

**THE IMPACT OF RISK BASED AUDIT ON FINANCIAL PERFORMANCE IN
COMMERCIAL BANKS IN KENYA.**

BY

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DECLARATION

This research project is my original work and has not been submitted for a degree in any other university or institution of higher learning.

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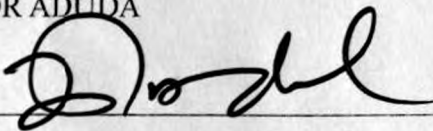
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This research project has been submitted for presentation with my approval as the student's supervisor.

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Date 12/11/12

DEDICATION

To my parents and my family, for the encouragement and support during this course. My mother Mary for her wise guidance and upbringing. My husband Peter and son Jeremy who have always been on my side whenever i needed them.

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To all of you, may our good Lord bless you mightly.

ABSTRACT

The financial performance requires appropriate risk based audit practices hence effective and efficient internal audit. For the purpose of this study the researcher sought to determine the impact of risk-based audit on financial performance in commercial banks in Kenya. This study adopted Correlation research design for it describes the specific phenomenon in its current trends, current events and linkages between different factors at the current time. The target population for the study constituted of 44 respondents who were finance officers, internal auditors, the credit officers, relationship officers/managers and accountants at commercial banks in Kenya. The study administered questionnaires which included structured and unstructured questions to all the respondents since it was the most appropriate tool to gather information. Descriptive statistics such as mean, standard deviation and frequency distribution were used to analyze the data. Data presentation was done by the use of pie charts and tables for ease of understanding and interpretation.

From the findings, the study concludes that risk based auditing through risk assessment, risk management, annual risk based planning, internal auditing standards and internal auditing staffing should be enhanced. This would enable the firm to be able to detect risks on time and concentrate on high risk areas leading to increased transparency and accountability, hence enhancing financial performance. Proper planning improves efficiency, accuracy, completeness, timeliness, convenience and clarity. Credible audit reports, auditor independence to identify and rectify audit errors, effective implementation of audit recommendations, financial management and compliance with accepted audit standards, effective internal audit staff and independent audit committee influence financial performance in commercial banks. From the findings, the study recommends that management in commercial banks in Kenya should adopt effective risk based audit practices such as risk assessment, risk management, annual risk based planning, internal auditing standards and internal auditing staffing to enhance effective and efficient financial performance.

LIST OF ABBREVIATIONS

CBK	-	Central Bank of Kenya
CEO	-	Chief Executive Officer
CG	-	Corporate Governance
CR	-	Control Risk
IA	-	Internal Audit
IAC	-	Internal Audit Capacity
IIA	-	Institute of Internal Auditors
IR	-	Inherent Risk
OECD	-	Organization for Economic Co-operation and Development
PPF	-	Professional Practice Framework
PWC	-	PriceWaterHouseCoopers
RBA	-	Risk Based Audit
RBIA	-	Risk Based Internal Audit
RMD	-	Risk Management Department
ROA	-	Return on Asset
ROE	-	Return on Equity
ROI	-	Return on Investment
SAS	-	Statements of Auditing Standards
SEC	-	Securities and Exchange Commission
SOX	-	Sarbanes–Oxley Act
SPSS	-	Statistical Package for Social Science
TCE	-	Transaction Cost Economics

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CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

Increased concerns regarding corporate accountability in various developed nations have been associated with the need for appropriate Risk Based Audit which involves risk management and internal control systems (Beekes and Brown, 2006). This has been reflected through recent voluntary corporate governance guidelines. The subjectivity of this area has given rise to different levels of emphasis on risk management and internal control and is, correspondingly, reflected in the governance guidelines of developing countries (Basel Committee on Banking Supervision, 2006). While these voluntary guidelines that have originated in each organization may provide different levels of focus on Risk based Audit and governance, it is uncertain as to what extent these different levels of focus exert an influence, either direct or indirect, on an organization's risk management and internal control practices (Sarens and De Beelde, 2006).

Risk Based Auditing could improve the precision of financial statement information by issuing qualified opinions to firms with unreliable financial statements; auditors enable investors to screen out such firms. Uncertainty regarding the association between the focus of voluntary corporate governance guidelines and risk management and internal control activities in practice has created a research gap in this area. Beekes and Brown (2006) refer to company responses to such voluntary guidelines as a rich area for research. The impact of risk based audit has been found to mitigate the occurrence of risks through enhancing quality financial reporting, minimizing losses and eventually improving bank financial performance (Vafeas, 1999).

For organizations to gain competitive advantage firms in developing countries like Kenya require to improve corporate governance to promote governance and accountability for the purposes of attracting capital gain, sustainability and curb vice such as corruption. An internal audit function could be viewed as a "first line defense" against inadequate corporate governance and financial reporting. With appropriate support from the Board of

Directors' Audit Committee, the internal audit staff is in the best position to gather intelligence on inappropriate accounting practices, inadequate internal controls, and ineffective corporate governance (Vafeas, 1999).

The financial crisis of 2008 is to a large extent attributable to excessive risk-taking by banks. Given that corporate governance is essentially a mechanism for addressing agency Problems and controlling risk within the firm, it is not surprising that the recent initiatives and Statements by banking supervisors, central banks, and other authorities have emphasized the importance of effective corporate governance practices in the banking sector (Basel Committee on Banking Supervision 2010; Board of Governors of the Federal Reserve System 2010a-b; OECD 2010). Thus, it is now widely acknowledged that shortcomings in the bank Corporate Governance may have had a central role in the development of the crisis. This paper, aim to provide empirical evidence on the effects of corporate governance on bank Performance during the financial crisis. In particular, we use data on large publicly-traded U.S. banks to examine whether banks with strong governance were associated with higher Profitability and better stock market performance amidst the crisis.

According to Renneboog (2000). 93 firms in quoted companies 14% of them had CEO chairs, and 86% of them had separate roles for the two posts. A majority of the firms in the sample were run by indigenous CEOs, as only 37% of them had foreign chief executives and that high degree of ownership concentration had the largest shareholders owning on average 32.65% of equity. This compares with an average of 13.42% of shares owned by directors. Hillman *et al.*, 2000). Indicated that effective corporate governance improve corporate performance due to improved ownership, managerial control and governance of the companies

1.1.1 Concept of Risk Based Audit

It is a process, an approach, a methodology and an attitude of mind rolled into one. The simplest way to think about risk-based audit conceptually is to audit the things that really matter to your organisations. Risk based audit (RBA) is a term derived from the Institute

of International Audit (IIA) research foundation based in the USA (IIA, 2004). In 1999, the board of directors of IIA voted to approve a new definition of internal auditing and a new Professional Practice Framework (PPF). The board through deliberation came to a conclusion that a significant gap existed between available guidance and current practise of internal auditing, and that a new framework was needed to carry the profession into the 21st century (IIA, 2004). Ideally, RBA is a paradigm shift from traditional approach of pre-auditing or transactional audit to systems audit and finally to RBA. In pre-audit, management abdicated their responsibilities to internal audits; there were no audit reports and no review of the system by management. On the other hand, systems audit was passive and reactive control based audit with no involvement of management in audit planning. Therefore, for internal audit to be effective and efficient, RBA was introduced (IIA, 2004).

Internal Auditing is defined by Institute of Internal Auditors (IIA) as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (IIA , 2003). This definition is designed to embrace the expanding role of internal audit which in recent years has evolved from a narrow focus on control to include risk management and corporate governance (Brody and Lowe, 2000). This definition is used as a framework to develop hypotheses concerning the characteristics of companies that use internal audit, while there is considerable overlap between the areas of risk management, control and governance (Colbert, 2002).

1.1.2 Financial Performance

Financial performance is a measure of a Bank's policies and operations in monetary terms. It is a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. There are many different ways to measure a bank's

financial performance. This may be reflected in the firm's return on investment, return on assets, value added, among others and is a subjective measure of how a firm can use assets from its primary mode of business and generate revenues.

According to Mishkin (2007), the financial industry, like other industries is in business to earn profits by selling its products. To maximize the profits, financial institutions develop new products to satisfy their own needs as well as those of their customers; in other words, innovation-which can be extremely beneficial to the economy- is driven by the desire to get (or stay) rich. This view of the innovation process leads to the following simple analysis: A change in the financial environment will stimulate a search by financial institutions for innovations that are likely to be profitable.

Starting in the 1960s, individuals and financial institutions operating financial markets were confronted with drastic changes in the economic environment: inflation and interest rates climbed sharply and became harder to predict, a situation that changed demand conditions in financial markets. The rapid advance in computer technology changed supply conditions. In addition, financial regulations became more and more burdensome. Financial institutions found that many of the old ways of doing business were no longer profitable; the financial services and products they had been offering to the public were no longer selling (McNamee and Selim, 1999). Many financial intermediaries found that they were no longer able to acquire funds with their traditional financial instruments, and without these funds they would soon be out of business. To survive in the new economic environment, financial institutions have to research and develop new products and services that would meet customer needs and prove profitable, a process referred to as financial engineering. The financial innovation that occurs suggests that there are three basic types of financial innovation: responses to changes in demand conditions, responses to changes in supply conditions, and avoidance of regulations (Ball and Shivakumar 2004).

1.1.3 Measures of Financial Performance

There are many different ways to measure a bank's financial performance. This may be reflected in the firm's return on investment, return on assets, value added, among others and is a subjective measure of how a firm can use assets from its primary mode of business and generate revenues. Financial performance of banks can be evaluated using many financial indicators such as liquidity ratios, profitability ratios and others for example, Saleh and Zeitun, (2007). However, in this paper we use three major profitability indicators to evaluate the financial performance of commercial banks, namely ROA, ROE and Profit margin.

The financial statements of corporations in Oman that published commonly contain a variety of financial ratios designed to give an indication of the corporation's performance. As it known in accounting literature, there are limitations associated with use of some financial ratios. In this research, however, ROA ratio with interest income size is used to measure the performance of commercial banks. Asset management, the bank size, and operational efficiency are used together to investigate the relationships among them and the financial performance. Simply stated, much of the current bank performance literature describes the objective of financial organizations as that of earning acceptable returns and minimizing the risks taken to earn this return (Hempel and Coleman, 1986).

1.1.4 Risk Based Audit and Financial Performance

Empirical research has investigated the existence or extent of internal auditing from risk or governance perspectives. Goodwin-Stewart and Kent (2006) use an agency framework to explore firm characteristics associated with the existence of internal audit function from risk management, control and governance perspectives influence, accountability and enhance provision of financial statement thereby influencing financial performance in financial institutions (CBK,2010).

The empirical findings by Al-Tamimi (2002) and Al-Mazrooei (2007) highlighted that UAE banks are efficient in risk based auditing. Drzik (1995) found out that Bank Administration Risk based audit Survey showed that large banks in the US had made

substantial progress in their financial performance. Comprehensive risk based auditing influence effective financial reporting activities and influencing profit and loss sharing in the source of funds especially investment account holders as explained by Sundararajan (2007, pp.36-35). He concludes that the application of risk based audit particularly for credit and overall banking risks is important for Banks.

There is a generally accepted relationship between risk and return, that is, the higher the risk the higher the expected return. Therefore, traditional measures of bank performance have measured both risks and returns. The increasing competition in the national and international banking markets, the change over towards monetary unions and the new technological innovations herald major changes in banking environment, and challenge all banks to make timely preparations in order to enter into new competitive financial environment. (Spathis, and Doumpos, 2002) investigated the effectiveness of commercial banks based on their assets size. They used in their study a multi criteria methodology to classify Greek banks according to the return and operation factors, and to show the differences of the bank's profitability and efficiency between small and large banks. The study seeks to establish the relationship between risk based audit and financial performance in commercial banks in Kenya.

1.1.5 The Commercial Banking Industry in Kenya

The Banking industry in Kenya is governed by the Companies Act, the Banking Act, the Central Bank of Kenya Act, and the various prudential guidelines issued by the Central Bank of Kenya (CBK). The banking sector was liberalised in 1995 and exchange controls lifted. The Central Bank of Kenya, which falls under the Ministry of Finance, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system. Central Bank of Kenya publishes information on Kenya's commercial banks and non-banking financial institutions, interest rates and other publications and guidelines (CBK, 2011)

Banks represent a significant and influential sector of business worldwide that plays a crucial role in the global economy. There are 44 commercial banks in Kenya .

Commercial banks are financial intermediaries that serve as financial resource mobilization points in the global economy. They channel funds needed by business and household sectors from surplus spending to deficit spending units in the economy. A well developed efficient banking sector is an important prerequisite for saving and investment decisions needed for rapid economic growth. A well functioning banking sector provides a system by which a country's most profitable and efficient projects are systematically and continuously funded. The role of banks in an economy is paramount because they execute monetary policy and provide means for facilitating payment for goods and services in the domestic and international trade (GOK ,2007).

Commercial banks are custodians of depositor's funds and operate by receiving cash deposits from the general public and loaning them out to the needy at statutorily allowed interest rates. Loans are based on the credit policy of the bank that is tightly coupled with the central bank interest rate policy. These in effect determine the level of financial risk in a particular bank (CBK,2010).Commercial bank in Kenya comprises 90% of the outstanding loan assets portfolio. While Kenya's mortgage market is growing, the industry is dominated by the commercial banks indicating barriers to entry or high risk for medium and smaller banks. However, the growth rates indicate that the small sized banks have the fastest growth rate of 38% on average, followed by medium banks which are growing at 25% on average with large banks closely following at 24% on average (CBK, 2010).

1.2 Statement of the problem

Recent corporate collapses and financial scandals have provoked world-wide concern with corporate governance highlighted apparent failures of accountability (Spira and Page 2003), and subsequent new laws, regulations in response to them (the Sarbanes-Oxley Act, 2002) provide compelling evidence that risk based audit, serves as part of sound corporate governance framework (Spira and Page 2003). matters and is important. Kenyan banks have in the recent past experienced a number of corporate failures related to corporate governance structures in place such as the City Bank's . \$8 billion scandal in

generated charges, have focused attention on corporate governance issues in the financial sector. In 2007, Standard Chattered bank was placed under statutory management amidst suspicions of money laundering and fraud. Corporate failures are usually preceded by financial hardship and declining financial performance

Chen (2003) investigated the relationship between Risk Based Internal Audit and corporate governance structures. It was found that there existed a significant positive relationship between the level of RBIA used and corporate governance bank's board size. The findings of this study indicated a significant negative correlation existed suggesting that a small board size seems to be more effective, and is more likely to use RBIA, as a complementary mechanism. On contrary Krishnan, (2005) carried out an empirical analysis on the role of risk based audit on internal corporate governance and found that the percentage of non-executive directors and supervisors on the board of directors was significant negative associated with the use of RBIA indicating that the higher level of independent directors and supervisors on the board presents better corporate governance, hence may not employ higher percentage of RBIA for monitoring of risk management. Finally, the result indicated that financial institutions use a relatively high level of RBIA when there was a higher level of shareholdings held by institutional shareholders and internal auditors' technical competence are higher.

An effective risk management by financial and effective risk-based supervision by regulators is highly dependent both on the implementation of adequate corporate governance and on the risk based audit (Katz 1998). In Kenya, commercial banks operate in an institutional environment where internal auditing is a statutory requirement. Despite all of the recent attention focused on RBA, research on the existence or extent of this sector in general in financial Institutions has been scant.

Local studies on impact of risk based audit on financial performance in commercial banks are scanty with a few done focusing on role of auditing and governance in government . For instance, Maiteka (2010) undertook a study of the influence of risk based audit on corporate governance in public sector in kenya focusing on selected

ministries. From the findings, risk based auditing was found to assess risks facing government ministries on time and concentrate on high risk areas in order to increase transparency and accountability, hence enhancing good governance. This study will differ from that done by Mululu (2005) because Mululu's study considered all the listed companies without being specific on distinct companies in different sector of the economy who found out commercial bank which adopted effective auditing influence bank performance. Kibet (2008) carried out a survey on the role of internal audit in promoting good corporate governance in State Owned Enterprises and found that effectiveness and contribution of internal audit in promoting corporate governance for companies listed in the NSE. Kibara (2007) similarly carried out a survey of internal auditors risk management practices in the banking industry in Kenya and found that seven banks out of twenty one (33 %) had not established a separate risk management department. Keitany (2000) studied the internal audit control function and its implication for risk assessment by the external auditor and found that extent of reliance of internal controls was not sensitive to the strength of internal audit departments, companies should not do away with it. Despite the influence of risk based audit on financial performance in organization, studies on risk based audit on financial performance of banks in Kenya has been neglected. This study seeks to fill the knowledge gap by establishing the impact of RBA on financial performance in commercial banks in Kenya . The study sought to answer the following questions

- i. What are the risk based audit practices adopted by commercial banks in Kenya?
- ii. What is the impact of risk based audit on financial performance in commercial banks in Kenya?

1.3 Objectives of the Study

1.3.1 Main objective

The main objective of this study was to determine the impact of risk-based audit on financial performance in commercial banks in kenya

1.3.2 Specific Objectives

The study was guided by the following specific objectives:

- i. To determine risk based audit practices adopted by commercial banks in Kenya
- ii. To establish the impact to which risk based audit influence financial performance in commercial banks in Kenya

1.4 Value of the study

This study is paramount in that it will enable directors and management appreciate the importance of risk based audit practices and assist them in rating their level of compliance against those of their competitors or the entire market, and in determining whether risk based audit practices improve banks financial performance .

The study will help shareholders know the various mechanisms through which they can exercise their control. Potential investors will also benefit as they will be able to determine banks that are properly governed in making their investment decisions to improve commercial bank financial performance.

The government in the developing policy papers, policy making regarding risk based audit and its effects on financial performance of commercial banks. The policy maker will know how well to incorporate the sector effectively to ensure its full participation.

The academicians who will be furnished with relevant information regarding the relationship between risk based audit and financial performance in the commercial banks. The study will contribute to the general body of knowledge and form a basis for further research.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter summarizes the information from other researchers who have carried out their research in the same field of study. Specific emphasis has been put on the major issues in risk based audit practices on financial performance of commercial bank in Kenya. The specific areas covered here are theoretical orientation, empirical review and summary of the literature.

2.2 Theoretical review

2.2.1 Agency Theory

A significant body of work has built up in this area within the context of the principal-agent framework. The work of Jensen and Mecklin (1976) in particular and of Fama and Jensen (1983) are important. Agency theory identifies the agency relationship where one party, the principal, delegates work to another party, the agent. The agency relationship can have a number of disadvantages relating to the opportunism or self interest of the agent: For example, the agent may not act in the best interests of the principal, or the agent may act only partially in the best interests of the principal. There can be a number of dimensions to this including for example, the agency misusing his power for pecuniary or other advantage, and the agent not taking appropriate risks in pursuance of the principals interests because he (the agent) views those risks as not being appropriate and the principal may have different attitudes to risks. There is also the problem of information asymmetry whereby the principal and the agent have access to different levels of information; in practice this means that the principal is at a disadvantage because the agent has more information.

In the context of financial institutions and issues of corporate control, agency theory view corporate governance mechanisms especially the board of directors, as being an essential

monitoring device to try to ensure that any problems that may be brought about by the principal-agent relationship, are minimized. Blair (1996) states; managers are supposed to be the 'agents' of a financial Institutions 'owners' but managers must be monitored and institutional arrangements must provide some checks and balances to make sure they do not abuse their power. The costs resulting from managers misusing their position, as well as the costs of monitoring and disciplining those to try to prevent abuse have been called 'agency costs'. Much of agency theory, as related to financial Institutions is set in the context of the separation of ownership and control as described in the work of Berle and Pears(1932).In this context, the agents are the managers and the principals are the shareholders ,and this is the most important commonly cited agency relationship in the corporate governance context.

2.2.2 Transaction Cost Economics

Transaction cost economics (TCE) as expounded by the work of Williamson (1975, 1984) is often viewed as closely related to agency theory. Transaction cost economics views the firm as a governance structure whereas the agency theory views the firm as a nexus of contracts. Essentially, the latter means that there is a connected group or series of contracts amongst the various players, arising because it is seemingly impossible to have a contract that perfectly aligns the interests of principal and agents in a corporate control situation.

As firms grow in size, whether caused by the desire to achieve economies of scale, or by technological advances, or by the fact that natural monopolies have evolved, they have increasingly required more capital which needed to be raised from the capital markets and wider shareholder base needed to be established. The problem of the separation of ownership and control and the resultant corporate governance issues have thus arisen. Coase (1937) examines the rationale for the firm's existence in the context of a framework of the effectiveness of internal as opposed to external contracting. He states "the operation of a market costs something and by forming an organization and allowing some authority (an entrepreneur) to direct the resources, certain marketing costs are

saved". The entrepreneur has to carry out his function at less cost, taking into account the fact that he may get factors of production at a lower price than the market transactions which he supersedes. Williamson (1984) builds on the earlier work of Coase, and provides a justification for the growth of larger firms and conglomerates, which essentially provide their own internal capital market. He states that the costs of any misaligned actions may be reduced by judicious choice of governance structure rather than merely realigning incentives and pricing them out.

Hart (1995) states there are a number of costs to writing a contract between principal and agent, which include the cost of thinking about and providing for all the different eventualities that may occur during the course of the contract, the cost of negotiating with others, and the costs of writing the contract in an appropriate way so that it is, for example, legally enforceable. These contracts tend to mean that contracts are apt to be incomplete in some way and so contracts will tend to be revisited as and when any omissions or required changes come to light. Hart indicates that, 'in a world of incomplete contracts (where agency, problems are also present), governance structure can be seen as a mechanism for making decisions that have not been specified in the initial contract.

2.2.3 Stakeholder Theory

In juxtaposition to agency theory is stakeholder theory. Stakeholder theory takes into account of a wider group of constituents rather than focusing on shareholders. A consequence of focusing on shareholders is that the maintenance or enhancement of shareholders' value is paramount whereas when a wider stakeholder group such as employees, providers of credit, customers, suppliers, government and the local community is taken into account the overriding focus on shareholder value become less self evident. Nonetheless many companies do strive to maximize shareholders value whilst at the same trying to take into account the interests of the wider stakeholder group. One rationale for effectively privileging shareholders over other stakeholders is that they are recipients of the residual free cash flow (being the profits remaining once other

stakeholders such as loan creditors, have been paid). This means that the shareholders have vested interest in trying to ensure that resources are used to maximum effect, which in turn should be to the benefit of the society.

Risk-based auditing derives largely from models that assume that inherent risk (IR) and control risk (CR) are distinct concepts and that IR arises from attributes of the audit environment that are completely independent of attributes that determine the level of control risk. Operationalizing the distinction between IR and CR has however, proved troublesome as the literature review below indicates. There appears to be little consensus regarding attributes that may identify IR and there is little published evidence regarding how IR is considered by practitioners. Also, it is not yet clear neither does it make good logical sense to try to separate IR and CR in the manner demanded by standard setters (DeFond et al., 2000).

Assessing the risk of material misstatement at the financial statement level as well as at the planning stage, adds to and clarifies the direction on performing a combined assessment of inherent, and control risk, leaving the ability for the auditor to assess other risk factors in an audit (McCord, 2002). This approach to auditing has also changed the view of substantive procedures performed by auditors. For example, the use of statistical sampling has significantly reduced, but remains an important part of auditor's substantive procedures and once they wish to ensure that it is efficient and effective. Sherer and Turley (1998) suggest that in order to improve the risk-based approach, ways must be identified in which auditors' judgement of inherent risk and control risk can become more accurate and consistent.

One area in particular that would seem to warrant significant reliance on internal audit work is that of fraud risk assessment. Because internal auditors have greater knowledge about a company's operations than external auditors, they are particularly adept at fraud risk assessment. This assertion is supported by KPMG studies which indicate that internal auditors are more likely to discover fraud than external auditors (KPMG, 2003). For instance, while 65% of frauds were discovered in 2003 by internal auditors, only 12%

were discovered by external auditors (KPMG, 2003). So, it would behoove external auditors to rely on internal audit work relating to fraud risk assessment.

2.3 The Concept of Risk Based Audit

Risk based audit (RBA) is a term derived from the Institute of International Audit (IIA) research foundation based in the USA (IIA, 2004). In 1999, the board of directors of IIA voted to approve a new definition of internal auditing and a new Professional Practice Framework (PPF). The board through deliberation came to a conclusion that a significant gap existed between available guidance and current practise of internal auditing, and that a new framework was needed to carry the profession into the 21st century (IIA, 2004). Ideally, RBA is a paradigm shift from traditional approach of pre-auditing or transactional audit to systems audit and finally to RBA. In pre-audit, management abdicated their responsibilities to internal audits; there were no audit reports and no review of the system by management. On the other hand, systems audit was passive and reactive control based audit with no involvement of management in audit planning. Therefore, for internal audit to be effective and efficient, RBA was introduced (IIA, 2004).

Internal Auditing is defined by Institute of Internal Auditors (IIA) as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (IIA , 2003). This definition is designed to embrace the expanding role of internal audit which in recent years has evolved from a narrow focus on control to include risk management and corporate governance (Brody and Lowe, 2000). This definition is used as a framework to develop hypotheses concerning the characteristics of companies that use internal audit, while there is considerable overlap between the areas of risk management, control and governance (Colbert, 2002; McNamee and Selim, 1999).

Besides focusing on the level of risk, the risk-based method helps to evaluate and build value into the financial reporting process and the clients company. In order to do this, the auditor must have an up to date insight of the clients business and activities. This knowledge is gained through the way the client operates their business, management, internal and external environments (McNamee and Selim, 1999). The knowledge gathered can help to design the audit program that includes the most effective and efficient combination of tests responsive to each client's unique circumstances. For this reason, the risk-based approach is then superior to traditional auditing methods (Gibson, 2003).

Although the new system of auditing has become more popular over the years, there are obvious advantages and disadvantages that need to be considered. For example, the aims of this risk-based approach are to assess and identify the high-risk areas, while at the same time, the auditor is minimising the risk of negligence (Griffiths, 2006). This can therefore speed the audit work and help to allocate specialists to specific areas of the audit. However, this process can cause more time to be spent on the audit and raise costs, thus not making economic sense. Unfortunately, another problem faced by auditors when adopting the risk-based approach is when identifying high-risk areas. Auditors must decide what evidence is required and in how much detail (Commonwealth of Australia, 2004).

Risk-based internal auditing focuses on strategic analysis and business process evaluation and on assessing the goals, risks and controls that must coalesce for an organization's success (Rivenbark, 2000). By identifying, assessing, and monitoring a company's risk, internal auditing helps assure that resources are adequate and focused on priorities (Kunkel, 2004). Generally, risk-based auditing assesses areas of heightened risk (Griffiths, 2006), and, importantly, conducts continuous risk assessments (O'Regan, 2002; Marks, 2001). The knowledge gained from a comprehensive annual risk assessment as well as from risk assessments undertaken at the outset of every internal audit engagement should be shared with management and the board (Jackson, 2005).

Since one of the primary responsibilities of the audit committee is to review and monitor the audit process, active and independent audit committees can influence the extent of the audit (Dezoort, 1997). Independent directors on audit committees have incentives to protect their reputation and avoid potential litigation. These incentives can be explained by the demand-based perspective in the context of regulatory oversight and the scrutiny of the role of independent directors ((Lorenzo,2001). The demand-based perspective suggests that independent directors seek differentially higher audit quality. Such greater assurance provided by the external auditor necessarily requires additional audit work which is reflected in higher audit fees. Evidence consistent with this view is provided by Carcello et al. (2002) and Abbott et al. (2003).

Given the importance of risk management in financial's functioning, the efficiency of bank's risk management is expected to significantly influence its financial performance (Harker and Satvros, 1998). An extensive body of literature (Santomero and Babbel, 1997) argues that risk management matters for financial performance of firms. According to Pagano (2001), risk management is an important function of financial institutions in creating value for shareholders and customers. The corporate finance literature has linked the importance of risk management with the shareholder value maximization hypothesis. This suggests that banks will engage in risk management policies if it enhances shareholder value (Ali and Luft, 2002). Thus, effective credit risk management either in non-banking firms or in banking entities is expected to enhance the value of the firm and shareholder wealth.

2.4 Financial Performance Measures

Measurement of financial performance by ratio analysis helps identify organisational strengths and weaknesses by detecting financial anomalies and focusing attention on issues of organisational importance. Given that the mission of a profit organisation is the reason for its existence, it is appropriate to focus on financial resources in their relationship to mission. Turk et al (1995) suggested that the key to analysis and measurement of the financial and operational control and impact is related to the central

question. Their model reflects the interrelationship between a series of questions about the mission and the financial resourcing and control of the organisation. They suggest that such a framework provides an appropriate analysis for past performance which will help an organisation move towards its future direction. The profitability analysis are achieved on a set of indicators to measure the banking performances. The indicators result/arise from the accounting dates, which illustrate the reference periods in the most synthetic expressions of balance sheet and the profit and loss account (Pagano, 2001).

Profitability of banks is affected by a number of factors. Some of these are endogenous, some are exogenous and yet structural. Changes in policies made by RBA are exogenous to the system. This includes changes in monetary policy, changes in quantitative credit control like changes in Credit Risk Regulatory, Short and long-term Rates, manipulation of bank rates, qualitative credit controls like selective credit control measures, C/D ratio, recognized guidelines on lending to priority sectors, changes in interest rates on deposits and advances, levy of tax on interest income (Blair, 1996)). Various other factors like careful control of expenditure, timely recovery of loans are endogenous. Various structural factors include geographical spread of bank branches, decentralization in the management and structural changes in deposits and advances. Banking structure and profitability structure of banking system across countries have a bearing on the profitability of banks.

Return on Equity or profit to equity, is the most significant indicator for profit, which measures the banking management in all its dimensions, and offers an image over the way to use the capital brought by shareholders, the effect of their retainer in bank's activity. The indicator is determined (Blair, 1996)

The return on equity ratio (ROE) measures how much the shareholders earned for their investment in the company. The higher the ratio percentage, the more efficient management is in utilizing its equity base and the better return is to investors.

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Average Shareholder's Equity}}$$

The other measure of financial performance in the bank is return on investment. Return on Investment (ROI) analysis is one of several commonly used financial metrics for evaluating the financial consequences of business investments, decisions, or actions. ROI analysis compares the magnitude and timing of investment gains directly with the magnitude and timing of investment costs. A high ROI means that investment gains compare favorably to investment costs (Ball and Shivakumar ,2004).

$$\text{Return on Investment} = \frac{\text{Gain} - \text{Investment Cost}}{\text{Investment Cost}}$$

Return on Equity (ROE) and liquidity state indicate the financial performance of commercial banks and computed as the ratio of Liability to assets.

Return on Assets is an indicator of how profitable a commercial bank is relative to its total assets.

$$\text{Return on Asset} = \frac{\text{Net Income}}{\text{Total Assets}}$$

ROA gives an idea as to how efficient management is at using its assets to generate earnings.

Calculated by dividing a company's annual earnings by its total assets, ROA will be displayed as a percentage. Using ROA as a comparative measure is best to compare it against a company's previous ROA numbers or the ROA of a similar company thus this study will make use of ROA.

2.5 Risk Based audit practices

2.5.1 Risk Management

The separation of ownership and management functions and the presence of information asymmetry introduce the possibility of principal-agent conflicts (Haniffa and Hudaib 2006), it also incurs risks to stakeholders in the organization management, shareholders and creditors (Spira and Page 2003). Those agency conflicts, agency costs and risks are

now managed within the corporate governance framework through accountability mechanisms, such as internal control and audit (Haniffa and Hudaib 2006).

Stakeholders now compete to participate in corporate governance to seek power in organizations by asserting their own conceptions of risk and how it should be managed, and a focus on risk management has become central to this competition since it defines the accountability of the management of the organization (Spira and Page 2003). This is consistent with Hay and Knechels' (2004) argument that the demand for auditing is a function of the set of risks faced by individual stakeholders in an organization and the set of control mechanisms available for mitigating those risks. Therefore, internal auditing's risk management orientation has given the audit function increased credibility across the enterprise and greater acceptance by management (Beumer 2006).

Through Risk based audit sound risk management strategies which are forward looking and helps to improve business decisions (Fatemi and Glaum, 2000). It is not just about avoiding or minimizing losses, but about dealing positively with opportunities. It is a powerful tool for public sector managers (Drzik, 2000). Good risk management is based on a well-planned, logical, comprehensive and documented strategy. This strategy provides general policy guidance, and plans and procedures that can be used as part of the organization's everyday work to manage risk (OECD, 2005).

The Risk Based Internal Auditing (RBIA) approach involves management to a far greater extent. The risks to be covered in audits will exist in all parts of the organization and audits will therefore involve managers in departments never visited before (Millichamp, 2002). Many risks will be very significant to the organization and the discussion of their controls will involve more senior managers and directors than might be involved in traditional finance orientated audits (Al-Tamimi, 2002). RBIA emphasizes management's responsibility for managing risks. Audits will involve more discussion with managers about their risks and their responses to them. There will be an initial meeting with managers, possibly involving a risk workshop to examine risks in greater depth, and contact throughout the audit to discuss issues (Schnatterly, 2001).

The following IA major roles are required in risk management: determining processes and their objectives, identify risks that hinder the processes with management, test and controls mitigating the risks, reporting where risks are not sufficiently mitigated by controls and assure management that risks are mitigated to an acceptable level. This has been made easy with adoption of RBA in the public sector (Millichamp, 2002). Through enhanced capacity building for internal audit staff to update their knowledge and competency in dealing with modern trends in risk management and also establishment of audit committees are some of the measures that have been put in place to contain and manage risks (Schnatterly, 2001). Through RBA, the audit activity provides useful and relevant information to the organization for managing its risks.

The objective of RBIA is to provide independent assurance to the board that there is a sound of risk management framework within the organization, and risks that may affect the organisation's business objectives and strategies are been identified, managed and reduced to a level that is acceptable to the board (IIA 2003). One indication of risk management framework is the existence of a separate committee or group, comprised of directors and managers (Goodwin-Stewart and Kent 2006) to develop risk management development policy.

2.5.2 Annual Risk Based Planning

Planning is generally considered a vital internal audit activity and it includes preparing a strategic plan, annual plans and programs for individual risk based audit assignments. The operational standard of the Internal Audit, dealing with the planning aspects of the internal audit, requires the preparation of a strategic plan – usually a five-year plan, a periodic (annual) plan and plans for individual audit assignments (Karapetrovic, 1999). Most organizations' internal audit offices do not develop a strategic plan, the exercise of which would have enabled the audit staff to evaluate risk and identify high-risk areas that deserve audit attention. It could also have been an exercise by which the head of internal audit ensures the appropriateness of resources by projecting requirements in a timely fashion thus enhancing good governance.

The Internal Audit Office of many institutions prepares annual plans for their operations. Nonetheless, an annual plan prepared as a subset of a strategic plan is more useful (Sanda, Milkailu and Garba, 2005). An effective internal audit function requires the head of the internal audit office to periodically report to senior management on the internal audit activity's purpose, authority, responsibility and performance relative to its plan. In some situations where there is poor governance, there is no such practice and the Internal Audit Office communicates with top management only via annual audit plans and the reports on individual audit assignments (Wade, 2002).

Proper planning enables accomplishment of a large number of audits in a given period by improving efficiency. In some cases the numbers of the audit engagements are completed in the budgeted time and the number of actual audits performed in a period is usually less than the number of audits stated in the annual audit plan (Sanda, Milkailu and Garba, 2005). This is usually caused by adhoc audit assignments by the management and urgent requests by external parties. Adhoc audit assignments signify the relevance of internal audit to management (Van Gansberghe, 2005), and reflect positively on audit effectiveness and also in good governance. The supply side argument suggests that during the audit planning stage, auditors assess corporate governance risk and plan procedures or charge risk premiums based on their assessment (Karapetrovic, 1999).

In planning the engagement and determining its scope, the external auditor's main objective is to gather evidence to support giving an opinion on the financial statements. Secondly, and as a product of the audit, the composition of the governance body and what matters are to be communicated to it are considered. When planning the engagement, the internal auditor is not required to design procedures specifically to gather information to report to the governance body (Karapetrovic, 1999). Rather, matters to be communicated are those which come to the auditor's attention in the course of the engagement and which the auditor deems to be significant and relevant to the governance body. To make clear the scope of the work and their responsibilities regarding communication, the internal auditors may elect to include this information in an engagement letter.

According to Davidson et al. (2005), an auditor's duty is to give a fair and truthful view of a client's set of company accounts, but auditors cannot guarantee that the company accounts are entirely free of errors and irregularities. Therefore, in their audit planning, auditors must identify and assess the risk that they need to discover. If an item is discovered, auditors must consider the context and presentation of the item and then decide whether it affects the true and fair view of the company accounts. The Statements of Auditing Standards, SAS 220, states that 'Auditors should consider materiality and its relationship with audit risk when conducting an audit' (O'Regan, 2002).

However, in pre-audit, management abdicated their responsibilities to internal audits; there were no audit reports and no review of the system by management. On the other hand, systems audit was passive and reactive control based audit with no involvement of management in audit planning (Seddon, 2000). Therefore, for internal audit to be effective and efficient, Risk Based Audit (RBA) was introduced.

2.5.3 Internal Auditing Standards

The principles of good governance transparency and accountability, fairness and equity, efficiency and effectiveness, respect for the rule of law and high standards of ethical behavior represent the basis upon which to build open (OECD, 2005). For Risk Based Audit (RBA) to provide good governance in public sector they must embrace the International Auditing standards that guide the internal audits ethics of work and maintain professional auditing standards.

As organizations grow in size and complexity, effective risk management becomes increasingly problematic (Fraser and Henry 2007). Previous study for demand of internal auditing linked to the cost vs. benefit from undertaking monitoring (Goodwin-Stewart and Kent 2006). Carcello, *et al.* (2005) asserts that increased organizational complexity would result in greater risk and companies facing higher risk will increase their organizational monitoring. In addition, from transaction cost perspective, larger firms have opportunities to gain economies of scale from investment in the fixed costs of internal auditing (Carey *et al.* 2006).

2.5.4 Internal Auditing capacity

Events since mid 1970s have contributed to the growth of internal auditing. The Foreign Corrupt Practices Act of 1977 mandated public companies to establish and maintain effective internal accounting controls to provide reasonable assurance that assets are safeguarded and that transactions are properly authorized and recorded. To accomplish this, many companies established internal audit functions, increased internal audit staffing, and strengthened internal audit independence. Beasley et al. (2000) show that these investments in internal auditing have been effective, as companies with internal audit staffs are less prone to financial fraud than companies without internal auditing. Also, Coram et al. (2008) find that organizations with internal audit staffs are more likely than those without internal auditing to detect and self-report occurrences of fraud. The number and magnitude of errors requiring adjustment by the external auditors have been found to be substantially lower for entities that had an internal audit department compared to those that did not have an internal audit department, (Wallace and Kreutzfeldt, 1991). The internal audit function is important because it adds value and therefore reduces detected errors (Goodwin and Kent, 2004).

In 1987, a report by the Treadway Commission recommended that public companies establish an internal audit function to be fully supported by top management and have effective reporting relationships. This means that the internal auditors' qualifications, staff, status within the company, reporting lines, and relationship with the audit committee of the board of directors must be adequate to ensure the internal audit function's effectiveness and objectivity (Treadway Commission, 1987,) . The report urged that the internal audit function be "staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company (Treadway Commission, 1987,).

The New York Stock Exchange enacted a requirement in 2003 that all listed companies must have an internal audit function, either in-house or outsourced. This requirement was approved by the Securities and Exchange Commission (SEC) later in that year. Relying

on internal auditing can avoid unnecessarily duplicating audit procedures. It also can benefit external auditors because internal auditors have certain advantages. The internal auditors generally have more knowledge about the company's procedures, policies, and business environment than do the external auditors. However, external auditors must reconcile the advantages of relying on internal auditing with the need to maintain both the appearance and reality of independence as defined for external auditors,(Gramling, Maletta, Schneider and Church, 2004).

According to Norman Marks (2007), emerging request from boards is that internal auditors review and comment on the organization's governance policies, processes, and practices. The IIA recognizes this in its International Standards for the Professional Practice of Internal Auditing (Standards). Standard 2100 states (emphasis added).The internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach."

Internal audit quality, which is determined by the internal audit department's capability to provide useful findings and recommendations, is central to audit effectiveness. Internal audit has to prove that it is of value to the organization and earn a reputation in the organization. Internal audit has to evaluate its performance and continually improve its service. According to Ziegenfus, (2000), audit quality is a function of the level of staff expertise, the scope of services provided and the extent to which audits are properly planned, executed and communicated.

The IIA's standard, 1210 on proficiency of the auditor require that the internal auditors possess the knowledge, skills and other competencies needed to perform their responsibilities (IIA, 1999). The auditors' should be interested in attending courses for the purpose of gaining professional qualification, such as for certification as an internal auditors and the employer can provide financial support. Since, internal audit work requires knowledge and experience on a wide range of systems and operations, it is imperative to deploy auditors with extensive professional skills and to upgrade their skills

through continuing professional training and development. Given the high level of staffing with temporary employees, the difficulty of recruitment and retention of auditors with the right technical proficiency is evident. Krishnan (2005) revealed that the auditors view the office as given insufficient attention in terms of staffing. Continuous skill upgrading is another dimension that deserves attention so as to achieve a high level of technical proficiency. Therefore, audit quality is arguably a function of extensive staff expertise; reasonableness of the scope of service; and effective planning, execution and communication of internal audits.

The audit activity needs a professional staff that collectively has the necessary qualifications and competence to conduct the full range of audits required by its mandate. In order to ensure good governance, auditors must comply with minimum continuing education requirements established by their relevant professional organizations and standards. The head of the audit activity must be able to effectively recruit, retain, and manage highly skilled staff. Moreover, the chief audit executive should be an articulate public spokesperson for the audit activity (Kunkel, 2004).

2.6 Empirical review

Recent scandals and bankruptcy in large financial Institutions revealed huge gaps between boards of directors, executive management, internal control and organizational performance. The importance of internal control and audit is aggravated even more after accounting firms are being sued by shareholders for their inability to detect fraud (Schnatterly, 2001; Lerach, 2001) Since then, the changes involved strengthening internal control in organisations (SOX, 2002). At the same time, several authors proposed that quality and corporate governance (CG) should be dealt as inseparable areas. For instance, the CG framework published by British Standards Institution (Castka et al., 2004) makes a significant contribution to this trend. This work offers organizations a framework for establishing, maintaining, improving and documenting their CG management system. The authors assert that these concepts cannot be mutually exclusive but merge together.

each offering a different yet complementary perspective on the activities of an organisation, to form a robust strategic business management tool.

In 1999, the Institute of Internal Auditors (IIA) promulgated a new definition of internal auditing which identifying an assurance and consulting role for internal audit, highlighting the changing focus and the expansion scope of internal auditing into risk management, corporate governance, and adding value (Jenny 2004). The new definition emphasize that internal audit function can add value to the organization in terms of risk management and corporate governance, and RBIA is an approach that can help to meet these requirements (IIA 2003). This approach is consistent with Turnbull's broader approach to internal control as Turnbull implies that high level, risk-based internal audit functions are a *sine qua non* (Fraser and Henry 2007). Survey was designed to gather information on the current use of RBIA in banking industry. The questionnaire is developed based on the Standards for the Professional Practice of Internal Auditing (IIA 2004) and the Implementation Rules for Bank Internal Audit and Internal Control System (FSC 2007), and includes four parts part one asked about current status of the bank's risk management; part two requests for the definition of RBIA activity in audit charter and technical competence of internal auditors; part three investigates the performance of RBIA in related to audit planning, nature of work and communication; and part four inquire about basic information of the Microfinance Institutions (Millichamp, 2002).

Chen, (2003) investigated the relationship between corporate governance and risk-taking behavior in Taiwanese Banking Industry sample consists of all of the 39 domestic banks. and of the 39 surveys mailed, 24 completed responses were returned for a response rate of 61.54%. Of the 24 survey responses, 13 (54.1%) of the credit unions report that more than 60% of their internal audit activities are risk oriented. It was found that 8 of 24 (33.3%) respondents indicating that they use a relatively high level of RBIA, about 61%-80%, while 6 (25%) of the domestic banks report that about 21%-40% of their internal audit work are risk-based (Sarens and de Beelde, 2006).

Liebman (2004) strongly advocates that ISO 9000 and ISO 14000 can be used to reduce risks with compliance with the Sarbanes-Oxley Act (SOX, 2002): Because of SOX, the CEOs and CFOs of public companies must certify their financial statements, and each year they must certify the effectiveness of their systems of internal controls mandated by the law. Top management needs to obtain better information about the effectiveness of their organizations. Quality and environmental people should be at the table when the internal financial auditors develop their reports to top management and the board of directors (Verschoor, 2002).

Kibara (2007) in his study on a survey of internal auditors risk management practices in the banking industry in Kenya found out that, most banks in Kenya were in process of drafting the Early Rate Mode process and strategies. Kibet (2008) concluded that internal audit function played a role in corporate governance. The limitations of the study were time constraints, restriction to state owned corporations and having to make prior arrangement in order to meet the heads of IADs. Recommendations of further study were effectiveness and contribution of internal audit in promoting corporate governance for companies listed in the NSE. Additionally, a study on the influence of internal audit and audit committee on financial reporting quality was recommended

The Sarbanes-Oxley Act of 2002 has also contributed to the growth of internal auditing. "Internal auditors have enjoyed increased prominence, higher salaries, and a greater public appreciation for the role that internal auditing can play in a well-governed organization (Hermanson, 2006)." In particular, companies are using internal auditors to strengthen and evaluate their internal control systems to comply with the internal controls provisions of Sarbanes-Oxley. A 2003 survey by The Institute of Internal Auditors indicated that 20% of companies included in the Fortune 1,000 did not yet have internal audit departments but 50% of the Fortune 1,000 companies planned to increase their internal audit staffs to comply with Sarbanes-Oxley (Harrington, 2004). A later survey of 117 chief audit executives of public companies subject to the provisions of Sarbanes-Oxley indicated that 111 reported their companies increased internal audit budgets from 2002 to 2005 (Kaplan & Schultz, 2006). Of these 111, 32% increased internal audit

budgets by more than 50%. Another survey of 402 companies reports that more than half of them increased internal audit resources as a result of Sarbanes-Oxley, with 15% indicating more than a 50% increase (PricewaterhouseCoopers, 2006).

Kibara (2007) conducted a survey of internal auditors risk management practices in the banking industry in Kenya. The study sought to establish banking internal auditors' perception of their distinct role in the bank wide ERM process, and whether there was any conflict between internal audit and risk management departments being established to take over the ERM process. Bank internal auditors risk assessment practices in Kenya were also probed. To achieve the objectives set, a survey of involving all heads of internal audit departments in the banking industry in Kenya was conducted. Data analysis was done, and 14 with response rate of 52%, it was concluded that the outcome of the study fairly represented the banking industry internal auditors' practices and perception of risk management. It also emerged that only 14% of the internal auditors could clearly list the distinct role of IAD and those of Risk Management Department. For institutions both departments, a conflict was already brewing between IAD and RMD in 29% of the institutions. The conflict centered mainly on lack of clarity on the distinct roles to be played by those two departments in the whole ERM process. The study found that, most banks in Kenya were in process of drafting the ERM process and strategies.

According to Heath and Norman, (2004), when senior managers were given multiple objective to achieve it may become almost impossible to measure their success in improve the firm performance through accountability for achieve firm value leading to failure. Several studies suggest that firms with more independent directors perform worse than those with relatively fewer independent directors. For example, Agrawal and Knoeber (1996) reported a negative correlation between the proportion of outside directors and Tobin's Q index (which is a measure of growth prospects of assets, defined by the future profitability of the asset in relation to its replacement cost). This is consistent with evidence established by Bhagat and Black (1997) that a high proportion of independent directors is strongly correlated with slower past growth across a number of accounting variables, but not so with future performance. Evidence from Bhagat and

Black (1997) and Klein (1997) also shows that a high proportion of independent directors correlates with lower past profitability.

2.7 Relationship between Risk based Auditing and Financial performance

The empirical findings by Al-Tamimi (2002) and Al-Mazrooei (2007) highlighted that UAE banks are efficient in risk based auditing. Drzik (1995) found out that Bank Administration Risk based audit Survey showed that large banks in the US had made substantial progress in their financial performance. Comprehensive risk based auditing influence effective financial reporting activities and influencing profit and loss sharing in the source of funds especially investment account holders are explained by Sundararajan (2007, pp.36-35). He concludes that the application of risk based audit particularly for credit and overall banking risks is important for Banks.

The presence of real options based flexibilities should enhance effective risk based audit practices that diminish earnings volatility and thereby reduce the costs associated with potential financial distress. The presence of real options based flexibilities should enhance effective risk management practices that diminish earnings volatility and thereby reduce the costs associated with potential financial distress (Andersen, 2008). To the extent an organization is able to manage risks imposed by dynamic global conditions potential under investment problems would be reduced resulting in higher earnings (Froot, Scharfstein and Stein, 1994). Hence, risk based audit can be extended to include a real options perspective where firms are able to develop opportunities and claims on the future that can be evaluated based on assumptions about underlying risk factors (Leiblein, 2003). Stulz, (1984) carried out a study on the rationale of risk based audit to organizations. He indicated that there exist a rationale for RBA for lenders and financial institutions in the business of lending influencing bank financial performance (Santomero, 1995).

Transparency, disclosure and trust, which constitute the integral part of corporate governance, can provide pressure for improved financial performance. Financial performance, present and prospective is a benchmark for investment. The McKinsey Quarterly surveys suggest that institutional investors will pay as much as 28% more for the shares of well governed companies in emerging markets (Mark, 2000). According to the corporate governance survey 2002, carried out by the Kuala Lumpur stock exchange and accounting firm Price Water House Coopers (PWC), the majority of investors in Malaysia are prepared to pay 20% premium for companies with superior corporate governance practices.

It was disclosed that all the dimensions of financial transparency, Disclosure and trust had positive relationships with most of the financial performance dimensions in commercial banks in Uganda. For instance capital adequacy, earnings, assets quality highly showed positive correlations with openness competence honesty and kindness. Regression analysis was used to find the influence of the independent variable.

Corporate Governance on the dependent variables financial performance (capital adequacy, asset quality, earnings and liquidity). An analysis of Variance was produced reflecting the variables corporate Governance and financial performance. Results indicated that Corporate Governance (Transparency, Trust and Disclosure) predicts 34.5 % of the variance in the general financial performance of Commercial banks in Uganda. The significant contributors to financial performance were openness and reliability. Openness and Reliability all these are measures of trust.

Prior research has examined the effect of corporate governance on auditors' decisions (judgments). Cohen and Hanno (2000) find that management control philosophy and corporate governance structure affect auditors' pre-planning (client acceptance) and planning (extent and timing of testing) judgments; specifically, auditors were more willing to recommend client acceptance and more likely to reduce substantive tests in the presence of a stronger corporate governance or management control philosophy. Bedard and Johnstone (2004) examined auditors' assessments of and planning and pricing

decisions related to earnings manipulation risk and corporate governance risk, and showed that auditors plan increased effort and billing rates for clients with earnings manipulation risk and that the positive relation between earnings manipulation risk and both effort and billing rates are greater for clients that have heightened corporate governance risk. Lee *et al.* (2004) found that an independent audit committee and board members who are concerned about incurring legal liability and harming reputation support external auditors in accomplishing their assurance duties. Yatim *et al.* (2006), examined the relationship between corporate governance and audit fees, finding that external audit fees are positively and significantly associated with good audit committees. Cohen *et al.* (2007) examined the effect of the role of the board of directors in monitoring management (agency role) and/or the role of the board in helping to formulate corporate strategies (resource dependence role) on the auditors' planning judgments, and showed that auditors respond to the role of the board when making judgments with respect to control risk assessments and the planned scope of audit tests. The way management and control are organized affects the company's performance and its long run competitiveness. It determines the conditions for access to capital markets and the degree of investors' confidence (Brownbridge, 2007).

Banking institutions around the world face a number of challenges in meeting the changing expectations and needs of their citizens. Responses to these challenges typically include setting up and delivering service delivery reforms, fiscal management, seeking to operate more effectively, efficiently and openly and developing new capabilities for civil society participation, partnership and resource management (Brownbridge, 2007). The principles of good governance transparency and accountability, fairness and equity, efficiency and effectiveness, respect for the rule of law and high standards of ethical behavior represent the basis upon which to build open (OECD, 2005).

IIA (2005) in their submission to the Turnbull Review Group requested that boards should be responsible for determining acceptable risks and for managing them. While board members have ultimate responsibility for risk management and internal control, they require assurance that risks throughout the organization have been identified.

assessed and managed (Fraser and Henry 2007). Hence, internal auditing's risk-based orientation would be a key component for such assurance. Haniffa and Hudaib (2006) indicated that board size affects the extent of monitoring and controlling. As a small board may be seen to be more effective, we would expect a higher percentage of RBIA may be used. However, as bigger boards seems to be more symbolic rather than being a part of the management process (Haniffa and Hudaib 2006; Chen 2003), they would require internal audit activities to be more risk orientation, as a substitute mechanism.

2.8 Conclusion

This study seeks to establish the impact of RBA on financial performance of commercial banks in Kenya. To understand the impact of RBA on financial performance of the banks, this study will examine whether the use of RBA practices such as risk management, risk assessment, annual risk planning, audit staffing affects financial performance of the banks. RBA is seen as the process and structure used to direct and manage the business affairs of the bank towards enhancing credit unions prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interest of other stakeholders. Claessens et al. (2002) maintain that better corporate frameworks benefit firms through greater access to financing, lower cost of capital, better performance and more favourable treatment of all stakeholders. RBA helps in defining the relation between the commercial banks and its financial market environment, the social and political systems in which it operates. RBA is linked to financial performance of financial institutions. The study therefore seeks to investigate the impact of RBA on financial performance in commercial banks in Kenya.

CHAPTER THREE

RESEARCH DESIGN AND METHODOLOGY

3.1 Introduction

This chapter presents the research design and methodology that was used to carry out the research. It presented the research design, the population, sampling, data collection and data analysis.

3.2 Research design

Research design refers to the way the study is designed, that is the method used to carry out the research (Mugenda and Mugenda (2003). Correlation research design was adopted in the investigation in which quantity data was collected and analysed in order to describe the specific phenomenon in its current trends, current events and linkages between different factors at the current time. Correlated research design was chosen because it enabled the researcher to establish the impact of risk based audit on financial performance of commercial banks. It was used to obtain information concerning the current status of the impact of risk-based audit on financial performance in commercial banks in Kenya.

3.3 Population and Sampling

The target population for the proposed study was for the 44 commercial banks operating Kenya. These include 10 commercial banks listed in Nairobi Stock Exchange and 34 unlisted commercial banks as indicated in the Appendix II. The population of 44 commercial banks is small therefore the study carried out a census survey of all the 44 commercial banks in Kenya.

3.4 Data collection

Questionnaires were used to obtain important information about the population. According to Sproul (1998), a self-administered questionnaire is the only way to elicit

self-report on people's opinion, attitudes, beliefs and values. The questionnaire contained both closed-ended and also a few open ended questions.

The study used both primary and secondary data. Primary data is the information the researcher will obtain from the field. Primary data was collected using semi-structured questionnaires. The questionnaires will be administered using drop and pick method. The questionnaires used because it allowed the respondents who were auditors to give their responses in a free environment and help the researcher gather information that did not been given out has interviews being used.

3.5 Data analysis

For collected data to be understood by the common man easily, it needs to be analysed. The researcher used qualitative and quantitative techniques in analysing the data. After receiving questionnaires from the respondents, the responses was edited, classified, coded and tabulated to analyze quantitative data using Statistical Package for Social Science (SPSS version 17). Tables and charts were used for further representation of the data for easy understanding and analysis. The collected data was thoroughly examined and checked for completeness and comprehensibility. The data was then be summarized, coded and tabulated. Inferential statistic regression and correlation was used to establish the impact of risk based audit on financial performance in commercial banks. The inferential statistic seeks to establish a causal effect relating independence variables to the dependent variable. While risk based audit practice was quantified from Likert questions. Correlation analysis was used to establish the strength of the relationship between risks based audit and the financial performance in commercial banks in Kenya.

Regression analysis was then being applied to cross check the conclusion reached in the first approach. A regression model relating each of the four risk based audit practices to value of the bank as proxied by Tobin's Q and Book-to-market ratio was specified.

To test of relationship between the percentage RBA practices and bank performance. Tobin model was used in data analysis, which is a regression technique suited to analyze



limited (censored) dependent variables (Spekle' *et al.* 2007). The return on assets (ROA) percentage was used to indicate the financial performance measure of the bank. The model treats financial performance of commercial banks as the dependent variable while the independent variables was the risk based audit practices which included risk management, annual risk based planning, internal auditing standards and Internal audit Capacity. The response on RBA practices was measured by computing responses derived from the Likert-Scaled questions. Prior research has examined the effect of corporate governance on financial performance using linear gression models (Cohen and Hanno, 2000). The relationship equation is represented in the linear equation below.

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + e$$

Where

Y= Return on Assets

α = Constant Term

β_1 = Beta coefficients

X_1 = Risk Management

X_2 = Annual Risk Based Planning

X_3 = Internal Auditing Standards

X_4 = Internal audit Capacity

e = standard errors

Return on Assets is an indicator of how profitable a commercial bank is relative to its total assets. ROA gives an idea as to how efficient management is at using its assets to generate earnings. Calculated by dividing a company's annual earnings by its total assets. ROA was displayed as a percentage. Using ROA as a comparative measure is best to compare it against a company's previous ROA numbers or the ROA of a similar company. This indicated how effective RBA practices lead to profitability on the commercial banks in Kenya.

3.6 Validity and reliability

Piloting was carried out to test the validity and reliability of the instruments. Validity indicates that degree to which the instrument measures the constructs under investigation (Mugenda and Mugenda, 2003). There are three types of validity test which include content, criterion and related construct validity. This study used content validity because it was measured the degree to which the sample of the items represents the content that the test is designed to measure.

A pilot study was conducted by the researcher taking some questionnaires to the staff in commercial banks in Nairobi which was filled by some respondents at random. From this pilot study the researcher was able to detect questions that need editing and those that may be ambiguous. The final questionnaire was then printed and was used to collect data to be used for analysis.

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION OF FINDINGS

4.1 Introduction

This chapter discusses the interpretation and presentations of the findings. The objective of this study was to determine the impact of risk-based audit on financial performance in commercial banks in Kenya. This chapter focused on data analysis, interpretation and presentation and presents the discussion and conclusions of the study seeking to answer the research questions.

4.2 Data Presentation

Background Information

The target population of the study was 44 banks where 44 respondents responded and returned the questionnaires. This constituted 100% response rate. Mugenda and Mugenda (2003) indicated a response rate of above 50% is sufficient for a study and therefore a response rate of 100% for this study was very good of the 44 respondents who were the finance officers, internal auditors, credit officers, relationship officers/managers and accountants working at commercial banks in Kenya.

4.2.1 Operational years of the bank

Table 1: Operational years of the bank

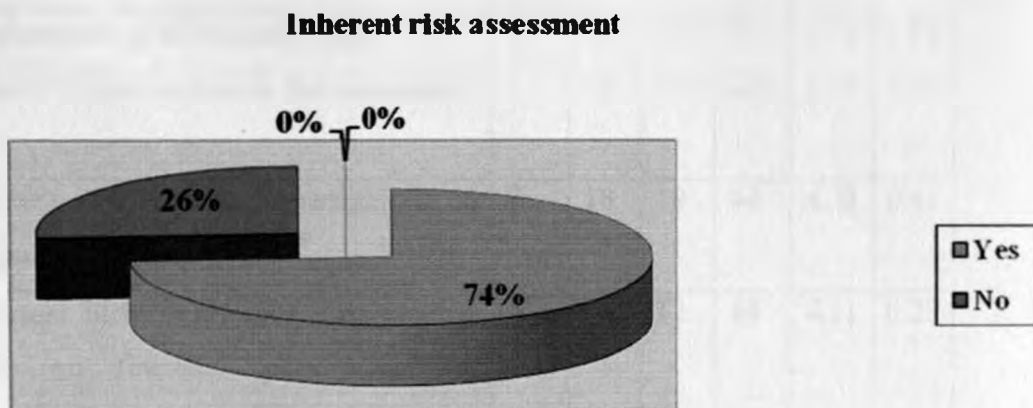
	Frequency	Percentage
11 to 20 years	17	39%
1 to 10 years	11	25%
21 to 30 years	9	20%
Over 30 years	7	16%
Total	44	100

Source: Author (2012)

The study sought to investigate the years in which their bank had been in operation. The study found that, majority (39%) of the respondents indicated that the bank had been in operation for 11 to 20 years, 25% indicated that the bank had been in operation for 1-10 years while 20% of the respondents indicated the their bank had been in operation for 21 to 30 years while 16 % of the respondents indicated that the banks had been in operation for over 30 years . This implied that majority of commercial banks had been in operations for a long period.

4.2.2 Risk Based Audit and Financial Performance

Figure 1: Inherent risk assessment



Source: Author (2012)

This study sought to know the whether inherent risk assessment affect financial performance at commercial banks in Kenya. From the findings, 74% of the respondents indicated that inherent risk assessment affect affect financial performance at commercial baks in Kenya while 26 of the respondent indicted that inherent risk assessment does not affect affect financial performance at commercial banks in Kenya. This implied that inherent risk assessment affect financial performance at commercial banks in Kenya greatly.

4.2.3 Extent to which Risk assessment affects commercial banks Financial Performance

Table 2: Extent to which Risk assessment affect commercial banks Financial Performance

Statement	Average extent	Great extent	Very great extent	Total	Mean	Std deviation
Consideration of risk assessment in the detection of errors	4	11	29	44	4.67	0.73
The auditors understanding of the bank's risk	7	17	20	44	4.79	0.83
Difficult and costly to assess risks at the commercial banks	1	10	33	44	4.87	0.77
The bank auditor's involvement of management in risk evaluation process	7	18	19	44	4.33	0.41
The bank auditors identification of changes that have influence on financial performance at commercial banks in Kenya	4	28	12	44	4.11	0.23
Auditors recognition of work environment in risk assessment	8	17	19	44	4.47	0.67

Source: Author (2012)

The study sought to know the extent to which the given factors affect risk assessment on financial performance at commercial banks in Kenya. From the findings difficult and costly to assess risks, the auditors understanding of the banks risk and consideration of risk assessment in the detection of errors affected risk assessment on financial performance at commercial banks in Kenya to a very great extent as indicted by a mean of 4.87, 4.79 and 4.67 with a standard deviation of 0.77, 0.83 and 0.73. The study found that auditors recognition of work environment in risk assessment, auditor's involvement

of management in risk evaluation process and auditors identification of changes that have influence on financial performance at banks affected risk assessment on financial performance at commercial banks in Kenya to a great extent as indicted by a mean of 4.47, 4.33 and 4.11 with a standard deviation of 0.67,0.41 and 0.23. This clearly indicate that difficult and costly to assess risks, auditors understanding of the bank's risk and consideration of risk assessment in the detection of errors in the bank affect risk assessment on financial performance to a very great extent.

4.2.4 Significance of the given factors in influencing judgment of risk

Table 3: Significance of the given factors in influencing judgment of risk

Statement	Moderately significant	Significant	Very significant	Total	Mean	Std deviation
Effective controls	10	8	26	44	4.71	0.76
Lack of adequate funds	2	19	23	44	4.44	0.53
The complexity of operations	12	15	17	44	4.43	0.42
The quality of personnel in internal audit	9	11	24	44	4.64	0.79

Source: Author (2012)

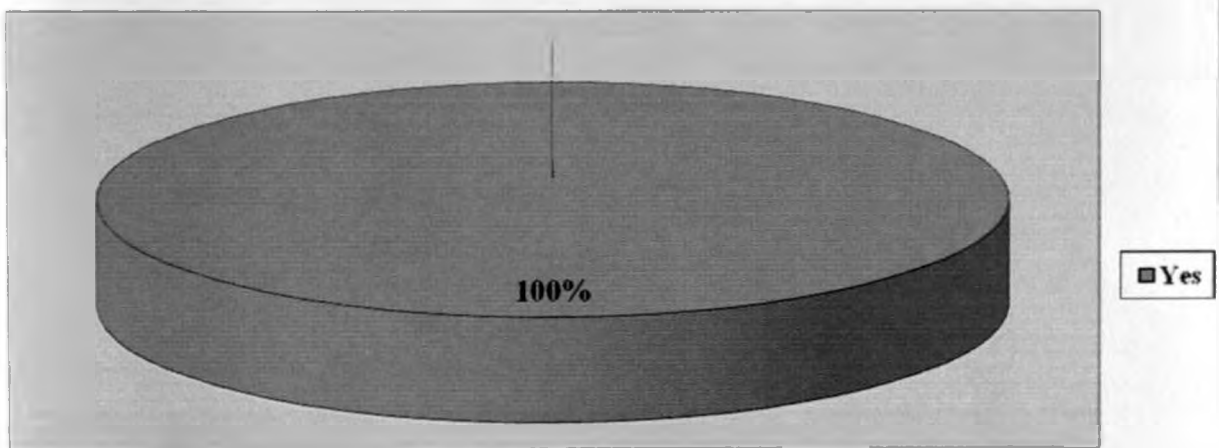
The respondents were requested to indicate the extent to which the given factors in influencing judgment of risk at the commercial banks were significant. From the findings, majority of the respondents indicated that effective controls and quality of personnel in internal audit were very significant in influencing judgment of risk at the commercial banks in Kenya as indicated by a mean of 4.71 and 4.64 with stadard deviation of 0.76 and 0.79. The study further found that most of the respondent indicated that lack of adequate funds and the complexity of operations were significant in influencing judgments of risk at commercial banks as indicated by a mean of 4.44 and 4.43 with standard deviation of 0.53 and 0.42. This implied that the management need to bear the

responsibility for managing risks. This concurred with Al-Tamimi, (2002) who found that many risks will be very significant to the organization and the discussion of their controls will involve more senior managers and directors than might be involved in traditional finance oriented audits.

4.2.5 Whether Management of Risks Influence Financial Performance in the Bank

Figure 2: Whether Management of Risks Influence Financial Performance

Risk management influence on financial performance



Source: Author (2012)

The figure 4.2 indicates the response on whether the management of risks influence financial performance at commercial banks in Kenya. From the findings, all 100% of the respondents indicated that managing of risks influence financial performance at commercial banks in Kenya. This implied that The Risk Based Internal Auditing (RBIA)

approach involves management to a far greater extent. This concurred with Millichamp (2002) who found that the risks to be covered in audits will exist in all parts of the organization and audits will therefore involve managers in departments never visited before.

	1	2	3	4	5
1. The audit is a necessary part of the business	4	3	2	1	0
2. The audit is a waste of time and money	0	1	2	3	4
3. The audit is a necessary part of the business	4	3	2	1	0
4. The audit is a waste of time and money	0	1	2	3	4
5. The audit is a necessary part of the business	4	3	2	1	0
6. The audit is a waste of time and money	0	1	2	3	4
7. The audit is a necessary part of the business	4	3	2	1	0
8. The audit is a waste of time and money	0	1	2	3	4

The results of the survey are shown in Table 1. The data shows that the majority of respondents (70%) agreed or strongly agreed that the audit is a necessary part of the business. This is in line with the findings of Millichamp (2002) who found that the risks to be covered in audits will exist in all parts of the organization and audits will therefore involve managers in departments never visited before. The data also shows that the majority of respondents (70%) disagreed or strongly disagreed that the audit is a waste of time and money. This is also in line with the findings of Millichamp (2002) who found that the risks to be covered in audits will exist in all parts of the organization and audits will therefore involve managers in departments never visited before. The data also shows that the majority of respondents (70%) agreed or strongly agreed that the audit is a necessary part of the business. This is in line with the findings of Millichamp (2002) who found that the risks to be covered in audits will exist in all parts of the organization and audits will therefore involve managers in departments never visited before. The data also shows that the majority of respondents (70%) disagreed or strongly disagreed that the audit is a waste of time and money. This is also in line with the findings of Millichamp (2002) who found that the risks to be covered in audits will exist in all parts of the organization and audits will therefore involve managers in departments never visited before.

4.2.6 Significance of the given risk based audit services in influencing financial performance in the bank

Table 4:Significance of the given risk based audit services in influencing financial performance in the bank

Risk Based Services	Average extent	Great extent	Very great extent	Total	Mean	Std. deviation
Risk Based Audit Reporting time	8	5	31	44	4.78	0.64
Assessment of risks	5	13	26	44	4.41	0.39
Risk Based audit Annual plans with the Management	2	7	35	44	4.88	0.64
Auditing process	6	14	24	44	4.19	0.41
Action audit queries on time	9	21	14	44	4.05	0.33
Implementation of audit recommendation by the Management	4	4	36	44	4.93	0.71
Adequate auditing staff	4	10	30	44	4.68	0.55

Source: Author (2012)

The study sought to find out the extent to which the given risk based audit services were significant in influencing financial performance in the bank. From the findings, majority of the respondents indicated that implementation of audit recommendation by the management, Risk Based audit annual plans with the management, risk based audit reporting in time and adequate auditing staff affected the financial performance at commercial banks to a very great extent as indicated by a mean of 4.93, 4.88, 4.78 and 4.68 with standard deviation of 0.71, 0.64, 0.64 and 0.55. The study further found that most of the respondents indicated that assessment of risks, auditing process and action audit queries on time affected the financial performance to a great extent as indicated by a mean of 4.41, 4.19 and 4.05 with standard deviation of 0.39, 0.41 and 0.33. This implies that the implementation of risk based auditing in banks is expected to improve financial performance, transparency, accountability and efficiency in the management of bank's affairs making it more effective in the delivery of best services to its clients. This

concluded with the GOK, (2006) which found out that risk based audit implementation will also deepen the facilitation of private sector participation in the economy by encouraging investments, job creation and development of business initiatives to reduce poverty.

4.2.7 Whether bank annual audit planning affect return on assets in the bank

Table 5: Whether bank annual audit planning affect return on assets in the bank

	Frequency	Percentages
Yes	38	86
No	6	14
Total	44	100

Source: Author (2012)

The study sought to know whether bank annual audit planning affect return on asset at the commercial banks in Kenya. From the findings, majority 86% of the respondents indicated that annual audit planning at the commercial banks in Kenya affected the financial performance while 14% of the respondents indicated that annual audit planning at commercial banks in Kenya did not affect the financial performance in the bank. In some cases the numbers of the audit engagements are completed in the budgeted time and the number of actual audits performed in a period is usually less than the number of audits stated in the annual audit plan. This concurred with that Sanda, Milkailu and Garba, (2005) who urged that proper planning enables accomplishment of a large number of audits in a given period by improving efficiency.

4.2.8 Extent to which the given factors affect bank financial performance

Table 6: Extent to which the given factors affect bank financial performance

	Very great extent	Great extent	Average extent	Total	Mean	St Dev
Disclosure about financial risk and risk management	8	11	25	44	4.56	0.67
Disclosure about compliance risk and risk	1	14	29	44	4.91	0.87
Disclosure about environmental and safety risk and risk management	2	14	28	44	4.74	0.63
Disclosure about technology risk and risk management	4	16	24	44	4.63	0.59
Internal process risk and risk management	9	13	22	44	4.46	0.45
Change management risk and risk management	5	15	24	44	4.11	0.39

Source: Author (2012)

The study sought to know the extent to which the given factors affect bank's financial performance. From the findings, majority of the respondents indicated that disclosure about compliance risk and risk management, disclosure about environmental and safety risk and risk management, disclosures about technology risk and risk management and disclosure about financial risk and risk management affected the commercial bank's financial performance to a very great extent as indicated by a mean of 4.91, 4.74, 4.63 and 4.56 with standard deviation of 0.87, 0.63, 0.59 and 0.67. The study further found that most of the respondents indicated that change management risk and risk management and internal process risk and risk management affected the commercial bank's financial performance to a great extent as indicated by a mean of 4.46 and 4.11 with a standard deviation of 0.45 and 0.39.

4.2.9 Whether auditing codes affect return on assets in the bank

Table 7: Whether auditing codes affect return on assets in the bank

	Frequency	Percent
Yes	36	82
No	8	18
Total	44	100

Source: Author (2012)

The respondents were required to indicate whether auditing codes affect return on assets in the commercial banks in Kenya. From the findings, majority, 82% of the respondents indicated that the auditing codes affected return on assets in the bank while 18% of the respondents indicated that auditing codes did not affect return on assets in the bank. The findings were in line with Jackson, (2005), who stated that the aim of the audit codes is to improve the quality and effectiveness of audits by substantially changing audit practice.

4.2.10 Extent to which auditing standards affect return on assets in the bank

Table 8: Extent to which auditing standards affect return on assets in the bank

	Average extent	Great extent	Very great extent	Total	Mean	Std Dev
Bank Auditors technical and professional skills	4	14	26	44	4.63	0.66
Bank Auditors Readiness to embrace change	6	19	19	44	4.32	0.39
Quality audit reports	7	13	24	44	4.56	0.43
Quality criteria to measure internal auditors performance	3	11	30	44	4.90	0.79

Source: Author (2012)

The study sought to know the extent to which the given auditing standards affects the return on assets at commercial banks in Kenya. From the findings, majority of the respondents indicated that quality criteria to measure internal auditors performance, bank auditors technical and professional skills and quality audit reports affected the return on assets at commercial banks in Kenya hence influencing the financial performance as indicated by a mean of 4.90, 4.63 and 4.56 with standard deviation of 0.79, 0.66 and 0.43. The study further noted that most of the respondents indicated that the bank auditors readiness to embrace change affected the return on assets at commercial banks in Kenya to a great extent as indicated by a mean of 4.32 with standard deviation of 0.39. From the findings, the study found that auditing standards define what an audit is, promote consistency, facilitate education, provide a means to judge performance and influence auditor's behaviour. Therefore auditing standards affect many of the other factors that impact on auditors' behavior such as inspections and enforcement and firm methodologies. Effective audit standards take account of the complex environment that influences auditor's behavior and improves the quality and effectiveness of audits by substantially changing audit practice.

4.2.11 Extent to which the given set of risk based audit practices influence return on assets in the bank

Table 9: Extent to which risk based audit practices influence return on assets

	Average extent	Great extent	Very great extent	Total	Mean	Std Dev
Active and independent audit committee	4	11	29	44	4.83	0.69
Independent directors	5	16	23	44	4.87	0.72
Management's ownership interest	23	13	8	44	3.16	0.11
Financial management compliance with accepted audit standards	3	10	31	44	4.77	0.59
Limited auditors in the bank	37	3	4	44	2.90	0.09
Proficiency of the internal auditor	1	9	34	44	4.91	0.78

Audit planning	4	15	25	44	4.79	0.64
Effective internal audit staff	8	17	19	44	4.65	0.54
Risk assessment	5	3	36	44	4.73	0.63
Risk management	7	11	26	44	4.72	0.60

Source: Author (2012)

Table 9 indicates the response on the extent to which commercial bank's return on asset was influenced by the given possible set of risk based audit practices. From the findings, majority of the respondents indicated that proficiency of the internal auditor, active and independent audit committee and independent directors, audit planning and financial management compliance with accepted audit standards influenced return on assets bank to a very great extent as indicated by a mean of 4.91, 4.87, 4.83, 4.79 and 4.77 with standard deviation of 0.78, 0.72 0.69, 0.64 and 0.59. Most of the respondents indicated that risk assessment, risk management and effective internal audit staff influenced return on assets bank to a great extent as indicated by a mean of 4.73, 4.72 and 4.65 with standard deviation of 0.63, 0.60 and 0.54. The study further noted that most of the respondents indicated that Management's ownership interest and Limited auditors in the bank influenced return on assets bank to a low extent as indicated by a mean of 3.16 and 2.90 with standard deviation of 0.11 and 0.09.

4.2.12 Regression Analysis

A multivariate regression model was applied to test the relationship between the percentage of RBA practices and financial performance in commercial banks in Kenya. The logistic regression used in this model was

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \epsilon$$

Where

Y= Return on Assets

α = Constant Term

β = Beta coefficients

X₁= Risk Management

X₂= Annual Audit Risk Based Planning

X₃= Internal Auditing Standards

X₄= Internal auditing Capacity

e = Standard errors

Model Summary

Table 10: Model Summary (b)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. Change
1	.877(a)	.769	.761	.19456	.945	719.412	46	234	0.01(a)

Source: Author (2012)

A Predictors: (Constant), Risk Management, Annual Audit Risk Based Planning, Internal Auditing Standards and Internal auditing Capacity

B Dependent Variable: Return on Assets

Adjusted R² is called the coefficient of determination and gives the extent to which return on assets varies with variation in factors influencing financial performance at commercial banks in Kenya. From table above, the value of adjusted R² is 0.761. This implies that there was a variation of 76.1% of return on asset, which varied with variation in factors influencing financial performance at commercial banks in Kenya. These factors were risk management, annual risk based planning, internal auditing standards and internal auditing capacity at a confidence level of 99.95%. The unexplained variation could be attributed to other factors not included in the model as well as random factors.

Table 11: ANOVA(b)

Model		Sum of Squares	df	Mean Square	F	Sig. Chan
1	Regression	37.421	46	8.124	719.412	0.01(a)
	Residual	6.987	234	.039		
	Total	62.264	264			

Source: Author (2012)

A Predictors: (Constant), Risk Management, Annual Audit Risk Based Planning, Internal Auditing Standards and Internal audit Capacity

B Dependent Variable: Return on Assets

The strength of variation of the predictor values influence the financial performance of commercial banks in Kenya variable at 0.01 significant levels.

Table 12: Coefficients (a)

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig. change
		B	Std. Error	Beta		
1	(Constant)	4.000	.346		3.126	0.01
	Risk Management	0.637	.129	.5254	3.451	0.04
	Annual Risk Based Planning	0.546	.233	.4477	.0042	0.01
	Internal Auditing Standards	0.443	.194	.4188	.0121	0.03
	Internal audit Capacity	0.537	.147	.4648	1.472	0.02

Source: Author (2012)

A Predictors: (Constant), Risk Management, Annual Audit Risk Based Planning, Internal Auditing Standards and Internal audit Capacity

B Dependent Variable: Return on Assets

$$Y = 4.000 + 0.637X_1 + 0.546X_2 + 0.443X_3 + 0.537X_4$$

Where X_1 = Risk Management, X_2 = Annual Audit Risk Based Planning, X_3 = Internal Auditing Standards and X_4 = Internal audit Capacity

From the above regression model, it was found that return on asset in commercial banks would be at 4.000 holding risk management, annual audit risk based planning, internal auditing standards and internal audit capacity constant. A unit increase in effective risk management would lead to increase in return on asset in commercial banks by factor of 0.637 with a P Value of 0.04, a unit increase in annual audit risk based planning would lead to increase in return on asset in banks by factor of 0.546 with a P Value of 0.01, a unit increase in internal auditing standards would lead to increase in return on asset in banks by factor of 0.443 with a P Value of 0.03 while a unit increase in internal audit capacity would lead to increase in return on asset in banks by factor of 0.537 with a P Value of 0.02.

There is a positive relationship between return on asset and risk based audit factors influencing financial performance in commercial banks in Kenya clearly indicating that effective risk management, annual audit risk based planning, internal auditing standards and internal audit capacity influence financial performance in commercial banks in Kenya as they were statistically significant with a P-Value of 0.04, 0.01, 0.03 and 0.02 at 95% confidence level. This implied that the risk management, annual risk based planning, internal auditing standards and internal audit capacity influence return on asset in commercial bank in Kenya.

4.3 Summary and interpretation of findings

The adjusted R^2 is 0.761 indicating that there was a variation of 76.1% of return on asset with variation in risk based audit practices. This reveals that there exists a strong positive relationship between return on assets and risk based audit factors influencing financial performance in commercial banks in Kenya clearly indicating that effective risk management, annual risk based planning, internal auditing standards and internal audit capacity influence financial performance in commercial banks in Kenya as they were statistically significant with a P-Value of 0.04, 0.01, 0.03 and 0.02 at 95% confidence level. The findings were similar to that of Maiteka (2010) who found that there existed a strong and positive relationship between risk based audit and corporate governance in public sectors with an adjusted R^2 of 0.783 indicating that the risk based audit explain 78.3 % of the variability in the corporate public governance in enhancing public service delivery. Thus the adjusted R^2 of 0.761, implied that the risk management, annual risk based planning, internal auditing standards and internal audit capacity positively influence return on assets in commercial banks in Kenya. The findings concurred with Kibet (2008) who concluded that internal audit function played a role in corporate governance and recommended that effectiveness and contribution of internal audit in promoting corporate governance for companies listed in the NSE hence improving financial performance of the financial institutions.

The study found that risk based audit influence return on assets in commercial banks. The findings were similar to that of Chen, (2003) who investigated the relationship between corporate governance and risk-taking behavior in Taiwanese Banking Industry. He took a sample consisting of 39 domestic banks, and of the 39 surveys mailed, 24 completed responses were returned thus a response rate of 61.54%. Of the 24 survey responses, 13 (54.1%) of the credit unions reported that more than 60% of their internal audit activities are risk oriented. It was found that 8 of 24 (33.3%) respondents indicated that they use a relatively high level of RBIA, at about 61%-80%, while 6 (25%) of the domestic banks reported that about 21%-40% of their internal audit work are risk-based.

From the findings, difficult and costly to assess risks, the auditors understanding of the banks risk and consideration of risk assessment in the detection of errors affected risk assessment of financial performance at commercial banks in Kenya to a very great extent .The findings were in contrast with Liebesman (2004) who found negative relationship between ISO 9000 and ISO 14000 reducing risks with compliance with the Sarbanes-Oxley Act (SOX, 2002). He found that because of SOX, the CEOs and CFOs of public companies who failed to certify their financial statements, each year they must certify the effectiveness of their systems of internal controls mandated by the law. The study found out that auditors recognition of work environment in risk assessment, auditor's involvement of management in risk evaluation process and auditors identification of changes that have influence on financial performance at banks affected risk assessments on financial performance at commercial banks in Kenya to a great extent as indicted by a mean of 4.47, 4.33 and 4.11 . It is clear that difficult and costly in assessing risks, auditors understanding of the bank's risk and consideration of risk assessment in the detection of errors in the bank affect risk assessments on financial performance to a very great extent.This concurred with Millichamp, (2002) who indicated that Internal Audit major roles are required in risk management in determining processes and their objectives, identifying risks that hinder the processes with management, test and controls mitigating the risks, reporting where risks are not sufficiently mitigated by controls and assure management that risks are mitigated to an acceptable level. This has been made easy with adoption of RBA in the public sector

The study established effective controls and quality of personnel in internal audit were very significant in influencing judgment of risk at the commercial banks in Kenya as indicated by a mean of 4.71 and 4.64 . The study found that lack of adequate funds and the complexity of operations were significant in influencing judgment of risk at commercial banks as indicated by a mean of 4.44 and 4.43. This implied that the management need to bear the responsibility for managing risks. This concurred with Al-Tamimi, (2002) who found that many risks will be very significant to the organization and the discussion of their controls will involve more senior managers and directors than might be involved in traditional finance oriented audits.

The study found that implementation of audit recommendation by the management, Risk Based audit annual plans with the management, risk based audit reporting in time and adequate auditing staff affected the financial performance at commercial banks to a very great extent as indicated by a mean of 4.93, 4.88, 4.78 and 4.68. The findings were similar to PricewaterhouseCoopers, (2006), which carried out a study on influence of internal auditors on company performance. The findings indicated that 20% of companies included in the Fortune 1,000 did not yet have internal audit departments but 50% of the Fortune 1,000 companies planned to increase their internal audit staffs to comply with Sarbanes-Oxley (Harrington, 2004). A later survey of 117 chief audit executives of public companies subject to the provisions of Sarbanes-Oxley indicated that 111 reported that their companies increased internal audit budgets from 2002 to 2005 (Kaplan & Schultz, 2006). Of these 111, 32% increased internal audit budgets by more than 50%. Another survey of 402 companies reports that more than half of them increased internal audit resources as a result of Sarbanes-Oxley, with 15% indicating more than 50% increase. The study further found that most of the respondents indicated that assessment of risks, auditing process and action audit queries on time affected the financial performance to a great extent as indicated by a mean of 4.41, 4.19 and 4.05. The implications of implementation of risk based auditing in banks is expected to improve financial performance, transparency, accountability and efficiency in the management of bank's affairs making it more effective in the delivery of best services to its clients. This concurred with the GOK, (2006) which found out that risk based audit implementation will also deepen the facilitation of private sector participation in the economy by encouraging investments, job creation and development of business initiatives to reduce poverty.

From the findings, the study found that annual audit planning at the commercial banks in Kenya affected the financial performance at 86%, while 14% of the respondents indicated that annual audit planning at commercial banks in Kenya did not affect the financial performance in the bank. In some cases the numbers of the audit engagements are completed in the budgeted time and the number of actual audits performed in a period is usually less than the number of audits stated in the annual audit planning. The findings

were similar to that of Sanda, Milkailu and Garba, (2005) who argued that proper planning enables accomplishment of a large number of audits in a given period by improving efficiency

From the findings, majority of the respondents indicated that proficiency of the internal auditor, active and independent audit committee and independent directors, audit planning and financial management compliance with accepted audit standards influence return on assets of the bank to a very great extent as indicated by a mean of 4.91, 4.87, 4.83, 4.79 and 4.77 .The findings concurred with those of Sanda, Milkailu and Garba, (2005) who found out that according to the corporate governance survey 2002, carried out by the Kuala Lumpur stock exchange and accounting firm Price Water House Coopers (PWC),results indicate that the majority of investors in Malaysia are prepared to pay 20% premium for companies with superior corporate governance practices. The study found that risk assessment and management and effective internal audit staff influenced return on assets of the bank to a great extent as indicated by a mean of 4.73 and 4.72 . The study further noted that most of the respondents indicated that Management's ownership interest and Limited auditors in the bank influenced return on assets bank to a low extent as indicated by a mean of 3.16 and 2.90 .This concurred with IIA, (2004) which states that the internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach. The study findings were similar to Cohen and Hanno (2000) whose study findings results indicated that Corporate Governance (Transparency, Trust and Disclosure) predicts 34.5 % of the variance in the general financial performance of Commercial banks in Uganda.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The objective of the study was to determine the impact of risk-based audit on financial performance in commercial banks in Kenya. The study addressed risk based audit practices which included risk management , Risk based audit annual planning. internal audit standards and auditing capacity.

This study adopted Correlation research design for it describes the specific phenomenon in its current trends, current events and linkages between different factors at the current time. The target population for the study constituted of 44 respondents who were finance officers, internal auditors, credit officers, relationship officers/managers and accountants at commercial banks in Kenya. The study administered the questionnaires which included structured and unstructured questions to all the respondents since it was the most appropriate tool to gather information. Descriptive statistics such as mean, standard deviation and frequency distribution were used to analyze the data. Data presentation was done by the use of pie charts and tables for easy of understanding and interpretation. The study sought to fill the knowledge gap by establishing the impact of RBA on financial performance in commercial banks in Kenya.

From the findings, the study established that inherent risk assessment affect financial performance at commercial banks in Kenya to a very great extent. The study established that effective controls and quality of personnel in internal audit were very significant in influencing judgment of risk at commercial banks. Lack of adequate funds and the complexity of operations were significant in influencing judgment of risks in the banks. From the findings, the study established that majority of the respondents agreed that management of risks influence financial performance at commercial banks in Kenya to a very great extent. The study established that implementation of audit recommendation by the management, discussion of risk based audit annual plans with the

management, reception of risk based audit reports in time and reception of adequate resources for risk based audit affected the financial performance in commercial banks.

Proper planning enabled accomplishment of a large number of audits in a given period by improving efficiency. The numbers of the audit engagements are completed in the budgeted time and the number of actual audits performed in a period is usually less than the number of audits stated in the annual audit plan. Implementation of audit recommendation by the management, risk based audit annual plans with the management, risk based audit reporting in time and adequate auditing staff affected the financial performance at commercial banks. From the findings, the study established that accuracy, completeness, timeliness, convenience and clarity contributed to transparency and accountability in the commercial banks.

Annual audit planning and the auditing codes at the commercial banks in Kenya affected the financial performance to a very great extent. Quality audit reports, quality criteria to measure internal auditors performance, banks auditors technical and professional skills and bank's auditors readiness to embrace change, auditing standards affected the financial performance too.

From the findings, the study established that auditing standards define what an audit is, promote consistency, facilitate education, provide a means to judge performance and influence auditor behaviour. Further, auditing standards affect many of the other factors that impact on auditor's behaviour such as inspections and enforcement and firm methodologies. Effective audit standards take account of the complex environment that influences auditor behaviour and improves the quality and effectiveness of audits by substantially changing audit practice.

The professional proficiency of the internal auditor influence performance of auditors responsibilities to a very great extent. Thus the internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies so as to improve profitability of the bank. The study established that there exists a positive relationship

between return on asset and risk based audit factors influencing financial performance in commercial banks in Kenya clearly indicating that effective risk management, annual audit risk based planning, internal auditing standards and internal audit capacity influence financial performance in commercial banks in Kenya as they were statistically significant with a P-Value of 0.04, 0.01, 0.03 and 0.02 at 95% confidence level.

5.2 Conclusion of the study

Risk based internal auditing through risk assessment, risk management, annual risk based planning, internal auditing standards and internal auditing staffing should be enhanced to be able to detect risks on time and concentrate on high risk areas leading to increased transparency and accountability, hence enhancing financial performance.

Risk based audit should help management in assessing the risks and recommend corrective measures for improvement. Auditors understanding of the bank's risk, consideration of risk assessment in the detection of errors, auditors recognition of work environment in risk assessment, auditor's involvement of management in risk evaluation process and auditors identification of changes that have influence on performance affects risk assessment in influencing on financial performance at commercial banks in Kenya.

From the findings, the study concluded that management of risks influence performance to a very great extent. Implementation of audit recommendation is still the prerogative of management and should be undertaken on a timely manner to enhance the financial performance. This study also concluded that for any risk based audit to improve the financial performance in banks, the auditors must embrace international Auditing Standards that guide the internal audit ethics of work and maintain professional auditing standard.

From the findings, the study concluded that the management should be able to embrace proper annual audit planning so as to improve efficiency, accuracy, completeness, timeliness, convenience and clarity. This is because if the annual audit planning are complied with, it can create transparency and accountability in the commercial banks

hence influence return on asset. From the findings, the study concluded that auditing codes affect risk based audit to a very great extent. Quality audit reports and criteria to measure internal auditors performance, auditors technical, professional skills and readiness to embrace change and auditing standards influence financial performance.

From the findings, the study concluded that Internal auditing staffing influence financial performance greatly. Therefore, proficiency of the internal auditor required knowledge, skills, and other competencies needed to perform individual responsibilities must be ensured in order to improve the financial performance in commercial banks in Kenya. From the findings, the study concluded that credible audit reports, auditor independence to identify and rectify audit errors, effective implementation of audit recommendations, financial management and compliance with accepted audit standards, effective internal audit staff and independent audit committee influence financial performance in the banks.

The study concluded that there exists a positive relationship between return on asset and risk based audit practices influencing financial performance in commercial banks in Kenya, clearly indicating that effective risk management, annual risk based planning, internal auditing standards and internal audit capacity influence financial performance in commercial banks in Kenya .

5.3 Policy Recommendations

From the findings and conclusions, the study recommends that risk based audit should be enhanced through adoption of better risk assessment, internal auditing standards, annual risk based planning and internal auditing staffing practices so as to achieve success in financial performance in commercial banks in Kenya.

From the findings, the study recommends that management of commercial banks in Kenya should emphasize on auditors understanding of the risk based audit, risk assessment in the detection of errors, work environment in risk assessment, involvement of management in risk evaluation process and identification of changes in order to

effectively control and improve the quality of personnel in internal audit, ensure adequate funds and the complexity of operations in the financial performance.

From the findings, the study recommends that management in commercial banks in Kenya should bear the responsibility defining effective implementation of audit recommendation, risk based audit annual plans, reception of risk based audit reports in time and adequate resources for risk based audit. This would enhance transparency and accountability through improved efficiency, accuracy, completeness, timeliness, convenience and clarity.

From the findings, the study recommends that management of commercial banks in Kenya need to develop and retain adequate quality professionals in order to ensure the quality audit reports, internal auditor's performance, technical, professional skills, readiness to embrace change, auditing standards and proficiency of the internal auditor required knowledge, skills, and other competencies needed to perform individual responsibilities.

From the findings, the study recommends that management of commercial banks in Kenya should adopt effective risk based audit practices such as risk assessment, risk management, annual risk based planning, internal auditing standards and internal auditing staffing to enhance effective and efficient performance in the commercial banks in Kenya.

5.4 Limitations of the Study

The main limitation of study was inability to include more organizations. This study concentrated only on commercial banks. The study would have covered more institutions across all sectors so as to provide a more broad based analysis. However, resource constraints placed this limitation.

The study also faced challenge of time resource, limiting the study from collecting information for the study particularly where the respondents delayed in filling the questionnaire and travelling for collection of the the filled questionnaire.

The study also faced limitation where the management were failing to reveal the financial performance of the bank and sometime delayed in filling of the questionnaire. The researcher did follow up to ensure data was collected without further delays.

The study also faced a limitation, whereby the respondents were found to be uncooperative because of the sensitivity of the information required for the study. The researcher explained to the respondents that the information they provided was to be held confidential and was only for academic purpose only.

5.5 Suggestions for further studies

This study determined the impact of risk-based audit on financial performance in commercial banks in Kenya. The study recommends that a further study should be carried out to investigate the challenges of risk-based audit on financial performance.

The study recommends a further research should be carried out to determine other impacts of risk-based audit on financial performance of microfinance institutions in Kenya.

The study also recommend that a further study should be undertaken to establish challenges affecting implementation of risk based audit in banking institutions focusing on commercial banks.

From the findings and conclusions, the study recommend that a study should be carried out to survey the risk based audit practices adopted by Deposit Taking microfinance Institutions in Kenya.

The study recommends a further research should be carried out to determine impact of risk-based audit on Saving Credit cooperative societies registered under SASRA in

Kenya. This would lead to revealing the effects of risk based audit practices on financial performance of regulated SACCOs in Kenya

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APPENDICES

Appendix I: Questionnaire

This questionnaire is prepared for the purpose of collecting data for Research Project in partial fulfillment of the requirement for an award of master of business administration degree and therefore all information will be handled confidentially.

SECTION A: BACKGROUND INFORMATION

1. What is the name of your bank?(Optional)
2. Please indicate the number of employees in your bank.....
3. Kindly indicate the number of years your bank has been in operation. (Tick as applicable)
 - i. 1-10 yrs []
 - ii. 11-20 yrs []
 - iii. 21-30 yrs []
 - iv. 31 and Above []

SECTION B: MAIN ISSUES: RISK BASED AUDIT AND FINANCIAL PERFORMANCE

4. Does an inherent risk assessment affect financial performance at your bank
Yes []
No []

5. To what extent do the following factors on risk assessment affect financial performance at your bank?

	Very great extent	Great extent	Average extent	Low extent	Very low extent
Consideration of risk assessment in the detection of errors.					
The auditors understanding of the bank's risk					
Difficult and costly to assess risks at the bank .					
The bank auditor's involvement of management in risk evaluation process.					
The bank auditors identification of changes that have influence on financial performance at bank					
Auditors recognition of work environment in risk assessment					

6. How significant are the following factors in influencing judgments of risk in your bank?

	Very significant	Significant	Moderately significant	Slightly significant	Insignificant
Effective controls					
Lack of adequate funds					
The complexity of operations					
The quality of personnel in internal audit					

7) Does management of risk influence financial performance in your bank?

Yes []

No []

8) Indicate the significance of the following risk based audit services in influencing financial performance in your bank?

Risk Based Services	Very great extent	Great extent	Average extent	Low extent	Very low extent
Risk Based Audit Reporting time					
Assessment of risks					
Risk Based audit Annual plans with the Management					
Auditing process					
Action audit queries on time					
Implementation of audit recommendation by the Management					
Adequate auditing staff					

9) Does bank annual audit planning affect return on assets in your bank?

Yes []

No []

10) To what extent do the following factors affect bank financial performance? Use a scale of 1 to 5 where: 1 = No extent at all; 2 = little extent; 3 = Moderate extent; 4 = Great extent; 5 = A very great extent

	5	4	3	2	1
Disclosures about financial risk and risk management					
Disclosures about compliance risk and risk management					
Disclosures about environmental and safety risk and risk management					

Disclosures about technology risk and risk management.					
Internal process risk and risk management.					
Change management risk and risk management.					

11) Does auditing codes affect return on assets in your bank?

Yes []

No []

12) To what extent do the following auditing standards affect the return on assets in your bank?

	Very great extent	Great extent	Average extent	Low extent	Very low extent
Bank Auditors technical and professional skills					
Bank Auditors Readiness to embrace change					
Quality audit reports					
Quality criteria to measure internal auditors performance					

13) The following is a set of risk based audit practices please indicate to what extent the practices influence return on assets in the bank. 1 = very low extent; 2 = low extent; 3 = average extent; 4 = Great extent; 5 = very great extent.

	Very great extent	Great extent	Average extent	Low extent	Very low extent
Active and independent audit committee					
Independent directors					
Management's ownership interest					
Financial management and compliance with accepted audit standards					
Limited auditors in the bank					
Proficiency of the internal auditor					
Audit planning					
Effective internal audit staff					
Risk assessment					
Risk management					

Appendix II: List of Commercial Banks in Kenya

- 1) Bank of Africa (K) Ltd.
- 2) Bank of India
- 3) Citibank N.A. Kenya
- 4) Habib Bank A.G. Zurich
- 5) Habib Bank Ltd.
- 6) Bank of Baroda (K) Ltd.
- 7) Barclays Bank of Kenya Ltd.
- 8) Diamond Trust Bank Kenya Ltd.
- 9) K-Rep Bank Ltd.
- 10) Standard Chartered Bank (K) Ltd.
- 11) Ecobank Ltd
- 12) Gulf Africa Bank (K) Ltd
- 13) First Community Bank
- 14) Consolidated Bank of Kenya Ltd.
- 15) Development Bank of Kenya Ltd.
- 16) Kenya Commercial Bank Ltd.
- 17) National Bank of Kenya Ltd.
- 18) Post Bank Ltd
- 19) CFC Stanbic Bank Ltd.
- 20) African Banking Corporation Ltd.
- 21) City Finance Bank Ltd.
- 22) Commercial Bank of Africa Ltd.
- 23) Co-operative Bank of Kenya Ltd.
- 24) Credit Bank Ltd.
- 25) Charterhouse Bank Ltd.
- 26) Chase Bank (K) Ltd.
- 27) Dubai Bank Kenya Ltd
- 28) Equatorial Commercial Bank Ltd.
- 29) Equity Bank Ltd.
- 30) Family Bank Ltd.
- 31) Fidelity Commercial Bank Ltd.
- 32) Fina Bank Ltd.
- 33) Giro Commercial Bank Ltd.
- 34) Guardian Bank Ltd.
- 35) Imperial Bank Ltd.
- 36) Middle East Bank (K) Ltd.
- 37) NIC Bank Ltd.
- 38) Oriental Commercial Bank Ltd.
- 39) Paramount Universal Bank Ltd.
- 40) Prime Bank Ltd.
- 41) Southern Credit Banking Corporation Ltd.
- 42) Trans-National Bank Ltd.
- 43) Victoria Commercial Bank Ltd.
- 44) Housing finance bank ltd

LISTED COMMERCIAL BANKS

1. Barclays Bank of Kenya Ltd (BBK)
2. CFC Stanbic Holdings Ltd - merger
3. Diamond Trust Bank Kenya Ltd (DTB)
4. Equity Bank Ltd – listed in 2006
5. Kenya Commercial Bank Ltd (KCB)
6. National Bank of Kenya Ltd (NBK)
7. NIC Bank Ltd
8. Housing Finance Bank Ltd
9. Standard Chartered Bank Ltd (StanChart)
10. Co-operative Bank of Kenya Ltd – listed in 2008

Source: Central Bank of Kenya (2012)