

**THE RELATIONSHIP BETWEEN INTERNAL AUDIT FUNCTION AND  
FINANCIAL PERFORMANCE OF MID-SIZE MANUFACTURING FIRMS IN  
NAIROBI COUNTY, KENYA**

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## DECLARATION

This research project is my original work and has not been presented for an award in any university.

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## DEDICATION

I wish to dedicate this project to all the people who made it possible for me to achieve my academic dreams and especially to my dear parents Mr. **James Thumbi** and Mrs. **Gladys Thumbi** for their immense contribution and support towards this achievement. Thank you for all the sacrifices you have made throughout my life to see me progress in my education.

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## **LIST OF ABBREVIATIONS**

<b>CG</b>	:	Corporate Governance
<b>IAC</b>	:	Internal Audit Characteristics
<b>IIA</b>	:	Institute of Internal Auditors
<b>IC</b>	:	Internal Controls
<b>KAM</b>	:	Kenya Association of Manufacturers
<b>MVA</b>	:	Market Value Added
<b>NSSF</b>	:	National Social Security Fund
<b>ROA</b>	:	Return on Assets
<b>ROE</b>	:	Return on Equity
<b>ROI</b>	:	Return on Investments
<b>UK</b>	:	United Kingdom
<b>US</b>	:	United States
<b>WARMA</b>	:	Water Resources Management Authority

## **ABSTRACT**

This study sought to investigate the existing relationship between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi County, Kenya. To fulfill its objective the study operated a descriptive research approach. The target population in the study was the medium size manufacturing firms. 30% of the medium size manufacturing firms in Nairobi were selected for the study. This generated 30 firms. Primary data was collected using a quantitative approach. The respondents were either of the three (3) business unit heads designated as CEOs or senior Managers, general managers and functional heads from each of the firms who are responsible for day – to day operations of the enterprises. The data obtained was mainly quantifiable in nature and hence was analyzed by descriptive analysis. The researcher conducted inferential analysis which included a multiple regression analysis. The study concludes that internal audit functions have a significant effect on the financial performance of mid- size manufacturing firms in Nairobi. There was a strong positive relationship between financial performance of mid-size manufacturing firms and internal audit aspects of functions. There is therefore the need for mid-size manufacturing firms to adopt effective internal processes and practices that address key internal auditing practices for effectiveness of audit quality. In order to implement good internal audit independence, managers need to know that they should be concerned about the interrelationships between internal audit independence and financial performance. Internal auditors must have sufficient proficiency and training to carry out the tasks assigned to them.

## **CHAPTER ONE: INTRODUCTION**

### **1.1 Background of the Study**

The central reason for internal audits is to help managing executives in the effective absolution of their tasks by providing them with scrutiny, evaluation, approvals and relevant observations regarding the undertakings appraised (Okezie, 2004). Raja (2002) argued that the increase of internal audit normally adds value and improves on an organization's operations because of its objectivity and the consultative forums with other departments in the same organization. Meckling (2000) identified auditing as one of the methods for monitoring and controlling the activities in the agency theory. Accordingly, internal auditing is an independent, goals reassurance and checking events premeditated to enhance significance and advance an organization's maneuvers.

Theoretically, Adams (1994) argued that, agency theory also offers a valuable hypothetical background for the study of internal auditing function. The internal audit support enhances the system of responsibility and accountability that the managerial boards and personnel required to organizational shareholders (Eighme & Cashell, 2002). According to contingency theory, the goal of an audit is to check the dependability of a firm's data, guidelines, approaches and procedures. Several dynamics influence a firm's ultimate outcomes and the contingency framework takes these aspects into consideration in the entire auditing course. According to Daft (2010), the presence of such factors is why appraising becomes manageable by utilizing the contingency theory, with such that methods and results of reviews are reliant on on adjustable and conditional elements.

Most mid-size manufacturing sector organizations in Kenya have well-designed core audit sections with competent personnel responsible for guaranteeing that internal regulation structures are sufficient and value practices are in place (Olando, Jagongo & Mbewa, 2013). However, there is continued poor financial performance, incidences of fraud, incidences of budgets not being followed and cases of non-conformance to rules and regulations on usage of finance. This has put financial position of such organizations at risk despite investing in the internal audit department.

### **1.1.1 Internal Audit Function**

According to Messier (2011), internal audit function occupies a significant part of the organizational structure of in-house control. This facilitates effective internal auditing and reporting with assurance of highest possible level of review and appraisal of various activities in an organization. Depending on its performance, internal audit could either earn a good or bad reputation in the firm (Sarens, 2006). For internal audit to remain reputable, it has to keep on evaluating its performance and continually improving its services. According to Hutchinson and Zain (2009), internal audit is a significant part of the control arrangements in a firm and corporate governance involves oversight undertakings by the panel of executives and audit committees to ensure that the financial reporting practice is sound and up to the mark.

Previously, internal auditors were not recognized in organizations and were treated as mere accountants but that scenario has changed in that their services are currently treated as management oriented services (Hutchinson & Zain, 2009). According to Beyanga (2011), internal audit greatly assists organizations to achieve their expected goals through use of strategic methodologies for determining and refining the usefulness and proficiency of the governance procedures of organizational threats and how they can be controlled.

### **1.1.2 Financial Performance**

Financial performance is normally derived from sound financial statements as determined by the auditors on independence basis (Johnsone, 2001). There have been various measures of financial performance which include return on sales, return on assets and return on equity. The advantages of these measures of financial performance are the lenience of computing the financial health and financial position of an organization (Hansen & Mowen, 2005).

In this study, ROE will be utilized as the measure of financial performance. Return on equity (ROE) displays the level to which businesses organize their capital or net worth efficiently, quantify the productivity of their ventures created by proprietors of their own investment or stakeholders of the business. ROE shows the profitability of own capital as the business profitability.

Manufacturing firms are viewed as precisely proficient if they are capable of obtaining optimum yields from given efforts applied in the manufacturing course. As such, return on equity is used to measure the effectiveness of the manufacturing firm in generating profits by exploiting its equity. This ratio may give an indication of good or bad material management in implementing cost control or management of the firms' property. In a study on the connection between capital structure and financial performance of manufacturing companies, Njenga (2015) established that ROE of firms quoted in the NSE shows effectiveness of their earning on equity employed.

### **1.1.3 Internal Audit and Financial Performance**

Appropriately established structures of internal control enhance healthier financial performance of organizations in the current operating environment. According to Beyanga (2011), active in-house audit facilities aid in reducing overheads, detecting means of refining effectiveness and exploiting coverage to probable deterioration in performance due to inadequately safeguarded resources. Whittington and Pany (2001) noted that, internal control also includes the program for preparing, verifying and distributing to the various levels of management those current reports and analyses that enable executive management to maintain control over the variety of activities and functions that are performed in an organization (Beyanga, 2011).

Internal audit function and the financial performance have caused conflict and uncertainty in the organization's financial reports since the management is unwilling to support the internal audit function fully (Ebaid, 2011). It has been suggest that if left unexploited audit function is most likely to affect the financial performance of manufacturing sector organizations, corporate local scandals in manufacturing firms have led to ill-informed comments on the audit profession, particularly as regards to internal audit independence (Hutchinson & Zain, 2009). This study is therefore interested to investigate the relationship between the internal audit function and financial performance of mid-size manufacturing firms in Kenya.

### **1.1.4 Mid-Size Manufacturing Firms in Nairobi County**

Kenya has a large manufacturing sector serving both the local market and exports to the East African region and the rest of the world. It is dominated by subsidiaries of multinationals.

Kenya's manufacturing sector is among the key productive sectors identified for economic growth and development because of its immense potential for wealth, employment creation and poverty alleviation. According to Wamalwa & Awino (2011) manufacturing is an important sector in Kenya and it makes a substantial contribution to the country's economic development.

The average size of this sector for tropical Africa is 8 per cent (KAM, 2015). Manufacturing firms in Kenya are regulated by the Kenya Association of Manufacturers (KAM) as the umbrella body. The sector, which is dominated by subsidiaries of multi-national corporations, contributed approximately 13.8% of the gross domestic product in 2015 (KAM, 2015). The mid-size manufacturing firms play an important role in adding value to agricultural output and providing forward and backward linkages, hence accelerating overall growth.

Manufacturing in Nairobi consists of many small and medium-sized industries (Njeri, 2015). According to the Kenya Association of Manufacturers (KAM, 2015) there are 268 mid-size manufacturing firms operating in Nairobi cutting across 12 key manufacturing sectors involved in manufacturing of food, beverages and tobacco; textile and apparels; timber, wood products and furniture; pharmaceutical and medical equipments; metal and allied and plastics and rubber.

## **1.2 Research Problem**

The audit function has become an integral part of organizational financial management and an instrument of improving performance in the mid- size manufacturing sector (Al-Shammari, 2010). Thus, the internal auditing function gauges the usefulness of manufacturing firms in accomplishing approved purposes and thereby stimulating resilient authority and responsibility in firms. The recommendations made by internal audit for improvement helps management in manufacturing sector entities to improve their risk management, control and governance processes (Van Gansberghe, 2005). The internal audit function offers an unfailing, objective and impartial service to the management, board of directors, and audit committee, while stakeholders are interested in return on investments, sustainable growth, strong leadership, and reliable reporting on the financial performance

and business practices of a company (Ljubisavljević & Jovanovi, 2011). Hutchinson and Zain (2009) explored the relationship between internal audit quality (audit experience and accounting qualification) and firm performance (ROE) in Malaysia. The results showed a strong relationship between internal audit quality and firm performance with opportunities of high growth and that this positive link is decreased by the increasing independence of audit committee.

Locally, Gaturu and Ngahu (2015) did a study on the effect of computerized audit system on financial management at Water Resources Management Authority in Nairobi County. Their study found that computer-assisted audit techniques and internal controls influenced financial management in WRMA. Their main focus was on computerized audit system and its effect on financial performance of WARMA whose orientation in the sectors of economy is different from that of mid- size manufacturing firms in Kenya. Kiema, Ahmed and Ndirangu (2015) investigated the influence of internal audit independence on the financial performance of small and medium enterprises in the Construction Industry in Mombasa.

Kiema *et. al.*, (2015) found that some construction companies within Mombasa County do not accord the internal auditors the independence they deserved to effectively give their opinion on the financial statements of the organizations. The study did not give a clear direction of the relationship between internal audit function as a whole with the financial performance of firms in the mid- size manufacturing sector. Ondieki (2014) conducted a survey of the effects of internal audit on financial performance of commercial banks in Kenya and found that internal audit standards, independence of internal audit, professional competency and internal control had a positive relationship with financial performance of commercial banks. Ondieki looked at internal audit in the context of banking firms and did not link the internal audit function to the financial performance of the banks and therefore could be interesting to link the internal audit function and financial performance in the mid-size manufacturing firms.

As evidenced from the foregoing studies, there is unanimous agreement that if left unexploited internal audit is most likely to affect the financial performance of mid- size manufacturing firms. There have been no published studies on the relationship between the

internal audit function and financial performance of mid- size manufacturing sector organizations in Kenya hence the research gap. To this end the study sought to respond to the following research question: What is the relationship between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi County?

### **1.3 Research Objectives**

To determine whether a relationship exists between internal audit function and financial performance of mid-size manufacturing firms in Nairobi County, Kenya.

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

The study would be of help to mid- size manufacturing firms in Nairobi County as well as other organizations in Kenya because it would make them understand the role of internal audit function on the financial performance of organizations in Kenya. The findings of this study would benefit mid- size manufacturing firms in Kenya to improve their internal audit function and put in place measures that would improve internal audit function and overcome the challenges faced during the process.

The findings of the study would be useful to the government in identifying the linkage between internal audit functions and their effects on the financial performance of mid- size manufacturing firms. This would help the regulatory agencies concerned to come up with possible approaches aimed at solving the problems. Stakeholders within the sector would benefit from the issues raised in the study, which would help them to improve the existing internal audit function framework.

The results of this study would be useful to researchers, scholars, students and academics, who would use it as a basis for discussion on internal audit function and as a source of reference material on other related topics.



## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

This chapter delves into the literature on the relationship between the internal audit function and financial performance of mid- size manufacturing firms with the ultimate aim of establishing a research gap. The chapter also reviews research done by other scholars touching on the area of the internal audit function and financial performance and concludes with a summary of the literature reviewed

### **2.2 Theoretical Review**

This section discusses the theories on which this study is anchored. Theories are used by scholars when performing research studies to form a foundation for the parameters, or boundaries, of a study. This study is grounded on agency theory, contingency theory and stakeholder theory.

#### **2.2.1 Agency Theory**

The agency theory outlines the relationship or the dependency between an agent and a principal (Adams, 1994). The principal delegates responsibilities to the agent most often for a fee. It can also be postulated to mean the practice by which productive resources owned by one person or group are managed by another person or group of persons (Millichamp & Taylor, 2008). The agency theory is said to be one on the internal auditing theories. In the context of an organization, the agency theory argues that agents should act in the interest of their employers (shareholders). However, the aforementioned agents have been alleged to act in their own interest rather than on the behalf of the shareholders.

The foregoing is argued to beget mistrust between the two parties, particularly from the shareholders (employers). Consequently, the mistrust increases the inclination of enhanced monitoring of the agents' (directors and managers) activities. Upon the foregoing principle lies the foundation of auditing profession (Millichamp & Taylor, 2008). The theory further expounds on the principle agent problem, that is, agency dilemma. The dilemma is said to be occasioned by the inclination of the agent's inclination to act in his own best interest rather than those of the principal. There is a likelihood of moral hazard and conflict of interest arising in the corporate scene.

It is exemplified that, the principal (shareholders) may be sufficiently concerned that at the likelihood of being exploited by the agent (directors and managers) that a dilemma may arise in hiring the right agents. The foregoing is necessitated by the desire to minimize or get rid of agency costs (Bebchuk & Fried, 2004). According to Adams (1994), the agency theory can provide for richer and more meaningful research in the internal audit discipline. Agency theory contends that internal auditing, in common with other intervention mechanisms like financial reporting and external audit, helps to maintain cost-efficient contracting between owners and managers. Agency theory may not only help to explain the existence of internal audit in organizations but can also help explain some of the characteristics of the internal audit department, for example, its size, and the scope of its activities, such as financial versus operational auditing (Adams, 1994).

### **2.2.2 Contingency Theory**

The contingency theory of organization views organizations as rational entities capable and willing to make internal changes to achieve a technical fit between environment and structure as argued by Byars & Rue (2004). The goal of an audit is to test the reliability of a company's information, policies, practices and procedures. Government regulations require that certain financial institutions undergo independent financial audits, but industry standards can mandate audits in other areas such as safety and technology. Auditors require access to documents, systems, policies and procedures to manage an audit.

According to Daft (2010), audit teams may begin the audit process with meetings where they gather risk and control awareness, after which the field work begins. During the audit process, auditors perform substantive procedures and test controls. The audit sub processes, particularly in planning and field work, include contingencies such as business type, employee skill level, applicable laws, available audit workforce, available technology and systems, and deadline.

Daft (201) in his book wrote that contingency means one thing depends on other things and Contingency theory means: it depends. Audit functions are task-oriented and can be loosely structured. The functions also can vary considerably, depending on the area of a company under audit and the type of business model, so auditors must carefully manage their

inspections and take variables into account to get the job done. The contingency theory also can be applied to an audit team's structure. Typically, audit team managers receive audit projects (Daft, 2010). They then create ad hoc audit teams for the projects, selecting auditors based on expertise and experience in the subject areas, and on auditor availability, all of which add up to contingencies for any given audit project. Audit teams use a mix of structure and contingency to get the output rolling quickly.

### **2.2.3 Stakeholder Theory**

The stakeholder theory proposed by Freeman R. Edward (Freeman, 2004) is a theory of organisational management and business ethics that addresses morals and values in managing an organization. Stakeholder theory takes into account a wider group of constituents rather than focusing on shareholders. A consequence of focusing on shareholders is that the maintenance or enhancement of shareholders' value is paramount whereas when a wider stakeholder group such as employees, providers of credit, customers, suppliers, government and the local community is taken into account the overriding focus on shareholder value become less self-evident.

Nonetheless many companies do strive to maximize shareholders value whilst at the same trying to take into account the interests of the wider stakeholder group (Kay & Silberston, 1995). This means that the shareholders have vested interest in trying to ensure that resources are used to maximum effect, which in turn should be to the benefit of the society.

### **2.3 Determinants of Financial Performance**

The internal audit aspects that affect the financial performance of the firms include independence of internal audit (i.e. formalized principles, operations structure), professional competency (qualifications, auditors personnel, internal audit quality), internal control systems (reporting, management support of IA, advisory role) and internal audit standards (objectivity, accountability, discipline, risk management). In addition, working capital, firm characteristics and policies, capital structure, size of the firm and firm liquidity determine the financial performance of mid-sized enterprises.

### **2.3.1 Working Capital**

Makori and Jagongo (2013) conducted an empirical analysis of environmental accounting and firm financial performance amongst selected firms listed in Bombay Stock Exchange, India. The study relied on data from annual reports of the selected firms. The major findings indicated that the relationship between environmental accounting and return on capital employed (ROCE) was significant and negative. Patel (2014) argued that net profit ratio (NPR) and working capital are related. The authors established that there exist significant differences between industries in working capital practice over certain duration of time.

In addition, Rehman (2006) scrutinized the how WCM impacted on financial performance of Pakistani firms listed on Islamabad Stock Exchange (ISE). The study focused on the implication of average payment period and cash conversion cycle on the net operating profit of firms. An empirical study was conducted on working capital management as a financial strategy for Nestle Nigeria PLC. The firm under study was selected for a period of five years, that is, from 2004 to 2009. The study analyzed the effect of various constructs of WCM which included current ratio and collection days on gross profit movement coefficient.

The results obtained by Rehman (2006) indicated that there exists a negative correlation between current ratio and financial performance. The collection days were regressed against ROCE. The pertinent results showed that, the relationship between the two variables was negative. This implied that a reduction in collection days increased financial performance of the firm. Generally, therefore, the study revealed that WCM as a financial strategy not only affects firm liquidity but also its financial performance.

### **2.3.2 Firm Characteristics and Policies**

Certain firm characteristics are associated with high performance of firm. These include size, growth rate, dividends, liquidity and sales (Love & Rachinsky, 2007). The forms that have better growth rate can afford better machinery, and then gradually the assets and size of the firm will increase. Large firms attract better managers and workers who in turn contribute to the performance of the firm. So, both firm and its people support each other's goals. A study on Saudi's cement manufacturing firms indicated that the firm size is directly

proportional to firm's financial performance (Almazari, 2013). These findings concurred with a previous study conducted in Pakistan where it was noted that firm size had a significant effect on the financial performance of the firm (Raheman, Afza, Qayyum & Bodla, 2010).

A study conducted in Nigeria BY Bassey, Aniekan, Ikpe and Udo (2013) indicated that the size of the firm was one of the firm characteristics that were significant with debt ratio of the firm. Moreover, when examining agro-based firms in Nigeria between 2005 and 2010, Bassey *et. al.*, (2013) noted that the firm size was one of the major determinants of short-term debt ratio for the firms under study. A study on listed manufacturing firms in Ghana by Akoto, Awunyo and Angmor (Akoto et al., 2013) found that firm size significantly and positively influence financial performance.

### **2.3.3 Capital Structure**

Capital structure plays an important role in determining corporate performance. Barton & Gordon (2008) suggest that entities with higher profit rates will remain low leveraged because of their ability to finance their own sources. On the other hand, a high degree of leverage increases the risk of bankruptcy of companies. Outsourced capital is perceived as a liability to a firm since such an enterprise relies on external financing for its operations and had to compensate the capital source later.

Kuang-Hua and Ching-Yu (2009) empirically studied capital structure and financing decisions as evidenced by cases in East Asian Tigers and Japan. Their study involved samples from Hong Kong, Japan, Korea, Singapore, and Taiwan. The authors argued that the aforesaid countries had homogenous level of economic development. They acknowledged that there exist several elements that temporarily impact on capital structure, yet firms from the aforementioned countries rebalance their leverage following equity issuances. The study further revealed that firms have their target capital structure determined by the marginal benefits of debt and costs associated with debt.

### **2.3.4 Size of the Firm**

According to Yang and Chen (2009), the size of a firm is the amount and variety of production capacity and ability a firm possesses or the amount and variety of services a firm

can provide concurrently to its customers. The size of a firm is a primary factor in determining the profitability of a firm due to the concept known as economies of scale which can be found in the traditional neo classical view of the firm. It reveals that contradictory to smaller firms, items can be produced on much lower costs by bigger firms. In accordance with this concept, a positive relationship between firm size and profitability is expected. Large companies enjoy Economies of scale since their cost of capital is lower than in small firms.

The financial determinants of economies of scale occur due to size where large firms enjoy better interest and discount rates due to buying in large quantities (Pervan & Visic, 2012). There is a limit as to how big an organization can grow in order to achieve the economies of scale. After attaining a certain size the diseconomies of scale sets in as it becomes expensive to manage large organizations due to complexity, inefficiencies and bureaucracy. The hierarchy in small firms puts them in strategic position to counter the disadvantages arising from their size. They experience less agency problems and are more flexible in a changing environment. Serrasqueiro and Nunes (2008) found a positive relationship between size and performance in SMEs but not for large firms.

### **2.3.6 Liquidity**

Liquidity refers to the available cash for the near future, after taking into account the financial obligations corresponding to that period. It is the amount of capital (Cash, credit and equity) that is available for investment and spending (Pradhan & Shrestha, 2016). Liquidity therefore, not only helps ensure that a person or business always has a reliable supply of cash close at hand, but it is a powerful tool in determining the financial health of future investments as well. Under critical conditions, lack of enough liquidity even results in firm's bankruptcy (Khidmat & Rehman, 2014). Sound and prudent liquidity policies set out the source and amount of liquidity required to ensure it adequate for the continuation of operations.

The policies must be supported by effective procedures to measure, achieve and maintain liquidity. According to Deloof (2003) less profitable companies wait longer to pay their debts. The negative relationship between liquidity and profitability is also established by

Dong (2010) where it was found that decrease in the profitability occurs due to increase in cash conversion cycle. Mahmood and Qayyum, (2010) pointed out that to increase profitability of a company and ensuring sufficient liquidity to meet short term obligations as they fall due are two main objectives of working capital management. To measure firm liquidity, the study considered liabilities, debt management and cash flow.

## **2.4 Empirical Studies**

### **2.4.1 Global Studies**

Ebrahim, Abdullah and Faudziah (2014) did a study titled “The Effect of the Internal Audit and Firm Performance: A Proposed Research Framework.” The study was based on secondary data/desk search. The study attempted to propose a structure of the relationships between the internal audits characteristics (IAC); such as professional qualifications of the chief audit executive of the Internal Audit (IA), size, experience, and qualification; and firm performance. The study established that internal audit is a crucial part of corporate governance structure in an organization and corporate governance (CG) covers the activities of oversight conducted by the board of directors and audit committees to ensure credible financial reporting process.

Ewa and Udoyang (2012) carried out a study to establish the impact of internal design on banks’ ability to investigate staff fraud and staff life style and fraud detection in Nigeria. Data was collected from 13 Nigerian banks using a Four Point Likert Scale questionnaire and analyzed using percentages and ratios. The study found that internal control design influences staff attitude towards fraud such that a strong internal control mechanism is deterrence to staff fraud while a weak one exposes the system to fraud and creates opportunity for staff to commit fraud. The study therefore recommended that banks in Nigeria should upgrade their internal control designs and pay serious attention to the life style of their staff members as this could be a red flag to identifying frauds.

Peursem (2004), undertook a study in New Zealand on internal auditor’s role and authority. In this study, internal auditors were asked to come to a view on whether functions they perform in connection with audit engagements are essential, and to what degree they feel they enjoy the authority over, and independence from, management that is expected of a

professional. A very high percent (73%) response rate was achieved over the original and follow-up survey. The study found that characteristics of a true profession exist but do not dominate.

#### **2.4.2 Local Studies**

Locally, Olumbe (2012) conducted a study to establish the relationship between internal controls and corporate governance in commercial banks in Kenya. The researcher conducted a survey of all the 45 commercial banks in Kenya. It was concluded that most of the banks had incorporated the various parameters which are used for gauging internal controls and corporate governance. This was indicated by the means which were obtained enquiring on the same.

Mutua (2012) researched on impact of risk based audit on financial performance of commercial banks in Kenya. The study adopted a correlation research design with the target population being 44 commercial banks operating Kenya. Primary data was collected using semi-structured questionnaires. The study found that the risk based auditing through risk assessment, risk management, annual risk based planning, internal auditing standards and internal auditing staffing should be enhanced. Proper planning improves efficiency, accuracy, completeness, timeliness, convenience and clarity. Credible audit reports, auditor independence to identify and rectify audit errors, effective implementation of audit recommendations, financial management and compliance with accepted audit standards, effective internal audit staff and independent audit committee influence financial performance in commercial banks. The study recommended that management in commercial banks in Kenya should adopt effective risk based audit practices such as risk assessment, risk management, annual risk based planning, internal auditing standards and internal auditing staffing to enhance effective and efficient financial performance.

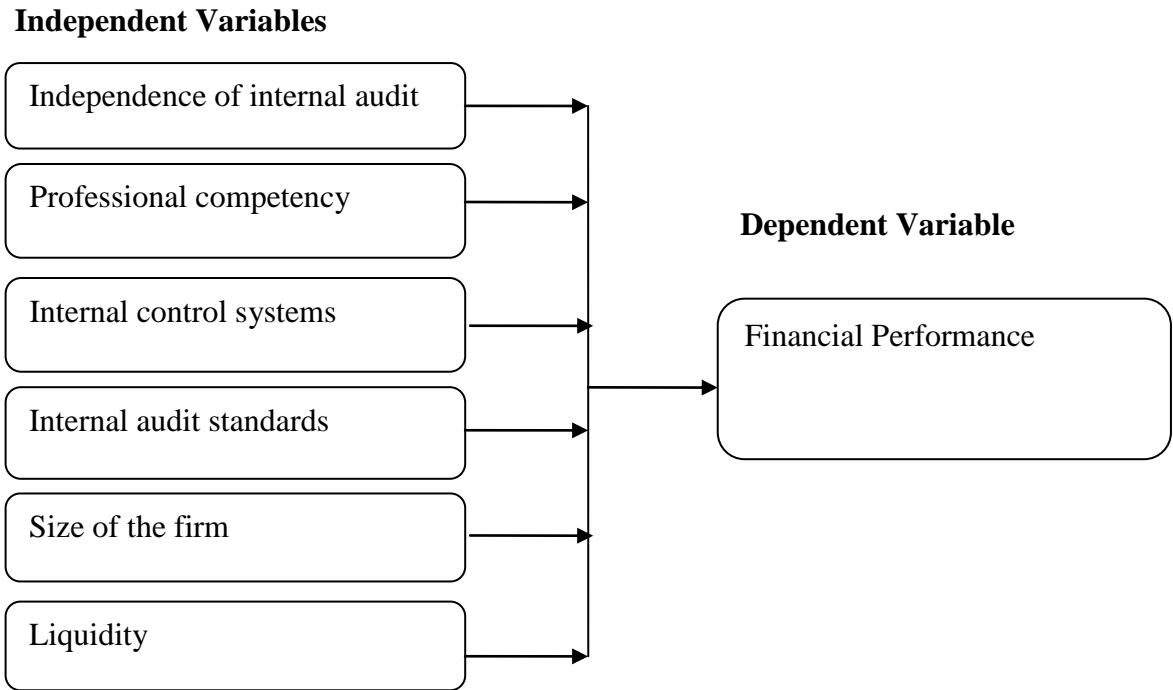
Wainaina (2011) carried out an evaluation of the internal control function: The case of Kenya Polytechnic University College. The researcher used the case study as the research design, as this type of design provides an opportunity to obtain responses which are more accurate and factual. The study involved an examination of the College's ICS's, with sample elements involved drawn from among others, the human resource, administration, finance



and internal audit. Semi structured questionnaires were used, supplemented with oral interviews to solicit for information. He established that, other than the prevention and detection of fraud, internal controls should reflect the strength of the overall accounting environment in an organization as well as the accuracy of its financial and operational records. The study recommended that to maintain a sound system of internal control, management should evaluate the risks the projects are exposed to, in the course of their operations.

**2.5 Conceptual Framework**

The various aspects of internal audit function that affect the financial performance of mid-size manufacturing firms in Nairobi County, Kenya form the variables of the study. In this study, the independent variables are independence of internal audit, professional competency, internal control systems, internal audit standards, size of the firm and liquidity while the dependent variable is financial performance of mid-size manufacturing firms in Nairobi County. These aspects form the undernoted diagram.



**Source: Researcher, 2016**

## **2.6 Summary of Literature Review**

From the foregoing review, whereas a lot has been done on internal audit in general, there is little done about internal audit function in relation to financial performance of firms in Kenya and specifically there is no study that has focused on effects of internal audit function on financial performance of mid- size manufacturing firms in Kenya. Therefore, there was need to establish the relationship between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi County, Kenya.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

This chapter provides a discussion of the research methodology that was used in the study. It discusses the research design especially with respect to the choice of the design. It also discusses the population of study, sample design, data collection, validity and reliability as well as data analysis.

### **3.2 Research Design**

This study employed a descriptive research design. Descriptive studies describe characteristics associated with the subject population. According to Cooper and Schindler (2006), a descriptive research collects data from members of a population and helps the researcher get the descriptive existing phenomena by asking individuals about their perceptions, attitudes, behaviour or values. Moreover, it explores the existing status of two or more variables at a given position in time and whether a relationship exists between them; hence most suited in establishing the relationship between internal audit function and financial performance of mid- size manufacturing firms in Nairobi County.

### **3.3 Population**

The target population in the study was the medium size manufacturing firms registered with the Kenya Association of Manufacturers. According to Kenya Association of Manufacturers (2015), the total number of medium size manufacturing enterprises operating in Nairobi, Kenya was 102.

### **3.4 Sample Design**

The study selected the mid-size manufacturing firms in Nairobi County. This was because, most of the mid-size manufacturing firms have their head offices located in Nairobi and therefore were possible to get responses within a reasonable time. Statistically, a sample of 10% of the target populations is considered appropriate according to Mugenda and Mugenda (2003). According to Saunders et al (2003), a sample should at a minimum; consist of 30 elements for statistical analysis. For the purpose of this study, 30% of the medium size manufacturing firms in Nairobi were selected.

This generated 30 firms from which the study collected information from. Thus out of a sampling frame of 102 registered medium size manufacturing firms in Nairobi County, only 30 firms that met the criteria of between 20 and 150 employees were sampled through random sampling. This was to ensure that only those firms that were medium size were included.

### **3.5 Data Collection**

This study collected both primary and secondary data. Primary data was collected using a questionnaire. On the other hand secondary data was obtained from the information published by the firms, industry regulators and government agencies on the financial performance of the medium size manufacturing firms in Nairobi County. The research instrument was divided into 5 sections, requiring responses to various dimensions based on the Likert type scale for purposes of enabling easy rating /ranking of answers, coding and data analysis; and a closing open ended section.

The first section, A, consisted of a brief background regarding the background information of medium size firms in the manufacturing industry which are the subjects of the study. The sections B, C, D and E focused on the effects of independence of internal audit, professional competency, internal control systems and internal audit standards on the financial performance of mid- size manufacturing firms in Kenya. The respondents were either of the three (3) business unit heads designated as CEOs or senior managers, general managers and functional heads from each of the firms who are responsible for day – to day operations of the enterprises. As such a total of 30 respondents were involved in this study. The respondents were selected because they had functional knowledge and overall responsibility for their operational areas.

### **3.6 Validity and Reliability**

Prior to the actual study, the researcher carried out a pilot study to pretest the validity and reliability of the data to be collected using questionnaires. Pretesting helped not only to discover errors, but also in training the research team and discovering the respondents' reactions to the questions. The pilot study was carried out by administering 10 questionnaires to mid- size manufacturing firms.

### 3.7 Data Analysis

The data collected was purely quantitative and it was analyzed by descriptive analysis. The descriptive statistical tools such as Statistical Package for Social Sciences (SPSS) and MS Excel helped the researcher to describe the data and determine the extent used. Data analysis uses frequencies, percentages, means and other central tendencies. The findings were presented using tables and charts. The Likert scales were used to analyze the mean score and standard deviation. In addition, the researcher conducted inferential analysis which included a multiple regression analysis so as to investigate the relationship between internal audit function and financial performance of mid- size manufacturing enterprises in Nairobi County, Kenya. For this regression, the data was broken down into the different aspects of internal audit function affecting the financial performance of the medium size manufacturing enterprises in Nairobi County. This offered a quantitative and qualitative description of the objectives of the study. The regression equation was:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \varepsilon$$

Where Y = financial performance of manufacturing firms (measured in terms of ROE).

$X_1$  = independence of internal audit (formalized principles, operations structure)

$X_2$  = professional competency (qualifications, auditors personnel, internal audit quality)

$X_3$  = internal control systems (reporting, management support of IA, advisory role)

$X_4$  = internal audit standards (objectivity, accountability, discipline, risk management)

$X_5$  = size of the firm (asset base, sales/market share)

$X_6$  = liquidity (liabilities, debt management, cash flow)

Further,  $\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$  and  $\beta_6$  = Regression Coefficients and  $\varepsilon$  = Error term (measured in terms of working capital, organizational policies and capital structure).

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

### **4.1 Introduction**

This section is concerned with analyzing the results of the study on the relationship between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi, Kenya. The results presented here show the discussion of the findings in comparison with relevant theory and literature as established by other authors in the same field of study. The data was collected through semi-structured questionnaire specifically designed to generate data relevant to the research objective and analyzed through descriptive analysis. Secondary data was used to supplement the data collected from the questionnaire. The questionnaire was designed in line with the objectives of the study. The data obtained was fed into SPSS version 20.0 and used to analyze the relationship between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi Kenya.

### **4.2 Response Rate**

The study involved 30 CEOs or senior managers, general managers and functional heads of the 30 selected medium size manufacturing firms in Nairobi Kenya as they understand the relationship between internal audit function and financial performance of mid-size manufacturing firms in Nairobi Kenya. The questionnaire return rate results are shown in Table 4.1.

**Table 4.1: Response Rate**

<b>Response</b>	<b>Frequency</b>	<b>Percentage</b>
Responded	27	90.0
Not responded	3	10.0
<b>Total</b>	<b>30</b>	<b>100.0</b>

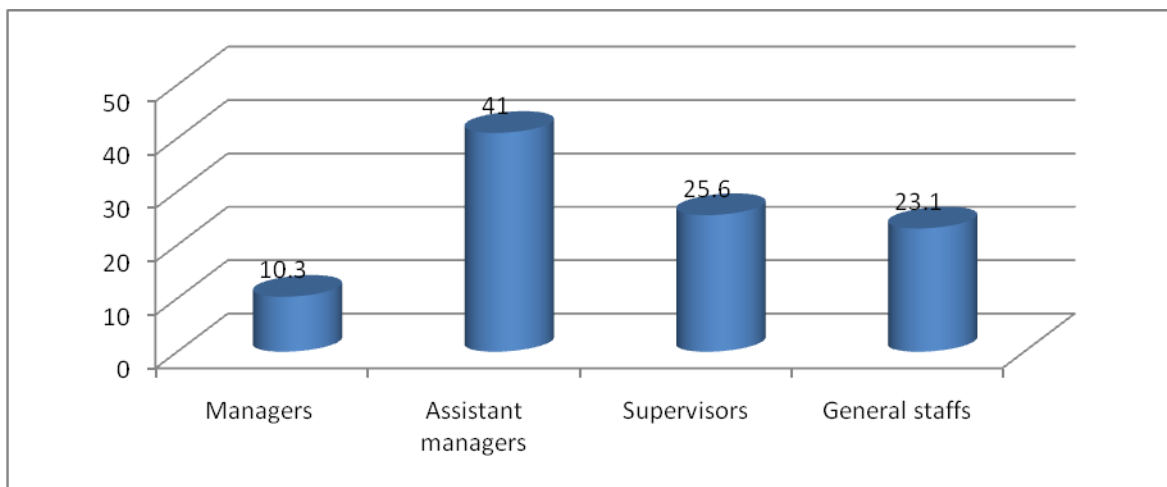
**Source: Research Data, 2016**

As shown in Table 4.1, 27 out of the 30 questionnaires were received back from the respondents fully filled which accounts to 90.0% response rate. On the other hand 3 of the questionnaires (contributing to 10.0% of the sample) were not received and therefore were not considered in the analysis. According to Kothari (2006), a 50% response rate is adequate, 60% is good, while 70% and above is rated to be very good. This also collaborates with Bailey's (2000) assertion that a response rate of 50% is adequate, while a

response rate greater than 70% is very good. From the foregoing, the response rate provides adequate data to proceed with the analysis.

### 4.3 Background Information

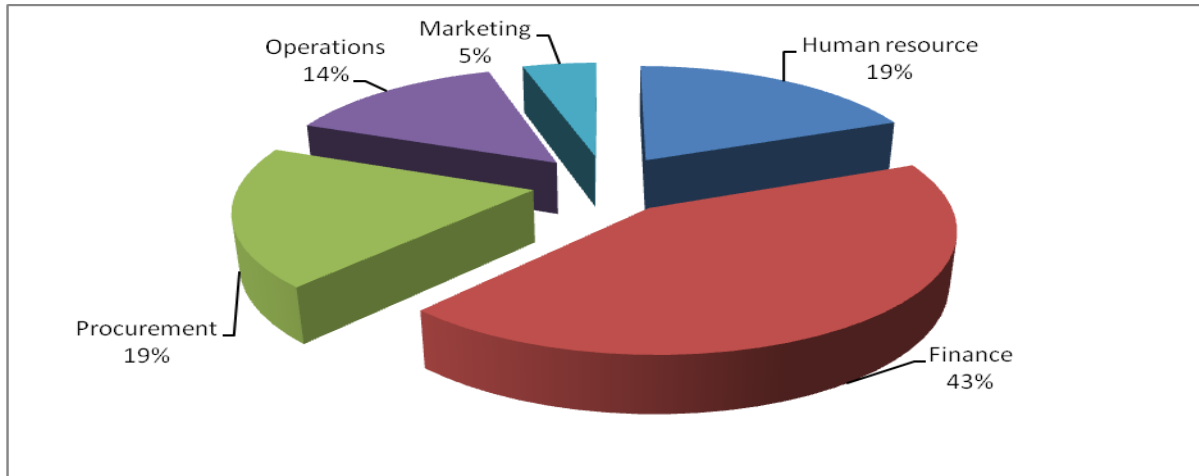
The study targeted to collect data from the staffs comprising of CEOs or senior managers, general managers and functional heads. As such, the study sample included managers, assistant managers, supervisors and general staff. This was relevant to assess the distribution of the respondents across the management levels. According to the results shown in Figure 4.1, majority (41.0%) of the respondents were assistant managers, 25.6% of them were supervisors, 23.1% of them indicated that they were general staffs, while 10.3% of the respondents comprised of managers. From these results, the respondents that participated in the study are mainly those involved in the formulation and implementation of the decisions concerned with the internal audit function and financial performance of mid-size manufacturing firms and hence their insights are viewed as more resourceful for knowledge and policy recommendations.



**Figure 4.1: Designation of the Respondents**

The study sought to establish the length of time that the respondents had been working in the mid-size manufacturing firms. From the results shown in figure 4.3, 42.9% of the respondents were working in the finance departments, 19.0% of them were working in the human resource departments, 19.0% worked in procurement department, and 14.3% worked in the operations department, while 4.8% worked in marketing departments. This implies

that all departments that were targeted by the study were involved and that the findings are not biased hence representative of the various departments' views on relationship between internal audit function and financial performance of mid-size manufacturing firms in Nairobi Kenya. The results are presented in Figure 4.2.



**Figure 4.2: Respondents' Departments**

The study sought to establish the length of time that the respondents had been working in the mid-size manufacturing firms in Nairobi. The results are as demonstrated in Table 4.2.

**Table 4.2: Duration Worked in Medium Size Manufacturing Firms in Nairobi**

Length of Service	Frequency	Percentage
Less than one year	4	15.0
1- 5 years	9	34.0
5-10 years	10	38.0
11 to 15 years	4	13.0
<b>Total</b>	<b>27</b>	<b>100.0</b>

**Source: Author, 2016**

From the study, 38% of the respondents indicated that they had worked with the medium size manufacturing firms in Nairobi for a period of 5 - 10 years, 34% of them had been working in the selected medium size manufacturing firms in Nairobi for 1-2 years, 15% of them had been working in the medium size manufacturing enterprises in Nairobi for less than one year whereas 13% of them had worked in the medium size manufacturing firms in



Nairobi for a period of 11 to 15 years. This implies that most of the staffs participating in this study had been operating for an ample time thus they were conversant of the information that the study sought pertaining to the relationship between internal audit function and financial performance of mid-size manufacturing firms in Nairobi Kenya.

The study further sought to ascertain the length of time that the firms have been in operation within the area. Table 4.4 shows the results.

**Table 4.3: Firms' Length of Operation**

<b>Length of Operation</b>	<b>Frequency</b>	<b>Percent</b>
0-5 years	6	23
6-10 years	12	45
Over 10 years	9	32
<b>Total</b>	<b>27</b>	<b>100</b>

**Source: Author, 2016**

From the study, 45% of the respondents indicated that their firms have been in operation for a period of 6-10 years, 32% of the firms had operated in the mid-size manufacturing industry for more than 10 years, while 23% of them indicated that their firms had been in operation for 0-5 years. This is a clear indication that most of the firms sampled had been operating in the industry for a long time hence are better placed to respond to the issues sought by this study concerning the relationship between internal audit function and financial performance of mid-size manufacturing firms in Nairobi. This is an indication that the companies have gone through several stages of transformation in the internal audit.

#### **4.4 Internal Audit Function and Financial Performance**

The main purpose of this study was to determine whether a relationship exists between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi County, Kenya. In this regard the respondents were required to indicate the extent to which internal audit functions affect the financial performance of the mid- size manufacturing firms in Nairobi.

**Table 4.4: Extent to which Internal Audit affects Firms' Financial Performance**

<b>Extent</b>	<b>Frequency</b>	<b>Percent</b>
To a very great extent	3	11.9
To a great extent	6	23.8
To a moderate extent	14	52.4
To a little extent	3	11.9
<b>Total</b>	<b>27</b>	<b>100.0</b>

Based on the results as tabulated in table 4.4, 52.4% of the respondents unanimously indicated that internal audit functions affect the financial performance of the mid- size manufacturing firms in Nairobi to a moderate extent and 23.8% of them indicated to a great extent. Further, 11.9% reiterated that internal audit functions affect the financial performance of the mid- size manufacturing firms in Nairobi to a very great extent, while another 11.9% of the population studied reported that internal audit functions affect the financial performance of the mid- size manufacturing firms in Nairobi to a little extent. The results are an indication that the internal audit functions have a significant effect on the financial performance of the mid- size manufacturing firms in Nairobi.

The respondents were required to indicate the various aspects that represent the scope of work for internal audit in the mid- size manufacturing organizations. Table 4.5 shows the results of the study.

**Table 4.5: Scope of Work for Internal Audit in the Organizations**

<b>Aspect</b>	<b>Frequency</b>	<b>Percentage</b>
Verification of financial transaction (Financial audit)	25	92.6
Assessing and promoting the adequacy of corporate governance	24	88.9
Assessment of internal control	26	96.3
Evaluates projects/ programs accomplishments (effectiveness)	24	88.9
Operational audit	22	81.5
Compliance audit	24	88.9
Assessment of organizational risk	23	85.2
Fraud investigation	20	74.1
Information system audit	21	77.8

According to Table 4.5, 96.3% of the respondents agreed that assessment of internal control represents scope of work for internal audit in their firms, followed by 92.6% who indicated

verification of financial transaction (Financial audit), 88.9% of the respondents indicated assessing and promoting the adequacy of corporate governance, 88.9% of them indicated evaluating projects/ programs accomplishments (effectiveness), 88.9% indicated compliance audit, 85.2% of them reported assessment of organizational risk, 81.5% indicated operational audit, 77.8% of the respondents indicated information system audit and 74.1% of the respondents indicated that fraud investigation represents scope of work for internal audit in the mid- size manufacturing firms in Nairobi.

The respondents were further required to indicate their level of agreement with the various statements provided regarding the internal audit function in the mid- size manufacturing firms in Nairobi. A scale of 1-5 was provided where; [1] is strongly disagree; [2] is disagree; [3] Neutral; [4] Agree; and [5] Strongly Agree.

**Table 4.6: Agreement with Statements on Independence of Internal Audit**

<b>Independence of internal audit</b>	<b>Strongly disagree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Strongly agree</b>	<b>Mean</b>	<b>Std. Dev.</b>
Independence of internal audit affects the financial performance of this organization	0	3.7	37	59.3	0	3.546	0.5905
There is independence of internal auditors in operations and structure	0	14.8	44.5	40.7	0	3.249	0.7078
This firm has formalized principles of internal audit providing for its position and powers in the framework of the firm	0	3.7	40.7	51.9	3.7	3.516	0.6197

From the study, majority of the respondents agreed that independence of internal audit affects the financial performance of this organization as shown by a mean score of 3.546 and that their firms have formalized principles of internal audit providing for its position and powers in the framework of the firms as shown by a mean score of 3.516. On the other hand the respondents indicated neutrality on that there is independence of internal auditors in operations and structure as shown by a mean score of 3.249.

**Table 4.7: Agreement with Statements on Professional Competency**

<b>Statements on Professional Competency</b>	<b>Strongly disagree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Strongly agree</b>	<b>Mean</b>	<b>Std. Dev.</b>
Professional competency affects the financial performance of this firm	0	7.4	40.7	51.9	0	3.467	0.6322
The internal audit staff is remaining current with changes in accounting and financial reporting requirements	0	7.4	37	55.6	0	3.533	0.6190
The internal auditor has an un-limited access to information they are supposed to audit before	0	3.7	40.7	44.5	11.1	3.583	0.7725
There are procedures in place for checking auditors' qualifications by the management	0	25.9	7.4	40.8	25.9	3.5528	1.1843
The auditors in this organization are qualified to undertake internal audit function	0	11.1	33.3	25.9	29.7	3.3322	1.4923

According to Table 4.7, most of the respondents settled that the internal auditor has an un-limited access to information they are supposed to audit before as shown by a mean score of 3.583. They also agreed that there are procedures in place for checking auditors' qualifications by the management as shown by a mean score of 3.5528 and that the internal audit staff is remaining current with changes in accounting and financial reporting requirements as shown by a mean score of 3.533. In addition, they remained neutral on that professional competency affects the financial performance of these firms and that the auditors in the organizations are qualified to undertake internal audit function as shown by a mean score of 3.467 and 3.3322 respectively. These results show that changes in financial performance of the studied manufacturing firms could be accounted for by changes in internal audit professional competency.

**Table 4.8: Agreement with Statements on Internal Control Systems**

<b>Statements on Internal Control Systems</b>	<b>Strongly Disagree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Strongly Agree</b>	<b>Mean</b>	<b>Std. Dev.</b>
Internal controls affects the financial performance of mid-size manufacturing organizations	0	7.4	37	51.9	3.7	3.5937	0.6582
Internal audit identifies and evaluates the organization's internal control system as a basis for reporting upon its adequacy and effectiveness	0	3.7	37	51.9	7.4	3.6146	0.7162
Management of the firm has been responsive to internal auditor's previous findings and recommendations	0	3.7	48.2	44.4	3.7	3.4896	0.6323
Internal auditors are considered as advisors to management on matters related to internal controls and governance	0	7.4	37	51.9	3.7	3.5521	0.6938
Controls audits in the organization have features built into them to ensure that fraudulent transactions are flagged or made difficult to transact	0	7.4	40.7	44.5	7.4	3.5104	0.7677

With regard to internal control systems, most of the respondents agreed that internal audit identifies and evaluates the organization's internal control system as a basis for reporting upon its adequacy and effectiveness, internal controls affects the financial performance of mid-size manufacturing organizations, internal auditors are considered as advisors to management on matters related to internal controls and governance and controls audits in the organization have features built into them to ensure that fraudulent transactions are flagged or made difficult to transact as shown by mean scores of 3.6146, 3.5937, 3.5521 and 3.5104 respectively. On the other hand majority of the respondents neither agreed nor disagreed that management of the firm has been responsive to internal auditor's previous findings and recommendations as shown by a mean score of 3.4896. As such, the scope of internal audit includes examination of the effectiveness of the internal control systems with the use of the financial management information systems to check the accuracy and reliability of the accounting records in use by the organization.

**Table 4.9: Agreement with Statements on Internal Audit Standards**

<b>Statements on Internal Audit Standards</b>	<b>Strongly disagree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Strongly</b>	<b>Mean</b>	<b>Std. Dev.</b>
Internal audit standards affects the financial performance of this firm	0	3.7	33.3	63	0	3.582	0.572
The structure of internal audit in enhancing its objectivity is strong	0	7.4	29.6	63	0	3.525	0.658
Internal audit demonstrate that it recognizes its accountability to the audit committee	0	3.7	29.6	66.7	0	3.615	0.566
internal audit evaluate and contribute to the improvement of risk management, control and governance using a systematic and disciplined approach in the industry	0	7.4	29.6	63	0	3.533	0.645

The results of this section are analyzed in line with a scale of 1 to 5 where 1 is strongly disagree, 2 is disagree, 3 is neutral, 4 is agree and 5 is strongly agree. To obtain the corresponding measure of agreement, the calculated weighted mean is rounded off to the nearest whole and the result counter-checked against the matching number in the key provided in the questionnaire. The highest ranking mean score was 3.615. This mean score corresponds to a measure of 4 which means that majority of the respondents indicated strong agreement with that internal audit demonstrate that it recognizes its accountability to the audit committee. The respondents further indicated strong agreement that internal audit standards affect the financial performance of these firms as shown by a mean score of 3.582, internal audit evaluate and contribute to the improvement of risk management, control and governance using a systematic and disciplined approach in the industry as shown by a mean score of 3.533 and that the structure of internal audit in enhancing its objectivity is strong as shown by a mean score of 3.525. This implies that internal audits standard affect the financial performance in the mid-size manufacturing firms in Nairobi significantly.

#### **4.5 Inferential Analysis**

Inferential data analysis was based on multiple regression model, whereby the dependent variable in this study was financial performance (measured in terms of ROE) while the independent variables were independence of internal audit, professional competency, internal control systems, internal audit standards, size of the firm and liquidity. The study

sought to complement the descriptive analysis by carrying out a multiple regression analysis. Regression analysis is a statistical tool for the investigation of relationship between variables. The researcher seeks to maintain the casual effect of a variable upon another.

Regression analysis allows one to model, examine and explore spatial relationship and can help explain the factors behind observed spatial patterns. Regression analysis is also used for prediction. A multivariate regression model was applied to determine the relative importance of each of the six variables with respect to the relationship between internal audit function and financial performance of mid- size manufacturing enterprises in Nairobi. The researcher applied the statistical package for social sciences (SPSS) to code, enter and compute the measurements of the multiple regressions for the study. The model summary for the regression is shown in table 4.11.

**Table 4.10: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.981(a)	0.863	0.691	0.752

Source: Author (2016)

**Predictors:** (Constant), independence of internal audit, professional competency, internal control systems, internal audit standards, size of the firm and liquidity

The six independent variables that were studied, explain only 86.3% of the financial performance of mid-size manufacturing firms in Nairobi as represented by the  $R^2$ . This therefore means the six independent variables only contribute about 86.3% to the financial performance of mid-size manufacturing firms in Nairobi while other factors not studied in this research contributes 13.7% of the financial performance of mid-size manufacturing firms in Nairobi.

**Table 4.11: ANOVA (b)**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.787	1	.447	4.617	.034
	Residual	62.191	26	.351		
	Total	63.978	27			

Source: Author (2016)

**Predictors:** (Constant), independence of internal audit, professional competency, internal control systems, internal audit standards, size of the firms and liquidity

**Dependent Variable:** Financial performance of mid-size manufacturing firms

The ANOVA F-statistic was used to test the research questions for the regressor coefficients for each variable to be equal to zero. An analysis to determine the combined influence of all the independent variables was done. All the independent variables were combined and involved in the analysis. The results of Analysis of variance (ANOVA) for regression coefficients are shown in Table 4.12. The analysis results revealed that the significance of F statistics is 0.034 which is less than 0.05. This implies that there is a significant relationship between independence of internal audit, professional competency, internal control systems, internal audit standards, size of the firm and liquidity and financial performance of mid-size manufacturing firms in Nairobi.

**Table 4.12: Multiple Regression Analysis**

	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	2.837	.112		4.358	0.000
Independence of internal audit	0.637	.075	0.235	1.379	0.020
Professional competency	0.420	.120	0.224	1.922	0.028
Internal control systems	0.295	.106	.279	2.793	0.015
Internal audit standards	0.553	.146	0.330	2.276	0.024
Size of the firm	0.116	0.2178	0.439	3.936	0.032
Firm liquidity	0.263	0.1937	0.752	3.247	0.029

Source: Author (2016)

The researcher conducted a multiple regression analysis so as to determine the relationship between internal audit function and financial performance of mid- size manufacturing enterprises in Nairobi. The regression equation ( $Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \beta_5X_5 + \beta_6X_6$ ) will be:



$$Y = 2.837 + 0.637X_1 + 0.420X_2 + 0.295X_3 + 0.553X_4 + 0.116X_5 + 0.263X_6$$

According to the regression equation established, taking all factors (internal control systems, professional competency, independence of internal audit, internal audit standards, size of the firm and firm liquidity) constant at zero, financial performance of mid-size manufacturing firms in Nairobi will be 2.837. The data findings analyzed also shows that taking all other independent variables at zero, a unit increase in independence of internal audit will lead to a 0.637 increase in financial performance of mid-size manufacturing firms in Nairobi. A unit increase in professional competency will lead to a 0.420 increase in financial performance of mid-size manufacturing firms in Nairobi; a unit increase in internal control systems will lead to a 0.295 increase in financial performance of mid-size manufacturing firms in Nairobi and a unit increase in internal audit standards will lead to a 0.553 increase in financial performance of mid-size manufacturing firms in Nairobi. In addition, a unit increase in firm size will lead to a 0.116 increase in financial performance of mid-size manufacturing firms in Nairobi while a unit increase in firm liquidity will lead to a 0.263 increase in financial performance of mid-size manufacturing firms in Nairobi.

At 5% level of significance and 95% level of confidence, firm size had a 0.032 level of significance, firm liquidity had a 0.029 level of significance, independence of internal audit had a 0.020 level of significance, professional competency had a 0.028 level of significance, internal audit standards had a 0.024 level of significance, independence of internal audit had a 0.020 level of significance, while internal control systems had a 0.015 level of significance hence the most significant factor for financial performance of mid-size manufacturing firms in Nairobi. From the foregoing results, the internal audit function is very important inside a firm where the internal audit is regarded as the key element in the application of accounting systems and this in turn, helps in evaluating the work of the department. The internal audit is considered as the backbone of the business accounting as it is the section that records all businesses related to the sector. The efficiency of internal audit helps develop the work of the company because the financial reports reflect the internal audit department's quality. In addition, an internal audit is considered as a significant part of the governance structure in the organization and governance covers the activities of oversight by the board of directors and audit committees to ensure credible financial reporting process.

## **CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS**

### **5.1 Introduction**

This is the final chapter in this study which gives the summary of the findings, the conclusions and recommendations of the study based on the objective of the study. It comes after identifying the background, problem at hand and the objectives in chapter one, literature review was done in chapter two, chapter three set out the methodology that the study used to collect data and chapter four analyzed the data obtained from the study. The chapter finally presents the suggestions for further studies on relationship between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi, Kenya.

### **5.2 Summary**

The study found that internal audit functions affect the financial performance of the mid-size manufacturing firms in Nairobi to a moderate extent. From the findings, assessment of internal control has the greatest representation of the scope of work for internal audit, followed by verification of financial transaction (Financial audit), then assessing and promoting the adequacy of corporate governance, evaluating projects/ programs accomplishments (effectiveness), compliance audit, assessment of organizational risk, operational audit, information system audit and finally fraud investigation represents scope of work for internal audit in the mid- size manufacturing firms in Nairobi.

The study found that there was agreement on that independence of internal audit affects the financial performance of this organization and that their firms have formalized principles of internal audit providing for its position and powers in the framework of the firms. However, there was neutrality on that there is independence of internal auditors in operations and structure. Accordingly, internal audit function played a role in governance which affects the financial performance providing for its position and powers in the framework of the firms.

On professional competency, the study established that the internal auditor has an un-limited access to information they are supposed to audit before, there are procedures in place for checking auditors' qualifications by the management and that the internal audit staff is

remaining current with changes in accounting and financial reporting requirements. On the other hand there was impartiality on that professional competency affects the financial performance of these firms and that the auditors in the organizations are qualified to undertake internal audit function. This is an implication that changes in financial performance of the studied manufacturing firms could be accounted for by changes in internal audit professional competency.

With regard to internal control systems, the study found that internal audit identifies and evaluates the organization's internal control system as a basis for reporting upon its adequacy and effectiveness, internal controls affects the financial performance of mid-size manufacturing organizations, internal auditors are considered as advisors to management on matters related to internal controls and governance and controls audits in the organization have features built into them to ensure that fraudulent transactions are flagged or made difficult to transact. However there was neutrality on that management of the firm has been responsive to internal auditor's previous findings and recommendations. These results denote that the scope of internal audit includes examination of the effectiveness of the internal control systems with the use of the financial management information systems to check the accuracy and reliability of the accounting records in use by the organization.

On internal audit standards, the study found that internal audit demonstrate that it recognizes its accountability to the audit committee, internal audit standards affect the financial performance of these firms, internal audit evaluate and contribute to the improvement of risk management, control and governance using a systematic and disciplined approach in the industry and that the structure of internal audit in enhancing its objectivity is strong.

The coefficient of determination showed that independence of internal audit, professional competency, internal control systems, internal audit standards, size of the firm and liquidity explain 86.3% of the financial performance of mid-size manufacturing firms in Nairobi as represented by the  $R^2$ . The ANOVA results revealed that the significance of F statistics is 0.034 which is less than 0.05. This implies that there is a significant relationship between independence of internal audit, professional competency, internal control systems, internal

audit standards, size of the firm and liquidity and financial performance of mid-size manufacturing firms in Nairobi.

According to the multiple regression analysis, if all the independent variables (internal control systems, professional competency, independence of internal audit, internal audit standards, size of the firm and firm liquidity) were kept constant at zero, the financial performance of mid-size manufacturing firms in Nairobi will be 2.837. At 5% level of significance and 95% level of confidence, firm size had a 0.032 level of significance, firm liquidity had a 0.029 level of significance, independence of internal audit had a 0.020 level of significance, professional competency had a 0.028 level of significance, internal audit standards had a 0.024 level of significance, independence of internal audit had a 0.020 level of significance, while internal control systems had a 0.015 level of significance hence the most significant factor for financial performance of mid-size manufacturing firms in Nairobi.

### **5.3 Conclusions**

The study concludes that internal audit functions have a significant effect on the financial performance of the mid- size manufacturing firms in Nairobi. Where the internal audit function is emphasised, clearly, it can impact positively on financial performance of the firms. From the findings, internal audit standards, independence of internal audit, professional competency and internal control had a positive relationship with financial performance of mid-size manufacturing firms, the study found that a unit increase in internal audit standards would lead to increase in financial performance of mid-size manufacturing firms, a unit increase in independence of internal audit would lead to increase in financial performance of mid-size manufacturing firms, a unit increase in professional competency would lead to increase in financial performance of mid-size manufacturing firms and further unit increase in internal control would lead to increase in financial performance of mid-size manufacturing firms.

The study also established that there was a strong positive relationship between financial performance of mid-size manufacturing firms and internal audit standards, independence of internal audit, professional competency and internal control. The study further concludes

that manufacturing firms that had invested on effective internal control systems had more improved financial performance as compared to those manufacturing firms that had a weak internal control system. From the findings, it was revealed that those mid-size manufacturing firms that observed integrity, ethical values, risk assessment, control activities, monitoring and information communication technology recorded high financial performance. The manufacturing firms face challenges in effective implementation of internal control systems due lack of sufficient resources to hire competent staff and to invest in modern technologies for example information communication technology. The findings of the study found that control activities had a significant positive relationship with financial performance indicators.

#### **5.4 Recommendations**

The study established that internal auditors play a very important role in enhancing the financial performance of mid-size manufacturing firms. There is therefore the need for the mid-size manufacturing firms to adopt effective internal processes and practices that address key internal auditing practices for effectiveness of audit quality. Audit quality is not primarily about auditing standards but about the quality of people, their training and ethical standards. As such the mid-size manufacturing firms should consider skills, personal qualities of audit partners and staff, and the training given to audit personnel as the important factors that determine auditor quality.

The study also established that in order to implement good internal audit independence, managers need to know that they should be concerned about the interrelationships between internal audit independence and financial performance. As such, there is need for the internal auditors to continuously update themselves with the changing times and technologies and sharpen their skills. By applying skills to the most critical points, building personal and professional credibility and recognising and responding to the needs, internal auditors can become indispensable thus speeding good governance and enhancing efficiency of internal audit.

The management of the firms should keep organizing seminars and workshops whereby these internal auditors would be trained frequently by experts either internally or externally.

Internal Auditors must have sufficient proficiency and training to carry out the tasks assigned to them. The auditor's work must be carefully directed, supervised and reviewed. The amount of supervision required corresponds to the experience and skill of the auditor. The head of the internal audit department should be responsible to the management/board in the organisation with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action on audit recommendations.

### **5.5 Limitations of the Study**

The researcher was likely to encounter various limitations that might have hindered access to information sought by the study. The main limitation of study was its inability to include more organizations in the Country. This was a study focusing on med- size manufacturing firms in Nairobi which is the business hub in the region. The study could have covered more enterprises across the Country so as to provide a more broad based analysis. The study countered this problem by carrying out the study in mid- size manufacturing enterprises across the various sectors and served as a representative.

The respondents approached were likely to be reluctant in giving information fearing that the information sought would be used to intimidate them or print a negative image about them or their enterprises. The researcher handled the problem by carrying an introduction letter from the University and assured them that the information they give would be treated confidentially and it would be used purely for academic purposes.

There were likely to be cases of acquiescence bias, where some staff would answer questions with an incline that does not represent the absolute truth. The answers could therefore be misinterpreted or falsified. The data collected was therefore likely to be inaccurate. The researcher therefore found it necessary to insist to the respondents to only give the real scenario in the organization. The researcher overcame this problem by urging the respondents to be truthful by writing the right information.

### **5.6 Recommendations for Further Studies**

The same study should be carried in medium size enterprises with operations in other industries such the financial sector, service sector, ICT sector among others to compare the

findings. This would be a modest attempt to enhancing formulation of policies regarding relationship between the internal audit function and financial performance of firms in Kenya. Further studies can be conducted with an aim of establishing the effects of the specific factors on the financial performance of the firms in Kenya. The specific intention would be to establish how firms endure the challenges in the internal audit functions and make a difference in their activities.

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## **APPENDICES**

### **Appendix 1: Cover Letter**

Jude Thumbi

C/O University of Nairobi

14<sup>th</sup> July, 2016

#### **TO WHOM IT MAY CONCERN**

Dear respondent

#### **REQUEST TO COLLECT DATA FOR MASTERS OF SCIENCE PROJECT**

I am a post graduate student at the University of Nairobi pursuing a Master's of Science (Finance) degree. I am currently conducting a research project on “**THE RELATIONSHIP BETWEEN THE INTERNAL AUDIT FUNCTION AND FINANCIAL PERFORMANCE OF MID SIZE MANUFACTURING FIRMS IN NAIROBI COUNTY, KENYA**”. The focus of my research will be on the Mid-Size manufacturing firms in Nairobi County and this will involve use of questionnaires administered to middle and senior managers on the relationship between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi.

I therefore request for your kind assistance in completing the attached questionnaire to the best of your knowledge. The information you give will be treated with strict confidence and is solely for academic purposes.

Your assistance and co-operation will be highly appreciated. Thank you.

Yours faithfully,

Jude Thumbi

MSC Finance, UoN

## Appendix II: Research Questionnaire

### PART I: BIO- DEMOGRAPHIC DATA

1. Name of the Firm (optional).....

2. What is your designation?

Manager	[ ]	Assistant manager	[ ]
Supervisor	[ ]	General staff	[ ]
Other (Specify.....)	[ ]		

3. Your department:

Human resource	[ ]	Finance	[ ]
Procurement	[ ]	Operations	[ ]
Marketing	[ ]	Other (Specify.....)	[ ]

4. How long has this mid- size manufacturing organization been in operation?

0 – 5 Years	[ ]	6 – 10 years	[ ]
10 years and above	[ ]		

5. How many staffs are employed in this firm?

Less than 5 staffs	[ ]	5- 7 employees	[ ]
8- 10 employees	[ ]	Over 10 employees	[ ]

### PART II: INTERNAL AUDIT FUNCTION AND FINANCIAL PERFORMANCE

6. To what extent do internal audit functions affect the financial performance of this mid-size manufacturing firm?

To a very great extent	To a great extent	To a moderate extent	To a little extent	To no extent

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

(a) Verification of financial transaction (Financial audit)	[ ]
(b) Assessing and promoting the adequacy of corporate governance	[ ]
(c) Assessment of internal control	[ ]

- (d) Evaluates projects/ programs accomplishments (effectiveness) [ ]
- (e) Operational audit [ ]
- (f) Compliance audit [ ]
- (g) Assessment of organizational risk [ ]
- (h) Fraud investigation [ ]
- (i) Information system audit [ ]
- (j) Other areas if any..... [ ]

8. With regard to this Firm, what is your level of agreement with the following statements regarding the internal audit function in the mid- size manufacturing firms in Nairobi? Rate your agreements on a scale of 1-5 where; [1] is strongly disagree; [2] is disagree; [3] Neutral; [4] Agree; and [5] Strongly Agree.

<b>Independence of internal audit</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
Independence of internal audit affects the financial performance of this organization					
There is independence of internal auditors in operations and structure					
This Firm has formalized principles of internal audit providing for its position and powers in the framework of the firm					
<b>Professional competency</b>					
Professional competency affects the financial performance of this Firm					
The internal audit staff is remaining current with changes in accounting and financial reporting requirements					
The internal auditor has an un-limited access to information they are supposed to audit before					
There are procedures in place for checking auditors' qualifications by the management					
The auditors in this Organization are qualified to undertake internal audit function					
<b>Internal Control Systems</b>					
Internal controls affects the financial performance of mid-size manufacturing organizations					
Internal audit identifies and evaluates the organization's internal control system as a basis for reporting upon its adequacy and effectiveness					
Management of the firm has been responsive to internal auditor's previous findings and recommendations					
Internal auditors are considered as advisors to management on matters related to internal controls and governance					



Controls audits in the organization have features built into them to ensure that fraudulent transactions are flagged or made difficult to transact					
<b>Internal audit standards</b>					
Internal audit standards affects the financial performance of this firm					
The structure of internal audit in enhancing its objectivity is strong					
Internal audit demonstrate that it recognizes its accountability to the audit committee					
internal audit evaluate and contribute to the improvement of risk management, control and governance using a systematic and disciplined approach in the industry					

9. How would you rate the financial performance of your Firm in the following areas? Use a scale of 1 to 5 on these attributes where 5=improving fast, 4=improving slowly, 3=neutral, 2=Declining gradually, 1= decreasing drastically.

Measures of Financial Performance	1	2	3	4	5
Sales growth					
Profits/return on equity					
Investments					
Share capital					
Customer base					
Others.....					

10. What do you think should be done to enhance the the internal audit function and financial performance of mid- size manufacturing firms in Kenya?

.....

.....

**THANK YOU!!!**



### **Appendix III: List of all Mid-Size Manufacturing Companies in Nairobi Kenya**

- |  |   |
|--|---|
| 1. Acme Container Ltd                    | 27. Dalco Kenya                             |
| 2. Adhesive Solutions Africa Ltd         | 28. Deepa Industries Limited                |
| 3. Africa Kaluworks (Aluware) Division K | 29. Deluxe Fruits Limited                   |
| 4. Africa Oil Kenya B.V                  | 30. Devsons Industries Ltd                  |
| 5. Ali Glaziers Ltd                      | 31. East Africa Glassware Mart Ltd          |
| 6. Allwin Packaging Intl. Ltd            | 32. East African Canvas                     |
| 7. Alpha Dairy Products Ltd              | 33. Eastern Chemical Industries Ltd         |
| 8. Alpha Fine Foods Ltd                  | 34. Energy Pak (K) Ltd                      |
| 9. Apex Steel Ltd                        | 35. Equatorial Tea Ltd                      |
| 10. AquaSanTec                           | 36. Excel Chemical Ltd.                     |
| 11. Aquva Agencies Ltd -Nairobi          | 37. Fairdeal Upvc, Aluminium and Glass Ltd  |
| 12. Arrow Rubber Stamp Company Ltd.      | 38. Famiar Generating Systems Ltd           |
| 13. Atlas Copco Eastern Africa Ltd       | 39. Flexoworld Ltd                          |
| 14. Avtech Systems Limited               | 40. Furmart Furnishers                      |
| 15. Bencon agencies                      | 41. Goldrock International Enterprises      |
| 16. Beta HealthCare                      | 42. Hydraulic Hose & Pipe Manufacturers Ltd |
| 17. Blowplast Limited                    | 43. Hydro Water Well (K) Ltd                |
| 18. Bosky Industries Ltd                 | 44. Ideal Manufacturing Co. Ltd             |
| 19. Braulic equipment and services       | 45. Imani Workshops                         |
| 20. Chafa enterprises                    | 46. Interconsumer Products Ltd              |
| 21. Chemplus Holdings LTD                | 47. Izmir Enterprises Ltd                   |
| 22. Collis F B                           | 48. JET Chemicals (Kenya) Ltd               |
| 23. Comet paints                         | 49. Kandia Fresh Produce Suppliers Limited  |
| 24. Commrcial Motor Spares Ltd           | 50. Kenya Grange Vehicle Industries Ltd     |
| 25. Complast Industries Ltd              |   |
| 26. Cuma Refrigeration EA Limited        |   |

- |  |                                      |
|--|--------------------------------------|
| 51. Kiesta Industrial Technical Services Ltd | 76. Reliable Concrete Works Ltd      |
| 52. Kim-Fay E.A Limited                      | 77. Renscope Scientific Kenya        |
| 53. KingSource Plastic Machinery Co.,Ltd.    | 78. Rhino Special Products Ltd       |
| 54. Magic juice                              | 79. Rock Plant Kenya Ltd.            |
| 55. Makiga Engineering Service Limited       | 80. Rotam Sub-Saharan Africa         |
| 56. Manzil Glass & Hardware Ltd              | 81. Rupa Cotton Mills EPZ Ltd        |
| 57. Mather & Platt Kenya Ltd                 | 82. Rural Electrification Authority  |
| 58. Maweni Limestone Ltd                     | 83. Sanpac Africa Ltd                |
| 59. Mellech Engineering & Construction Ltd.  | 84. Shade Systems(E.A)Ltd            |
| 60. Metsec Ltd.                              | 85. Shamas Motor Spares              |
| 61. MGS International (K) Ltd                | 86. Soko sweets ltd                  |
| 62. Mjengo Limited                           | 87. Stainless Steel Products Ltd     |
| 63. Molor paints & chemical                  | 88. Stamet Products (K) Ltd          |
| 64. Mombasa Canvas Ltd                       | 89. Statpack Industries Limited      |
| 65. New World Stainless Steel Ltd            | 90. Steel Structures Limited         |
| 66. North Star Cooling Systems Ltd           | 91. Stitch Masters Limited           |
| 67. Orchid Juice Limited                     | 92. Sunchet paint                    |
| 68. Palmhouse Dairies Ltd                    | 93. Superfit Steelcon Ltd            |
| 69. Petmix Feed                              | 94. Sweety and spicy food factory    |
| 70. Pharmaken Limited                        | 95. Synermed Pharmaceuticals (K) Ltd |
| 71. Polythene Industries Ltd                 | 96. Tenacity Locks Ltd               |
| 72. Print Fast Kenya Ltd.                    | 97. Tripac Chemical Industries Ltd   |
| 73. Quad cypher systems                      | 98. Warren Concrete Ltd              |
| 74. Raghad Enterprises                       | 99. Welfast Kenya Ltd                |
| 75. Reliable Concrete Works                  | 100. Welrods Limited                 |
|  | 101. Wigglesworth Exporters Ltd      |
|  | 102. Wines Of The World Limited      |

#### **Appendix IV: Sampled Mid-Size Manufacturing Firms in Nairobi County**

- |   |                                      |
|---|--------------------------------------|
| 1. Pharmaken Limited                      | 15. Stitch Masters Limited           |
| 2. Izmir Enterprises Ltd                  | 16. East African Canvas              |
| 3. Warren Concrete Ltd                    | 17. Dalco Kenya                      |
| 4. Allwin Packaging Intl. Ltd             | 18. Complast Industries Ltd          |
| 5. North Star Cooling Systems Ltd         | 19. Synermed Pharmaceuticals (K) Ltd |
| 6. Devsons Industries Ltd                 | 20. Deluxe Fruits Limited            |
| 7. Kandia Fresh Produce Suppliers Limited | 21. Bencon agencies                  |
| 8. Hydro Water Well (K) Ltd               | 22. Braulic equipment and services   |
| 9. Deepa Industries Limited               | 23. Chafa enterprises                |
| 10. Reliable Concrete Works               | 24. Comet paints                     |
| 11. Avtech Systems Limited                | 25. Magic juice                      |
| 12. Ideal Manufacturing Co. Ltd           | 26. Molor paints & chemical          |
| 13. Palmhouse Dairies Ltd                 | 27. Orchid Juice Limited             |
| 14. Interconsumer Products Ltd            | 28. Soko sweets ltd                  |
|   | 29. Sunchet paint                    |
|   | 30. Sweety and spicy food factory    |