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EFFECT OF THE NUMBER OF STAFF IN INTERNAL AUDIT ON FINANCIAL PERFORMANCE OF BANKS LISTED AT NAIROBI SECURITIES EXCHANGE IN KENYA

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ABSTRACT

This study sought to establish the effect of the number of staff in internal audit on financial performance of banks listed at NSE in Kenya. The research adopted descriptive cross-sectional research design. The target population was 135 IA professionals from the 11 Kenyan banks which were listed at the NSE. The research used a random stratified sampling where the population was separated into strata before using simple random sampling to get sample from each stratum. The study applied a method used for picking a sample out of a population that was below ten thousand to obtain a sample size of 100. Collection of primary data was by use of questionnaires while secondary data was gotten financials statements of the banks, CMA website, NSE website well as from CBK website. Data was analysed using multiple linear regression model. The findings and the results showed that number of staff in internal audit affected performance of banks listed at the NSE. The results showed that if there was an increase in number of personnel in internal audit by one unit the result would lead to an increase in results of the subject bank by a factor of 0.0068. Therefore, the number of staff in internal audit had a positive connection with the dependent variable. The main recommendation was for the BODs and other leaders of the subject banking institutions as well as the watchdog, CBK to come up with policies to monitor the number of staff in internal audit to ensure optimal business results.

Key Words: *Internal Audit, Financial Performance, NSE*

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INTRODUCTION

Audit is a continuous process of collecting and assessing evidence objectively on economic activities to determine the truth according to predetermined criteria and report to stakeholders (Castanheira, Lima & Craig, 2009). Internal auditing is an integral aspect of the corporate governance mosaic in both the public and the private sectors (Cohen et. al., 2002).

Due to the high level of public accountability required for Kenyan banks that are listed at the Nairobi Securities Exchange, Internal Audit has become a key mechanism for resolving the agency problem that arises.

Previously, historically, internal audit served merely as an administrative activity of verifying assets, confirming documents and reporting results of the same to management, BODs or external auditors. However, recently the profession has revolutionized such that firms have to prove how responsible they are in the use of owners' resources and efficiency in the service delivery. Commercial banks have come to the understanding that internal audit is vital in improving management of resources in the institutions resulting to improved results (Basel Committee, 2002).

The Institute of Internal Auditors (1999) supported that fact that internal audit is an independent advisory activity which leads to value addition and makes better how an institution is managed. It helps the firm achieve its goals through a methodical, orderly approach to appraising and refining the efficiency of risk management, systems of control and the procedure of management. Internal audit recommendations are of tremendous value not only to the directors of the institution but also the heads of the functions audited. Internal audit uses professional aptitudes through disciplined and logical appraisal of operational systems, procedures and policies that are in place in an organisation to ensure realization of the firm's objectives as well as through recommendations geared towards improvement (Dumitrescu, 2004).

Internal audit is also described as an autonomous controlling function which involves continual and serious evaluation of a bank so as to give propositions for its progress, value addition, and reinforce the whole management tool, including the risk management and system of internal control (Spahic, 2008)

The process of internal audit as such influences on the efficiency in preparation of financial statements and contributes to corporate governance aspects of the bank in general. Commercial banks must ensure that their internal auditing section have got adequate resources, monetary or otherwise to well cover the yearly internal audit plan and budget sanctioned by the audit committee (Basel Committee, 2002).

There are various facets of performance of banking institutions that can be studied. The foremost aspect of such analysis is the bank's profitability. The leading aim of every bank is maximization of returns, as a critical requirement for being in business. Banking institutions' profits if ploughed back into the business provide an essential equity that ultimately supports stability in financial terms.

The other financial performance pointers are; return on equity, return on assets as well as Return on Investment. These are usually used to measure the performance of companies, including banking institutions (Schiuma, 2003).

The banking business in Kenya is oversighted by the CBK. It licenses, supervises and regulates banking institutions and microfinance organizations as mandated by the Banking Act as well as other pieces of Kenyan legislation. Banks collect customer credits, sell loans and provide associated services. Moreover, they allow for diverse types of accounts, such as transactional, savings as well as fixed deposits. These corporates are meant to make profits for their owners. In the recent past, the Banking sector in Kenya has continued to grow in assets, liabilities, profitability and products broadening including but not restricted to internet and mobile banking products.

A report by Cytonn Investment as noted by Njigo, Oluoch & Ndambiri (2018) stated that Kenya's banks that are listed at the NSE have recorded negative EPS growth of about 8.2 percent in the 2017 when compared with positive EPS growth of 14.1 percent recorded in 2016. This bad performance was due to reduction of Net Interest Income (NII) following capping of interest rates. NII reduced to 8.4 percent in 2017 from 9.4 percent in 2016. Financial results of the banking sector in Kenya have been of great public interest. A case in point being the fact that the industry posted a Ksh. 89.5 billion pre-tax profit in 2011 that was a 20.5 percent increase from previous year Ksh.74.3 billion.

Statement of the Problem

The Banking Act and CBK regulations require banks to establish internal audit functions. Public demand for increased accountability of banks in light of Kenyan banking crisis of the late 1980's that led to collapse of several banks and subsequent regulatory action has transformed corporate governance. The collapsed 9 banks in the 1980's were family/community owned banks that failed mainly due to huge non-performing loans arising from poor governance. However, there has been laxity in financial support of internal audit functions by businesses especially banks as the financial/economic value of internal audit has never been well established. Mawanda (2008) conducted a research on influence of system of internal control on monetary results in a college in Uganda. This research examined and pursued to find out the connection between systems of internal control and monetary results in the college. Systems of internal controls were looked at from the perspective of Control Situation, Control Events and Internal Audit whereas monetary results focused on Liquidity, Responsibility and Reporting. The research found out that there is a positive correlation between structures of internal control and monetary results. Ejoh & Ejom (2014), studied on the influence of internal auditing activities on the monetary results in institutions of higher learning based in Nigeria. This study discovered that internal auditing function has got no important consequence on the monetary performance of the in the institutions. Very few studies have been conducted on related topics locally. Mutua (2012), researched on effect of risk influenced audit on monetary results of Kenyan banks. She observed that financial performance requires appropriate risk based audit practices hence effective and efficient internal audit. Agung (2011), studied about benchmarking and performance in commercial banks while Wanyoike (2007), studied about IA's departments role in enterprise risk management. Ondieki (2013) researched on the influence of internal auditing on monetary results of Kenyan banks. However, this study failed to look at key quantitative determinants of internal audit namely the number of staff in the section, the yearly budget size, coverage of annual IA plan and the number of IA reports issued in a year which the researcher looked at in this study. The qualitative determinants variables that Ondieki (2013) considered factors that require little investment in terms of resources to put in place. She also looked at the influence that IA has on all the Kenyan banking institutions most of which have private ownership. However, this study concentrated on the banks listed in the Nairobi Securities Exchange as such banks have a high level scrutiny as the bulk of their ownership are the general public and the expectation is that they have well-established internal audit departments. This study therefore endeavored to address the gaps noted in these related studies as already discussed.

Objectives of the Study

To establish the effect of the number of staff in internal audit on the financial performance of banks listed at NSE in Kenya.

LITERATURE REVIEW

Theoretical Framework

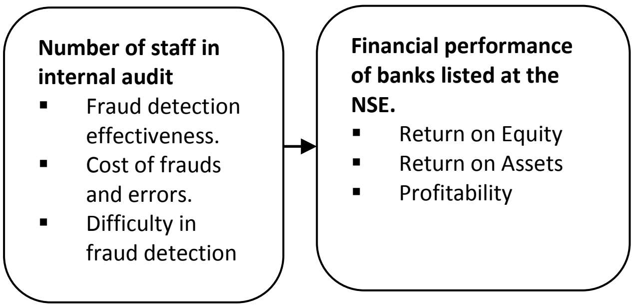
Contingency Theory

Davoren (2014) explained that the aim of an audit is to assess the reliability of an organization's information, policies, practices and procedures. Government regulations for instance the CBK regulations require that financial institutions undergo independent financial audits, but industry standards can mandate audits in other areas such as safety and technology. Regardless of the audit subject, various factors impact a company's final results, and the contingency theory consider these aspects during the audit process.

Morgan (2007) defines the core philosophies essential to contingency in brief: Firms are exposed structures that require cautious management to gratify and balance inner needs and to acclimatize to environmental situations; there exist no single superior way of directing. The suitable system is dependent on the nature of duty or setting one is operating from; Management has to be concerned, as a priority, with achieving arrangements and best fits and lastly that diverse kinds of administrations are needed in different types of environments.

According to Lutans (2011), the contingency theory of leadership and management states that there is no typical method by which firms can be led, controlled and managed. Organizations and their functions depend on various external and internal factors. Ondieki (2013), states that the functions of audits are themselves, types of organizations that are affected by various factors in the environment.

Conceptual Framework



Independent Variables **Dependent Variable**

Figure 1: The Conceptual Framework

Source: Author (2019)

Empirical Review

Influence of Number of Staff in IA on Banks' Performance in Financial terms

Cohen and Sayag (2010) studied on the effectiveness of Internal Audit and reviewed the main elements of internal audit effectiveness in firms in Israel. The key facets he noted included: Professionalism of IA staff, the worth audit work, objectivity of the firm as well as support by executive. They concluded that internal audit departments ought to engage enough number of qualified personnel to attain superior performance.

A study by Basel Committee (2002), noted that each bank should establish a strong internal audit section in order to effectively accomplish its vision and mission. The executive of the bank should ensure that the institution can continually look on proper internal audit function proportional to its size and to its operational realities. The actions include availing the suitable assets and staffing to internal audit to ensure satisfactory coverage of internal audit plan. A survey, by Ernst & Young (2007) surveyed audit leaders as well other senior managers and noted that majority of them disclosed that their firms' internal audit functions were substandard. Majority of the respondents considered robust risk management influences positively on their financial performance. They also believed that the number of personnel in internal audit positively affect their general risk management endeavors. As the function of the internal auditor changes and prospects of stakeholders grow, internal audit progressively require enough number of staff with proficiencies that surpass the outdated technical skills, for instance the ability to work with management and commercial units on relevant commercial issues.

Mawanda (2008) carried out a research on influence of internal system of control on monetary performance in a college based in Uganda. In this research he wanted to establish the relationship between internal system of controls and performance financially in the particular institution. System of internal controls were seen from the

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viewpoint of control setting, internal audit and control events while financial performance was viewed in terms of liquidity, liability and reporting. The scholar wished to find the origins of continual below expected financial results in relations to internal controls.

The research determined a strong connection between system of internal control and monetary performance. It suggested skill profiling of internal auditors that ought to be based on what the college presumes the auditors to do and what suitable number personnel would be requisite to perform the work. The study therefore recognized that an organization should have enough personnel and resources in IA to enable it come up with suitable internal controls that have an influence on the financial results.

Bouaziz (2012) examined the connection between the size of the auditor and financial performance on a sample of some 26 businesses in Tunisia listed at the Tunis Stock Exchange. The outcome demonstrated that the size of auditor has a vital consequence on the performance of businesses financially.

METHODOLOGY

The study assumed a descriptive cross-sectional research design, which according to Kothari (2004), is applied whenever the question stood well-defined specifically and where the researcher got particular matters to be described by the participants about the problem. The target population for this study was 135 Internal Audit professionals from the 11 registered Kenyan banks that were listed at NSE. This study attempted to identify all the internal audit professionals of the NSE listed banks which formed the different strata before selecting the number of professionals in each stratum to be included in the sample. This study adopted questionnaire as primary data collection instrument. According to Kombo and Tromp (2006), questionnaires are the most appropriate instruments for collecting information about issues that respondents may feel reluctant to discuss because they uphold confidentiality.

FINDINGS

Number of staff in internal audit

Descriptive Analysis

The study sought to establish the effect that the number of internal auditors have on monetary performance of Kenya banking institutions listed at the bourse. The mean as well as the standard deviation of independent variables are presented below. The respondents were requested to tick where appropriate, whereby: 5-strongly agree, 4-agree, 3-neutral, 2-disagree, 1-strongly disagree.

Table 4: Number of Staff in Internal Audit

Measures	Mean	Standard Deviation
Frauds and fraudulent activities are inherently unpredictable and difficult to detect even though they affect the performance of the bank	3.80	2.45
In the listed banks, frauds are detected by the internal audit staff in the course of their audit reviews.	4.50	3.03
Adequate number of internal auditors is important for effective fraud detection.	4.49	3.00
Number of staff in internal audit has effect on cost resulting from frauds and errors.	4.36	2.99

The above table 1 illustrated that the respondents were in agreement that in the listed banks, frauds were detected by Internal Audit personnel in during audit reviews as shown by the mean of 4.50. Adequate number of internal auditor was important for effective fraud detection and number of staff in internal audit has effect on cost resulting from frauds and errors as indicated by a mean of 4.49 and 4.36 respectively. Respondents disagreed with the statements that frauds and fraudulent activities were inherently unpredictable and difficult to

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detect even though they affect bank's performance as shown by a mean of 3.8.

Regression analysis

A regression analysis was performed to analyse the variable. A regression analysis was performed with number of Internal Audit staff (the independent variable) on the dependent variable financial performance of banks listed at the NSE was performed.

Table 2: Regression coefficients

Model	Unstandardized Coefficients Beta	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
(Constant)	2.438	0.280	------	8.703	0.0030
Fraud detection effectiveness	0.273	0.056	0.339	4.886	0.0045
Cost of frauds and errors	0.285	0.058	0.591	4.887	0.0067
Difficulty in fraud detection	-0.112	0.047	-0.236	- 2.389	0.0180

The results from table 2 showed that fraud detection effectiveness**,** cost of frauds and errors and difficulty in fraud detection had a significant direct influence on performance in financial terms of listed banks. A regression equation of Y = 2.438 + 0.273 Fraud detection effectiveness +0.285 Cost of frauds and errors**-** 0.112 difficulty in fraud detection. This showed a linear relationship between the variables.

Table 3: Model Summary

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.571	0.326	0.294	0.45298

In the model summary we found that 32.6% of monetary performance of Kenyan listed banking institutions could be accounted for by Fraud detection effectiveness cost of frauds and errors and difficulty in fraud detection. The adjusted R square is 0.294.

From the regression analysis, number of staff in internal audit was found to positively affect financial performance of banks listed at NSE. This is consistent with the findings of Miettinen (2011), who studied the link between quality of audit and performance financially. Audit quality was measured using audit staffing levels and audit committee meeting frequency. The result shows that audit quality has both a direct effect as well as a mediated effect through audit staffing numbers on monetary performance. The results imply that measures of audit quality are not merely symbolic but that they contribute to financial performance.

SUMMARY

The objective of the study was to assess the consequence of the number of staff in Internal Audit on monetary results of Kenyan banking institutions at the bourse. Results indicated that the number of staff in Internal Audit has direct positive consequence on monetary performance of the subject banks.

CONCLUSION

From the findings mentioned earlier, it was concluded that, number of staff in Internal Audit greatly influences monetary results of banking institutions listed at the NSE. Increase in number of internal auditors increases the ability of the department to detect frauds and errors resulting in increase in monetary performance such institutions.

RECOMMENDATIONS

The researcher recommended that the CBK, board and management of banks listed at the NSE should ensure adequate staffing of their internal audit departments as the same will lead to increase in internal audit quality that translates to improvement of financial performance of these banks.

Areas for Further Research

Firstly, there is need for other variables in internal audit to be looked at. Examples of such include systems of controls, use of technology in Internal Audit e.t.c. Secondly, There is need to use other methods of study to see whether the same result can be realized. Thirdly, this research was concentrated on banks that are listed at the NSE, there is need to have a wider research on the topic covering entire banking population or even diverse financial institutions and compare the results.

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