THE RELATIONSHIP BETWEEN INTERNAL AUDIT FUNCTION AND THE CORPORATE GOVERNANCE OF DEPOSIT TAKING MICROFINANCE INSTITUTIONS IN KENYA

BY
MARTIN EVERLYN MUTAVE
D63/80284/2012

A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF MASTER OF SCIENCE IN FINANCE DEGREE, BY THE UNIVERSITY OF NAIROBI

OCTOBER 2014
DECLARATION

I declare that this project is my original work and has not been presented in any other university or institution for academic credit.

Signature: ________________________ Date: ________________________

Everlyn Mutave Martin
Reg. No.: D63/80284/2012

The research project has been submitted for examination with my approval as the University Supervisor.

Signature: ________________________ Date: ________________________

Mr. Abdulatif Essajee
Department of Finance and Accounting
School of Business
University of Nairobi
ACKNOWLEDGEMENT

I am very grateful to the Almighty God for giving me strength and the gift of life to go through this demanding but rewarding exercise. The completion of this study was realized through the will of God and the contribution and support of many people who wholeheartedly supported me. Special thanks go to my supervisor, Mr. Abdulatif Essajee, who patiently and selflessly guided me throughout the entire process and assisted me with some very relevant guidance that helped kick start the project. Many thanks to my colleagues and classmates, who assisted me, encouraged me and supported me morally during the entire study period. They made me believe I can. I also thank all the Heads of Internal Audit in the Deposit Taking Microfinance institutions who spent their time to respond to my questionnaire I would not have been able to reach this far without their dedication. Finally am thankful to my family for their encouragement, support and understanding during the entire period I was enrolled for this programme.

May God bless you all!
DEDICATION

To the current and future leaders of microfinance institutions in Kenya as they continue improving lives through financial inclusion.
ABSTRACT

Every industry and organization should aspire to have a good corporate governance image that enhances the reputation of the industry and or organization making it attractive to customers, investors, suppliers, contributors or donors. Quite a number of studies have been done on the effectiveness of internal audit in promoting good corporate governance. Most of these previous studies focused on financial institutions. Others focused on establishing the relationship that exists between corporate governance and performance. The researcher felt that the internal audit function and the corporate governance area has not been fully exhausted and therefore focused on the licensed deposit taking microfinance institutions in Kenya. The objective of this study was to establish the relationship between the internal audit function and the corporate governance of the deposit taking microfinance institutions in Kenya. A descriptive cross-sectional design method was preferred for this study. The target population of this study was the 9 licensed deposit taking microfinance institutions in Kenya. The study targeted the Heads of Internal Audit and Company Secretaries of all the 9 deposit taking institutions. The study collected primary data on the current state of affairs of the deposit taking microfinance institutions. The main instrument for data collection was questionnaires with structured questions. The research was quantitative in nature and this implies that descriptive statistics was employed. The researcher also used a multivariate regression analysis to determine the relationship between the independent variables and the dependent variable. The study found out that that risk management had the greatest effect on corporate governance within deposit taking microfinance institutions in Kenya followed by internal controls while compliance and consulting and audit committee had the least effect respectively. The study recommends that the deposit taking microfinance institutions should recognize contribution of internal auditing in promoting good corporate governance. Additionally, the study recommends that the deposit taking microfinance institutions should apply internal auditing in its operations as an effective tool for ensuring compliance with set policies and procedures. The study further recommends that deposit taking microfinance institutions in Kenya be well equipped to implement corporate governance practices in their daily activities to the levels acceptable in developed market economies and improve accessibility to firm financing by enhancing transparency and accountability in the information disclosed.
# TABLE OF CONTENTS

**DECLARATION** .................................................................................................................................................. ii  
**ACKNOWLEDGEMENT** .......................................................................................................................................... iii  
**DEDICATION** ........................................................................................................................................................ iv  
**ABSTRACT** ........................................................................................................................................................... v  
**TABLE OF CONTENTS** ........................................................................................................................................ vi  
**LIST OF TABLES** .................................................................................................................................................. ix  
**LIST OF ABBREVIATIONS** .................................................................................................................................... x  
**CHAPTER ONE: INTRODUCTION** ........................................................................................................................ 1  
1.1.1 Internal Audit Function ................................................................................................................................. 2  
1.1.2 Corporate Governance ..................................................................................................................................... 3  
1.1.3 The Relationship between Internal Audit Function and Corporate Governance ................................. 5  
1.1.4 Deposit Taking Microfinance Institutions in Kenya ...................................................................................... 8  
1.2 Research Problem ............................................................................................................................................... 9  
1.3 Objectives of the Study ...................................................................................................................................... 11  
1.4 Value of the Study ............................................................................................................................................... 11  
**CHAPTER TWO: LITERATURE REVIEW** .......................................................................................................... 12  
2.1 Introduction .......................................................................................................................................................... 12  
2.2 Theoretical Review .............................................................................................................................................. 12  
2.2.1 The Agency Theory ........................................................................................................................................ 12  
2.2.2 Institutional Theory ...................................................................................................................................... 13  
2.2.3 Stakeholder Theory ....................................................................................................................................... 14  
2.4 Empirical Review ............................................................................................................................................... 16  
2.5 Summary of Literature Review ......................................................................................................................... 20  
**CHAPTER THREE: RESEARCH METHODOLOGY** ............................................................................................ 22
3.1 Introduction .......................................................................................... 22
3.2 Research Design .................................................................................. 22
3.3 Population ............................................................................................ 22
3.4 Data Collection ..................................................................................... 23
3.5 Data Analysis ........................................................................................ 24
3.5.1 Operationalization of the Variables of Study .................................... 26
CHAPTEER FOUR: DATA ANALYSIS, FINDINGS AND INTERPRETATIONS............. 27
  4.1 Introduction ........................................................................................ 27
  4.2 Response Rate .................................................................................... 27
  4.3 Internal Audit ..................................................................................... 28
    4.3.1 The Risk Management Aspect of Internal Audit Function ............ 28
    4.3.2 Effectiveness of Internal Audit Function in Internal Controls ...... 29
    4.3.3 Effectiveness of Internal Audit Function in Compliance and Consulting 30
    4.3.4 Effectiveness of Internal Auditing in the Audit Committee .......... 32
    4.3.5 Attributes of Corporate Governance in various Deposit Taking Microfinance Institutions in the last one year (July 2013 to June 2014)................. 34
  4.4 Inferential Analysis ............................................................................ 38
    4.4.1 Coefficient of Correlation ............................................................ 38
    4.4.2 Model Summary ........................................................................... 40
    4.4.3 Multiple Regression Analysis ....................................................... 41
  4.5 Summary and Interpretation of Findings .......................................... 43
CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS ............ 47
  5.1 Introduction ....................................................................................... 47
  5.2 Summary of findings ........................................................................... 47
  5.3 Conclusion ......................................................................................... 47
5.5 Policy Recommendations................................................................. 49
5.6 Suggestions for Further study ................................................................ 50
REFERENCES............................................................................................. 51
APPENDICES ............................................................................................... 56
Appendix 1: List of Licensed Deposit Taking Microfinance Institutions in Kenya as at
31 December 2013......................................................................................... 56
Appendix 2: List of sampled Microfinance Institutions with Head Offices in Nairobi
County to Pilot the Study Tool................................................................. 57
Appendix 3: Letter of Introduction ................................................................. 58
Appendix 4: Questionnaire .......................................................................... 59
# LIST OF TABLES

Table 4.1 Response Rate ........................................................................................................... 27

Table 4.2 The Risk Management Aspect of Internal Audit Function ................................. 28

Table 4.3 Effectiveness of Internal Audit in Internal Control ........................................... 29

Table 4.4 Effectiveness of Internal Audit Function in Compliance and Consulting .......... 31

Table 4.5 Effectiveness of Internal Audit Function in Audit Committees of Various Deposit Taking Microfinance Institutions ................................................................. 33

Table 4.6 Attributes of Corporate Governance Deposit Taking Microfinance Institutions in the last one year (July 2013 to June 2014) ......................................................... 34

Table 4.7 Coefficient of Correlation ...................................................................................... 39

Table 4.8 Model Summary ..................................................................................................... 40

Table 4.9 Coefficients of Multiple Regression Analysis ....................................................... 41
# LIST OF ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>AIDs</td>
<td>Acquired Immune Deficiency Syndrome</td>
</tr>
<tr>
<td>ASX</td>
<td>Australian Securities Exchange</td>
</tr>
<tr>
<td>CACG</td>
<td>Commonwealth Association of Corporate Governance</td>
</tr>
<tr>
<td>CAE</td>
<td>Chief Audit Executives</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FSAs</td>
<td>Financial Services Associations</td>
</tr>
<tr>
<td>IIA</td>
<td>Institute Internal Auditors</td>
</tr>
<tr>
<td>KPMG</td>
<td>Klynveld Peat Marwick Goerdeler</td>
</tr>
<tr>
<td>KWFT</td>
<td>Kenya Women Finance Trust</td>
</tr>
<tr>
<td>MFIs</td>
<td>Microfinance Institutions</td>
</tr>
<tr>
<td>MSE</td>
<td>Micro and Small Enterprises</td>
</tr>
<tr>
<td>NGOs</td>
<td>Non-Governmental Organizations</td>
</tr>
<tr>
<td>NSE</td>
<td>Nairobi Stock Exchange</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
</tr>
<tr>
<td>ROSCAs</td>
<td>Rotating Savings and Credit Associations</td>
</tr>
<tr>
<td>SACCOS</td>
<td>Savings and Credit Co-operative Societies</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SOEs</td>
<td>State Owned Enterprises</td>
</tr>
<tr>
<td>SPSS</td>
<td>Statistical Package for Social Sciences</td>
</tr>
<tr>
<td>UN</td>
<td>United Nations</td>
</tr>
<tr>
<td>US</td>
<td>United States</td>
</tr>
<tr>
<td>USA</td>
<td>United States of America</td>
</tr>
</tbody>
</table>
CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

It is now generally accepted that the correlation between internal audit and corporate governance affects all kinds of economic activity and that the perceived implications and consequences of this interaction have changed considerably in the recent years (Karagiorgos, Drogalas, Gotzamanis and Tampakoudis, 2010). Internal audit and corporate governance have now become a matter of major public concern. The contribution of internal audit to corporate governance is depicted via demarcating the relationship between internal audit and key elements of corporate governance. In this concept, it is a fact that the Board of Directors has been recognized as the key player in corporate governance by regulators and governance committees around the world (US Congress, 2002; ASX, 2003). The new definition of internal auditing focuses on corporate governance, especially the Board of Directors. This definition emphasizes internal audit’s role in aiding the entity to achieve its objectives. Because of the fact that the Board of Directors is ultimately responsible for the entity’s accomplishment of its objectives, the internal auditor’s contribution is to provide information to that group (Colbert, 2002).

Internal auditing, itself, is an important managerial control device (Carmichael, Willingham and Schaller, 1996), which is directly linked to the organizational structure and the general rules of the business (Cai, 1997). In today’s business environment internal auditors are now providing management with a far broader range of information concerning the organization’s financial, operational and compliance activities to improve effectiveness, efficiency, and economy of management performance and activities (Rezaee, 1996). Good corporate governance should provide proper incentives for the board and management to pursue
objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.

1.1.1 Internal Audit Function

According to Institute of Internal Auditors (IIA) (2009), internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Thus, internal auditing is being performed by professionals with a thorough understanding of the business culture, systems and processes, the internal audit activity which offers guarantee that internal controls in place are sufficient in order to alleviate the risks, governance processes are helpful and competent, and organizational goals and objectives are being met (IIA, 2004). This definition suggests that internal audit has undergone a paradigm shift from an emphasis on accountability about the past to improving future outcome which help entities operate in more effective and efficient manner (Nagy & Cenker, 2002).

Internal auditing is a profession and activity involved in advising organizations regarding how to better achieve their objectives through managing risks and improving internal control. Internal auditing involves the utilization of a systematic methodology for analyzing business processes or organizational problems and recommending solutions. The main role of the internal audit function is to guarantee that management official controls are being applied in an effective manner. The internal audit function, even though not obligatory, subsists in most private enterprise or corporate entities, and in government including federal, state, county and city governments. The task, quality and strong point of an internal audit function may be
different extensively within the approach of top executives and traditions of companies and organizations.

1.1.2 Corporate Governance

Corporate governance is a broad concept that has been used by regulators, investors, accountants, and boards of directors. While corporate governance has been reflected upon since the beginnings of the modern corporation (Kim and Nofsinger, 2007), it certainly has received increased attention and scrutiny over the last two decades. In this period, corporate governance issues have become important not only in the academic literature, but also in public policy debates. Corporate governance issues are in general receiving greater attention as a result of the increasing recognition that a firm’s corporate governance affects both its economic performance and its ability to access long-term, low investment capital (Mordelet, 2009). Corporate governance ranges throughout countries and firms. A higher quality of corporate governance allows firms to gain access to capital markets more easily, which is greatly significant for firms, which mean to boost their funds.

At a high level, corporate governance can be thought to have seven interrelated components: board of directors and committees, legal and regulatory, disclosure and transparency, business practices and ethics, enterprise risk management, monitoring, and communication. Internal audit performs critical roles in all aspects of corporate governance by: Supporting the audit committee in fulfilling its heightened responsibilities; Participating in the organization’s disclosure committee; Reviewing the effectiveness of the organization’s code of conduct, ethics policies, and whistle-blower provisions; Helping assess risks and gauge performance across the organization; Monitoring corporate governance activities and compliance with the organization’s policies; Facilitating and enhancing communications with the chief executive
The importance of effective corporate governance has been underscored by Arthur Levitt, former SEC chairman, who described corporate governance as processes “indispensable to effective market discipline” (Levitt, 1999). He defined corporate governance as “the link between a company’s management, directors, and its financial reporting system.” Levitt further explained that governance that “does not promote a culture of strong independent oversight, risks the organization’s very stability and future health” (Levitt, 1999). Levitt’s definition of corporate governance clearly reflects his regulatory position and concern about financial reporting. According to Monks and Minow (2001), corporate governance is the relationship among various participants in determining the direction and performance of corporations. Monks and Minow (2001) identify the primary participants of corporate governance as the shareowners, management, and the board of directors.

The Organization for Economic Co-operation and Development (OECD, 1999, 1) developed a broader definition: “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders, and other stakeholders. Corporate governance also 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 interests of the company and shareholders and should facilitate effective monitoring.” This definition is broader and introduces the concepts of goal congruence, incentives, monitoring, and control. To assess the performance or effectiveness
of a corporate governance system, instead of investigating the corporate governance mechanisms, the focus should be on corporate governance outcomes (Macey, 1997 and 1998; Gibson, 2003). It is well documented that even though the corporate governance mechanisms vary across countries the outcomes are similar (Kaplan, 1994; Gibson, 2003). Hence, all corporate governance systems no matter how they are structured, aim to reduce the agency conflicts inherent in the modern corporation.

The enhancement of corporate accountability and governance framework rely largely on understanding the underlying principles of corporate governance. These principles serve as invaluable catalyst in enhancing corporate performance. The essential corporate governance principles, according to Government of Australia (2003), include laying solid foundations for management and oversight by recognizing and publishing the respective roles and responsibilities of board and management; structuring the board to add value to the entity; promoting ethical and responsible decision making; safeguarding integrity in financial reporting; disclosing on a timely basis all material matters concerning the entity; respecting the rights of shareholders; establishing a system of risk oversight and internal control; enhancing board and management performance; remunerate fairly and responsibly all officials and recognize legal and other obligations to all legitimate stakeholders. The Commonwealth Association of Corporate Governance (CACG, 1999) sets out well-organized benchmark principles to be used within the Commonwealth. These principles highlight accountability, transparency and disclosure in corporate matters.

1.1.3 The Relationship between Internal Audit Function and Corporate Governance

As one of the important keystones and foundations of corporate governance, internal auditors are anticipated to work with audit committees, boards and senior management to assist put
the right tone at the top and helps to guarantee that ethical behavior flows down all the way through the ranks to lower level employees. 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. In recent years internal auditing has assumed a strategic dimension and that underscores why it has become an essential component of modern firms and financial management reforms in many developing countries (Barrier, 2003). Empirical studies have provided a link between the internal audit function and good corporate governance. It is now generally accepted that the correlation between internal auditing and corporate governance affects all kinds of economic activity and that the perceived implications and consequences of this interaction have changed considerably in the recent years. Internal auditing and corporate governance have now become a matter of major public concern. Internal auditing is involved in many of the current discussions taking place on corporate governance practices (Mordelet, 2009).

An internal audit function could be viewed as a first line of defense against inadequate organizational 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 and executive management, internal audit is one of the cornerstones of good corporate governance. Hermanson (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 modern firms. 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 Deposit Taking Microfinance Institutions in Kenya

The World Bank defines Microfinance Institutions (MFIs) as institutions that engage in relatively small financial transactions using various methodologies to serve low-income households, microenterprises, small-scale farmers, and others who lack access to traditional banking services. The key objective of MFIs is to provide microcredit and other financial services like savings to the otherwise poor people and help alleviate poverty.

Microfinance has been recognized as one of the most important tools for poverty alleviation (KWFT PILLAR 2005). The Kenya Microfinance sector consists of a large number of competing institutions which vary in formality, commercial orientation, professionalism, visibility, size and geographical coverage. These institutions range from informal organizations; rotating savings and credit associations (ROSCAs), financial services associations (FSAs), Savings and credit co-operative societies (SACCOs), NGOs, to commercial banks that are down scaling (Dondo, 2003). The goal of MFI organizations in Kenya is to raise the levels of income and welfare of people. They support the poor and unemployed by giving them loans often without collateral to establish small businesses. Kenyans today are faced by increased poverty, unemployment and insecurity of the AIDS pandemic, scarcity of food and rural urban migration among others. MFIs address the above problems by accessing small loans at affordable repayment rates, and other financial services for Micro and Small Enterprises (MSE). These take the form of self-help projects and individual enterprises. Most MFIs lend up to a maximum of KSh. 500,000 and a minimum of KSh. 5,000 per applicant.

There are nine deposit taking microfinance institutions licensed by the Central Bank of Kenya through the Microfinance Act, 2006 and the Microfinance (Deposit Taking
Institutions) Regulations 2008 issued there under which sets out the legal, regulatory and supervisory framework for the microfinance industry in Kenya. The Act enables Deposit Taking Microfinance Institutions licensed by the Central Bank of Kenya to mobilize savings from the general public, thus promoting competition, efficiency and access. The former UN Secretary-General, Kofi Annan stated that “Sustainable access to microfinance helps alleviate poverty by generating income and wealth, creating jobs, allowing children to go to school, enabling families to obtain health care and empowering people to make the choices that best serve their needs.” It is, therefore, expected that the microfinance industry will play a pivotal role in deepening financial markets and enhancing access to financial services and products by majority of the Kenyans.

1.2 Research Problem

Conflicts in different internal auditing roles in enhancing corporate governance have not gone away with contradicting opinions on how internal audit affect the corporate governance with some citing a positive effect (Herdman, 2002; Richards, 2002) and some saying it has very minimal effect if any (Davidson, Goodwin-Stewart and Kent, 2005). New challenges of corporate governance and business ethics that have been grappling corporate bodies are an indicator that business may after all not be all about profit making; proper management and customer care are to be taken into account if corporate bodies are to achieve their end goal of profit making. This requires the vital role of the internal audit function in maintaining strong corporate governance (Rosenstein and Rose, 2006). An effective internal audit function plays a key role in assisting the board to discharge its governance responsibilities. Literature on corporate governance suggests that well governed institutions tend to have a competitive advantage in the ability to attract investors and mobilize capital and thus generate growth in profits. By relating internal audit function to corporate governance, deposit taking MFIs can
have an insight into the value of internal audit function.

The number of corporate bodies collapsing or being placed under statutory management has been on the increase not only in Kenya but all over the world (Manduku, 2008). This has forced researchers to look into the details of these corporate failures and in so doing, internal audit function has come out as one factor that need to be addressed by corporate entities to guarantee their good corporate management. Therefore, a microfinance institution must determine the extent to which the investor is cushioned from losses associated with poor corporate management by investing in strong internal audit departments.

It has been recognized widely in Kenya that promotion of the micro and small enterprise sector is a viable and dynamic strategy for achieving national goals, including employment creation, poverty alleviation and balanced development between sectors and sub sectors. All these together are essential for the achievement of the government vision of industrialization by the year 2030. The importance of having strong performing MFIs can therefore not be overemphasized. According to Otero, (2004), the recent entrance of investors who are providing capital for the most advanced microfinance institutions has raised important issues regarding the characteristics and quality of the governing bodies that lead these institutions. Now microfinance institutions are infusing institution values into the day to day operations.

Most empirical studies done in Kenya have focused on internal audit elements and corporate governance practices in other sectors other than deposit taking MFIs and among them are a survey on the role of internal audit in promoting good corporate governance in SOEs (Kibet, 2008); Corporate governance practices in microfinance institutions in Nairobi Kenya (Mwasi, 2011); The relationship between internal controls and corporate governance in
commercial banks in Kenya (Olumbe, 2012) and the effectiveness of internal audit in promoting good corporate governance in the public sector in Kenya (Njui, 2012). To the best of the researcher’s knowledge, there is limited empirical evidence on the relationship of the internal audit function and the corporate governance of licensed Deposit Taking Microfinance Institutions in Kenya. This study seeks to fill the existing gap by answering the following research question; does internal audit play a role in promoting corporate governance in deposit taking microfinance institutions in Kenya?

1.3 Objectives of the Study

To examine the relationship between internal audit function and the corporate governance of licensed Deposit Taking Microfinance Institutions in Kenya.

1.4 Value of the Study

The study shall provide critical information to various stakeholders in the corporate world. The findings may provide a first-stop shop of the benefits of the role of internal audit function in promoting good governance practices within Deposit Taking MFIs.

The findings of this study shall also help internal auditors, management in MFIs, academicians and students of various fields in gaining more knowledge on the use, importance and need for internal audit in promoting good corporate governance structures.

Finally this study may help management to appreciate the role played by the internal auditors/internal audit function in their institutions. It may enable them to know whether their investment in strong internal audit department is worthwhile.
CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction
This chapter reviews the literature relating to relationship between internal audit function and the corporate governance of licensed Deposit Taking Microfinance Institutions in Kenya. The literature review has been organized in the following sections; first section covers the theoretical framework on internal audit and its impact on corporate governance, the second section covers the determinants of corporate governance and the third section covers the empirical studies on the relationship between internal audit function and the corporate governance of licensed Deposit Taking Microfinance Institutions in Kenya. The chapter concludes with a summary of literature review including identifying the research gaps that exist in the area of study.

2.2 Theoretical Review
2.2.1 The Agency Theory
Meckling and Jensen (1976) in their paper on the theory of the firm defined the agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. Thus, for internal audit to be effective there is need for not only its independence but also for top management support. The first scholars to propose, explicitly, that a theory of agency be created, and to actually begin its creation, were Stephen Ross and Barry Mitnick, independently and roughly concurrently. Ross is responsible for the origin of the economic theory of agency, and Mitnick for the institutional theory of agency. Ross introduced the study of agency in terms of problems of compensation contracting; agency was seen, in essence, as an incentives problem.
Mitnick introduced the now common insight that institutions form around agency, and evolve to deal with agency, in response to the essential imperfection of agency relationships. This behavior never occurs as it is preferred by the principal because it does not pay to make it perfect. But society creates institutions that attend to these imperfections, managing or buffering them, adapting to them, or becoming chronically distorted by them. Thus, to fully understand agency, one needs both streams to see the incentives as well as the institutional structures (Mitnick, 2006). From an agency perspective, the importance of strong governance stems from the need to align the interests of management with other stakeholders in the firm in order to reduce agency costs and increase the internal audit department effectiveness. Various corporate governance mechanisms can be used to monitor the management's behavior and these include independent directors on the board, an independent board chair, an effective audit committee and both external and internal audit. Davidson, Goodwin-Stewart and Kent, (2005) describe the complex interactions between these governance mechanisms as the corporate governance mosaic.

2.2.2 Institutional Theory

According to institutional theory by Fogarty, Zucca, Meonske and Kirch (1997), an organisation is designed and functions to meet social expectations in so far as its operations are visible to the public. Therefore organisational internal operations, which are often complex and difficult to identify, may take second place to the issue of external legitimacy. It is suggested that the external image of the organisation may be loosely coupled with its operating processes and the kind of technology it adopts.

Fogarty et al. (1997) asserted that the contribution of institutional theory is in the insight that the actual accomplishments of an organisation and what its structure suggests should
accomplish are often different. The organisation operates with internal processes that are not normally visible to those external to it, while other structures maintained for outsiders do not significantly add to output. Fogarty (1996) observes that scrutiny by outsiders can be avoided if the right structures are adopted by organizations. Loose technological coupling enables organizations to show success in external problems whilst allowing flexibility in operational processes. Thus the institutions should be ready to meet the high cost of adopting various technologies in the internal audit department and ensure that the staff are trained in order for the department to operate efficiently.

2.2.3 Stakeholder Theory

Research into corporate governance also discusses the stakeholder theory in relation to firms’ responsibility to the wider community. A stakeholder is any group of individuals who can affect or is affected by the activities of the firm, in achieving the objectives of the firm (Freeman, 1984). A similar view has been put forward by the World Business Council for Sustainable Development (1999), which also identifies stakeholders as the representatives from labor organizations, academia, church, indigenous peoples, human rights groups, government and non-governmental organizations and shareholders, employees, customers/consumers, suppliers, communities and legislators.

According to Ansoff (1965), a firm’s objective could be achieved through balancing the conflicting interests of these various stakeholders. Therefore, a fundamental aspect of stakeholder theory is to identify the stakeholders an organization is responsible for. Any stakeholder is relevant if their investment is, in some form, subject to risk from the activities of the organization (Clarkson, 1995). The moral perspective of stakeholder theory is all stakeholders have a right to be treated fairly by an organization, and managers should manage
the organization for the benefit of all stakeholders, regardless of whether the stakeholder management leads to better financial performance (Deegan, 2004).

2.3 Determinants of Corporate Governance

Corporate governance is a mechanism that leads to financial efficiency, social legitimacy or more generally goal attainment (cf. Judge 2010 for the two former, Aguilera et al. 2008 for the latter). The object of good corporate governance is attained when institutions demonstrate their public accountability and conduct their business within acceptable ethical standards. This demonstration will take the form of effective financial reporting, both internally and externally, and the unqualified encouragement of public debate in respect of such financial reports. There are four pillars on which good governance is based. Firstly there must be an effective body responsible for governance separate and independent of management to promote accountability, efficiency, effectiveness, integrity, responsibility. The leadership should be transparent and open with accurate and timely disclosure of information relating to all economic and other activities of the corporation.

Secondly there must be an all-inclusive approach to governance that recognizes and protects the rights of members and all stakeholders-internal and external. Thirdly the institution must be governed and managed in accordance with the mandate granted to it by its founders and society, and take seriously its wider responsibilities to enhance sustainable prosperity and finally the institutional governance framework should provide an enabling environment within its human resource which can contribute and bring to bear their full creative powers towards finding innovative solutions to shared problems. According to CalPERS, (2011), the main players in corporate governance include the Board of Directors, Board Committees, the Company Secretary, the Management team, the External and Internal auditors, the
Shareholders and other Stakeholders. The diffusion of an international benchmark model of
good governance, a country’s legal system, the desire to attract foreign investors and the
influence of interest groups are also other potential determinants of corporate governance.

2.4 Empirical Review

The much publicised corporate collapses of the past few years have focused global attention
on the need for strong corporate governance. Simultaneously, the Sarbanes ’Oxley Act of
2002 and the new expanded role of internal audit have preoccupied researchers and scientists.

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

Paape, Scheffe and Snoep (2002), explored the relationship between internal audit and
corporate governance. Data was collected from the largest companies of 15 European Union
(EU) countries. To accomplish the survey 332 questionnaires were sent, of which one
hundred and five were answered (response rate 32%). Despite the numbers and percentages of responses, it was clear that there was surprising, and even startling, differences in the way Internal Auditors operated in the EU, even in the largest companies, and their awareness of, and opinions about, their role in corporate governance concerns. The basic results of the research were the differences during internal auditors work and the perception of the role of internal auditors to corporate governance by country. It was a fact that there was lack of internal audit and audit committee in 50 companies and business managers were unaware of the recommendations and regulations on corporate governance. Compliance with regulations and procedures was viewed as the main purpose of internal audit, while the implementation of operational controls was considered as the main contributor of internal control. Put succinctly, there was plenty of room for evolution in both mind set and daily practice.

Gramling, Maletta and Schneider (2004) explored the relationship between internal audit and corporate governance. The most important finding of their study was the catalytic role of internal auditing in the effective corporate governance.

An effective internal audit function plays a key role in assisting the board to discharge its governance responsibilities. O’Leary & Stewart (2007) used exploratory study to present five ethical dilemmas for 66 internal auditors. For each scenario, a key element of corporate governance was operated in order to assess its influence on ethical decision making. These were audit committee support; management truthfulness regarding different accounting policies; management integrity regarding pressure on internal audit; external auditor characteristics; and organizational code of conduct. As a result, the researcher had been able to show the different ethical decision-making related to internal audit and corporate governance.
Kibet (2008) in his study, a survey on the role of internal audit in promoting good corporate governance in SOEs, aimed to explore the role and the use of internal audit function in promoting good corporate governance in public sector enterprises and the challenges faced by the internal auditors in SOEs. The study followed an exploratory research design and the population comprised of all SOEs with government equity of over 50% located in Nairobi. A sample of 43 state corporations was selected by way of geographical location and government shareholding. Data collection was by way of questionnaires and the respondents were the heads of internal audit departments. Data collected was analyzed using the SPSS and the output presented in frequency distribution tables, pie and bar charts. The study concluded that internal audit function played a role in corporate governance.

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.

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 31st 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.

Moraa, (2009) reported evidence on the relationship between corporate governance and the market value of all manufacturing companies in Kenya. The dependent variables in her study were corporate governance index and additional variables of control mechanism; ownership structure, board characteristics, and leverage. This provided 20 comprehensive description of firm-level corporate governance for a broad sample of manufacturing companies in Kenya. The study findings also proved that better-governed firms might have more efficient operations, resulting in a higher expected future cash-flow stream.

More recently, Christopher, Sarens and Leung (2010) presented a critical analysis of the independence of the internal audit function through its relationship with management and the audit committee. Results are based on a critical comparison of responses from questionnaires sent out to Australian chief audit executives (CAEs) versus existing literature and best practice guidelines. With respect to the internal audit function’s relationship with the audit committee, significant threats identified include CAEs not reporting functionally to the audit committee; the audit committee not having sole responsibility for appointing, dismissing and evaluating the CAE; and not having all audit committee members or at least one member qualified in accounting.
Ibrahim (2011) explored the nature and characteristics of internal audit function in Egyptian listed firms and assessed its ability to fulfill its role in corporate governance. The study was carried out through a questionnaire survey. The results showed that internal audit function in Egyptian listed firms, in its current status, faces many difficulties that affect negatively its effectiveness in corporate governance. Therefore, extensive efforts should be made to enhancing the internal audit profession in Egypt.

Finally, Njui (2012) carried a study through questionnaires to establish the effectiveness of internal audit in promoting good governance in the public sector in Kenya with special focus on the government ministries. The study found that internal control had the greatest effect on corporate governance within Kenya government ministries followed by risk management while compliance and consulting had the least effect. The conclusion was the Kenyan government ministries to accept internal auditing as a tool for effective internal control so as to realize their set objectives with ease.

2.5 Summary of Literature Review

Research gaps exist since none of the studies address in detail the relationship between internal audit function and the corporate governance of the deposit taking microfinance institutions in Kenya. Majority of the studies were either done on corporate governance practices or on internal audit and risk management. In addition, the majority of the studies were done in developed economies hence leaving scarce literature in developing economies. This study seeks to fill existing research gap by answering the following research question; does there exists a relationship between internal audit function and the corporate governance of licensed Deposit Taking Microfinance Institutions in Kenya? The above chapter reviews the various theories that inform internal audit function and corporate governance. In addition,
an empirical review is conducted where past studies both global and local is reviewed in line with the following criteria, related title, scope, methodology resulting into a critique. It is from these critiques that the research gap is identified.
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the research design, the target population, the sample size and procedures that were used to select the sample elements. It covers the research instruments and the procedure for collecting the primary data and defines the methods that were used to analyze data.

3.2 Research Design

According to Mutai (2001), research design refers to the procedures to be employed to achieve the objectives of the research. The research design constitutes the blueprint for the collection, measurement and analysis of data (Cooper and Schinder, 2007). A descriptive cross-sectional design method was preferred for this study. The method was chosen since it is more precise and accurate since it involves description of events in a carefully planned way (Babbie, 2004). This research design also portrays the characteristics of a population fully (Chandran, 2004).

3.3 Population

Target population refers to all the members of a real or hypothetical set of people, events or subjects to which a researcher wishes to generalize the results of the study (Ngechu, 2004). The target population of this study was all the nine licensed Deposit Taking MFIs in Kenya listed in appendix 1. Due to the population size of the licensed Deposit Taking MFIs in Kenya, the research took the census approach to collect data from all the nine Deposit Taking MFIs in Kenya. A census is where data is collected from all members of the population (Hair, Celsi, Money, Samouel, & Page, 2011). A census is used as a method of enumeration only
when there is need to have information on every individual or item in the population (Chandran, 2004).

3.4 Data Collection
The researcher collected primary data on the current state of affairs from (July 2013 to June 2014) of the nine licensed Deposit Taking MFIs. The main instrument for data collection was questionnaires with structured questions. Structured questions allow for uniformity of responses to questions. The questionnaire is a fast way of obtaining data as compared to other instruments (Mugenda & Mugenda, 1999). Questionnaires give the researcher comprehensive data on a wide range of factors. Questionnaires allow greater uniformity in the way questions are asked, ensuring greater compatibility in the responses.

A five point non-comparative Likert scale was used for the structured questions. The intent of the Likert scale is that the statement represents different aspects of the same attitude. Likert scale is simple to construct, and easy for the respondents to read, understand and respond appropriately to the statements put across. The Likert scale enhances the production of highly accurate results during analysis. The questionnaire was administered to the Heads of Internal Audit and the Company Secretaries of all the nine Deposit Taking MFIs in Kenya. This is because they are the most conversant respondents with the subject matter of the study.

3.4.1 Data Validity and Reliability
The researcher carried out a pilot study to pretest the validity and reliability of data collected using the questionnaire in 5 randomly selected MFIs without the capacity to take deposits but with head offices in Nairobi County (refer to appendix 2). According to Berg and Gall (1989), validity is the degree by which the sample of test items represents the content of test
is designed to measure. Content validity which was employed by this study is a measure of the degree to which data collected using a particular instrument represents a specific domain or content of a particular concept. Mugenda and Mugenda (1999) contend that the usual procedure in assessing the content validity of measure is to use a professional or expert in a particular field. Reliability is increased by including many similar items on a measure, by testing a diverse sample of individuals and by using uniform testing procedures. The researcher selected a pilot group of 5 individuals from non-deposit taking MFIs to test the reliability of the research instruments. The pilot data was not included in the actual study.

3.5 Data Analysis

Once the data had been collected, it was checked for completeness ready for analysis. Prior to secondary data analysis, primary data was analysed using descriptive statistics. Analysis was done with aid of the Statistical Package for Social Sciences (SPSS) package version 20.0. Descriptive statistics generated such as percentages, mean scores and proportions was presented in tables and charts. The researcher also used a multivariate regression analysis to determine the relationship between the independent variables and the dependent variable. The regression equation was;

\[ Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon \]

Where;

\( Y = \) Corporate governance in licensed Deposit Taking MFIs (Discipline, Transparency, Independence, Accountability, Responsibility, Fairness, Social responsibility)

\( \beta_0 = \) Constant Term

\( \beta_1, \beta_2, \beta_3, \) and \( \beta_4 = \) Beta coefficients
$X_1 = $ Risk Management (Risk Identification, Risk Assessment, Risk Mitigation and Risk Monitoring)

$X_2 = $ Internal Controls (monitoring, control activities, accounting information and communication)

$X_3 = $ Compliance and Consulting (compliance with specified procedures, provision for the timely reconciliation of accounts, promoting accountability, detection of fraudulent activities or irregularities, ensure effectiveness and efficiency of operations, reviews of operational and financial performance)

$X_4 = $ Audit Committee (as a main player of corporate governance, this control variable tested whether: the Board of Directors has an Audit Committee responsible for monitoring financial and compliance activities of Management; the Board of Directors satisfies itself that the Audit Committee has the skills and expertise needed; at least one member of the Audit Committee has recent and relevant financial experience; the Audit Committee conducts periodic reviews of its activities and practices compared with current best practices to ensure that its activities are constituent with leading practice; the Audit Committee is effective in strengthening the position of the internal audit function by providing an independent and supportive environment and reviews the effectiveness of the internal audit function; and the audit committee holds regular meetings and ensures that some meetings coincide with key dates within the financial reporting and audit cycle.

$\varepsilon = $ Error term
3.5.1 Operationalization of the Variables of Study

Corporate governance in this study was operationalized along the principles of discipline, transparency, independence, accountability, responsibility, fairness, social responsibility among other principles. Various elements of the corporate governance attributes were examined at the deposit taking MFIs to assess whether the MFIs upheld the above mentioned principles in its corporate governance practices.

Internal audit function was operationalized along risk management, internal controls and compliance and consulting perspectives of meeting goals and objectives, accountability to all stakeholders, and compliance with local laws and industry rules and regulations. Consequently, to ascertain risk management, the study sought to establish whether these institutions have adopted policies, operating procedures, reporting, and decision-making protocols to effectively manage, evaluate, and mitigate risk. Internal control activities will be assessed by the frequency of management and board review of transactions, the review process of monthly, quarterly, semi-annual and annual reports as well senior management monitoring of the institutions’ operations. To assess compliance, the researcher verified whether there were measures put in place to check compliance with policies and procedures, external auditors provide other non-assurance services like in development of strategic plans and drafting of policies and procedures.

3.5.2 Test of Significance

F-test was used to test the joint significance of all coefficients and T-test for the test significance of individual coefficients. The significance of the regression model was determined at 95% confidence interval and 5% level of significance.
CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND INTERPRETATIONS

4.1 Introduction

This chapter presents analysis of the data on the relationship between internal audit function and the corporate governance of deposit taking microfinance institutions in Kenya. The chapter also discusses the interpretation and provides the major findings and results of the study.

4.2 Response Rate

The researcher targeted the Heads of Internal Audit and the Company Secretaries of the 9 licensed deposit taking microfinance institutions. However, out of 9 questionnaires distributed 6 respondents completely filled in and returned the questionnaires, this represented a 67% response rate. This is a reliable response rate for data analysis as Mugenda and Mugenda (2003) pointed that for generalization, a response rate of 50% is adequate for analysis and reporting, 60% is good and a response rate of 70% and over is excellent.

Table 4.1 Response Rate

<table>
<thead>
<tr>
<th>Response Rate</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Filled in questionnaires</td>
<td>6</td>
<td>67</td>
</tr>
<tr>
<td>Unreturned questionnaires</td>
<td>3</td>
<td>33</td>
</tr>
<tr>
<td>Total</td>
<td>9</td>
<td>100</td>
</tr>
</tbody>
</table>
4.3 Internal Audit

4.3.1 The Risk Management Aspect of Internal Audit Function

The study was inquisitive to determine the effectiveness of internal auditing to risk management. For easier understanding, the researcher provided a scale of 1-5 where 1 represented ineffectiveness while 5 represented very effective. From the findings, most of the respondents indicated that the risk management aspect of internal audit function was moderately effective in assessing communication of risk and providing assurance that the risks are being appropriately managed as indicated by the mean score of 3.833, in each case. On the same breathe, risk identification within the institutions was effective as illustrated by a mean score of 4.50. The findings further suggest that effectively risks assessment, suggestions for risk management strategies and conduct of unplanned and informal reviews of other areas of concern, including unacceptable levels of risk was effective as depicted by mean score of 4.17 in each case. Respondents pointed that risk monitoring and assessment of ethics and values within the institutions was moderately effective due to application of internal auditing in risk management. This was illustrated by an indicative mean of 3.67. Further, respondents indicated that risk mitigation and assessment of performance management was effective as depicted by a mean score of 4.00 in each case. This reveals that the application of internal auditing within organizations effectively enhances risk management.

Table 4.2 The Risk Management Aspect of Internal Audit Function

<table>
<thead>
<tr>
<th>RISK MANAGEMENT</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Identification</td>
<td>4.5000</td>
<td>.83666</td>
</tr>
<tr>
<td>Risk Assessment</td>
<td>4.1667</td>
<td>1.16905</td>
</tr>
</tbody>
</table>
4.3.2 Effectiveness of Internal Audit Function in Internal Controls

Table 4.3 highlights the summary of the findings on the effectiveness of internal audit function in internal controls. According to the findings, respondents pointed out that internal audit function provided effective internal controls on financial, accounting information and communication as well as information within the institution as shown by an indicative mean of 4.17 for each case. The finding further indicated that internal audit function effectively enhanced internal controls by conducting of reviews of individual systems and processes, provision of managerial controls and operational policies controls as pointed out by a mean score of 4.50, 4.00 and 4.33 respectively. This implies that internal auditing influences internal control operation of the institutions to a great extent.

Table 4.3 Effectiveness of Internal Audit in Internal Control

<table>
<thead>
<tr>
<th>INTERNAL CONTROLS</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Mitigation</td>
<td>4.0000</td>
<td>.63246</td>
</tr>
<tr>
<td>Risk Monitoring</td>
<td>3.6667</td>
<td>.51640</td>
</tr>
<tr>
<td>Suggest risk management strategies</td>
<td>4.1667</td>
<td>.75277</td>
</tr>
<tr>
<td>Provide assurance that the risks are being appropriately managed</td>
<td>3.8333</td>
<td>.75277</td>
</tr>
<tr>
<td>Assess ethics and values within the organization</td>
<td>3.6667</td>
<td>.81650</td>
</tr>
<tr>
<td>Assess performance management</td>
<td>4.0000</td>
<td>.63246</td>
</tr>
<tr>
<td>Assess communication of risk</td>
<td>3.8333</td>
<td>.75277</td>
</tr>
<tr>
<td>Unplanned and informal reviews of other areas of concern, including unacceptable levels of risk</td>
<td>4.1667</td>
<td>.75277</td>
</tr>
<tr>
<td>Reviews of individual systems and processes</td>
<td>4.5000</td>
<td>.54772</td>
</tr>
<tr>
<td>Provide Financial controls</td>
<td>4.1667</td>
<td>.75277</td>
</tr>
<tr>
<td>Managerial controls</td>
<td>4.0000</td>
<td>.63246</td>
</tr>
<tr>
<td>Operational policies controls</td>
<td>4.3333</td>
<td>.81650</td>
</tr>
<tr>
<td>Control information within the institution</td>
<td>4.1667</td>
<td>.40825</td>
</tr>
<tr>
<td>Accounting Information and communication</td>
<td>4.1667</td>
<td>.75277</td>
</tr>
</tbody>
</table>

**4.3.3 Effectiveness of Internal Audit Function in Compliance and Consulting**

The study also sought to investigate effectiveness of internal audit function in compliance and consulting. From the study findings, most of the respondents pointed that internal audit role of compliance and consulting effectively ensures compliance with laws, regulations and contracts and also provides information about any fraudulent activities or irregularities as indicated by a mean of 4.67 and 4.50 respectively. The respondents affirmed that compliance and consulting activity was effective in the provision of effective systems for managing and accounting for physical and financial assets, timely reconciliation of accounts and in ensuring effectiveness and efficiency of operations. The findings also suggest that compliance and consulting activity is a source of information on major frauds and irregularities and provides suggestions for more helpful and competent use of resources. This was as indicated by a mean score of 4.33 in each case.

The compliance and consulting activity played a role of ensuring that expenditure is within budgetary provisions and disbursements of credit facilities comply with specified procedures by effectively conducting reviews of the agreement framework and specific compliance issues as well as reviews of operational and financial performance. This was illustrated by a mean score of 4.17 for each case. This internal audit activity effectively conducts appraisals
on the achievement of corporate goals and objectives and promotes accountability by ensuring that directors were accessible to shareowner inquiry concerning their key decisions affecting the company’s strategic direction and management was accountable to the directors as shown by a mean of 4.00 in each case. The findings of the study further suggested that internal audit function’s role in provision of advice and comment on devotion to the values and code of conduct/code of ethics of the organization was moderately effective as depicted by an indicative mean of 3.83. In summary, internal audit function plays an effective role in compliance and consulting within the deposit taking microfinance institutions under study.

Table 4.4 Effectiveness of Internal Audit Function in Compliance and Consulting

<table>
<thead>
<tr>
<th>COMPLIANCE AND CONSULTING</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ensure that expenditure is within budgetary provisions</td>
<td>4.1667</td>
<td>.40825</td>
</tr>
<tr>
<td>Ensure disbursements of credit facilities comply with specified procedures</td>
<td>4.1667</td>
<td>.40825</td>
</tr>
<tr>
<td>Provides for the timely reconciliation of accounts</td>
<td>4.3333</td>
<td>.81650</td>
</tr>
<tr>
<td>Provides effective systems for managing and accounting for physical and financial assets</td>
<td>4.3333</td>
<td>.81650</td>
</tr>
<tr>
<td>Promoting accountability: Are directors accessible to shareowner inquiry concerning their key decisions affecting the company’s strategic direction and is management accountable to the directors?</td>
<td>4.0000</td>
<td>.63246</td>
</tr>
<tr>
<td>Providing information about any fraudulent activities or irregularities</td>
<td>4.5000</td>
<td>.54772</td>
</tr>
<tr>
<td>Ensure effectiveness and efficiency of operations</td>
<td>4.3333</td>
<td>.81650</td>
</tr>
</tbody>
</table>
A source of information on major frauds and irregularities & 4.3333 & .51640

Reviews of the agreement framework and specific compliance issues & 4.1667 & .75277

Reviews of operational and financial performance & 4.1667 & .75277

Suggestions for more helpful and competent use of resources & 4.3333 & .51640

Appraisals of the achievement of corporate goals and objectives & 4.0000 & .89443

Compliance with laws, regulations and contracts & 4.6667 & .51640

Advice and comment on devotion to the values and code of conduct/code of ethics of the organization & 3.8333 & .75277

**4.3.4 Effectiveness of Internal Auditing in the Audit Committee**

Audit Committee is a main player of corporate governance and the study investigated the impact that internal audit function had on this control variable. The researcher provided a scale of 1-5 where 1 represented ‘Strongly disagree’ while 5 represented ‘Strongly agree’. From the study findings summarized in table 4.5, most respondents agreed that each institution had an Audit Committee responsible for monitoring financial and compliance activities of management and the Audit Committee conducted periodic reviews of its activities and practices compared with current best practices to ensure that its activities are consistent with leading practice.

It was agreed that the Board of Directors satisfied itself that the Audit Committee had the skills and expertise needed and at least one member of the Audit Committee has recent and relevant financial experience. The findings further affirmed that the Audit Committee is effective in strengthening the position of the internal audit function by providing an
independent and supportive environment and reviews the effectiveness of the internal audit function. Most respondents agreed that the audit committee holds regular meetings and ensured that some of the meetings coincide with key dates within the financial reporting and audit cycle. These affirmations were indicated by a mean score of 4.67 for each case. It was therefore imperative to conclude that the audit committee complimented the role played by internal audit function within the institutions under study to a large extent.

Table 4.5 Effectiveness of Internal Audit Function in Audit Committees of Various Deposit Taking Microfinance Institutions

<table>
<thead>
<tr>
<th>Audit Committee</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) The Board of Directors has an Audit Committee responsible for monitoring</td>
<td>4.8333</td>
<td>.40825</td>
</tr>
<tr>
<td>financial and compliance activities of Management.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) The Board of Directors satisfies itself that the Audit Committee has the</td>
<td>4.6667</td>
<td>.51640</td>
</tr>
<tr>
<td>skills and expertise needed; at least one member of the Audit Committee has</td>
<td></td>
<td></td>
</tr>
<tr>
<td>recent and relevant financial experience.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(iii) The Audit Committee conducts periodic reviews of its activities and</td>
<td>4.8333</td>
<td>.40825</td>
</tr>
<tr>
<td>practices compared with current best practices to ensure that its activities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>are consistent with leading practice.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(iv) The Audit Committee is effective in strengthening the position of the</td>
<td>4.6667</td>
<td>.51640</td>
</tr>
<tr>
<td>internal audit function by providing an independent and supportive environment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>and reviews the effectiveness of the internal audit function</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(v) The audit committee holds regular meetings and ensures that some meetings</td>
<td>4.6667</td>
<td>.51640</td>
</tr>
<tr>
<td>coincide with key dates within the financial reporting and</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
4.3.5 Attributes of Corporate Governance in various Deposit Taking Microfinance Institutions in the last one year (July 2013 to June 2014)

The study sought to investigate the extent to which corporate governance attributes are practiced in the institutions under study for the last one year. From the findings, most of the respondents pointed that accountability by and independence attributes of corporate governance were practiced within the institutions to a large extent as shown by a mean score of 4.44 and 4.56 respectively. The findings also suggested and to a large extent that there was transparency in the institutions’ operations, fairness in the way the institutions were directed and controlled and there was responsibility on the part of the directors and the executive management by defined roles and reporting lines as indicated by a mean of 4.33 in each case. Both discipline and social responsibility were upheld and implemented to a moderate extent in the institutions as depicted by a mean score of 3.89 and 3.94 respectively. In conclusion, the above mentioned corporate governance attributes were practiced to a large extent in most of the deposit taking microfinance institutions.

Table 4.6 Attributes of Corporate Governance Deposit Taking Microfinance Institutions in the last one year (July 2013 to June 2014)

<table>
<thead>
<tr>
<th>Corporate governance attributes</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accountability:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Are directors accountable to shareowners and management accountable to directors?</td>
<td>4.5000</td>
<td>.54772</td>
</tr>
<tr>
<td>(ii) Are directors accessible to shareowner inquiry concerning their</td>
<td>4.5000</td>
<td>.54772</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Question</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>(iii) Does the institution have a corporate charter which clearly sets</td>
<td>4.3333</td>
<td>1.03280</td>
</tr>
<tr>
<td>out Shareholders’ appropriate rights to ensure that boards are</td>
<td></td>
<td></td>
</tr>
<tr>
<td>accountable for their actions?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grand Mean</td>
<td>4.4444</td>
<td></td>
</tr>
<tr>
<td><strong>Transparency:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Does the institution make substantive disclosure of all significant</td>
<td>4.1667</td>
<td>.40825</td>
</tr>
<tr>
<td>aspects of remuneration policies and structures for key executives,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>and in particular the performance metrics which are in place to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>incentivize value-creation, to incorporate risk management</td>
<td></td>
<td></td>
</tr>
<tr>
<td>considerations and to align the interests of executives with those of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>shareholders?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) Is the operating, financial and governance information about</td>
<td>4.5000</td>
<td>.54772</td>
</tr>
<tr>
<td>companies readily transparent to permit accurate market comparisons;</td>
<td></td>
<td></td>
</tr>
<tr>
<td>this includes disclosure and transparency of objective globally</td>
<td></td>
<td></td>
</tr>
<tr>
<td>accepted minimum accounting standards, such as the International</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial Reporting Standards?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(iii) Does the institution aspire to transparent and open</td>
<td>4.3333</td>
<td>.81650</td>
</tr>
<tr>
<td>communication about its aims, its challenges, its achievements and its</td>
<td></td>
<td></td>
</tr>
<tr>
<td>failures?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grand Mean</td>
<td>4.3333</td>
<td></td>
</tr>
<tr>
<td><strong>Independence:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Are board elections totally free from political interference and</td>
<td>4.8333</td>
<td>.40825</td>
</tr>
<tr>
<td>the leadership of the board members exercise their responsibilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>diligently and embrace independence (this must ultimately change the</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
(i) How does theboard interact with management?

(ii) Is there a lack of conflict between the directors’ personal, financial, or professional interests and the interests of shareowners?

(iii) Independent board committees: does the committees who perform the audit, director nomination and executive compensation functions consist entirely of independent directors?

Grand Mean

Fairness:

(i) To ensure fairness in corporate governance does the institution call in an independent knowledgeable entity to assess a particular transaction and give their opinion on its fairness?

(ii) Fairness is practiced in the way companies are directed and controlled. Is the choice as to what is fair and will most likely be, made by taking into account the stakeholder’s position on the power-interest matrix?

(iii) Fairness entails the equitable treatment of all equity investors, including minority shareholders. Are there corporate governance structures and practices to protect and enhance the institution’s accountability to its shareowners and ensure that they are treated equally?

Grand Mean

Responsibility:

(i) Is the board ultimately responsible for the institution’s risk management philosophy, organizational risk framework and oversight?

<table>
<thead>
<tr>
<th></th>
<th>Rating</th>
<th>T-Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>way in which directors interact with management?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) Is there lack of conflict between the directors’ personal, financial or professional interests and the interests of shareowners?</td>
<td>4.1667</td>
<td>.40825</td>
</tr>
<tr>
<td>(iii) Independent board committees: does the committees who perform the audit, director nomination and executive compensation functions consist entirely of independent directors?</td>
<td>4.6667</td>
<td>.81650</td>
</tr>
<tr>
<td>Grand Mean</td>
<td>4.5555</td>
<td></td>
</tr>
<tr>
<td>Fairness:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) To ensure fairness in corporate governance does the institution call in an independent knowledgeable entity to assess a particular transaction and give their opinion on its fairness?</td>
<td>4.3333</td>
<td>.81650</td>
</tr>
<tr>
<td>(ii) Fairness is practiced in the way companies are directed and controlled. Is the choice as to what is fair and will most likely be, made by taking into account the stakeholder’s position on the power-interest matrix?</td>
<td>4.1667</td>
<td>.75277</td>
</tr>
<tr>
<td>(iii) Fairness entails the equitable treatment of all equity investors, including minority shareholders. Are there corporate governance structures and practices to protect and enhance the institution’s accountability to its shareowners and ensure that they are treated equally?</td>
<td>4.5000</td>
<td>.83666</td>
</tr>
<tr>
<td>Grand Mean</td>
<td>4.3333</td>
<td></td>
</tr>
<tr>
<td>Responsibility:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Is the board ultimately responsible for the institution’s risk management philosophy, organizational risk framework and oversight?</td>
<td>4.1667</td>
<td>.98319</td>
</tr>
</tbody>
</table>
(ii) Is the executive management charged with designing, implementing and maintaining an effective risk program? | 4.5000 | .54772 |

(iii) Are the roles and reporting lines should be explicitly set out for the board, board risk committees, chief executive officer, chief financial officer, the chief risk officer and business unit heads at a minimum? | 4.3333 | .81650 |

| Grand Mean | 4.3333 |

**Discipline:**

(i) Does the board encourage a culture of integrity permeating all aspects of the company and ensure that its vision, mission and objectives are ethically sound? | 4.5000 | .83666 |

(ii) Are there regulations advocating market-based remedies such as tighter investor monitoring and greater control over executives' remuneration, in order to safeguard financial stability? | 3.6667 | .51640 |

(iii) Is there market discipline device to affect the behavior of a corporate manager or a banker so as to reduce the agency costs associated with external financing of this person’s operations? | 3.5000 | .83666 |

| Grand Mean | 3.8889 |

**Social Responsibility**

(i) Has the board developed and disclosed a policy that outlines its role in overseeing corporate charitable contributions, the terms and conditions under which charitable contributions are permissible and the process for disclosing charitable contributions annually (The board should ensure that only contributions consistent with and aligned to the interests of the company and its shareowners are | 3.8333 | 1.16905 |
(ii) Internal dimension of corporate social responsibility: does the institution accord due diligence to their responsibility to internal stakeholders (specifically employees) addressing issues relating to skills and education, workplace safety, working conditions, human rights, equity/equal opportunity and labor rights?

| Grand Mean | 3.8333 |  .98319 |

(iii) Social responsibility refers to the actions taken by businesses in response to such expectations in order to enhance the mutually dependent relationship between business and societies. Does the institution strive to measure, disclose, and be accountable to internal and external stakeholders for organizational performance towards the goal of sustainable development?

| Grand Mean | 3.9444 |

### 4.4 Inferential Analysis

To establish the relationship between the independent variables and the dependent variable the study conducted inferential analysis which involved coefficient of correlation, coefficient of determination and a multiple regression analysis.

#### 4.4.1 Coefficient of Correlation

To compute the correlation between the study variables and their findings the study used the Karl Pearson’s coefficient of correlation \((r)\). From the findings, it was clear that there was a positive correlation between corporate governance and risk management as shown by a correlation figure of 0.470. There was a positive correlation between corporate governance and internal controls with a correlation figure of 0.372. The correlation coefficient of 0.55
implies a positive correlation between corporate governance and compliance and consulting. There was also a positive correlation between corporate governance and the control variable (audit committee) with a correlation of 0.148. This implies that there is a positive correlation between corporate governance and risk management, internal controls, compliance and consulting and the controlling variable, audit committee functions of internal audit in deposit taking microfinance institutions in Kenya.

**Table 4.7 Coefficient of Correlation**

<table>
<thead>
<tr>
<th></th>
<th>Corporate Governance attributes</th>
<th>Risk Management</th>
<th>Internal Controls</th>
<th>Compliance and Consulting</th>
<th>Audit Committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Governance</td>
<td>Pearson</td>
<td>1</td>
<td>.470***</td>
<td>.372*</td>
<td>.055</td>
</tr>
<tr>
<td>Governance attributes</td>
<td>Correlation Sig. (2-tailed)</td>
<td>.009</td>
<td>.043</td>
<td>.775</td>
<td>.435</td>
</tr>
<tr>
<td>Risk Management</td>
<td>Pearson</td>
<td>.470***</td>
<td>1</td>
<td>.501***</td>
<td>.099</td>
</tr>
<tr>
<td></td>
<td>Correlation Sig. (2-tailed)</td>
<td>.009</td>
<td>.005</td>
<td>.605</td>
<td>.002</td>
</tr>
<tr>
<td>Internal Controls</td>
<td>Pearson</td>
<td>.372*</td>
<td>.501***</td>
<td>1</td>
<td>.325</td>
</tr>
<tr>
<td></td>
<td>Correlation Sig. (2-tailed)</td>
<td>.043</td>
<td>.005</td>
<td>.080</td>
<td>.008</td>
</tr>
<tr>
<td>Compliance and Consulting</td>
<td>Pearson</td>
<td>.055</td>
<td>.099</td>
<td>.325</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Correlation Sig. (2-tailed)</td>
<td>.775</td>
<td>.605</td>
<td>.080</td>
<td>.287</td>
</tr>
</tbody>
</table>
4.4.2 Model Summary

The coefficient of determination was carried out to measure how well the statistical model was likely to predict future outcomes. The coefficient of determination, $R^2$ is the square of the sample correlation coefficient between outcomes and predicted values. As such, it explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (corporate governance) that is explained by all the four independent variables (Risk management, internal controls, compliance and consulting and control variable, audit committee).

### Table 4.8 Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>dimension0</td>
<td>1</td>
<td>.530*</td>
<td>.281</td>
<td>.568</td>
</tr>
<tr>
<td></td>
<td>.281</td>
<td></td>
<td>.166</td>
<td></td>
</tr>
</tbody>
</table>

R= 0.530, absolute value of correlation indicating that the data is at good level of prediction and the simple regression R Square (0.281) indicates that the model accounts for almost 53% of the total variation of the data. The three independent variables under internal audit function plus the control variable that were studied (Audit Committee, Compliance and consulting,
Internal Controls, Risk Management) explain only 53% of corporate governance of deposit taking microfinance institutions in Kenya as represented by the $R^2$. This therefore means the four independent variables only contribute about 53% to the formation of corporate governance of deposit taking microfinance institutions in Kenya while other factors not studied in this research contribute to 47% of corporate governance practices in all the nine licensed deposit taking microfinance institutions in Kenya.

4.4.3 Multiple Regression Analysis

The researcher also conducted a multiple regression analysis so as to identify the relationship between internal audit function and the corporate governance of all the nine licensed deposit taking microfinance institutions in Kenya. Multiple regressions is a statistical technique that allows the study to predict a score of one variable on the basis of their scores on several other variables. The main purpose of multiple regressions is to learn more about the relationship between several independent or predictor variables and a dependent or criterion variable. The researcher applied the statistical package for social sciences (SPSS) to code, enter and compute the measurements of the multiple regressions for the study.

Table 4.9 Coefficients of Multiple Regression Analysis

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>95.0% Confidence Interval for B</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
</tr>
<tr>
<td>1</td>
<td>3.448</td>
<td>1.235</td>
<td>2.793</td>
</tr>
</tbody>
</table>
The regression equation, \( Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \epsilon \) becomes:

\[
Y = 3.448 + 0.365X_1 + 0.251X_2 - 0.029X_3 - 0.314X_4 
\]

Where \( Y \) is the dependent variable (corporate governance), \( X_1 \) is Risk Management, \( X_2 \) is Internal Controls, \( X_3 \) is Compliance and Consulting and \( X_4 \) is Audit Committee.

Unstandardized coefficients indicate how much the dependent variable varies with the independent variables when all other independent variables are held constant. From the regression equation generated, taking all other factors (Risk management, internal controls, compliance and consulting and audit committee) constant at zero, corporate governance of deposit taking microfinance institutions in Kenya would be 3.448. Further, if all the other variables are kept constant, a unit increase in risk management will lead to a 0.365 increase in corporate governance of deposit taking microfinance institutions in Kenya. A unit increase in internal controls will lead to a 0.251 increase in corporate governance of deposit taking microfinance institutions in Kenya while a unit increase in compliance and consulting role of internal audit will have a resultant 0.029 decrease in corporate governance of deposit taking microfinance institutions in Kenya.

<table>
<thead>
<tr>
<th>Risk Management</th>
<th>.365</th>
<th>.168</th>
<th>.472</th>
<th>2.177</th>
<th>.039</th>
<th>.020</th>
<th>.711</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Controls</td>
<td>.251</td>
<td>.211</td>
<td>.253</td>
<td>1.189</td>
<td>.246</td>
<td>-.184</td>
<td>.686</td>
</tr>
<tr>
<td>Compliance and Consulting</td>
<td>-.029</td>
<td>.184</td>
<td>-.028</td>
<td>-.157</td>
<td>.877</td>
<td>-.408</td>
<td>.350</td>
</tr>
<tr>
<td>Audit Committee</td>
<td>-.314</td>
<td>.294</td>
<td>-.227</td>
<td>-1.068</td>
<td>.296</td>
<td>-.919</td>
<td>.291</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Corporate Governance attributes
microfinance institutions in Kenya. Lastly, a unit increase in the controlling variable, audit committee will result into a 0.314 decrease in corporate governance of deposit taking microfinance institutions in Kenya.

4.5 Summary and Interpretation of Findings

From the study findings it was clear that internal audit function of risk management was effective in identification, assessment and monitoring of risk, suggesting risk management strategies, assessing performance management and conducting unplanned and informal reviews of other areas of concern, including unacceptable levels of risk in deposit taking microfinance institutions in Kenya. This is in agreement with earlier findings by Prawitt, Smith and Wood (2006) that the internal audit function plays a unique role in corporate governance by monitoring organizational risks and ensuring that organizational processes are efficient and effectively controlled. However, the study findings showed that this function is moderately effective in risk monitoring, assessing communication of risk, providing assurance that the risks are being appropriately managed and assessing ethics and values within the institutions under study. This is consistent with Spira & Page (2003) who found that internal audit function evaluates risk exposures relating to the organization's governance, operations and information systems, in relation to; effectiveness and efficiency of operations, reliability and integrity of financial and operational information, safeguarding of assets and compliance with laws, regulations and contracts. Jackson (2000) also observed that the idea of risk had become essential to corporate governance and become connected to the idea of internal control.

Further, the study found that reviews of individual systems and accounting information and communication, control of information within the institution, provision financial, managerial
controls and operational policies controls aspects of internal controls were effective due to application of internal auditing. This is in line with Cai (1997) who indicated that by measuring and evaluating the effectiveness of organizational controls, internal auditing, itself, is an important managerial control device, which is directly linked to the organizational structure and the general rules of the business. Herdman (2002) also stated that an effective internal audit function is crucial to the success of a company in stemming fraud and abuse, and in the preparation of accurate financial statements.

The study found that the compliance and consulting aspect of internal audit function was effective in ensuring that expenditure was within budgetary provisions, disbursements of credit facilities comply with specified procedures, provision of effective systems for managing and accounting for physical and financial assets as well as providing suggestions for more helpful and competent use of resources. Further, the compliance and consulting aspect was also effective in promoting accountability, providing information about any fraudulent activities or irregularities and conducting reviews of the agreement framework and specific compliance issues and operational and financial performance. Appraisals of the achievement of corporate goals and objectives and compliance with laws, regulations and contracts were effectively conducted due to the application of internal auditing. However, it was found that the compliance and consulting function was moderately effective in providing advice and comment on devotion to the values and code of conduct/code of ethics of the deposit taking institutions in Kenya. These findings concur with Roe (2004) who focused on internal audit independence and corporate governance and found that compliance and consulting in the internal audit function as a first line protection against insufficient corporate governance and financial reporting. Gramling and Myers (2003) found that internal auditing
help corporate governance by reviewing the organization’s code of conduct and ethics policies to ensure they are current and are communicated to employees.

On the aspect of internal auditing to audit committee, the study findings implied an effective role played by this function in ensuring that the Board of Directors has an Audit Committee responsible for monitoring financial and compliance activities of Management and that the Audit Committee had the skills and expertise needed with at least one member of the Audit Committee possessing recent and relevant financial experience. The findings further suggested that the Audit Committee conducted periodic reviews of its activities and practices compared with current best practices to ensure that its activities are consistent with leading practice and held regular meetings and ensures that some meetings coincide with key dates within the financial reporting and audit cycle. The Audit Committee played a complementary role by effectively strengthening the position of the internal audit functions by providing an independent and supportive environment and reviews the effectiveness of the internal audit function. These findings are consistent with the existing literature which assert, “the members of an Audit Committee should be of appropriate competency (Xie, Davidson and DaDalt, 2003; Choi, Jeong and Park, 2004).”

Audit Committee members with financial or accounting expertise are thought to be able to unveil any opportunistic earnings management activities more effectively Choi et al., (2004). The study shows an awareness and existence of corporate governance practices in the licensed deposit taking microfinance institutions in Kenya. On the extent of practice of various attributes of corporate, the study findings revealed that accountability, transparency, independence, fairness, responsibility and discipline were applied to a large extent. The social responsibility aspect of corporate governance practices was practiced to a moderate extent by the deposit taking microfinance institutions in Kenya. The empirical findings of this study
are consistent with the guidelines developed by the capital markets authority and the prudential guidelines issued by the Central Bank of Kenya. They also relates to practices recommended by other jurisdictions outside Kenya like the Basel Committee on Banking Supervision, the guidelines by the Commonwealth association for corporate governance and the organization for economic cooperation and development.
CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction
This chapter demonstrates the summary of the research findings, the conclusion, the recommendations, limitation of the study and suggestions for further research.

5.2 Summary of findings
The study objective was to establish the relationship between internal audit function and the corporate governance of the deposit taking microfinance institutions in Kenya. The population was made up of 9 deposit taking microfinance institutions in Kenya. Out of the 9 institutions, only 6 institutions responded sufficiently. The response rate was 67%, which is ample for drawing conclusions. The respondents for this study were mainly Heads of Internal Audit. The study collected primary data on the current state of affairs. The research was quantitative in nature. This implies that descriptive statistics analysis was employed. The researcher also used a multivariate regression analysis to determine the relationship between the independent variables and the dependent variable.

The study concludes that risk management had the greatest effect on corporate governance within deposit taking microfinance institutions in Kenya followed by internal control while compliance and consulting and audit committee had the least effect respectively. The study recommends that the deposit taking microfinance institutions should recognize contribution of internal auditing. Additionally, the study recommends that the deposit taking microfinance institutions should apply internal auditing in its operations as an effective tool for ensuring compliance with set policies and procedures. The study further recommends that deposit taking microfinance institutions in Kenya be well equipped to implement corporate governance practices in its daily activities to the levels which might be acceptable in developed market economies and improve accessibility to firm financing by enhancing transparency and accountability in the information disclosed.

5.3 Conclusion
The research study has achieved its objectives of establishing the relationship between internal audit function and the corporate governance of licensed deposit taking microfinance
institutions in Kenya. Although there were a few failed responses, the research was successful given that a response rate of 67% was achieved. The data collected was analyzed and presented and from the analysis, it is evident that there was a correlation between internal audit function and the corporate governance of licensed deposit taking microfinance institutions in Kenya. A good number of the deposit taking microfinance institutions in Kenya indeed do practice good corporate governance as a result of effective application of the internal audit function. Based on the study finding, the study concluded that internal auditing is effective in risk management more particularly on risk assessment, suggesting risk management strategies and in conducting unplanned and informal reviews of other areas of concern, including unacceptable levels of risk.

On the internal controls aspect of internal auditing, the study concluded that reviews of individual systems and processes, operational policies controls and provision of financial controls and control information within the institution were most effective. In regards to compliance and consulting, the study found that compliance with laws, regulations and contracts, provision of information about any fraudulent activities or irregularities, provision for the timely reconciliation of accounts, provision of effective systems for managing and accounting for physical and financial assets were highly effective. This function also effectively ensured the effectiveness and efficiency of operations, provided suggestions for more helpful and competent use of resources and was a source of information on major frauds and irregularities.

Likewise, the audit committee strongly played a complementary role by effectively strengthening the position of the internal audit functions by providing an independent and supportive environment and reviews the effectiveness of the internal audit function. The respondents revealed that the audit committee has the financial skills and expertise needed and effectively executes its role of monitoring financial and compliance activities of management, conducting periodic reviews of its activities and practices compared with current best practices to ensure that its activities are consistent with leading practice and also holds regular meetings and ensures that some meetings coincide with key dates within the financial reporting and audit cycle. The study further concluded that the corporate governance attributes of accountability, transparency, independence, fairness, responsibility and discipline were applied to a large extent within these institutions. From the regression, the study concludes that risk management had the greatest effect on corporate governance.
within the licensed deposit taking microfinance institutions in Kenya followed by internal controls while compliance and consulting and audit committee had the least effect.

5.4 Limitations of the Study
This study may also have some weaknesses inherent in using questionnaires for data collection purposes. First is the misinterpretation of words by respondents. This results in some answers which reflect an ideal situation rather than the actual occurrence. Some respondents may also withhold some information which is important for the study. There is also likelihood of bias as some respondents may not be willing to disclose information which might give a negative impression of the institution to the public. The researcher had to be cautious not to appear to be getting information to give to a competitor firm by making the respondents understand that it was an academic research project. Time constraint was also another limitation which resulted in having some target respondents very busy and not willing to make the time to fill in the questionnaire. The researcher was also limited to the time allocated to complete the study.

The small size of the population could have limited confidence in the results and this might limit generalizations to other situations. Reluctance to respond to questionnaires was another limitation in collecting the required data for the study. This was due to some reservations held by the target population. This hence would have led to generalization during the analysis and presentation of the data made from those who responded to represent the views of the rest of the respondents. The researchers countered the limitation by making prior arrangements with the respondents as well as making personal calls and visits to remind the respondents to fill in the questionnaire.

5.5 Policy Recommendations
Corporate governance practices should be highly regarded in every organization. The deposit taking microfinance institutions for that matter should not be left out. Organizations should establish and review their corporate governance structures as this contributes greatly to the inward success and outward success of the organization. More so, corporate governance structures should be disclosed. The board should disclose structures established to prevent conflicts between the interests of all the relevant stakeholders and those of shareholders. To the implication of internal auditing on corporate governance aspects, the study recommended
that all aspects related to creating good image to the public should be enhanced through application of internal auditing for ease achievement of set goals.

The study recommended that in order for the deposit taking microfinance institutions to be effective in its operation and service delivery they should recognize contribution of internal auditing. Additionally, the study recommended that for the deposit taking microfinance institutions to effectively mitigate risk they should apply internal auditing in its operation. On effectiveness of internal auditing on internal controls, the study recommended that all deposit taking microfinance institutions should apply internal controls in its operation to ensure effective operation. Likewise, the study recommended that deposit taking microfinance institutions should accept internal auditing as a tool for effective internal control so as to realize their objectives set with ease.

**5.6 Suggestions for Further study**
This study has contributed to the body of knowledge and paved way for future research. An interesting and crucial area to be researched would be of how corporate governance relates or affects the quality of financial products offered by the deposit taking microfinance institutions in Kenya. The study suggests that further research to be done on the relationship between internal audit function and the corporate governance of specialized microfinance institutions in Kenya in order to give both negative and positive sides that can be reliable. The study also recommends that further research should be done on the challenges to effective performance of internal audit departments of the Kenyan microfinance institutions since the departments are bogged with myriad challenges with some not being autonomous from the finance departments.
REFERENCES


Barrier, M (2003). *One Right Path*. Internal Auditor, 60(6), 52-57


KPMG, (2004). Shaping the Audit Committee Agenda, KPMG LLP. Montvale, NJ


APPENDICES

Appendix 1: List of Licensed Deposit Taking Microfinance Institutions in Kenya as at 31 December 2013

1. Century DTM Limited
2. Faulu Kenya DTM Limited
3. Kenya women Finance Trust DTM Limited
4. Rafiki Deposit Taking Microfinance Limited
5. Remu DTM Limited
6. SMEP Deposit Taking Microfinance Limited
7. SUMAC DTM Limited
8. U & I Deposit Taking Microfinance Limited
9. Uwezo Deposit Taking Microfinance Limited

Source: Central Bank of Kenya Website
Appendix 2: List of sampled Microfinance Institutions with Head Offices in Nairobi County to Pilot the Study Tool

1. ECLOF
2. Jamii Bora Ltd
3. Musoni
4. Opportunity Kenya Ltd
5. SISDO

Source: Central Bank of Kenya
Appendix 3: Letter of Introduction

____ September, 2014

Everlyn Mutave Martin

School of Business, University of Nairobi

P.O. Box 30197, Nairobi

The Head of Internal Audit

…………………………

P.O Box …………………., Nairobi

Dear Sir/Madam,

RE: REQUEST FOR RESEARCH DATA

I am a postgraduate student at the University of Nairobi, School of Business. In partial fulfillment of the requirements for the award of Master of Science in Finance degree, I am required to conduct a study on “The relationship between Internal Audit Function and the Corporate Governance of Deposit Taking Microfinance Institutions in Kenya.”

For practicability of my research problem, I intend to focus on local institutions. Kindly provide me with primary research data by completing this self-administered questionnaire. The questionnaire consists of three parts thus it should not take more than 45 minutes to fill. Please note there is no right or wrong answer and confidentiality will be maintained. All the information collected through this questionnaire will not be used for any other purpose apart from its intended academic use. I thank you in advance for your co-operation.

Yours faithfully

Everlyn Mutave M
Appendix 4: Questionnaire

The relationship between Internal Audit Function and the Corporate Governance of Deposit Taking Microfinance Institutions in Kenya

SECTION A: BACKGROUND INFORMATION

1. Name of the institution: __________________ Location: _________________________
2. How many years has this institution been in operation in Kenya? ________ Years
3. Name and designation of the contact person: _________________________________
   Telephone number: ______________ Date of completing the questionnaire: ____________

SECTION B: INTERNAL AUDIT FUNCTIONS

4. How effective are the following functions of internal audit (compliance and consulting, risk management and internal controls) in your MFI? (Suitable target respondent: The Head of Internal Audit) Use a scale of 1-5 where: 1 = Ineffective; 2 = Slightly effective; 3 = Moderately effective; 4 = Effective; and 5 = Very effective;

<table>
<thead>
<tr>
<th>RISK MANAGEMENT</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>i Risk Identification</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ii Risk Assessment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>iii Risk Mitigation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>iv Risk Monitoring</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>v Suggest risk management strategies</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>vi Provide assurance that the risks are being appropriately managed</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>vii Assess ethics and values within the organization</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>viii Assess performance management</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ix Assess communication of risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>x Unplanned and informal reviews of other areas of concern, including unacceptable levels of risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## INTERNAL CONTROLS

1. Reviews of individual systems and processes
2. Provide Financial controls
3. Managerial controls
4. Operational policies controls
5. Control information within the institution
6. Accounting Information and communication

## COMPLIANCE AND CONSULTING

1. Ensure that expenditure is within budgetary provisions
2. Ensure disbursements of credit facilities comply with specified procedures
3. Provides for the timely reconciliation of accounts
4. Provides effective systems for managing and accounting for physical and financial assets
5. Promoting accountability: Are directors accessible to shareholder inquiry concerning their key decisions affecting the company's strategic direction and is management accountable to the directors?
6. Providing information about any fraudulent activities or irregularities
7. Ensure effectiveness and efficiency of operations
8. A source of information on major frauds and irregularities
9. Reviews of the agreement framework and specific compliance issues
10. Reviews of operational and financial performance
11. Suggestions for more helpful and competent use of resources
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
</table>
xii  | Appraisals of the achievement of corporate goals and objectives |
|xiii | Compliance with laws, regulations, and contracts |
xiv  | Advice and comment on devotion to the values and code of conduct/code of ethics of the organization |

5. Please indicate your level of agreement with the following statement as regards the **Audit Committee in your institution? (Suitable target respondent: The Company Secretary)** Use a scale of 1-5 where: 1-Strongly disagree; 2-Disagree; 3-Neither agree Nor disagree 4-Agree; 5-Strongly agree

<table>
<thead>
<tr>
<th>Audit Committee</th>
<th>Strongly disagree</th>
<th>Disagree</th>
<th>Neither agree Nor disagree</th>
<th>Agree</th>
<th>Strongly agree</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
</tr>
</tbody>
</table>

(i) The Board of Directors has an Audit Committee responsible for monitoring financial and compliance activities of Management.

(ii) The Board of Directors satisfies itself that the Audit Committee has the skills and expertise needed; at least one member of the Audit Committee has recent and relevant financial experience.

(iii) The Audit Committee conducts periodic reviews of its activities and practices compared with current best practices to ensure that its activities are consistent with leading practice.
(iv) The Audit Committee is effective in strengthening the position of the internal audit function by providing an independent and supportive environment and reviews the effectiveness of the internal audit function

(v) The audit committee holds regular meetings and ensures that some meetings coincide with key dates within the financial reporting and audit cycle.

### SECTION C: CORPORATE GOVERNANCE ATTRIBUTES

6. To what extent does your institution practice the following corporate governance attributes?

*(Suitable target respondent: The Company Secretary)* Use a scale of 1-5 where: 1-Not at all; 2-To a less extent; 3-To a moderate extent; 4-To a large extent; 5-To a very large extent.

<table>
<thead>
<tr>
<th>Corporate governance attributes</th>
<th>Not all (1)</th>
<th>To a less extent (2)</th>
<th>To a moderate extent (3)</th>
<th>To a large extent (4)</th>
<th>To a very large extent (5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accountability:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Are directors accountable to shareowners and management accountable to directors?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) Are directors accessible to shareowner inquiry concerning their key decisions affecting the company’s strategic direction?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(iii) Does the institution have a corporate charter</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
which clearly sets out Shareholders’ appropriate rights to ensure that boards are accountable for their actions?

**Transparency:**

(i) Does the institution make substantive disclosure of all significant aspects of remuneration policies and structures for key executives, and in particular the performance metrics which are in place to incentivize value-creation, to incorporate risk management considerations and to align the interests of executives with those of shareholders?

(ii) Is the operating, financial, and governance information about companies readily transparent to permit accurate market comparisons; this includes disclosure and transparency of objective globally accepted minimum accounting standards, such as the International Financial Reporting Standards?

(iii) Does the institution aspire to transparent and open communication about its aims, its challenges, its achievements and its failures?

**Independence:**

(i) Are board elections totally free from political interference and does the leadership of the board members exercise their responsibilities diligently and embrace independence (this must ultimately
<table>
<thead>
<tr>
<th>Change the way in which directors interact with management?</th>
</tr>
</thead>
<tbody>
<tr>
<td>(ii) Is there lack of conflict between the directors’ personal, financial, or professional interests, and the interests of shareowners?</td>
</tr>
<tr>
<td>(iii) Independent board committees: does the committees who perform the audit, director nomination and executive compensation functions consist entirely of independent directors?</td>
</tr>
<tr>
<td><strong>Fairness:</strong></td>
</tr>
<tr>
<td>(i) To ensure fairness in corporate governance does the institution call in an independent knowledgeable entity to assess a particular transaction and give their opinion on its fairness?</td>
</tr>
<tr>
<td>(ii) Fairness is practiced in the way companies are directed and controlled. Is the choice as to what is fair and will most likely be, made by taking into account the stakeholder’s position on the power-interest matrix?</td>
</tr>
<tr>
<td>(iii) Fairness entails the equitable treatment of all equity investors, including minority shareholders. Are there corporate governance structures and practices to protect and enhance the institution’s accountability to its shareowners, and ensure that they are treated equally?</td>
</tr>
</tbody>
</table>
Responsibility:

(i) Is the board is ultimately responsible for the institution’s risk management philosophy, organizational risk framework and oversight?

(ii) Is the executive management charged with designing, implementing and maintaining an effective risk program?

(iii) Are the roles and reporting lines should be explicitly set out for the board, board risk committees, chief executive officer, chief financial officer, the chief risk officer, and business unit heads at a minimum?

Discipline:

(i) Does the board should encourage a culture of integrity permeating all aspects of the company, and ensure that its vision, mission and objectives are ethically sound?

(ii) Are there regulations advocating market-based remedies such as tighter investor monitoring and greater control over executives' remuneration, in order to safeguard financial stability?

(iii) Is there market discipline device to affect the behavior of a corporate manager or a banker so as to reduce the agency costs associated with external financing of this person’s operations?
### Social Responsibility

(i) Has the board developed and disclosed a policy that outlines its role in overseeing corporate charitable contributions, the terms and conditions under which charitable contributions are permissible, and the process for disclosing charitable contributions annually (The board should ensure that only contributions consistent with and aligned to the interests of the company and its shareowners are approved).

(ii) Internal dimension of corporate social responsibility: does the institution accord due diligence to their responsibility to internal stakeholders (specifically employees) addressing issues relating to skills and education, workplace safety, working conditions, human rights, equity/equal opportunity, and labor rights?

(iii) Social responsibility refers to the actions taken by businesses in response to such expectations in order to enhance the mutually dependent relationship between business and societies. Does the institution strive to measure, disclose, and be accountable to internal and external stakeholders for organizational performance towards the goal of sustainable development?