

Internal Audit Independence and Share Performance of Firms Listed In the Nairobi Stock Exchange

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Abstract: Internal audit is considered as the backbone of the business accounting as it is the section that scrutinizes all businesses transactions of a company. The main objective of the study is to establish the relationship between Internal Audit Independence and Share performance of firms listed in the Nairobi Stock Exchange. The study adopted a descriptive research design targeting 60 companies quoted in the Nairobi Stock Exchange as of December 2013. The study found existence of significantly positive correlation between internal audit independence and share performance (Pearson correlation coefficient $r = .456$ Sig. = .011). It is recommended that listed companies should adopt effective corporate governance practices that address key auditing independence for effectiveness of audit department. This will go a long way to cut or eliminate wastage and thus improve company returns to attract investors in the stock exchange market.

Keywords: Audit committees, Board of directors, Business accounting, Corporate governance, Evaluation, Internal audit, Share performance, Share value, Stakeholders, Stock Exchange.

1. INTRODUCTION

Internal audit department is very important in every firm and it is regarded as the key element in the application of accounting systems which in turn, helps in evaluating the work of the department. The internal audit is considered as the backbone of the business accounting as it is the section that checks all businesses processes. Efficiency of internal audit helps develop a company because the financial reports reflect the internal audit department's quality. Moreover, an internal audit is a significant part of the corporate governance structure in an organization and corporate governance encompasses oversight activities taken by the board of directors and audit committees to make sure that the financial reporting process is credible (Public Oversight Board, 1994).

In this era of intense competition, both world-wide and domestic, business firms of all sizes and varieties have become more and more concerned with the share figures they achieve in the marketplace. Some managers appear interested as much, if not more, in shares performance as profits or returns on investment. For product and brand managers in particular, the sense of urgency associated with the gains and losses of shares for the product/brand in their charge may be likened to what winning or losing of a war front means to generals or the general staff. Though such military analogies are not to be taken literally, one fact seems obvious; shares command the attention of business managers as key indices for measuring the performance of a product or brand in the marketplace. Many individuals in business indeed keep a close watch over day-by-day changes in market shares, so much so that market-share movement to them is almost synonymous to market information about a company (Ljubisavljević and Jovanovi, 2011)

To the extent that market shares are used as market performance indices, it is clearly desirable for the individuals concerned to have thorough knowledge of the processes which generate market-share figures and to be able to analyze the impact of their own actions on market shares, as well as their profit implications (Collier and Gregory 1996). Lacking

such knowledge, one might be tempted to oversimplify the cause-and-effect relationships between market shares and marketing variables, or to equate market shares to profitability (a not unusual tendency even among seasoned businessmen) and fall into deadly traps of blindly competing for market shares for their own sake. Despite the obvious importance associated with it in many firms, the approach of many managers to market-share analysis may be described as casual (Goodwin and Yeo, 2001).

Research Problem:

Local studies on relationship between internal audit independence and share performance are scanty, hence the empirical gap that the present study sought to bridge. Majority are concentrated on internal audit and corporate governance. For instance, Maiteka (2010) undertook a study of the influence of internal audit on corporate governance in public sector in Kenya focusing on selected ministries. From the findings, internal 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. Although prior research (Mak, 2009 and Simons, 2010) suggest a link between accounting control practices and financial performance, majority of prior studies had concentrated mostly on the budgeting aspect of accounting controls. This aside, the available studies so far had dealt exclusively with large privately-owned companies especially in the advanced countries. Given the growing role of the internal audit in contemporary corporate governance, independence has gained renewed attention. Little is known at present, about the relationship between internal audit independence and share performance. It is in an attempt to fill this gap that the study is setting out to assess empirically the relationship between internal audit independence and share performance. This study thus sought to answer the following research question; what is the relationship between internal audit independence and share performance on firms listed in the Nairobi stock exchange?

Objective of the Study:

The main objective of the study was to establish the relationship between Internal Audit Independence and Share performance of firms listed in the Nairobi Stock Exchange

Value of the Study:

The study finding is important to scholars and researchers by adding to the body of existing knowledge on internal audit independence. The study also gives recommendation for further researchable areas which will be useful in furthering the understanding of internal audit function and share performance. The study is of value to the management who are able to appreciate the importance of an independent internal audit function in their organization.

2. LITERATURE REVIEW

Several scholars have studied the concept of Internal Audit Independence and Share performance of firms listed. Sarens (2009) have raised the question “when can we talk about an effective IA function?” Soh and Martinov (2009) aimed at finding out the relationship and interaction between the audit committee and the internal audit function. The results of the study suggested that there was a greater appreciation for the importance of mutual reliance and a strong relationship between the audit committee and the internal audit function. McGimpsey et al. (1992) set out to determine how internal audit is adapting in a changing management culture. Ndimitu (2011) aimed at establishing the relationship between internal audit and effective management in Embu water and sanitation company Ltd. Murithi (2009) set out to survey the role of internal audit in enterprise risk management for quoted companies under the industrial and allied sector listed at the NSE. Sigowo (2009) aimed at exploring the role of internal audit function in promoting good corporate governance in SACCOs. From the above review, limited studies have concentrated on the relationship between internal audit independence and share performance. This study therefore seeks to fill this gap.

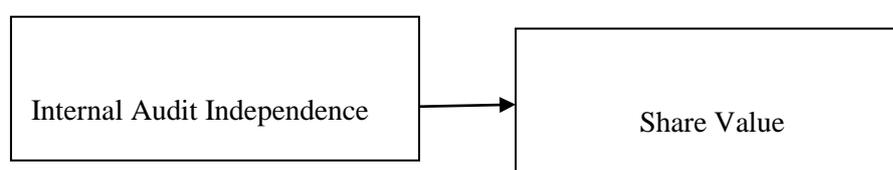


Figure: 1.1. Conceptual framework

Internal Audit Independence and Share Performance:

Internal audit department of any organization strives to instill accountability in financial resources management spanning prudent hiring, training and all other internal processes. Best practices in a company reflects to the outside world in two ways; positive outlook if the company practices good processes and negative outlook if vice versa. It is the internal audit department that ensures that good practices are followed throughout all processes to enable a company make profits that will influence the share price in the stock exchange.

An internal audit function could be viewed as a first line of defense against inadequate organization governance and financial reporting. With appropriate support from the board and audit committee the internal audit is in the best position to gather intelligence on inappropriate accounting practices, inadequate internal controls and ineffective corporate governance (Zekele, 2007). It is therefore an integral and necessary part of an effective corporate governance framework. Alongside the board, executive management and external audit, internal audit is one of the cornerstones of good corporate governance. Hermanson and Rittenberg (2003) states that the nature of internal audit activity today typically includes risk management, control governance and compliance work all of which map directly into corporate governance. Khas (1999) argues that the internal auditing functions as part of the corporate governance structure plays an increasingly important role in monitoring the internal control system of the company and its financial reporting systems. Moreover, Kinfu (2006) notes that one of the strongest means to monitor ethics and governance in institutions can be through an internal audit function. These statements clearly indicate the contribution that internal audit function has towards enhancing effective and good corporate governance in commercial banks in Kenya. Chapman and Anderson (2000) argues that the inclusion of assurance and consultancy in the definition of internal auditing results in internal auditing becoming a proactive consumer focused activity concerned with the important issues of control, risk management and governance. Hass and Burnaby (2006) further notes that organizations have encountered a rapid change in the economic complexity, expanded regulatory requirements and technological advancement. These changes have given internal audit function a set of expanded opportunities to support management provide services to other organizational functions and generate direct reporting links to the audit committee. Ramamoorthi (2003) indicates that overtime there has been a massive shift in focus to one that promotes and supports effective organizational governance. Ruud (2003) further notes that in today's business environment the internal audit function has become a major support function for management, the audit committee, the board of directors and other stakeholders. Morgan (1979) consequently notes a significant opportunity for internal auditing has emerged to demonstrate its potential to add value and to break away from historical characteristic as organizational policemen and watchdog.

Empirical Studies:

In recent years, researchers and practitioners have widely discussed the need for internal auditors of adding more value to their companies' operations, and contributing to the achievement of corporate objectives. This new perspective has focused increasing attention on issues such as performance evaluation and effectiveness of internal auditing (Dittenhofer, 2001; Bou-Raad, 2000; IIA, 1999). Several parties advocated the need to assess internal auditing (IA) effectiveness, though, at present, there is not a shared framework of reference to this scope (for instance Ridley & D'Silva, 2008; Mihret & Yismaw, 2007; Van Gansberghe, 2005; KPMG, 2004; Dittenhofer, 2001; Sawyer, 1995; Barrett, 1986). Recently, Sarens (2009) have raised the question "when can we talk about an effective IA function?" in his editorial about future perspectives of IA research. Looking at the existing literature, there are many possible answers to this question. Different authors have related IA effectiveness to different issues, focusing on IA processes, outputs and outcomes.

McGimpsey et al. (1992) set out to determine how internal audit is adapting in a changing management culture. The results of the study were: audits are becoming more cost effective by being risk driven; for internal audit to be effective senior management must clearly signal to the rest of the organization its supports for internal audit; Internal audit practices was moving away from merely reporting control deficiencies to management and finally internal audit function had adapted technology to aid in continuous monitoring of the organization data online.

3. RESEARCH METHODOLOGY

The study adopted a descriptive research design and the target population for the study included 60 companies quoted at the NSE as of December 2013. The researcher collected data on share performance and the stock market returns volatility

was obtained by computing the monthly returns of stock for all the 60 firms which were listed at the Nairobi Securities exchange for the period 2009 to 2013 and then comparing the monthly returns with the previous month's returns. Using this data, the researcher conducted correlation analysis to establish the extent of relationship between internal audit independence and share performance.

4. DATA ANALYSIS AND INTERPRETATION

Internal Audit Independence and Share Performance:

In order to establish relationship between internal audit Independence and Share Performance, the respondents were asked whether there is a relationship between internal audit independence and share Performance. Findings are as shown in table 4.1

Table: 4.1. Relationship between internal audit Independence and Share Performance

	Frequency	Percentage
YES	37	82.2%
NO	8	17.8%
Total	45	100.0%

Majority of the respondents (82.2%), were on the view that there is a relationship between internal audit Independence and Share Performance, while 17.8% viewed that there was no any relationship between internal audit Independence and Share Performance. Of the (82.2%) who said yes, 67% of the respondents attested that the relationship between internal audit Independence and Share Performance was positive. Respondents viewed the relationship to be positive because, the independence of the audit function was guaranteed since there were audit committees at the Board level and that internal auditing is an overall monitoring activity with responsibility to management for assessing the effectiveness of control procedures which are the responsibility of other functional managers ensuring better overall share performance. On the other hand, 15.2% of the respondents viewed the relationship to be negative because the independence of the audit function was not guaranteed. To further understand relationship between internal audit Independence and Share Performance, respondents were requested to indicate their level of agreement on the following statements relationship between internal audit independence and share Performance. The responses were rated on a five point Likert scale where: 1 - Strongly Disagree 2 – Disagree 3 - Neutral 4- Agree and 5- Strongly Agree. The findings are as shown in table 4.2

Table 4.2 Level of agreement on relationship between internal audit Independence and Share Performance

Statements	Mean	Std. Deviation
With appropriate support from the board and audit committee the internal audit is in the best position to gather intelligence on inappropriate accounting practices, inadequate internal controls and ineffective corporate governance	3.9667	.92913
Internal Audit Independence is an integral and necessary part of an effective corporate governance framework.	4.2167	.93201
The nature of internal audit activity today typically includes risk management, control governance and compliance work	3.5167	1.04948
Organizations have encountered a rapid change in the economic complexity, expanded regulatory requirements and technological advancement therefore giving internal audit function a set of expanded opportunities to support management provide services to other organizational functions and generate direct reporting links to the audit committee	2.875	.91812

From the findings, respondents strongly agreed that, Internal Audit Independence is an integral and necessary part of an effective corporate governance framework (mean= 4.2167) and that with appropriate support from the board and audit committee, the internal audit is in the best position to gather intelligence on inappropriate accounting practices, inadequate internal controls and ineffective corporate governance (mean= 3.9667). In addition, respondents agreed that the nature of internal audit activity today typically includes risk management, control governance and compliance work (mean= 3.5167). On the other hand, respondents disagree to a little extent that Organizations have encountered a rapid change in the economic complexity, expanded regulatory requirements and technological advancement therefore giving internal audit function a set of expanded opportunities to support management provide services to other organizational functions and generate direct reporting links to the audit committee (Mean=2.875). This implies that internal audit Independence is an integral and necessary part of an effective corporate governance framework.

Correlation Analysis:

The Karl Pearson's product-moment correlation was used to analyse the association between the independent and the dependent variable. The Pearson product-moment correlation coefficient is a measure of the strength of a linear association between two variables. The Pearson correlation coefficient, r , can take a range of values from +1 to -1. A value of 0 indicates that there is no association between the two variables. A value greater than 0 indicates a positive association, that is, as the value of one variable increases so does the value of the other variable. A value less than 0 indicates a negative association, that is, as the value of one variable increases the value of the other variable decreases. Pearson's Correlation Coefficient was carried out and the results obtained are presented in table 4.3

Table 4.3: Pearson product-moment correlation

	Share Performance	Internal Audit Independence
Share performance	1	
Internal Audit Independence	0.456	1
*. Correlation is significant at the 0.05 level (2-tailed).		

There is a positive (but not strong) correlation between internal audit independence and share performance (Pearson correlation coefficient $r = .456$ Sig. = .011) and that internal audit Independence is an integral and necessary part of an effective corporate governance framework. In line with these findings are Dittenhofer, 2001; Bou-Raad, 2000; IIA, 1999 findings who argue that in recent years, researchers and practitioners have widely discussed the need for internal auditors of adding more value to their companies' operations, and contributing to the achievement of corporate objectives. This new perspective has focused increasing attention on issues such as performance evaluation and effectiveness of internal auditing

5. SUMMARY, CONCLUSION AND RECOMMENDATIONS

Summary of Findings:

The study established a positive correlation between internal audit independence and share performance and that internal audit Independence is an integral and necessary part of an effective corporate governance framework. Further, the study revealed that Fraud investigation, verification of financial transaction (Financial audit), and Assessment of internal control are the major scope of work for internal audit. Respondents viewed the relationship to be positive because, the independence of the audit function was guaranteed since there were audit committees at the Board level and that internal auditing is an overall monitoring activity with responsibility to management for assessing the effectiveness of control procedures which are the responsibility of other functional managers ensuring better overall share performance.

Recommendations:

The study points to the important role that auditors play in mitigating the adverse effects of poor corporate governance. There is thus the need for the listed companies to adopt effective corporate governance practices that address key auditing practices for effectiveness of audit quality. In order to implement good internal audit independence, managers should be concerned about the interrelationships between internal audit independence and firm share performance. The study findings confirm this correlation and therefore, organizations that adopt and implement good internal audit independence have higher advantage of increasing their share performance. More so, this will ensure that interests of the firm are served and there is easier access to funding from investors

Suggestions for further Research:

This study examined the relationship between internal audit independence and share performance of firms listed in the Nairobi stock exchange over a period of 5 years. There is a need for further studies for a longer period above five years. A similar study should also be carried out on non-listed companies. In addition, more variables depicting internal audit independence should be adopted to uphold the study's findings.

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