

**THE EFFECT OF INTERNAL AUDIT ON FINANCIAL PERFORMANCE OF
MICROFINANCE INSTITUTIONS IN KENYA**

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DECLARATION

I, the undersigned, declare that this is my original work and has not been presented to any institution or university other than the University of Nairobi for examination.

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DEDICATION

I dedicate this research project to my parents, Naushad and Kinya, and to my brother Faiz.
May this project be a source of inspiration and may it make you proud.

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LIST OF ABBREVIATIONS

DTM	Deposit Taking Microfinance
FC	Firm Characteristics
FSA	Financial Services Association
MFI	Micro Finance Institutions
NBFI	Non- Banking Financial Institution
NGO	Non Governmental Organization
OLS	Ordinary Least Squares
ROA	Return on Asset
ROE	Return on Equity
ROI	Return on Investment
ROSCA	Rotating Savings and Credit Associations
SACCO	Savings and Credit Co-operatives
SPSS	Statistical Package for Social Sciences
VIF	Variance Inflation Factor
WRMA	Water Resources Management Authority

ABSTRACT

This current study's objective was to determine the effect that internal audit has on financial performance of microfinance institutions in Kenya. The study measured internal audit using internal audit standards, independence, professional competence and internal audit control. A descriptive research design was adopted. The study's population constituted of 55 microfinance institutions and a census approach was adopted. Data was collected from both primary and secondary sources. Questionnaires were administered to collect primary data while secondary data was obtained from the annual financial statements of the microfinance institutions. From the questionnaires distributed, there was a response rate of 83.64%.

Statistical Package for Social Sciences (SPSS), was used to analyze the data gathered. Mean and standard deviation were the descriptive statistics used to analyze the data. Regression analysis and correlational analysis were the inferential statistics utilized to establish the relationships between the dependent and the independent variables. Tables and graphs were used to present the findings.

The research findings showed that independence of internal audit, internal audit standards, and professional competence had a positive relationship with MFI's financial performance. It was established that internal audit accounted for 28.4% of the financial performance of MFIs. At 0.05 significance level, only independence of internal audit was statistically significant. The study therefore concluded that internal audit had an effect on MFI's financial performance as supported by a significance value of 0.007. The study recommended that MFIs should be sensitized on the importance of internal audit independence in order to improve financial performance and to have reliable financial reports. MFIs should also employ competent internal auditors and remunerate them fairly to improve the quality of the internal audit reports. The study recommends that a similar study be carried out in commercial banks offering microfinance services so that there can be comparison and generalization of the findings in this study.

CHAPTER ONE: INTRODUCTION

1.1 Background of Study

Internal audit has been recognized as an elementary administrative scheme comprising principally of examining documents, reviewing operations and presenting to the panel of executives, board or external auditors since history. Internal audit had been known to enhance the objectives and discussions within and without the organizational departments which in turn enhanced the value within the organization (Raja, 2002). Management is obliged to increase or maximize shareholders' wealth while displaying competence in the performance of its duties. Internal audit therefore checks on this performance in accordance with modern day practices due to the amalgamation of diverse forces which led to a quiet revolution of the profession. Companies presently require immense capability from internal audit, in light of inadequate capital, to display enhanced competence in identifying and mitigating risks.

The expansion of technology has enabled internal audit to monitor and examine facts with intensified rapidness, thereby improving the internal audit sector. Making changes to an existing internal audit department can be an important undertaking as it differs among organizations. The transformation from simply establishing and observing rules and regulations, to accurately delivering additional significance requires numerous organizational changes. According to Ramamoorti (2003), various microfinance institutions pay their staff poorly hence making them unenthusiastic, have weak ethical standards and their governance practices are unproductive emerging into asset mismanagement.

There is an apprehension in the entire world whether the internal audit function has the capability to grant hitherto, divergent benefits to an organization in achieving its objectives. This latent deviated into a provocation and resulted into actualization of the meaning of internal audit by the Institute of Internal Auditors (the IIA). According to Basel Committee (2002) microfinance institutions have come to an understanding that internal audit is significant in enhancing supervision of resources in the microfinance institutions conveying an enhanced fiscal performance of microfinance institutions.

There are various theories that try to explain internal audit's importance to an organization. The agency theory which is the overarching theory, makes the assumption that separation of ownership and management leads to transparency in internal audit function. The contingency theory states that internal audit is most effective when it is matched with the financial risks inherent to the nature of the organization. The stakeholder theory identifies stakeholders and defines performance outcomes as the defined satisfaction measure. These theories have been further discussed under literature review.

Ondieki (2014), investigated the effect internal audit had on commercial banks' financial performance in Kenya. He observed that internal audit practices and financial performance had a positive relationship. The study focused on internal controls, internal control standards, independence of internal audit and professional competency. It is against this backdrop that the current study will be focusing on the Microfinance Institutions in Kenya and investigate whether similar findings will be replicated.

1.1.1 Internal Audit

The acceptable definition according to IIA (2016) of internal audit revolves around objective assurance, independence and consultative designed activities that add value to the overall operations of the organization. The central reason for internal audits is to help managing executives in the effective performance of their tasks by providing them with scrutiny, evaluation, approvals and relevant observations regarding the undertakings appraised (Okezie, 2004).

According to Messier (2011), internal audit function occupies a significant part of the organizational structure of in-house control. This facilitates effective internal auditing and reporting with assurance of highest possible level of review and appraisal of various activities in an organization. The reputation whether bad or good is solely determined by internal audit level of performance which implies that the auditing functions evaluate performance to improve services (Sarens, 2006).

According to Hutchinson and Zain (2009), internal audit is a significant part of the control arrangements in a firm and corporate governance involves oversight undertakings by the audit committees and the panel of executives to ensure that financial reporting practice is sound and up to the mark. From prior years, internal auditors were just part of employees in accounting department before their services were realized to be critical in service oriented management aspects (Hutchinson & Zain, 2009). According to Beyanga (2011), internal audit may play a greater role in achieving the expectations of an organization by using strategic methodologies for determining and refining the usefulness and proficiency of the governance procedures of organizational threats and how they can be controlled.

The operationalization of internal audit, according to IIA (2016) includes the standards of internal audit, auditor independence, internal controls and competence in performing their professional duties. The adherence to internal audit standards are crucial in boosting the effectiveness of the process according to the publication of IIA (2008) including aspects such as attribute, implementation standards and performance. Further it is argued that the auditor is supposed to be independent of both the personnel related and operational related activities within the firms. This is with the aim, of not compromising the opinions of the auditor in terms of integrity, recommendations and conclusions. Also according to KPMG (2015) on detection of fraud, competence in performing professional duties is a key consideration. Further the designed systems within the firm should adhere to the internal checks in line with the internal control function which includes organizing, directing, planning and controlling program operations and the systems put in place to report, measure and monitor performance of this program (Esmailjee, 1993).

1.1.2 Financial Performance

Microfinance institutions' performance in the market can be scrutinized at both micro and macro levels (Muga, 2012). Profit generation is the crucial prerequisite of an aggressive microfinance association and the nominal source of finance at the micro level. However, it is not simply a consequence, it is an essential for thriving microfinance institutions in the face of emerging rivalry in the financial market. At the macro level, a cost effective microfinance section is superiorly able to endure pessimistic shocks and accord firmness to the financial structure. High profits may possibly endorse financial stability of microfinance institutions and its security as it provides an essential foundation of equity particularly if re-invested into the company.

Return on assets (ROA), the return on equity (ROE) and Return on Investment (ROI) are the three mentioned accounting –based performance models (Schiuma, 2003). These are extensively used to appraise the performance of industries as well as microfinance institutions. The directors of the microfinance institutions and analysts adopt ROA and ROE to evaluate firm’s performance and anticipate trends in the industry. They will input financial data in numerical schemes to forecast the institution’s deficiencies and an array of supplementary purposes where a computation of prosperity is preferred. The key aim of this research was to evaluate if internal audit can essentially improve microfinance institution’s financial performance.

1.1.3 Internal Audit and Financial Performance

Internal audit is a valuable instrument for management in progressing development geared towards improving financial performance (Beyanga, 2011). Internal auditors assist to govern a firm more effectively and efficiently to enhance the shareholders’ wealth. In conclusion, Hermanson and Rittenberg (2005) vindicated that the subsistence of a successful internal audit function is connected with exceeding managerial performance.

According to KPMG (2015) internal audit may result to improved financial performance through strict adherence to its auditing aspects. Internal audit standards will lead to improved financial performance as a result of auditors carrying out the functions within the criteria approved, being professional and objective for improved risk management (Fadzil et al, 2005). Through independence of internal auditors, financial performance can be improved since the auditors are independent from the activities which they evaluate and must likewise be independent from the routine internal control processes and perform their activities objectively and impartially without conflict of interest.

The internal motivation, competence in performing duties professionally as well as systematic professional development of each internal auditor are essential factors for the right functioning of the general internal audit department of any firm thus leading to improved performance (Beyanga, 2011).

The objectives related to internal audit control are associated with management methods, management plans and those procedures that meet the goals, mission and objectives coupled with overall performance. Hence internal audit, which acts as a supervisory body can save the institute from negligence and irregularities hence pushing the business to attain high levels of outputs and profits (Institute of Internal Auditors, 2016).

From the findings of the studies mentioned, we expect internal audit and financial performance to have a positive relationship in Microfinance Institutions in Kenya.

1.1.4 The Microfinance Institutions in Kenya

Kenya's microfinance industry has grown significantly over the last twenty five years, comprising different types of Microfinance institutions (MFIs) with varying legal structures and ownership structures. The entry of many institutions into the sector coupled with the transformation of the original players from NGO status to deposit taking microfinance institutions has created an intensely competitive environment. Competition is further realized from established commercial banks offering similar products (Waweru & Spraakman, 2012). In fact, Kenya's microfinance industry is among the oldest and most established in Africa (Hulme, Kashangaki, & Mugwanga, 1999).

Kenya's MF sector comprises providers who vary in their legal structure, mission, methodology and sustainability and include Microfinance Banks, Commercial Banks

(focus on micro-finance), non-banking financial institutions (NBFIs), Deposit Taking MFIs (DTMs), Credit only MFIs, Wholesale Micro-finance Lenders, Developmental Institutions, Insurance companies, Savings and Credit Cooperatives (SACCOs), Rotating Savings and Credit Associations (ROSCAs), Financial Services Associations (FSAs) and local money lenders (Ali, 2015). This is an indication of a competitive sector.

Kenyan MFIs are further characterized by their level of formalness or ownership structure, where the formal MFIs' operations are subject to general laws, banking regulation and supervision while semi-formal MFIs are registered but not subject to bank regulation and supervision (Ayele, 2014).

With the rise in competition, there is an increased risk of unethical lending practices and loan pricing among the microfinance institutions which leads to an increased need for internal audit to check on these practices in order to enhance accountability and transparency in reporting of financial performance.

1.2 Research Problem

The internal audit function gauges the usefulness of microfinance firms in accomplishing approved objectives and in implementing recommendations made by internal audit for improvement of their risk management, control and governance processes (Van Gansberghe, 2005). The internal audit function offers an unfailing, impartial and objective service to the directors of the board, management and the audit committee whereas the stakeholders are more concerned on ROI, growth, sustainability, leadership and the reporting that can rely on the financial performance.

Various studies have been done regarding the influence of internal audit on financial performance. Hutchinson and Zain (2009) while exploring the association between quality of internal audit performance of the firm and return on equity (ROE) in Malaysia, depicted the association between quality of internal audit and the performance of firms. Opportunities that result to high growth are further increased by the independence of the audit committee. Also Salih (1983) while evaluating the internal controls at Ethiopian Airline's Nairobi branch alluded that the lack of separation of custodian and accounting functions was a weakness within the branch that affected service delivery to customers and increased costs.

Locally Otieno (2012) studied the enforcement of corporate authority on financial performance of Kenya's microfinance institutions and posited that corporate governance acts as a crucial role on microfinance institutions steadiness, presentation and the institution's capacity to grant liquidity in complex market conditions. 22.4% of microfinance institution's financial performance was attributed to corporate governance factors, according to the findings. Akenga (2011) studied about benchmarking and performance in microfinance institutions, and found that internal audit is important in benchmarking the firm's financial utilization aspects. Gaturu and Ngahu (2015) studied the effect that computerized audit systems had on financial management at Water Resources Management Authority in Nairobi County. Their study found that financial management at WRMA was influenced by internal controls and the use of computer-assisted audit techniques.

Most of the reviewed studies have glaring methodological weaknesses. It is evident that majority of the studies relied on qualitative approaches and lacked robust statistical tests

on the relationships among studied variables. Further, some of the studies such as Gaturu and Ngahu (2015) did not specify and justify their research designs and the sampling procedures used.

The existing studies have also not explored, under the conceptual discussion, the influence of factors such as internal audit standards, the independence of the audit department staff, professional competence and internal control mechanisms in the context of MFIs in Kenya. This leads to this study's primary contention by answering the research question; what effect does internal audit have on the financial performance of MFIs in Kenya?

1.3 Research Objective

To determine the effect that internal audit has on financial performance of MFIs in Kenya.

1.4 Value of the Study

The function of internal audit in microfinance institutions will be made effective and professional through the study as it will assist the shareholders realize the role of internal auditors as a significant managerial control system in the firm since it safeguards their interests.

Through actualizing recommendations given through internal audit reports, management will be able to improve on the performance of microfinance institutions, since it will view internal audit as an independent function.

For researchers, this study will contribute to existing theory by expanding knowledge on internal audit practices that comply with professional standards such as International Standards on Audit and also provide a basis for future research based on the research findings by identifying and filling research gaps.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

The chapter is dedicated to reviewing theoretical foundations that underpin the arguments of the study and reviews literature relating to the study objectives to be tested. The sources of literature will include academic journals, books and articles that relate to the study attributes. The chapter concludes with the proposed conceptual model that will guide empirical research.

2.2 Theoretical Foundation

The theories, pertinent to internal audit and financial performance reviewed in this study are; agency theory, stakeholder theory and contingency theory. These are as discussed below:

2.2.1 Agency Theory

This theory, which is also the overarching theory, is based on the assumptions and philosophy that separating ownership and management leads to transparency in audit. It's the most discussed theory in finance as far as internal audit is concerned (Shleifer&Vishny, 1997). The theory is based on the argument that audit functions minimize the problems that may arise due to principals who are the owners and stakeholders of the firm, and the agents who are the management undertaking the assigned roles within the managerial spheres of the firm (Kinuu et al., 2012). The other theory's assumption is that agency costs led to design of audit practices that are applied by firms to mitigate any agency problems that may arise. Therefore, good auditing practices adopted by the firm mean the enhancement of transparency in operations leading to better financial performance.

The associated critique on agency theory is the neglect of the institutional perspective upon which the operations of audit practices and system takes place through a fixed set of strict hypotheses; thus the argument of rational adoption of best auditing practices through theoretical background within the confines of the differences in the firm's operations. The decisions of internal audit give limited room to solving the associated challenges affecting various stakeholders, which leads to results that are not fully conclusive. This paper tries to investigate this area more deeply by integrating the agency theory with stakeholders' involvement particularly focusing on the best internal audit practices under which microfinance institutions operate.

2.2.2 Contingency Theory

Kaplan and Mike (2014) advanced contingency theory which posits that internal audit may be more effective when matched with the inherent nature of the organizational financial risks experienced. The essence of a contingency theory in internal audit would be, to find a 'fit' between contingent factors and firms' internal audit management practices and establish propositions of fit that will result in desired outcomes. According to the theory, firms embrace focusing on financial risks from the beginning and establishing a separate process to check organizational resilience to these risks, whereas others keep their financial risk management function that initially isolates itself from the other line of business units.

However the more financial risk function begins to accumulate business-relevant expertise and risks, they begin to integrate internal audit function to the business functions (Hammond et al., 2006). The theory concludes that to effectively manage financial risks, it depends on a contingent of organizations' circumstances and context (Kaplan and Mike, 2014). Seemingly, the theory still requires empirical data especially in the different context

of internal audit in microfinance institutions in Kenya. Additionally, the combination of internal audit functions with other variables is necessary to strengthen this theory. This theory guides the conceptualization of internal audit and its influence on Kenya's microfinance institution's financial performance.

2.2.3 Stakeholder Theory

The theory identifies stakeholders and defines performance outcomes according to Hilt (1998) as the defined satisfaction measure. It is a theory on organizational management and business ethics that seeks to address values and morals in managing an organization. The theory assumes that employees, shareholders, suppliers and customers are primary stakeholders while government, trade associations and political groups and more so, communities are secondary stakeholders and have an indirect relationship with the firm (Clarkson, 1995). Hilt (1998) provides the best way of identifying relevant stakeholders as: legitimacy surrounding claims of stakeholder, the power of the stakeholders over the firm and the urgency of the stakeholders' demands.

The critiques of the stakeholder theory opine that, the analytical focus on how to resolve internal auditing challenges is too narrow and the shareholders are not the only ones who make investments in the firm. The firm will therefore be affected by the relationships among the various stakeholders and the environment it operates in. The theorem is based on a common set of strict hypotheses which mostly ignores the firm's context in which the stakeholders have the upper hand. Thus, it imparts a theoretical background to the decisions of the stakeholders which may be irrational depending on the context of the decision. Since financial performance and internal audit is important to different stakeholders including the owners, government and communities at large, this theory will add knowledge on the

study findings on how these stakeholders can benefit through strict adherence to internal audit as a prerequisite to better financial performance. The shareholders therefore have vested interest to ensure that resources are utilized to the utmost effect and which should reciprocate to the advantage of the society.

2.3 Factors Affecting Financial Performance of Microfinance Institutions

The factors that affect the financial performance of the microfinance institutions include savings portfolio, firm characteristics, loan portfolio and dividend policy as discussed herein.

2.3.1 Saving Portfolio

The need for microfinance institutions to rely on their own operations has necessitated the need for diversifying their products and also consolidating their share of the market which makes them depend less on donor funding and grants from the government. This has been achieved through micro finance institutions tailoring their saving products to reduce unforeseen shocks in an effort to cushion their customers from these unnecessary shocks. This in turn makes customers repay their loans to support these institutions. The different types of products and services associated with MFIs are deposits, savings that are voluntary or compulsory and insurance products.

The customers of MFIs obliged to have savings as a requirement to access their future loans as a value of their savings, form compulsory savings. These mandatory savings can be made possible through a savings accounts kept outside of the microfinance or through a deposit held by microfinance institution itself. On the other hand, the amount of savings held by the microfinance institutions which is not essential for an existing loan is referred

to as voluntary savings; which can either be reserved as a component of the general deposits of the MFI's or held outside of the MFI. The significance of savings services can be ascertained from the perception of the customers and the MFIs as according to the studies of Robinson (2001). Savings services can additionally be an important method for liquidity management to clients through analyzing the rate of return, their convenience to cash, divisibility of savings and collateral.

The three vital reasons why savings are an attractive source to microfinance institutions include; being effortless, achievable and accessible at a low cost, liquidity risks are minimized in comparison to large savings because customers withdraw diminutive amounts of capitals. These small deposits are a stable means of capital as compared to acquiring these funds from the donors or Central Banks. Enhancing deposits from clients lets MFIs advance their operations and also enables them to obtain a strong market demand. Studies made by Robinson (2001) highlighted that savings are vital to the underprivileged as it aids them secure a sustainable finance source and minimize the cost of borrowing these finances.

2.3.2 Firm Characteristics

Organizational behavior literature suggests that firm characteristics (FC) have an influence on how an organization performs. According to Kauser and Shaw, (2004), firms may be characterized by their level of formalization, how centralized decision making is, and the complexity of their organizational structure. In addition, Hoang, Igel, and Laosirihongthong (2010) suggest that firm characteristics like its age, size, industry type, technology adoption and degree of a firm's innovativeness do influence firm performance. Other organizational characteristics said to act as explanatory variables of firm

performance include number of employees, length of time in business (age), location of the business, its structure, control tools and type of ownership (Heffernan & Flood, 2000; van den Bosch, Elving, & de Jong, 2006).

Ryals& Payne (2001) posit that technology is an important element in customer data management. They argue that a company's ability to understand and respond to customers' needs will depend on the type and amount of information held about customers. Appropriate relationship marketing strategies can thus be developed as a result of technology adoption, because the use of IT enables a firm to determine the economics of customer acquisition, customer retention and lifetime value (Ryals& Payne, (2001).

2.3.3 Loan portfolio

The needs of approximately 80 per cent of the poor are essentially derived from biological resources as per the research by Araya and Christen (2004). Because they rely heavily on natural resources for survival, the poor are the most affected by environmental degradation (Hall, et al., 2008). The failure of an income-generating opportunity is due to the over-exploitation of natural resources and its contamination hence the direct translation into losses of the inputs into their diverse activities. The underprivileged households mostly utilize natural resources as a protection to shocks, the amplified vulnerability to natural disasters and the increased conflicts due to insufficient resources. Portfolio quality therefore relates to the MFI's ability to control, monitor and ensure repayment from its clients. The loss of income generating opportunities will lead to reduction in loan portfolio which will in the end affect the performance of MFIs.

Individual loans form the loan portfolio in microfinance institutions because it is the sum of all loans held by a financial company or a bank at any specified day. The economic status of the clients in a certain location and the size of the individual loan will influence the size of the loan portfolio. Loan portfolio poses the greatest risk to MFI's soundness and security since it's the prevalent asset and dominant source of revenue. Loan portfolio in MFIs is most vital since portfolio quality depicts the risk of loan delinquency and establishes future incomes and ability to expand outreach and serve existing clients.

According to a research done by Sindani (2012) he ascertained that majority of the micro finance institutions depend solely on the thriving lending program that relies on loan repayments made by their customers and their funds. This necessitates for a restrictive credit control system to be put in place so as to limit it from redundant lending therefore improving on profitability of micro finance institutions (Kakuru, 2000). Credit management is part of the credit control function that deals with the determination of customers' credit ratings. Rosenberg (2009) argued that client delinquency is considered to be an important correlate of MFI's loan default. The safety and the soundness of any MFI depends on the management of the credit function and the loan portfolio in an effective manner.

The procedure through which risks that are inherent in the credit process are controlled and handled is referred to as loan portfolio management. The expert managers in loan portfolio intensify their efforts in cautiously monitoring loan performance and approving loans. Nawai and Shariff (2010) in their review paper explaining what determines the repayment performance of microcredit programs, highlighted that group lending was an effective measure of loan portfolio management. In order to optimize portfolio value, there needs to

be diversification to reduce risk, acquisition of sufficient funds, proper asset mix to provide growth and efficient operations to optimize cash flows (Wood, 2004).

2.3.4 Dividend Policy

This is the policy that provides regulation and guidelines that a firm employs to make a decision on the payment of dividends to shareholders (Nissim&Ziv, 2001). Dividend, which can be described as the reward given to shareholders in exchange for their risk and investment, is dependent on diverse factors in the organization. Firms ought to allocate their earnings to the investors if they are not able to identify viable investments which would bring superior returns than those anticipated by the shareholders (Mizuno, 2007). The amount of dividends distributed to shareholders or members in cash are made from retained earnings.

A policy to pay regular and extra dividends is adopted by MFIs in the period they accumulate higher profit and thus share extra profit as extra dividends instead of increasing the regular dividend payout ratio. The investment opportunity schedule of the company is therefore achieved by the policy in place in conjunction with the externally raised cost of capital and its target capital structure. Bartram (2009), asserted that free cash flows can be minimized by way of dividend payout to shareholders thereby according managers minimal chances of making suboptimal investments. This avails stockholders with affirmative information which shows that the firm is performing well hence reducing uncertainties. In conclusion therefore, the value of the firm and its performance is improved through higher returns from optimal investments.

2.4 Empirical Studies

2.4.1 Global Studies

Studies by Ljubisavljević and Jovanovi (2011) sampled 200 small and medium firms in the year 2011 showing the role of the internal audit function in Serbian firms. The study applied a questionnaire survey and established that the internal audit's effectiveness was weak. This study however, did not determine the extent to which internal audit had on firms' overall financial performance. The current study considers a conceptualized model of internal audit measures and how each influences microfinance institutions' financial performance in Kenya.

Hutchinson and Zain (2009) focused on internal audit experience and accounting qualification and their effect on the firms' financial performance listed on the Malaysia Bursa in 2003. The study sampled 60 firms and collected data by administering questionnaires and gathering secondary data from annual reports. To test the association between firm performance and its internal audit, a multiple regression was used and suggested that further studies on other factors of internal audit be carried out that may affect firm's performance. From the recommendations, this study seeks to test internal audit standards' effectiveness, the competence of the internal auditors, their independence and the existence of an internal control system on microfinance institutions' financial performance in Kenya.

Prawitt, Smith and Wood (2009) sampled 218 unique companies between the fiscal years 2000 and 2005 in order to estimate an abnormal accrual model comprising of 528 firm-year observations. This study used OLS regression to determine the link between the quality of internal audit (experience and qualification) and earnings management. The

results ended up showing that there exists a link between the experience of internal auditors and earnings management. The current study goes further to include more internal audit measures like professionalism and independence as exhibited among the microfinance institutions in Kenya.

Davidson, Goodwin-Stewart and Kent (2005) in their study, sought to find out the link between internal governance structures and earnings management of Australian firms. The governance structures comprised of the board of directors, the internal audit function and external auditors. A sample of 434 firms listed on the Australian stock exchange during the year 2000, was selected and a broad cross-sectional regression analysis was used to test the association among the independent variables and the dependent variable. The researchers concluded that there was no strong linkage between the choice of external auditors and the role of the internal auditors.

2.4.2 Local Studies

Ndege (2012) studied on factors that determine commercial banks' financial performance in Kenya. The internal audit operations and its recommendation form the foundation for long term prosperity or decline of an organization since the benefits are not only felt in the short term. Management at all levels, should therefore be more aware of the role of internal audit so as to foster organizational efficiency and adequacy to improve its viability. Nevertheless, it seems that negligence has crept in and therefore this study seeks to analyze the influence that internal audit has on financial performance and specifically that of microfinance institutions in Kenya.

Mutua (2012) studied the influence that risk based audits have on commercial banks' financial performance in Kenya using a correlation research design with the target

population being 44 commercial banks operating in Kenya by administering a questionnaire. The study found that risk based auditing influences financial performance of banks and thus should be enhanced, recommending internal auditing standards to be adopted for financial performance to be realized.

Wainaina (2011) evaluated the internal control function of Kenya Polytechnic University College, and used a case study as the research design. This involved examining the College's internal control system, and semi structured questionnaires. Internal controls contributed to an organization having a sound general accounting environment and precise financial and operational records. The study recommended that to preserve a sound system of internal controls, management should assess the risks the college is exposed to, while performing its operations. The current study therefore examines the extent to which each of the internal audit practices influence financial performance.

The role of internal audit on commercial banks' financial performance was studied by Ondieki (2014). The research achieved a positive relationship between financial performance and internal audit practices in commercial banks, recommending that management should adopt effective internal audit practices to increase performance. The current study will examine the internal audit practices and how they influence financial performance of MFIs.

2.5 Research gaps

Studies done both in the global and local context have exhibited contextual, conceptual and methodological gaps. For instance, studies by Ljubisavljević and Jovanovi (2011); Hutchinson and Zain, (2009); Prawitt, Smith and Wood, (2009) were all done in other

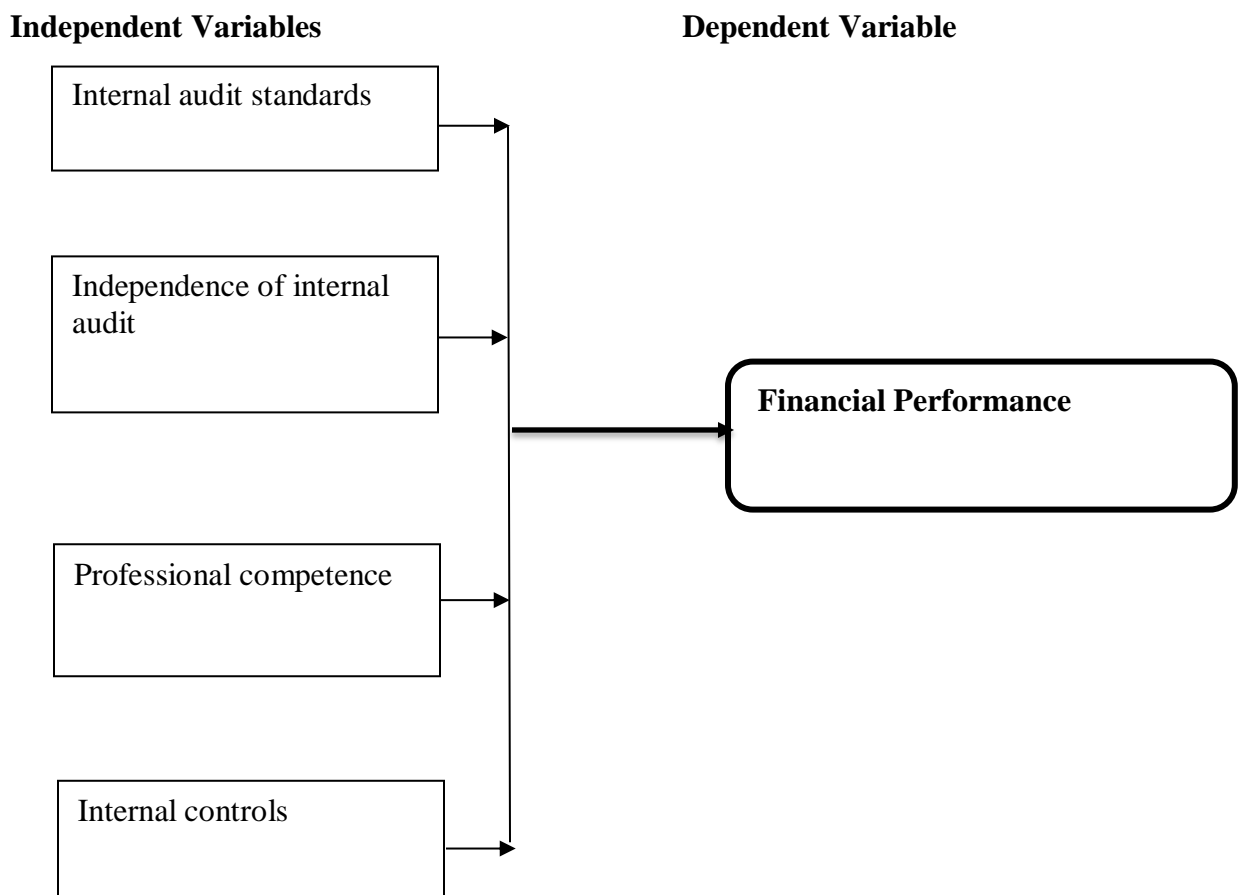
countries which is a different context from the current study which is set to be carried out in Kenya and specifically the microfinance sector. The studies further did not determine the extent to which internal audit has on the overall financial performance of the firm by considering only one or two internal audit practices in a simple regression model resulting to methodological gaps.

The current study considers a conceptualized model of all the four internal audit measures and how each influences microfinance institutions' financial performance in Kenya. The current study will consider testing internal audit standards, internal audit independence, professional competence and internal controls on microfinance institutions' financial performance in Kenya. Ndege (2012) researched on factors that determined commercial banks' financial performance in Kenya. This study had commercial banks as its context as opposed to the current study which aims to consider microfinance institutions in Kenya.

2.6 Conceptual Framework

A conceptual framework explains the relationship among linked concepts and explains the relationship among the variables in the study (Ravitch & Riggan, 2012). The conceptual framework of this research has been developed founded on the literature and empirical reviews. Internal audit has been conceptualized as the independent variable to include indicators such as; internal audit standards, internal audit independence, professional competence and internal controls. Financial performance is operationalized as the dependent variable.

Figure 2.1: Conceptual Framework



Source: Researcher, (2017)

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This particular chapter is set to highlight and discuss the methodology proposed for the study in question. The methodological sections proposed are the design to be employed, population to be targeted highlighting also the methods for data collection and finally analytical techniques to be employed during analysis.

3.2 Research Design

The study will adopt a descriptive cross-sectional design. Information about the subjects that will be gathered represents a snap shot of what is going on at that point in time. The research design is envisaged to offer the researcher an opportunity to collect data across different microfinance institutions and empirically test the relationship of the constructs along its conceptualization. In view of the breath of the study, cross-sectional survey affords the researcher the opportunity to capture data on internal audit and MFI's financial performance in Kenya.

Nachmias and Nachmias (2004) posit that cross sectional studies enable the researcher to establish if significant relationships among variables exist and the strength of these relationships. The research design will be guided by the purpose of the study, the type of investigation, the extent of researcher involvement, the stage of knowledge in the field and the type of analysis. This design has been used successfully by, Mutuku (2012) to perform regression analysis and draw conclusions.

3.3 Target Population

The unit of analysis will be microfinance institutions in Kenya. These institutions are classified into: microfinance lenders who are lenders, those that take deposits and those that are retailers. There are 55 microfinance institutions registered in Kenya (Association of Microfinance Institutions, 2016). A census approach will be used hence the whole population will form the sample.

3.4 Data Collection

Both primary and secondary data sources will be used in this study because they reinforce each other (Saunders et al, 2007). Primary data will be collected through a methodological triangulation method utilizing a questionnaire survey and the interview method. Structured questionnaire will comprise of closed questions developed in line with the objectives and will be administered to internal audit managers or heads of finance where internal audit managers are not available. Secondary data on financial performance will be obtained from quarterly reports and annual reports of microfinance institutions. The data will cover a period of 5 years from the year 2011 to May 2016.

3.5 Data Analysis

This study aims to find the causal effect between internal audit and MFI's financial performance in Kenya. The link between the variables will be established using a bivariate regression analysis. Data will be captured and analyzed using SPSS (Statistical Package for Social Sciences). In addition the test of significance will be done to determine whether the effect will be significant.

Before regression analysis; the data will be cleaned and subjected to the tests of regression assumptions that are made about variables during statistical tests. Statistical procedures to be used in analysis may have some errors and therefore need to be tested. Statistical analyses which use regression, analysis of variance, t-tests and correlation are based on the assumption that data set is normally distributed, there is no multicollinearity and the data is homoscedastic. Normality tests allow for inferences about the population since it establishes if a data set is well-modelled by a normal distribution. Linearity establishes that the data to be used for analysis is sampled from a population that relates to the variables of interest in a linear manner, lack of multicollinearity ensures stability of results. It is carried out primarily to avoid the problem of multiple counting, brought about when a researcher uses the same type of information more than once with different variables which is common in technical analysis, whereas homogeneity which is carried out to establish the significance of the variance of the variables used in the study, ensures that standard errors are not over or under-estimated.

In order to test for normality, the Shapiro-Wilk test will be used. To test for multicollinearity, tolerance and Variance Inflation Factor (VIF) will be used where tolerance of less than 1 indicates lack of multicollinearity, Variance Inflation Factor (VIF) greater or equal to 5 shows multicollinearity is a problem, over 15 indicates possible multicollinearity problems whereas over 30 indicates serious multicollinearity problems. Both graphical and Levene's test for homogeneity of variance will be used to test for homogeneity. If the Levene's statistic is significant at the 0.05 levels, the null hypothesis that the groups have no equal variances will be rejected.

The regression equation used will be derived from the equation of a straight line which will result in model given below;

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

Where

Y the dependent variable, represents financial performance measured using Return on Asset

β_0 is a constant term,

X₁- Internal audit standards is measured using the level of adoption of the various internal audit standards by microfinance institutions.

X₂- Independence of internal audit is measured using the extent of independence of the internal auditor in the respective microfinance institutions

X₃- Professional competence is measured by the level of professional competence of the internal auditor in specific microfinance institutions

X₄- Internal controls is measured by internal control systems' effectiveness in each microfinance institutions

ε - Error term

Statistical significance will be measured using the F- test statistic. If the p- values are very small (<0.05), there will be strong statistical evidence in support of the alternative hypothesis. If the p- values are large, there'll be insignificant statistical evidence and hence you fail to reject the null hypothesis.

Inferential statistics technique to be used include multiple linear regression analysis and Pearson's product moment coefficient correlation (r). All the statistical tests will be conducted at 95 percent confidence level.

CHAPTER FOUR: DATA ANALYSIS, INTERPRETATION AND DISCUSSION

4.1 Introduction

This chapter deals with the analysis, interpretation and discussion of the data gathered from the desk study and questionnaire survey. Information was divided into two sections in this chapter. Analysis of the respondents' general information was detailed in the first section, while the second section dealt with descriptive and inferential statistics to analyze the data on the objectives.

4.1.1 Questionnaire Response Rate

Detailed questionnaires were designed and distributed to understand the causal effect between internal audit and microfinance institutions' financial performance in Kenya. The questionnaires which were 55 were conveyed, out of which 46 were filled and returned which is a response rate of 83.64%. This reaction rate was viewed as agreeable for the examination.

This reaction rate was appropriate since according to Mugenda and Mugenda (2003) who stipulated that a half reaction rate was sufficient for investigation and announcing; a 60% reaction rate was great and a 70% and over was excellent. For the questionnaires not availed, inaccessibility of the respondents was referred to as the principle reason in spite of diligent subsequent meet-ups. The eagerness of the respondents to take an interest in the examination is shown by the reaction rate. Table 4.1 beneath demonstrates the quantity of surveys dispersed and returned from the respondents including their response rate.

Table 4.1: Response Rate

Respondents	Questionnaires Distributed	Questionnaires Returned	Response Rate
	55	46	83.64%

Source: Researcher, (2017)

4.1.2 Reliability Analysis

In this area everything was analyzed and the summated scores were computed for the factor classes to decide the reliability of the outcome. Every one of the things (proclamations) in the survey were investigated and the scores for the 5 factor classes were summated. Cronbach's coefficient α , for each factor was figured and a factor analysis which indicated a one factor display was led. The Cronbach's coefficient α value was therefore used to establish the elements' internal reliability in every class.

Table 4.2: Reliability Analysis

Variable	Cronbach's Alpha
Internal audit standards	0.84
Independence of internal audit	0.79
Professional competence	0.75
Internal controls	0.88

Source: Researcher, (2017)

All factor categories had a Cronbach's α value greater than 0.70, meaning that internal consistency was adequately proven. Cronbach's α values fall between 0.50 to 0.70, they are considered acceptable.

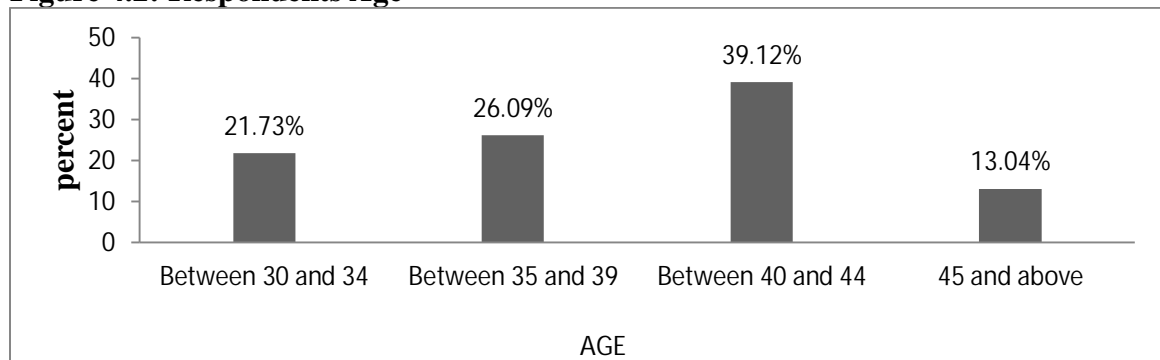
4.2 Demographic Information

The first section of the questionnaire investigated the results of the demographic characteristics of the respondents. The respondents' socio demographic characteristics included age, gender, and work experience. These variables indicate the proportions of the respondents who were interested in this study.

4.2.1 Age

The respondents' age may lead to varying levels of employee performance. So as to maintain a strategic distance from biasness, this study needed to explore the piece of the respondents as far as age sections to comprehend their familiarity with internal audit and performance in microfinance institutions. The investigation consequently suggested a conversation starter asking for the respondents to show their age sections. Figure 4.1 demonstrates the consequences of the discoveries on the age sections of the respondents.

Figure 4.2: Respondents Age



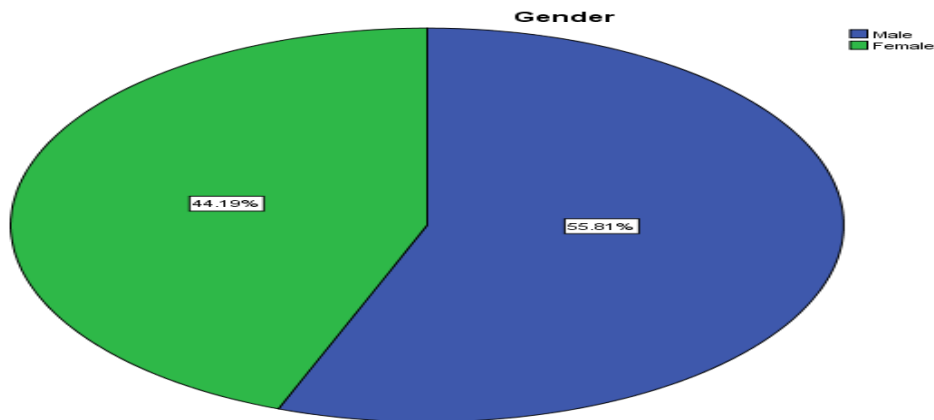
Source: Researcher, (2017)

From the study, 39.12% speaking to larger part of the respondents were matured in the vicinity of 40 and 44 years took after by 26.09% who were between 35and 39 years old while 21.73% of them showed that they were in the vicinity of 30 and 34 years. A couple of the respondents, 13.04% were over 45 years old.

4.2.2 Gender

The study thought that it was foremost to decide the respondents' gender with a specific end goal to learn whether there was sex equality in the positions demonstrated by the respondents. As per the examination it was clear that greater part of the respondents were male which spoke to (55.81%) while (44.19%) were female. Acker (2006) watched that gender equity was a vital characteristic since it can be utilized to enhance execution of all the staff included. He contended that it cultivated cooperation and furthermore made a feeling of solidarity and the part of cooperating for a shared objective with each individual exertion, regardless of whether male or female, being imperative to the accomplishment of the general destinations. A gender responsive firm gives a helpful workplace where a staff/supervisor should collaborate with different associates of the inverse gender in quest for greatness and accomplishment of set targets.

Figure 4.3: Gender



Source: Research Data, (2017)

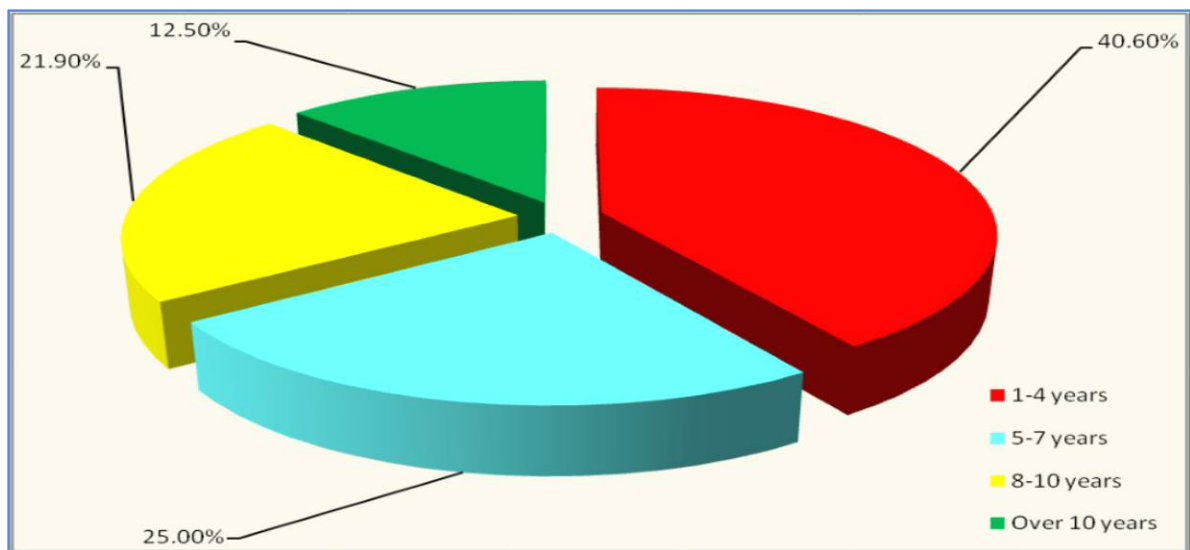
The discoveries demonstrated that the association examined had both male and female individuals. The discoveries infer that the perspectives communicated in these discoveries

are gender balanced and can be taken as illustrative of the suppositions of both genders concerning internal audit among microfinance organizations.

4.2.3 Work Experience

The length of administration/working in an association decides the degree to which one knows about the issues being examined by the study. In the wake of innovative progressions and globalization, there are probably going to be many changes in the institutional and working condition that the respondents should know when reacting to the issues sought by the study. The study has therefore tried to set up the respondents' tenure in the MFIs. The outcomes are introduced in Figure 4.3.

Figure 4.4: Length of Time Worked



Source: Researcher, (2017)

The study results portrayed in figure 4.3 uncovered that 40.60% of the respondents showed that they had an experience of 1 - 4 years in the associations, 25.00% of them had worked in the associations for a time of between 5 - 7 years, 21.90% of them had a working knowledge of 8-10 years, while 12.50% of the respondents demonstrated that they had

experience of over 10 years in the institutions. This demonstrates that the greater part of the respondents had enough work involvement in the establishment to react viably. A large portion of the respondents had worked in the microfinance organization for long, hence they comprehended the impacts of internal audit on MFI's financial performance in Kenya.

4.3 Internal Audit Standards

The study sought to determine how internal audit standards influenced microfinance institutions' financial performance in Kenya. The summary of the discovered findings is shown in Table 4.3.

Table 4.3: Internal Audit Standards Statements

Internal Audit Standards Statements	N	Mean	Standard deviation
Whether standards for audits and audit-related services did affect performance in our organization	44	3.6190	0.49151
Our internal audit professionals did observe internal audit standards	45	3.6429	0.48497
Effectiveness of auditing was as a result of performing auditing work according to the set internal audit standards	43	3.8333	0.37720
The auditors in our organisation objectively performed their roles and adhered to the accepted professional standards and practices.	44	3.8049	0.40122
The formal auditing standards in our organisation recognized that, other than financial reports, internal auditors should provide related services on other information.	45	3.7442	0.44148
The internal audit in our firm evaluates and contributes to governance, risk management and control effectiveness by use of a systematic and disciplined approach in the microfinance institutions	45	3.6744	0.47414

The respondents were consequently given statements to rate on a likert scale. In light of the discoveries, the respondents concurred that Standards for internal audit and review of related services impacted performance in their institutions as represented by a 3.6190 mean and a 0.49151 standard deviation. It was additionally settled that internal audit standards were observed by their internal audit staff. This was represented by a 3.6429 mean and a

0.48497 standard deviation. Further examination demonstrated that performing internal audit work as per the standards of internal audit contributed altogether to internal audit effectiveness (mean=3.8333, standard deviation=0.37720) and that internal auditors in their organizations objectively carried out their roles and complied with the acknowledged professional practice criteria (mean=3.8049, standard deviation=0.40122).

The respondents likewise demonstrated that formal auditing guidelines in their institutions recognized the fact that internal auditors additionally provided services with respect to information other than financial reports as represented by a 3.7442 mean and a 0.44148 standard deviation. It was likewise settled that organizations' internal audit standards contributed to better risk management, control and governance by utilizing an approach that's both systematic and disciplined in the microfinance institutions (mean=3.6744, standard deviation=0.47414).

4.4 Independence of Internal Audit

The study's second objective was to determine the influence that independence of internal audit had on MFI's financial performance. Table 4.4 shows the findings of the study.

Table 4.4: Independence of Internal Audit

Independence of internal audit	N	Mean	Standard deviation
The internal audit in our firm reports to the Board of Directors	46	3.6279	0.48908
Our firm relies much on its own internal audit department which is independent	46	3.6905	0.46790
There has not been any case of conflict of interest reported in our internal audit department	46	3.5814	0.49917
There are formalized principles of internal audit guiding its position and powers in the framework of the microfinance institutions in Kenya	46	3.8333	0.37720
Internal audit in our firm is independent of both the personnel and operational activities within the firm	46	3.7442	0.44148
The achievement of the function and objective of internal audit has resulted to effectiveness in our firm	46	3.6744	0.47414
The essence of auditing in our firm is independence	46	3.547	0.5100

According to the analysis of the findings, it was established that internal audit in the microfinance institutions reported to the Board of Directors as supported by a 3.6279 mean and a 0.48908 standard deviation. Microfinance institutions were found to rely much on their own internal audit department which is independent as indicated by a 3.6905 mean and a 0.46790 standard deviation. The respondents concurred that there had not been any case of conflict of interest reported in their internal audit departments (mean=3.5814, standard deviation= 0.49917), it was also established that there were formalized principles of internal audit guiding the position and powers in the framework of the microfinance institutions in Kenya (mean=3.8333, standard deviation=0.37720). Additionally the study revealed that internal audit in the microfinance institution was independent of both the

personnel and operational activities within the firm (Mean=3.7442, standard deviation=0.44148).

Respondents also agreed that the achievement of the function and objective of internal audit has resulted to effectiveness in their firms as illustrated by a 3.6744 mean and a 0.47414 standard deviation. Majority of the respondents likewise concurred that the essence of auditing in their firms was independence as indicated by a 3.547 mean and a 0.5100 standard deviation. The findings revealed that independence of auditors in microfinance institutions is a cornerstone of the internal auditing profession. This is because the internal auditors need to be objective in order to perform their work and prepare reports that reflect the internal control systems' strengths and weaknesses that the microfinance institutions rely on when reporting their financial performance.

4.5 Professional Competence

The study sought to establish a link between professional competence and MFI's financial performance in Kenya. A summary of the findings are shown in Table 4.5.

Table 4.5: Professional competence

Professional competence	N	Mean	Standard deviation
The auditors in my firm are qualified to undertake audit functions	46	3.6279	0.48908
Professionalism is strongly emphasized within my firm audit	45	3.7209	0.45385
For effective fraud detection, there should be measures that can enhance the internal auditors' efficacy.	45	3.7442	0.44148
In our firm frauds are identified by the internal audit function	46	3.9767	1.62552
Financial performance in our firm is affected by fraudulent activities and fraud detection which are inherently not easy to predict and detect.	45	1.8744	0.47414

From the analysis of the findings, it was established that the internal auditors in MFIs were qualified to undertake audit functions as shown by a 3.6279 mean and a 0.48908 standard deviation. Additional findings revealed that professionalism was strongly emphasized within the microfinance institution's audits as supported by a 3.7209 mean and a 0.45385 standard deviation. It was also found out that effective fraud detection requires having measures in place that enhance the internal auditors' efficacy. (Mean=3.7442, standard deviation=0.44148). On further analysis of the findings, identification of fraud by the internal audit function was supported by a 3.9767 mean and a 0.162552 standard deviation.

Further, there was a disagreement from a majority of the respondents that fraudulent activities and fraud detection were not easily predictable and that they affected the financial performance of MFIs as supported a 1.8744 mean and a 0.47414 standard deviation. It was therefore established that the auditors in the microfinance institution are qualified to undertake audit functions. This implies that they have professional skills needed to conduct internal auditing functions.

4.6 Internal Controls

The respondents were further presented with statements to rate concerning the influence of internal control on financial performance of microfinance institution. Table 4.6 below shows the results of the findings.

Table 4.6: Internal Controls

Internal Controls	N	Mean	Standard deviation
Internal audit reports are prepared and reviewed timely by the audit committee	45	3.7442	0.44148
Internal audit recommendations touching on significant risk areas are implemented immediately	46	3.6977	0.46470
The internal control system is effective in minimizing potential losses in the microfinance institution	46	3.6977	0.46470
Fraudulent truncations are hard to transact or are timely flagged out by the inbuilt features in the organisation's internal control system.	45	3.6047	0.49471
In our firm, intentional errors are fairly predictable by industry since they are concentrated in a few areas.	46	3.8605	0.35060
The lack of segregation between accounting and custodial functions in our firm hinders fraud detection and reporting	45	1.7442	0.44148

The respondents indicated that internal audit reports were prepared and reviewed timely by the audit committee as indicated by a 3.7442 mean and a 0.44148 standard deviation. The findings further found out that internal audit recommendations touching on significant risk areas were implemented immediately as supported by a 3.6977 mean and a 0.46470 standard deviation. Further findings indicated that the internal control system was effective in minimizing potential losses in the microfinance institution (mean=3.6977, standard deviation=0.46470) and that the microfinance institutions' internal control systems had inbuilt features that flagged out fraudulent truncations or made them difficult to transact. (mean=3.6047, standard deviation=0.49471). It was also established that in the microfinance institutions, intentional errors were concentrated in relatively few areas and that they were fairly predictable by industry (mean=3.8605, standard deviation=0.35060). Finally, the respondents disagreed that, the non-separation accounting and custodial functions in their firms hindered fraud detection and reporting (mean=1.7442, standard

deviation=0.44148). The study revealed that internal audit reports were prepared and reviewed timely by the audit committee. This timely preparation and review of audit reports enhances the quality of the audits and timely implementation of the recommendations suggested in the reports.

4.7 Inferential Analysis

Inferential analysis was used in this study to establish whether internal audit influenced microfinance institutions' financial performance in Kenya. Analysis of inferential statistics was aimed to reach conclusions that went beyond the immediate data between the study's independent variables alone. A coefficient of determination and a multiple regression analysis were used as part of inferential analysis to establish a link between the independent and dependent variables. The independent variables in this study included internal audit standards, independence of internal audit, professional competence and internal controls while financial performance was the dependent variable.

4.7.1 Regression Analysis

The researcher additionally tested the relationship among the independent variables using multiple regression analysis. SPSS was used by the researcher to code, enter and calculate the multiple regression measures for the study. Coefficient of determination is computed to explain the extent to which the variations in the dependent variable (financial performance) can be explained by the change in the four independent variables (standards of internal audit, independence of internal audit, professional competence and internal controls). Regression analysis yielded various values including R, R², F ratio, t-values and p-values. The R-value reflects the strength of the relationship between the variables while R² values depict the extent to which variations in indicators are explained. The F-value

shows the statistical significance of the overall model, while t-values represent the significance of individual variables. Further, beta values show the positive or negative effect of the independent variable on the dependent variable. Finally, p-values represented the significance of the model parameters. This study tested the relationships at 95 percent confidence level ($\alpha=0.05$) at which point a decision to confirm the relationship was made. Results that yielded p values < 0.05 led to significant relationships while, results with p values >0.05 resulted in insignificant relationships.

4.7.2 Correlation Analysis

The degree of association between the independent and the dependent variables was measured using the Pearson correlation. Coefficients for Pearson correlation range from -1 to +1. Negative correlation is assumed where the value is negative while a positive correlation is assumed when the value is positive. Where the Pearson coefficient is less than 0.3, the correlation is assumed to be weak. Where the Pearson coefficient is more than 0.3 but less than 0.5, the correlation is assumed to be moderate. A strong correlation is assumed when the Pearson coefficient is more than 0.5.

Table 4.7: Correlation Coefficients

		Internal audit standards	Independence of internal audit	Professional competence	Internal controls	Financial Performance
Internal audit standards	Pearson Correlation	1	0.699**	0.533**	0.559**	0.379**
	Sig.(2-tailed)		0.000	0.000	0.000	0.009
	N	46	46	46	46	46
Independence of internal audit	Pearson Correlation	0.699**	1	0.585**	0.618**	0.503**
	Sig.(2-tailed)	0.000		0.000	0.000	0.000
	N	46	46	46	46	46
Professional competence	Pearson Correlation	0.533**	0.585**	1	0.954**	0.378**
	Sig.(2-tailed)	0.000	0.000		0.000	0.010
	N	46	46	46	46	46
Internal controls	Pearson Correlation	0.559**	0.618**	0.954**	1	0.346*
	Sig.(2-tailed)	0.000	0.000	0.000		0.019
	N	46	46	46	46	46
Financial Performance	Pearson Correlation	0.379**	0.503**	0.378**	0.346*	1
	Sig.(2-tailed)	0.009	0.000	0.010	0.019	
	N	46	46	46	46	46

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

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

From the analysis above, independence of internal audit and financial performance had the strongest positive relationship. Its related Pearson correlation coefficient was 0.503 and because $P < 0.05$, this implied that the relationship is statistically significant. In addition, internal audit standards, professional competence and internal controls were positively correlated to financial performance (Pearson correlation coefficient = 0.379, 0.378 and 0.346 respectively and $P < 0.05$ implying statistically significant relationships. The independent variables were established to be crucial determinants of financial performance

as per the correlation matrix. This is because they had a positive relationship with the dependent variable, even though most of them had a moderate correlation with financial performance; the dependent variable.

4.7.3 Model Summary

In order to describe how the mean of the dependent variable changes with varying conditions, a regression model was used. The focus of the regression analysis was on internal audit standards, internal audit independence, professional competence and internal controls and microfinance organizations' financial performance. The relationship between financial performance and the independent variables was tested using multiple regression analysis.

Table 4.8: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.533 ^a	0.284	0.214	142.93670

a. Predictors: (Constant), internal audit standards, independence of internal audit, professional competence and internal controls

b. Dependent Variable: Financial performance

From the study, financial performance was explained by 28.4% by changes in the four independent variables as represented by the R^2 . Other factors contributed 71.6% to financial performance. These factors, not studied in this research, are significant and are therefore crucial to Kenya's MFI's financial performance.

Table 4.9: ANOVA

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	332152.902	4	83038.225	4.064	0.007 ^a
Residual	837666.924	41	20430.901		
Total	1169819.826	45			

a. Dependent Variable: Financial performance

b. Predictors: (Constant), internal audit standards, independence of internal audit, professional competence and internal controls

The model is statistically significant as represented by a significance value of 0.007 which is less than 0.05. Thus the model can be used in predicting how internal audit standards, independence of internal audit, professional competence and internal controls influence financial performance of microfinance institutions in Kenya. The F critical value was 4.064 at 5% level of significance implying that the overall model is significant. The coefficient results are as shown in Table 4.11 below.

Table 4.10: Coefficient Results

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	1500.893	115.716		12.971	0.000
Internal audit standards	4.937	25.028	0.037	0.197	0.845
Independence of internal audit	51.865	23.008	0.451	2.254	0.030
Professional competence	65.063	51.297	0.562	1.268	0.212
Internal controls	-57.073	53.331	-0.490	-1.070	0.291

a. Dependent Variable: Financial performance

To determine the link between financial performance and the independent variables, multiple regression analysis was conducted. The results from the SPSS tables above led to

the equation ($Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \varepsilon$) becoming:

$$Y = 1500.893 + 4.937X_1 + 51.865X_2 + 65.063X_3 - 57.073X_4$$

From the established regression equation, and considering all factors (internal audit standards, independence of internal audit, professional competence and internal controls) the constant at zero financial performance was 1500.893. From the analysis of the data findings, taking all other independent variables to be zero, financial performance will increase by 4.937 from a unit increase in internal audit standards. When independence of internal audit increases by one unit, financial performance will increase by 51.865. When professional competence increases by one unit, financial performance will increase by 65.063. Financial performance will decrease by 57.073 from a unit increase in internal controls. At the 95% confidence level and 5% significance level, internal audit standards had a level of significance of 0.845; independence of internal audit had a level of significance of 0.030; professional competence had a level of significance of 0.212 while internal controls showed a level of significance of 0.291. Only independence of internal audit was statistically significant in explaining financial performance since its level of significance was less than 0.05 ($p < 0.05$).

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter involves summarizing the study and making conclusions based on the findings. Also presented, are the recommendations and areas for further research.

5.2 Summary of Findings

The findings indicated that all the independent variables (internal audit standards, internal audit independence, internal audit controls and professional competence) had a positive correlation with microfinance institutions' financial performance in Kenya. Independence of internal audit had the strongest positive influence on financial performance with a Pearson correlation coefficient of 0.503. Internal audit standards, professional competence and internal controls were also positively correlated to financial performance with Pearson correlation coefficients of 0.379, 0.378 and 0.346 respectively.

The independent variables in the study explained 28.4% of the financial performance as represented by R^2 , the coefficient of determination. Therefore, there are other factors that need to be studied which contribute 71.6% to financial performance. These other factors were considered significant and therefore are crucial determinants of financial performance.

The test results showed that the coefficient estimates were positive for all the independent variables except internal controls. When internal audit standards increase by one unit, financial performance increases by 4.937. When independence of internal audit increases by one unit, financial performance will increase by 51.865. When professional competence increases by one unit, financial performance will increase by 65.063. Financial

performance will decrease by 57.073 from a unit increase in internal controls. However, independence of internal audit was the only independent variable that was statistically significant in explaining financial performance since its level of significance was less than 0.05 ($p < 0.05$).

From the ANOVA test, the overall model was established as statistically significant since the F critical value was 4.064 at 5% significant level. The model was statistically significant in predicting whether internal audit standards, internal audit independence, internal audit controls and professional competence influence microfinance institutions' financial performance in Kenya. This was supported by a 0.007 significance level.

5.3 Conclusions

The study's objective of establishing whether internal audit had an effect on financial performance of Kenya's MFIs was met. Conclusions arrived at from the findings, indicated that internal audit accounted for 28.4% of financial performance of microfinance institution in Kenya.

Independence of internal audit was found to have a statistically significant relationship with financial performance. This therefore means that internal audit standards, internal audit controls and professional competence, as components of internal audit do not impact financial performance significantly.

The ANOVA model of analysis resulted in the F-statistic value of 4.064 that implied the regression model was statistically significant and was a good fit as indicated by a significance value of 0.007.

5.4 Recommendations

Microfinance institutions in Kenya should be made aware of the improvements to financial performance that could be gained by allowing the internal auditors to be independent while preparing their internal audit reports. The microfinance institutions should employ competent internal auditors and remunerate them fairly to ensure that the management is advised properly through quality internal audit reports. Regulations should be enacted to ensure that all microfinance institutions comply with internal audit best practices. This should mirror the regulations that the Central Bank of Kenya imposes on commercial banks to ensure transparency and accountability in the handling of customers' money

The management of microfinance institutions should also procure the latest internal audit software systems. This would improve the efficiency with which the internal audit procedures help in detection of fraud and in identifying risky areas that could expose the microfinance institutions. Microfinance institutions should train their employees on how to use the software systems. Frequent internal audit software upgrades should be done to keep up with the changes in technology.

5.5 Limitations of the study

To collect primary data, questionnaires were administered. Out of the 55 questionnaires administered, only 46 were filled and returned. There were instances where the respondents skipped some questions in the questionnaires therefore the responses given for each question differed.

Another limitation was the reluctance of the respondents to disclose data about the microfinance institutions. The reluctance was due to the fear by the respondents that there

would be a breach of confidentiality. The study had to rely on referrals from other respondents to be able to obtain the relevant data, so as to achieve its objective.

MFI's annual financial statements were used to gather secondary data. The gathered data's integrity was therefore based on the integrity of the financial statements. This means that if there were material misstatements or omissions in the financial statements then the findings would be limited by the omissions and misstatements.

5.6 Recommendations for future research

The study contributed knowledge in understanding the relationship between internal audit and microfinance institutions' financial performance. However, future research should study other financial measures as well as non- financial measures such as employee satisfaction and quality so as to further build on the knowledge obtained on the relationship between internal audit and performance. It is also recommended that future research should expand into the context of commercial banks offering microfinance services so as to allow for comparisons to be made and to enable generalization of the findings already established in the context of microfinance institutions in Kenya.

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APPENDICES

Appendix 1: Questionnaire

The questionnaire aims to collect data from microfinance institutions with the goal of examining “**the effect of internal audit on financial performance of micro-finance institutions in Kenya**”. Data obtained will be held in confidence and the identity of respondents will be kept anonymous. Your cooperation in this data collection exercise is highly appreciated.

SECTION A: BACKGROUND INFORMATION

Respondent Details:

1. Name of Organization.....
2. Designation.....
3. Department.....
4. Gender
 - a) Male
 - b) Female
5. Age in Years
 - a) up to 29
 - b) 30 – 34
 - c) 35 – 39
 - d) 40 – 44
 - e) 45 and above
6. Years of Service in the Microfinance Industry.....

SECTION B: INTERNAL AUDIT STANDARDS

7. Please indicate the extent to which each of the following statements match internal audit standards in your organization where 1=strongly disagree 2= disagree 3=neither disagree nor agree 4=agree 5=strongly agree

Items	Strongly disagree (1)	Disagree (2)	Neither disagree nor agree (3)	Agree (4)	Strongly agree (5)
Internal Audit Standards Statements					
Whether standards for audits and audit-related services did affect performance in our organization					
Our internal audit professionals did observe internal audit standards					
Effectiveness of auditing was as a result of performing auditing work according to the set internal audit standards					
The auditors in our organisation objectively performed their roles and adhered to the accepted professional standards and practices.					
The formal auditing standards in our organisation recognized that, other than financial reports, internal auditors should provide related services on other information.					
The internal audit in our firm evaluates and contributes to governance, risk management and control effectiveness by use of a systematic and disciplined approach in the microfinance institutions					

SECTION C: INDEPENDENCE OF INTERNAL AUDIT

8. Kindly indicate the extent to which you agree or disagree with the following statements as relates to independence of internal audit in your firm where 1=strongly disagree 2=disagree 3=neither disagree nor agree 4=agree 5=strongly agree

Items	Strongly disagree (1)	Disagree (2)	Neither disagree nor agree (3)	Agree (4)	Strongly agree (5)
Independence of internal audit					
The internal audit in our firm reports to the Board of Directors					
Our firm relies much on its own internal audit department which is independent					
There has not been any case of conflict of interest reported in our internal audit department					
There are formalized principles of internal audit guiding its position and powers in the framework of the microfinance institutions in Kenya					
Internal audit in our firm is independent of both the personnel and operational activities within the firm					
The achievement of the function and objective of internal audit has resulted to effectiveness in our firm					
The essence of auditing in our firm is independence					

SECTION D: PROFESSIONAL COMPETENCE

9. Kindly indicate the extent to which you agree or disagree with the following statements as relates to professional competence in your firm where 1=strongly disagree 2= disagree 3=neither disagree nor agree 4=agree 5=strongly agree

Items	Strongly disagree (1)	Disagree (2)	Neither disagree nor agree (3)	Agree (4)	Strongly agree (5)
Professional competence					
The auditors in my firm are qualified to undertake audit functions					
Professionalism is strongly emphasized within my firm audit					
For effective fraud detection, there should be measures that can enhance the internal auditors' efficacy.					
In our firm frauds are identified by the internal audit function					
Financial performance in our firm is affected by fraudulent activities and fraud detection which are inherently not easy to predict and detect.					

SECTION E: INTERNAL CONTROLS

10. Kindly indicate the extent to which you agree or disagree with the following statements as relates to internal controls in your firm where 1=strongly disagree 2= disagree 3=neither disagree nor agree 4=agree 5=strongly agree

Items	Strongly disagree (1)	Disagree (2)	Neither disagree nor agree (3)	Agree (4)	Strongly agree (5)
Internal Controls					
Internal audit reports are prepared and reviewed timely by the audit committee					
Internal audit recommendations touching on significant risk areas are implemented immediately					
The internal control system is effective in minimizing potential losses in the microfinance institution					
Fraudulent truncations are hard to transact or are timely flagged out by the inbuilt features in the organisation’s internal control system.					
In our firm, intentional errors are fairly predictable by industry since they are concentrated in a few areas.					
The lack of segregation between accounting and custodial functions in our firm hinders fraud detection and reporting					

THANK YOU

Appendix II: List of Microfinance Institutions in Kenya

Name		Contacts
1	Faulu Kenya DTM Limited	Postal Address: P. O. Box 60240 – 00200, Nairobi Telephone: +254-20- 3877290 -3/7, 38721883/4 Fax: +254-20-3867504, 3874875 Email: info@faulkenya.com , customercare@faulkenya.com Website: www.faulkenya.com Physical Address: Faulu Kenya House, Ngong Lane -Off Ngong Road
2	Kenya Women Finance Trust DTM Limited	Postal Address: P. O. Box 4179-00506, Nairobi Telephone: +254-20- 2470272-5, 2715334/5, 2755340/42 Pilot Line: 070 - 3067000 Email: info@kwftdtm.com Website: www.kwftdtm.com Physical Address: Akira House, Kiambere Road, Upper Hill,
3	SMEP Deposit Taking Microfinance Limited	Postal Address: P. O. Box 64063-00620 Nairobi Telephone: 020-3572799 / 26733127 / 3870162 / 3861972 / 2055761 Fax: +254-20-3870191 Email: info@smep.co.ke info@smep.co.ke info@smep.co.ke Website: www.smep.co.ke Physical Address: SMEP Building - Kirichwa Road, Off Argwings Kodhek Road
4	Remu DTM Limited	Postal Address: P. O. Box 20833-00100 Nairobi Telephone: 2214483/2215384/ 2215387/8/9, 0733-554555 Email: info@remultd.co.ke info@remultd.co.ke info@remultd.co.ke Physical Address: Finance House, 14th Floor, Loita Street
5	Rafiki Deposit Taking Microfinance	Postal Address: 12755-00400 Nairobi Telephone: 020-216 6401 Cell - phone: : 0719 804 370/0734 000 323 Email: info@rafiki.co.ke Website: www.rafiki.co.ke Physical Address: : 2nd Floor, El-roi Plaza, Tom Mboya Street
6	UWEZO Deposit Taking Microfinance Limited	Postal Address: 1654-00100 Nairobi Telephone: 2212917 / 9 Email: info@uwezodtm.com Website: www.uwezodtm.com Physical Address: Park Plaza Building, Ground Floor, Moktar Daddah Street
7	Century Deposit Taking Microfinance Limited	Postal Address: P. O. Box 38319 – 00623, Nairobi Telephone: +254-20- 2664282, 20 6768326, 0722 168721, 0733 155652 Email: info@century.co.ke
8	SUMAC DTM Limited	Postal Address: P. O. Box 11687-00100, Nairobi Telephone: (254) 20 2212587, 20 2210440 Fax: (254) 2210430 Email:

		info@sumacdtm.co.ke Website: www.sumacdtm.co.ke Physical Address: Consolidated Bank House 2nd Floor, Koinange Street
9	U&I Deposit Taking Microfinance Limited	Postal Address: P.O. Box 15825 – 00100, Nairobi Telephone: (254) 020 2367288, Mobile: 0713 112 791 Fax: (254) 2210430 Email: info@uni-microfinance.co.ke Website: http://uni-microfinance.co.ke/uni-microfinance/ Physical Address: Asili Complex Building 1st Floor, River Road
10	Blue Limited	Chester House, Koinange Street P.O. Box 27749, 00100 Nairobi
11	K-Rep Development Agency	K-Rep Centre, 7th Floor, Wood Avenue, Kilimani P.O. Box 10528, 00100 Nairobi
12	Eclof Kenya	Chiromo, Royal Offices, Mogotio Road P.O. Box 34889, Nairobi
13	KADET	Capital Hill, Cathedral Road, Community P.O. Box 1676, 00200 Nairobi
14	Bimas	Bimas Complex P.O. Box 2299 Embu
15	Sisdo	Ngong Road, Ngong Lane P.O. Box 76622, 00508 Nairobi
16	Micro Africa Ltd	P.O. Box 52926, Nairobi
17	Opportunity Kenya	Geomaps Centre, Matumbata Road, Upper Hill P.O. Box 19497, 00202 Nairobi
19	Yehu Microfinance Trust	Buxton, Tom Mboya Street P.O. Box 82120 Nairobi
20	Fusion Capital Ltd	ACK Garden Hse., Wing A, Ground Floor, 1st Ngong Avenue, Community (Next to ArdhiHse)
21	Canyon Rural Credit Ltd	Studio Hse., 3rd Floor P.O. Box 46532, 00100 Nairobi
22	One Africa Capital Ltd	Koinange Street, Ratansi Education Trust Building, 2nd Floor P.O. Box 74093, 00200 Nairobi
23	Jitegemea Credit Scheme	Jogoo Road, KCB Building P.O. Box 46514 Nairobi
24	AAR Credit Services	Methodist Ministries Centre, 1st Floor, Oloitokitok Road
25	Agakhan Foundation Microcredit Programme	Mpaka Plaza, Westlands, 3rd Floor P.O. Box 13149, 00100 Nairobi
26	AdokTimo	Sifa House, Ground Floor, Mission Road (Off Kakamega Road, Opposite Kibuye Market) Kisumu

27	Pamoja Women Development Programme	Kikinga House, Kiambu Town P.O. Box 2472, 00100 Nairobi
28	JuhudiKilimo Co. Ltd	Mucai Road, Ngong Road P.O. Box 10528, 00100 Nairobi
29	Musomi Kenya Ltd.	Cape Office Park, Along Ring Road, Kilimani, Opposite Yaya Centre P.O. Box 25351, 00100 Nairobi
30	Molyn Credit Ltd.	Bruce Hse, 9th Floor, Standard Street P.O. Box 10144, 00100 Nairobi
31	Renewable Energy Technology Assistance Programme (RETAP)	WauminiHse, Westlands, 1st Floor P.O. Box 28201, 00200 Nairobi
32	Rupia Ltd.	View Park Towers, 10th Floor P.O. Box 2987, 00200 Nairobi
33	Taifa Options Microfinance	Finance House, Kenyatta Highway P.O. Box 727 Ruiru
34	U & 1 Microfinance Ltd.	1st Floor, Asili Complex, River Road/ Latema Road Junction (Opposite Kampala Coach)
35	Select Management Services Ltd.	Kenya Re Towers, Off Ragati Road P. O. Box 27639, 00506 Nairobi
36	Greenland Fedha Ltd.	KTDA Farmers Building P.O. Box 30213, 00100 Nairobi
37	Youth Initiatives Kenya (YIKE)	Kariobangi North, Sanoda House, 2nd Floor P.O. Box 50622, 00200 City Square, Nairobi
38	Biashara Factors	Finance House, 11th Floor, Loita Street P.O. Box 66065, 00800 Nairobi
39	Platinum Credit Ltd.	2nd Floor, NHIF Building, Community P.O. Box 73304, 00200 Nairobi
40	Ngao Credit Ltd.	2nd Floor, NHIF Building, Community P.O. Box 60776, 00200 Nairobi
41	Indo Africa Finance	Museum Hill Centre, 3rd Floor, Museum Hill Road P.O. Box 39435, 00623 Nairobi
42	Springboard Capital	Kensia House (Along Muran'ga Road, Opposite Kobil Petrol Station), 1st Floor, Suite No. 12 P.O. Box 23720, 00100 Nairobi
43	Mini Savings & Loans Ltd.	Highway Building, Githunguri Town (Near Githunguri Post Office) P.O. Box 874, 00216 Githunguri, Kiambu
44	KEEF-Kenya Enterprise Empowerment Foundation	Mapa House, 3rd Floor, Kiambu Road P.O. Box 648 Kiambu
45	Women Enterprise Solutions	Development House, Moi Avenue P.O. Box 4083, 00200 Nairobi
46	Focus Capital Ltd.	Donholm Mina Centre P.O. Box 2406, 00202 Nairobi

47	Samchi Credit Ltd.	Parklands Plaza P.O. Box 16982, 00620 Nairobi
48	Fountain Credit Services Ltd.	Ngong Road (Near Kobil Petrol Station) P.O. Box 72367, 00200 Nairobi
49	Milango Financial Services	Rozina Building, Moi Avenue P.O. Box 99637, 80107 Mombasa
50	Nationwide Credit Kenya Ltd.	Trishul Towers, 1st Floor (Near Globe Cinema Roundabout, Next to Paramount Plaza) P.O. Box 41873, 00100 Nairobi
51	Fort Credit Limited	Equity Plaza, Thika, 2nd Floor P.O. Box 6685, 00100 Thika
52	Jitegemee Trust	K-Rep Centre, Wood Avenue P.O. Box 21768, 00505 Nairobi
53	Oiko Credit	Methodist Ministries Centre, Oloitokitok Road, 2nd Floor P.O. Box 67181 Nairobi
54	MESPT	2nd Floor, Vision Towers, Muthithi Road, Westlands P.O. Box 187, Sarit Centre, 00606 Nairobi
55	Women Enterprise Fund	NSSF Building, Eastern Wing, Block A, 14th Floor P.O. Box 17126, 00100 Nairobi