academicJournals

Vol. 11(8), pp. 168-174, 28 April, 2017
DOI: 10.5897/AJBM2017.8267
Article Number: ADF46A163919
ISSN 1993-8233

http://www.academicjournals.org/AJBM

African Journal of Business Management

Full Length Research Paper

Internal auditing and financial performance of public institutions in Kenya: A case study of Kenya Meat Commission

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Received 27 January, 2017; Accepted 17 March, 2017

Internal auditing provides audit services to the management at all levels, including board of directors and audit committee, thus improving the organizations corporate governance. The objectives that guided the research were effect of corporate governance on financial performance and effect of audit committee on financial performance. The researcher used case study research design; this was due to the fact that data was collected from one organization only, that is, Kenya Meat Commission (KMC). The sample size was all fifty seven management staff at KMC. Open and close ended questionnaires were used to collect primary data from the respondents. The data collected was quantitative. Descriptive statistics, time series and regression analysis were used to analyze the data. The data was presented in the form of tables. The data collected ascertained that internal auditing plays a major role in the financial performance. The findings of this study, however, are at odds with the aforementioned position. The researcher found that the relationship between the internal audit function existence and financial performance at the KMC was insignificant. That is, existence of internal auditing does not influence the profitability and return on investment. The researcher recommends that the internal audit function should be more independent and manned by competent staff. There should also be an independent oversight body to oversee the operations of the state corporation.

Key words: Financial performance, internal auditing, corporate governance audit committee.

INTRODUCTION

Internal auditing is often seen as an overall monitoring activity with responsibility to management for assessing the effectiveness of control procedures which are the responsibility of other functional managers (Kent, 2003). Internal auditing is taking on increased importance in many of today's global organizations by assisting management in evaluating controls and operations and thereby providing an important element of global control. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations (Kent, 2003). Being independent and objective, internal auditing helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve

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the effectiveness of risk management, control, and governance processes.

According to Millichamp (2000), Mainoma (2007) and Sani (2009), internal auditing includes among others reviewing the adequacy and effectiveness of internal control system, its compliance with government regulations, accounting rules and standards, securing the asset of the organization in order to prevent misappropriation. This ensures that the organizational goals and objectives are achieved. Internal auditing acts as an in-house consultant on control matters. Hermanson and Rittenberg (2003) deduced that an effective internal audit function existence leads to superior organizational performance. Similar sentiments were expressed by Prasad and Rao (1989). They observed that the internal auditor saves the organization from malpractices and irregularities by acting as a watch dog. This helps ensure high level of productivity and profit.

Peursem (2004), a study undertaken in New Zealand, internal auditors were required to evaluate the importance of their functions in connection with audit engagements. The findings of the study were true professions exist although it does not dominate auditors with high level of experience and are in public practice have significant influence over the management. Additionally, if the auditors have accountancy training, their influence level is high due to the fact that they are members of accountancy professional bodies. These findings are supported by Coopers and Craig (1983), Cooper et al. (1966) and Gramling (1997), who had portrayed reservations over the effectiveness of the role of internal auditors. Peursem conducted a follow up study in New Zealand to determine whether the auditor influences his role. This involved checking on internal auditors' objectivity while working with the management so as to be able to report on their performance.

The findings of the study were that for those internal auditors who best balanced their role, they had external professional status and their organizations had both formal and informal communication network. Sunday (2007) conducted a study on internal audit function and corporate governance. The study established that there is a positive relationship between quality of internal audit function and quality of corporate governance. Makoju (2000) noted that bureaucracy and sluggishness of government employees has resulted to the inadequate performance of state corporations. The issue of high incidences of fraud and government staff employment being inclined to political affiliation rather than ability to perform was also found to have contributed to the inadequate financial performance.

In his study, Dogo (2003) established that the existence of accounting systems of public institutions in Kenya does not guarantee proper and up to-date financial records. This made auditing of such institutions very cumbersome if not impossible. The study also established that accounting control practices such as internal auditing of a company plays a key role in the success of an enterprise as it prevents possible deviations from the predetermined objectives and policies. Therefore, the study recommends that public institutions should install exhaustive system of accounting controls in order to better financial performance. The study focused on existence of accounting systems and performance of public institutions. However, it failed to establish the influence of internal auditing on financial performance. Therefore, this research seeks to investigate the ways in which internal auditing influences financial performance in public institutions in Kenya.

RESEARCH DESIGN AND METHODOLOGY

The research design adopted case study design. This is because data was collected and analyzed from 57 management staff at Kenya Meat Commission. A case study is an in depth investigation of an individual, group, institution or phenomenon (Mugenda, 2003). The target population comprised 57 management staff from all the 15 departments at the Kenya Meat Commission. A census study will be conducted. Primary data was collected from the respondents using open and closed ended questionnaires. The reason for using a questionnaire is because it is cheap and quick as compared to face to face interview. The questionnaires were developed from the three mentioned variables that is corporate governance and audit committee which are the independent variables and financial performance which is the dependent variable. It had four sections, section one constituted the bio data of the respondents, section two had questions on internal auditing function in the institution, section three had questions on the influence of internal auditing on financial performance and the last was on financial performance. The indicators of each variable were used to develop questions using the likert scale. Data was summarized in tables and the mean values calculated for each variable as shown in Tables 2, 3 and 4.

The questionnaires were administered using drop and pick later method. This is because some of the respondents are seniors officers and the researcher had difficult time accessing them due to their busy schedules. Data was collected in the month of July 2012. The data collected was quantitative. Descriptive statistics and time series were used to analyze the quantitative data. Time series is an arrangement of statistical data in accordance with the time of its occurrence. According to Yule and Kendall (2000), "When we observe numerical features of an individual or a population at different points of time, the sets of observations constitute a time series". The following regression model was generated to show the relationship between the independent variable and the dependent variable.

$$Y = a + \beta 1X1 + \beta 2X2 + e$$

where Y = Financial Performance, a = Constant, X1 = Corporate Governance, X2 = Audit Committee, βj = Coefficient of Xj, and e = Error Term

Table 1 gives an explanation of the independent and dependent variables used in the study.

RESULTS AND DISCUSSION

From the 57 questionnaires distributed, 50 filled in questionnaires were collected. Tables 2, 3 and 4 indicate

Table 1. Description of variables used in regression analysis.

Variable	Type of variable	Explanation of variables
Corporate governance	Predictor-X1	Whether there is indication of corporate governance factors
Audit committee	Predictor-X2	Financial statements Integrity and independence of audit function
Financial performance	Dependent-Y	Annual profit targets

the mean and the standard deviation for the variables. Table 2 shows the influence of internal audit independence on financial performance. Table 3 shows the influence of corporate governance on financial performance, while Table 4 shows the influence of audit committee on financial performance. The mean score of the study ranges from 1.49 to 4.59, while the standard deviation ranges from 0.045 to 1.61. For a five point likert scale, this is an indication that the study concepts were being practiced in a reasonable level. Additionally, the standard deviation is small. This implies that the study sample is a reasonable reflection of the population (Saunders, 2006). The study used both correlation and regression analysis to test the relationship between dependent and independent variables. Tables 5 and 6 show the correlation, while Tables 7, 8 and 9 summarize the regression statistics for the regression model. These include regression coefficients, F-statistic and the regression coefficients. The parameters indicate that the regression model was significant. This means that the independent variables not only have positive influence on financial performance but it is also significant.

As shown in Table 2, the mandate of the internal audit department is properly stated by company management was rated the highest with a mean score of 4.60 followed by management's open door policy with a mean score of 4.54. The internal audit reports being handled by top management rather than the finance manager, the internal audit department authority is properly stated, and the appointment or removal, promotion and remuneration of all internal audit staff is by merit were rated slightly above average. Further, internal audit reports and recommendations are acted upon by company's management, and the internal audit department staff is adequate qualified and experienced was rated slightly below average. No restrictions to any part of the company or to any document, and autonomy in work execution were rated lowest. The finding of the study that the internal audit function's mandate is properly stated by company management was highly rated as asserted in earlier studies by Sani (2009), who noted that internal audit is responsible for the audit of all financial transactions by conducting an ongoing carrying examination of all accounting books and records maintained in the organization with a view to checking or detecting fraud and correcting errors. According to Mathison (2005), the scope and objective depend upon the responsibilities assigned to the internal auditor by the management, the size and structure of the enterprise and the skills and experience of the internal auditor.

The finding of the study that the internal audit department of the company has inadequate staff that is qualified and experienced contradicts earlier studies of Sabari (2003) and Dandago (2000) who concluded that internal audit department should be properly organized, adequately staffed and equipped to be able to effectively perform its functions. However, Sunday (2003), argued that the internal audit function's mandate depends upon the size, structure and management of the organization. Therefore, it is different for each organization. According to Momoh (2005), the internal auditor should ensure that all financial transactions comply with approved regulations and that there exists sufficient security in the undertaking.

As shown in Table 3, accountability was rated the highest with a mean score of 4.91 followed by disclosure and transparency with a mean score of 4.81. Leadership had a mean score of 3.98 while stakeholder's rights had a mean score of 3.40. This is an indication that all corporate governance factors considered in this study had impact on financial performance with accountability, disclosure and transparency and leadership taking the lead. The finding of this study reaffirms earlier study by Sani (2009), who concluded that leaders must be transparent and accountable. According to Fadzil et al. (2005), accountability is the whereby state corporations, organizations and the people within them, are made answerable for their decisions and actions, including how they manage public funds and all facets of performance, and yielding themselves to appropriate external scrutiny. Adeniyi (2004) noted that people in leadership positions are faced with different forms of accountability to their various stakeholders. Dittenhofer (2001) concluded that efficient use of resources, strengthened accountability, improved management and service delivery can be brought about by leaders who practice good governance, hence, contributing to reduction in poverty and improvement in people's lives. Bejide (2006) opined that transparency helps stakeholders have assurance in the decision-making processes and actions of parastatal organizations. Therefore, corporate governance essentially leads to accountability, disclosure and transparency and effective communication to various stakeholders.

As shown in Table 4, financial statements integrity was rated the highest with a mean score of 4.74 followed by

Table 2. Internal audit function.

Variable	N	Mean		Std. Deviation
	Statistic	Statistic	Std. Error	Statistic
Company's management has properly stated the mandate of internal audit function	57	4.5965	0.10871	0.82071
There is autonomy in work execution	57	1.8596	0.19460	1.46919
The management uses open door policy	57	4.5439	0.10931	0.82527
Appointment, removal, promotion and remuneration of all internal audit staff is by merit	57	2.60	0.194	1.462
The internal audit department authority is clearly stated	57	2.65	0.193	1.458
There are no restrictions to any part of the company or documents	57	1.49	0.146	1.104
internal audit reports and recommendations are acted upon by management	57	2.47	0.196	1.477
The internal audit department staff is adequate, qualified and experienced o	57	2.47	0.196	1.477
The internal audit reports are handled by top management reports rather than finance manager.	57	2.63	0.195	1.472
Valid N (listwise)	57	-	-	-

Table 3. Corporate governance and financial performance.

Variable	N	Mean		Std. Deviation
	Statistic	Statistic	Std. Error	Statistic
Disclosure and transparency	57	4.81	0.073	0.549
Leadership	57	3.98	0.213	1.609
Stakeholder's rights	57	3.40	0.239	1.801
Accountability	57	4.91	0.045	0.342
Valid N (listwise)	57	-	-	-

internal audit function with a mean score of 3.98. External auditor independence and risk management systems had a mean score of 3.32 and 3.05, respectively. The finding of this study concurs with Papadatou (2005), who stated that integrity comprises both straightforward dealing and completeness. He noted that integrity requires honesty and objectivity, and high level of morality in the management of public funds and resources, and management of an organization's affairs. According to Papadatou (2005) integrity relies on the control framework effectiveness and moral standards and professionalism of the individuals within the organization and it is reflected both in the organization's decision-making procedures and in the quality of its financial and performance reporting. Internal audit function was also found to have major impact on financial performance which was reaffirmed by Roe (2004), who stated that" the audit function evolution is as a result of search for information by interested parties in order to assess performance of others in whom they have vested interest". He additionally argued that interested parties need audit function as a monitoring mechanism as it enforces accountability. A study by KPMG (2007) found that the existence of internal audit function in organizations results in improved performance and helps in undertaking forensic audit in cases of corporate calamities like financial fraud. Thus, internal audit due to its nature of being a watchdog could protect the organization from the unethical practices and irregularities hence allowing the organization to achieve its objectives of ensuring high levels of productivity and profitability. According to Millichamp (2000), internal audit constitutes independence, staffing, training, relationship, due care, planning, controlling and recording, system control, evidence,

Table 4. Audit committee and financial performance.

Variable	N	Mean		Std. Deviation
	Statistic	Statistic	Std. Error	Statistic
External auditor independence	57	3.32	0.163	1.227
Financial statements integrity	57	4.74	0.089	0.669
Internal audit function	57	3.98	0.213	1.609
Risk management systems	57	3.05	0.169	1.274
Valid N (listwise)	57	-	-	-

Table 5. Corporate governance-financial performance.

		Corporate governance (X_1)
Financial performance (Return on Investment)	Correlation (r)	0.665
	Sig. (2-tailed)	0.0322

Table 6. Audit committee-financial performance.

		Audit committee (x_2)
Financial performance (Return on Investment)	Correlation (r)	0.518
	Sig. (2-tailed)	0.0079

and reporting. Essentially, then, internal audit cannot undertake its functions without these key elements. Bejide (2006) established that internal audit service will help reduce overhead, identify efficiency improvement ways and uncover possible losses as a result of insufficiently safeguarded company assets which result in reduced profitability. Similarly, Barrett (2002) had stated that internal audit is key in performance improvement. Fadzil et al. (2005) had established that internal auditors help in increasing shareholders value through running the company efficiently and effectively. Hermanson and Rittenberg (2003) had concurred with these findings that the existence of an effective internal audit function is associated with high levels of organizational performance.

Hypothesis testing

The null hypothesis stated that there is no relationship between the corporate governance and the financial performance of KMC. The study showed that there was a strong positive relationship between corporate governance and financial performance of the company as indicated by the correlation coefficient. These findings, as indicated in Table 5, can be generalized given that the significance level was below the acceptable level of 0.05 (p-value < 0.05). It was 0.0322, while the correlation coefficient was 0.665. Based on these findings, the null hypothesis was therefore rejected.

On whether audit committee influenced the financial performance of the company, the null hypothesis stated that there was no relationship between the audit committee and the financial performance. The study, however, revealed that there was a significant level of relationship between the two as shown by the coefficient of correlation, that is, 0.518. The p-value was less than the acceptable significance level of 0.05 (p-value < 0.05), meaning that these findings were acceptable and can be generalized. Based on the results presented in Table 6, the null hypothesis was rejected.

A model summary was used to predict the value of the dependent variable using independent variables. This study's dependent variable was financial performance of Kenya Meat Commission (Return on Investment), while the independent variables were corporate governance and audit committee. The R-value was 0.6721, as indicated in Table 7, meaning that there is a strong positive relationship between the dependent variable and the independent variables. The R Square was 0.5824 implying that 58.24% of the financial performance in KMC can be explained by the two independent variables covered in this study. The rest 41.76% of the financial performance can be explained by other factors that are not captured in the study. The regression model used was significant with the F statistic being 0.0298 (as shown in Table 7), which was less than the acceptable significance level of 0.05. This means that the independent variables do not only have positive influence

Table 7. Model summary.

Variable	Regression statistics
Multiple R	0.6721
R Square	0.3273
Adjusted R Square	0.5824
Standard Error	0.4104
Observations	50

Table 8. ANOVA analysis.

Variable	df	SS	MS	F	Significance
Regression	3	3.687086	1.229029	0.0298059	0.000433607
Residual	45	7.57822	0.168405	-	-
Total	48	11.26531	-	-	-

Table 9. Regression coefficients.

Variable	Coefficients	Standard Error	t Stat	P-value
Intercept	1.6125	0.282829134	5.701322128	8.64902E-07
X1 (Corporate Governance)	0.296666667	0.33506704	0.497412896	0.021319788
X2 (Audit Committee)	0.241306818	0.298145914	1.050050217	0.009301717

on financial performance but also the influence is significant. Based on this outcome, the prediction of the outcome of the study using this model was acceptable, that is, determination of financial performance (return on investment) the independent variables, namely, corporate governance and audit committee.

Using Excel, the values of the βs in the regression model (Y=a+β1X1+β2X2+e) used to determine the causal effect of the independent variables on the dependent variable were determined. The following are the values as extracted from Excel. From the tabulated aforementioned figures, the completed model was:

$$Y = 1.6125+0.29667X1+0.24130X2+e$$

This means that 29.7% of the financial performance was caused by corporate governance. Another 24.1% was caused by the effectiveness and efficiency of the audit committee. There was another portion of the financial performance of KMC that could be explained by other factors besides the factors covered in this study.

CONCLUSIONS

Generally, it is believed that the existence of internal auditing results in increased organizational financial performance. According to Bejide (2006), internal audit service results to reduction in overheads, efficiency improvement ways and uncovering of possible losses due to insufficiently safeguarded company assets all of which lead to reduced profitability. According to Hermanson and Rittenberg (2003), internal audit function existence leads to increased organizational performance. Similar sentiments were raised by Prasad and Rao (2000), through their observation that the internal auditor protects the organization from unethical practices and irregularities due to their nature of acting as watch dogs. This ensures high levels of profitability and productivity which are actually the organizational objectives. The study findings however disputes the position stated earlier. The researcher found that the relationship between the existence of an internal audit function and financial performance at the Kenya Meat Commission was insignificant. This means, existence of internal auditing does not influence the profitability of an organization. This finding contradicts that of KPMG (2000) which established that internal audit function and financial performance have a positive association. A survey conducted on 201 senior company executives in the United States, the KPMG, established that the existence of internal audit function in organizations contributes significantly towards performance improvement and identifying profit improvement opportunities.

The findings in this study are at odds with those of Fadzil (2005) which established that stakeholders' value is increased because internal auditors helps in managing a company in a more efficient and effective manner. However, these findings agree to that of Griffiths (2000) which found internal audit and performance are uncorrelated. The study established that there are negative attitudes to internal audit and that the function lacked qualified staff. The insignificant relationship between internal auditing and financial performance may result from the size of KMC. The staff members in the internal audit department are only five. The department lacked professional autonomy while undertaking their duties. From the findings, the internal audit department lacked independence to execute their work thus audit conducted by the department was limited in scope. Accessibility to the highest level of management was lacking. Under these circumstances the watchdog job of protecting the organization from unethical practices and irregularities is greatly undermined. Political influence was determined by number of government appointees in board. Prasad and Rao (2000) had eluded that political influence is normally shown by the appointments inboard members. The effect of political influence on the relationship between internal auditing and financial performance was significant.

RECOMMENDATIONS

Based on these conclusions, there should be regular management and performance audits. This will help identify the underperforming areas. Also, the government should offload some of its interest to private enterprises with a view to minimize political influence in decision making. The board of directors should be appointed by a well-defined public interest groups such as business community, professional bodies and customers. The internal audit department should have more independence so as to be effective and enhance financial performance. The recruitment systems should be streamlined so that recruitment is done of employees who are qualified in their respective areas regardless of their political affiliation. There should be adequate marketing campaigns; this will help to increase the company's turnover. There should be an independence oversight body to oversee the operations of state corporations.

LIMITATIONS AND AREAS OF FURTHER STUDY

This study was a case study limited to Kenya Meat Commission. A survey could be conducted over other public institutions. Also, the study focused on internal auditing and financial performance. Future study involving other factors that may influence financial performance of public institutions may be viable.

CONFLICT OF INTEREST

The authors have not declared any conflict of interest.

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