THE EFFECTS OF INTERNAL AUDIT QUALITY ON FINANCIAL PERFORMANCE OF FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE

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A RESEARCH PROJECT REPORT SUBMITTED IN THE PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR AWARD OF MASTER OF BUSINESS ADMINISTRATION DEGREE OF THE SCHOOL OF BUSINESS UNIVERSITY OF NAIROBI

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DECLARATION

This Research Project is my original work and has not been presented for a degree in any other institution or university.

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D61/79399/2015

This Research Project has been carried out by the candidate under my supervision as the University Supervisor.

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DR. CYRUS IRAYA

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DEDICATION

This project is dedicated to my family and church members who have always encouraged me on my journey of life.

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LIST OF ABBREVIATIONS

AC:	Audit Committee
AICPA:	American Institute of Certified Public Accountants
ASX:	Australian Securities Exchange
CAE:	Chief Audit Executive
CEO:	Chief Executive Officer
CFO:	Chief Financial Officer
FRC:	Financial Reporting Council
IFRS	International Financial Reporting Standards
IAASBIAF:	International Auditing and Assurance Standards Board Internal Audit Functions
IAQ:	Internal Audit Quality
IIA:	Institute of Internal Auditors
NYSE	New York Stock Exchange
SACCO	Savings and Credit Co-operative
SOA:	Sarbanes-Oxley Act of 2002
SPSS	Statistical Package for Social Sciences
ROCE	Return on Capital Employed

ABSTRACT

Internal auditing is a vital aspect of all organizations for the efficient and effective management of resources, addition of value and improvement of operations for them to realize their financial goals. The internal audit department is a neutral source of information for smooth management of resources, thus stakeholders have a level of confidence in the financial reports of the firm which reflect the quality of the department. The study employed a descriptive research design. The population was made up of all the firms listed on the Nairobi securities exchange. Data used was both primary and secondary. Questionnaires were used to collect relevant information. The audited and published financial statements of firms listed at the NSE provided data on the financial performance. Quantitative and qualitative analyses were used to analyze the data obtained. The independent variables studied: Top management support, auditor's independence, professional proficiency of auditors and auditor's quality of work were found to have a significant relationship with financial performance.

CHAPTER ONE

INTRODUCTION

1.1 Background of this Study

Audit quality is vital for every organization to achieve efficient and effective management of resources. It leads to the improvement of financial performance as a key implementation strategy of the accounting system and helps management check the work of each department within the firm as a whole. Around the world, audit quality assures the achievement of quality financial statements or reports for firms listed on the stock markets of any country. This is the cornerstone of institutions of any type that are charged with the responsibility of checking records related to business activities. The functions of internal audit reflect the quality of the financial reports or information that the institutions maintain to create confidence among the stakeholders, and also reflect the efficiency and credibility of the institution's audit department within the organization's practices as part of the corporate governance structure of the firm's management and practices.

According to Clarkson (1995), stakeholders have the organization's interest at heart and are impacted by its operations, it could be negative or positive in the way in which it affects them. Stakeholders normally mentioned are employees, government, customers, competitors and political activist groups and the viability of any organization is greatly influenced by them. (Dill, 1958; Murray & Vogel, 1997). In stakeholder theory, the firm intends to convert the stakeholders' interests into goods and services thereby creating value for them. Profits can no longer be taken solely as success of a firm, but its success is influenced greatly by stakeholder relationships and is a broad range of issues which need to be addressed.

Agency theory is a contract whereby a person (agent) is appointed by another person or a number of people (principal(s)) to perform some service on their behalf. Conflicts may arise when the agent and the principal have interests which are different and do not align. An internal audit function can address this when it is independent and has the support of top management. Legitimacy theory is established on the belief that companies are always seeking for confirmation that they are doing business within the norms which their society finds acceptable to ensure they continue operating. Legitimacy is very important for businesses and all organizations. Strategy can be changed, when what society thinks is realized, to meet their needs and expectations. Value will be added to the business when financial statements meet the user's expectations.

Eighme & Cashell (2002) state that the internal audit department is charged with providing information that enhances the system support, the responsibility of the management of the institution and employees as well as the stakeholders of the institution in operation and financial performance of the institution. The internal auditors are neutral information providers to the top management of the institution for smooth management of the entity in lieu of their resources. The internal audit department also provides neutral, reliable and objective information that helps with the management of the organization. The stakeholders are more interested in the return made by the institution, sustainable growth, and reliable information reported about financial performance as a sign of financial health of the organization and its practices (Al-Shammari, 2010).

The Institute of Internal Auditors (2000) propose that, to provide a systematic approach that is well able to assess and enhance the strength of risk management, organization and the process of governance is the internal audit function. However, on the role of internal audit, there is a likelihood that this will lead to amplified responsibilities. In addition, internal audit is required to increase responsibilities that are crucial to the support of the management and the audit committee.

1.1.1 Internal Audit Quality

According to DeAngelo (1981), internal audit quality is the combined possibility that an auditor will become aware of and account for material misstatement. In this case, the meaning of audit quality is composed of two mechanisms that are: the capacity to spot misstatements and the readiness to divulge the misstatements that are discovered in an audit assignment. Measuring the internal audit quality is divided into two variables that are aimed to be captured which are the accounting qualifications (AQ) and the auditing experience (AEXP) of the internal audit staff. The impact of internal audit quality on a company's financial performance has an impact on the firm's agency relationship and this has not been studied extensively by most scholars in emerging economies, although auditing services has been well perceived as one of the mechanisms that is used to mitigate the agency problem that mostly exists between the management of the firms and the shareholders. The auditing service is just another element of the corporate governance structure and significant aspect of the regulatory system for protecting the interests of shareholders and to serve the other stakeholders in public firms around the world.

Audit quality is defined as the independence, objectivity, consulting activity and assurance designed to provide an accurate picture over a period of time of a firms' performance (The Institute of Internal Auditors, 2008). It is an exercise of improving risk management, operations and administration of the entity to achieve the intended goals and the protections of the shareholders wealth and provides accurate information to financial accounting information users. It helps the institution create discipline, improve management process and risk management to achieve the organizational goals. Firm managers are always engaged in returns management to increase their incentive and maximize shareholders wealth. However, if there is an auditor who can assure the quality of returns, the principal will have more confidence in the return generated by the firm and place greater weight in that measure in designing the managers' contract to avoid a conflict of interest (Dunn et al., 2000).

Internal audit performs an essential part in enhancing the achievement of company goals. Additionally, it also influences the implementation of strategies that are aimed at ensuring their success (Ljubisavljević & Jovanovi, 2011). Internal audit is charged with the responsibility for improving management and audit committees (Hutchinson & Zain, 2009). Therefore, the internal audit report is prepared as a form of communication between internal audit and the management. Additionally, it is established as a crucial guideline to enhance the management of the company and ensure its success (Ljubisavljević & Jovanovi, 2011).

1.1.2 Financial Performance

The measurement of the outcome of a company's operations and policies in financial terms is what defines financial performance (Yan, 1997). It is also the firm's willingness and ability to meet its agreements as well as long term financial obligations to provide services in the near future (Meckling, 2000).

According to Raw (1986), performance is used in reference to a business that generates significant and positive cash flow which increases at a faster rate in comparison to the overall economy. The firm performance which is a dependent variable is assessed on a few indicators. The return on assets (ROA), return on equity (ROE) and the return on investment (ROI) are mentioned as three indicators of accounting based performance (Schiuma, 2003). These indicators are used widely to check the performance of firms and capture their internal efficiency. A company associated with growth often has a profitable reinvestment opportunity to meet its retained earnings. Businesses that grow are often seen in the technology industries. Firms that have experienced consistent strong performance tend to employ external directors as they have the edge to do so.

1.1.3 Internal Audit Quality and Financial Performance

According to the agency and resource dependence theories, people play a role in helping to improve the performance of the firm given that they possess insight in regards to dealing with operation and achieving their responsibilities at the highest level of quality. Hutchinson and Zain (2009) have discovered using several regression analyses that between firm's performance and the internal audit quality there exists a positive correlation.

According to Fadzil et al. (2005), it is clear that internal auditors are more capable of running a company more competently and effectively in the interest of shareholders. A study by KPMG (1999) established that internal audit plays a crucial part in enhancing performance and assisting in profit verification in corporate scandal identification. This is predominantly in relation to financial fraud that relates to weak governance. In this case, internal audit works as a control measure which saves the organization from irregularities and malpractices and enables the organization to accomplish its objectives of enhancing a high level of productivity and profit.

Roth (2004) indicates that for the accomplishment of goals and objectives through reliable financial reports which management uses for decisions, there is the need for adept and effective internal controls. Poor or unnecessary internal controls lower productivity and increase the complexity of processing transactions without adding value to the activities. Humphrey (2006) highlights that employees get a better appreciation of their contribution through audit interviews and review of audit reports with internal auditors. Meletta (2004) equally states that audit committees, leaders and management teams are constantly searching for better approaches for performance management within audit departments. This can be accomplished by outlining quality assurance programs and implementing effective performance measurement frameworks.

1.1.4 Firms Listed at the Nairobi Securities Exchange (NSE)

The Nairobi Securities Exchange (NSE) was formed as a volitional organization of brokers in 1954. By modernizing its infrastructure, it has helped in increasing investor confidence. In the 1980s there was a design and policy implementation reform to encourage sustainable economic growth for a streamlined and strong financial structure by the Kenyan government. There has been a boom in the past years at the

NSE which has resulted in the increase of volume traded, with the stock market registering increased activity especially with initial offers.

In July 2011, the Nairobi Stock Exchange Limited changed its name to the Nairobi Securities Exchange Limited. The change in name showed a critical plan to develop into a comprehensive utility providing securities exchange which assists trading, clearing and payment of equities, debt, derivatives and other related instruments. Periodic reports of performance are required from companies by the NSE to ensure good management. In addition to a market report, a daily price list is also provided to keep investors aware of their assets' worth.

Corporate Governance guidelines of 2002 issued by the NSE recognizes the significant contribution of internal audit and actually provides best practices companies can adopt when setting up an audit function. In Kenya, internal audit has increasingly become crucial in the public sector. All listed firms are requested to have an internal audit department. An internal audit function should be established by the board of directors and it has to be independent of the activities they audit and be carried out with candour (Capital Markets Authority Act Cap. 485A).

Most quoted companies have functional internal audit departments charged with quality assurance and adequacy of internal control systems. In instances where budgets are not adhered to, poor financial performance is still prevalent. Massive amounts of funds cannot be accounted for because there is no adherence to the rules and regulations on the use of finances and this has put companies at risk of poor financial outputs. Effective and efficient internal controls are expected of firms listed on the Nairobi Securities Exchange to give a reasonable assurance that, the entity's objective in regard to conforming to regulations and laws, efficiency of operations and reliability of financial reports, is being achieved. According to the Capital Market Authority Act, it is a prerequisite for listed companies to safeguard shareholders' investments and assets by having a solid structure of internal controls. Despite the existence of a sophisticated system of internal controls and internal audit teams in quoted companies, a number of companies continue to experience financial distress which has threatened their survival in the business environment.

1.2 Research Problem

In recent years, corporate accounting scandals coupled by an outcry for transparency and integrity in financial reporting have given rise to two logical outcomes. Internal audit skills are now critical in resolving the complicated accounting manipulations which have muddled financial statements. In addition, public outcry for change and regulatory action has modified the face of corporate governance. As a result, the bar of ethical and legal scrutiny has been raised for agents of companies working for the principals. These outcomes are jointly responsible for addressing investors' anxieties about the financial reporting system. However, laxity still exists in implementing these internal audit findings and recommendations. (Kinyua et al., 2015).

Tighter regulations and enhanced standards for accounting and governance of firms has been the result of the occurrence of financial scandals. The Corporate and Auditing Accountability and Responsibility Act (Sarbanes and Oxley, 2002) was enacted in 2002 in the USA after the World.com and Enron scandals, where investors lost huge amounts of money. These scandals were caused by weak financial controls and ineffective internal audit practices that the Act tries to address.

The Capital Markets Authority report of 2013 in Kenya showed most firms registering declining financial performance. Most notably included Kenya Airways which reported a loss of KSh 10 billion; Mumias Sugar company KSh a 3.4 billion loss; Uchumi Super Markets a KSh 226 million loss; and Eveready East Africa Limited KSh 248 million loss. Declining financial performance quoted by firms from data available from a World Bank report, adversely affected the Kenyan economy. According to the World Economic Forum (WEF), Kenya was ranked 106 out of 144 countries due to mega corporation scandals. Some of the companies cited by the report for poor corporate governance were Cooper Motor Corporation (CMC) and Centum Ltd.

Audit quality was measured by Geiger and Rghunandan (2002) to check whether a going concern had been issued in the previous year for clients that went bankrupt. They discovered that a going concern judgement was likely to be presented by auditors in the later years but less likely in the initial years, which is contradictory to the concern that audit quality is affected adversely by a long client-auditor relationship.

Kasiva (2010) did an investigation on the effect of risk based audit in light of financial execution in commercial banks in Kenya. Matoke and Omwenga (2016) also distributed a journal on audit quality and financial execution of state recorded organizations. None of these examinations have taken a look at the impacts of internal review quality on financial execution of listed companies. With this, there exists a gap that should have been filled by this investigation on the impacts of internal audit on the financial performance of recorded state organizations.

A report was issued in on the affairs of Cooper Motors Corporation Holdings Ltd. which was being looked into by the Board of Capital Markets Authority. There was a complaint raised with Institute of Certified Public Accountants of Kenya (ICPAK), regarding Deloitte's conduct as external auditors. They highlighted that as auditors; they should have identified the deficiencies especially in the financial statements which were contrary to International Financial Reporting Standards (IFRS) and should have pointed them out. The International Standards of Auditing (ISA) however, state that the external auditor's use professional skepticism and report any irregularities or fraud they encounter but their work does not involve unearthing them. Before the external auditor realizes it, the internal audit should already know and through the internal audit reports made, the audit committee should be aware of it.

This study is therefore aimed at answering the question: What is the effect of internal audit quality on firm financial performance in Kenya?

1.3 Objective of the Study

To scrutinize the effects of audit quality on the financial performance of firms listed at the Nairobi Securities Exchange (NSE).

1.4 Value of the Study

This study may benefit the Government of Kenya by providing an understanding of how audit quality attributes affect firm operations and the effective management of resources. The study will also recommend how audit practices can be improved. The study will provide useful insight to the NSE on the current status of auditing in the listed firms. It will also be useful to stakeholders in the Kenyan financial sector as it provides ample evidence in regards to the association between audit quality and their firm performance as introduced by them when formulating the Code of Corporate Governance for Micro Finance Institutions in Kenya under Micro Finance Act.

Furthermore, academic scholars will find this study as a useful guide to conduct further research in the field of auditing and as a source for audit quality literature in particular by providing evidence drawn from audit practice in Kenya and also help them to appreciate and enhance their knowledge of internal auditing.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

Several theories will be reviewed and empirical evidence on the significance of internal audit quality to firm financial performance will be presented in this chapter.

2.2 Theoretical Perspectives

This study will make use of three main theories namely; agency theory, legitimacy theory and stakeholder theory.

2.2.1 Agency Theory

Agency theory is a contract under which a person (the agent) is employed by one or more individuals (principals) to conduct some services for them; consequently any ensuing decisions for the firm are made by the agent. Jensen and Meckling (1976) state that agency theory highlights management behavior, agency cost and the ownership order of the organization. The management of the firm is charged with the responsibility of maximizing shareholders' wealth. According to the authors, there is not a particular theory that signaled and explained the conflicting interest of individuals participating in business operations and have the same goals of maximizing firm returns. Jensen & Meckling (1976) explained it as a relationship between principal and agent, which involves the delegation of duties of managing the business affairs with an intention to maximize returns. The agents and principals look to get as much conceivable utility with the minimum conceivable use of resources. Therefore, for internal audit quality to be effective, support from top management is as vital to the firm as much as the independence of the stakeholders is, or else problems can arise in agency relationships linking the agents (management) and the principals (shareholders)

Agency theory also addresses the problem of conflict of the desires of the agents and principals when their attitude toward risk is different. Because of dissimilar risk tolerance levels, the principal and agent may each be inclined to take actions which are at odds with each other. Shareholder wealth maximization may not be pursued as the agents might pursue avenues that are in their own self-interest. (Bonazzi et al. 2007, Lan et al. 2010, Demsetz et al. 1985). The agency problem in separating ownership and management is therefore the assumed diverging goals of the cooperating parties. Owners (principals) must therefore ensure their interests are protected through measures like employing external auditors which constitute agency costs but internal audit if effective and efficient, is a way by which principals can ensure and check that management is acting in their interest.

2.2.2 Stakeholder Theory

The theory assumes that moral values and business ethics are essential in managing an organization. Wheeler et al., (2003) explain that this theory came about as a combination of the organizational and sociological disciplines. The theorists believe that in organizations, managers possess a network of relationships which include suppliers, employees, lenders and other business partners who have the company's interests at heart. They make key decisions to realize the objectives of the organization like resource allocation and control and the activities that impact the organization and in one way or the other on others also. Stakeholders have diverse interests in the organization, of either environmental or of an economic nature. The benefits of its stakeholders (owners, employees, customers and local committees) should determine how the organization is managed and should maintain the survival of the firm.

Friedman (1970) meant to generalize the term stakeholder with the notion of the stockholder and that management should be responsible for only that group. Stakeholders in a narrow sense are those who are vital to the prosperity and survival of the company and in a wider sense, any individual or group who is affected or can affect a particular organization (Freeman, 1984).

As a normative theory, it demands management to have an ethical duty to safegurad the firm as a whole and the lawful claims of all stakeholders (Friedman, 1970). The survival and health of the firm must be looked after by management especially top management by balancing the multiple claims of conflicting stakeholders. The interests in the organization by different groups and individuals identify them as stakeholders and it is assumed that all their interests have intrinsic value to the continued positive performance of the organization.

2.2.3 Legitimacy Theory

Legitimacy theory is concerned with the perception that a company is operating within the acceptable norms of a society. Organizations attempt to align themselves and conform to the social values which are implied or come with their activities and the basis of admissible conduct on the social structure which they are a component of. The legitimacy theory also expounds the growth and survival of organizations based on the need to maintain and acquire the support of its constituent stakeholders. This theory implies that the internal audit function of the firm will help how society perceives the organization’s activities and based on societal expectations be used in reporting its operations. So long as the organization meets the society’s expectations, it will be allowed to continue its operations. Therefore, the right to operate and society perception are interrelated. The absence of legitimacy could impact an organization's ability to carry out economic exchange for required resources. This connection encourages organizations to put in place control mechanisms that establish the ability to manage relationships among stakeholders and safeguarding the perceptions of the organization's legitimacy (Pasewark et al., 1995).

2.3 Determinants of Financial Performance of Listed Firms

Capacity measures give an instrument to the association to deal with its budgetary and non-money related capability. Responsibility is expanded and upgraded, guaranteeing that tasks bolster the hierarchical technique and that better administrations and more noteworthy fulfillments are given to a client.

2.3.1 Effectiveness of Internal Auditors and the Internal Audit Function

The suitability of internal auditors and professional proficiency increase the quality of internal audit. It requires internal auditors to possess the appropriate skills, training, qualifications, knowledge and ability to carry out what is expected of them. A good audit can be performed when the staff have the experience, education, training and collectively can administer all that is required by its mandate the entire scope of audits requested by its directive (Al-Twaijry 2010, Brierley and Gwillian 2003). The greater the training, integrity, skill and expert capabilities of internal auditors, the more effective the department will be.

Accomplishing audit's goal by collecting substantial and relevant audit evidence to provide a fair judgement on the financial statements in compliance with the Generally Accepted Accounting Principles (GAAP) is effective auditing. Audit effectiveness helps firms accomplish their objectives through the process of systematically approaching and evaluating control and governance processes and the management of risk in a disciplined approach so as to improve its effectiveness. It also enhances responsibility that employees and executive directors have towards stakeholders and owners (Eighme & Cashell, 2002).

2.3.2 Liquidity

Liquidity according to IFRS (2006) implies availability of cash for the near future after meeting financial obligations in a given period. It is the ability to meet one’s financial obligation in the purchase or sale of assets without much loss on its value.

Liquidity and financial performance are key to the management of financial institutions. As Richard and Laughlin (1980) suggest, the liquidity level for managers and investors for assessing the fate of a company, calculation of investing risk and return and stock price as well as the necessity of removing weaknesses and defects of traditional liquidity ratios are very important. The impact of liquidity to company performance therefore leads to the conclusion that it contributes to the positive financial performance of a company.

2.3.3 Financial Leverage

The monetary use of an organization is the proportion of its aggregate obligations, both short and long haul, to the measure of its value capitalization. A high proportion of obligation to capital puts the organization at threat when there are vacillations in deals volume and income. Obligation commitments must be paid on time, paying little mind to the benefit level or the measure of income. An organization with higher funding to obligation will have a simpler time meeting its obligation commitments. Shareholders are paid with profits, yet the timetable is not inflexible as with obligation. A noteworthy preferred standpoint of monetary use is enhancement of shareholders' riches through a blend of obligation and value, exploiting the tax framework which favours obligation financing by making premium deductibles from earnings when figuring the organization's assessment risk.

2.3.4 Firm Size

Stierwald (2010) discovered positive and critical parameter evaluates for firm size. The examination demonstrates greater firms are more beneficial than littler firms. The size of a firm fundamentally upgrades its execution. Stierwald (2010) states that a conceivable reason is that substantial firms abuse scale economies and advantage from economies of scale. An option to clarify is that, huge firms can access capital at much lower expenses than smaller firms. Firsteberg and Malkiel (1994) asserted that when there are eight or less individuals on a board, it energizes more prominent focus, cooperation and real collaborations and dialogue.

2.4 Empirical Literature Review

Maijoor and Vanstraelen (2006) did a comparative study to explore the issue of earnings administration in a European setting. They analyzed the impacts of national audit condition, audit firm quality (utilizing intermediary of audit firm size) and dependence on worldwide capital markets on income administration exercises.

Utilizing information from firms in France, Germany and the UK, they found that when it came to earnings administration activities differs from nation to nation. Their examination discovered three critical discoveries. Firstly, stricter national audit conditions assume a critical part in obliging income administration exercises paying slight note to the extent of the audit firms between the three nations. Secondly, the impact of huge size audit firms on income administration exercises just exists in the UK because of a stricter speculator insurance condition yet not in France or Germany. Thirdly, firms that depend on worldwide capital markets are related with more elevated amount of collections, which suggests that NYSE listings do not dissuade income administration.

Chen, Lin and Zhou (2005) give evidence to show that huge size and specialist auditors are related with financial reported of a higher level. Utilizing information from Taiwan IPO firms, their examination uncovers that the customers of the Big Five auditors detailed less unforeseen accumulations. The outcome suggests large auditing firms can moderate earnings administration, and, along these lines, add to more exact financial data. Lee et al. (2006) completed an investigation to analyze the connection between the extent of audit firms on both the precision and conservatism of appraised income gauges given in the Australian IPO plans. Utilizing an example of 215 firms, from 1991 to 1998, they found that profit estimates detailed and audited by the then Big Six firms are more precise than from little firms. They found that big size auditors are more moderate on detailed profit forecasts, which shows a high caliber of financial reporting.

The work of Caramanis and Lennox (2008) analyzed the impacts of audit effort (utilizing intermediary of audit hours worked) on the nature of profit. When an audit exertion is low, directors are more forceful in overseeing profit with a specific end goal to meet or beat the income standard. Their discoveries additionally demonstrated a significant negative connection between audit hours and revenue-expanding earnings administration. This implies that a significant number of auditors work longer hours and can screen aggressive earnings management. They therefore inferred that lower audit exertion gives an open door for directors to forcefully manage their reported earnings.

The examination led by Yassiariti and Nelson (2012) took audit expenses as a measure of audit quality in which they recommended that, when a firm pays higher audit charges, auditors do effective services for the firm contrasted with those organizations that try to bring down audit expenses by paying less. O'Sullivan and Diacon (2002) showed that more audit hours and highly qualified audit staff are constantly essential for more exhaustive audit services subsequently leading to more audit expenses. Yuriarti (2011) examined the connection between factors that have impact on audit nature of 24 Bandung firms in Indonesia for the year 2009. The findings uncovered that higher audit charges enhanced audit quality as auditors put in more effort to give quality audit services to contracting firms.

The audit quality have a secondary impact on corporate administration that impact the firm performance as expressed by the study directed by Desender (2010) which give more credit to the auditing firms. The neutral audit is being considered as a major aspect of the corporate administration, which is utilized as the instrument of controlling firm assets to accomplish the objectives of the organizations. Nonetheless, notwithstanding the immediate impact of audit excellence on accounting dependability, there is an incidental impact by the relationship between audit quality and corporate administration components (Knechel & Willekens, 2006; Desender, 2010).

Brown and Caylor (2004) proposed that an organization that has a conventional approach to auditor alternation is connected in a positive way with return on value as an intermediary for firm performance. Carey and Simnett (2006) analyzed the relationship linking audit residency and irregular working capital accumulation. Their discussion mentions that pivot of audit is one of the primary strategy activities that have been executed in numerous locales around the globe to manage worry regarding audit quality. Their outcomes demonstrate that there is no confirmation of a relationship of either the marked or supreme measure of strange working capital gatherings with long audit accomplice residency.

Kamonjo (2012) examined the impact of corporate governance practices on financial performance of SACCOs in Kirinyaga County. The results of this investigation showed that between the volume of the board and the money related performance there is a negative relationship; the normal board estimate being seven. The investigation likewise uncovered a positive connection between the recurrence of meetings held by the board every year and ROCE; the normal number of gatherings every year being ten. As to nearness of inward audit work, the examination uncovered a negative connection amongst ROCE and the presence of the internal audit work with just 23.7% of the respondents demonstrating that they have an audit division in their SACCOs.

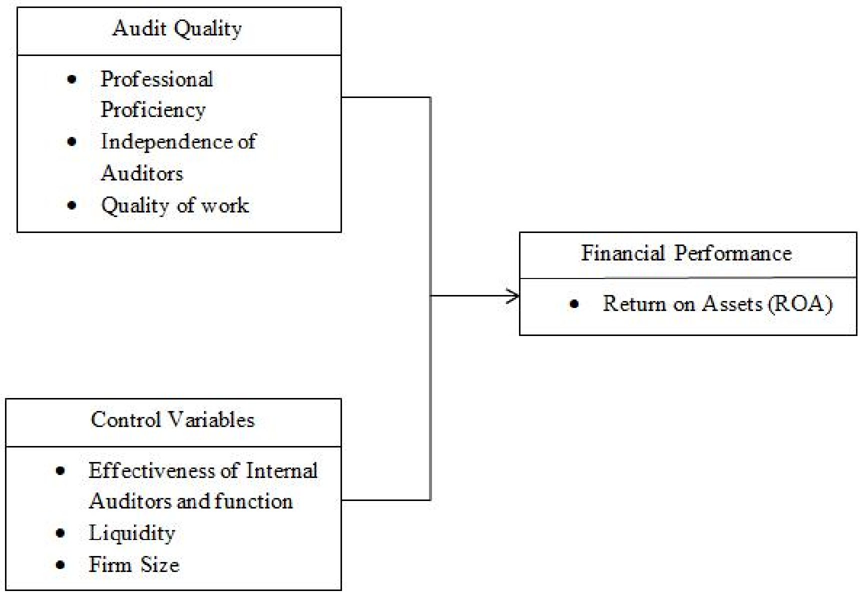
Njeru (2013) in his examination looked to set up the freedom of inward audit and how it identifies with corporate administration among business banks in Kenya. Information was gathered utilizing a 27 question poll conveyed to all the 43 business banks in Kenya as of 31/12/2012. The examination discovered that since the Chief Executive Officer (CEO) had the ability in many banks to authorize the internal audit spending plan, there existed a danger to internal audit independence, decide the remuneration of the Chief Audit Executive (CAE) and in addition, contract and fire the CAE. The examination additionally discovered that there was a linear connection between internal audit autonomy and corporate governance among commercial banks in Kenya.

Mugo (2013) conducted an investigation to build up the connection linking internal audit independence and corporate governance in Technical Training Institutions in Kenya. Information was gathered utilizing questionnaires and in addition, survey of accessible archives and records focusing on essentially finance officers, Heads of offices, administration council individuals among others. The investigation found that management of the organizations is focused on the control framework which effectively takes part in checking and the supervision of the exercises of the Technical Training Institutions in Kenya.

2.5 Conceptual Framework

The study's conceptual framework will be composed of the independent and the dependent variables. Financial performance will be the dependent variable and the independent variables are the audit committee size, auditors' experience, auditors' independence and auditors' qualification.

Figure 1: Conceptual Framework



2.6 Summary of Literature Review

In accordance to the review of theories and existing literature, it is maintained that control instruments are supplements; since directors regularly increment interest in both internal and external auditing so as to safeguard their status, as extra external auditing is relied upon, it is anticipated to be related with more internal auditing and enhanced management systems. The potential of listed firms are subject to the internal audit quality kept by the firm as the idea of a positive affiliation is as per Hay et al. (2008) who "...present contentions that controls, administration and auditing are complements, not substitutes, therefore, an expansion in one will prompt an expansion in the others" (Hay et al., 2008).

The examinations did have focused such a great amount on demonstrating the presence of an audit expectation gap in different nations. Different examinations have additionally taken a look at insights about the genesis of audit quality and finding answers to the issue. A couple of different studies have looked at the reasons for audit quality and even developed a quality model to demonstrate its diverse segments. . The review of literature notes that there has been research that has been done for the most part in the USA, Malaysia, Egypt, Iran, India, Nigeria as well as Singapore. Very few examinations have been completed on the audit quality in Kenya's point of view; this survey contributed towards filling this gap.

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CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

In this section, the researcher sought to respond to the various research questions so as to meet the goal and intent of the study. This section deals with research philosophy, research design, sampling, research instruments, data collection and analytical methods. Research methodology is described as a way to comprehensively address the research problem, (Kothari, 2004).

3.2 Research Design

Research design is the ordering of conditions for gathering and data evaluation in a way that strives to put together pertinence to the research justification with a cost-cutting measure in procedure (Kothari, 2008). The research used here was a descriptive survey design. Information about a group of people (one or more), who are asked a number of questions with their answers being recorded and inputted into spreadsheet tables. The questions may be about their opinions, attitudes, characteristics or experiences.

Willing participants are asked questions and their replies are put together with percentages, frequency counts or more sophisticated statistical indexes, from the answers received, from which inferences can be drawn about a particular population. Additionally, it discusses in detail the prevailing status of two or more variables at a given position in time. It also checks to see if there is anything linking them and what is most suited in establishing the perceived role, effectiveness and evaluation of internal audit function in companies listed on the NSE.

3.3 Population

Kombo and Tromp (2006) describe population as a complete category of elements or persons that at the minimum have one thing that they share in common. Mugenda and Mugenda (2003) interpret it as a whole group of individuals, events or objects that have a common noticeable attribute and adjust to a given description. A census of all companies was used since it is accurate and involves the whole population. The study population will be the firms listed on the NSE, which are 66 listed companies.

3.4 Data Collection

There are several strategies for information gathering as stipulated by Ngechu (2004. Choosing an instrument or apparatus for the most part depends on the traits of the subjects; investigative theme, issue question, targets, outlines, and anticipated information and outcomes. This is on the grounds that each device and instrument gathers particular information. There are two major sources of data normally used and they are primary and secondary information sources.

In this study, primary and secondary data were used. The researcher gathered important and relevant information on companies' performance statements from the NSE as well as the associated annual statements. The information collected was based on a period of five years that is from 2011-2016. The period was deemed appropriate to enable this study to achieve its objectives. Secondary data was obtained using a review of existing publications on the relationship between auditing and executive compensations.

The researcher administered a review survey for every individual from the objective sample populace. The poll was carefully composed and tested out with a few people for facilitating enhancements. This was done with the specific end goal to improve its legitimacy and enhance the precision of information to be gathered for the examination.

3.5 Reliability and Validity Tests

Reliability is an estimate of the extent to which a particular measuring method presents the same kind of results or data after it is replicated. Cooper & Schindler (2011) argued that the measuring tool should be an accurate counter or indicator of what the research is interested in measuring. Therefore, to ensure that the research instruments collect the desired data, it is important to validate them before they are administered. To ensure that the research instrument collects the desired information, it was given to colleagues and other experts in the research field in order to identify any ambiguous and unclear questions

3.6 Data Analysis

Data was categorized, ordered, manipulated and summarized to enable the research questions to be answered. This was done by entering data into a computer through Microsoft Excel to enable manipulation of the data before inputting the data into SPSS after which analysis was done using the SPSS statistical package. Descriptive statistics, frequency tables, mean and standard deviation will be used to present the research findings.

Descriptive statistics according to Cooper and Schindler (2008) means statistical measures are used to depict the center, spread and shape of distribution when presenting the findings. Regression analysis was utilized to link the connection linking audit quality and financial performance. The dependent element is the financial performance calculated by return on assets (ROA). The independent variable is audit quality which was measured by the given parameters: audit committee size; qualification; independence and experience. These parameters were measured using mean scores derived from an analysis of the five-point Likert scale questions from the questionnaire. This study covered a five-year period from 2011-2016. The following models will be used:

3.6.1 Conceptual Model

The relationships among the variables will be estimated using a function:

FP = f (AQ)…………………………………………………………………… (1)

FP = Financial Performance

AQ= internal Audit Quality

3.6.2 Analytical Model

The Regression equation is modeled as follows;

$Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \beta_5X_5 + \beta_6X_6 + \varepsilon$

Y Financial performance calculated by Return on Assets

X_1 is Professional proficiency of Internal Auditors

X_2 is Auditors’ Independence

X_3 is Quality of work of internal auditors

X_4 is Top management support for the internal audit department

β_0 is the regression constant

$\beta 1$, $\beta 2$, $\beta 3$, $\beta 4$, $\beta 5$ and $\beta 6$ are the coefficients of independent variables,

ε : Standard Error term.

X_5 and X_6 = Control variables are leverage (L) and (S) size respectively.

X_5= Leverage ratio of total debt to total assets

X_6 **=** Size, defined as the natural log (Ln) of Total assets

The independent variables represented the point of view of the responders to the questionnaire about these concepts, a 5-point scale (1 = strongly disagree to 5 = strongly agree) was used to estimate all the items for the independent variables.

X_1 is Professional Proficiency, X_2 is Auditors Independence, X_3 is Quality of Work and X_4 is Top Management Support. All these variables are measured in the questionnaire.

3.6.3 Variables and Variable Measurement and Selection

The dependent variable is shown as the financial performance of companies listed on the NSE. ROA is considered the best measure of profitability since it measures the return on all assets utilized in generating profit. It is computed by dividing the profit before interest and tax by the book value of total assets. The independent variables consist of 4 elements namely; Internal Audit Standards, Internal Audit Independence, Professional Competence and Top Management Support.

3.6.4 Test of Significance

The outcome of the regression analysis were assessed based on the R^2, ANOVA, and significance of F statistics and the significance of beta values from the coefficients of the X variables. Results will be said to be statistically significant within the 0.05 level, which means the value of the significance must be smaller than 0.05. Significance will be tested at a 5% level.

CHAPTER FOUR

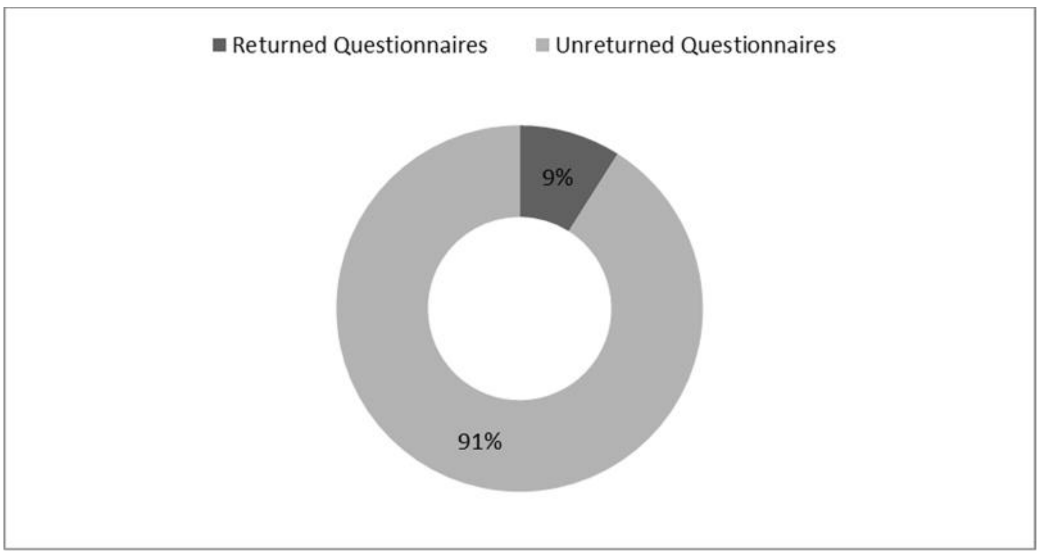
DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the various statistical approaches used to check the effect of internal audit quality on the financial performance of firms listed on the NSE. Data gathered from the field is shown and examined using descriptive and inferential statistics.

4.2 Response Rate

Figure 4.1: Response Rate



The study was done using the entire listing of firms listed the NSE. Out of the 66 expected respondents, 60 were able to fill out and return the questionnaires; this led to a response rate of 91% to be achieved. The response rate was deemed to be adequate, since Sekaran, (2016) contends that any response above 75% is classified as optimal. Based on this, the response rate was excellent.

4.3 Validity and Reliability Analysis

The reliability of the questionnaire was evaluated through Cronbach's Alpha which assesses the consistency or how closely a set of items are as a group. Cronbach's alpha was calculated by the application of SPSS version 20 for reliability analysis. The value of the alpha coefficient ranges from 0-1 and may be used to describe the reliability of factors extracted at 0.5 significance level from dichotomous and or multi-point formatted questionnaires or scales.

When the value is higher, it displays a generated scale which is more reliable. 0.7 has been shown as the acceptable reliability coefficient by Cooper & Schindler (2011). According to (Mugenda & Mugenda, 2008) therefore, all the 5 scales were reliable as evidenced by their reliability values which passed the recommended threshold of 0.7.

Table 4.1: Reliability Coefficients

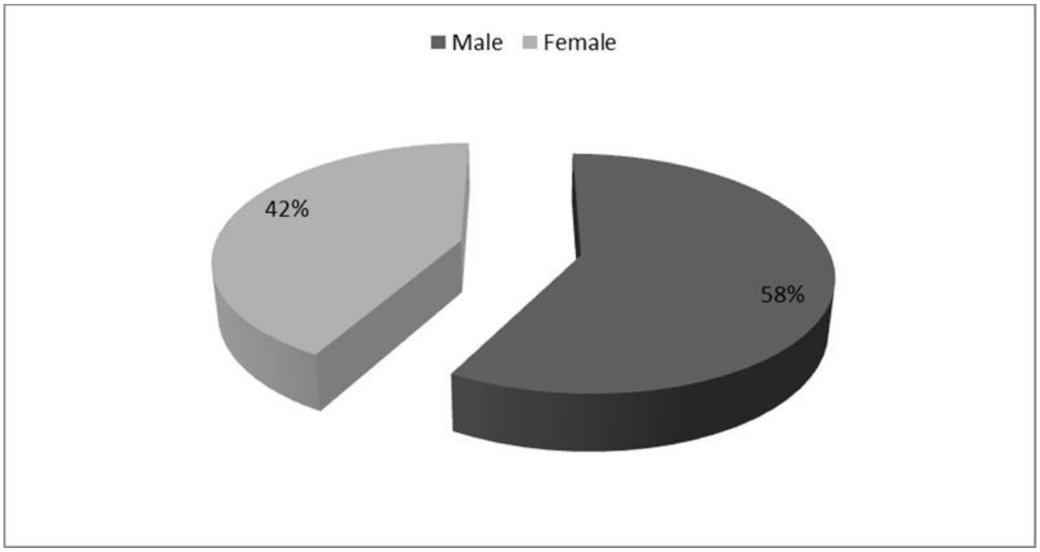
Scale	Cronbach's Alpha	Number of items
Professional proficiency of internal auditors	0.754	4
Audit independence	0.765	4
Quality of work of internal auditors	0.814	4
Top management support	0.712	4

4.4 Profile of the Respondents

4.4.1 Respondents Gender

The study sought to determine the gender disparity of the respondents. Figure 4.2 below displays the results of the analysis.

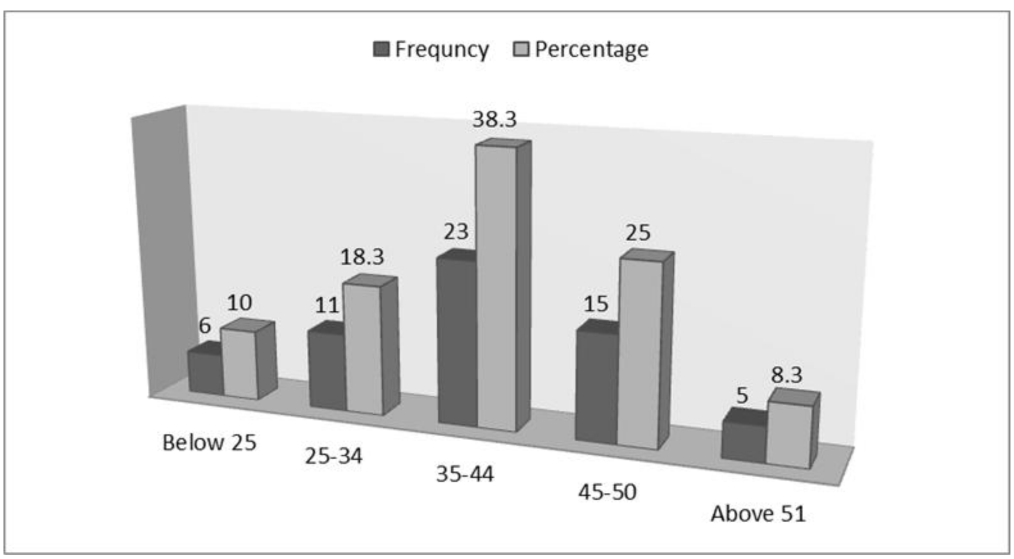
Figure 4.2: Gender of the respondents



From the findings, it was established that most of the respondents (58%) were male with a slightly lesser number of 42% of the respondents being female. The disparity calculated of 16% was not sufficient to create any bias on the study.

4.4.2 Age Bracket of the Respondents

Figure 4.3: **Age Bracket of the Respondents**

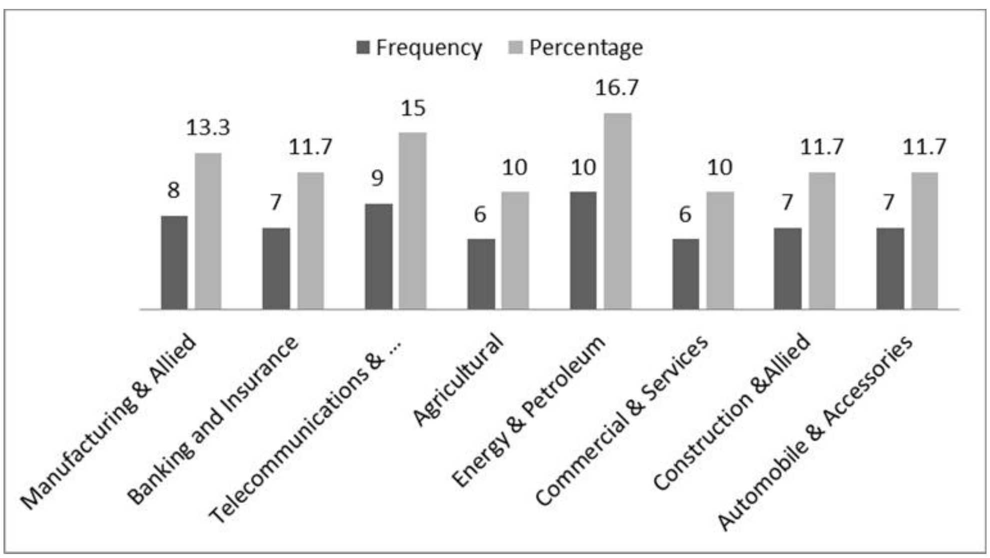


The respondents were asked to specify their age. From the analysis, a major part of the respondents (73.3%) indicated that their age bracket was between 35 and 44 years old while 25% of the respondents were aged between 45 and 50 years. Analysis of results also showed that 18.3% of the respondents were between 25-34 years of age and this age group carried a frequency of 11 respondents. 10% of the respondents indicated that they were below 25 years old while those aged 51 and above constituted the least among the respondents. From the results, it can be decided that a majority of the respondents were appropriately aged to provide data on the effects of internal audit quality on financial performance of firms listed in the NSE.

4.4.3 Respondents' Industry

This section attempted to determine the industry to which the respondents belonged to. The outcome was is shown in figure 4.4.

Figure 4.4: Industry of the Respondents



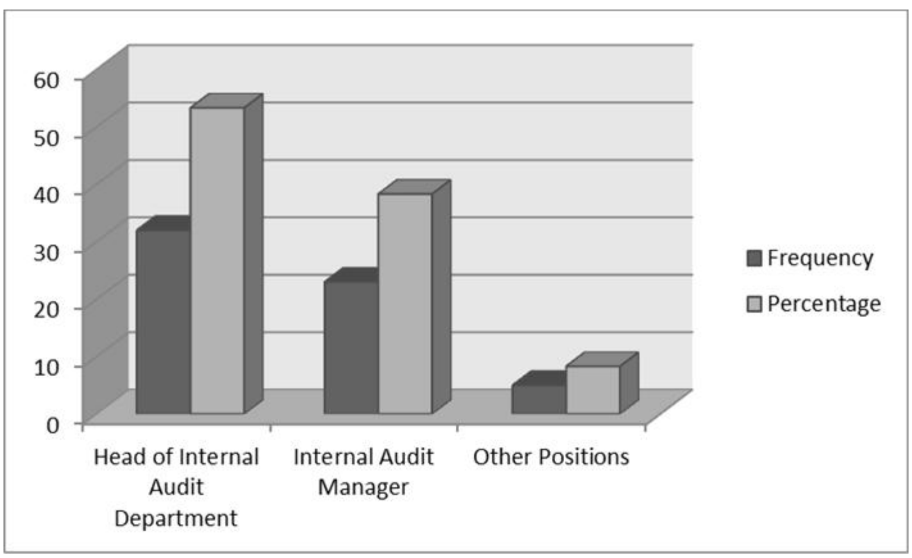
Computations based on frequency distribution in Fig. 4.5 indicate that majority (16.7%) of the respondents worked in the energy and petroleum industry. 15% of the respondents were employed in the telecommunications and technology industry.

13.3% of the respondents were employed in the manufacturing and allied industry. 11.7% of the total respondents were employed in the banking and insurance industry while another 11.7% of the respondents were employed in the construction and allied industry, yet another 11.7% of the respondents were identified as being employed in the automobile and accessories industry. Respondents employed in the commercial and service industry were the least (10%) among respondents. The study thus inferred from the results that the respondents were well distributed in the sectors of firms listed in the NSE.

4.4.4 Position in the Organization

The study attempted to determine the position of the respondents in the organization. The results from the analysis are shown in the figure below:

Figure 4.5: Position in the Firm

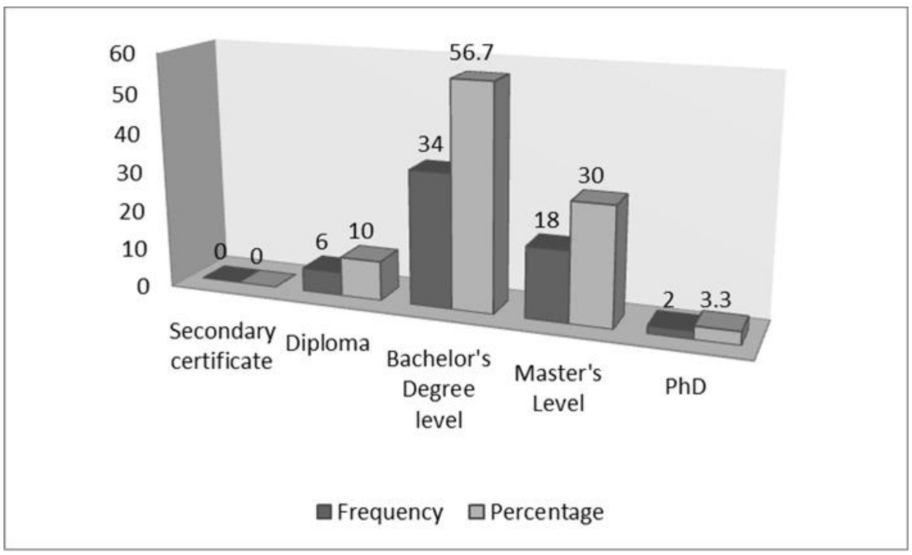


From the examination of the data based on frequency distribution, (53.3%) of the respondents were heads of the internal audit department. In addition, there were respondents who highlighted that they were internal audit managers with a frequency of 23 which corresponds to 38.3% of the total. The group of respondents in departments other than the aforementioned constituted the least frequency 5 which is 8.3% of the total respondents.

4.4.5 Level of Education

This section attempted to ascertain the educational level of respondents and the results are as depicted in figure 4.6 below

Figure 4.6: Respondent Level of Education



The highest level of education of the respondents was asked and it was revealed that 56.7% of the respondents had their bachelor's degree, 30% indicated their highest level as a masters' degree, 10% of the respondents revealed their highest educational level as being a diploma level, while the least percentage of 3.3% of the respondents stated that they had a PHD. This shows that most of the respondents in this study had university degree as their highest level of education and therefore had the knowledge to fully analyze the result of internal audit quality on financial performance of firms listed in the NSE.

4.5 Diagnostic Tests

The preferred regression model was subjected to a range of diagnostic tests to check the validity of the model. The diagnostic tests included: the Breusch-Pagan test for heteroscedasticity and White Heteroscedasticity Test (LM) for constant variance of residual over time, the ARCH (Autoregressive Conditional Heteroscedasticity) test which detects the problem of heteroscedasticity and the Ramsey RESET test which is used for the specification of the regression. Further regression and correlation analysis were used to establish the connection between the dependent and the independent variables. The outcome is presented in Table 4.2 below.

Table 4.2: Diagnostic Tests

Test	**F-statistics**	**Probability**
Ramsey RESET Test:	1.23	0.29
White Heteroskedasticity Test:	2.28	0.064
ARCH Test	2.29	0.063
Breusch-Pagan Test for Heteroskedasticity LM Test:	2.12	0.071

Table 4.2 displays that the parameters of the regression analysis are stable and the model can be used for estimation at a 5 percent confidence level. The Ramsey RESET Test for model specification, ARCH Test and White Heteroscedasticity Test for constant variance of residuals and Breusch-Godfrey Serial Correlation LM Test for serially correlated residuals used the null hypothesis of good fit (specification, heteroscedasticity, and non-autocorrelated against the alternative hypothesis of model mis-specification, heteroscedasticity, and autocorrelated respectively. All the probability values are less than F-statistics coefficients at 5 percent level of relevance

and therefore the null hypothesis was not rejected. The diagnostic test outcomes were therefore satisfactory.

4.6 Effectiveness of the Internal Audit Function

The study sought to establish the effectiveness of the internal audit function. The respondents were requested, on a five point Likert scale to indicate their effectiveness. The range was from 1 to 5 to show their level of agreement. The score of one meant "strongly disagree" two represented "disagree", three showed "neutral", four indicated "agree" and five meant "strongly agree" .

Table 4.3: Effectiveness of the Internal Audit Function

Effectiveness of the internal audit function		
Observation	Mean	Standard Deviation
Professional proficiency	4.32	0.845
a) Internal audit employees have the appropriate education in auditing	3.98	0.716
b) The auditors in the organization are qualified to undertake the audit function	4.52	0.458
c) Frauds are identified by the internal audit function	4.15	0.325
Organizational independence		
a) Independence is required for the efficiency of internal audit	4.26	0.21
b) Internal auditors may not have conflict of interests	4.33	0.48
c) Internal auditors work independently and conduct their work without interference	3.98	0.79
Quality of audit work (standards)		
a) Audit recommendations are clearly conveyed and their implementation lead to control improvements and efficiency	4.04	0.5489
b) Standards for audits and related services influence performance of the organization	3.61	0.45

c) Working in compliance to internal auditing standards contribute and influence the effectiveness of auditing	4.11	0.39
d) Auditors perform their roles objectively in compliance with accepted practice criteria	4.09	0.11
Top management support		
a) Management provides enough support and training for internal audit staff	4.79	.109
b) Management regards internal audit as an important function	4.13	0.78
Audit Committee		
a) The size of the Audit Committee is adequate with qualified people to function on it	3.99	0.26
b) The frequency of the Committee meeting is sufficient to fulfil all tasks required	3.78	.23

From the analysis of findings majority of the respondents concurred with statements relating to professional proficiency, auditor's independence, quality of work of internal auditors and top management support. From the findings in the SPSS analysis, the statement:- Management provides enough support and training for internal audit staff had the highest level of mean (4.79). This signifies that larger part of the respondents concurred with the statement. The standard deviation calculated from the analysis was 0.109 which showed that most of the respondents thought the same thing. In addition a large section of the respondents strongly agreed that the auditors in the organization are qualified to undertake the audit function. This was supported by the mean value of 4.65. The statement also tallied a standard deviation of .458 which also showed that there was not much difference from the mean mark. A great portion of the respondents strongly agreed with the statement; internal auditors may not have conflict of interests, this was assumed from the mean value calculated in the analysis of 4.33**.** The standard deviation of 0.48 calculated showed that a greater part of respondents were of a comparable judgement. Generally, it was identified that the internal audit quality influence the financial performance of firms that have been listed on the NSE.

4.7 Descriptive Statistics on Return on Assets

The payment of dividends to shareholders reduces the retained earnings of the firm. This may affect a firm's ability to reinvest, therefore affecting future expansion options. Bhattacharya (2009) noted that the positive impact of profitability and firms with growth opportunities supports the findings that healthy firms have the benefit of easily acquiring relatively low-cost credit compared to others. The study analyzed the return on investments of the listed firms for a period between 2011 and 2016. The findings are as shown in Table 4.4 below.

Table 4.4: Return on Assets

Year	**Return on Assets**				
	Median	**Minimum**	**Maximum**	**Mean**	**Std deviation**
2011	2.42	0.21	2.75	Mean	Std. Dev.
2012	2.53	0.51	2.93	1.95	1.63
2013	2.63	0.56	3.11	2.44	1.95
2014	3.01	1.02	4.12	2.87	2.01
2015	3.42	2.12	5.92	3.59	2.15
2016	3.57	2.34	6.33	3.66	2.19

Table 4.4 above indicates that the listed firms witnessed increased market capitalization based on the return on investments. The ROA increased from 1.95 in year 2012 to 3.66 in year 2016. This was a 1.71 change (increase) in ROA. This shows that the firm's return on assets significantly enhanced market capitalization.

4.8 Inferential Statistics

The study tried to find the effects of internal audit quality on the financial performance of firms listed on the NSE. The factors investigated were: professional expertise of internal auditors, auditors' independence, standard of work of internal auditors and support from top management.

4.8.1 Correlation Analysis

After the descriptive analysis, the Pearson correlation analysis was used to analyze and check the connection of the independent and dependent variables. It is an estimation of the strength of a linear relationship between 2 elements and is represented by r. It thus, helped in ascertaining the strengths of the relationship in the model, that is, which variable best described the effects of internal audit quality on financial performance of firms listed in the NSE.

Table 4.5: Correlation Matrix

		Professional proficiency	Auditors Independence	Quality of work of	Top Management	Financial Performance
Professional proficiency of internal auditors	Pearson Correlation	1				
	Sig. (2-tailed)	.				
Auditor's independence	Pearson Correlation	0.495	1			
	Sig. (2-tailed)	0.031	.			
Quality of work of internal auditors	Pearson Correlation	0.534	0.459	1		
	Sig. (2-tailed)	0.012	0.002	.		
Top management Support	Pearson Correlation	0.448	0.689	0.843	1	
	Sig. (2-tailed)	0.042	0.043	0.033	.	
Financial Performance	Pearson Correlation	0.613*	0.623*	0.672*	0.836*	1
	Sig. (2-tailed)	0.01	0.011	0.015	0.009	.
	N	60	60	60	60	60

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

Source: Researcher 2017

From the results, the Pearson Correlation coefficient between the professional proficiency of internal auditors and financial performance was 0.613. This indicates a strong and positive linear association between the predictor and the explanatory variable. Auditors' independence had a correlation value of 0.623 with financial performance. Also noted was that the quality of work of the internal auditors had a correlation value of 0.672 with financial performance, which indicated a significant, positive and linear connection linking the two variables. The study also noted that top management support had a correlation value of 0.836 with the financial performance of firms listed in the NSE. The research therefore generally accepted that a valid, positive and significant correlation linking the dependent and independent variables.

4.8.2 Regression Analysis

The regression model was:

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

Whereby Y represents financial performance, X_1 is professional proficiency of internal auditors, X_2 is auditor's independence, X_3 is quality of work of internal auditors and X_4 is the top management support. B_0 is the model's constant, and $\beta_1 - \beta_4$ are the regression coefficients while ε is the model's significance from f-significance results obtained from analysis of variance (ANOVA).

4.8.2.1 Model Summary

Table 4.6: Model's Goodness of Fit Statistics

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.990[a]	.979	.978	.06256

a. Predictors: (Constant), professional proficiency of internal auditors, auditors' independence, quality of work of internal auditors and top management support

Table 4.6 shows that there is a good linear association between the dependent and independent variables used in the study. This is shown by a correlation (R) coefficient of 0.990. The determination coefficient as measured by the adjusted R-square presents a moderately strong relationship linking dependent and independent variables with a value of 0.979. This depicts that the model accounts for 97.9% of the total observations while 2.1% remain unexplained by the regression model.

4.8.2.2 Analysis of Variance

Table 4.7: Analysis of Variance (ANOVA)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	10.273	4	2.568	656.169	.000[b]
	Residual	.22	55	.004		
	Total	10.493	59			

a. Dependent Variable: Financial performance

b. Predictors: (Constant), professional proficiency of internal auditors, auditor's independence, quality of work of internal auditors and top management support.

Source: Researcher 2017

The ANOVA statistics presented in Table 4.10 was used to present the regression model significance. An F-significance value of p = 0.000 was established showing that there is a probability of less than 0.1% of the regression model presenting false information.

4.8.2.3 Regression Coefficients

Table 4.8: Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	.463	.094		4.932	.000
	Professional proficiency of internal auditors	.747	.097	.656	7.689	.000
	Auditors' independence	.017	.021	.021	.843	.403
	Quality of work of internal auditors	.292	.037	.298	7.858	.000
	Top management support	.087	.080	.083	1.091	.280

a. Dependent Variable: Financial performance

Source: Researcher (2017)

The following regression result was obtained:

$Y= .463+ .747X_1 +.017X_2 + .292X_3 + .087X_4$

From the regression coefficients, when auditors independence, quality of work of internal auditors and top management support are held constant, a unit increase in professional proficiency of internal auditors will lead to a .747 increase in the financial performance of the firms listed in the NSE. When professional proficiency of internal auditors, their independence, quality of work of internal auditors and top management support are constant, a unit increase in auditors' independence will lead to a .017 increase in the financial performance of the firms listed in the NSE. Holding professional proficiency of internal auditors, auditors' independence and top management support constant, a unit increase in quality of work of internal auditors would lead to a .292 increase in performance. Also noted is that when professional proficiency of internal auditors, auditors independence and quality of work of internal auditors are constant, a unit increase in and top management support will lead to a .087 increase in financial performance.

4.9 Discussion of Findings

The study exhibited that there was a notable contrast in the financial performance of firms listed on the NSE because of changes in proficiency of internal auditors, quality of work of the internal auditors, top management support and independence of the internal auditors. This evidently displays that variations in financial performance of the firms could be deemed to be from changes in these independent variables (proficiency of internal auditors, standard of work of the internal auditors, top management support and independence of the internal auditors). The study revealed that a strong affirmative connection existed between firms listed on the NSE and proficiency of internal auditors, grade of work of the internal auditors, top management support and independence of the internal auditors.

From the independent variables measured (proficiency of internal auditors, level of work of the internal auditors, top management support and independence of the internal auditors) revealed that a considerable 97.8% of financial performance of firms at the NSE is shown by adjusted R2 (0.978). This establishes that 97.8% of financial performance was the result of the independent variables whilst 2.2% of the financial performance of firms on the NSE was the result of arbitrary variations and factors not studied in this research.

From the study, it was confirmed that the internal auditor's professional proficiency had a coefficient of 0.747 which shows that the financial performance of firms listed on the NSE were positively and consequentially impacted by it. Humphrey (2006) affirmed that auditors gain an appreciable understanding of the activities they execute and the reason they are necessary through audit interviews and evaluation of audit reports. This is presumed therefore that between the internal audit role and financial performance of firms a positive relationship will exist.

The study concluded that coefficient for internal auditor's quality of work was 0.292 which shows that the financial performance of companies listed on the NSE were impacted positively by quality of work of the internal auditors. Roth (2004) established that the achievement of objectives and goals from management decisions are provided reliable financial reports which come out of good internal controls.

The study noted that top management support had a correlation value of 0.836 and significance of 0.009, (from the Pearson Correlation Matrix) with financial performance of firms listed on the NSE. The enquiry thus confirmed a strong affirmative correlation linking the top management support and financial performance of firms listed on the NSE. Eighme and Cashell (2002) observed top management support increased the system of responsibility that the management and workers had towards the stakeholders of the firm.

An affirmative and positive relationship exists linking internal audit independence and financial performance of firms listed on the NSE (Pearson correlation coefficient r=0.623 Sig = 0.011) and that for financial performance to increase, internal audit is a vital and necessary part. This is in line with Ljubisavljević and Jovanovi (2011) who proposed that organizational independence of the internal audit department helps it output reliable financial reporting to all stakeholders of the company which meets the requirements they may have regarding the financial performance.

Cooper and Craig (1983) discovered that an incorrect view existed of internal auditors and the function they provided and what was discerned as being done by the management, which presumed that the traditional financial auditing function that was largely performed in that period, could be exceeded by the internal auditors doing more.

Peursem (2004) perceived that a considerable influence over management was exerted by public practice and adept auditors and also accountancy trained auditors revelled in the prestige that emanated from the 'mystique' of their job which came from them being part of established and famous accountancy professional bodies. Previous studies by Cooper et al. (1966) and another done by Gamling (1997) are supported by this research, the studies discovered that there existed three concepts by people who could in their capacity hold everything stable; the external expert prestige held by the internal auditor; the existence of a communication network which is both casual and formal; and the deduction of the part played by the internal auditor. Managing ambiguity by the internal auditor informs these concepts.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

In this chapter, a summary and discussions of the findings, conclusions, recommendations and suggestions for further studies are presented.

5.2 Summary

The internal audit function is important to the growth of firms as it provides essential services for the management of the firms. It is helpful in bringing a “methodical disciplined way to gauge and refine the control and governance procedures, effectiveness of risk management” Institute of Internal Auditors. It is a vital function and as evidenced by the increasing demand for this service in several organizations.

The Internal Audit department is seen as an important factor when it comes to accounting systems being applied. The financial reports express the work and quality of an internal audit department and it efficiency will help in enhancing the quality of activities of the company.

The significance of internal audit is displayed in the increasing demand for this service in all organizations. Unfortunately, researchers have paid minimal attention to it and its effects on the financial performance of organizations. The role of this research was to establish if there is a connection between the internal audit and financial performance of firms listed in the NSE in Kenya. From the analysis the study confirmed that the professional competence of internal auditors affects the performance of firms to a great extent.

The study highlighted the internal controls that influence the financial performance of those firms in Kenya to a great extent. It also revealed that internal audit controls in an organization have features built into them to ensure that fraudulent transactions are exposed. Intentional errors are concentrated in relatively few audits and these are fairly predictable by industry. Others agreed that cash receipts bear fairly strong controls, organizations that reveal an internal control problem encounter a significant increase in market-adjusted cost of capital.

The study also revealed that sticking with professional standards is a vital component of internal audit. Internal auditors also offer activities other than financial reporting as recognized by formal auditing standards. Standards for audits and audit-related activities affect the production of firms listed on the NSE. Performing auditing work in compliance with the internal auditing standards positively influences the efficacy of auditing. Furthermore, internal audit practices and contribute to the improvement of risk management, control and governance in firms with efficient and controlled approaches.

The study further revealed that, an internal auditor must be free of both the staff and operational pursuits of an organization. The internal audit department in organizations must be separate from the activities which it regulates and must also be independent from the daily internal control processes. Every firm should have official principles of internal audit validating its position and powers in the framework of the firm. Independence is a vital component of auditing, the truthfulness of the auditor‘s opinions, conclusions and recommendations should be respected as such. Internal auditors must not have a conflict of interests with the firm; and finally, independence in carrying out an internal auditor's duties is essential for the achievement of the function and objective of internal audit.

5.3 Conclusion

The study examined the effects of internal audit quality on the financial performance of firms listed on the Nairobi Securities Exchange. . The research concluded that the quality of work of the internal audit sector has conspicuously and positively impacted the financial performance of organizations listed on the NSE. The independent variables studied: professional proficiency of auditors, auditor's independence, quality of work of auditor's and top management support showed that they all positively and significantly influence financial performance in a significant way.

Roth (2004) observed that financial performance was deemed reliable for management to utilize to make decisions which would accomplish their objectives and goals. This was provided by good internal control. However, if the time used to process transactions go up, productivity reduces and no value is added to activities if internal controls are inappropriate. Internal audit often help reveal efficiency breakthroughs which lead to effective process improvements. Additionally employees having such interactions with internal auditors can obtain new perspectives with regards to their positions and may bring about ideas that improve the performance of the firm.

The employees and management of firms owe a responsibility to the owners and stakeholders of the firms, and internal audit helps enhance that (Eighme & Cashell, 2002). Shareholders are concerned about their investments and interested in the returns. Other stakeholders are interested in reliable financial reports on business practices and performance and growth of the firm, an when these are combined, the internal audit department provides a neutral and objective service to management and other stakeholders.

The internal audit enhances the system of accountability that the executive directors and employees have towards stakeholders (Eighme & Cashell, 2002). The internal audit department accords an independent, dependable, objective, and neutral function to the management, board of directors, and audit committee. Stakeholders on the other hand are concerned about the return on investments, sustainable increase, and reliable reporting on the financial performance of an oaganization (Ljubisavljević & Jovanovi, 2011).

5.4 Recommendations

There is the need for firms to adopt effective internal processes and practices that address key internal auditing practices for effectiveness of audit quality cannot be overemphasized. Audit quality is mainly about the quality of people, their training and moral calibre. As such the firms listed on the NSE should consider the skills, personal qualities of audit personnel and the tutelage given to audit staff as the important factors that determine auditor quality.

The study also established that in order to implement good internal audit independence, managers need to know that they should be concerned about the interrelationships between internal audit independence and financial performance. Internal auditors need to continuously update themselves with the ever changing times and technologies and also enhance their skills. By applying skills in vital instances, as well as building personal and professional credibility, internal auditors can become indispensable by spreading good governance and enhancing the efficiency of internal audit. The management of firms should organize seminars and workshops for internal auditors to be trained frequently by experts and be updated with the new practice principles.

5.5 Limitations of the Study

Due to inadequate funds the researcher conducted this research under serious financial constraints. This made it hard for an in-depth study to be conducted. Some respondents were biased while giving information due to reasons such as victimization as such the research findings were skewed.

Secondly the limitation of time was much evident since the sources of the data operate on working days and the researcher is equivalently equally an employee. Respondents were naturally skeptical and uneasy when asked to contribute to a study in which they were not aware of its ramifications. To make the respondents feel at ease, the researcher made it clear the nature of the study and its proposed function. The researcher further explained that the research was purely an academic undertaking and that data divulged would be kept in secret by the researcher. The research process was an expensive and tiresome exercise since the researcher had to commute frequently to where the respondents were and also had to communicate frequently to follow up with the respondents.

5.6 Suggestions for Further Research

It is of great importance to have quality audit work done and greater belief to be placed in financial statements prepared by companies as such further studies to look into areas that concern audit quality such as turnover of auditor's satisfaction of services to customers and their loyalty.

The study sought to determine the effects of internal audit quality on financial performance of firms listed on the NSE. The research proposes that an in-depth study should be carried out on the impact of internal audit quality on financial performance of state corporations and also on companies not listed on the Nairobi Securities Exchange.

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APPENDICES

Appendix I: Questionnaire

EFFECT OF INTERNAL AUDIT QUALITY ON FINANCIAL PERFORMANCE OF FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE

Part A: DEMOGRAPHICS

1. Gender
    a. Male
    b. Female

2. Indicate where you fall among the following age brackets (years)
    a) Below 25
    b) 25-34
    c) 35-44
    d) 45-50
    e) Above 51

3. Kindly answer the following questions by ticking (√) against your preferred choice (s).

    Please indicate which industry you are in?

    a) Manufacturing & Allied

    b) Banking and insurance

    c) Telecommunications & Technology

    d) Agricultural

    e) Energy & Petroleum

f) Commercial & Services

g) Construction & Allied

h) Automobile & Accessories

i) Others? Please specify……………………..

4. Please indicate your position in the organization

a) Head of Internal Audit Department

b) Internal Audit Manager

c) Other?

Please specify…………………………………………………………………

5. Level of education

a) Secondary certificate

b) Diploma level

c) Bachelor's Degree level

d) Masters level

e) PhD

6. What professional courses have you attained? Tick the appropriate

I. CPA [ ]

II. ACCA [ ]

III. CCP [ ]

IV. Others [ ]

(Specify) ……………………………………………………

7. Who do the internal audit department report to and regularly submit their reports?

a) Board of Directors

b) Chief Executive Officer

c) Audit committee

d) Chief Finance Officer

e) Other? Please specify…………………………………………………………….

Part B: EFFECTIVENESS OF INTERNAL AUDIT FUNCTION

What are your views on the following statements regarding the effectiveness of Internal Audit Function? *(Circle the number closest to your view)*

Statement	Agree			Disagre e	
Professional proficiency	5	4	3	2	1
d) Internal audit employees have the relevant education in auditing	5	4	3	2	1
e) The auditors in the organization are qualified to undertake the audit function	5	4	3	2	1
f) Frauds are identified by the internal audit function	5	4	3	2	1
Organizational independence	5	4	3		1
d) Independence is necessary for the effective achievement of the internal audit function	5	4	3	2	1
e) Internal auditors may not have conflict of interests	5	4	3	2	1
f) Internal auditors work independently and conduct their work without interference	5	4	3		1
Quality of audit work (standards)	5	4	3	2	1
e) Audit recommendations are clearly conveyed and their implementation lead to control improvements and efficiency	5	4	3	2	1
f) Standards for audits and related services influence performance of the organization	5	4	3	2	1 1
g) Working in compliance to internal auditing standards contribute and influence the effectiveness of auditing	5	4	3	2	1
h) Auditors carry out their roles objectively in compliance with accepted practice criteria	5	4	3	2	1
Top management support	5	4	3	2	1
c) Management provides enough support and training for internal audit staff	5	4	3	2	1
d) Management regards internal audit as an important	5	4	3	2	1

function					
Audit Committee	5	4	3	2	1
c) The size of the Audit Committee is adequate with qualified people to function on it	5	4	3	2	1
d) The frequency of the Committee meeting is sufficient to fulfil all tasks required	5	4	3	2	1

Appendix II: Listed Companies on NSE

AGRICULTURAL

1. Eaagads Ltd Ord 1.25

2. Kapchorua Tea Co. Ltd Ord Ord 5.00

3. Kakuzi Ord.5.00

4. Limuru Tea Co. Ltd Ord 20.00

5. Rea Vipingo Plantations Ltd Ord 5.00

6. Sasini Ltd Ord 1.00

7. Williamson Tea Kenya Ltd Ord 5.00

COMMERCIAL AND SERVICES

8. Express Ltd Ord 5.00

9. Kenya Airways Ltd Ord 5.00

10. Nation Media Group Ord. 2.50

11. Standard Group Ltd Ord 5.00

12. TPS Eastern Africa (Serena) Ltd Ord 1.00

13. Scangroup Ltd Ord 1.00

14. Uchumi Supermarket Ltd Ord 5.00

15. Atlas Development and Support Services

16. Longhorn Publishers Ltd

17. Deacons (East Africa) Plc Ord 2.50

18. Nairobi Business Ventures Ltd

TELECOMMUNICATION AND TECHNOLOGY

19. Safaricom Ltd Ord 0.05

AUTOMOBILES AND ACCESSORIES

20. Car and General (K) Ltd Ord 5.00

21. Sameer Africa Ltd Ord 5.00

BANKING

22. Barclays Bank Ltd Ord 2.00

23. CFC Stanbic Holdings Ltd ord.5.00

24. I&M Holdings Ltd Ord 1.00

25. Diamond Trust Bank Kenya Ltd Ord 4.00

26. HF Group Ltd Ord 5.00

27. KCB Group Ltd Ord 1.00

28. National Bank of Kenya Ltd Ord 5.00

29. NIC Group PLC

30. Standard Chartered Bank Ltd Ord 5.00

31. Equity Group Holdings Ord 0.50

32. The Co-operative Bank of Kenya Ltd Ord 1.00

INSURANCE

33. Jubilee Holdings Ltd Ord 5.00

34. Sanlam Kenya PLC Ord 5.00

35. Kenya Re-Insurance Corporation Ltd Ord 2.50

36. Britam Holdings Ltd Ord 0.10

37. CIC Insurance Group Ltd Ord 1.00

38. Librty Kenya Holdings

INVESTMENT

39. Olympia Capital Holdings ltd Ord 5.00

40. Centum Investment Co Ltd Ord 0.50

41. Trans-Century Ltd

42. Home Africa Ltd Ord 1.00

43. Kurwitu Ventures

MANUFACTURING AND ALLIED

44. B.O.C Kenya Ltd Ord 5.00

45. British American Tobacco Kenya Ltd Ord 10.00

46. Carbacid Investments Ltd Ord 5.00

47. East African Breweries Ltd Ord 2.00

48. Mumias Sugar Co. Ltd Ord 2.00

49. Unga Group Ltd Ord 5.00

50. Eveready East Africa Ltd Ord.1.00

51. Kenya Orchards Ltd Ord 5.00

52. Flame Tree Group Hooldings Ltd Ord 0.825

CONSTRUCTION AND ALLIED

53. Athi River Mining Ord 5.00

54. Bamburi Cement Ltd Ord 5.00

55. Crown Berger Ltd 0rd 5.00

56. E.A. Cables Ltd Ord 0.50

57. E.A. Portland Cement Ltd Ord 5.00

ENERGY AND PETROLEUM

58. Kenol Kobil Ltd Ord 0.05

59. Total Kenya Ltd Ord 5.00

60. KenGen Ltd Ord. 2.50

61. Kenya Power & Lighting Co Ltd

62. Umeme Ltd Ord 0.50

REAL ESTATE INVESTMENT TRUST

63. Stanlib Fahari I-REIT

EXCHANGE TRADED FUND

64. New Gold Issuer (RP) Ltd

INVESTMENT SERVICES

65. Nairobi Secutities Exchange Ltd Ord 4.00