THE RELATIONSHIP BETWEEN INTERNAL AUDIT INDEPENDENCE AND SHARE PERFORMANCE OF FIRMS LISTED IN THE NAIROBI STOCK EXCHANGE

LUCAS ALWALA OTENE

A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS OF THE AWARD OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

NOVEMBER, 2014
DECLARATION

This research project is my original work and has not been submitted for examination to any other university.

Sign……………………………………….         Date……………………………………

LUCAS ALWALA OTENE

D61/60384/2011

This research project has been submitted for examination with my approval as the University of Nairobi Supervisor

Sign……………………………………….         Date……………………………………

DR. JOSIAH ADUDA

Lecturer, University of Nairobi
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DEDICATION

I dedicate this work to my friends and family for the sacrifice they have made for me to complete this thesis. Their concern, support, encouragement and enthusiasm have inspired me to achieve this goal.
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<th>Full Form</th>
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<tr>
<td>CMA</td>
<td>Capital Market Authorities</td>
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<td>CPI</td>
<td>Consumer Price Index</td>
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<td>CR</td>
<td>Control Risk</td>
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<td>IIA</td>
<td>Institute of Internal Auditors</td>
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<td>IR</td>
<td>Inherent Risk</td>
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<td>NSE</td>
<td>Nairobi Stock Exchange</td>
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<tr>
<td>PPP</td>
<td>Purchasing Power Parity</td>
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ABSTRACT

The internal audit department is very important inside a firm that the internal audit is regarded as the key element in the application of accounting systems which in turn, helps in evaluating the work of the department. The internal audit is considered as the backbone of the business accounting as it is the section that records all businesses related to the sector. The main objective of the study was to establish the relationship between Internal Audit Independence and Share performance of firms listed in the Nairobi Stock Exchange. The study adopted a descriptive research design to sample the target population of 60 companies quoted at the NSE as of December 2013. The study found out that there exists a significantly strong positive correlation between internal audit independence and share performance. A significantly strong positive correlation also exists between valuation ratios (dividend pay-out ratio) and share performance. However the study findings conclude a strong and an insignificant correlation between exchange rate and share performance. The study findings also conclude that a weak and an insignificant correlation between inflation rate and share performance exists. The study also found that there has been a significant increase of exchange rates, inflation rate, dividend payout ratio and ROI over the 5 year period. Also the study concludes that Fraud investigation, verification of financial transaction (Financial audit), and assessment of internal control are the major scope of work for internal audit. The study concludes that there exists a significantly strong positive correlation between internal audit independence and share performance. A significantly strong positive correlation also exists between valuation ratios (dividend pay-out ratio) and share performance. However the study findings conclude a strong and an insignificant correlation between exchange rate and share performance. The study findings also conclude that a weak and an insignificant correlation between inflation rate and share performance exists.
CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

The internal audit department is very important inside a firm that the internal audit is regarded as the key element in the application of accounting systems, which in turn, helps in evaluating the work of the department. The internal audit is considered as the backbone of the business accounting as it is the section that records all businesses related to the sector. The efficiency of internal audit helps develop the work of the company because the financial reports reflect the internal audit department’s quality. Moreover, an internal audit is a significant part of the corporate governance structure in an organization and corporate governance encompasses oversight activities taken by the board of directors and audit committees to make sure that the financial reporting process is credible (Public Oversight Board, 1994).

The financial and corporate strategy of a company is underpinned by effective internal systems in which the internal audit has an important role in raising the reliability of the internal control system, improving the process of risk management and above all, satisfying the needs of internal users. The internal audit support enhances the system of responsibility that the executive directors and employees have towards the owners and other stakeholders (Eighme and Cashell, 2002). Taken together, the internal audit department provides a reliable, objective, and neutral service to the management, board of directors, and audit committee, while stakeholders are interested in return on investments, sustainable growth, strong leadership, and reliable reporting on the financial performance and business practices of a company (Ljubisavljević and Jovanovi, 2011).
Internal auditor’s independence from the board of directors is of great importance to shareholders and is seen as a key factor in helping to deliver audit quality. However, an audit necessitates a close working relationship with the board of directors of a company. The fostering of this close working relationship has led (and continues to lead) shareholders to question the perceived and actual independence of auditors and to demand tougher controls and standards over independence to protect them (Fama, 2006). As far as independence and objectivity are concerned, auditors need to be conscious of threats to objectivity and apply suitable safeguards where necessary. Reputation is a key factor in promoting trust and auditor independence and is an important quality that shareholders look for. Auditors have an important incentive to maintain independence to protect their reputation and thereby help them to retain and win audits (Goodwin and Yeo, 2001).

1.1.1 Internal Audit Independence

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

Gunther and Moore (2002) notes internal auditing is conducted in diverse legal and cultural environment within organization that varies in purpose, size, complexity and structure; and by persons within or outside the organization. While differences may affect
the practice of internal auditing in each environment, conformance with the Institute of Internal Auditors (IIA) international standards for the professional practice of internal auditing is essential in meeting the responsibilities of internal auditors and the audit activity. Central Bank of Kenya (2006) has further emphasized that the board of directors shall set up an effective internal audit department, staffed with qualified personal to perform internal audit functions, covering the traditional function of financial audit as well as the function of management audit. The internal auditing activity evaluates risk exposure relating to the organization’s governance, operations and information systems in relation to the effectiveness and efficiency of operations, reliability and integrity of financial and operational information, safeguard of assets and compliance with laws, regulations and contracts. Based on the results of the risk assessment, the internal auditor evaluates the adequacy and effectiveness of how risk are identified and managed in the above areas. They also assess other aspects such as ethics and values within the organization, performance management, communication of risk and control information within the organization in order to facilitate a good governance process (IIA Research Foundation, 2004).

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

1.1.2 Share Performance

In this era of intense competition, both world-wide and domestic, business firms of all sizes and varieties have become more and more concerned with the share figures they achieve in the marketplace. Some managers appear interested as much, if not more, in shares performance as profits or returns on investment. For product and brand managers in particular, the sense of urgency associated with the gains and losses of shares for the product/brand in their charge may be likened to what winning or losing of a war front means to generals or the general staff. Though such military analogies are not to be taken literally, one fact seems obvious: shares command the attention of business managers as key indices for measuring the performance of a product or brand in the marketplace. Many individuals in business indeed keep a close watch over day-by-day changes in market shares, so much so that market-share movement to them is almost synonymous to market information (Ljubisavljević and Jovanovi, 2011)

To the extent that market shares are used as market performance indices, it is clearly desirable for the individuals concerned to have thorough knowledge of the processes which generate market-share figures and to be able to analyze the impact of their own actions on market shares, as well as their profit implications (Collier and Gregory 1996). Lacking such knowledge, one might be tempted to oversimplify the cause-and-effect relationships between market shares and marketing variables, or to equate market shares
to profitability (a not unusual tendency even among seasoned businessmen) and fall into deadly traps of blindly competing for market shares for their own sake. Despite the obvious importance associated with it in many firms, the approach of many managers to market-share analysis may be described as casual (Goodwin and Yeo, 2001).

Internal audit makes a large contribution to the achievement of company goals, and the implementation of strategies for their achievement (Ljubisavljević and Jovanovi, 2011). In addition, the internal audit function is responsible for reinforcing management and audit committee (Hutchinson and Zain, 2009). Likewise, internal audit determines the reliability, reality, and integrity of financial and operational information that comes from different organizational units, on which appropriate business decisions at all levels of management are based. Successful implementation of internal audit tasks means that it must be independent, i.e., company management should in no way influenced by its work, information, conclusions, and evaluations. In this way the internal audit report becomes a means of communication between internal audit and management, and an important guideline for the successful management of the company (Ljubisavljević and Jovanovi, 2011).

1.1.3 Internal Audit Independence and Share Performance

An internal audit function could be viewed as a first line of defense against inadequate organization governance and financial reporting. With appropriate support from the board and audit committee the internal audit is in the best position to gather intelligence on inappropriate accounting practices, inadequate internal controls and ineffective corporate
governance (Zekele, 2007). It is therefore an integral and necessary part of an effective corporate governance framework. Alongside the board, executive management and external audit, internal audit is one of the cornerstones of good corporate governance. Hermanson and Rittenberg (2003) states that the nature of internal audit activity today typically includes risk management, control governance and compliance work all of which map directly into corporate governance. Khas (1999) argues that the internal auditing functions as part of the corporate governance structure plays an increasingly important role in monitoring the internal control system of the company and its financial reporting systems. Moreover, Kinfu (2006) notes that one of the strongest means to monitor ethics and governance in institutions can be through an internal audit function. These statements clearly indicate the contribution that internal audit function has towards enhancing effective and good corporate governance in commercial banks in Kenya. Chapman and Anderson (2000) argues that the inclusion of assurance and consultancy in the definition of internal auditing results in internal auditing becoming a proactive consumer focused activity concerned with the important issues of control, risk management and governance. Hass and Burnaby (2006) further notes that organizations have encountered a rapid change in the economic complexity, expanded regulatory requirements and technological advancement. These changes have given internal audit function a set of expanded opportunities to support management provide services to other organizational functions and generate direct reporting links to the audit committee. Ramamoorthi (2003) indicates that overtime there has been a massive shift in focus to one that promotes and supports effective organizational governance. Ruud (2003) further notes that in today’s business environment the internal audit function has become a major
support function for management, the audit committee, the board of directors and other stakeholders. Morgan (1979) consequently notes a significant opportunity for internal auditing has emerged to demonstrate its potential to add value and to break away from historical characteristic as organizational policemen and watchdog.

1.2 Research Problem

A company’s accounting control practices is widely believed to be crucial to the success of an enterprise as it acts as a powerful brake on the possible deviations from the predetermined objectives and policies. This means that an organization that put in place an appropriate and adequate system of accounting controls is likely to perform better (in financial terms) than those that do not. As Okezie (2004) puts it, “an enterprise’s internal audit function can significantly affect the operations of the enterprise and may have an impact on the ability of the entity to remain a going-concern. Conrad (2003) had portrayed Enron’s demise as the consequence of a “few unethical ‘rogues’ or ‘bad eggs’ acting in the absence of any control”. Thus inadequate control systems may negatively affect an organization’s success. According to Hermanson and Rittenberg (2003) the existence of an effective internal audit function is associated with superior organizational performance.

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

Local studies on relationship between internal audit independence and share performance are scanty, hence the empirical gap that the present study sought to bridge. Majority are concentrated on internal audit and corporate governance. For instance, Maiteka (2010) undertook a study of the influence of internal audit on corporate governance in public sector in Kenya focusing on selected ministries. From the findings, internal auditing was found to assess risks facing government ministries on time and concentrate on high risk areas in order to increase transparency and accountability, hence enhancing good governance. Murithi (2011) studied the relationship between corporate governance practices and financial performance of investment banks in Kenya; Cherono (2011) looked at the impact of CMA corporate governance code on the financial performance of commercial banks in Kenya; Nyakoe (2010) studied the relationship between corporate governance and risk management practices among commercial banks in Kenya; Sigowo
(2009) examined the role of internal audit in promoting good corporate governance in SACCOs and Murithi (2009) studied the role of internal auditor in enterprise wide risk management for listed companies in Kenya under Industrial and Allied Sectors.

Although prior research (Mak, 2009 and Simons, 2010) suggest a link between accounting control practices and financial performance, majority of prior studies had concentrated mostly on the budgeting aspect of accounting controls. This aside, the available studies so far had dealt exclusively with large privately-owned companies especially in the advanced countries. Given the growing role of the internal audit in contemporary corporate governance, independence has gained renewed attention. The tension resulting from the pressure to provide value added services while maintaining independence prompts my research objective which is to analyze whether internal audit functions in practice are operating independently in line with theoretical best practice guidelines. Little is known, at present, about the relationship between internal audit independence and share performance. It is in an attempt to fill this gap that we setting out to assess empirically the relationship between internal audit independence and share performance. This study thus sought to answer the following research question: what is the relationship between internal audit independence and share performance on firms listed in the NSE?

1.3 Objectives of the Study

The main objective of the study was to establish the relationship between Internal Audit Independence and Share performance of firms listed in the Nairobi Stock Exchange
1.4 Value of the Study

The study finding was important to scholars and researchers by adding to the body of existing knowledge on internal audit. The study also gives recommendation for further researchable areas which will be useful in furthering the understanding of internal audit function and share performance. The study helped the researcher to acquire practical skills that will help in carrying out more researches in some future time. This is because during the process of carrying the study, the researcher will come up with new inspiring problem in the area.

The study was of value to: the management who are able to appreciate the importance of an independent internal audit function in their organization; the internal auditors who through this study be in a position to appreciate their role in promoting share performance. The study will help managers improve internal audit departments and controls in firms. This will involve evaluating whether the policies and processes established by management are operating effectively and provide recommendations for improvement.

The study helped firms to manage risks. Risk management relates to how an organization sets objectives, then identifies, analyzes and responds to those risks that could potentially impact its ability to realize its objectives.

The study helped the institute of internal auditors which was in a position to have more insight on how the internal audit function was executing it mandate in companies. This informed on skills and knowledge gaps inherent within the function and hence provides workable solutions.
CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

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

2.2 Theoretical Framework

The theories discussed here are agency theory, stewardship theory and stakeholder’s theory

2.2.1 Agency Theory

Meckling and Jensen (1976) define agency relationship as a contract under which one or more person(s) (the principal) engages another person (agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. Watts and Zimmerman (1986) argues that agency theory in its purest form also assumes that individuals will take into account all available information, rationally and instantly, to make decisions. Assumptions of an efficient market can be relaxed to explain the importance of accounting practices and contracting services. In an imperfect market where principals cannot know everything at any one point in time, emphasizes the need to incur agency costs as a means of monitoring. This involves contracting accountants and auditors. Fama (1980) proposes that separation of security ownership and control can...
be explained as an efficient form of economic organization within the “set of contracts” perspective. He set aside the typical presumption that a corporation has owners in any meaningful sense and the concept of the entrepreneur for the purposes of the large modern corporation. Instead the two functions attributed to the entrepreneur, management and risk bearing were treated as naturally separate factors within the set of contracts called a firm. He proposes that the firm is disciplined by competition from other firms which forces the evolution of devices for efficiently monitoring the performance of the entire team and of its individual members. In addition individual participants in the firm and in particular its manager face both the disciplined and opportunity provided by the markets for their services both within and outside of the firm. Sheret and Kent (1983) and Watts (1988) suggest that internal auditing is a bonding cost borne by agents to satisfy the principal’s demand for accountability made by external participants especially shareholders. The cost of internal auditing can be judged to be monitoring cost which is incurred by the principals to protect their economic interests. Agency theory contends that internal auditing like other intervention mechanism like financial reporting and external auditing helps to maintain cost efficient contracting between owners and managers.

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

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

2.2.2 Stewardship Theory

Stewardship theory has its roots from psychology and sociology and is defined by Davis, Schoorman and Donaldson (1997) as a steward protects and maximizes shareholders wealth through firm performance, because by so doing, the steward’s utility functions are maximized”. In this perspective, stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders. Unlike agency theory, stewardship theory stresses not on the perspective of individualism (Donaldson and Davis, 1991), but rather on the role of top management being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards
are satisfied and motivated when organizational success is attained. Agyris (1973) argues that while agency theory looks at an employee or people as an economic being, which suppresses an individual’s own aspirations, on the other hand Donaldson and Davis (1991) argues that stewardship theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust. It stresses on the position of employees or executives to act more autonomously so that the shareholders’ returns are maximized. Indeed, Fama (1980) contend that executives and directors are also managing their careers in order to be seen as effective stewards of their organization, whilst, Shleifer and Vishny (1997) claims that managers return finance to investors to establish a good reputation so that that can re-enter the market for future finance.

Davis et al. (1997) and Tosi et al. (2003) notes that the involvement-oriented, participative management philosophy espoused by the stewardship theory automatically reduces the need for strict internal control mechanisms to curb governance challenges and agency costs, part of which is the involvement of internal audit in an organization. Meckling and Jensen (1994) further states the cost incurred to curb agency problems (reducing information asymmetries and accompanying moral hazards) is less when owners directly participate in the management of the firm as there is a natural alignment of owner managers interest with growth opportunities and risk. This alignment reduces their incentive to be opportunistic and hence owner managed firms have little to guard against the governance challenges. It follows from the above that stewardship theory unlike agency theory is a complete contrast and doesn’t emphasize on the need to incur monitoring or agency cost which includes establishing an internal audit function.
Nevertheless Donaldson and Davis (1991) further notes that returns are improved by having both of these theories combined rather than separated which implies that management must strike a balance.

2.2.3 Stakeholder Theory

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

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

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

2.3 Determinants of Share Performance

The main determinants of share performance includes micro- and macroeconomic variables like exchange and inflation rates, valuation ratios, country ratings and financial and other non-financial variables like sovereign spreads as discussed below.
2.3.1 Valuation Ratios

Although the market efficiency theory says that the stock market returns are not predictable, still the valuation ratios play an important role in predicting future equity returns. Valuation ratios are believed to extract information in prices about risk and expected returns (Keim, 1988 in Fama and French, 1992). On the other hand, Fama and French (1992) also argue that most of valuation ratios are scaled versions of price and therefore are redundant for describing average returns. They argue that valuation ratios mimic the underlying common risk factors in equity returns and according to the asset-pricing model should be no more than proxies of $\beta$. However, the empirical findings point out that valuation ratios capture risk factors, which are missed out by the beta of the capital asset-pricing model.

Campbell and Shiller (1998) show that the conventional valuation ratios such as dividend-price and price-earnings ratios are particularly powerful in predicting returns when compared with many other statistics, used in forecasting stock prices. Fama and French (1992) show that there are strong relations between average returns and size, leverage, E/P and book-to-market equity. Maroney, Naka and Wansi (2004) have studied weekly equity market total returns in six East Asian countries and argue that leverage ratios are important in predicting market returns. They argue that these factors have significant explanatory power in a number of the sample markets with dividend yield and earning/price ratios being also important but in fewer markets. Moreover, the study shows that the relationship between size, trading volume, dividend yield, earning/price ratios and return is contrary to the relationship between the same variables in many
developed markets. This is especially true for size. The study shows that the importance of earnings-to-price ratio is limited (Claessens, Dasgupta and Glen, 1998).

2.3.2 Inflation

The majority of studies show that there is a negative relationship between inflation and expected returns in developed countries and that the Fisher hypothesis does not hold in the stock markets (Gultekin, 1983 and Erb et al, 1995 for the literature review). Only recently Boudoukh and Richardson (1993) find that nominal stock returns and inflation are negatively correlated in the short term, but positively correlated in the long term. However, in contrast to the latter statement, Erb, Harvey and Viskanta (1995) do not find a positive relation between long-term inflation and long-term average returns.

Erb, Harvey and Viskanta (1995) found a significant negative relation between inflation and stock returns in most of the countries. They argue that the cross-sectional analysis shows that inflation conveys information about risk exposure. Supporting this argument they show that more than 50 percent of the cross-sectional variation in average inflation rates can be accounted for by country credit risk ratings showing a significant relation between inflation and country risk (Erb, Harvey and Viskanta, 1995).

According to the study by Erb, Harvey and Viskanta (1995) average inflation explains 29 percent of the cross-sectional variation in the average equity returns volatility and the relation between volatility and average inflation is positive. Thus, the level or changes in expected inflation should be important in forecasting equity returns. Moreover, country credit risk ratings account for more than 50% of the cross-sectional variation in average inflation rates. Erb et al state that "in general, the lower a country's perceived sovereign
credit rating the higher the country's rate of inflation and the higher the expected rate of return on the country's stock and bond markets” (Erb, Harvey and Viskanta, 1995, p.37). Cutler, Poterba and Summers (1989) find that inflation together with market volatility has negative and statistically significant effects on market returns. In general, inflation in emerging markets has significant implications for equity returns as one of the common characteristics of emerging markets is high inflation or hyperinflation in many countries.

2.3.3 Exchange rate

Errunza and Losq (1997) present a thorough analysis of the effect of currency risk on expected returns in emerging markets. They find negative correlation between expected returns and exchange rates, which means that it is not necessarily true that foreign investors are exposed to a greater risk than domestic investors. They also argue that currency risk of real returns is smaller than for nominal returns and PPP (Purchasing Power Parity) reduce or eliminate the effect of exchange rates for long-term investments. Furthermore, it is possible to hedge currency risk through certain financial instruments. And finally, high currency risk of emerging markets equity may overall reduce the risk of an international portfolio, given the low correlation between emerging and developed markets.

Bailey and Chung (1995) study the effect of exchange rate fluctuations on the risk premium of stock returns in Mexico. They argue that under conditions when price levels and exchange rates are significantly volatile and cannot be costlessly hedged, the share prices of exporting (importing) firms may have ex ante premium for exchange rate risk as
they are adversely (favourably) affected by appreciation in the real value of the domestic currency. Moreover, share of firms, not involved in international trade, may also reflect "a currency risk premium due to the impact of exchange rate changes on foreign competitors, input costs, aggregate demand, or other factors, that affect cash flows and required returns" (1995, p.541-542).

Bailey and Chung (1995) found "some evidence that exchange rate fluctuations are a priced factor in cross-sections of national stock index returns converted into a common currency, but little evidence that these risks are priced has emerged from studies of cross-sections of stock returns from the same country" (p.542, 1995). According to the regression analysis results, Bailey and Chung (1995) show that the Mexican stock market perform poorly when currency and political risks are high supporting the fact that there are premiums for currency and political risks.

### 2.4 Review of Empirical Studies

In recent years, researchers and practitioners have widely discussed the need for internal auditors of adding more value to their companies’ operations, and contributing to the achievement of corporate objectives. This new perspective has focused increasing attention on issues such as performance evaluation and effectiveness of internal auditing (Dittenhofer, 2001; Bou-Raad, 2000; IIA, 1999). Several parties advocated the need to assess internal auditing (IA) effectiveness, though, at present, there is not a shared framework of reference to this scope (for instance Ridley & D’Silva, 2008; Mihret & Yismaw, 2007; Van Gansberghe, 2005; KPMG, 2004; Dittenhofer, 2001; Sawyer, 1995; Barrett, 1986). Recently, Sarens (2009) have raised the question “when can we talk about
an effective IA function?” in his editorial about future perspectives of IA research. Looking at the existing literature, there are many possible answers to this question. Different authors have related IA effectiveness to different issues, focusing on IA processes, outputs and outcomes.

Certain authors related IA effectiveness with the quality of IA procedures, such as the level of compliance with IIA standards or the ability to plan, execute and communicate audit findings (for instance Fadzil et al., 2005; Xiangdong, 1997; Spraakman, 1997). However, this approach suffers from a major limitation as it is based on the hypothesis that IA activity is effective if IA procedures are carried out properly, without considering the needs of the main stakeholders in each individual audit (Lampe and Sutton, 1994). This is in contrast with the current trend that stresses the relevance of value-added activities and indicates stakeholders’ satisfaction as one of the critical performance categories for IA activities (see, for instance, the Practice Advisory 1311-2).

Soh and Martinov (2009) aimed at finding out the relationship and interaction between the audit committee and the internal audit function. The results of the study suggested that there was a greater appreciation for the importance of mutual reliance and a strong relationship between the audit committee and the internal audit function. The quality of individuals in key roles within each function as well as personal attributes and values of members were also perceived to be critical for the effectiveness of each mechanism and in ensuring a strong functional relationship between both. Lastly the finding presented a level of diversity in the participation in and practice of performance evaluation of both the audit committee and internal audit function.
McGimpsey et al. (1992) set out to determine how internal audit is adapting in a changing management culture. The results of the study were: audits are becoming more cost effective by being risk driven; for internal audit to be effective senior management must clearly signal to the rest of the organization its supports for internal audit; Internal audit practices was moving away from merely reporting control deficiencies to management and finally internal audit function had adapted technology to aid in continuous monitoring of the organization data online.

Ndimitu (2011) aimed at establishing the relationship between internal audit and effective management in Embu water and sanitation company ltd. The following conclusion was noted: with commitment to integrity and accountability, internal auditing provides value to governing bodies and senior management as an objective source of independent advice. A fact that ensures proper processes are followed in generating and safeguarding the organization’s wealth. Murithi (2009) set out to survey the role of internal audit in enterprise risk management for quoted companies under the industrial and allied sector listed at the NSE. The sample comprised of all 18 listed companies under the Industrial and Allied Sectors with the NSE as at 31st December 2008. The conclusion was that the internal auditors were well aware of their core roles in risk management but it was further discovered internal audit function were spending a lot of time in risk management beyond their mandate due to lack of a specialized risk department in the organization.

Sigowo (2009) aimed at exploring the role of internal audit function in promoting good corporate governance in SACCOs. The following conclusion were made: the independence of the audit function was guaranteed since there were audit committee at
the Board level; the internal audit function spent around 36% of their time in doing
corporate governance test, assessing internal controls, risk management and ensuring
compliance and finally it was noted that internal audit function was being involved in
pre-auditing tasks hence limiting their effectiveness.

2.5 Summary of Literature Review

Several scholars have studied the concept of Internal Audit Independence and Share
performance of firms listed. Sarens (2009) have raised the question “when can we talk
about an effective IA function?” Soh and Martinov (2009) aimed at finding out the
relationship and interaction between the audit committee and the internal audit function.
The results of the study suggested that there was a greater appreciation for the importance
of mutual reliance and a strong relationship between the audit committee and the internal
audit function. McGimpsey et al. (1992) set out to determine how internal audit is
adapting in a changing management culture. Ndimitu (2011) aimed at establishing the
relationship between internal audit and effective management in Embu water and
sanitation company ltd. 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. Sigowo (2009) aimed at exploring the role of internal audit function in
promoting good corporate governance in SACCOs. From the above review limited
studies have concentrated on the relationship between internal audit independence and
share performance. This study therefore seeks to fill this research gap by studying firms
listed in the Nairobi Stock Exchange.
3.1 Introduction

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

3.2 Research Design

The study adopted a descriptive research design. According to Schindler (2003), a descriptive research design is appropriate where the study seeks to describe the characteristics of certain groups, estimate the proportion of people who have certain characteristics and make predictions. Mugenda and Mugenda (2003) describes descriptive research design as a systematic, empirical inquiry into which the researcher does not have a direct control of the independent variables as their manifestation has already occurred or because the independent variable cannot inherently be manipulated.

3.3 Target Population

Target population in statistics is the specific population about which information is desired. According to Ngechu (2004), a population is a well-defined or set of people, services, elements, events, group of things or households that are being investigated. The target population for the study included 60 companies quoted at the NSE as of December 2013.
3.4 Data Collection

The study used secondary data collected from the Nairobi Securities Exchange. The use of secondary data was justified on the basis that some of these sources had information that was very pivotal to the study and had been vetted and accepted.

3.5 Data Analysis

The researcher collected data on share performance. The stock market returns volatility obtained by computing the monthly returns of stock for all the 60 firms which were listed at the Nairobi Securities exchange as at 31 December 2013, for the period 2009 to 2013 and then comparing the monthly returns with the previous month’s returns. Using this data, the researcher conducted a regression analysis to establish the extent of relationship between internal audit independence and share performance.

The study applied the following regression model:

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

Where \( Y \) = the share performance (measured by return on investment (ROI)). ROI looks at investment earnings compared with the original cost of the investment.

\( X_1 \) = is the inflation rate measured by the Consumer Price Index (CPI)

\( X_2 \) = Exchange rate

\( X_3 \) = Valuation ratios (dividend pay-out ratio)

\( X_4 \) = Internal Audit Independence

\( \beta_1 \)– \( \beta_4 \) are the regression co-efficient or change introduced in \( Y \) by each independent variable.
\( \mu \) is the random error term accounting for all other variables that affect share performance but not captured in the model.

The researcher carried out a T-test at 95% confidence level to establish the significance of the independent variable in explaining the changes in the dependent variable.

**CHAPTER FOUR: DATA ANALYSIS AND INTERPRETATION**

4.1 Introduction

This chapter presents analysis and findings of the research. The objective of this study was to establish the relationship between Internal Audit Independence and Share performance of firms listed in the Nairobi Stock Exchange for the period between 2009 - 2013.

4.2 Descriptive Statistics

4.2.1 Inflation Rate

**Table 4.1: Descriptive statistics Inflation Rate**

<table>
<thead>
<tr>
<th>Year</th>
<th>Median</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>9.85</td>
<td>3.21</td>
<td>12.46</td>
<td>10.5</td>
<td>1.25</td>
</tr>
<tr>
<td>2010</td>
<td>3.76</td>
<td>1.23</td>
<td>6.57</td>
<td>4.1</td>
<td>2.63</td>
</tr>
<tr>
<td>2011</td>
<td>13.45</td>
<td>4.26</td>
<td>17.63</td>
<td>14.0</td>
<td>5.24</td>
</tr>
<tr>
<td>2012</td>
<td>9.23</td>
<td>2.85</td>
<td>10.21</td>
<td>9.4</td>
<td>3.12</td>
</tr>
<tr>
<td>2013</td>
<td>5.43</td>
<td>2.01</td>
<td>7.13</td>
<td>5.7</td>
<td>1.22</td>
</tr>
</tbody>
</table>
From the findings, it can be noted that the year 2010 recorded the lowest value for inflation rate at 4.1 while the year 2011 recorded the highest value for inflation rate at 14.0. In addition, values for standard deviation depicts variability in inflation rates during the five –year period with the highest deviation of 5.24 in the year 2011 and the lowest at 1.22 in the year 2013.

### 4.2.2 Exchange Rate

**Table 4.2: Descriptive Statistics Exchange Rate**

<table>
<thead>
<tr>
<th>Year</th>
<th>Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Median</td>
</tr>
<tr>
<td>2009</td>
<td>73.21</td>
</tr>
<tr>
<td>2010</td>
<td>77.01</td>
</tr>
<tr>
<td>2011</td>
<td>84.63</td>
</tr>
<tr>
<td>2012</td>
<td>85.01</td>
</tr>
<tr>
<td>2013</td>
<td>85.42</td>
</tr>
</tbody>
</table>

From the findings, it can be noted that the year 2009 recorded the lowest value for exchange rate at 75.82 while the year 2013 recorded the highest value for exchange rate at 86.31. In addition, values for standard deviation depicts variability in inflation rates during the five –year period with the highest deviation of 2.04 in the year 2013 and the lowest at 1.06 in the year 2010. The findings revealed that there have been a significant increase of exchange rates during the five-year period.
### 4.2.3 Dividend Payout ratio

#### Table 4.3: Dividend Payout ratio

<table>
<thead>
<tr>
<th>Year</th>
<th>Median</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>2.42</td>
<td>0.21</td>
<td>2.75</td>
<td>2.53</td>
<td>0.243</td>
</tr>
<tr>
<td>2010</td>
<td>2.53</td>
<td>0.51</td>
<td>2.93</td>
<td>2.61</td>
<td>0.203</td>
</tr>
<tr>
<td>2011</td>
<td>2.63</td>
<td>0.56</td>
<td>3.11</td>
<td>2.83</td>
<td>0.148</td>
</tr>
<tr>
<td>2012</td>
<td>3.01</td>
<td>1.02</td>
<td>4.12</td>
<td>3.14</td>
<td>0.135</td>
</tr>
<tr>
<td>2013</td>
<td>3.42</td>
<td>2.12</td>
<td>5.92</td>
<td>3.47</td>
<td>0.190</td>
</tr>
</tbody>
</table>

From the findings, the means for the dividend payout ratio for the listed firms as extracted from the financial and annual statements of the listed firms reflect an upward increase over the 5 year period, with the lowest being a mean of 2.53 in year 2009 while the highest being a mean of 3.47 in year 2013. In addition, the standard deviation depict a variation in the dividends paid out by the different listed firms in NSE. The steady increase in dividend payout ratio values over the 5 year period indicates that the listed firms’ adopted an enhanced dividend policy over that period.

### 4.2.4 Return on Investments

Retained earnings are diminished by the payment of dividends. This may affect a firm’s ability to reinvest, thus negatively impacting future growth prospects. Bhattacharya
(2009) noted that the positive impact of profitability and firms with growth opportunities supports the findings that healthy firms enjoy better access to relatively low-cost credit. The study analyzed the return on investments of the listed firms for a period between 2009 and 2013. The findings are as shown in Table 4.4 below.

**Table 4.4 Return on Investments**

<table>
<thead>
<tr>
<th>Year</th>
<th>Median</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>2.42</td>
<td>0.21</td>
<td>2.75</td>
<td>Mean</td>
<td>Std. Dev.</td>
</tr>
<tr>
<td>2010</td>
<td>2.53</td>
<td>0.51</td>
<td>2.93</td>
<td>1.95</td>
<td>1.63</td>
</tr>
<tr>
<td>2011</td>
<td>2.63</td>
<td>0.56</td>
<td>3.11</td>
<td>2.44</td>
<td>1.95</td>
</tr>
<tr>
<td>2012</td>
<td>3.01</td>
<td>1.02</td>
<td>4.12</td>
<td>2.87</td>
<td>2.01</td>
</tr>
<tr>
<td>2013</td>
<td>3.42</td>
<td>2.12</td>
<td>5.92</td>
<td>3.59</td>
<td>2.15</td>
</tr>
</tbody>
</table>

Table 4.4 above indicates that the listed firms witnessed increased market capitalization based on the return on investments. The ROI increased from 1.95 in year 2009 to 4.23 in year 2013. This was a 2.28 change (increase) in ROI. This shows that the firm’s return on investments significantly enhanced market capitalization.

**4.2.5 Internal Audit Independence and Share Performance**

In order to establish relationship between internal audit Independence and Share Performance, the respondents were kindly asked whether there is a relationship between internal audit independence and share Performance. Findings are as shown in table 4.5.
Table 4.5 Relationship between internal audit Independence and Share Performance

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>YES</td>
<td>37</td>
<td>82.2%</td>
</tr>
<tr>
<td>NO</td>
<td>8</td>
<td>17.8%</td>
</tr>
<tr>
<td>Total</td>
<td>45</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Majority of the respondents (82.2%), were on the view that there is a relationship between internal audit Independence and Share Performance, while 17.8% viewed that there was no any relationship between internal audit Independence and Share Performance.

Of the (82.2%) who said yes, 67% of the respondents attested that the relationship between internal audit Independence and Share Performance was positive. Respondents viewed the relationship to be positive because, the independence of the audit function was guaranteed since there were audit committees at the Board level and that internal auditing is an overall monitoring activity with responsibility to management for assessing the effectiveness of control procedures which are the responsibility of other functional managers ensuring better overall share performance. On the other hand, 15.2% of the respondents viewed the relationship to be negative because the independence of the audit function was not guaranteed.
To further understand relationship between internal audit Independence and Share Performance, respondents were requested to indicate their level of agreement on the following statements relationship between internal audit independence and share Performance. The responses were rated on a five point Likert scale where: 1 - Strongly Disagree 2 – Disagree 3 - Neutral 4- Agree and 5- Strongly Agree. The findings are as shown in table 4.6

**Table 4.6 Level of agreement on relationship between internal audit Independence and Share Performance**

<table>
<thead>
<tr>
<th>Statements</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>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</td>
<td>3.9667</td>
<td>.92913</td>
</tr>
<tr>
<td>Internal Audit Independence is an integral and necessary part of an effective corporate governance framework.</td>
<td>4.2167</td>
<td>.93201</td>
</tr>
<tr>
<td>The nature of internal audit activity today typically includes risk management, control governance and compliance work</td>
<td>3.5167</td>
<td>1.04948</td>
</tr>
<tr>
<td>Organizations have encountered a rapid change in the economic complexity, expanded regulatory requirements and technological advancement therefore giving 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</td>
<td>2.875</td>
<td>.91812</td>
</tr>
</tbody>
</table>

From the findings, respondents strongly agreed that: Internal Audit Independence is an integral and necessary part of an effective corporate governance framework (mean= 4.2167) and that 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 (mean = 3.9667). In addition, respondents agreed that the nature of internal audit activity today typically includes risk management, control governance and compliance work (mean = 3.5167). On the other hand, respondents disagree to a little extent that Organizations have encountered a rapid change in the economic complexity, expanded regulatory requirements and technological advancement therefore giving 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 (Mean=2.875). This implies that internal audit Independence is an integral and necessary part of an effective corporate governance framework.

4.2.6 Scope of work for internal audit

Table 4.7 Scope of work for internal audit

<table>
<thead>
<tr>
<th>Statement</th>
<th>F</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Verification of financial transaction (Financial audit)</td>
<td>39</td>
<td>86%</td>
</tr>
<tr>
<td>Assessing and promoting the adequacy of corporate governance</td>
<td>26</td>
<td>57%</td>
</tr>
<tr>
<td>Assessment of internal control</td>
<td>37</td>
<td>82%</td>
</tr>
<tr>
<td>Evaluates projects/ programs accomplishments (effectiveness)</td>
<td>27</td>
<td>61%</td>
</tr>
<tr>
<td>Operational audit</td>
<td>35</td>
<td>77%</td>
</tr>
<tr>
<td>Compliance audit</td>
<td>33</td>
<td>74%</td>
</tr>
<tr>
<td>Assessment of organizational risk</td>
<td>29</td>
<td>65%</td>
</tr>
<tr>
<td>Fraud investigation</td>
<td>40</td>
<td>89%</td>
</tr>
<tr>
<td>Information system audit</td>
<td>31</td>
<td>69%</td>
</tr>
</tbody>
</table>
From the findings, majority of respondents indicated scope of work for internal audit to be; Fraud investigation (89%), verification of financial transaction (Financial audit) (86%), and Assessment of internal control (82%). Respondents also stated the scope of work for internal audit to include; Operational audit (77%), Compliance audit (74%), Information system audit (69%), Assessment of organizational risk (65%), Evaluates projects/ programs accomplishments (effectiveness) (61%) and Assessing and promoting the adequacy of corporate governance (57%) respectively. This implies that Fraud investigation, verification of financial transaction (Financial audit), and Assessment of internal control are the major scope of work for internal audit.

4.3 Correlation Analysis

The Karl Pearson’s product-moment correlation was used to analyse the association between the independent and the dependent variables. The Pearson product-moment correlation coefficient (or Pearson correlation coefficient for short) is a measure of the strength of a linear association between two variables and is denoted by $r$. The Pearson correlation coefficient, $r$, can take a range of values from +1 to -1.

A value of 0 indicates that there is no association between the two variables. A value greater than 0 indicates a positive association, that is, as the value of one variable increases so does the value of the other variable. A value less than 0 indicates a negative association, that is, as the value of one variable increases the value of the other variable decreases. Pearson’s Correlation Coefficient was carried out and the results obtained are presented in table 4.8
Table 4.8: Pearson product-moment correlation

<table>
<thead>
<tr>
<th></th>
<th>Share Performance</th>
<th>Inflation Rate</th>
<th>Exchange rate</th>
<th>Valuation ratios (dividend pay-out ratio)</th>
<th>Internal Audit Independence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share performance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflation rate</td>
<td>.325</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exchange rate</td>
<td></td>
<td>.932*</td>
<td>.794</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Valuation ratios</td>
<td></td>
<td>.821</td>
<td>.850</td>
<td>.590</td>
<td>.601</td>
</tr>
<tr>
<td>Internal Audit Independence</td>
<td></td>
<td>.456</td>
<td>.730</td>
<td>.615</td>
<td>.601</td>
</tr>
</tbody>
</table>

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

The study findings in table 4.8 shows a significantly strong positive correlation between internal audit independence and share performance (Pearson correlation coefficient r = .456 Sig. = .011). A significantly strong positive correlation also exist between valuation ratios (dividend pay-out ratio) and share performance (r=0.821 Sig. = 0.021). However the study findings shows a strong and an insignificant correlation between exchange rate and share performance (r=.932 Sig. =0.341). The study findings also shows a weak and an insignificant correlation between inflation rate and share performance (r= 0.325, Sig. = 0.298).
4.4 Regression Analysis

Regression analysis was also performed to examine the relationship between internal audit independence and share performance. The following model was adopted for the study.

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

Where \( Y \) = the share performance

\( X_1 \) = inflation rate

\( X_2 \) = Exchange rate

\( X_3 \) = Valuation ratios (dividend pay-out ratio)

\( X_4 \) = Internal Audit Independence

\( \beta_1 - \beta_4 \) are the regression co-efficient or change introduced in \( Y \) by each independent variable

\( \mu \) is the random error term accounting for all other variables that affect share performance but not captured in the model.
Table 4.9: 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>1</td>
<td>.998(^a)</td>
<td>.996</td>
<td>.996</td>
<td>47.43</td>
</tr>
</tbody>
</table>

\(a\). Predictors: (Constant) inflation rate, exchange rate, dividend pay-out ratio and internal audit independence

The coefficient of determination (R Square) is used to test the goodness-of-fit of the model. That is, R Square measures the proportion or percentage of the total variation in the dependent variable explained by the independent variable. The value of R Square lie between 0 and 1 and if R Square value is 1 the there is a perfect fit while R Square value 0 indicates that there is no relationship between dependent and independent variables.

From the study findings in Table 4.4, the R Square value was 0.996 indicating that independent variables (inflation rate, exchange rate, dividend pay-out ratio and internal audit independence) explain 99.6% variation in share performance.

Table 4.10: Analysis of Variance (ANOVA)

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Regression</td>
<td>4</td>
<td>568.62</td>
<td>25.273</td>
<td>.000</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>41</td>
<td>167.94</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>45</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(a\). Dependent Variable: Share performance  
\(b\). Predictors: (Constant), inflation rate, exchange rate, dividend pay-out ratio and internal audit independence
The analysis of variance shows an F value of 25.273 and a significance (p) value of 0.000 which indicates that not all the predictor variables (inflation rate, exchange rate, dividend pay-out ratio and internal audit independence) explain variations in share performance.

**Table 4.11: Regression Coefficients**

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>(Constant)</td>
<td>.635</td>
<td>.873</td>
<td>1.117</td>
<td>.021</td>
</tr>
<tr>
<td>Inflation rate</td>
<td>-.060</td>
<td>.214</td>
<td>-.180</td>
<td>-.283</td>
</tr>
<tr>
<td>Exchange rate</td>
<td>-.052</td>
<td>.426</td>
<td>-.167</td>
<td>1.302</td>
</tr>
<tr>
<td>Dividend pay-out ratio</td>
<td>.123</td>
<td>.256</td>
<td>.404</td>
<td>.479</td>
</tr>
<tr>
<td>Internal audit independence</td>
<td>0.098</td>
<td>0.145</td>
<td>0.263</td>
<td>0.254</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Share performance

The regression equation appears as follows:

\[ Y_i = 0.635 - 0.060X_1 - 0.052X_2 + 0.123X_3 + 0.098X_4 \]

Constant = 0.635, shows that if all the independent variables (inflation rate, exchange rate, dividend pay-out ratio and internal audit independence) all rated as zero, share performance would rate 0.635.

0.06 \(X_1\) denotes that if all other independent variables are rated as zero, a change of magnitude 0.06 in \(X_1\) (inflation rate) lead to a unit change in \(Y\) (spending by share performance). Similarly, a change of magnitude 0.052 in exchange rate, 0.123 in dividend pay-out ratio, and 0.098 in internal audit independence leads to a unit change in share performance.
The magnitudes of the coefficients of regression also show the strength of the influence that the independent variables have on the dependent variable. Therefore, share performance is strongly influenced by internal audit independence (coefficient 0.098) and dividend pay-out ratio (coefficient 0.123).

The sign of regression coefficient indicate the nature of relationship between the variables. Therefore, direct relationships exist between share performance and internal audit independence (coefficient 0.098) and dividend pay-out ratio (coefficient 0.123). However, an inverse relationship exists between share performance and exchange rate (coefficient -0.052) and inflation rate (coefficient -0.060).

4.5 Summary and Interpretations of Findings

There is a strong positive correlation between internal audit independence and share performance (Pearson correlation coefficient \( r = .456 \) Sig. = .011) and that internal audit Independence is an integral and necessary part of an effective corporate governance framework. Further, the study revealed that Fraud investigation, verification of financial transaction (Financial audit), and Assessment of internal control are the major scope of work for internal audit. In line with these findings are Dittenhofer, 2001; Bou-Raad, 2000; IIA, 1999 findings who argue that in recent years, researchers and practitioners have widely discussed the need for internal auditors of adding more value to their companies’ operations, and contributing to the achievement of corporate objectives. This new perspective has focused increasing attention on issues such as performance evaluation and effectiveness of internal auditing.
The study revealed to be positive internal audit Independence and share performance because, the independence of the audit function was guaranteed since there were audit committees at the Board level and that internal auditing is an overall monitoring activity with responsibility to management for assessing the effectiveness of control procedures which are the responsibility of other functional managers ensuring better overall share performance. Equally, Sigowo (2009) aimed at exploring the role of internal audit function in promoting good corporate governance in SACCOs. 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.

In addition, there existed a strong positive correlation between valuation ratios (dividend pay-out ratio) and share performance ($r = .821$ Sig. $= .028$). Similar to these findings is Campbell and Shiller (1998) who show that the conventional valuation ratios such as dividend-price and price-earnings ratios are particularly powerful in predicting returns when compared with many other statistics, used in forecasting stock prices. Fama and French (1992) show that there are strong relations between average returns and size, leverage, E/P and book-to-market equity. Maroney, Naka and Wansi (2004) have studied weekly equity market total returns in six East Asian countries and argue that leverage ratios are important in predicting market returns. They argue that these factors have significant explanatory power in a number of the sample markets with dividend yield and earning/price ratios being also important but in fewer markets. Moreover, the study
shows that the relationship between size, trading volume, dividend yield, earning/price ratios and return is contrary to the relationship between the same variables in many developed markets. This is especially true for size. The study shows that the importance of earnings-to-price ratio is limited (Claessens, Dasgupta and Glen, 1998).

On the other hand, the study findings shows a strong and an insignificant correlation between exchange rate and share performance ($r = .932$ Sig. =0.341). Related to the findings, are Errunza and Losq (1997) findings who present a thorough analysis of the effect of currency risk on expected returns in emerging markets. They find negative correlation between expected returns and exchange rates, which means that it is not necessarily true that foreign investors are exposed to a greater risk than domestic investors. They also argue that currency risk of real returns is smaller than for nominal returns and PPP (Purchasing Power Parity) reduce or eliminate the effect of exchange rates for long-term investments. Furthermore, it is possible to hedge currency risk through certain financial instruments. And finally, high currency risk of emerging markets equity may overall reduce the risk of an international portfolio, given the low correlation between emerging and developed markets. Also, similarly, Bailey and Chung (1995) study the effect of exchange rate fluctuations on the risk premium of stock returns in Mexico. They argue that under conditions when price levels and exchange rates are significantly volatile and cannot be costless hedged, the share prices of exporting (importing) firms may have ex ante premium for exchange rate risk as they are adversely (favourably) affected by appreciation in the real value of the domestic currency. Moreover, share of firms, not involved in international trade, may also reflect "a currency risk premium due to the impact of exchange rate changes on foreign
competitors, input costs, aggregate demand, or other factors, that affect cash flows and required returns" (1995, p.541-542).

Also, the study findings shows a weak and an insignificant correlation between inflation rate and share performance ($r= 0.325$, Sig. = 0.298). Similar findings were experienced by Boudoukh and Richardson (1993) who found out that nominal stock returns and inflation are negatively correlated in the short term, but positively correlated in the long term. Erb, Harvey and Viskanta (1995) found a significant negative relation between inflation and stock returns in most of the countries. They argue that the cross-sectional analysis shows that inflation conveys information about risk exposure. Supporting this argument they show that more than 50 percent of the cross-sectional variation in average inflation rates can be accounted for by country credit risk ratings showing a significant relation between inflation and country risk (Erb, Harvey and Viskanta, 1995). Also, Cutler, Poterba and Summers (1989) find that inflation together with market volatility has negative and statistically significant effects on market returns.
CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction
This chapter presents summary of the study findings, conclusion and recommendations. The chapter is presented in line with the objective of the study which was to establish the relationship between internal audit independence and share performance of firms listed in the Nairobi Stock Exchange.

5.2 Summary of Findings
The study established that year 2010 recorded the lowest value for inflation rate at 4.1 while the year 2011 recorded the highest value for inflation rate at 14.0. Also, there have been a significant increase of exchange rates during the five-year period. In addition, the study established that dividend payout ratio for the listed firms as extracted from the financial and annual statements of the listed firms reflect an upward increase over the 5 year period. Also, there was a significant increase of ROI over the 5 year period.

The study established a strong positive correlation between internal audit independence and share performance and that internal audit Independence is an integral and necessary part of an effective corporate governance framework. Further, the study revealed that Fraud investigation, verification of financial transaction (Financial audit), and Assessment of internal control are the major scope of work for internal audit. Respondents viewed the relationship to be positive because, the independence of the audit function was guaranteed since there were audit committees at the Board level and that internal auditing is an overall monitoring activity with responsibility to management.
for assessing the effectiveness of control procedures which are the responsibility of other functional managers ensuring better overall share performance.

In addition, there existed a strong positive correlation between valuation ratios (dividend pay-out ratio) and share performance. However, study findings show a strong and an insignificant correlation between exchange rate and share performance and also there existed insignificant correlation between inflation rate and share performance though weak.

Finally, the study indicates that not all the predictor variables (inflation rate, exchange rate, dividend pay-out ratio and internal audit independence) explain variations in share performance.

### 5.3 Conclusion

The study concludes that there exists a significantly strong positive correlation between internal audit independence and share performance. A significantly strong positive correlation also exists between valuation ratios (dividend pay-out ratio) and share performance. However, the study findings conclude a strong and an insignificant correlation between exchange rate and share performance. The study findings also conclude that a weak and an insignificant correlation between inflation rate and share performance exists.

In addition, the study concludes that Fraud investigation, verification of financial transaction (Financial audit), and Assessment of internal control are the major scope of work for internal audit. The positive relationship exists because, the independence of the audit function was guaranteed since there were audit committees at the Board level and
that internal auditing is an overall monitoring activity with responsibility to management for assessing the effectiveness of control procedures which are the responsibility of other functional managers ensuring better overall share performance.

The study also concludes that there has been a significant increase of exchange rates, inflation rate, dividend payout ratio and ROI over the 5 year period. Also the study concludes that Fraud investigation, verification of financial transaction (Financial audit), and assessment of internal control are the major scope of work for internal audit.

Also, the study concludes that not all the predictor variables (inflation rate, exchange rate, dividend pay-out ratio and internal audit independence) explain variations in share performance.

5.4 Recommendations
The study points to the important role that auditors play in mitigating the adverse effects of poor corporate governance. There is thus the need to for the listed companies to adopt effective corporate governance practices that address key auditing practices for effectiveness of audit quality.

Audit quality is not primarily about auditing standards but about the quality of people, their training and ethical standards. As such the listed companies should consider skills, personal qualities of audit partners and staff, and the training given to audit personnel as the important factors that determine auditor quality. Research in business ethics has shown that personality type is directly related to individuals’ ethical orientation (Rayburn and Rayburn, 1996).
In order to implement good internal audit independence, managers need to know that they should be concerned about the interrelationships between internal audit independence and firm share performance. The study findings strongly confirm this correlation and therefore; banks that adopt and implement good internal audit independence have higher advantage of increasing their share performance. More so, this will ensure that interests of the firm are served and there is easier access to funding from investors.

Finally, there is need for the regulatory agency i.e. the Central Bank of Kenya to continue enforcing and encouraging firms to adhere to the guidelines on internal audit independence for financial institutions. This can be ensured through enacting more rules and regulations thus ensuring that banks maintain confidence in shareholders and customers and give them safe level of their savings and investments.

5.5 Limitations of the Study
This study has several limitations. First, it is possible that the nature of data from the financial statements is impacting the results in an unanticipated manner or limits the power of the tests to detect associations. This may be created by variation of statistical figures illustrating the key variables measurements.

Data collection was limited to secondary sources. The study would gain better insight into the relationship between internal audit independence and share performance of firms listed in NSE by collecting primary data from personnel involved in share performance.

The study was limited to the 60 listed firms in NSE. A more comprehensive examination of the relationship between internal audit independence and share performance would be achieved if other unlisted firms’, government agencies and institutions and are involved
in the study. This would offer insight into the way internal audit independence and share performance are related at other levels of governance.

5.6 Suggestions for Further Research

This study examined the relationship between internal audit independence and share performance of firms listed in the Nairobi stock exchange over a period of 5 years. There is a need for further studies to carry out similar tests for a longer time period.

A similar study should also be carried out on non listed companies. In addition, more variables depicting internal audit independence should be adopted to uphold the study’s findings that indeed internal audit independence influences share performance.

Due to the importance of having high quality audit, the listed further studies should explore the areas that relate to audit quality such as customer service satisfaction, customer loyalty, auditors switching and auditors turnover. This will go along incorporating quality and independence of management and board membership; internal audit considerations.

The study may have assumed that the efficient share performance of banks’ relies on internal audit independence as mentioned above. However, the study does not openly rule out the fact that some other variables in the environment could be critical for firm share performance. Hence, future research could usefully focus on the macroeconomic conditions necessary to promote maximum share performance within the Kenyan banking system and/or other firms in other industries i.e. causes of share performance differences that are not related to internal audit independence

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References


Public Oversight Board. (1994). Strengthening the professionalism of the independent auditor. Stamford, CT: POB.


Appendix 1: Questionnaire

Internal Audit Independence

SECTION B: Internal Audit Independence and Share Performance

1. Do you think there is a relationship between internal audit Independence and Share Performance?
   Explain?...........................................................................................................................................
   ..........................................................................................................................................................

2. If yes, what kind of relationship do you think internal audit Independence has on Share Performance?
   (a) Positive □  (b) Negative □
   Explain your answer above
   ..........................................................................................................................................................
   ..........................................................................................................................................................

3. On a scale of 1-5, tick in the appropriate box on how you strongly agree or disagree with the following statements on internal audit independence and share performance.

<table>
<thead>
<tr>
<th>Statements</th>
<th>5</th>
<th>4</th>
<th>3</th>
<th>2</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td>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</td>
<td></td>
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</tr>
<tr>
<td>Internal Audit Independence is an integral and necessary part of an effective corporate governance framework.</td>
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The nature of internal audit activity today typically includes risk management, control governance and compliance work.

Organizations have encountered a rapid change in the economic complexity, expanded regulatory requirements and technological advancement therefore giving 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.

4. Which of the following represent the scope of work for internal audit in your organization? (Please mark each boxes as much as it is applicable)

   (a) Verification of financial transaction (Financial audit)  
   (b) Assessing and promoting the adequacy of corporate governance  
   (c) Assessment of internal control  
   (d) Evaluates projects/ programs accomplishments (effectiveness)  
   (e) Operational audit  
   (f) Compliance audit  
   (g) Assessment of organizational risk  
   (h) Fraud investigation  
   (i) Information system audit  
   (j) Other areas if any….................................................................
Appendix 1: List of listed companies in NSE

AGRICULTURAL

1. Eaagads Ltd Ord 1.25
2. Kapchorua Tea Co. Ltd Ord Ord 5.00
3. Kakuzi Ord.5.00
4. Limuru Tea Co. Ltd Ord 20.00
5. Rea Vipingo Plantations Ltd Ord 5.00
6. Sasini Ltd Ord 1.00
7. Williamson Tea Kenya Ltd Ord 5.00

COMMERCIAL AND SERVICES

8. Express Ltd Ord 5.00
9. Kenya Airways Ltd Ord 5.00
10. Nation Media Group Ord. 2.50
11. Standard Group Ltd Ord 5.00
12. TPS Eastern Africa (Serena) Ltd Ord 1.00
13. Scangroup Ltd Ord 1.00
14. Uchumi Supermarket Ltd Ord 5.00
15. Hutchings Biemer Ltd Ord 5.00
16. Longhorn Kenya Ltd

**TELECOMMUNICATION AND TECHNOLOGY**

17. AccessKenya Group Ltd Ord. 1.00

18. Safaricom Ltd Ord 0.05

**AUTOMOBILES AND ACCESSORIES**

19. Car and General (K) Ltd Ord 5.00

20. CMC Holdings Ltd Ord 0.50

21. Sameer Africa Ltd Ord 5.00

22. Marshalls (E.A.) Ltd Ord 5.00

**BANKING**

23. Barclays Bank Ltd Ord 2.00

24. CFC Stanbic Holdings Ltd Ord 5.00

25. Diamond Trust Bank Kenya Ltd Ord 4.00

26. Housing Finance Co Ltd Ord 5.00

27. Kenya Commercial Bank Ltd Ord 1.00

28. National Bank of Kenya Ltd Ord 5.00

29. NIC Bank Ltd Ord 5.00

30. Standard Chartered Bank Ltd Ord 5.00
31. Equity Bank Ltd Ord 0.50
32. The Co-operative Bank of Kenya Ltd Ord 1.00

**INSURANCE**

33. Jubilee Holdings Ltd Ord 5.00
34. Pan Africa Insurance Holdings Ltd 0rd 5.00
35. Kenya Re-Insurance Corporation Ltd Ord 2.50
36. CFC Insurance Holdings
37. British-American Investments Company (Kenya) Ltd Ord 0.10
38. CIC Insurance Group Ltd Ord 1.00

**INVESTMENT**

39. City Trust Ltd Ord 5.00
40. Olympia Capital Holdings Ltd Ord 5.00
41. Centum Investment Co Ltd Ord 0.50
42. Trans-Century Ltd

**MANUFACTURING AND ALLIED**

43. B.O.C Kenya Ltd Ord 5.00
44. British American Tobacco Kenya Ltd Ord 10.00
45. Carbacid Investments Ltd Ord 5.00
46. East African Breweries Ltd Ord 2.00

47. Mumias Sugar Co. Ltd Ord 2.00

48. Unga Group Ltd Ord 5.00

49. Eveready East Africa Ltd Ord.1.00

50. Kenya Orchards Ltd Ord 5.00

51. A.Baumann CO Ltd Ord 5.00

**CONSTRUCTION AND ALLIED**

52. Athi River Mining Ord 5.00

53. Bamburi Cement Ltd Ord 5.00

54. Crown Berger Ltd Ord 5.00

55. E.A. Cables Ltd Ord 0.50

56. E.A. Portland Cement Ltd Ord 5.00

**ENERGY AND PETROLEUM**

57. Kenol Kobil Ltd Ord 0.05

58. Total Kenya Ltd Ord 5.00

59. KenGen Ltd Ord. 2.50

60. Kenya Power & Lighting Co Ltd