

**THE RELATIONSHIP BETWEEN THE INDEPENDENCE AND  
OBJECTIVITY OF THE INTERNAL AUDIT FUNCTION AND  
EARNINGS PER SHARE (EPS) IN COMPANIES LISTED IN NSE**

**BY**

**MARY NYARUAI MUGWE**

**D61/61617/2010**

**A RESEARCH PROPOSAL SUBMITTED IN PARTIAL  
FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF  
THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION  
(MBA), SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI**

**OCTOBER, 2012**

## DECLARATION

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

Signed..... Date .....

Mugwe Mary Nyaruai

REG NO: D61/61617/2010

This Research Project has been submitted for examination with my approval as University Supervisor.

Signed..... Date .....

Dr. Josephat Lishenga

Department of Finance and Accounting

School of Business, University of Nairobi

## **ACKNOWLEDGMENT**

This Research Project would not have been possible without the cooperation and support of a number of people, who in one way or the other steered me towards my ultimate goal. I would like to express my appreciation to them and especially to the following:- my loving husband Mr. Dishon Wanjere for his moral support and encouragement and my entire family for their understanding when I was not there for them during the project period; I wouldn't have made it this far without them, my children Jeremy Wanjere and Judy Muthoni for giving me a reason to work even harder, my mother Teresa Wanjugu Mugwe , my late father John Mugwe for the foundation he laid for us and my late sister Agnes Mugwe for the great support and foundation she gave me earlier in my life.

I wish to express my sincere gratitude to my project supervisor, Dr. Lishenga, Department of Finance and Accounting for his tireless guidance, selfless dedication and encouragement in making this project a reality. I also wish to acknowledge the contribution of the rest of university of Nairobi fraternity especially the library staff, MBA coordination office and moderators to the success of this project.

Most important of all I extend my gratitude to the Almighty God for strength, good health, knowledge and vitality that helped make this project a reality.

**To all, I remain forever grateful**

## **DEDICATION**

I dedicate this work to my family and those who supported me throughout the completion of this project.

## **ABSTRACT**

The major aim of this study was to find out the relationship between the independence and objectivity of internal audit function and EPS (profitability) in companies listed in the NSE. Objectivity, denoting having an impartial, unbiased attitude, is integral to the internal audit profession. While the increasing involvement of internal auditors in enterprise risk management (ERM) poses a threat to their professional objectivity, the expanding oversight responsibilities of audit committees may act to mitigate any such effect. This study presents empirical evidence on the effects of the extent of internal auditors' involvement in ERM and their relationship with the audit committee and the management, on the loss of internal auditors' perceived objectivity and their effect on profitability.

This study draws on agency and institutional theory to examine the issue of internal audit's independence through its relationship with components of corporate governance. The internal audit function is actively considered as one of the four components of corporate governance, along with the board, management and external auditors. It serves this purpose by providing a range of services in its capacity of monitoring and consulting which is actively sought by the other components of corporate governance to satisfy their extended accountability requirements. The integrity of these services is, however, only assured if internal audit maintains its independent status. As such there is a "tension" resulting from the pressure to provide these value added services as perceived by the parties involved and maintaining its independence status.

Based on an extended study of organizations listed in the NSE, this study critically examines the results of the study against existing literature and best practice guidelines to determine if internal audit functions operating under this tense environment are operating independently.

Data from the field was analyzed using frequencies and percentages. The data was also edited, coded and well arranged in order to ensure accuracy and completeness. According to the research findings, internal auditors contribute to profitability of firms mainly through detection of fraud and advising management on internal control system.

The findings indicated that the major constraints to internal audit effectiveness were lack of independence in some aspects. It was also established that there is 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 auditor, then they will be profitable thus having a positive EPS.

## TABLE OF CONTENTS

<b>DECLARATION</b> .....	i
<b>ACKNOWLEDGMENT</b> .....	ii
<b>DEDICATION</b> .....	iii
<b>ABSTRACT</b> .....	iv
<b>TABLE OF CONTENTS</b> .....	v
<b>LIST OF TABLES</b> .....	viii
<b>ABBREVIATIONS</b> .....	ix
<b>CHAPTER ONE</b> .....	1
<b>INTRODUCTION</b> .....	1
1.1 Background of the study .....	1
1.1.1 Nairobi stock exchange .....	3
1.1.2 Earnings per share .....	4
1.1.3 Relationship between independence of internal audit function and the earnings per share.....	4
1.2 Statement of Research Problem .....	5
1.3 Objective of the study .....	7
1.4 Significance of the study .....	8
<b>CHAPTER TWO</b> .....	10
<b>LITERATURE REVIEW</b> .....	10
2.1 Introduction .....	10
2.2 Internal auditing .....	10
2.3 Underlying theories: Agency and Institutional theory .....	11

2.4 Internal audit independence and objectivity.....	13
2.5 Enterprise Risk Management (ERM) and consulting activities.....	16
2.6 Internal audit function and the management.....	20
2.7 Audit Committees .....	21
2.8 Internal audit as a management training ground.....	23
2.9 Knowledge Gap in Reviewed Literature.....	24
<b>CHAPTER THREE.....</b>	<b>27</b>
<b>RESEARCH METHODOLOGY .....</b>	<b>27</b>
3.1 Introduction.....	27
3.2 Research design.....	27
3.3 The population.....	27
3.4 Sampling.....	28
3.5 Data Collection.....	29
3.6 Data Collection procedure.....	30
3.7 Data Analysis .....	30
3.8 Ethical Issues.....	31
<b>CHAPTER FOUR.....</b>	<b>32</b>
<b>DATA ANALYSIS, RESULTS AND DISCUSSION.....</b>	<b>32</b>
4.1 Introduction.....	32
4.1.1 Response rate.....	32
4.2 General Information .....	32
4.3 Relationship between Independence and Objectivity of the Internal Audit Function and Earnings per Share (EPS).....	36

<b>CHAPTER FIVE</b> .....	46
<b>SUMMARY, CONCLUSION AND RECOMMENDATIONS</b> .....	46
5.1 Introduction .....	46
5.2 Operations of the Internal Audit .....	46
5.2.1 Dismissal and hiring of CAE .....	46
5.2.2 Mechanism to safeguard the independence of Internal Audit .....	47
5.3 Summary .....	48
5.4 Conclusions .....	49
5.5 Recommendations .....	50
5.6 Limitations of the Study.....	50
5.7 Area for Further Research.....	50
5.8 Implications on Policy, Theory and Practice .....	51
REFERENCES .....	52
<b>APPENDICES</b> .....	58
APPENDIX I : LETTER OF INTRODUCTION .....	58
APPENDIX II : INTERNAL AUDIT QUESTIONNAIRE.....	59
APPENDIX III: COMPANIES LISTED IN NAIROBI STOCK EXCHANGE.....	63
APPENDIX IV: SUMMARY OF OTHER STUDIES.....	66



## **LIST OF TABLES**

Table 4. 1: Industry Classification .....	33
Table 4. 2: Period Operating in Kenya .....	33
Table 4. 3: Position Held in the Organization.....	34
Table 4. 4: Highest Academic Qualifications .....	34
Table 4. 5: Work Experience .....	35
Table 4. 6: Members of Any Professional Body.....	35
Table 4. 7: Internal Audit Committee .....	36
Table 4. 8: Number of Members in Audit Committee.....	36
Table 4. 9: Number of Independent Members .....	37
Table 4. 10: Number of Professionally Qualified Accountants in the Committee .....	37
Table 4. 11: Person the Internal Audit Department Reported To Functionally.....	38
Table 4. 12: Person the Internal Audit Department Reported to Administratively .....	39
Table 4. 13: Person Mandated to Appoint, Dismiss and Evaluate Head of the Internal Audit Function .....	39
Table 4. 14: Statements on Internal Audit Committee .....	40
Table 4. 15: Person that Approved the Internal Audit Budget .....	41
Table 4. 16: Statements on Internal Audit Planning .....	42
Table 4. 17: Period Internal Auditor Stayed Within the Internal Audit Department.....	42
Table 4. 18: Organization Hiring Employees .....	43
Table 4. 19: Statements on Internal Auditor .....	44
Table 4. 20: Earnings per share.....	44

## **ABBREVIATIONS**

<b>ATS</b>	Applicant Tracking System
<b>CAE</b>	Chief Audit Executive
<b>CBK</b>	Central Bank of Kenya
<b>CDS</b>	Credit-Default Swap
<b>CEO</b>	Chief Executive Officer
<b>CFO</b>	Chief Financial Officer
<b>CMA</b>	Capital Market Authority
<b>EPS</b>	Earning Per Share
<b>ERM</b>	Enterprise Risk Management
<b>FDI</b>	Foreign Direct Investment
<b>GAAP</b>	Generally Acceptable Accounting Principles
<b>IA</b>	Internal audit
<b>IIA</b>	Institute of Internal Auditors
<b>IAF</b>	Internal Audit Function
<b>ISA</b>	International Standard on Auditing
<b>IAS's</b>	Internal Auditing Professional Standards
<b>KPMG</b>	Klynveld Peat Marwick Goerdeler
<b>MIA</b>	Malaysian Institute of Accountants
<b>MTG</b>	Management Training Ground
<b>NSE</b>	Nairobi Securities Exchange
<b>US</b>	United States
<b>SPSS</b>	Statistical Programme for Social Sciences

# **CHAPTER ONE**

## **INTRODUCTION**

### **1.1 Background of the study**

Auditor independence and objectivity are the cornerstones of the profession. 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 (KPMG, 2008). The assurance services provided by auditors derive their value and credibility from the fundamental assumptions of independence of mind and independence in appearance. Internal audit is considered as a value adding activity in contemporary organization (Al-Twajjry, Brierley & Gwilliam 2003; Bou-Raad 2000). Implicit in this notion is the assumption that internal audit is effective. Nevertheless, organizations in developing countries seem to emulate the concept and practices of internal audits applied in western societies (Al-Twajjry, Brierley & Gwilliam, 2003).

The definition of internal audit highlights the independence and objectivity of internal auditing with respect to both assurance services and consulting. Independence and objectivity are closely related. Independence is the freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement, functional and organizational levels (Glossary to the IIA, 2001).

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 (Glossary to the IIA, 2001).

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. While the IIA standards emphasize independence at the organizational level, the definition indicates that it is also important at the individual, engagement and function levels.

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. In fact, 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 are; they 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 know to them that if not disclosed may distort the reporting of activities under review. IIA has also published a framework to guide internal auditors with respect to objectivity. This framework 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.

There are two factors that influence the independence and objectivity of an internal audit (Goodwin, 2003). These factors are the relationship with the audit committee and the use of the function as a management training ground. This is especially so because the audit assistant may not be willing to audit his future supervisor.

### **1.1.1 Nairobi stock exchange**

A stock exchange is a form of exchange which provides services for stock brokers and traders to trade stocks, bonds, and other securities. Stock exchanges also provide facilities for issue and redemption of securities and other financial instruments, and capital events including the payment of income and dividends. Securities traded on a stock exchange include shares issued by companies, unit trusts, derivatives, pooled investment products and bonds. Securities markets took centuries to develop. Kenneth (February 2009). Economist Ulrike Malmendier of the University of California at Berkeley argues that a share market existed as far back as ancient Rome (Peter, 1967).

The NSE was incorporated in 1954. The NSE adopted a call-over system at inception and an open-outcry system in 1991. The CDS was launched in 2004 and now the ATS in 2006. The NSE has close to 500,000 CDS account holders presently. The NSE enjoys a

large pool of educated potential investors, a favourable socio-economic reform environment and a stable political climate (www.nse.co.k)

### **1.1.2 Earnings per share**

Earnings per share are the portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serve as an indicator of a company's profitability.

it is calculated as:

$$= \frac{\text{Net Income - Dividends on Preferred Stock}}{\text{Average Outstanding Shares}}$$

### **1.1.3 Relationship between independence of internal audit function and the earnings per share.**

Earnings per share is one of the elements of profitability. Without profitability, the business will not survive in the long run (Pandey, 1995). It is believed that if the quality of internal audit of a firm is effective, then it will perform well financially. The main objective of internal audit function is enabling management to perform proper risk assessments in relation to corporate objectives by means of keeping in check the control systems in the business (Ramaswamy, 1994).

ISA 610 recognizes the work of internal auditors in relation to the profitability. Organizations must ensure that professional rules on independence of the internal audit function are not interfered with. This may however be compromised by the fact that internal auditors provide consulting activities. Organizations that perform well with high profit margins have their internal controls well checked by the internal audit department.

The failure to check internal controls by internal audit department leads to increase in frauds hence a reduction in profitability levels (Balunywa, 1999). Internal auditing frequently involves measuring compliance with the entity's policies and procedures. This helps a firm accomplish its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process. This is aimed at helping firms to meet their core objectives especially profits (Gupta, 1987).

The internal auditing involvement in strengthening internal controls may lead the external auditors to reduce the assessed level of control risk. As a consequence, the auditor's reliance on internal controls should result in less substantive testing and hence a lower audit fee (Collier and Gregory, 1996). Additionally, internal auditing professional standards (IAS's) require the function to monitor and evaluate the effectiveness of the organization's risk management process and its contribution to profitability (IIA 2003). This involves determining risk which is acceptable and what actions should be undertaken in order to avoid share or control risk to increase revenue in a firm.

## **1.2 Statement of Research Problem**

Much of the debate and research efforts to date have centered on the external auditors' professional objectivity, leading to various regulatory changes to safeguarding auditor independence (Cohen, Krishnamoorthy & Wright, 2004; Gramling, Maletta, Schneider & Church, 2004; Schneider, 2003). 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 (Schneider, 2003). 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 organisation, internal auditors are also required to review and report upon decisions made by the senior management of the same organisation, 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, 1999). 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. All listed companies are required to have an internal audit department. There have been forums to improve the function in public sector True independence (Cecilia, 2006. The board should establish an internal audit function which should be independent of the activities they audit and should be carried out with impartiality (the Kenya Gazette 31st May 2002). The CMA has established guidelines for listed companies for good corporate governance practices by public listed companies (Capital Markets Authority Act Cap. 485A).

Kibara (2007) carried out a survey of internal auditors risk management practices in banking industry in Kenya, Keitany (2000) studied internal audit control function and its implication for the risk assessment by the external auditors. Similarly Kimani (2006) 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 frauds in an



organization and they wanted any justification on the retention of the Price water house coopers as the External auditors. According to the ISA the role of the external auditor should not be to unearth fraud but carry out his work relying on the information provided by the management of which the internal auditors are part of. 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.

Faced with the above scenario therefore, a study should be carried out to establish the independence and objectivity of the internal auditors which is in turn affects on how effective the internal audit function will be in the company. This research sought to carry out a survey on the relationship between independence and objectivity of internal audit function in companies listed in the NSE and performance. This led to the following questions:

- i) To what extent does involvement in enterprise risk management affect independence and objectivity of internal audit in listed companies in Kenya and its relation to EPS?
- ii) To what extent is the internal audit function independent from the management in listed companies in Kenya and its relation to EPS?
- iii) Does the relationship between the audit committee and the internal audit function provide for the internal audit's independent role in listed companies in Kenya and it's relation to EPS?

- iv) To what extent does the use of internal audit as a management training ground affect the internal audit independent role in listed companies in Kenya and its relation to EPS?

### **1.3 Objective of the study**

The general objective of the study was to establish the relationship between the Independence and objectivity of the internal audit function and Earnings per share (EPS) in companies listed in NSE.

### **1.4 Significance of the study**

The study was important to the following;

#### **1.4.1 Management**

The study would help management appreciate the role played by the internal audit function in the organization and the importance of them being independent and objective in their roles to accomplish their objectives.

#### **1.4.2 Academic community**

The study contributed significantly to the internal audit debate. The study would benefit 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 accounts students to become better managers of their organizations.

#### **1.4.3 Staff**

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 would be 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.

#### **1.4.4 Investors**

The investors are interested to know how their company is being run by the management. This study would enlighten them on the importance of having an internal audit function in the organizations they invest in. They were able to know whether the internal controls put in place were functioning without interference from the management or any other interested parties.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This section aims at analyzing the conceptual framework and empirical researches that have been done. This chapter provided a review of the literature on internal audit independence and objectivity which is important for effectiveness of the internal audit function.

#### **2.2 Internal auditing**

For decades, the workings of internal audit were little known and poorly understood by the accountants. In those days, aside from the pressure to reduce costs and perform some sensitive investigation, there wasn't much attention and appreciation for the function. Indeed, in many companies, internal audit was viewed as a necessary evil. Audit committees relied on it a bit, and management viewed it more as a service to fulfill corporate objectives (Antoine; 2004).

Internal audit (IA) is provided to do a wide range of activities. In the recent years, the internal audit function has been expanding its scope to embrace consulting activities in which managers are viewed as internal audit customers. Therefore internal audit is a partner of the management and therefore should aim to add value to the organization. Internal audit has strengthened over the years (Antoine; 2004). Millichamp (2002) defined internal auditing as an independent appraisal function established by the management of the organization for the review of the internal control system as a service to the organization. It objectively examines, evaluates and reports on the adequacy of the control as a contribution to the proper, economic, efficient and effective use of resources.

Independence of the internal audit is established by the organization but objectivity is an appropriate mindset. The IA is expected to provide recommendations for improvement in those areas where opportunities or deficiencies are identified while management is responsible for internal controls; the internal audit function provides assurance to the management and the audit committee that the internal controls are effective and are working as intended. The internal audit function is led by CAE. The CAE delineate the scope of activities, authority and independence for IA in a written charter that is approved by the audit committee. The objectivity, skills and knowledge of competent internal auditors can significantly add value to the organization's internal control and risk management and governance process. An effective IA activity can provide assurance to other stakeholders (IAA Research Foundation, 2004).

### **2.3 Underlying theories: Agency and Institutional theory**

The essential concern of corporate governance arises from the separation of ownership and control in modern public corporations. This is the essence of the agency theory as argued by early scholars such as Berle and Means (1932) and Jensen and Meckling (1976). Under this concept the responsibility of control is vested in the board and management, the agents of the shareholders. The board who only meets a few times a year in turn appoints management (as their agents) headed by the Chief Executive Officer to manage the organisation. While the independent external auditors provide an assurance to the shareholders as to the overall satisfactory performance of the board and management, it is the independent internal auditors who provide an assurance to the board via the audit committee as to the satisfactory performance of management. Agency

theory in this context provides the basis to explain the independent role and responsibilities assigned to the internal audit function (Adams, 1994).

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.

In addition and as a consequence to the above changes, there is pressure on management to pursue and utilize updated management ideologies to ensure the organization is governed efficiently, effectively and economically for the benefit of the board and ultimately to the shareholders. Many of these have been a result of social expectations in response to recent corporate scandals. Here, the study draws on institutional theory which essentially posits that organisational management and control structures tend to conform to social expectations as argued by early scholars (Meyer and Rowan, 1977; Di Maggio and Powell, 1991; Scott, 1987). Based on this reasoning, this study takes the stand that included in this organisational 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.

This study hence draws on both agency and institutional theory in the above context to examine the issue of internal audit's independence through its relationship with the audit committee (as a subcommittee of the board) and the management.

#### **2.4 Internal audit independence and objectivity**

The professional Internal auditor must have independence to fulfill his professional obligations to be able to provide free unbiased, opinion and report matters as they are rather than managers would like them to appear (Sawyer ,1988). Independence of internal auditor enables him/her to perform their work freely and objectively. Vansco *et al* (1997) noted that without independence, the desired results of the IA cannot be realised. He also concluded that that the role of internal audit requires unrestricted independence in order to perform a variety of duties for the organization they serve.

According to the IIA's Independence and Objectivity: A Framework for Internal Auditors, threats to internal auditor objectivity can be classified under seven categories: self review; social pressure; economic interest; personal relationship; familiarity; cultural, racial and gender biases; and cognitive biases (Mutchler, Chang & Prawitt, 2001).

Self review results from an auditor reviewing their own work. (Mutchler et al., 2001). Self review is considered a threat as "it may be more difficult to evaluate without bias one's own work" An early study by Plumlee (1985) considered internal auditors' involvement in the design of internal control systems as a key threat to internal auditor objectivity. Plumlee concluded that self-review does impact on objectivity, as "auditors in those situations are not likely to detect problems or consider alternatives to their solution without prompting" Church and Schneider also addressed whether self-review

could affect the objectivity of internal auditors (1991; 1992). They posited that internal auditors who had been involved in the design of an internal control system would be unable to remain objective in the subsequent audit of that control system. They found no difference in the allocated audit hours between auditors that had participated in the internal control system design and auditors that hadn't. They concluded that prior involvement in systems design did not affect internal auditors' objectivity and that internal auditors are aware of the risk to their objectivity and make a conscious effort to adhere to auditing standards.

Social pressure exists when an internal auditor perceives that they are being pressured by a group within the organization (Mutchler et al., 2001). The most significant social pressure within an organisation comes from management because of the status and power that management has (Harrell et al., 1989). Several studies have shown that management pressure impacts the objectivity of internal auditors. A study conducted by Harrell et al. (1989) looked at management's ability to impair objectivity by informing the internal auditors of their preferred internal control system evaluations. They found that internal auditors were biased by the knowledge of management's preferred outcomes and that objectivity was therefore compromised. Their study also found that membership with the Institute of Internal Auditors (IIA) enabled internal auditors to better resist management influence and thus maintain their objectivity. Brody and Lowe (2000) looked at management pressure within the context of the consulting role of internal auditors and its impact on internal auditor objectivity. They found that internal auditor' decisions regarding an acquisition scenario were influenced by their company's role, and that they provided assessments that were in the best interests of their company. Ahlawat and Lowe



(2004) proposed that, as the role of internal auditing now entails adding value to the organisation, this would impact on their ability to be impartial and auditors would therefore be susceptible to employer/client advocacy. They also looked at whether the identity of the internal audit provider had an impact on any advocacy. The study found that internal auditors are disposed to advocacy and as such do not retain their objectivity. The authors went on to say that “objectivity in practice is essentially a myth” (Ahlawat & Lowe, 2004). Another finding of the study was that advocacy was less extreme when the internal audit function was outsourced which indicates outsourcing does not impair objectivity.

The economic interest threat arises when an internal auditor has financial interests that may be affected by internal audit findings (Mutchler et al., 2001). Gul and Subramaniam (1994) investigated whether gifts and discounts had an impact on an internal auditor’s objectivity. The impact of the receipt of gifts and discounts by internal auditors was assessed through their ability to resist management pressure over an unrecorded liability dispute. No significant results were found for gifts and discounts, suggesting they do not impact internal auditors’ objectivity. A study by Schneider (2003) sought to identify whether incentive compensation or stock ownership affected internal auditor objectivity. Schneider (2003) found that, when incentive compensation for internal auditors was tied to stock prices, their objectivity was impaired. This was determined as the internal auditors being less likely to report GAAP violations. Schneider did not find any effect when incentive compensation was tied to earnings, or for stock ownership impairing objectivity.

Familiarity refers to a long-term relationship between the auditor and client, in this case the internal auditor and the employees being audited, which may cause the auditor to be less objective and rely on past dealings with the client instead (Mutchler et al., 2001). Gul and Subramaniam (1994) considered the impact of familiarity on internal auditor objectivity. They found that familiarity significantly affected the internal auditors' ability to resist management pressure. The survey participants who were presented with the scenario of being familiar with the manager of the accounting department were seen to be less likely to disagree with the manager than those presented with the scenario where there was little familiarity. This finding is consistent with the findings by Ahlawat and Lowe (2004) whereby advocacy of client position was found to be lower when outsourcing of the internal audit function existed as compared to when internal audit was in-housed.

## **2.5 Enterprise Risk Management (ERM) 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 Plumlee (1985) found internal auditor objectivity impairment could result from self-review. By contrast, the Church and Schneider studies (1991; 1992) 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, Brody and Lowe (2000) and Ahlawat and Lowe (2004) found that the consultancy role of internal audit had a negative impact on internal auditor objectivity.

In 2005, the IIA conducted an online survey with internal auditors regarding their involvement in ERM (Gramling & Myers, 2006). The survey found that internal audit was primarily responsible for ERM in 36% of the organisations surveyed (Gramling & Myers, 2006). Further, the study also found that some internal auditors were engaged in roles that the IIA had recommended as being unsuitable i.e. should not be undertaken. Another recent study conducted by Fraser and Henry (2007) 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 (Brody & Lowe, 2000; Ahlawat & Lowe, 2004; Plumlee, 1985). 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 (Plumlee, 1985; Brody & Lowe, 2000; Ahlawat & Lowe, 2004).

Arena et al. (2006) 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. Allegrini et al. (2006), 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 Contrôle Internes, 2005), in Belgium, consulting averages 12 per cent of annual working time (IIA Belgium, 2006), while in Italy, only a few large companies (8% of the top 100 firms) use internal audit for consulting activities (Allegrini and D’Onza, 2003)). However, consulting activities appear to be increasing – for example, Allegrini et al (2006) indicate an increase from 7 to 26 per cent of time allocated to consulting activities in Italian companies. Paape et al. (2003) found that 64% of respondents to their survey of chief internal auditors across fifteen European nations reported that their function engaged in consultancy and management support activities. Furthermore, 61% of respondents disagreed with the suggestion that it is better for internal audit not to accept consultancy assignments in order to protect and maintain independence.

Van Peurseem (2004) 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”. Most of those who commented on this change did not perceive it as a

problem. Van Peursem's (2005) study, attempted to explain how internal auditors deal with the conflict between their audit oversight responsibilities and the provision of support to management. Van Peursem 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 communications in which they engage.

Schneider (2003) 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.

Two other experimental studies by both Brody and Lowe (2000) and Ahlawat and Lowe (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 may not be able to maintain their objectivity.

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, Selim et al. (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, e.g. 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.

## **2.6 Internal audit function and the management**

Van Peurseem (2005), based on interviews with Australian internal auditors, 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. Similarly, Clark, Gibbs and Shroeder (1981) 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 organisational 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 relationship between the internal audit staff and the company's management is clearly important in determining the independence and objectivity of the internal auditor (Al-Twaijry *et al.* 2003; IIA, 2006). Management support for IA is thus important both in the abstract (managers must see the activity of the audit department as legitimate) and in ensuring that IA departments have the resources needed to do their jobs thus adding value to the organization.

## **2.7 Audit Committees**

An essential role of audit committees is to support the internal audit function, ensuring that they have the necessary status and resources to remain objective (Bailey, 2007). The

study by Gul and Subramaniam (1994) provides some empirical support towards internal auditor ability to resist management pressure in situations when an audit committee is present as opposed to when such a committee is not. On the other hand, it is also argued that the mere existence of an audit committee do not make it effective, but the differing characteristics of such a committee e.g. composition and its relationship with other governance mechanisms are also important factors. For example, Scarbrough, Rama and Raghunandan (1998) investigated the relationship between audit committee composition and the interaction between internal auditors and the audit committee. The study consisted of responses to a mailed questionnaire from 72 Canadian chief internal auditors. The results indicate that audit committees composed entirely of non-employee members had greater interaction with internal auditing. Likewise, the study by Raghunandan, Read and Rama (2001) also looked at audit committee composition and interactions with internal auditing based on a survey of 114 US chief internal auditors. The results of this study indicate not only that audit committees composed of independent directors have greater interaction with internal auditing but also when at least one member of the audit committee has an accounting or finance background. These results were also evident in two other studies, Goodwin (2003) and Goodwin and Yeo (2001) which involved a survey of 48 private sector and 72 public sector chief internal auditors in Australian and New Zealand organisations; and a survey of chief internal auditors in Singapore, respectively.

Sarens and De Beelde (2006) used a case study approach of five Belgian companies to explore the expectations and perceptions of both senior management and internal auditors with respect to the relationship between the two parties. They found that, when internal



audit operates primarily in a management support role, there is a lack of perceived objectivity and the relationship with the audit committee is weak. They also found that senior management's expectations significantly influence internal audit and that the support of senior management is critical to the acceptance and appreciation of the internal audit function within the organization. Christopher et al. (2009) found that independence threats associated with internal audit's relation with management stem from the involvement of the CEO or chief financial officer (CFO) in the internal audit function's plan and budget, management regarding the internal auditor as a partner and using the internal audit function as a stepping stone to other positions. Van Peurseem (2005), in a multiple case study of six senior internal auditors in New Zealand, found that internal auditors' close relationship with management can place their independence from management at risk. For example, interviewees recognised a need to balance the conflicting interests of their managers with the interests of their profession and were conscious that they have a responsibility to report over their employer's head if necessary.

## **2.8 Internal audit as a management training ground**

Using the internal audit function as a management training ground is a widely used and growing practice (Baker 2010). Prior research finds that this practice is used by approximately 30 percent of all companies (Anderson et al. 2012) and by a majority of large publicly traded companies (Oxner and Oxner 2006; Abbott et al. 2010; Messier et al. 2011). Similarly, a recent survey conducted by the IIA that reveals that 31percent of all survey respondents and 64 percent of Fortune 500 companies use the IAF as a management training ground (IIA 2009).

A study carried out by William F. Messier, Jr (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 (IAF) as a management training ground (MTG) affects external audit fees and the external auditors' perceptions of the IAF. The study concluded that over half of all companies that have an IAF specifically hire internal auditors with the purpose of rotating them into management positions (or cycle current employees into the IAF for a short stint before promoting them into management positions). It was found that external auditors charge higher fees to companies that use the IAF as a MTG. It was found that external auditors perceive internal auditors employed in an IAF used as a MTG to be less objective but not less competent than internal auditors employed in an IAF not used as a MTG. These results have important implications for the many companies that use their IAF as a MTG. 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 (Baker, 2010).

Goodwin and Yeo (2001) investigated the impact on objectivity of using internal audit as a training ground. They surveyed 65 chief internal auditors in Singapore to explore the extent of the practice and perceptions of whether it could impair objectivity. The study found that internal auditing was viewed as a stepping stone to a managerial position in 43% of companies, that internal auditors would in the future be transferred to line positions in 48% of companies and that an auditee could be the future boss of an internal

auditor in 49% of companies. Some 32% of respondents believed that using the internal audit function as a management training ground could impair the work of internal auditors. Further, the second approach of transferring existing employees to work in internal audit can give rise to familiarity and self-review threats. These threats could be compounded by a lack of commitment to the internal audit profession, including an awareness and understanding of the IIA code of ethics. None of these issues have been explored in depth. Undoubtedly, there are benefits for the organization from using internal audit as a training ground but no study has weighed up the costs and benefits of the practice from the perspective of internal audit.

## **2.9 Knowledge Gap in Reviewed Literature**

It can be noted from the literature that the internal audit have seen their role evolve from performing internal audit function to focusing on adding value to the organization and its scope has expanded to much broader spectrum of activities. Internal audit is viewed as a service provider to the organization such that their continued existence is dependent on adding value to the organization. New emphasis is being placed on adding value to the organization though prevention of risks and identifying risks (audit wire 200). The internal auditors shift of focus from 'policing' to a function that adds value to the organization should be natured well by especially ensuring that their independence and objectivity is not affected. Fraser and Henry argue that high involvement in Enterprise Risk Management raise independence issues of the internal auditor while on the other hand, Plumee 1985, Brode & Lowe,200 have a conflicting view that Enterprise Risk Management will impair objectivity of the internal audit. The study is set to close the gaps identified in the literature review.

Only a few academic studies have examined the effectiveness of IA and the impacts on the performance, and even fewer have dealt with the issue empirically. In one of the very few studies that examined the effect of internal auditing on organizational performance, Eden and Moriah (1996) assigned 224 bank branches to experimental conditions (audited or not audited) and monitored their performance for a year. Their findings showed that performance significantly improved during the half year following the audit in the experimental branches, while the control branches experienced a decline due to poor general business conditions. It should be reiterated that Eden and Moriah are nearly alone in developing and testing an explanatory model of IA effectiveness. While that study offers a useful jumping-off point for understanding how good auditing can improve a company's performance, it does not go far enough in explaining when and why IA works, and the conditions that facilitate or impede it. Helping to bridge this gap will be one of the main contributions of this study.

Little research has been done on the independence and objectivity of the internal audit locally e.g., Kibara (2007) carried out a survey of internal auditors risk management practices in banking industry in Kenya, Keitany (2000) studied internal audit control function and its implication for the risk assessment by the external auditors. Similarly Kimani (2006) studied perceived role of internal auditors in corporate governance. These researches have focused on the role of the internal audit function and little has been done to address the issue of independence which is the cornerstone of the profession.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

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

#### **3.2 Research design**

The study adopted a descriptive survey design to establish the objectivity and the independence of internal audit. Kothari (2004) states that surveys are concerned with describing, recording, analyzing and interpreting conditions that either exist or existed. The author further posits that surveys are concerned with conditions or relationships that exist, opinions that are held, processes that are going on, effects that are evident or trends that are developing. In this case, the researcher did not manipulate the variable or arrange for events to happen. One questionnaire was given to a key informant in each of the selected listed firms to be collected on completion by the researcher.

#### **3.3 The population**

Sekaran (2003) 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 publicly listed companies in the Nairobi Stock exchange. There were 60 publicly listed companies as per the listed obtained from the NSE at June 2012(see

Appendix III). The study respondents were made up of audit managers of the listed companies.

### **3.4 Sampling**

According to Sekaran (2003), sampling is a process of selecting a sufficient number of elements from the population, so that a study of the sample and an understanding of its properties or characteristics would make it possible for us to generalize such characteristics to the population elements.

#### **3.4.1 Sampling Frame**

Kothari (2004), states that a sampling frame is also known as a source list from which a sample is derived. The author further states that this source list contains the names of all items of a universe or population. This list should be comprehensive, correct, reliable and appropriate. It is extremely important for the sample frame to be as representative of the population as possible. Sampling frame can be thought of as a list of all elements in the population of interest, for example, names of individuals, telephone numbers, house addresses. The sampling frame operationally defines the target population from which the sample is drawn and to which the sample data will be generalized. In this study, the sample frame was shown in appendix III in which all registered companies as at June 2012 had been listed.

#### **3.4.2 Sample Size**

Size of sample refers to the number of items to be selected from the universe to constitute a sample as stated by Kothari (2004). The author further recommends that the sample size should neither be excessively large, nor too small. It should be optimum.

This was a sample survey study such that 30% of all the publicly listed firms in the Nairobi Stock exchange as at June 2012 were studied. A complete list of the publicly listed firms in Kenya as at June 2012 showed that they were 60 in number. In this study, the sample size was 18 companies. These were obtained from a population that had been stratified into categories of agricultural, commercial and services, telecommunication and technology, banking, insurance, investment, manufacturing and allied, construction and allied and lastly energy and petroleum. The percentage applied on their individual totals was 30%. This agreed with the observation made by Kerlinger (1983) that 10%-30% of the population was representative for any given research study.

### **3.5 Data Collection**

The main instrument for data collection is the questionnaire (see Appendix 2). A standardized questionnaire was used to enable comparison of information. The questionnaire was divided into two main parts. Section one sought to gather general information of the organisation and the respondent whereas section two sought to gather thematic information on the study variable. Secondary data was obtained from secondary sources notably existing literature on independence and objectivity of internal audit. The structured questionnaires were accompanied by a list of all possible alternatives from which respondents selected the suitable answer that described their situation by simply ticking (Mugenda, 1999). The advantage of using this type of instrument was the ease with which it accorded the researcher during the analysis. Moreover they were 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 Data Collection procedure**

The researcher employed a drop and pick technique in distribution of the questionnaires. The target was to meet and give one questionnaire to one key informant (Chief Audit Executive) in each of the selected sample.

### **3.7 Data Analysis**

Data analysis technique applied both qualitative and quantitative using statistical programme for social sciences (SPSS) and MS Excel for simple data analysis. This was applied to compare the impact of the independent and the dependent variable. Data generated was analyzed using correlation and simple linear regression analysis to determine the relationship between the independence of the internal audit function and profitability. Measures of central tendency was calculated, percentages, frequencies and tables that describe the phenomena under investigations was applied. Thus interpretation of data was done by drawing inferences from the computed frequencies, means and percentages.

#### **3.7.1 Conceptual Model**

The following function showed the mathematical relation of dependent and independent variable

$$EPS=f(IAFI, IAFO,)$$

Where:



EPS= Earnings per Share

IAFI= Internal Audit Function Independence

IAFO= Internal Audit Function Objectivity

The data that was used in this model was primary data.

### **3.8 Ethical Issues**

During data collection, analysis and interpretation, the researcher adhered to all guidelines for undertaking and reporting research work. For instance, the structure of the questionnaire was such that there was no provision for the name of the informant. Secondly, the information volunteered in the questionnaire was treated with great confidentiality and solely for research purpose.

Thirdly, the interviews and completion of questionnaires was done in private. Finally, all sources of secondary data which had been used in this proposal had been acknowledged accordingly.

## **CHAPTER FOUR**

### **DATA ANALYSIS, RESULTS AND DISCUSSION**

#### **4.1 Introduction**

This chapter presents an analysis and findings of the study as set out in the research objective and research methodology. The study findings are presented on the relationship between the Independence and objectivity of the internal audit function and Earnings per share (EPS) in companies listed in NSE. The data was gathered from primary data using a questionnaire.

##### **4.1.1 Response rate**

The study targeted 30 respondents out of which 18 responded giving a response rate of 60%. This response rate was relatively low because some target respondents were reluctant to provide the information citing that it was against their company policy to provide such information while some lost the questionnaires.

#### **4.2 General Information**

The study sought to establish the respondents' general information. This covered industry classification, length the firm had been in operation and demographic statistics of the person filling in the questionnaire.

The study sought to establish the industry classification of the company. From the responses, the companies in the energy and petroleum, insurance and banking industry were 17% each; those in the agricultural, commercial and services, telecommunication and technology industry registered 11% each while those in the manufacturing and allied,

investment and construction and allied industry were 6% each as summarized in table 4.1 below.

**Table 4. 1: Industry Classification**

	<b>Frequency</b>	<b>Percent</b>
Energy and Petroleum	3	17
Insurance	3	17
Banking	3	17
Agricultural	2	11
Commercial and services	2	11
Telecommunication and technology	2	11
Manufacturing and allied	1	6
Investment	1	6
Construction and allied	1	6
<b>Total</b>	<b>18</b>	<b>100</b>

The study also aimed to determine the length of time the firms had been operating in Kenya. Majority (83%) of the firms had operated in Kenya for over 15 years followed by 11% that had operated in Kenya for a period of 11-15 years while 6% had operated in Kenya for a period of 1-5 years as shown in table 4.2 below.

**Table 4. 2: Period Operating in Kenya**

	<b>Frequency</b>	<b>Percent</b>
Over 15 years	15	83
11 – 15 years	2	11
1- 5 years	1	6
<b>Total</b>	<b>18</b>	<b>100</b>

On the position held in the organization, most of the respondents were internal audit managers at 72%, 17% were auditors whereas 11% were deputy audit managers as shown in table 4.3 below.

**Table 4. 3: Position Held in the Organization**

	<b>Frequency</b>	<b>Percent</b>
Internal Audit manager	13	72
Auditor	3	17
Deputy Audit Manager	2	11
<b>Total</b>	<b>18</b>	<b>100</b>

The study required the respondents to indicate their highest academic qualifications. According to findings in table 4.4 below, 39% of the respondents had masters degrees as their highest academic qualification followed closely by those with bachelors degree at 33% and 17% had CPA (K) as their highest academic qualifications while 11% had PhD. in addition, most of the respondents had combinations of the above qualifications and ACCA qualification.

**Table 4. 4: Highest Academic Qualifications**

	<b>Frequency</b>	<b>Percent</b>
MBA	7	39
Bachelors degree	6	33
CPA (K)	3	17
PhD	2	11
<b>Total</b>	<b>18</b>	<b>100</b>

The respondents were also to indicate their work experience as an internal auditor. 33% of the respondents had work experience of between 5-10 years as internal auditor, 28% had work experience of between 10-20 years, and 22% had work experience of 1-3 years while 17% had work experience of between 3-5 years as shown in table

**Table 4. 5: Work Experience**

	<b>Frequency</b>	<b>Percent</b>
Between 5-10 years	6	33
Between 10-20 years	5	28
1- 3 years	4	22
Between 3-5 years	3	17
<b>Total</b>	<b>18</b>	<b>100</b>

On whether the respondents were members of any professional body, majority (56%) were members of ICPAK, 22% were members of IAA whereas another 22% were members of other professional bodies such as ISACA, Global Association of Risk Professionals, ACCA, Institute of Engineers of Kenya and Engineers Registration Board.

**Table 4. 6: Members of Any Professional Body**

	<b>Frequency</b>	<b>Percent</b>
ICPAK	10	56
IIA	4	22
Others	4	22
<b>Total</b>	<b>18</b>	<b>100</b>

The study aimed to establish the whether the company had an internal audit committee. From the findings, all the respondents unanimously agreed that their company had an internal audit committee as shown in table 4.7 below.

### 4.3 Independence and objectivity of the internal audit function

**Table 4. 7: Internal Audit Committee**

	<b>Frequency</b>	<b>Percent</b>
Yes	18	100

Regarding the number of members in the audit committee, 39% of the firms had between 4-6 members in the committee, 33% of the firms had between 1-3 members in the audit committee while 28% had between 7-9 members as indicated in table 4.8 below.

**Table 4. 8: Number of Members in Audit Committee**

	<b>Frequency</b>	<b>Percent</b>
4-6	7	39
1-3	6	33
7-9	5	28
Total	18	100

The study further sought to identify the number of the audit committee members that were independent. 44% of the respondents indicated that all members were independent, 22% indicated minority of members were non independent, another 22% indicated majority of members were non independent while 11% indicated others including 4 non-executive members and 3 independent members in the audit committee as summarized in table 4.9 below.

**Table 4. 9: Number of Independent Members**

	<b>Frequency</b>	<b>Percent</b>
All members are independent	8	44
Minority of members are non independent	4	22
Majority of members are non independent	4	22
Others	2	11
<b>Total</b>	<b>18</b>	<b>100</b>

On the number of Audit Committee members that were professionally qualified accountants, 28% indicated that all Audit Committee members were qualified accountants, 6% indicated that none of members were qualified accountants whereas majority (67%) noted that others by specifying that the Audit Committee had 1-5 members who were qualified accountants as displayed in table 4.10 below.

**Table 4. 10: Number of Professionally Qualified Accountants in the Committee**

	<b>Frequency</b>	<b>Percent</b>
All are qualified accountants	5	28
None of members are qualified accountants	1	6
Others	12	67
<b>Total</b>	<b>18</b>	<b>100</b>

On the level of internal audit committee involvement relative to its role with the internal audit function, the respondents mentioned that internal audit committee was highly involved; the committee had quarterly meetings to discuss routine/special audits; the internal audit function presented quarterly reports to the audit committees and the issues discussed were then presented to the main board; adequately involved in four quarterly meetings annually; the internal committee approved the internal audit work plan; the internal audit committed reported directly to the board audit committee on all findings

and status of audit issues; responsible for internal audit and held management accountable; audit reports were sent on monthly basis and thereafter follow up on the implementation of the recommendation was facilitated.

The study also sought to establish the person the internal audit department reported to functionally. 67% indicated that they reported to Audit Committee only, 17% indicated they reported to Audit Committee and CEO while those who reported to Audit Committee, CEO and CFO, Audit Committee, CEO, CFO and BOD and Others like CEO, vice chairman and audit committee registered 6% each as shown in table 4.11 below.

**Table 4. 11: Person the Internal Audit Department Reported To Functionally**

	<b>Frequency</b>	<b>Percent</b>
Audit Committee Only	12	67
Audit Committee and CEO	3	17
Audit Committee, CEO and CFO	1	6
Audit Committee, CEO, CFO and BOD	1	6
Others (please specify	1	6
<b>Total</b>	<b>18</b>	<b>100</b>

Regarding the person the internal audit department reported administratively, majority (78%) indicated that they audit department reported to the CEO administratively while 22% cited that they report to the CEO and BOD administratively as indicated in table 4.12 below.



**Table 4. 12: Person the Internal Audit Department Reported to Administratively**

	<b>Frequency</b>	<b>Percent</b>
CEO	14	78
CEO and BOD	4	22
<b>Total</b>	<b>18</b>	<b>100</b>

The study also required the respondents to indicate the person mandated to appoint, dismiss and evaluate the head of the internal audit function. 33% indicated that CEO was mandated to appoint, dismiss and evaluate the head of the internal audit function and another 33% noted that AC/BOD/CEO was mandated to appoint, dismiss and evaluate the head of the internal audit function, while 17% indicated that AC was mandated to appoint, dismiss and evaluate the head of the internal audit function and another 17% cited that AC/CEO was mandated to appoint, dismiss and evaluate the head of the internal audit function as summarized in table 4.13 below.

**Table 4. 13: Person Mandated to Appoint, Dismiss and Evaluate Head of the Internal Audit Function**

	<b>Frequency</b>	<b>Percent</b>
CEO	6	33
AC	3	17
AC/BOD/CEO	6	33
AC/CEO	3	17
<b>Total</b>	<b>18</b>	<b>100</b>

The respondents were required to indicate their level of agreement with the statements on a scale of 1-5 where 1=strongly agree, 2=agree, 3=neither agree nor disagree, 4=disagree and 5=strongly disagree.

On whether CAE was regularly invited to the audit committee meetings, the respondent agreed with a mean of 1.8125; on whether CAE had regular private contacts with the audit committee (chair/ or individual members, the respondents agreed with a mean of 2.25. The respondents also agreed that the audit committee gave input to the internal audit planning at a mean of 1.5; the management allowed them to follow up on their recommendation as shown by a mean of 1.5625; the Board members were curious to strengthen and support the internal audit function at a mean of 1.5; and the management and other organs of the system support understood and appreciated the role of internal audit function with a mean of 1.75. This information is well summarized in table 4.14 below.

**Table 4. 14: Statements on Internal Audit Committee**

	<b>Mean</b>	<b>Std. Deviation</b>
The CAE regularly invited to the audit committee meetings	1.8125	1.10868
The CAE have regular private contacts with the audit committee (chair/ or individual members	2.25	1.23828
The audit committee give input to the internal audit planning	1.5	0.7303
Management allow you to follow up on your recommendation	1.5625	0.81394
Board members are curious to strengthen and support the internal audit function	1.5	1.0328
Management and other organs of the system support understand and appreciate the role of internal audit function	1.75	1

In addition, the study sought to identify the person that approved the internal audit budget. 31% indicated that Board of Directors approved the internal audit budget, 25% indicated that Audit Committee approved the internal audit budget, 9% indicated that Audit Committee and CEO approved the internal audit budget, 13% said that Board,

Chief executive Officer and Chief Financial Officer approved the internal audit budget while indicated Chief Executive Officer and Audit Committee and Chief Financial Officer approved the internal audit budget were 6% each.

**Table 4. 15: Person that Approved the Internal Audit Budget**

	<b>Frequency</b>	<b>Percent</b>
Board of Directors	5	31
Audit Committee	4	25
Audit Committee and CEO	3	19
Board, Chief executive Officer and Chief Financial Officer	2	13
Chief Executive Officer	1	6
Audit Committee and Chief Financial Officer	1	6
<b>Total</b>	<b>16</b>	<b>100</b>

The respondents were required to indicate their level of agreement with the statements on a scale of 1-5 where 1=strongly agree, 2=agree, 3=neither agree nor disagree, 4=disagree and 5=strongly disagree.

On whether the CEO gave input for the internal audit planning, the respondents agreed with a mean of 2.3125; on whether the CFO gave input for the internal audit planning, the respondents strongly disagreed at a mean of 5.5; on whether the internal audit staff were rotated to other departments in your company, the respondents neither agreed or disagreed with a mean of 3.4375.

**Table 4. 16: Statements on Internal Audit Planning**

	<b>Mean</b>	<b>Std. Deviation</b>
The CEO give input for the internal audit planning	2.3125	1.19548
The CFO give input for the internal audit planning	5.5	10.37304
Internal audit staff are rotated to other departments in your	3.4375	1.31498

The study aimed to establish the number of years an internal auditor stayed within the internal audit department. From the responses, majority (56%) of the respondents indicated that internal auditor stayed within the internal audit department for a period of between 2-4 years, 28% indicated between 5-7 years, 11% indicated between 8-10 years while 6% indicated less than 2 years as shown in table 4.17 below.

**Table 4. 17: Period Internal Auditor Stayed Within the Internal Audit Department**

	<b>Frequency</b>	<b>Percent</b>
Between 2-4 years	10	56
Between 5-7 years	5	28
Between 8-10 years	2	11
Less than 2 years	1	6
<b>Total</b>	<b>18</b>	<b>100</b>

On whether the organization hired employees (new graduates or senior level employees from other organization) in the internal audit function with a promise they would be promoted into senior level management, 72% said no while 28% said yes as shown in table 4.18 below.

**Table 4. 18: Organization Hiring Employees**

	<b>Frequency</b>	<b>Percent</b>
No	13	72
Yes	5	28
<b>Total</b>	<b>18</b>	<b>100</b>

The study required the respondents to indicate their level of agreement with the statements on a scale of 1-5 where 1=strongly agree, 2=agree, 3=neither agree nor disagree, 4=disagree and 5=strongly disagree.

The respondents disagreed that their company assigned existing employees into internal audit function for a specified amount of time before being cycled back into management at a mean of 3.9375. They were neutral that it was common for internal auditors to move to other functions within the company and internal auditor was involved in training of staff with means of 3 and 2.5 respectively. On the other hand, they agreed that people within the organization perceived internal audit as their partner and internal auditors were highly involved in establishing internal control system in their organization as shown by means of 2.375 and 2.3125 respectively. They also strongly agreed that internal auditors were always involved in reviews of the internal control system with a mean of 1.4375 as summarized in table 4.19 below.

**Table 4. 19: Statements on Internal Auditor**

	<b>Mean</b>	<b>Std. Deviation</b>
Your company assigns existing employees into internal audit function for a specified amount of time before being cycled back into management	3.9375	1.12361
Common for internal auditors to move to other functions within the company	3	1.21106
Internal auditor is involved in training of staff	2.5	0.96609
People within the organization perceive internal audit as their partner	2.375	0.88506
Internal auditors are highly involved in establishing internal control system in your organization	2.3125	1.30224
Internal Auditors are always involved in reviews of the internal control system	1.4375	0.62915

The study aimed to establish whether the organization used the internal audit function as management training ground. It also sought to establish whether the internal auditors are used to train staff in other sections of the organization.

**Table 4. 20: Earnings per Share**

	<b>Frequency</b>	<b>Percent</b>
Between 0-2.9	<b>8</b>	<b>44</b>
Between 3-5.9	<b>7</b>	<b>38</b>
Between 6-8.9	<b>1</b>	<b>6</b>
Between 9-11.9	<b>1</b>	<b>6</b>
Over 12	<b>1</b>	<b>6</b>
<b>Total</b>	<b>18</b>	<b>100</b>

The study sought to establish the EPS of the companies. 44 %t of the companies have their EPS raging from 0 to 2.9 while 38% have EPS raging from 3-5.9 the other 18% have their EEPS above 6 %.

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSION AND RECOMMENDATIONS**

#### **5.1 Introduction**

This chapter provides the summary of the findings from chapter four, and also the conclusions and recommendations of the study based on the objectives of the study. The objective of this study was to establish the relationship between the Independence and objectivity of the internal audit function and Earnings per share (EPS) in companies listed in NSE.

#### **5.2 operations of the internal audit**

In this study, majority of the companies have established the internal audit function in the organization while others have outsourced the services. The companies listed in the NSE are observing the CMA (2002) guidelines which require the board of directors to establish an internal audit function that is independent. In this study 67 % of the companies reported to the audit committee functionally meaning that they are following the CMA (2002) guidelines. In this study also the average number of meetings held with the audit committee are four, meaning that there are quarterly checks.

##### **5.2.1 Dismissal and hiring of chief audit executive**

67% reported that the audit committee participates in the hiring dismissal of the head of the internal audit. The high involvement of the audit committee in recruiting and dismissal of the head of internal audit have a positive signal on the independence of the internal audit function making it difficult for the management to dismiss the CAE for raising adverse queries. This study supports the CMA (2002) guidelines on corporate



governance for companies listed in the NSE that require approval for any appointment or dismissal of senior staff members of the internal audit function to be sanctioned by the audit committee and that it should be informed of any resignation of internal audit staff members. It also calls for the resigning staff an opportunity to submit reasons for resigning. It is argued that when the audit committee is involved in the key decisions such as termination of the head of the internal audit contract, there will be great empowerment of the IAF. In other words management influence decreases thus promoting independence.

### **5.2.2 Mechanism to safeguard the independence of the internal audit function**

Majority of the respondents indicated that they were independent by reporting to the audit committee 67 % to be precise. The respondents reported that having the CAE submitting their reports to the audit committee have a positive impact on their independence. A lot of literature supports the independence of the internal audit function. Vanasco (1996) observed that the internal audit profession must have independence to fulfill their professional obligation, to render a free unbiased, unrestricted opinion and report matters as they are and not as the management executives would like them to be. Independence permits internal auditors to perform their work freely and objectively. He concluded that the role of the internal audit requires unrestricted independence in order to perform a variety of duties for the organization and add value thus promoting profitability in the organization.

### **5.3 Summary**

The study found that all the companies had an internal audit committee, majority (39%) of the firms had between 4-6 members in the committee and all members were independent. Majority (67%) of the Audit Committee had 1-5 members who were qualified accountants. Most (78%) of the firms audit department reported to the CEO administratively and 67% of the firms internal audit department reported to Audit Committee functionally. In most (33%) firms, AC, BOD and CEO were mandated to appoint, dismiss and evaluate the head of the internal audit function. 31% indicated that Board of Directors approved the internal audit budget and majority (56%) of the firms internal auditor stayed within the internal audit department for a period of between 2-4 years.

The study also established that in most firms CAE was regularly invited to the audit committee meetings and had regular private contacts with the audit committee (chair/ or individual members. The audit committee gave input to the internal audit planning; the management allowed them to follow up on their recommendation; the Board members were curious to strengthen and support the internal audit function; and the management and other organs of the system support understood and appreciated the role of internal audit function. The CEO gave input for the internal audit planning; people within the organization perceived internal audit as their partner, internal auditors were highly involved in establishing internal control system in their organization and internal auditors were always involved in reviews of the internal control system.

## **5.4 Conclusions**

The study concludes that all the companies in NSE have internal audit committee with most of them having independent members. Majority of the firms (67%) audit department report to the CEO administratively and Audit Committee functionally. In most AC, BOD and CEO are mandated to appoint, dismiss and evaluate the head of the internal audit function and the Board of Directors approves the internal audit budget.

The study also concludes that most firms CAE are regularly invited to the audit committee meetings and have regular private contacts with the audit committee (chair/ or individual 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 MBA 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. It can be noted from the study that also that the telecommunication and technology industry has also a high EPS. The study concludes that there 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 on the IAF have higher profits while those who have partially complied have low profits resulting to low EPS.

### **5.5 Recommendations**

The study recommends that Management should provide support for IA is thus important both in the abstract and in ensure that IA departments have the resources needed to do their jobs thus adding value to the organization. It is recommended that the internal audit function should report to the Board or the audit committee functionally to enhance independence, objectivity and professionalism.

### **5.6 Limitations of the Study**

The respondents were reluctant in giving information fearing that the information asked would be used to intimidate them or paint a negative image about them or the company. The researcher handled this problem by carrying an introduction letter from the University and assured the respondents that the information they gave would be treated with confidentiality and was used purely for academic purposes.

### **5.7 Area for Further Research**

This study recommends that a similar study should be done on the relationship between the Independence of the internal audit function and profitability (EPS) in all private companies. This will enable comprehensive conclusions to be made on the relationship between independence and objectivity of the internal audit function and the profitability (EPS). Additionally there is a positive finding regarding the reduced problems of financial reporting where the IAF is more active and independent.

## **5.8 Implications on Policy, Theory and Practice**

The study should help management appreciate the role played by the internal audit function in the organization and the importance of them being independent and objective in their roles to accomplish their objectives.

The study should benefit 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 should help accounts students to become better managers of their organizations.

This study should benefit 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.

This study should enlighten investors on the importance of having an internal audit function in the organizations they invest in and be able to know whether the internal controls put in place were functioning without interference from the management or any other interested parties.

## REFERENCES

- Adamec, B. A., Leinicke, L. M., Ostrosky, J. A., & Rexroad, W. M. (2005). Getting a Leg Up. *The Internal Auditor*, 62 (3), 40-45.
- Adams, M.B. (1994), 'Agency theory and the internal audit', *Managerial Auditing Journal*, Vol.9, Issue. 8.
- Ahlawat, S. S., & Lowe, D. J. (2004). An Examination of Internal Auditor Objectivity: In-House versus Outsourcing. *Auditing: A Journal of Practice and Theory*, 23 (2), 14-158.
- Ahmad, Z. and Taylor, D. (2009), Commitment to independence by internal auditors: the effects of role ambiguity and role conflict, *Managerial Auditing Journal*, Vol. 24 No. 9, pp. 899-925.
- Allegrini, M., D'Onza, G., Paape, L., Melville, R. & Sarens, G. (2006), The European literature review on internal auditing, *Managerial Auditing Journal*, Vol. 21, No. 8, pp. 845-853.
- Arena, M., Arnaboldi, M. & Azzone, G. (2006), Internal audit in Italian organizations: A multiple case study , *Managerial Auditing Journal*, vol. 21 no. 3, pp. 275-92.
- Al-Twaijry, AAM, Brierley, JA & Gwilliam, DR 2003, 'The development of internal audit in Saudi Arabia: An institutional theory perspective', *Critical Perspectives on Accounting*, vol. 14, no. 5, pp. 507-31.
- Antoine, R 2004, *Internal Audit: Spotlight Shines on Its New Role*, viewed 5<sup>th</sup> March 2012, from <http://accounting.smartpros.com>>
- Bailey, J. A. (2007). Best Practices for Internal Auditor Independence. *Internal Auditing*, 22 (2), 34-37.
- Baker, N. 2010. The rotational route. *Internal Auditor*. 67(6):32-37.
- Balunywa Waswa. (2003).A hand book of Business Management (4th Edition). The Business Publishing Group.
- Berle, A.A., and Means, G.C. (1932), *The Modern Corporation and Private Property*, New York, McMillan
- Blue Ribbon Committee. (1999). *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*. New York: New York Stock Exchange.

- Bou-Raad, G 2000, Internal auditors and the value added approach: the new business regime, *Managerial Auditing Journal*, vol. 15 no. 4 pp. 183-6.
- Brody, R. G., & Lowe, D. J. (2000). The New Role of the Internal Auditor: Implications for Internal Auditor Objectivity. *International Journal of Auditing*, 4 (2), 169-176.
- Capital Markets Authority Act Cap. 485A guidelines on corporate Governance practices by public listed companies in Kenya.
- Cecilia Nordin Van Gansberghe Internal auditing in the public sector: a consultative forum in Nairobi, Kenya, shores up best practices for government audit professionals in developing nations. *Internal Auditor*. FindArticles.com. 28 Mar, 2012.
- Christopher, J., Sarens, G. and Leung, P. (2009), "A critical analysis of the independence of the internal audit function: evidence from Australia", *Accounting, Auditing and Accountability Journal*, Vol. 22 No. 2, pp.200-220.
- Church, B., & Schneider, A. (1992). Internal Auditor Involvement in Internal Control System Design: Is Objectivity Impaired? *Journal of Applied Business Research*, 8 (4), 15 -24.
- Church, B. & Schneider, A. (1991). Maintaining Objectivity Despite Conflicting Duties. *Internal Auditing*, 7 (2), 11-17.
- Clark, M., Gibbs, T. and Shroeder, R. (1981), CPAs Judge Internal Audit Department Objectivity, *Management Accounting*, 62: 40-3.
- Cohen, J., Krishnamoorthy, G., & Wright, A. (2004). The Corporate Governance Mosaic and Financial Reporting Quality. *Journal of Accounting Literature*, 23, 87-152
- DeZoort, F.T., Houston, R.W. and Reisch, J.T. (2000), Compensation for internal auditors, *Internal Auditor*, Vol. 57 No. 3, pp. 43-46.
- Dickins, D. and O'Reilly, D. (2009), The qualifications and independence of internal auditors, *Internal Auditing*, Vol. 24 No. 3, pp. 14-21.
- Di Maggio, P.J., and Powell, P.W. (1983), The iron cage revisited: Institutional isomorphism and collective rationality in organizational fields, *American Sociological Review*, 48: 147-160

- Eden, D. and Moriah, L. (1996), Impact of Internal Auditing on Branch Bank Performance: A Field Experiment, *Organizational Behavior and Human Decision Performance*, 68: 262-71.
- Fraser, I. and Henry, W. (2007). Embedding risk management: structures and approaches, *Managerial Auditing Journal*, Vol. 22, No. 4, pp. 392-409.
- Fern F. H. (1985). Independence: An Incomplete Standard. *The Internal Auditor*, 42, 30-34.
- Gordon, G and Fischer, M.I. (1996), Internal auditors: their role in the institutions of higher education in Malaysia. Published
- Goodwin, J. (2003). The Relationship between the Audit Committee and the Internal Audit Function: Evidence from Australia and New Zealand. *International Journal of Auditing*, 7, 263-278
- Goodwin, J. and T.Y. Yeo. 2001. Two factors affecting internal audit independence and objectivity: Evidence from Singapore. *International Journal of Auditing* 5: 107-125
- Gramling, A. A. & Myers, P. M. (2006). Internal Auditing's Role in ERM. *Internal Auditor*, 63 (2), 52-58.
- Gramling A. A., Maletta M. J., Schneider A. and Church, B. K. (2004). The role of the internal audit function in corporate governance: A synthesis of the extant internal auditing literature and directions for future research, *Journal of Accounting Literature* 23, pp.194-244.
- Gul, F., & Subramaniam, N. (1994). Audit Committee, Gifts and Discounts, and Familiarity as Factors Affecting Internal Auditors' Professional Objectivity. *The Review of Business Studies*, 3 (1), 89-99.
- Harrell, A., Taylor, M., & Chewing, E. (1989). An Examination of Management's Ability to Bias the Professional Objectivity of Internal Auditors. *Accounting, Organizations and Society*, 14 (3), 259-269.
- Hass, S., Abdolmohammadi, M.J. and Burnaby, P. (2006). The Americas literature review on internal auditing, *Managerial Auditing Journal*, Vol. 21 No. 8, pp. 835-844.
- Institute of Internal Auditors (IIA). 2001. Independence and Objectivity: A Framework for Internal Auditors. The Institute of Internal Auditors: Altamonte Springs, FL



- Institute of Internal Auditors (IIA). (2007). Glossary – Consulting Services. Retrieved August 24<sup>th</sup>, 2012, from <http://www.theiaa.org/guidance/standards-and-practices/professional-practices-framework/standards/standards-for-the-professional-practice-of-internal-auditing/?search=consultancy&C=816&I=2343>
- Institute of Internal Auditors, (2012). Attribute standards 1100, 1110, 1111, 1130 Retrieved on 28<sup>th</sup> March, 2012, from <http://www.theiaa.org/guidance/standards-and-guidance/ippf/standards/standards-items/index.cfm?c=3093>
- James, K. (2003). The effects of internal audit structure on perceived financial statement fraud prevention, *Accounting Horizons*, Vol. 17 No. 4, pp. 315-327.
- Jensen, M.C., AND Meckling, W. H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics* 3CD:305-360.
- Koome, J. (2009), A survey of the role of the internal auditors in enterprise wide risk Management for listed companies in Kenya (industrial and allied sectors. Unpublished MBA thesis, University of Nairobi.
- Kibara, C.W. (2007), internal auditors risk management practices in banking industry in Kenya. Unpublished MBA thesis, University of Nairobi
- Keitany J. L., (2000), The internal audit control function and its implication for risk assessment by the external auditor. A case of quoted companies unpublished study. Unpublished MBA thesis, University of Nairobi
- Kothari, C. R. (2004). *Research Methodology: Methods and Techniques, second edition*. New Delhi. New Age International (P) Limited, Publishers.
- KPMG. (2003), Internal Audit's Role in Modern Corporate Governance. Hongkong retrieved from [www.kpmg.com.hk](http://www.kpmg.com.hk)
- Melville, R. (2003), The contribution internal auditors make to strategic management, *International Journal of Auditing*, Vol. 7, pp. 209-223.
- Meyer, J.W., and Rowan, B. (1977), Institutional organisation: Formal structure as myth and ceremony, *American Journal of Sociology*, 83: 310-363
- Millichap, A.H 2002 auditing United Kingdom: book power
- Mutchler, J., Chang, S., & Prawitt, D. (2001). Independence and Objectivity: A Framework from Research Opportunities in Internal Auditing. Altamonte Springs, FL: The Institute of Internal Auditors.

- Nagy, A.L. and Cenker, W.J. (2002), An assessment of the newly defined internal audit function, *Managerial Auditing Journal*, Vol. 17, No. 3, pp. 130-137.
- Oxner, T. H., and J. Kusel. (1996). Trends in the job market. *Internal Auditor* 53 (3): 20-27.
- Oxner, T. H., and K. Oxner. (2006). Boom time for internal audit professionals. *Internal Auditor* 63 (3): 50-57.
- Paape, L., Scheffe, J. and Snoep P. (2003), The relationship between the internal audit function and corporate governance in the EU – a survey, *International Journal of Auditing*, Vol. 7, pp. 247-262
- Pandey I.M. (1995). *Financial Management*, (7th Revised Edition), Vikas Publishing House.
- Plumlee, R. D. (1985). The Standard of Objectivity for Internal Auditors: Memory and Bias Effects. *Journal of Accounting Research* vol.23 (2). Retrieved from <http://www.jstor.org> on 20<sup>th</sup> March 2012.
- Ramaswamy M.S. (1994). *Auditing* (4th Edition). Sanjay Printers, Snandara
- Rezaee, Z. and Farmer, L. E. (1994), 'The changing role of the audit committee,' *Internal Auditing*, 10(4) Spring: 10-20.
- Sarens, G. And I. de Beelde. (2006). The relationship between internal audit and senior management: A qualitative analysis of expectations and perceptions. *International Journal of Auditing* 10: 219-241.
- Sawyer, I. (1988), *Sawyer's internal auditing; the practice of modern auditing* Altamonte Springs, Fla: The Institute of Internal Auditors.
- Scarbrough, D. P., Rama, D. V. & Raghunandan, K. (1998). Audit Committee Composition and Interaction with Internal Auditing: Canadian Evidence. *Accounting Horizons*, 12 (1), 51-
- Schneider, A. (2003). An Examination of Whether Incentive Compensation and Stock Ownership Affect Internal Auditor Objectivity. *Journal of Managerial Issues*, 15 (4), 486-497.
- Scott, W.R. (1987). The adolescence of institutional theory, *Administrative Science Quarterly*, 32: 493-511

- Selim, G., S. Sudarsanam and M. Lavine, (2003). The role of internal auditors in mergers, acquisitions and divestitures: an international study. *International Journal of Auditing*. 7 (3): 223-246.
- Shamira Hussein ,(2004), The effect of audit committees on major disclosures and other non financial characteristics of companies listed in NSE, unpublished study.
- Vanasco, R, R, Skousen, C, R & Santagato, L, R (1997) *Auditor Independence: An International Perspective*, *Managerial Auditing journal*, retrieved from <http://www.ukessays.com/custom-essays/auditor-independence-enron.php> on 19th March 2012.
- Van peurse, K.A (2004) internal Auditor's role and authority. New Zealand evidence, *managerial auditing journal*.
- Van Peurse,K.A. (2005), Conversationswith InternalAuditors – The Power of Ambiguity, *Managerial Auditing Journal*, 5: 489–512.
- Venasco, R.R. (1996). Auditor independence, An international perspective, *managerial Auditing journal*, Vol.II No.9,pp – 4 -48
- William F. Messier, Jr, (2011). The Effect of Using the Internal Audit Function as a Management Training Ground on the External Auditor's Reliance
- Zain, M. and Subramaniam, N. (2007), Internal auditors perceptions on audit committee interactions: A qualitative study in Malaysian public corporations, *Corporate Governance*, 15(5) September: 894-907

## **APPENDICES**

### **APPENDIX I : LETTER OF INTRODUCTION**

MARY N MUGWE  
UNIVERSITY OF NAIROBI  
P.O BOX 46372 – 00100  
NAIROBI.

Dear respondent

I am a master of business administration (MBA) student in the University of Nairobi. In partial fulfillment of the post graduate degree programme, I am undertaking a research study on the relationship between independence and objectivity of the internal audit function and Earnings per share in companies listed in NSE in Kenya.

I would highly appreciate if you could kindly spare some time to complete the questionnaire attached. The results of the report will be used solely for academic purposes and will be treated with utmost confidence.

Thanks in advance

Yours faithfully,

Mary Mugwe

## APPENDIX II : INTERNAL AUDIT QUESTIONNAIRE

### PART ONE: GENERAL INFORMATION

1. Name of your company  
.....
2. What is the industry classification of your company? (please tick one)  
 Agricultural  commercial and services  
 Manufacturing and allied  telecommunication and technology  
 Energy and Petroleum  insurance  
 Banking  Investment  
 Construction and allied
3. 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
4. Your position in the organization.....
5. What your academic qualifications?  
 PHD  MBA  Bachelors degree  CPA (K)  
Others (specify please) .....
6. 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
7. Are you a member of any professional body?  
 ICPAK  IAA  
 Others (please specify) .....

### PART TWO

8. Does your company have an Internal Audit Committee?  
 Yes  No
9. How many members are there in the Audit Committee?.....
10. 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 .....
11. How many of the Audit Committee members are professionally qualified accountants?
- All are qualified accountants
- None of members are qualified accountants
- Others (please specify) .....
12. What is the level of internal audit committee involvement relative to its role with the internal audit function?
- .....
- .....
13. To whom does the internal audit department report 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).....
14. To whom does the internal audit department report administratively?
- CEO  CFO  CEO and BOD  AC  Co. Sec
- Others (please specify).....
15. Who is mandated to appoint, dismiss and evaluate the head of the internal audit function?
- CEO  CFO  CEO/CFO  AC  AC/BOD/CEO  AC/CFO
- AC/CEO
16. Is the CAE regularly invited to the audit committee meetings?
- Strongly Agree  Agree  Neither Agree or disagree  Disagree  strongly disagree
17. Does the CAE have regular private contacts with the audit committee (chair/ or individual members)?
- Strongly Agree  Agree  Neither Agree or disagree  Disagree  strongly disagree

18. Does the audit committee give input to the internal audit planning?  
 Strongly Agree  Agree  Neither Agree or disagree  Disagree  strongly disagree
19. The management allows you to follow up on your recommendation.  
 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. Who approves the internal audit budget?  
 Audit Committee  
 Board of Directors  
 Chief Executive Officer  
 Chief Financial Officer  
 Audit Committee and CEO  
 Audit Committee and the Board  
 Audit Committee and Chief Financial Officer  
 Board, Chief executive Officer and Chief Financial Officer  
 Audit Committee and Company Secretary  
 Others, (please specify) .....
23. Does the CEO give input for the internal audit planning?  
 Strongly Agree  Agree  Neither Agree or disagree  Disagree  strongly disagree
24. Does the CFO give input for the internal audit planning?  
 Strongly Agree  Agree  Neither Agree or disagree  Disagree  strongly disagree
25. The internal audit staff are rotated to other departments in your company.

- Strongly Agree  Agree  Neither Agree or disagree  Disagree  strongly disagree
26. 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
27. 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
28. 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
29. Is it common for internal auditors to move to other functions within the company?
- Strongly Agree  Agree  Neither Agree or disagree  Disagree  strongly disagree
30. Internal auditors are highly involved in establishing internal control system in your organization.
- Strongly Agree  Agree  Neither Agree or disagree  Disagree  strongly disagree
31. Internal auditors are always involved in reviews of the internal control system.
- Strongly Agree  Agree  Neither Agree or disagree  Disagree  strongly disagree
32. The internal auditor is involved in training of staff.
- Strongly Agree  Agree  Neither Agree or disagree  Disagree  strongly disagree
33. Do people within the organization perceive internal audit as their partner?
- Strongly Agree  Agree  Neither Agree or disagree  Disagree  strongly disagree



## **APPENDIX III: COMPANIES LISTED IN NAIROBI STOCK EXCHANGE**

### **AGRICULTURAL**

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

### **COMMERCIAL AND SERVICES**

1. Express Ltd
2. Kenya Airways Ltd
3. Nation Media Group
4. Standard Group Ltd
5. TPS Eastern Africa (Serena) Ltd
6. Scan Group Ltd
7. Uchumi Supermarket Ltd
8. Hutchings Biemer Ltd
9. Longhorn Kenya Ltd

### **TELECOMMUNICATION AND TECHNOLOGY**

1. Access Kenya Group Ltd
2. Safaricom Ltd
3. CMC Holdings Ltd
4. Car and General (K) Ltd

5. Sameer Africa Ltd
6. Marshalls (E.A) Ltd

### **BANKING**

1. Barclays Bank Ltd
2. CFC Stanbic Holdings Ltd
3. Diamond Trust Bank Kenya Ltd
4. Housing Finance Co. Ltd
5. Kenya Commercial Bank Ltd
6. National Bank of Kenya Ltd
7. NIC Bank Ltd
8. Standard Chartered Bank Ltd
9. Equity Bank Ltd
10. The Co-operative Bank of Kenya Ltd

### **INSURANCE**

1. Jubilee Holdings Ltd
2. Pan Africa Insurance Holdings Ltd
3. Kenya Re-insurance Corporation Ltd
4. CFC Insurance Holdings
5. British –American Investments Company (Kenya) Ltd

### **INVESTMENT**

1. City Trust Ltd
2. Olympia Capital Holdings Ltd
3. Centum Investment Co Ltd
4. Trans-Century Ltd

## **MANUFACTURING AND ALLIED**

1. B.O.C Kenya Ltd
2. British American Tobacco Kenya Ltd
3. Carbacid Investments
4. East African Breweries Ltd
5. Mumias Sugar Co. Ltd
6. Unga Group Ltd
7. Eveready East Africa Ltd
8. Kenya Orchards Ltd
9. A. Baumann Co Ltd

## **Construction and Allied**

10. Athi River Mining
11. Bamburi Cement Ltd
12. Crown Berger Ltd
13. E.A Cables Ltd
14. E.A Portland Cement Ltd

## **Energy and Petroleum**

15. Kenolkobil Ltd
16. Total Kenya Ltd
17. Kengen Ltd
18. Kenya Power & Lighting Company Ltd

## APPENDIX IV: SUMMARY OF OTHER STUDIES

**Table I. SUMMARY OF OTHER STUDIES DONE IN THE AREA**

Author	Title	Objectives	Methodology & gaps
Christopher, Sarens, and Leung (2009)	A critical analysis of the independence of the internal audit function.	Aims to critically analyze the independence of the internal audit function through its relationship with management and the audit committee	Survey Identified a number of threats to independence including having the CEO or CFO approve the internal audit budget and being involved in the audit plan, not reporting functionally to the AC, the AC not having sole responsibility for appointing and dismissing the CAE and a lack of AC accounting expertise.
Selim, Woodward and Allegrini (2009)	An examination of the internal audit objectivity role of internal auditors in mergers, acquisitions and divestitures	Aims to provide a comparison of the nature, extent and consequences of definitional change on internal audit consulting activities undertaken by UK/Ireland and Italian internal auditors	Conducted a Survey and Found that internal auditors in both jurisdictions are involved in risk management and governance; UK/Ireland internal auditors are more involved in project management and disaster recovery while Italians are more involved with legislative compliance. There was mixed support for concern about whether involvement in consulting compromises objectivity.
Ahlawat and Lowe (2004)	An examination of the internal audit objectivity	Examines whether the consulting role of internal auditors impacts on their ability to remain objective	Experimental questionnaire Significant advocacy existed in the judgement of both in-house and outsourced internal auditors.
Schneider (2003)	Examination of whether incentive compensation and stock ownership affect internal audit objectivity	Exploratory study that attempts to determine whether incentive compensation and stock ownership affect internal auditors' objectivity. This is assessed through the internal auditors' decision on whether to report a GAAP violation.	Focused on the consulting activities only.  Experimental questionnaire Stock ownership did not affect the internal auditors' reporting decision. When

<p>Brody and Lowe (2000)</p>	<p>The new role of the internal auditor</p>	<p>Explores whether internal auditors view their consulting role as one in which they are able to provide objective feedback to management or one in which they are to provide solutions that they believe are in the best interests of their company. Examines whether internal auditors' judgments are dependent on their company's role (buyer or seller) in an acquisition.</p>	<p>incentive compensation was tied to stock prices a significantly higher percentage of internal auditors would not report the GAAP violation than when the compensation was tied to earnings or when it was fixed salary. The study focused on the compensation and not other factors that affect independence.</p> <p>Experimental questionnaire Internal auditors are likely to assume the position that is in the best interests of their employer. Provides evidence of the consulting role of internal auditors impairing their objectivity.</p>
<p>Nagy and Censer (2002)</p>	<p>An assessment of the newly defined internal audit function</p>	<p>Interviews gained an assessment of internal audit in the following four areas of audit scope, organizational structure, risk management and AC. The assessment was in terms of changes in the internal audit department over a ten-year time frame.</p>	<p>Interviews Found a definite shift in the role of internal audit towards more operational activities; the new internal audit definition reflected current practice</p>
<p>DeZoort, Houston and Reisch (2000)</p>	<p>Compensation for internal auditors</p>	<p>Examines the existence, nature, frequency and consequences of incentive- based compensation plans for internal auditors.</p>	<p>Survey Incentive-based compensation plans were found to be available to almost half of respondents. The most common types of plans involved bonuses based on overall company performance, internal audit performance and individual performance. Respondents perceived a</p>
<p>Paape, Scheffe and Snoep (2003)</p>	<p>Relationship between the internal audit function and corporate</p>	<p>Examines the relationship between the internal audit function and corporate</p>	<p>Respondents perceived a</p>

<p>Christopher, Sarens, and Leung (2009)</p>	<p>governance.</p> <p>Independence of the internal audit function.</p>	<p>governance among the top listed companies in the European Union</p> <p>Aims to critically analyze the independence of the internal audit function through its relationship with management and the audit committee. Explores the extent to which publicly traded, middle-market companies employ high quality independent internal auditors in the post-SOX era.</p>	<p>number of advantages of incentive-based remuneration but the key disadvantage was impairment of objectivity/independence.</p> <p>Survey Not all top listed EU companies have an IAF or an AC. Less than half of the respondents report to the AC. ACs generally meet four times a year. ACs are not always involved in the appointment and dismissal of the CAE. A significant percentage of respondents (28%) believe they aren't required to adhere to the Standards for the Professional Practice of Internal Auditing. Not all CAE's were aware of CG recommendations/regulations. The study was focused on EU companies only.</p>
<p>Dickins and O'Reilly (2009)</p>	<p>The qualification of the internal auditors</p>	<p>Explores the extent to which publicly traded, middle-market companies employ high quality independent internal auditors in the post-SOX era.</p>	<p>Survey Threats to independence included considering the internal auditor as a "partner" with management.</p>
<p>Sarens and De Beelde (2006b)</p>	<p>The relationship between internal audit and senior management</p>	<p>Describes and compares how internal auditors perceive their current role in risk management with US and Belgian companies</p>	<p>Survey Found that 89% of CAEs have compensation structures that include stock-based rewards or bonuses based on operating results. Focused mainly on the qualifications of the internal auditor in companies</p>
<p>Gramling and Myers (2006)</p>	<p>Internal audit's role in ERM</p>	<p>Examines the extent to which internal audit functions adhere to the ERM roles recommended by the IIA.</p>	<p>In the US cases, internal auditors provide valuable input to the internal a control review and disclosure</p>

<p>Fraser and Henry (2007)</p>	<p>Embedding risk management, structures and approaches.</p>	<p>Examines mechanisms for the identification and management of critical risks and also identifies what the role of internal audit and the audit committee should be in risk management.</p>	<p>requirements of SOX. In the Belgian cases, internal auditors play a pioneering role in the creation of a higher level of risk awareness and a more formalized risk management system. The study focused on the US and Belgium countries only.</p> <p>Survey found internal audit's role in core ERM roles could be extended as it is less than the department would prefer. Also found that IA's involvement in inappropriate activities is greater than it should be. Focused on ERM activities only.</p>
<p>Ahlawat and Lowe (2004)</p>	<p>Impacts of consulting activities on the objectivity of the internal auditor</p>	<p>Examines whether the consulting role of internal auditors impacts on their ability to remain objective and whether an outsourced internal audit function is susceptible to client advocacy.</p>	<p>Interviews Found that internal audit did have a role to play in risk management. However, due to expertise and independence issues it is recommended a separate risk function should be set up. Also found AC are increasingly involved in risk management but also recommends a risk committee be set up with the time and expertise to direct risk management. Has not specified to what extent.</p>
<p>Goodwin and Yeo (2001)</p>	<p>Two factors affecting internal audit independence and objectivity</p>	<p>Examines whether the use of internal audit as a management training ground influences the independence and objectivity of internal auditors.</p>	<p>Experimental questionnaire Found the extent of client advocacy was less severe in the case of outsourced internal auditors, as opposed to in-house auditors.</p>
<p>Christopher, Sarens and Leung (2009)</p>	<p>Analysis of the independence of the internal audit function through its relationship with management and the audit committee</p>	<p>Aims to critically analyze the independence of the internal audit function through its relationship with management and the audit committee</p>	
<p>Keitany J. L. (2000)</p>	<p>The internal audit control function and its implication for risk assessment by the</p>	<p>Function of the internal audit control and implication of the internal audit to risk management and reliance by the</p>	<p>Survey Found that the internal auditor function is used quite extensively as a management training ground. Some 32% of</p>

<p>Shamira Hussein (2004)</p>	<p>external auditor. A case of quoted companies</p> <p>The effect of audit committees on major disclosures and other non financial characteristics of companies listed in NSE</p>	<p>external auditor.</p> <p>The effect of the audit committee on disclosure of information</p>	<p>respondents believed that the practice could impair internal audit objectivity.</p> <p>Survey Found that, in 50% of cases, internal audit staff are transferred to management positions. In 60% of companies, employees remain in internal audit for less than four years</p>
<p>Charles Wanyoike Kibara (2007)</p>	<p>A survey of internal auditor's risk management practices in the banking industry in Kenya.</p>	<p>Risk management practices by internal auditors in the banking industry in Kenya.</p>	<p>The study focused on the risk assessment by the external auditor i.e. reliance of the internal audit work by the external auditor</p>
<p>Jonathan Koome (2009)</p>	<p>A survey of the role of the internal auditors in enterprise wide risk management for listed companies in Kenya (industrial and allied sectors)</p>	<p>The role performed by the internal auditor in risk management.</p>	<p>The study focused on the audit committees' on disclosures. And did not focus on their other contributions in the internal audit function.</p> <p>Survey The study focused on the risk management in the banking industry only and has not focused on other sectors.</p> <p>Survey Focused on the role of internal auditor's role in risk management. And did not focus on the threat of independence and objectivity in achieving their goals.</p>