kenya. The results may not be applicable to other firms in other sectors of the economy such as manufacturing among others.

### **5.5 Suggestion for Further Research**

A similar study can be carried out this time focus been microfinance institutions and find out how different the findings would be. A similar study should be conducted examining the relationship using a longitudinal basis and using a panel data approach to capture other omitted variables that matter in the relationship. A future study can be carried out to find out the relationship between the experience, skills and qualification level of board members and the performance of the bank.

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## Appendices

### Appendix 1: Reference Letter



# UNIVERSITY OF NAIROBI

## SCHOOL OF BUSINESS

### MBA PROGRAMME

Telephone: 020-2059162  
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P.O. Box 30197  
Nairobi, Kenya

DATE...10/06/2013

#### TO WHOM IT MAY CONCERN

The bearer of this letter ...EDWIN MURITHI NJERU.....

Registration No. ...D61/67265/2011.....

is a bona fide continuing student in the Master of Business Administration (MBA) degree program in this University.

He/she is required to submit as part of his/her coursework assessment a research project report on a management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate your assistance to enable him/her collect data in your organization.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.

**PATRICK NYABUTO**  
**FOR: MBA CO-ORDINATOR**  
**SCHOOL OF BUSINESS**





## Part 2 Independence of Internal Audit Function

Please put a tick [√] where applicable to indicate your answer. These statements are in line with the IIA standards in relations to internal audit independence.

	<b>Questions</b>	<b>Audit Board Committee</b>	<b>Chief Executive Officer</b>	<b>Chief Finance Officer</b>	<b>Others (Specify)</b>
11.	Who approves the internal audit charter?				
12.	Who determines the compensation/ salary of the head of internal audit?				
13.	Who hires and fires the head of internal audit?				
14.	Who approves the internal audit budget?				
15.	Who approves the internal audit annual plan?				
16.	To whom does the head of internal audit report functionally?				
17.	To whom does the head of internal audit report administratively?				
18.	Who reviews the annual progress of the audit activities in relation to the plan?				

### Part 3: Corporate Governance

Kindly tick [√] the appropriate box as to whether you agree or not with the statement below in relation to your bank.

	Questions	Responses	
		Yes	No
19.	Do shareholders with more than 5% stake in the bank form part of executive directorship or senior management?		
20.	Does your board constitute at least 5 members?		
21.	Are the non executive directors in the board at least three-fifth of the board composition?		
22.	Is the chairman of the board a non executive director?		
23.	Do directors always assume office after Central Bank of Kenya approval is obtained?		
24.	Does the board meet at least four times in a financial year?		
25.	Do all member of the board attend at least 75% of the board meetings in a financial year?		
26.	Is the strategic plan always approved by the board?		
27.	Has the board established an Audit Board Committee?		
28.	Is the chairman of the Audit Board Committee a non executive director?		
29.	Has the board put in place an effective internal audit department staffed with qualified personnel?		
30.	Has the board put in place an independent compliance function?		
31.	Does the board regularly review the bank's compliance policy to assess the extent to which it's managing compliance risk?		
32.	Does the board always maintain an adequate capital base with respect to the requirements of the Banking Act and business operations?		

33.	Does the board review the Central Bank inspection report and audit reports and advice on the way forward?		
34.	Is it the responsibility of the board of directors to appoint, dismiss and define the duties of senior management?		
35.	Are the directors informed on a regular basis on the business condition of the bank?		
36.	Does the board regularly review its required mix of skill and experience and other qualities to assess its effectiveness?		
37.	Has the board established a Credit Committee whose main purpose is to oversee the lending policy of the bank?		
38.	Has the board established an Asset and Liabilities Committee (ALCO) to assess the mix of assets and liabilities of the bank?		
39.	Has the board established a Risk Management Committee to ensure quality, integrity and reliability of the bank's risk management process?		
40.	Are both the Chief Finance Officer and Chief Audit Executive members of ICPAK?		

**Thank you for participating in the survey.**

### **Appendix 3: List of Commercial Banks in Kenya**

1. ABC Bank
2. Bank of Africa
3. Bank of Baroda
4. Bank of India
5. Barclays Bank of Kenya
6. CFC Stanbic Bank
7. Chase Bank
8. Citibank
9. Co-operative Bank of Kenya
10. Commercial Bank of Africa
11. Consolidated Bank
12. Credit Bank
13. Development Bank of Kenya
14. Diamond Trust Bank
15. Dubai Bank
16. Ecobank
17. Equatorial Commercial Bank
18. Equity Bank
19. Family Bank
20. Fidelity Commercial Bank
21. Fina Bank
22. First Community Bank

23. Giro Commercial Bank
24. Guardian Bank
25. Gulf African Bank
26. Habib A.G. Zurich
27. Habib Bank Ltd
28. Housing Finance Corporation of Kenya
29. Investment & Mortgage Bank
30. Imperial Bank
31. Jamii Bora
32. K-Rep Bank
33. Kenya Commercial Bank
34. Middle East Bank
35. National Bank of Kenya
36. NIC Bank
37. Oriental Commercial Bank
38. Paramount Bank
39. Prime Bank
40. Standard Chartered Bank
41. Trans-National Bank
42. UBA Kenya Ltd
43. Victoria Commercial Bank