

**THE RELATIONSHIP BETWEEN OBJECTIVITY OF INTERNAL
AUDITORS AND INCENTIVE BASED COMPENSATION
CASE STUDY OF INSURANCE COMPANIES IN KENYA**

**BY
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DECLARATION

This research project is my original work and has not been presented for a degree or any other award in any university.

Signature

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This research project has been submitted for examination with my approval as the University supervisor.

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DEDICATION

The project is dedicated to my loving wife Pamela Ingosi who inspired and taught me the virtues of humility, honesty, perseverance and hard work. I will forever be grateful to you.

To my dad and mum, Mr and Mrs Obat, your desire for nothing short of the best has been driving me ever since.

To my children, so much is expected from you as is of me.

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ABBREVIATIONS AND ACRONYMS

AAERs	Accounting and Auditing Enforcement Releases
AKI	Association of Kenya Insurers
ATS	Automated Trading system
CAE	Chief Audit Executive
CBK	Central Bank of Kenya
CDS	Central Depository System
CEO	Chief Executive Officer
CMA	Capital Markets Authority
COSO	Committee of Sponsoring Organizations of the Treadway Commission
EPS	Earnings per Share
ERM	Enterprise Risk Management
ESOP	Employee Stock Ownership Plan
GAAP	Generally Accepted Accounting Principle
GAO	Government Accountability Office
IA	Internal Audit
IIA	Institute of Internal Auditors
IRA	Insurance Regulatory Authority
NACD	National Association of Corporate Directors
SEC	Securities and Exchange Commission
US	United States
KMO	Kaiser-Meyer-Olkin

ABSTRACT

This study examines the relationship between objectivity of internal auditors and incentive based compensation awarded to them-case study of insurance companies in Kenya, where a survey of the audit head and the audit staff was undertaken to establish the current practice in these areas.

The first is the relationship between the internal audit function and the audit committee. It is argued that a good working relationship and preferably a strong one can enhance organizational independence of the internal audit function.

The second is the extent to which the internal audit function is used as a management training ground. While acknowledging the benefits of this practice, it is argued that it might affect individual objectivity because internal auditors may be reluctant to withstand pressure from an auditee who could be their future supervisor. The study established that this is a common phenomenon in organizations and that those who believe that they will, in some future date, be in management positions perceive that their objectivity won't be impaired perhaps because of the involvement of the audit committee in the affairs of the internal audit function.

The other factor examined how incentive based compensation affect internal auditors' reporting decisions. The study sought to find the effect of these schemes through experimentation where the respondents were given a situation of a hypothetical company XYZ Ltd which involved a GAAP violation and asked whether they would report the violation. It was established that they would report the issue irrespective of their compensation scheme probably because they viewed the benefits as short term.

CHAPTER ONE

INTRODUCTION

1.1 Background of the study

Independence and objectivity of the Internal Auditors are to the profession of internal auditing what the Hippocratic Oath is to the practice of medicine. But a changing business world, increasing economic competition, globalization and broadened responsibilities for internal auditors are creating pressure on the profession, all of which can jeopardize these hallmark characteristics (Mutchler, 2003).

In recognition of the more influential role placed by the internal audit, the Institute of Internal Auditors (IIA), recently revised its definition of internal auditing. The current definition states that: 'Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organizations 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' (IIA, 2001). This definition highlights the importance of independence and objectivity to the internal audit function. Internal auditors add value because their analysis and suggestions for improvement are objective; they are insulated from underlying pressure or motivation for a, particular outcome or recommendation (Solomon et al, 1999).

1.1.1 Objectivity of Internal Auditors

The IIA attribute standards stress the importance of both the organizational independence of the internal audit function and the individual objectivity of internal auditors. To achieve organizational independence, the chief audit executive should report to a level within the

organization that allows the internal audit activity to fulfil its activities. On an individual level, internal auditors should have an impartial, unbiased attitude and avoid conflict of interest (IIA, 2001). It is argued that the relationship between internal audit and the audit committees may affect organizational independence while the use of incentive based compensation may affect individual objectivity (Kroonce & Marchant, 1995). The assurance services provided by auditors derive their value and credibility from the fundamental assumptions of independence of mind and independence in appearance. Auditor independence and objectivity are the cornerstones of the profession. Internal audit function is therefore, considered as a value adding activity in contemporary organization (Antle & Nalebuff, 1991). Implicit in this notion is the assumption that internal audit is effective. Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Objectivity requires internal auditors not to subordinate their judgment on audit matters to that of others (Advisory panel on auditor independence, 2004). Hence, the IIA distinction between the two terms appears to be that objectivity is a state of mind while independence is the state of affairs that permits an internal auditor to operate with an objective attitude.

In recognition of the potential for conflict, the Institute of Internal Auditors (IIA) has issued a number of professional standards and guidelines with respect to independence and objectivity. For instance, in 2001 the IIA published “Independence and Objectivity: A Framework for Internal Auditors” (IIA, 2001) as a guide for managing threats to objectivity. The IIA Code of Ethics consists of a number of basic principles which internal auditors are expected to uphold, together with rules of conduct which describe the norms of behavior expected of internal auditors. The principle relating to objectivity requires internal auditors to exhibit the highest

level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined.

Furthermore, internal auditors are expected to make a balanced assessment of all the relevant circumstances and they should not be unduly influenced by their own or others' interests when forming judgments. The rules of conduct specify that internal auditors: shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment, shall not accept anything that may impair or be presumed to impair their professional judgment and they shall not disclose all material facts known to them that if not disclosed may distort the reporting of activities under review. IIA has also published a framework that requires internal auditors to identify, assess and manage threats to their objectivity, including the need to consider safeguards that can mitigate the effects of the threats.

1.1.2 Incentive-based compensation schemes

The term "Incentive-based compensation" can refer to several different methods of compensation, ranging from the basic concept of merit pay to more sophisticated forms of short or long-term incentive compensation. Typically, incentive-based compensation package includes several types of contingent compensation, such as bonus plan payments, stock options and/or stock bonuses, pay rise and promotions and profit sharing (Salterio, 1994).

Incentive-based compensation plans generally provide for an annual payment plans based upon certain measures of company performance. Generally, a board's compensation committee, in consultation with outside compensation consultants, will design a plan establishing benchmarks for corporate performance in certain categories, such as earnings per share, return on assets, or return on equity. If the company or the functional department of a company such as internal audit

function achieves those benchmarks in a given year, a bonus is paid for that year. If the benchmark is exceeded, a larger amount is paid. However, if the goal is not met, either a smaller amount or no bonus is paid. Pay according to such plans is thus contingent on corporate achievement of certain predetermined objectives (Wright & Wright, 2009). According to Braun, (2011), such compensations can be used to measure or enhance functional department's objectivity.

1.1.3 Incentive-based Compensation and Objectivity of Internal Auditors

Positive Accounting Theory suggests that people act to maximize company performance when they have incentives to maximize their own personal wealth, for example through incentive-based compensation (Wright & Wright, 2009). In recent years, internal auditors have received incentive-based compensation in the form of bonuses tied to overall company performance. Internal auditors are seen as adding value to the firm because of their role as business consultants in areas such as internal controls, effectiveness and efficiency of operations, and compliance with organizational policies and procedures. Hence, many organizations believe that internal auditors should be rewarded for the successes of the firm. Moreover, many believe that rewarding internal auditors with incentive-based compensation will increase their productivity and effectiveness as well as improve their morale and motivation (DeAngelo, 2008). According to a recent survey by DeAngelo (2008) in financial institutions in Chicago, 51 per cent of auditing department heads received incentive-based compensation. In the same survey, almost half of the respondents indicated that incentive-based compensation was available to internal auditors in their organizations. Of those reporting the availability of incentive-based compensation, 70 per cent indicated that this compensation was based on overall company

financial performance. A majority of these performance measures were related to reported earnings, such as net income, earnings per share, return on equity, and return on assets. Internal auditors also sometimes own stock in the companies in which they are employed. In fact, the DeAngelo (2008) study reports that 23 per cent of the internal auditors who received incentive-based compensation were awarded stock options.

1.1.4 Insurance companies in Kenya

Kenya has 49 insurance companies-two are under receivership. The insurance industry in Kenya is regulated by the Insurance Regulatory Authority (IRA), a semi-autonomous regulator, set up in 2008. IRA is expected to improve regulation and stability of the industry. The Authority, in partnership with the Commissioner of Police, created the Insurance Investigation Unit to investigate insurance fraud. It also registered the first Islamic insurance firm, Takaful insurance. Previously, IRA was a department of the Ministry of Finance, which administered the insurance industry, and it was headed by the Commissioner of Insurance. The Finance Act 2011 boosted the power of the Authority through amendments to the Insurance Act that substituted the word “minister” with “Authority”.

The industry operates under an umbrella body, the Association of Kenya Insurers (AKI), which was established in 1987. Before then, it was called the Insurance Association of Eastern Africa. Membership is open to any registered insurance company. Its main objective is to promote prudent business practices, create awareness among the public and accelerate the growth of insurance business in Kenya (www.akinsure.com extracted on 1st September 2014). At the apex of the insurance sector are two reinsurance companies, the quasi-public Kenya Reinsurance Corporation (Kenya Re) and East African Reinsurance Company. By 2010, short and long-term

underwriters were 44, of which 21 provide medical insurance. The industry's assets grew by 2.1 per cent to Kshs181.2 billion (\$2.132 billion). Net premiums rose by 33.1 per cent to Kshs85.4 billion (\$1.005 billion) and general insurance claims by 30 per cent to Kshs28.1 billion (\$330.6 million). IRA now holds directors of the insurer to be jointly and severally liable for the recovery of the assets in case of mismanagement. The Authority was also given powers to manage assets of an insurance company in the public interest and take any other action in this regard (www.ira.go.ke extracted on 30th August 2014).

1.2 Research Problem

To date, there have been a limited number of studies on the objectivity and independence of internal auditors' role in listed insurance companies in the stock markets (Brown & Calderon, 2006). Much of the debate and research efforts have centered on the external auditors' professional objectivity, leading to various regulatory changes to safeguarding external auditors' independence (Colbert et al, 1996). However, cases such as WorldCom and Enron highlight the role that internal auditors may play in enhancing the monitoring and reporting of corporate governance processes (Levitt, 2008). For example, Cynthia Cooper, the head of internal audit of WorldCom has become renowned for her courage in exposing various accounting misappropriations by the senior management. Nevertheless, internal auditors remain in a unique position. While they are employees of the organization, internal auditors are also required to review and report upon decisions made by the senior management of the same organization, which potentially places them in a position of conflict and thus their independence while conducting their work. Further, the role of internal auditors is also broadening significantly in terms of their participation in more value-adding activities such as consultancies (IIA, 2001).

Internal auditors thus continue to face various challenges to their professional objectivity in an increasingly dynamic and uncertain environment.

In Kenya, the internal audit function is becoming increasingly important and it's very crucial in the public sector. In fact, all listed companies are required to have an internal audit department (Koome, 2011). As stipulated in the Kenya Gazette (31st May 2002), the board of Directors of a public company or any listed company should establish an internal audit function which should be independent of the activities they audit and should be carried out with impartiality. Capital Markets Authority (CMA) has established guidelines for listed companies for good corporate governance practices by public listed companies (CMA Act Cap. 485A).

Kibara (2012) carried out a survey of internal auditors risk management practices in banking industry in Kenya. He observed that most of the banks that went under and/or collapsed did not have objective and independent internal audit functions, while in some the reports obtained from the internal audit did not give the true reflection of the reality on the ground. Similarly, Keitany (2010) while carrying out a study on the perceived role of internal auditors in corporate governance, case study of Uchumi Supermarkets Limited, observed that many questions were raised by the shareholders company when it was declared insolvent as to the role of not only the internal auditors but also the external auditors in detecting frauds in an organization and they wanted any justification on the retention of the PriceWaterhouseCoopers as the External auditors. While looking at the relationship between the independence and objectivity of the internal auditors and the Earning per Share (EPS) of companies listed in the NSE, Mugwe (2010), that the major constraints to internal audit effectiveness were lack of independence in some aspects. The study also established that there was a positive relationship between independence of internal audit and profitability of firms. This meant that if organizations provide

a conducive working environment to the internal auditors, then they will be profitable thus having a positive EPS.

In Kenya, there are 54 licensed Insurance companies (www.ira.go.ke retrieved on 30th August 2014) in the year 2014. However, out of these, only six have been listed while a number have gone under in the last few years. There are yet others which are struggling to break even. These challenges no wonder explain why Insurance penetration in Kenya has never gone beyond 3% despite the service being an essential service. While a number of studies done on the objectivity of internal auditors have focused on companies, none has been done on insurance sector, yet such a study could help remedy the poor performance of the industry. It is on basis that this study was conducted to establish the independence and objectivity of the internal auditors which in turn affects how effective the internal audit function will be in the industry. This research therefore sought to establish the relationship between incentive-based compensation and objectivity of internal auditors in insurance companies in Kenya. In order to establish this relationship, the researcher was guided by this question; Is there any relationship between the incentive-based compensations and objectivity of internal auditors in the insurance companies in Kenya?

1.3 Objective of the study

The objective of the study was to establish the relationship between incentive-based compensation and the objectivity of internal auditors in insurance companies in Kenya.

1.4 Value of the study

The study is significant to the following several groups and people which include but not limited to the CMA, Insurance companies' management and staff, academic community and the investors at the NSE. The study would help management of the concerned parties appreciate the role played by the internal auditors in the organization and the importance of them being independent and objective in their roles. The smooth and efficient running of any organization depends directly on how well its employees are equipped with relevant skills. They must from time to time be assisted to perform better in their present position through some form of training and also be prepared for possible promotions and transfers. This study is important for employees in terms of identifying what skills are required to perform their duties in order to have high quality staff resulting to good performance and professional growth.

To the academic community, the study is of benefit to future accounting students both as a source of related literature and provide insightful information on how internal audit function independence and objectivity affect the quality of the internal audit in organizations' and consequently organization's performance. Such information would help accounting students to become better managers of their organizations. Finally, the findings of the study would be of benefit to the current and aspiring investors at the NSE. Of interest to investors is to know how their company is being run by the management. This study would enlighten them on the importance of having an objective internal audit function in the organizations they invest in. They will be able to know the efficacy of compensation schemes put in place by the management for internal auditors.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

In this section a review the theoretical discussion and empirical literature on the relationship between incentive-based compensations and internal auditor's objective is examined. The section also discusses the theories of incentive-based compensations in line with the topic of the study. Finally the section dwells in empirical research on the same before concluding with the critical review and summary of the literature related to the topic of the study.

2.2 Theoretical Framework

The theoretical approach adopted defines and explains the various theories or models that analysts have used to explain the potential relationship that exists between performance-based rewards and internal auditors' objectivity. Examples of the financial theories discussed below are Agency Theory, Institutional Theory and Positive Accounting Theory.

2.2.1 Agency Theory

Agency theory suggests that an agent is capable of engaging in dysfunctional behaviours known as adverse selection and moral hazard (Dhaliwal, 1993). The dysfunctional behaviours arise when the agent and the principal have different risk preferences and conflicting goals. This is because agents, who possess more private information about their task environment than their superior, are assumed to use this private information to make decisions in their self-interests. The existence of private information is an illustration of information asymmetry (Brown and Johnstone, 2000) which refers to subordinates who possess more private information than their

superior relating to their area of responsibility (Ponemon, 1992). Thus, it is argued that when information asymmetry is high, dysfunctional behaviours are more likely to occur than when information asymmetry is low (Ponemon, 1990).

Agency theorists posit that the principal can minimize moral hazard problems by developing an incentive-based compensation scheme (a control subsystem), which aligns the interests of principal and agent (Emerson, 1993). The concern of shareholders as a result of this agency theory has been strengthened over time especially through the government's and professional body's response to recent corporate scandals. Australia has addressed this through a range of changes to accounting standards, ethical guidelines and statutory legislative requirements that directly enhances the independence of the external auditor. These changes also indirectly imply a strengthened independent role of the internal auditor, especially through a strengthened audit committee function.

2.2.2 Institutional Theory

Here, the study draws on institutional theory which essentially posits that organizational management and control structures tend to conform to social expectations as argued by early scholars (Krishnan, 1996; Matsumura and Tucker, 1995). Based on this reasoning, this study takes the stand that included in this organizational management and control structures are management control structures put in place to respond to a range of control and compliance requirements instituted as a result of recent corporate scandals. Included in this range are assurance feedback mechanisms such as internal audit's value added services which are used by the board (through the audit committee), management and external auditors in fulfilling their extended accountabilities in line with social expectations.

2.2.3 Positive Accounting Theory

The market uses accounting information to infer firm prospects and value. Given the recent increased linkage between manager's compensation and firm value, it is important to examine the relation between compensation and accounting choices, if any. Implicit in the argument that aggressive accounting can be used to affect stock price, is the assumption that manipulative accounting affects the market. The significant average negative return around the announcement of a restatement suggests the market is not able to detect the use of "purposeful" accounting practices that lead to the restatement, ex-ante. This makes restatements an ideal venue to examine the effect of sensitivity of compensation (to stock price) on accounting choices.

There is mixed evidence that auditors manage earnings and other performance benchmarks to maximize their performance-based compensation. Kirk (2000) documents that executives manage accruals to maximize bonus payments. Haynes *et al*, (1998) find no evidence that earnings management, proxy by firms subject to Accounting and Auditing Enforcement Releases (AAERs), is associated with insider equity sales to capitalize on higher market valuations. However, Wallman (1996) finds that managers are more likely to exercise their stock appreciation rights and be net sellers of equity in periods with overstated earnings. Wallman (1996) and Haynes *et al*, (1998) samples however focus on periods prior to 1993. Although Libby and Kinney (2000) attribute this relation to the internal auditor's attempt to exploit the nonlinearity in the option compensation payoff, they do not test for this empirically.

There are also some recent papers that empirically examine restatements but do not concentrate on internal auditor's compensation. For instance, Mayhew *et al* (2000) examine the usefulness of

accounting information in predicting restatements whereas Magee and Tseng (2002) examine the effect of internal audit function characteristics on the propensity to restate.

2.3 Determinants of Internal Auditor's Objectivity

Internal auditing is essentially crucial in connecting and linking the business and financial reporting processes of corporations and not-for-profit providers (Johnstone, 2000). Control mechanism is needed to be set up to monitor and direct, promote or even restrain the various activities of an organization for the very purpose of achieving its objective (Hackenbrack and Nelson, 2008). As so, internal auditors play a vital role in ensuring the company's risk profile is under monitoring and areas to improve risk management is improved. In an economy that relies highly upon independent process information, internal audit has since become an indispensable control mechanism in both public and private organization. At the end of it, the purpose of internal auditing is to improve organization efficiency and effectiveness through constructive criticism.

Amid a global drive to improve organizational governance, internal auditors face many challenges and opportunities, including increasingly complex and pervasive technology, a need for new skills, flattening organizational structures, demand for an expanding scope of services, and increasing competition and globalization. Internal auditors are developing new strategies to meet these challenges and are becoming more proactive, providing a broadened variety of services and otherwise changing the internal audit model. As the demand for the variety and amounts of non-audit services increases, the need for appropriate guidance and standards for assuring professionalism and especially objectivity in audit services also increases. In addition,

the organizational positioning and independence of the internal audit function itself becomes increasingly important (Mutchler, 2003).

2.3.1 Annual Bonus Pay

According to Hackenbrack and Nelson (2008) bonus pay is a form of additional compensation paid to an employee or department as a reward for achieving specific goals or hitting predetermined targets. A performance bonus is compensation beyond normal wages and is typically awarded after a performance appraisal and analysis of projects completed by the employee over a specific period of time.

Not all companies offer bonus plans, and those that do often define the maximum amount that an employee can receive for exemplary performance. Companies that use an appraisal or employee review process may set a score threshold that an employee will have to meet or exceed in order to be considered. Because this bonus is given for performance above expectations, employees are not automatically entitled to it. Performance bonuses may be given to an entire team or department if, for example, specific sales figures were met, or if the actions of that group were deemed to have been exceptional.

2.3.2 Employee Stock Options

A stock option gives an employee the right to buy a certain number of shares in the company for a fixed price for a certain number of years. The fixed price of each share (also called the grant price, exercise price, or strike price) is typically the market price of the stock on the day on which the grant is issued. Stock options typically vest over a period of four years (that is, 25% per year) and typically expire ten years after the options are fully vested. For example, a

company might give an employee 200 stock options – that is, the right to purchase 200 shares of the company’s stock-at the fixed price of \$10 per share (the market price of the stock on the day options are issued).

Broad-based stock options, like other forms of profit-sharing (Salterio, 1996), gain sharing (Simunic, 2000) and employee ownership (Braun, 2011), provide a means for employees to profit from their company’s performance. But, they are distinctive in four ways that are likely to influence employees’ perceptions of and responses to stock options. First, whereas profit-sharing and gain sharing plans offer employees financial gains from increases in their company’s productivity, sales, or profits, broad-based stock option plans allow employees to benefit from increases in their company’s stock price – an indicator of company performance that is likely to be perceived by many employees as less amenable to their direct influence than company productivity, sales, or even profit, but perhaps of greater potential benefit to their pocketbooks (if their company’s stock soars on the market).

Second, relative to Employee Stock Ownership Plans (ESOPs), which hold company stock in a retirement trust for employees, broad-based stock options, offer the potential for a quick payout to employees, provided employees’ options, once vested, are in-the-money. Employees in an ESOP must wait until they retire or leave the company to receive their ESOP shares. Employees with broad-based options may, in contrast, exercise their vested options at any time, long before retiring or leaving the company. Although employees may exercise their stock options and hold onto their shares of company stock, employees typically sell their shares of company stock – gaining cash infusion – as soon as they exercise their options (Trompeter, 2004).

2.3.3 Company – Employee Profit Sharing plan

Savvy CEOs understand that high levels of employee performance are directly tied to how much they feel a sense of ownership towards the company (whether fiscal or based only on dedication). With a profit sharing plan, employees participate in a share of the profits from the company but employee profit sharing is typically distinct from actual equity ownership, which will be discussed in a future article. As we have discussed various ways you can incentivize employees over these past few articles, a clear pattern has emerged: Employees are not always most motivated by money. However, it is interesting to note that when it comes to “profit sharing plans”, there can be a clear exception...but again, this motivation doesn’t have as much to do with money as you might think.

Because your employee profit sharing plan is tied directly to the company actually making a profit, the strongest motivator for employees is that sense of ownership they get by participating in the profit sharing plan. The bottom line is that if they can help improve profits, they also get to reap the rewards. When your employees adopt a sense of ownership in your company, you virtually always see increases in productivity and a reduction in costs and expenses, which in turn leads to increased profits. The first and most important step prior to implementing any profit sharing plan is to be sure that you are clear about what you want to accomplish with it. Do you want the profit sharing plan to function as part of a retirement benefit? Are you more interested in a long-term motivation tool? Or does it make sense to keep it simple and structure your plan as a “bonus” cash distribution?

Although there are many variations on profit sharing plans, there are generally two primary methods of profit sharing to consider which is either Retirement Plan Version or the Basic Plan. The Retirement Plan Version according to (Trompeter, 2004) offers employees the opportunity

to contribute a predetermined amount of their annual profits into a deferred payment vehicle (deferred profit sharing plan), such as a trust that the employee can access upon retirement from the company in much the same way that they would make a contribution to a standard retirement plan, such as an IRA or 401(k). While this is not the same as the employee's retirement plan, this profit sharing plan structure is still subject to regulation by the IRS and has specific parameters for implementation. This plan can also take the form of a "Cross-Tested" that favours companies with an aging work force who are considering how they will fund their retirement. On the other hand, the Basic Plan has become increasingly common in recent years and involves a relatively simple allocation of funds providing essentially the same percentage or dollar amount to each employee who is participating or who is vested in the plan.

2.3.4 Enterprise Risk Management and consulting activities

Consulting activities raise significant threats to objectivity in the forms of self-review and social pressure. There have been several studies that have examined whether internal audit consultancy impairs objectivity. In general, prior research as discussed earlier, has found that internal auditor objectivity can be impaired by consulting activities, but there have been conflicting results. For example, the early study by St.Pierre (1984) found internal auditor objectivity impairment could result from self-review. By contrast, the Mugwe (2010) study found that there was no loss in objectivity when internal auditors were involved in auditing an internal control system that they had helped design. On the other hand, Koome (2009) found that the consultancy role of internal audit had a negative impact on internal auditor objectivity.

2.3.5 Internal audit as a management training ground

Using the internal audit function as a management training ground is a widely used and growing practice (Mugwe, 2010). Prior research finds that this practice is used by approximately 30 per cent of all companies (Committe, 2009) and by a majority of large publicly traded companies (Mutchler, 2003). Similarly, a recent survey conducted by the IIA reveals that 31 per cent of all survey respondents and 64 per cent of Fortune 500 companies use the internal audit function as a management training ground (IIA, 2001).

A study carried out by Windsor and Ashkanasy (2010) with the objective of establishing the effect of Using the Internal Audit Function as a Management Training Ground on the External Auditor's Reliance. The study examined how using the internal audit function as a management training ground affects external audit fees and the external auditors' perceptions of the internal audit function. The study concluded that over half of all companies that have an internal audit function specifically hire internal auditors with the purpose of rotating them into management positions (or cycle current employees into the internal audit function for a short stint before promoting them into management positions). It was found that external auditors charge higher fees to companies that use the internal audit function as a management training ground. It was found that external auditors perceive internal auditors employed in an internal audit function used as a management training ground to be less objective but not less competent than internal auditors employed in an internal audit function not used as a management training ground. These results have important implications for the many companies that use their internal audit function as a management training ground. However, even if the status is relatively autonomous, if it serves as a training ground for management, problems may arise since the trainee learns the

internal audit function and then goes and works for a unit being audited, they will know how to hide the problems and/or fraud (Mugwe, 2010).

2.4 Empirical Studies

Increased responsibility and accountability have led to large increases in internal auditor's compensation. American institute of certified public accountants (2001) projected that compensation would increase by over 10 per cent in 2004 and over 50 per cent by 2007. Compensation types also have changed with increased use of stock options and stock grants provided to align internal auditor interests with shareholders' interests In late 2005, Pearl Meyer reported that internal auditor pay at large U.S. companies was up 42 per cent in the past five years, and that there had been a large shift toward stock grants (up 230 per cent in five years) and away from stock options (down 16 per cent) (Blue Ribbon Committee, 2005). Thus, the use of stock option grants for internal auditor members may have declined somewhat in the past few years.

A study done by Mutchler (2003) asserts that although the literature is not necessarily consistent in its precise definition of objectivity, it is generally agreed that objectivity relates to the quality of the assessments, judgments, and decisions that are activities of any assurance or consulting service, and independence relates to the state of the environment in which the assurance or consulting service takes place. Specifically, objectivity is defined as a state of mind in which biases do not inappropriately affect assessments, judgments, and decisions while independence is defined as freedom from material conflicts of interest that threaten objectivity. Objectivity is a desired characteristic of the individual or team who make choices among the full set of assurance service possibilities and of the individual or teams who are engaged in the performance of

assurance services and who are making the necessary assessments, judgments, and decisions. Independence is a desired characteristic of the environment in which the individual or team performs the assurance services; i.e., it is desirable for the individual or team to be free from material conflicts of interest that threaten objectivity. Conflicts of interest can arise from the individual or teams' personal environment or from the general environment in which the activity takes place. Clearly, internal auditing is a profession and value-adding and effective assurance services offered by internal auditors require objectivity; integrity, competence, and the use of due care.

Magee and Tseng (2002) in their study on internal audit function and good corporate governance defined independence as not having a relationship, which would interfere with the exercise of independent judgment in carrying out the functions of the committee. The audit committee is a subcommittee of the board of directors, without executive powers, which oversees the internal and external audit processes of the firm. The audit committee is expected to maintain a continuing review of the corporation's financial data and to ensure that the firm has adequate internal controls, appropriate accounting policies, and external auditors who deter fraud and promote high-quality and timely financial statements.

According to a study conducted by Turner (2003), the practice of using the internal auditing function as a management training ground is not limited to junior staff but also applies to senior internal audit management as well for motivation. In some companies the chief internal auditor position is rotated, with line managers taking on the role for a period such as three years (Moore, 2000). While there are many advantages of using the internal audit function as a training ground for future managers, the practice can also have its dangers. It may block independence particularly when it involves senior internal audit personnel. These employees may have little

long-term interests in internal auditing and have no incentive in enhancing to enhance the quality of the internal audit function. Furthermore, the study established that they may be unwilling to take strong positions on issues that arise; particularly when they may be transferred back to the department they are currently auditing. The problem is exacerbated when the person in charge of the department may become the internal auditor's immediate superior once he or she is transferred back to a line position.

The dilemma is comparable to that discussed by Trompeter (2004) with respect to internal auditors taking on consulting work for their auditors. These authors argue that internal auditors may be less likely to take corrective action for fear of disrupting the relationship they have with the management. Thus it would appear that objectivity is strengthened when the organization staffs the function with professional internal auditors. This is particularly the case when the chief internal auditor is a career auditor who is unlikely to be transferred to a line management position in the foreseeable future. It is possible however that any threat to objectivity arising from the use of the internal audit function as management training ground may be minimized if there is a strong and independent audit committee that closely monitors and reviews the work of the internal audit function.

Sweeney and Roberts (2004) found that the independence of the internal audit department and the level of authority to which the internal audit staff report are the two most important criteria influencing the objectivity of their work. It can thus be argued that organizational independence will increase the internal auditor's effectiveness. This independence both lessens the conflict between loyalty to the employer and loyalty to specific managers, and gives auditors a supportive work environment in which they can conduct their tasks objectively and without pressure. The study's finding is in tandem with that of SEC. In September 1998, Arthur Levitt,

the then chairman of the SEC, remarked that the desire of internal auditors to increase the value of their stock options gave them a potential incentive to manipulate their accounting numbers.

Two other studies by both Sweeney and Roberts (2004) and Peecher (2004) examined whether internal auditors can remain objective when consulting to management in a corporate acquisition setting. The two studies involved internal auditors acting for the buyer or seller in an acquisition. The role that the company was taking in the negotiation process was found to influence participants' judgments, with internal auditors allocated to the buyer condition providing significantly higher likelihood judgments about inventory obsolescence compared to those allocated to the seller condition. The researchers conclude that this suggests that internal auditors who act as consultants for extra pay may not be able to maintain their objectivity.

Blue Ribbon Committee (2005) in their study argue that managers use incentive compensation to “camouflage” or facilitate the extraction of rents from shareholders. For example, the true value of option pay may be distorted by the apparent wide spread practices of option backdating and option re-pricing. Pay practices, such as deferred compensation, may not be fully disclosed. If such pay “uncertainty” is correlated with reported pay, this should also imply a relationship between pay and future returns. The direction of this relationship is uncertain. Investors might under-react to non-cash compensation, as they have been shown to under-react to other types of corporate events (Trompeter, 2004) which would also imply a positive relationship between incentive pay and future stock price performance. However, firms that pay their internal auditors the highest also tend to be firms that have experienced high returns and high operating performance relative to their peer firms.

Brown and Calderon (2006) used an experimental design to explore the impact on internal audit objectivity of participation in incentive-based reward schemes. His study examined whether the

type of compensation would influence US internal auditors' willingness to report the failure to recognize an inventory loss (a GAAP violation). He found that, when compensation was tied to stock price, a significantly higher percentage of internal auditors would not report the GAAP violation compared to when the compensation was tied to earnings or was fixed. However, it is unclear why an incentive payment linked to stock price had an impact while one linked to earnings did not. Further, there was no evidence that stock ownership influenced internal auditors' willingness to report the GAAP violation.

Mason and Gibbins (2006) conducted a survey of New Zealand internal auditors to identify functions that internal auditors perceive to be essential to their role. The survey also sought to understand the nature of the internal auditor's "role dilemma" which arises from the expectation that internal auditors will both assist management and independently evaluate management. Comments received from respondents indicated that internal audit's role has changed in recent years to one of consultant rather than of "policeman" thereby justifying the rewards. Most of those who commented on this change did not perceive it as a problem. The study attempted to explain how internal auditors deal with the conflict between their audit oversight responsibilities and the provision of support to management. They found that the tension involved in maintaining this dual role leads to role ambiguity but that this ambiguity is not necessarily undesirable. Three concepts emerged from the interviews which impact on internal auditors' ability to maintain their independence: how they create and establish their own role and duties; the role of professional status; and the nature of the incentives they receive. He concluded that independence from management is a dominant feature of successful auditing programs. Those auditors able to set their own agenda seem to be the most powerful in this respect because their selection of what to audit and when they can include assessments of senior managers as well as assessments for them.

In 2007, the IIA conducted an online survey with internal auditors regarding their involvement in pay for performance schemes. The survey found that internal auditors were primarily subjected to various forms of incentives in 36% of the organizations surveyed. Further, the study also found that some internal auditors were engaged in roles that the IIA had recommended as being unsuitable. They again undertook a multiple case study of internal audit functions in six Italian companies and found that only in one of the firms, the internal audit function had engaged significantly in consulting activities. DeAngelo (2008), in their literature review of European internal auditing, report that consulting generally forms a relatively small part of internal audit activities in Europe (e.g. in France, assurance services represent 73% of work (Institut Francais de l'Audit et du Controle Internes, 2005), in Belgium, consulting averages 12 per cent of annual working time, while in Italy, only a few large companies (8% of the top 100 firms) use internal audit for consulting activities.

Wright and Wright (2009) developed a model where no firm wants to admit to having internal auditors who are below average, and so no firm allows its internal auditors' pay package to lag market expectations. The combination of typical glamour characteristics (high returns and high operating performance) combined with the publicized "allure" of the firms that can afford to pay the best (and the associated star effects that high pay may produce for the firm's internal auditors), and an inability to distinguish luck from skill, may prompt investors to overreact to these firms, resulting in a negative relation between internal auditors' pay and future returns. Incentivization raises significant threats to objectivity in the forms of self-review and social pressure. There have been several studies that have examined whether internal audit motivation impairs objectivity. In general, prior research as discussed earlier, has found that internal auditor objectivity can be impaired by incentivization, but there have been conflicting results. For

example, they established that internal auditor's objectivity impairment could result from self-review. By contrast, the Windsor and Ashkanasy studies (2010) found that there was no loss in objectivity when internal auditors were involved in auditing an internal control system that they had helped design. On the other hand, Sweeney and Roberts (2004) and Peecher (2004) found that the consultancy role of internal audit had a negative impact on internal auditor objectivity.

Keitany (2010) studied internal audit control function and its implication for the risk assessment by the audit committee. The findings of the study indicated that internal auditors have a good working relationship with their audit committee especially due to the fact that they have private and regular access to the committee. The audit committee reviews the internal audit program, their budget and the results of the internal audit activities. The audit committee is comprised of both independent and non-executive directors and the frequency of meetings is high. More to this with the chief internal auditor having private access to the audit committee the committee is likely to be more involved in the hiring and firing of the chief internal auditor. The study also found out that the internal audit function is not viewed as a training ground to management in the organization. Those who perceive that they are on the path to a managerial position don't view that as going to affect their objectivity in any way perhaps due to the audit committee involvement in the affairs of the internal audit function.

Similarly, Koome (2011) studied perceived role of internal auditors in corporate governance. He observed that many questions were raised by the shareholders of the Uchumi Supermarkets Ltd when it was declared insolvent as to the role of the external auditors in detecting and preventing frauds in an organization and they wanted any justification on the retention of the PricewaterhouseCoopers as the External auditors. This means that the audit committees through

internal audit reports should be aware of any irregularities in the company. If the above goal is to be accomplished, the internal auditors must be independent and objective.

Kibara (2012) carried out a survey of internal auditors risk management practices in banking industry in Kenya; the study concludes that all the companies in NSE have internal audit committee with most of them having independent members. The audit committee gives input to the internal audit planning and the management allows follow up on recommendation. The management and other organs of the system support understand and appreciate the role of internal audit function. The CEO give input for the internal audit planning and internal auditors are always involved in reviews of the internal control system. The study also concludes that the head of internal audit are qualified by having all of them qualified accountants and a big number being post graduates. From the study it is found not all the firms are fully independent, most firms that have a high EPS were banks which was highly attributed to the regulations of the CBK which is their regulator. The study concludes that there is a positive relationship between independence and objectivity of the internal audit and profitability (EPS) as it is noted that the companies that have fully adhered to the CMA (2002) guidelines have higher profits while those who have partially complied have low profits resulting to low EPS.

Another recent study conducted by Salterio (2013) found that internal audit can be heavily involved in ERM. This study consisted of interviews with Financial Directors, Audit Committee Chairs, internal auditors and Risk Directors of five listed companies as well as four audit partners from the “Big Four” audit firms. They also found evidence of internal auditors having responsibility for ERM practices, despite both COSO and the IIA position paper stating responsibility must rest with management. In general, these results show that internal auditors, in some cases, are involved in ERM that have been deemed unsuitable by the IIA, thus

signalling a high risk for loss of internal auditor objectivity. Prior studies pertaining to internal auditor involvement in management consultancy suggests that such consultancies could lead to an actual loss of objectivity (Sweeney and Roberts (2004) and Peecher (2004)). High involvement is defined as situations in which an internal auditor is extensively involved in all three categories of ERM activities as identified by the IIA, while ‘low involvement’ is regarded as minimal involvement of activities that are regarded as core to internal auditors. Involvement by internal auditors at a high level of ERM is likely to expose them to self-review and social pressure threats, both of which have been found to impair objectivity.

2.5 Summary of Literature Review

There are clearly gaps in the literature which indicate opportunities for further research. We know that internal auditors are generally engaging in more consulting activities and that they perceive that this is an opportunity to add value to their organization. However,

Zhang (2009) is one of the few studies to identify the types of assignment carried out by internal audit departments, both before and after 1999. Further examination of varying trends in both the level of consulting and the nature of consulting activities across different jurisdictions is clearly warranted.

From the small number of experimental studies that have been conducted, it appears that internal auditors do not act without bias when performing consulting activities. However, these studies need to be replicated and extended to different situations and different groups of internal auditors to determine the generalizability of the findings. For instance, the nature of consulting activities may be important, for example involvement in systems design and implementation may have a different impact on objectivity than involvement in business valuation, feasibility studies or

project management. There could also be industry differences, with internal auditors in industries that emphasize compliance, such as the finance sector, being at greater risk of compromising independence compared to less regulated industries. We do not know how the performance of consulting activities impacts assurance services and whether internal auditors are able to maintain their objectivity when they provide both types of services. The relationship between the internal audit staff and the company's management is clearly important in determining the independence and objectivity of the internal auditor (IIA, 2001).

It is evident from the preceding historical review and summary that internal auditing has evolved remarkably over the years and has gained an increasingly important role within organizations, whether in industry, government, or the financial sector. Alongside this development, the internal auditing function today accepts a broader responsibility toward the organization itself and its stakeholders. It is also evident that a variety of factors may influence the independence and objectivity of internal audit function in the organization. To the extent that their objectivity is impaired by these situations, the effectiveness of the internal audit function is reduced (Committee, 2009). However, no prior research had been examined on whether internal auditor incentive-based compensation or stock ownership affects auditors' objectivity.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter sets to explain the research methodology used in this study. It discusses the research design especially with respect to the choice of the design. It also discusses the population of the study, data collection methods as well as data analysis and data presentation methods used in the study.

3.2 Research design

The research problem was to be solved using a descriptive case study design. This enabled an analysis of the relationship between the objectivity of internal audit and incentive-based compensation in insurance companies in Kenya. According to Kothari (2004), a case study research refers to a body of techniques for collecting data and obtaining responses from individuals to a set of prepared questions. Descriptive case study technique with self-administered questionnaires as the survey instrument is considered appropriate for this study. This research design has also been used in similar studies in Kenya. For instance, Mugwe (2010), Koome (2011) and Kibara (2012). All of them did research on the role of internal auditors in different business settings in Kenya, i.e. Banking, Manufacturing and allied and NSE listed companies respectively.

3.3 Population

Saunders (2009) states that population refers to the entire group of people, events, or things of interest that the researcher wishes to investigate. The population of the study comprised of all the

insurance companies in Kenya (*Appendix I*) as at August 2014 which gave a saturated sample size of 49 (www.cma.or.ke, retrieved on 30.08.2014). The focus of the study was the Internal Audit Department of the companies. The listed insurance companies are considered more structured and strict on corporate governance requirements compared to others not yet listed. For example, Capital Markets Authority's guideline (2002) on corporate governance, states that there must be internal committee to oversee the operations of the corporation.

3.4 Sample Design

Sample design refers to the process of deciding and arriving at the correct sample size for the study. According to Kothari (2004), size of sample refers to the number of items to be selected from the universe to constitute a sample. The author further recommends that the sample size should neither be excessively large, nor too small. It should be optimum. Since this study was involved a descriptive survey, all insurance companies were used as sample for the study which was to be 100% of the population. This not only agrees with but surpasses the observation made by Saunders (2009) that 10% - 30% of the population was representative for any given research study.

3.5 Data Collection

The main instrument for data collection was the questionnaire (*Appendix II*). A standardized questionnaire was used to enable comparison of information. The questionnaire was divided into three main parts. Section one sought to gather general information of the sample, basically the bio data and personal information. Section two of the questionnaire sought to establish the formation of the internal audit departments and further examine their operations and functional

structures. Finally, section three dwelt on the relationship between incentive-based compensation schemes (stock options, profit sharing and bonus pay) and the objectivity of the internal audit.

The structured questionnaires was based on a 5-point Likert scale measurements where 1=Strongly Agree and 5=Strongly Disagree. Kothari (2004) states the advantage of using this type of instrument as the ease which it accords the researcher during the analysis. Moreover it is easy to administer and economical to use in terms of time and money. The administration of the questionnaires used the key informant method where only the Audit managers in selected company who had sufficient information about the issues of internal audit were interviewed. A drop and pick technique was used in the administration of the questionnaires.

3.6 Validity and Reliability

Kothari (2004), states that pilot testing is important for developing and testing adequacy of research instruments, finding out whether research material is realistic and workable, as well as determining the extent of effectiveness of the sampling frame and technique. Identification of logistical problems that may occur whilst using proposed methods and finding out resources that may be needed in terms of finance and research assistants. The target population consisted of insurance companies in Kenya. In conducting the Reliability Measurement, the researcher first pre-tested the questionnaire on 10% of the sample of the population to ensure its reliability. The aim of the pilot testing as Saunders (2009) emphasize was to eliminate common errors and omissions and help in testing the study plan. To minimize error and increase reliability of data collected, the reliability pre-test questionnaire was tested using scores obtained from a single test administered to individuals from within the sampling frame hence save time. Reliability test statistics based on Cronbarch alpha (.731) revealed coefficients greater than 0.7 across the item

measures i.e. Predictor variables and outcome variable under study. This indicated a high level of internal consistency for our scale with this specific sample hence acceptable instrument to proceed with the inferential analysis.

3.7 Data Analysis

Data was analysed using descriptive statistics where quantitative and qualitative approaches were used. Quantitative data analysis was done by sections as indicated on the survey questionnaire. Data collected using semi-structured questionnaires was entered into Statistical Package for Social Sciences (SPSS) version 21.0 spreadsheet and cleaned. Descriptive statistics were run to establish the accuracy of entry of scores by assessing range, mean, standard deviation and normality of data. Inferential statistics mainly Spearman's Rank Correlation, Multiple Regression and Factor Analysis (Principal Axis Factoring method) were used to determine the relationship between the independence of the internal audit function and incentive-based compensation. In this analysis, all the item measures under study were subjected to descriptive analysis followed by spearman's rank correlation, multiple regression and finally factor analysis to show the existence and strength of relationship, overall contribution of change in the total variance, and the prediction power of the predictor variables with regards to the aspects under study. All the data were analyzed at 95% level of significance or $\alpha=.05$ and the degrees of freedom depending on the particular case was determined.

The model used in data analysis is given below. Y is the dependent variable, X_1 to X_4 were the independent variables.

Regression model:

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

Where Y = Internal auditor's objectivity measured by reported EPS

X_1 = Bonus payments measured as a percentage of current basic salary

X_2 = Incremental stock ownership as a percentage of post tax earnings

X_3 = Profit share measured as a percentage of overall company's residual earnings

X_4 = Well remuneration as a percentage of the overall salary package.

$\beta_0, \beta_1, \beta_2, \beta_3,$ and β_4 = The parameters to be estimated

μ = The random error term

The F-Statistic for the multiple linear regression models was computed to determine the significance of the model, that is, to what extent the variation in the independent variable explains the changes in the dependent variable.

$$F = [SSR / (k)] / [RSS / (n-k-1)]$$

Where SSR = the regression sum of squares (SSR)

RSS= the error sum of squares or the residual sum of square

3.8 Ethical Consideration

Ethical issues were considered before, during and after the study. Before the study was conducted, the proposal was presented to the University of Nairobi for approval. Relevant local authorities were informed of the study for clearance to access the listed insurance companies. Verbal consent was sought from the respondents before they participated in the study. The respondents who chose to participate were assured that the information they gave was confidential and would not be used for any other purpose except for this study. Every questionnaire remained anonymous, as the respondents were only assigned identity numbers instead of writing their na

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents findings of the study under thematic areas namely Questionnaire Response Rate, Background of the study participants, Formation of the internal audit departments, their operational and functional structures; and finally the Relationship between incentive-based compensation schemes and the objectivity of the internal auditors.

4.2 Questionnaire Response Rate

Response rate refers to the percentage of subjects who respond to questionnaires (Mugenda and Mugenda, 2003). The study set out to administer 49 questionnaires in a sample of 49 insurance companies in Kenya (*Appendix I*). However, only 31 questionnaires were returned duly filled and completed. This translated to 63.3% response rate, which was good. This is in line with Mugenda and Mugenda (2003) who noted that a response rate of 60% is good and a response rate of 70% and over is very good. The 18 respondents did not participate in the study were either out in the fieldwork through the entire study period or declined to participate.

4.3 Background of the study participants

The study sought to investigate the general information of the respondents which included the demographic and organization characteristics. Demographic characteristics of the respondents presents analysis of the demographic descriptions of the respondents by the respondent's position in the company, academic qualifications, work experience, and professional membership. While

the organization characteristics presents analysis of the company's descriptions by the duration of company's operation in Kenya.

This information was necessary to give an overview of the characteristics of the respondents as summarized in the subsections below.

4.3.1 Distribution of Respondents by Academic Qualifications

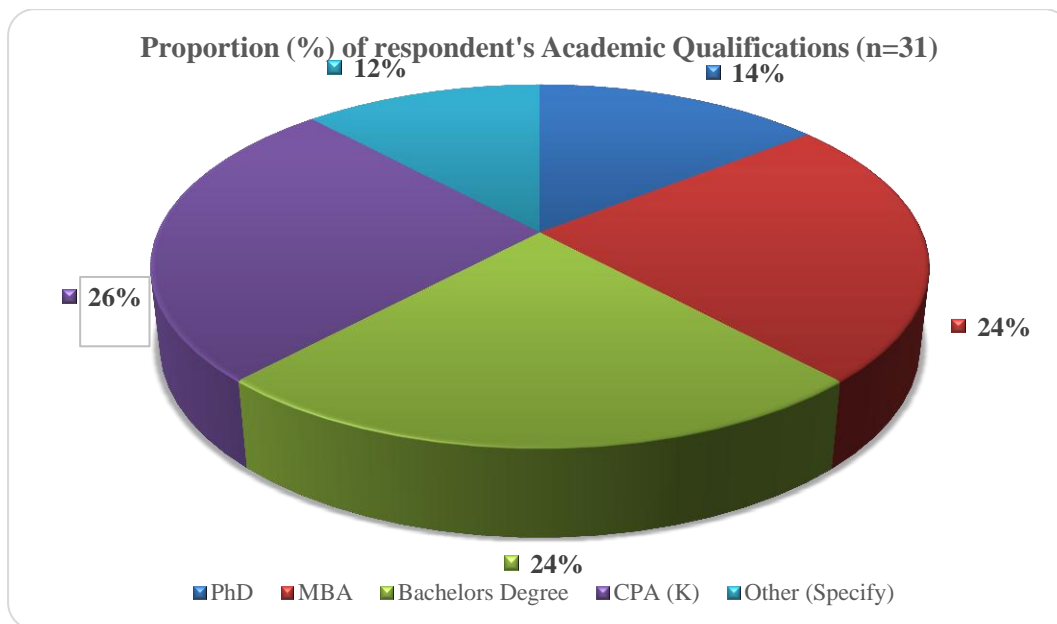


Figure 1. Distribution of Respondents by Academic Qualifications

Figure 1 above shows that majority (26%) of the respondents (internal auditors) are qualified accountants, followed closely by holders of MBA (24%) and Bachelor's Degree (24%). However, only 14% of the respondents had PhDs. Furthermore, 12% of the respondents specified that they have academic qualifications in other fields such as Msc. in finance and CSIA. This generally translates to 96.8% of respondents having at least a Bachelor's Degree, implying that majority of the internal auditors in Kenya are highly qualified and knowledgeable to give the right information sought by the study, and offer quality auditing services. The findings are in line

with Kibara (2012) study which concluded that heads of internal audit are qualified accountants and a big number being post graduates.

4.3.2 Distribution of Respondents by Work Experience

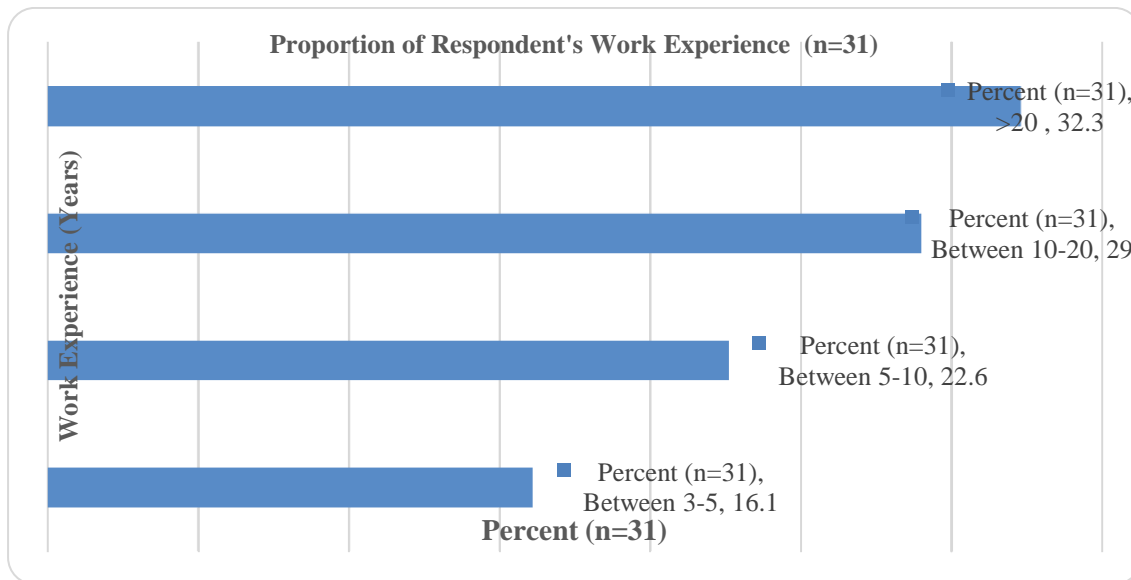


Figure 2. Distribution of Respondents by Work Experience

Table 2 above shows that most (32.3%) of the respondents have more than 20 years work experience as internal auditors. This was followed closely by those having 10-20 years (29.0%), with 22.6% of the respondents indicating that they have 5-10 years of work experience. Minority (16.1%) indicated that they have 3-5 years of work experience. It is also worth noting that no respondent indicated that they have below 3 years (Between 1-3 years) of work experience as internal auditors. This implies that the information that was given in the study was given by those who are highly experienced in the field of internal auditing thereby improving the validity and reliability of this information.

4.3.3 Distribution of Respondents by Professional Membership

Table 1 below shows that majority (87.1%) of the respondents belong to a professional body while 12.9% do not belong to any professional body. This highly suggests how united the audit professionals in Kenya are thus implying some level of regulation leading to professionalism.

Table 1. Distribution of Respondents by Membership in Professional Body

Membership	Percent (n=31)
Yes	87.1
No	12.9
Total	100.0

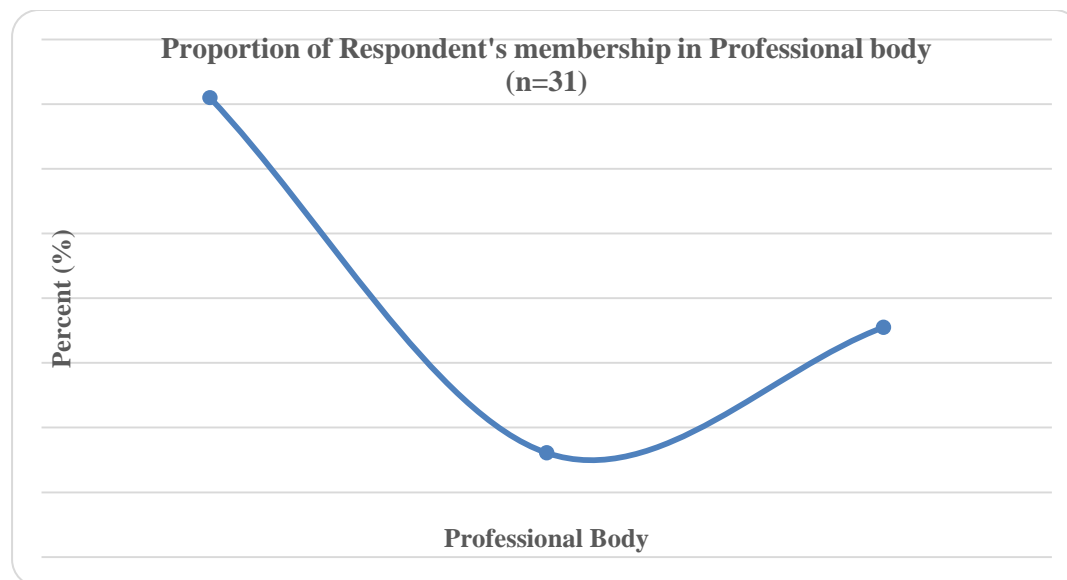


Figure 3. Distribution of Respondents by Membership of Professional Bodies

Figure 3 above shows that majority of the respondents (71.0%) are members of ICPAK, while only 16.1% belong to IAA. A significant number (32.3%) also specified that they are members of other professional bodies such as AAIK, AIIK, ICIFA, ICPSK, and KIM.

4.3.4 Duration of a company's operation in Kenya

Table 2. Distribution of Respondents by duration of their company's operation

Duration (Years)	Percent (n=31)
1-5	12.9
6-10	12.9
11-15	12.9
>15	61.3
Total	100

Table 2 above shows that majority, 19 (61.3%) of the insurance companies in Kenya have been in operation for over 15 years. However, only 4 (12.9%) of the companies having been in operation for 1-5 years, 6-10 years and 11-15 years respectively. This showed that the distribution was skewed towards the >15 years. This implies that most of the insurance companies currently operating in Kenya are more experienced in internal auditing matters suggesting high quality internal auditors.

4.4 Formation of internal audit departments, their operations and functional structures

The researcher sought to find out the use of internal audit function as a management training ground. Descriptive statistics were run for all the items to assess the accuracy of entry of data, mean score for each item and normality. Table 3 below shows the means recorded across all item measures. The study findings revealed lower means above average recorded across all item measures except one item (Possibility of an auditee to be the future boss of an internal auditor), registering slightly higher mean. Based on a 5 point Likert scale where 1=Strongly Agree and 5=Strongly Disagree; this implies that majority agreed with the five items measures that internal audit function is used as a management training ground. Based on the acceptable range for

skewness or kurtosis of -1.5 to 1.5 (Tabachnick & Fidell, 2013), all the item measures were normally distributed.

Table 3. Mean item measures for internal audit functions as a management training ground

Management training item measures (n=31)	Min	Max	Mean	SD	Skewness	
					Statistic	S.E
Internal auditing as a stepping-stone to a managerial position.	1.00	2.00	1.7097	.46141	-.972	.421
Experience in internal auditing assist in advancement to management positions.	1.00	2.00	1.2258	.42502	1.379	.421
Transfer of internal auditors to management positions in the future.	1.00	3.00	1.7419	.63075	.252	.421
Transfer to a management position foreseeable in the coming year.	1.00	3.00	1.8387	.58291	.011	.421
Possibility of an auditee to be the future boss of an internal auditor.	1.00	4.00	2.1613	.89803	.844	.421

Table 4. Distribution of internal audit function by composition and reporting channels

	Percent
Presence of company's internal audit committee (n=31)	100.0
Audit committee members composition (n=31)	
All are qualified accountants	32.3
None are qualified accountants	0.0
Diversified	67.7
Total	100.0
Functional reporting of internal audit department (n=31)	
Audit Committee Only	67.7
Audit Committee and CEO	19.4
Audit Committee, CEO and CFO	3.2
Audit Committee, CEO, CFO and BOD	9.7
Total	100.0
Administrative reporting of internal audit department (n=31)	
CEO	9.7
CFO	32.3
CEO and BOD	58.1
Total	100.0

Table 4 above shows that all the insurance companies (100.0%) visited have internal audit committee implying the recognition of internal auditors as key players in improving organization's efficiency and effectiveness through constructive criticism. This is in line with

Kibara (2012) study which concluded that all the companies listed at the NSE have internal audit committee with most of them having independent members. When asked whether the audit committee members are professionally qualified accountants, majority (67.7%) indicated that they have diversified fields of expertise while about one-third (32.3%) of the respondents indicated that they are all qualified accountants. It is worth noting that no audit committee member was not an accountant, this is key to the field of auditing. Positive observation implies that as the audit committee gives input to the internal audit planning and the management allows follow up on recommendation. About two-thirds (67.7%) of the respondents indicated that the internal audit department reports functionally to the Audit Committee only, followed by Audit Committee and CEO (19.4%); with very few reporting to Audit Committee, CEO, CFO and BOD. However, when it comes to administrative issues, majority (58.1%) indicated that the internal audit department reports to the CEO and BOD, followed by about one-third (32.3%) reporting to CFO; with very few respondents indicating that the department report administratively to CEO only. This is further supported by the same study, Kibara (2012) which concluded that the head of internal audit are qualified accountants and the CEO gives input for the internal audit planning.

Table 5. Mean organizational supportiveness and strengthening of the audit functions

	Min.	Max.	Mean	S.D	Skewness	
	Statistic	Statistic	Statistic	Statistic	Statistic	S.E
Regular invitation of CAE to the audit committee meetings.	1.00	2.00	1.4194	.50161	.344	.421
Input of audit committee to the internal audit planning.	1.00	2.00	1.2581	.44480	1.163	.421
Curiosity of the board members to strengthen and support the internal audit function.	1.00	2.00	1.3871	.49514	.487	.421
Understanding and appreciation of the role of internal audit function by	1.00	3.00	1.5484	.67521	.855	.421

management and other organs of the system.						
Input of the CEO for the internal audit planning.	1.00	5.00	3.3333	1.47001	-.625	.427
Rotation of the internal audit staff to other departments in the company.	1.00	3.00	1.4667	.57135	.732	.427

Table 5 shows lower score means above average were recorded across all item measures except input of the CEO for the internal audit planning, registering slightly higher score means below average ($\mu=3.3333$). Based on a 5 point Likert scale where 1=Strongly agree and 5=Strongly disagree; this implies that majority strongly agreed with the items measures as supporting and strengthening the audit functions except one item (*Input of the CEO for the internal audit planning*) which majority of the respondents seemed to have neither agreed nor disagreed with the item. This result is in contrast with Kibara (2012) who concluded that CEOs give input for the internal audit planning. All the item measures were normally distributed (Acceptable skewness range of -1.5 to 1.5).

Table 6. Distribution of respondents by stay period and job promotion

Duration of internal auditor's stay within the internal audit department (n=29)	Percent
Less than 2 Years	27.6
Between 2-4 Years	44.8
Between 5-7 Years	27.6
Total	100.0
Newly hired employees promised promotion employees into senior level management in the internal audit function. (n=31)	51.6

Table 6 shows that most of the respondents (44.8%) indicated that they have stayed in the internal audit department as internal auditors between a period of 2-4 years. This was followed

by equal proportion of respondents (27.6%) within less than 2 years and between 5-7 years. It is also worth noting that no internal auditor had stayed for more than 8 years in internal audit department. The table also illustrates that 51.6% of the respondents indicated that their organizations hire employees (new graduate or senior level employees from other organizations) in the internal audit function with a promise they will be promoted into senior level management. Windsor and Ashkanasy (2010) supports this in their study which concluded that over half of all companies that have an internal audit function specifically hire internal auditors with the purpose of rotating them into management positions (or cycle current employees into the internal audit function for a short stint before promoting them into management positions).

Table 7. Mean involvement in internal audit and administrative functions

Item measures (n=31)	Min.	Max.	Mean	SD	Skewness	
	Statistic	Statistic	Statistic	Statistic	Statistic	S.E
Assignment of existing employees into internal audit function for a specified amount of time before being cycled back into management.	1.00	5.00	3.5484	1.38657	-.869	.421
Usual movement of internal auditors to other functions within the company.	2.00	5.00	3.4667	1.04166	-.298	.427
High involvement of internal auditors in establishing internal control system the organization.	1.00	2.00	1.1613	.37388	1.937	.421
Regular involvement of internal auditors in reviews of the internal control system.	1.00	2.00	1.5806	.50161	-.344	.421

Table 7 above shows that lower means above average were recorded in High involvement of internal auditors in establishing internal control system the organization and Regular involvement of internal auditors in reviews of the internal control system. ($\mu=1.1613$ and $\mu=1.5806$ respectively). This implies that majority of the internal auditors strongly agreed with the two item measures. On the contrary, higher means above average were recorded in

assignment of existing employees into internal audit function for a specified amount of time before being cycled back into management and Usual movement of internal auditors to other functions within the company ($\mu=3.5484$ and $\mu=3.4667$ respectively). This could imply that majority of the internal auditors disagreed and/or neutral with the two item measures. Based on the acceptable skewness range of -1.5 to 1.5, all the item measures were normally distributed except for item High involvement of internal auditors in establishing internal control system the organization. From the results observed, it is worth noting that majority of the internal auditors strongly agreed that Internal auditors are highly involved in establishing internal control system in their organization. On the contrary, majority disagreed that their companies assign existing employees into internal audit function for a specified amount of time before being cycled back into management. This scenario on the contrary contradicts with Ashkanasy (2010) which concluded that over half of all companies that have an internal audit function specifically hire internal auditors with the purpose of rotating them into management positions (or cycle current employees into the internal audit function for a short stint before promoting them into management positions).

4.5 Relationship between incentive-based compensation schemes and the objectivity of the internal auditors.

Table 8. Mean of incentive-based compensations schemes and objectivity of internal auditors

	Min	Max	Mean	S.D	Skewness	
	Statistic	Statistic	Statistic	Statistic	Statistic	S.E
Internal Audit unit is well remunerated.	1.00	5.00	1.8710	1.33521	1.508	.421
Internal Auditors are given incentive based compensations.	1.00	5.00	3.3226	1.42331	-.245	.421
Bonus Pay is awarded to Internal Audit Members.	1.00	5.00	2.9032	1.27423	-.014	.421
Profit is shared with Internal	2.00	5.00	3.3871	.98919	-.217	.421

Audit Members.							
Stock option is available to Internal Audit Members whenever performance is achieved.	2.00	5.00	3.6129	1.14535	-.296	.421	
Internal Audit Department is guided by objectivity and independence in reporting.	1.00	5.00	1.5161	1.12163	2.305	.421	

Table 8 above shows descriptive statistics table which includes the mean, standard deviation, and number of observations for each variable selected for the model. The study recorded lowest means in Internal Audit unit is well remunerated and Internal Audit Department is guided by objectivity and independence in reporting ($\mu=1.8710$ and $\mu=1.5161$ respectively). This implies that majority of the internal auditors agreed with the two item measures. However, three items, Internal Auditors are given incentive based, Profit is shared with Internal Audit Members and Stock options is available to Internal Audit Members whenever performance is achieved registered slightly above average ($\mu=3.3226$, $\mu=3.3871$ and $\mu=3.6129$ respectively); an indication that majority of the respondents were either neutral or disagreed based on those three item measures. Finally, the study revealed that respondents either agree or neutral that Bonus Pay is awarded to Internal Audit Members ($\mu=2.9032$). Based on the acceptable skewness range of -1.5 to 1.5, all the item measures were normally distributed except for one item, Internal Audit unit being well remunerated.

Table 9. Statistics output for Cronbach's Alpha

Reliability Statistics		
Cronbach's Alpha	Cronbach's Alpha Based on Standardized Items	N of Items
.731	.744	6

Cronbach's alpha test was run to determine the overall reliability coefficient for a set of key independent and dependent variables to be assessed in the regression model of the study. The test revealed that Cronbach's alpha is **.731**, which indicates a high level of internal consistency for our scale with this specific sample hence adequate to proceed with the inferential analysis.

4.5.1 Spearman's Rank Correlation analysis

Before the regression analysis, Spearman's Rank Correlation was first run to determine if there is a linear relationship and the degree of strength between the objectivity of internal auditors and item measures of incentive-based compensations within the insurance companies in Kenya as shown in Table 10.

Table 10. Spearman's Rank Correlation Output

			Internal Audit unit is well remunerated.	Internal Auditors are given incentive based compensations.	Bonus Pay is awarded to Internal Audit Members.	Profit is shared with Internal Audit Members.	Stock option is available to Internal Audit Members whenever performance is achieved.	Internal Audit Department is guided by objectivity and independence in reporting.
Spearman's rho	Internal Audit unit is well remunerated.	Correlation Coefficient	1.000	.066	-.288	.040	.131	.020
		Sig. (2-tailed)	.	.726	.116	.831	.482	.914
		N	31	31	31	31	31	31
	Internal Auditors are given incentive based compensations.	Correlation Coefficient	.066	1.000	.614**	.725**	.720**	-.075
		Sig. (2-tailed)	.726	.	.000	.000	.000	.689
		N	31	31	31	31	31	31
	Bonus Pay is awarded to Internal Audit Members.	Correlation Coefficient	-.288	.614**	1.000	.683**	.684**	-.305
		Sig. (2-tailed)	.116	.000	.	.000	.000	.095
		N	31	31	31	31	31	31
	Profit sharing is awarded to Internal Audit Members.	Correlation Coefficient	.040	.725**	.683**	1.000	.878**	-.092
		Sig. (2-tailed)	.831	.000	.000	.	.000	.622
		N	31	31	31	31	31	31
	Stock options is available to Internal Audit Members whenever performance is achieved.	Correlation Coefficient	.131	.720**	.684**	.878**	1.000	-.081
		Sig. (2-tailed)	.482	.000	.000	.000	.	.665
		N	31	31	31	31	31	31
	Internal Audit Department is guided by objectivity and independence in reporting.	Correlation Coefficient	.020	-.075	-.305	-.092	-.081	1.000
		Sig. (2-tailed)	.914	.689	.095	.622	.665	.
		N	31	31	31	31	31	31

** . Correlation is significant at the 0.01 level (2-tailed).

Table 10 shows the output of Spearman's Rank Correlation analysis. The results revealed that there is a negative correlation between *Internal Audit Department is guided by objectivity and independence in reporting*, and *Internal Auditors are given incentive-based compensations* ($r = -.075$, $p = .689$). That is as the value of predictor variables and the outcome variable are inversely proportionate. This means that when there is an increase in incentive-based compensations among the Internal Auditors in Kenyan Insurance companies, the Internal Audit Department realises a decrease in objectivity and independence in reporting. However, this correlation was not statistically significant ($p < .05$). Furthermore, there was lack of multi-collinearity since the two predictors were not strongly related indicating adherence to one of the assumptions of regression.

Positive correlation was only established between the outcome variable (*Internal Audit Department is guided by objectivity and independence in reporting*) and *Internal Audit unit is well remunerated* ($r = .020$, $p = .914$). This implies that when the internal audit unit is increasingly well remunerated, the Internal Audit Department is increasingly guided by objectivity and independence in reporting. However, this correlation was not statistically significant ($p < .05$).

On the same, negative correlation was established in most of the individual relationships between each predictor variables and the outcome variable. This was observed between the outcome variable and *Bonus Pay is awarded to Internal Audit Members* ($r = -.305$, $p = .095$), *Profit shared with Internal Audit Members* ($r = -.092$, $p = .622$), and *Stock options is available to Internal Audit Members whenever performance is achieved* ($r = -.081$, $p = .665$). This generally implies that an increase in *Bonus Pay awarded to Internal Audit Members*, *Profit sharing awarded to Internal Audit Members*, and *Stock options*

available to Internal Audit Members whenever performance is achieved, proportionately leads to a decrease in objectivity and independence in reporting within the Internal Audit Department and the company. However, there was no specific relationship which was statistically significant. It is worth noting that there was a very low correlation between the predictor variable and outcome variable which according to (M. Harris and G. Taylor, 2008), this warrants a further investigation.

4.5.2 Regression Analysis for the predictors of objectivity of the internal auditors

Multiple regression analysis was run to show how independent variables predict the outcome based on the model output ($Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \mu$). From the results obtained in Table 11, the quality of the prediction of the dependent variable by the independent variables was above average ($R=.534$). Statistically, this model can predict the internal auditor's objectivity by almost 28.6% of the total variance in the model ($R^2=.286$). The rest (71.4%) cannot be explained by the variables in the model equation. Therefore, the overall regression model is not fit for the data since the model cannot account for more than half of the total variance of the model. This is further confirmed by the ANOVA summary table, which indicates that the model's R^2 is not significantly different from zero, $F(5, 25) = 1.999, p < .05$. Again, the overall regression model is not fit for the data since the independent variables do not statistically significantly predict the dependent variable. Table 11, Table 12 and Table 13 summarizes these factors.

Table 11. Regression model summary for predictors of internal auditor's objectivity**Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.534 ^a	.286	.143	1.03853

a. Predictors: (Constant), Stock options is available to Internal Audit Members whenever performance is achieved., Internal Audit unit is well remunerated., Internal Auditors are given incentive based compensations., Bonus Pay is awarded to Internal Audit Members., Profit sharing is awarded to Internal Audit Members.

Table 12. Analysis of Variance (ANOVA) for the model**ANOVA^a**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	10.778	5	2.156	1.999	.114 ^b
	Residual	26.964	25	1.079		
	Total	37.742	30			

a. Dependent Variable: Internal Audit Department is guided by objectivity and independence in reporting.

b. Predictors: (Constant), Stock options is available to Internal Audit Members whenever performance is achieved., Internal Audit unit is well remunerated., Internal Auditors are given incentive based compensations., Bonus Pay is awarded to Internal Audit Members., Profit sharing is awarded to Internal Audit Members.

Table 13. Regression Analysis of incentive-based compensations and internal auditor's objectivity prediction model

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.738	.712		1.037	.309
	Internal Audit unit is well remunerated.	.184	.165	.219	1.117	.275
	Internal Auditors are given incentive based compensations.	.101	.204	.129	.497	.623

Bonus Pay is awarded to Internal Audit Members.	-.513	.259	-.583	-1.983	.058
Profit sharing is awarded to Internal Audit Members.	.269	.469	.237	.573	.572
Stock options is available to Internal Audit Members whenever performance is achieved.	.187	.411	.191	.454	.654

a. Dependent Variable: Internal Audit Department is guided by objectivity and independence in reporting.

4.5.3. Estimated model coefficients

Regression model:

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

Where Y = Internal auditor's objectivity measured by reported EPS

X₁ = Bonus payments measured as a percentage of current basic salary

X₂ = Incremental stock ownership as a percentage of post tax earnings

X₃ = Profit share measured as a percentage of overall company's residual earnings

X₄ = Well remuneration as a percentage of the overall salary package.

$\beta_0, \beta_1, \beta_2, \beta_3,$ and β_4 = The parameters to be estimated

μ = The random error term

Therefore, the general form of the equation to predict objectivity of the internal auditor based on the incentive-based compensation schemes achieved, is:

$$\begin{aligned} \text{Predicted } Y &= .738 + (-.513X_1) + (.187 X_2) + (.269 X_3) + (.184 X_4) + \mu \\ &= .738 - .513X_1 + .187 X_2 + .269 X_3 + .184 X_4 + 1.03853 \end{aligned}$$

The F-Statistic for the multiple linear regression models to determine the extent the variation in the independent variable explains the changes in the dependent variable is:

$$F = [SSR / (k)] / [RSS / (n-k-1)]$$

Where SSR = the regression sum of squares (SSR)

RSS= the error sum of squares or the residual sum of square

$$\text{Predicted F-Statistic} = [\text{SSR} / (\text{k})] / [\text{RSS} / (\text{n-k-1})]$$

$$\text{F} = [10.778 / (\text{k})] / [26.964 / (\text{n-k-1})]$$

4.6. Factor Analysis

Factor analysis was further conducted using Principal Axis Factoring method of extraction to identify those items that strongly predict objectivity of internal auditors. All the 4 item measures for incentive-based compensation schemes were first tested for sample size adequacy using Kaiser-Meyer-Olkin (KMO) and Bartlett's test of sphericity. Table 14 shows the results indicating that the sample size was statistically significantly adequate for each item (KMO=.650; $\chi^2=72.963$; df =15; p<0.05) leading to factor analysis.

Table 14. KMO and Bartlett's test of sphericity

KMO and Bartlett's Test	
Kaiser-Meyer-Olkin Measure of Sampling Adequacy.	.650
Approx. Chi-Square	72.963
Bartlett's Test of Sphericity	df
	6
Sig.	.000

These item measures were further subjected to extraction to determine which factors could be extracted. They have been summarized in Table 14 below.

Table 15. Total variance explained by incentive-based compensation factors

Factor	Initial Eigenvalues			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	2.537	63.416	63.416	2.412	60.292	60.292
2	1.093	27.324	90.740	.544	13.607	73.899
3	.275	6.877	97.617			
4	.095	2.383	100.000			

Table 14 below summarized how these item measures were further subjected to extraction to determine the number of possible item measures that could be extracted from the relationship between incentive-based compensation schemes (stock options, profit sharing and bonus pay) and the objectivity of the internal auditors. About 4 possible factors could be extracted, however based on the standard Eigen values set at 1; only 2 factor clusters were valid. The overall variance for the objectivity of the internal audit item measures accounted for by the factors was 73.90%. This finding confirms that the four items of incentive-based compensation schemes can be used by insurance companies in Kenya to predict the objectivity of internal auditors. Factor 1 registered the highest variance of 60.29% with Factor 2 (13.61%) being the least hence implying that Factor-1 is 4.43 times better predictor of the internal auditor's objectivity.

Table 16. Rotated Factor Matrix for Internal audit objectivity

Incentive-based compensation item measures	Factor	
	1	2
Stock options is available to Internal Audit Members whenever performance is achieved.	.966	
Profit sharing is awarded to Internal Audit Members.	.914	
Bonus Pay is awarded to Internal Audit Members.	.802	-.385
Internal Audit unit is well remunerated.		.592

Extraction Method: Principal Axis Factoring.

Rotation Method: Varimax with Kaiser Normalization.

a. Rotation converged in 3 iterations.

Table 15 shows that three item measures, *Stock options available to Internal Audit Members whenever performance is achieved*, *Profit shared with Internal Audit Members*, and *Bonus Pay awarded to Internal Audit Members* loaded highly on Factor 1. The three predictors all seem to relate to shares, therefore this factor can be labelled, Shares-based

compensation, Category-1. Again, two item measures (Bonus Pay awarded to Internal Audit Members, and Internal Audit unit well remunerated) loaded highly on Factor 2. The two items which highly loaded on Factor 2 seemed to relate to salary or monetary package, therefore this factor can be labelled, Salary-package compensation, Category-2. From the findings in Table 14, it is evident that Factor 1 (Category-1) is the best predictor for internal auditor's objectivity, that is shares-based incentive compensations better predict the objectivity of internal auditors than Factor 2 (Salary-package based incentive compensations).

Table 17. Regression analysis for incentive-based compensation Category-1

Factor 1 Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.985	.676		1.457	.157
	Bonus Pay is awarded to Internal Audit Members.	-.588	.213	-.669	-2.763	.010
	Profit sharing is awarded to Internal Audit Members.	.329	.450	.290	.730	.472
	Stock options is available to Internal Audit Members whenever performance is achieved.	.312	.396	.318	.788	.437

Table 16. shows an attempt to establish the most powerful predictor of Factor 1 which revealed that Stock options is available to Internal Audit Members whenever performance is achieved was the best predictor of internal auditor objectivity ($\beta=.318$, $t=.788$, $p<0.05$). This was followed by the Profit sharing is awarded to Internal Audit Members ($\beta=.290$, $t=.730$, $p<0.05$) and the least powerful predictor being Bonus Pay is awarded to Internal Audit Members ($\beta=-.669$, $t=-2.763$, $p<0.05$). Of the three predictors, only Bonus Pay awarded to Internal Audit Members was statistically significance in the observed outcome ($p=.010$).

Table 17 below shows an attempt to establish the most powerful predictor of Factor 2 which revealed that Internal Audit unit well remunerated was the best predictor of internal auditor objectivity ($\beta=.368$, $t=2.115$, $p<0.05$). The least powerful predictor was the Bonus Pay awarded to Internal Audit Members ($\beta=-.169$, $t=-.972$, $p<0.05$). It is worth noting that the most powerful predictor of internal auditor's objectivity in Factor 2 was statistically significant ($p<0.05$).

Table 18. Regression analysis for incentive-based compensation Category-2

Factor 2 Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.370	.597		2.294	.029
	Bonus Pay is awarded to Internal Audit Members.	-.149	.153	-.169	-.972	.339
	Internal Audit unit is well remunerated.	.309	.146	.368	2.115	.043

4.7 Assessment of internal auditors in reporting GAAP violation

Table 19. Assessment of internal auditors in reporting GAAP violation

Item measures (n=31)	Percent
Your compensation is salary only.	100.0
Your compensation is a salary plus a significant bonus tied to accounting earnings.	93.5
Your compensation is a salary plus a significant bonus tied to the company's stock price.	87.1
Your compensation is salary plus a share of company's earnings.	90.3
Your compensation is a straight salary and you own a significant number of shares of company stock.	87.1

Table 18 above shows the distribution of respondents when presented with an audit-related case scenario of a hypothetical corporation XYZ which assessed whether they would report GAAP violation based on those five individualized scenarios. When asked if they would report on the GAAP violation when presented with five personal situations.

All the respondents (100.0%) indicated that they would report on the GAAP violation if their compensation is salary only. Majority indicated that they would report GAAP violation if they are presented with compromising situations; that is at least 9 in every 10 would report the GAAP violation (87.1%).

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter summarizes the main findings of the study, followed by conclusions arising from the findings, then the recommendations, and finally the suggestions for future research on the same.

5.2 Summary of findings

The study sought to determine the relationship between the objectivity of internal auditors and incentive-based compensation, a case study of insurance companies in Kenya. Incentive-based compensation schemes were majorly measured by four item measures in the questionnaire; that is the Bonus payments measured as a percentage of current basic salary, Incremental stock ownership as a percentage of post tax earnings, Profit share measured as a percentage of overall company's residual earnings, and Well remuneration as a percentage of the overall salary package.

The findings revealed that there is a negative correlation between *Internal Audit Department's objectivity and independence in reporting*, and *Internal Auditors are given incentive-based compensations* ($r = -.075$, $p = .689$). An increase in incentives awarded to the Internal Auditors in Kenyan Insurance companies leads to a decrease in objectivity and independence in reporting. However, this correlation was not statistically significant. Positive correlation was only established between the *Internal Audit Department is guided by objectivity and independence in reporting* and *Internal Audit unit is well remunerated* ($r = .020$, $p = .914$). This implies that when the internal audit unit is

increasingly well remunerated there tend to be objectivity in reporting. This correlation again was not statistically significant.

Negative correlation was established in most of the individual relationships between each predictor variables and the outcome variable. This was observed between the outcome variable and *Bonus Pay is awarded to Internal Audit Members* ($r = -.305$, $p=.095$), *Profit sharing is awarded to Internal Audit Members* ($r = -.092$, $p=.622$), and *Stock options is available to Internal Audit Members whenever performance is achieved* ($r = -.081$, $p=.665$). This generally implies that an increase in *Bonus Pay awarded to Internal Audit Members*, *Profit sharing awarded to Internal Audit Members*, and *Stock options available to Internal Audit Members whenever performance is achieved*, proportionately leads to a decrease in objectivity and independence in reporting within the Internal Audit Department and the company. However, there was no specific relationship which was statistically significant with a generally very low correlation between the predictor variable and outcome variable.

Multiple regression analysis to show how independent variables predict the outcome variable based on the model output ($Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \mu$) revealed that the quality of the prediction of the dependent variable by the independent variables was above average ($R=.534$). However, this model can only predict the internal auditor's objectivity by almost 28.6% of the total variance in the model ($R^2=.286$). The rest (71.4%) cannot be explained by the variables in the model equation. Therefore, the overall regression model is not fit for the data since the model cannot account for more than half the total variance of the model, and the independent variables do not statistically

significantly predict the dependent variable as confirmed by ANOVA, $F(5, 25) = 1.999$, $p < .05$.

A further Factor Analysis using Principal Axis Factoring method extracted based on the standard Eigen values set at 1; only 2 factor clusters were extracted out of the possible 4 factors. The study revealed that the overall variance for the objectivity of the internal audit item measures accounted for by the factors was 73.90%. This finding confirms that the four items of incentive-based compensation schemes can be used by insurance companies in Kenya to predict the objectivity of internal auditors. Factor 1 which appeared to be Shares-based compensations registered the highest variance of 60.29% with Factor 2 which appeared to Salary-package based compensation being the least 13.61% hence implying that Factor-1 is 4.43 times better predictor of the internal auditor's objectivity. From the 4 predictors, *Stock options available to Internal Audit Members whenever performance is achieved*, *Profit sharing awarded to Internal Audit Members*, and *Bonus Pay awarded to Internal Audit Members* loaded highly on Factor 1. While two predictors, *Bonus Pay awarded to Internal Audit Members*, and *Internal Audit unit well remunerated* loaded highly on Factor 2.

The study finally established the most powerful predictor in both Factor 1 and Factor 2. In Factor 1, the findings revealed that Stock options available to Internal Audit Members whenever performance is achieved was the best predictor of internal auditor objectivity ($\beta=.318$, $t=.788$, $p<0.05$). This was followed by the Profit sharing is awarded to Internal Audit Members ($\beta=.290$, $t=.730$, $p<0.05$) and the least powerful predictor being Bonus Pay is awarded to Internal Audit Members ($\beta=-.669$, $t=-2.763$, $p<0.05$). Of the three predictors, only Bonus Pay awarded to Internal Audit Members was statistically

significance in the observed outcome ($p=.010$). In Factor 2, the findings revealed that Internal Audit unit well remunerated was the best predictor of internal auditor objectivity ($\beta=.368$, $t=.2.115$, $p<0.05$). The least powerful predictor was the Bonus Pay awarded to Internal Audit Members ($\beta=-.169$, $t=-.972$, $p<0.05$). It is worth noting that the most powerful predictor of internal auditor's objectivity in Factor 2 was statistically significant ($p=.043$). A descriptive statistics revealed that majority (87.1%) would report GAAP violation even if they are presented with compromising situations.

5.3 Conclusions

Based on the findings, the following conclusions can be drawn:

There is a negative correlation between objectivity of the internal auditors and the incentive-based compensations. That is an increase in incentive-based compensations awarded to the Internal Auditors in Kenyan Insurance companies, leads to a decrease in objectivity of the internal auditors in reporting, and vice versa. However, this correlation was not statistically significant hence a further research with more sample size should be conducted to verify these findings.

There is a positive correlation between the Internal Auditor's objectivity and independence in reporting and their level of remuneration; that is an increase in remuneration in the internal audit unit leads to an increase in objectivity and independence of Internal Audit Department in reporting, and vice versa. However, this correlation was not statistically significant.

There are two factors (Shares-based and Salary-based compensations) which account for overall variance for the objectivity of the internal audit item measures by 73.90%. The

four schemes for incentive-based compensations can be used by insurance companies in Kenya to predict the objectivity of internal auditors. Factor 1 (Shares-based compensations) can highly predict the objectivity of internal auditors by a variance of 60.29%, while Factor 2 (Salary-based compensations) can predict the same by a variance of 13.61%. Suggestively, Factor-1 is 4.43 times better predictor of the internal auditor's objectivity than Factor-2

In summary based on the findings, there is a negative correlation between objectivity of internal auditors and the incentive-based compensations in Kenyan insurance companies. An increase in incentive-based compensations among the Internal Auditors in Kenyan Insurance companies, leads to a decrease in objectivity of the internal auditors. However, this relationship was not statistically significant hence a further research with more sample size should be conducted to verify this.

5.4 Recommendations

Based on the study findings and the above conclusions, the following recommendations were made:

The management of insurance companies in Kenya should monitor and evaluate the type of incentive-based compensation scheme they offer to their internal auditors lest they experience a decrease in objectivity in financial reporting.

Since there was a positive correlation between the Internal Audit Department's objectivity and independence in reporting and their level of remuneration, organizations should make efforts to offer a relatively better remuneration package for the internal

auditors for the greater good of organization's success. This is because internal auditors are key players in improving the efficiency and effectiveness of organizations.

The organization's management team should be keen on how they reward their internal auditors. If close monitoring is not effected, then there is a high likelihood of having internal auditors who lose their objectivity in their line of work.

Further studies should be conducted with a bigger sample size on the same so as to improve on the internal validity, external validity of the findings, and make the regression model used a better fit since it could only predict the objectivity of internal auditors by almost 28.6% of the total variance in the model. This model could not account for a whole 71.4% of the total variance. Again further research would help improve the internal validity of the findings as very low correlations were recorded in some aspects and statistical insignificance in predicting the outcome.

5.6 Suggestion for further research

1. From the findings, this study was limited within four incentive-based compensation schemes as indicated on the regression model and therefore may have left out certain aspects or predictors which did not explain the relationship.
2. This study was limited to insurance companies in Kenya which also limited the sample size. However, there is need to conduct a similar study that will include other industries (e.g. banking, NGOs, etc.) to validate the effectiveness and efficiency of this model.
3. If resources allow, similar study can also be conducted but with a relatively bigger sample size so as to improve on the internal validity, and external validity of the

findings as some analyses recorded very low correlations were recorded in some aspects and statistical insignificance in predicting the outcome.

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APPENDICES

APPENDIX I: LIST OF INSURANCE COMPANIES IN KENYA

1. AAR Insurance
2. APA Insurance
3. APA Life
4. Africa Merchant Assurance
5. Apollo Life Assurance
6. AIG Kenya Insurance
7. British American Insurance
8. Cannon Assurance
9. Capex Life Assurance
10. CFC Life Assurance
11. CIC General Insurance
12. CIC Life Assurance
13. Continental Reinsurance
14. Corporate Insurance
15. Directline Assurance
16. East Africa Reinsurance
17. Fidelity Shield Insurance
18. First Assurance
19. GA Insurance
20. GA Life Assurance
21. Geminia Insurance

22. ICEA LION General Insurance
23. ICEA LION Life Assurance
24. Intra Africa Assurance
25. Invesco Assurance
26. Kenindia Assurance
27. Kenya Orient Insurance
28. Kenya Reinsurance
29. Madison Insurance
30. Mayfair Insurance
31. Mercantile Insurance
32. Metropolitan Life Insurance
33. Occidental Insurance
34. Old Mutual Life Assurance
35. Pacis Insurance
36. Pan Africa Life Assurance
37. Phoenix of East Africa Assurance
38. Pioneer Assurance Company
39. Real Insurance Company
40. Resolution Insurance
41. Takaful Insurance of Africa
42. Tausi Assurance
43. Heritage Insurance
44. Jubilee Insurance

- 45. Monarch Insurance
- 46. Trident Insurance
- 47. UAP Insurance
- 48. UAP Life Assurance
- 49. Xplico Insurance

APPENDIX II: INTERNAL AUDIT QUESTIONNAIRE

PART ONE: GENERAL INFORMATION

1. Name of your company
.....
2. For how long has your firm been operating in Kenya? (Please tick one)
☐ 1- 5 years ☐ 6 – 10 years ☐ 11 – 15 years ☐ over 15 years
3. Your position in the organization.....
4. What are your academic qualifications?
☐ PHD ☐ MBA ☐ Bachelors degree ☐ CPA (K)
Others (specify please)
5. How long is your work experience as an internal auditor?
☐ 1- 3 years ☐ between 3-5 years ☐ between 5-10 years ☐ between 10-20 years
☐ > 20 years
6. Are you a member of any professional body?
☐ ICPAK
☐ IAA
☐ Others (please specify)

PART TWO

Using the Internal Audit Function as a Management Training Ground.

7. Do you view internal auditing as a stepping-stone to a managerial position?

1	2	3	4	5
Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

8. Does experience in internal auditing assist in advancement to management positions?

1	2	3	4	5
Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

9. Will internal auditors be transferred to management positions in the future?

1	2	3	4	5
Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>

10. A transfer to a management position foreseeable in the coming year

1	2	3	4	5
Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>

11. There is a possibility that an auditee could be the future boss of an internal auditor

1	2	3	4	5
Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>

12. Does your company have an Internal Audit Committee?

☐ Yes ☐ No

13. How many of the Audit Committee members are independent members?

☐ All members are independent
☐ All members are non-independent
☐ Minority of members are non-independent
☐ Majority of members are non-independent
☐ others please specify the number

14. How many of the Audit Committee members are professionally qualified Accountants?

☐ All are qualified accountants
☐ None of members are qualified accountants
☐ Others (please specify)

15. What is the level of internal audit committee involvement relative to its role with the internal audit function?

.....

16. To whom does the internal audit department report to functionally?

☐ Audit Committee Only

- ☐ Audit Committee and CEO
- ☐ Audit Committee and CFO
- ☐ Audit Committee, CEO and CFO
- ☐ Audit Committee, CEO, CFO and BOD
- ☐ CEO Only
- ☐ Others (please specify).....

17. To whom does the internal audit department report to administratively?

- ☐ CEO
- ☐ CFO
- ☐ CEO and BOD
- ☐ AC
- ☐ Co. Sec
- ☐ Others (please specify).....

18. Is the CAE regularly invited to the audit committee meetings?

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neither Agree or disagree
- ☐ Disagree
- ☐ strongly disagree

19. Does the audit committee give input to the internal audit planning?

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neither Agree or disagree
- ☐ Disagree
- ☐ strongly disagree

20. The Board members are curious to strengthen and support the internal audit function.

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neither Agree or disagree
- ☐ Disagree
- ☐ strongly disagree

21. The management and other organs of the system support understand and appreciate the role of internal audit function.

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neither Agree or disagree
- ☐ Disagree
- ☐ strongly disagree

22. Does the CEO give input for the internal audit planning?
- ☐ Strongly Agree
 - ☐ Agree
 - ☐ Neither Agree or disagree
 - ☐ Disagree
 - ☐ strongly disagree
23. The internal audit staff is rotated to other departments in your company.
- ☐ Strongly Agree
 - ☐ Agree
 - ☐ Neither Agree or disagree
 - ☐ Disagree
 - ☐ strongly disagree
24. On average how many years does an internal auditor stay within your internal audit department?
- ☐ Less than 2 years
 - ☐ between 2-4 years
 - ☐ Between 5-7 years
 - ☐ between 8-10 years
 - ☐ More than 10years
25. Your organization hire employees (new graduates or senior level employees from other organization) in the internal audit function with a promise they will be promoted into senior level management.
- ☐ Yes
 - ☐ No
26. Your company assigns existing employees into internal audit function for a specified amount of time before being cycled back into management.
- ☐ Strongly Agree
 - ☐ Agree
 - ☐ Neither Agree or disagree
 - ☐ Disagree
 - ☐ strongly disagree
27. Is it common for internal auditors to move to other functions within the company?
- ☐ Strongly Agree
 - ☐ Agree
 - ☐ Neither Agree or disagree
 - ☐ Disagree
 - ☐ strongly disagree
28. Internal auditors are highly involved in establishing internal control system in your organization.
- ☐ Strongly Agree

- ☐ Agree
- ☐ Neither Agree or disagree
- ☐ Disagree ☐ strongly disagree

29. Internal auditors are always involved in reviews of the internal control system.

- ☐ Strongly Agree
- ☐ Agree
- ☐ Neither Agree or disagree
- ☐ Disagree ☐ strongly disagree

PART THREE

Kindly state your level of agreement with the following statements. Note that the numbers listed denote the following levels of agreement: 1 = Strongly Agree, 2 = Agree, 3 = Neutral, 4 = Disagree and 5 = Strongly Disagree

<i>Item</i>	1	2	3	4	5
30. Internal Audit unit is well remunerated					
31. Internal Auditors are given incentive based compensations					
32. Bonus Pay is awarded to Internal Audit Members					
33. Profit sharing is awarded to Internal Audit Members					
34. Stock options is available to Internal Audit Members whenever performance is achieved					
35. Internal Audit Department is guided by objectivity and independence in reporting					

Does internal auditor incentive compensation, affects internal auditors' reporting decisions?

Assume that you are an internal auditor in XYZ Corporation-a hypothetical company and presented with the following circumstance.

Your work paper file contains a memo from a manufacturing concern to XYZ's CEO. The memo informs him/her that a batch of equipment recently manufactured is severely defective. This equipment, which had cost kshs 95,000 to manufacture, is currently in inventory. According to this, the equipment could not be sold in its current condition and re-work would not be financially feasible. He/She has concluded that the equipment will have to be discarded with no salvage value. According to generally accepted accounting principles, a loss of kshs 95,000 should be recognized on this inventory. A loss would reduce pre-tax earnings below the company's kshs1.2 million target. Without recognizing this loss, the pre-tax earnings for the current year would be kshs1.25 million. You now see a draft of the company's annual income statement and it does not show this loss.

Would you report on the GAAP violation if;

40. Your compensation is salary only?

Yes []

No []

41. Your compensation is a salary plus a significant bonus tied to accounting earnings.

Yes []

No []

42. Your compensation is a salary plus a significant bonus tied to the company's stock price.

Yes []

No []

43. Your compensation is salary plus a share company's earnings.

Yes []

No []

44. Your compensation is straight salary and you own a significant number of shares of company stock.

Yes []

No []