

**ASSESSING THE RELATIONSHIP BETWEEN  
INTERNAL AUDIT FUNCTIONALITY AND  
ACCOUNTING QUALITY IN SELECTED  
FIRMS AT THE NAIROBI SECURITIES  
EXCHANGE, KENYA**

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(Accounting Option)

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## APPROVAL SHEET

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## **ABSTRACT**

In view of sudden collapse of some reputable companies, this study examines whether the internal audit departments in selected companies listed at the Nairobi Securities Exchange are functional and assesses the level of accounting quality in the financial statements of the selected companies. Finally, it explores the relationship, if any, between the functionality of internal audits and accounting quality. The indicators of internal audit functionality are identified as internal audit structure, internal audit independence and management support. Questionnaires were purposively administered to ten selected companies to evaluate perception of internal audit functionality while on accounting quality; Healy Model of earnings management was used. The weakest perceived indicator of internal audit functionality was found to be internal audit independence where political pressure was perceived as the greatest barrier to internal audit functionality. On accounting quality three of the ten selected companies showed undesirable levels of accruals hence poor accounting quality. It is recommended that corporate governance report of listed companies should include a signed statement on internal auditor independence. Finally accounting bodies should also explore ways of managing discretionary accruals to improve on accounting quality.

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# **CHAPTER ONE**

## **INTRODUCTION**

### **Background of the Study**

Internal audit has been increasingly gaining prominence in the corporate world. It is a key feature in many business regulatory frameworks. It is also a fundamental ingredient in corporate governance. It is defined 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.

According to Institute of Internal Auditors (2013), internal auditors provide the governing body and senior management with comprehensive assurance based on the highest level of independence and objectivity within the organization. Three areas of assurance are mentioned; ‘assurance on the effectiveness of governance, risk management, and internal controls.’

While internal audit is designed to add value to the organization, its traditional focus has been value preservation. (KPMG-South Africa , 2008). For example, historically, when internal audit focused on monitoring business operations, processes and governance functions, it would examine whether a control was being performed or procedures were being followed and report either “yes” or “no”. Now, internal audit’s focus is not on whether a control is being performed, but on whether it is the right control and if it is being performed correctly and cost effectively.

The assurance function of internal audit doubtlessly involves assurance on the financial statements, the key question being whether a functional internal audit adds value to the financial statement in terms of quality.

Internal auditors are well versed in risk management and control and are capable of helping companies address complex business challenges. Performed by professionals with an in-depth understanding of the business culture, systems and processes, internal audit assists their organizations by independently identifying and examining risks and controls supporting the accuracy and integrity of financial reporting (The Institute of Internal Auditors, 2012).

A functional internal audit is an internal audit which is set up and operationalized according to requisite professional standards. The essential ingredients that define the functionality of internal audit as encapsulated in the International Standards for the Professional Practice of Internal Auditing include independence, management support and structure.

Internal audit independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. (Institute of Internal Auditors, 2016). When such conditions exist, internal audit functionality and effectiveness is hindered.

An optimal internal audit structure is similarly vital. It includes the organization, plan and the reporting framework of the internal audit department. The internal audit plans and procedures should be effective in minimizing risk especially that of financial statement accuracy.

Internal audit functionality depends also on management support including Management oversight considerations, such as whether the necessary resources (people and otherwise) and tools have been dedicated to the compliance and risk

management effort, whether the tone-at-the-top is inclined towards having tighter internal controls, and whether the board of directors and senior management, through their words and actions, are communicating the importance of risk awareness across the company. (ICPAK, 2013).

Accounting quality on the other hand has been defined as the ability of accounting measures to reflect the economic position and performance of a firm. (Verleun, Georgakopoulos, Sotiropoulos, & Vasileiou, 2011). Higher quality accounting information should benefit investors and other stakeholders by protecting them against opportunistic behavior of management. Accounting quality seeks to explain or verify the usefulness of accounting figures as they are presented in the financial statements through the prisms of relevance and reliability. Financial statements are like the long awaited report card on the financial performance of an organization. A company's earning is believed to be the most important item in the financial statements (CHEN, 2010). Accounting quality therefore is largely about the quality of reported earnings, especially in listed companies where shareholders would want to keep an eye on the growth of their invested wealth and may want an assurance on the reliability of the reported earnings.

Financial statements may be characterized by a high degree of relevance either when used to predict future events or when they confirm predictions and actions of the past. (Kythreotis, 2014) Another key factor in relevance is timeliness. Earnings are therefore relevant if they can be used predictively or if they validate prior expectations, or if they are timely.

Financial Accounting Standards Board Concepts Statement No 2 defines reliability as "the quality of information that assures that information is reasonably free from error or bias and faithfully represents what it purports to represent". (Board,

2004) For example, the representation of receivables in a balance sheet at a specified dollar amount, net of any allowance for bad debts, purports that the stated number of dollars is collectible. However, if the allowance is too small and many more of the receivables are uncollectible, that depiction would not be reliable because it would not be representationally faithful of the number of dollars that are collectible.

Verleun et al. (2007) identify three metrics for measuring accounting/earnings quality as value-relevance, earnings management and asymmetric timeliness of earnings. Earnings management is singled out as the most frequently applied metric for measuring accounting quality and has been summarized as the ability of management to use judgment in financial reporting to either mislead some stakeholders or to influence contractual outcomes at their own benefits.

Earnings management has to do with the subjective estimates that the management makes. In general, earnings viewed as being of high quality are those that have a lower level of earnings management and/or higher accrual quality (Kamarudin & Ismail, 2014). Estimates like uncollectable debts, inventory valuation and write-offs are to a large extent subjective. These have an influence on the accounting quality of the financial statements as they are discretionary and hence their reporting may serve certain immoral purposes. The other measure of accounting quality is value relevance. That is, does the accounting information capture the true value of the firm as revealed in the share price? This deals with the level of synchrony between the information in the company financial statement and the share price.

In this study, the earnings management measurement has been preferred to the value relevance measurement since the value relevance metric relies on market information which is seldom perfect. Verleun et al. (2011). Thus if the market is

highly inefficient a value relevance assessment could result in the conclusion that accounting quality is low while this is not the case.

This research project seeks therefore to assess the functionality of internal audit department, the quality of financial statement and to explore any relationship between internal audit functionality and accounting quality.

### **Statement of the Problem**

Effective Corporate governance plays a significant role in business honesty and efficiency (Igor, 2013). Of significance is the fact that corporate governance failure is always the main road to financial crimes and misconducts (Peter, 2016). A key ingredient of corporate governance is functional internal audit departments (Fredrick & Omwono , 2014) and a key outcome of effective corporate governance is high accounting quality (Nolia, Zam, & Chek, 2011).

The business world has woken up to the collapse of some big companies. Before these downfalls, accounting information as captured in the financial statements told tales of financial health and presented them as viable going concerns. Indeed, the Enron scandal in the United States still continues to capture public imagination (William, 2002) as was the collapse of Parmalat company in Italy, which led to Europe's biggest bankruptcy to date (Rezart, 2016).

In Kenya, there have been several incidents where listed firms were for long thought to be financially stable only to come tumbling down due to financial manipulation. CMC Holdings, Mumias Sugar, Kenya Airways, Uchumi, and Haco Tiger brands are among the listed companies that have recently been involved in alleged financial scandals where book cooking was unearthed (Daily Nation, 2015). Of puzzling interest is that these institutions which collapse suddenly, have internal audit

departments whose role among many is the provision of assurance on the financial statements.

The jury is therefore still out on the quality of financial statements presented to shareholders and the effectiveness of internal audit departments. The researcher will also seek to ascertain if there is any relationship between internal audit functionality and accounting quality.

### **Research Questions**

The research seeks to answer the following fundamental questions:

1. To what extent are internal audit departments functional as perceived by the levels of independence, management support and internal audit structure?
2. To what degree can the accounting information as captured in the financial statements be described as ‘quality’?
3. What is the relationship between internal audit functionality and accounting quality?

### **Hypothesis**

1. Null Hypothesis ( $H_0$ ): There is no significant relationship between internal audit functionality and accounting quality.
2. Alternative Hypothesis ( $H_1$ ): There is a significant relationship between internal audit functionality and accounting quality.

### **Significance of the Study**

The findings of this study will help shareholders and other users of financial statements to better appreciate the quality of the financial statements which should be closer to the actual reality.

Regulatory bodies such as Capital Markets Authority will be able to assess compliance with operational guidelines especially those that relate to internal audit.

Researchers can appreciate the use of models in evaluating certain concepts and be motivated to develop more and better models for use in industry and the broader society.

### **Justification for the Study**

Despite the fact that managers make financial representations which are deemed satisfactory, and notwithstanding the existence of internal audit functions, some organizations still experience sudden collapse. It is therefore important to establish the quality of these financial representations and the functionality of internal audit departments, beyond and above their mere existence. Subsequently, it will be of value to assess any relationship between internal audit functionality and accounting quality.

In assessing internal audit functionality, the variables of independence, structure and management support have been chosen since they feature preeminently in the operational guidelines of the relevant professional bodies, in this case, the institute of internal auditors.

The earnings construct as a measure of accounting quality is preferred since the alternative value-relevance construct is beset by certain limitations. Of major concern is the fact that value relevance relies on the share price yet the securities exchange is not perfect and is affected by many non-financial factors as speculation.

### **Scope and Limitations**

While value relevance, earnings management and asymmetric timeliness of earnings are the major proxies and determinants of accounting quality according to Verleun et al. (2011), the research will mainly consider the earnings management construct of accounting quality. Earnings management is singled out since it is the most frequently applied metric on accounting quality (Verleun et al., 2011). It is

therefore understood that this is not a comprehensive view of accounting quality and therefore limitations will attend the application of earnings management to accounting quality.

The sampling method chosen to select the ten listed companies is purposive sampling. This is because of time and resource limitations. Literature on research tends to agree that random sampling is more representative of the population (Aaamir, 2014).

Lastly, this is only a study of relationship. The existence of a relationship does not imply causation.

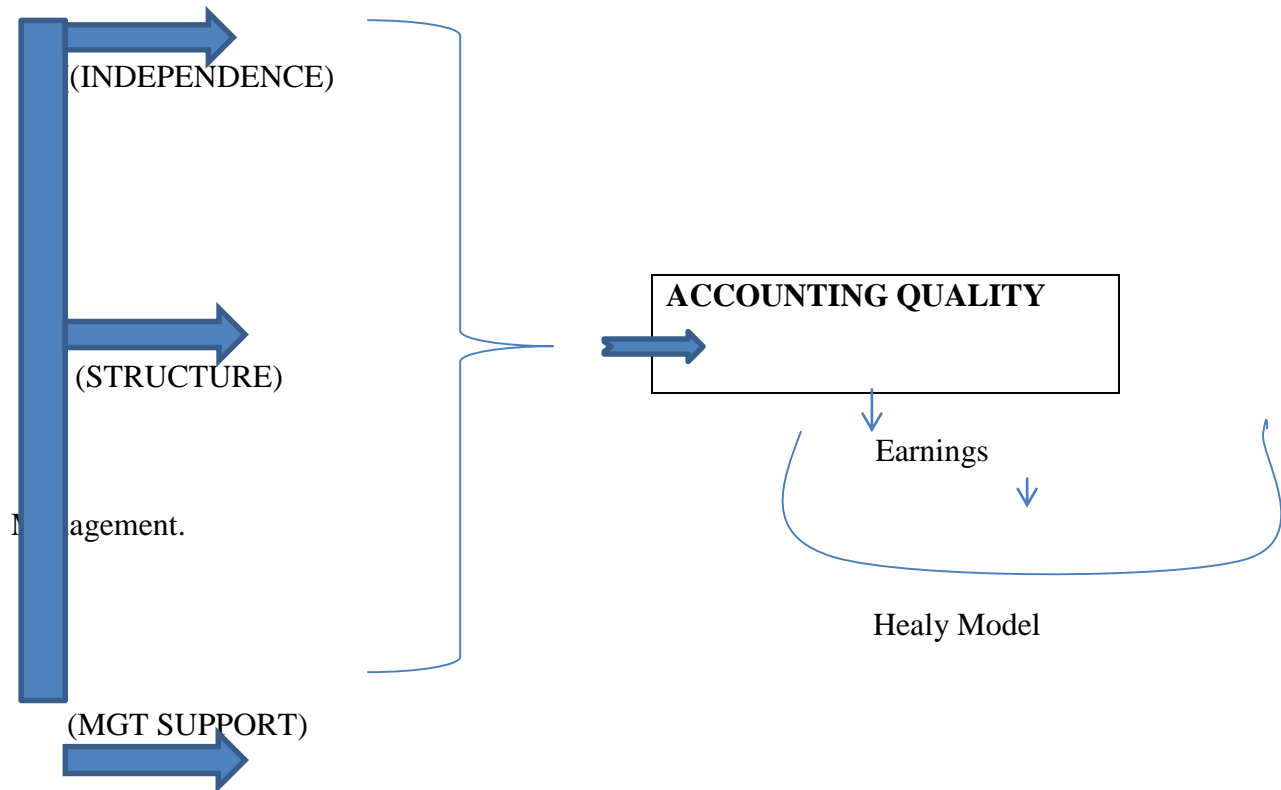
### **Conceptual Framework**

The study seeks to ascertain whether there exists a significant relationship between Internal Audit Functionality as the independent variable and Accounting Quality as the dependent variable and whether the existence of the former affects the existence of the latter. Quality parameters for internal audit include the extent to which internal audit function is structured, the level of independence and management support. On the other hand, accounting quality is evaluated by assessing the level of earnings management particularly through the Healy Accounting model which assumes that any change in accruals over a period of time is due to the change in discretionary accruals.

**INDEPENDENT VARIABLE**  
**VARIABLE**

**DEPENDENT**

**INTERNAL AUDIT**



### **Definition of Terms**

**Accounting:** The process of capturing processing, reporting and analyzing financial data. (Cambridge, 2013)

**Accounting quality:** Full and transparent financial information that is not designed to obfuscate or mislead users. (Achim, 2014)

**Add value:** The internal audit activity adds value to the organization (and its stakeholders) when it provides objective and relevant assurance, and contributes to the effectiveness and efficiency of governance, risk management, and control processes. (Chartered Institute of Internal Auditors, September, 2015)

**Assurance:** services involving the internal auditor's objective assessment of evidence to provide an independent opinion or conclusions regarding an entity, operation, function, process, system, or other subject matter. (Chartered Institute of Internal Auditors, September, 2015)

**Board:** A board is an organization's governing body, such as a board of directors, supervisory board, head of an agency or legislative body, board of governors or trustees of a nonprofit organization, or any other designated body of the organization, including the audit committee to whom the chief audit executive may functionally report. (Chartered Institute of Internal Auditors, September, 2015)

**Earnings Management:** Occurs when a business management has the opportunity to make accounting decisions that change reported income and exploits those opportunities. (Roman Weil, 2009)

**Functional:** The quality of having a practical use. Effective. (Webster, 1828)

**Internal Audit:** Internal auditing is 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 (Institute of Internal Auditors, 2016).

**Internal Audit Charter:** The internal audit charter is a formal document that defines the internal audit activity's purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity's position within the organization, including the nature of the chief audit executive's functional reporting relationship with the board; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities. Final

approval of the internal audit charter resides with the board. (Institute of Internal Auditors, 2016)

**Internal Audit Independence:** Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. (Institute of Internal Auditors, 2016)

**Internal Audit Functionality:** Whether the internal audit department is suited to serve its purpose well.

**Internal Audit Structure:** The organization, plan and the reporting framework of the internal audit department.

**Standard:** A professional pronouncement promulgated by the Internal Audit Standards Board that delineates the requirements for performing a broad range of internal audit activities, and for evaluating internal audit performance (Institute of Internal Auditors, 2016).

**Discretionary Accruals:** The accruals component managers can choose within the flexibility of accounting regulations in adjusting a firm's cash flows.

## **CHAPTER TWO**

### **REVIEW OF RELATED LITERATURE AND STUDIES**

This chapter provides a critical review of related literature on the relationship between internal audit and accounting quality. Over the recent past, various regulatory bodies have recommended the establishment of internal audit functions within organizations. The spotlight has been on whether the presence of internal audit functions add value to the accounting quality in light of the inherent cost implications. This chapter reviews literature resulting from studies done with respect to internal audit and accounting quality. The literature is reviewed under the subsections of audit history, internal audit , accounting quality and the relationship between internal audit and accounting quality.

#### **Internal Audit**

##### **Evolution of the Role of Internal Audit**

Audit has been defined as the ‘independent examination and expression of opinion on the financial statements of an enterprise by an independent auditor in pursuance of his appointment and in compliance with any relevant statutory obligation’ (Madya, 2012).

Audit has an insightful history. According to Ramamoorti (2003), quoting accounting historian Richard Brown, ‘The origin of auditing goes back to times scarcely less remote than that of accounting...Whenever the advance of civilization brought about the necessity of one man being entrusted to some extent with the property of another, the advisability of some kind of check upon the fidelity of the former would become apparent.’ It is instructive to note that Ramamoorti here pegs the need of audit on the agency concept; the fact that audit is required since those who

manage are different from the actual owners of the business. On the other hand, Watts and Zimmerman (1983) suggest that the appearance of independent audits is more recent with the passage of Registered Companies Act of 1862 in England. It was not until the Companies Act 1900, however, that a general legal obligation for annual audits was imposed on registered companies in England (Audit Quality Forum, 2005).

Prior to the 1930s, no laws or regulations obliged American corporations to have their financial statements audited. However a few companies had done so for more than a decade, including United States Steel Corporation, E. I. duPont de Nemours & Company, General Motors Corporation, Eastman Kodak Company, and International Business Machines Corporation. (Zeff, 2003). Hence, when auditing was not yet a legal requirement, it was already in vogue, this is suggestive of the truth of the statement that practice has generally outrun minima. People may have seen the need and decided to formulate laws addressing the need. That the practice of auditing did not begin because of the regulations is an argument that has much currency. Indeed according to information appearing on Securities and Exchange Commission Historical Society, the New York Stock Exchange required audited financial statements only in 1933 perhaps in response to the stock market crash and the subsequent Great Depression.

In Asia, Audit practice and regulation came later except perhaps for China which is known to be an ancient civilization. Fattah and Ganiyy (2013) make an observation that ancient cultures always had highly developed economic systems, though the mainstay of audit and accountancy was just book-keeping in a single entry format. The world had to wait until the period of the renaissance in Italy for the concept of double-entry book-keeping to evolve which was seen then as an attempt to correct the fraud-friendly practice of single entry book keeping.

In Africa audit practice and regulation was adopted much later. This must be because of the informal structure of the financial and the wider business market. An exception is found in South Africa where as early as 1887, the Johannesburg Stock Exchange, the largest stock exchange in Africa, was already formed to facilitate trade in gold which had then just been discovered.

Thus far, the kind of audit that was done was external audit. This was an external eye, removed and independent from the organization, to verify the management's representations in the financial statements. Internal Audit developed as a distinct practice from external audit about the turn of the 20<sup>th</sup> century. This, Ramamoorti (2003), argues was because of the fact that managers wanted to verify the integrity of the information they were using to make important business decisions. Later, internal audit gradually moved from an "audit for management" emphasis to an "audit of management" approach and in 1941, the Institute of Internal Auditors was established in the United States of America to handle issues of standardization of practice and professional guidance.

According to Institute of Internal Auditors (2013), internal auditors provide the governing body and senior management with comprehensive assurance based on the highest level of independence and objectivity within the organization. Three areas of assurance are mentioned; 'assurance on the effectiveness of governance, risk management, and internal controls.' The primary role of Internal Audit is seen as helping the Board and Executive Management to protect the assets, reputation and sustainability of the organization. Badara (2012), highlight compliance as a key component of internal audit. This includes compliance with laws and regulations, organizational policies and accounting standards.

Internal audit function is not only important for big companies but also small and medium enterprises. In many instances, establishing internal audit is a matter left to the discretion of the organization. However, companies listed in the stock exchange are required by law to have an internal audit function. Other sectors also require establishment of internal audit function by statute. A good example being the Savings and Credit Cooperative Societies in Kenya under the Sacco Society Regulatory Authority regulations.

How should an organization evaluate the need for establishing an internal audit function? The criteria for establishing an internal audit department should revolve around informational needs. For instance, according to the Fraser & Lindsay (2004), The Audit Committee may want to get independent and objective assurance on the adequacy of internal controls from someone other than the Chief Executive Officer or Chief Finance Officer. The Chief Executive Officer may want to get independent and objective assurance on the adequacy of internal controls from someone other than the Chief Finance Officer or line managers. The Chief Finance Officer may want to get independent and objective assurance on the adequacy of internal controls from someone other than the line managers. Finally, the organization may get too large or geographically dispersed for frequent and economical first-hand monitoring of controls by the Audit Committee, Chief Executive Officer or Chief Finance Officer.

In all these foregoing scenarios, there is clearly a need for an independent office, other than those primarily responsible, to verify the adequacy of internal controls.

## **Internal Audit Functionality**

Functionality, according to Merriam Webster's online dictionary is the 'quality or state of being functional.' To be functional is the ability 'to perform a regular function'. At the heart of the question therefore, is whether internal audit have the requisite ability to perform their designated functions. Which brings us to the question; what is the function of internal audit? Indeed what is internal audit?

According to the institute of internal auditors, internal audit is "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 (Institute of Internal Auditors, 2012)". Hence, internal auditing can well be classified into three diverse areas; risk management, corporate governance and internal control.

Has internal audit been functional especially in light of its role? According to the definition of internal audit, internal audit is basically an assurance and consulting function. It carries out an assurance function on the three broad areas of risk management, corporate governance and internal controls. With the sudden collapse of companies such as Enron, the spotlight is shining on internal audit function. While many reasons have been cited for the collapse of Enron company for instance, Albeksh (2016) found that the internal audit function in the company failed in the ethical and financial aspects as a result of continuous deception, greed, bribery, speculation and fraud. The corporate governance environment was clearly less than stellar. You go to Parmalat in Italy and you find almost a similar story albeit with different actors; a compromised corporate governance and risk management environment despite the existence of the internal audit function (Melis, 2005).

Internal audit activities play an important part in the effective governance and risk and control framework of any organisation ((ICAEW), March, 2004). What therefore determines the capacity and the ability of internal audit to perform their functions? Many factors have been cited and many studies conducted on the same subject. However, recurring factors remain independence of the internal audit function, structure of the internal audit function and management support accorded to the internal audit function (Theofanis & Konstantinos, July, 2015 ).

### **Internal Audit Independence**

Internal auditors should not be placed in a position where their independence can be questioned and feel unable to make objective professional judgments (Gathogo George, 2016). On independence, The Institute of Internal Auditors has issued a number of attribute standards and associated advisory statements relating to independence and objectivity. Standard 1100 states that “the internal audit activity should be independent, and internal auditors should be objective in performing their work.” The related Practice Advisory 1100-1 indicates that independence allows internal auditors to be impartial and unbiased in the exercise of judgment and is achieved through organizational status and objectivity.

Internal Auditors should never be engaged in routine activities as this will impair their independence. The objectivity of internal auditor is presumed to be impaired when undertaking a monitoring activity for which he was responsible during the previous year (Ammar, 2015). Indeed, internal auditors should not develop and install procedures, prepare records or engage in any other activity, which they would normally review and appraise and which could reasonably be construed to compromise the independence of the internal auditor (Gathogo George, 2016).

The Institute of Internal Auditors maintains that independence of internal audit office “can best be achieved through a dual CAE reporting relationship — functionally to the board of directors and administratively to senior management.” (Institute of Internal Auditors, 2003). The closer a Chief Audit Executive is aligned to a company’s board or audit committee, the more internal audit will be objective and independent in its analysis of a company’s internal controls (Hoffelder, 2013).

### **Internal Audit Structure**

What are the plans, systems and procedures put in place by the internal audit department to carry out its mandate? The institute of Internal Auditors is promoting flexible audit plans in tandem with the organization’s changing risk profiles and aligned with organizations goals and objectives. (Anderson & Svare, 2013) In a recent global survey of internal audit practitioners, most audit departments are far from flexible in adapting their audit plans to better handle unexpected and fast-paced changes in risks. (Institute of Internal Auditors, 2015). The report recommends making the traditional audit plan more flexible in order to respond to emerging risks. Indeed, the report concludes that the current business dynamic demands near continuous risk assessment to provide true assurance.

The retroactive perspective of the internal audit has changed with Risk Based Internal Auditing and the internal auditors have started considering all risks which may prevent the achievement of the objectives of businesses by focusing on events that may occur in the future. (Vahit & Celayiy, September, 2014) It should be noted that it was determined that one of the most important reasons why many businesses, which recently failed in the commercial sense, came to this point is the internal audit structures which do not meet the business structures and are not effective enough for minimizing the existing risks.

Indeed, according to IIA Standard 2010, the chief audit executive should establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization's goals. (Institute of Internal Auditors, 2012)

On the basis of data from 153 Italian companies, Arrena & Azonne (2009), postulate that the effectiveness and functionality of internal auditing is influenced by: (1) the characteristics of the internal audit team, (2) the audit processes and activities, and (3) the organizational links. Internal audit effectiveness increases in particular when the ratio between the number of internal auditors and employees grows, the Chief Audit Executive is affiliated to the Institute of Internal Auditors, the company adopts control risk self-assessment techniques, and the audit committee is involved in the activities of the internal auditors.

### **Management Support**

American Institute of Chartered Public Accountants-AICPA (2010), adds management support as another key indicator of effectiveness and functionality. 'A critical part of the Audit Committee's role is to assess the relationship of the Chief Audit Executive and the management team whose support can greatly influence the effectiveness of the internal audit function and its value to the Audit Committee.' (Fraser & Lindsay, 2004).

Still, Fraser, and Lindsay (2004) mention the fact that internal audit functions need an adequate complement of staff with the appropriate experience and qualifications for the risks and businesses they audit. This can only take place when there is significant level of management support. Staff require continued training in their disciplines and must stay abreast of technological advances and changes in the organization's business. The internal audit function should also make full advantage of the work and resources of the external auditors by coordinating activities.

Badara (2012) also mentions staffing as one of the essential elements of functional internal audits in addition to independence, training, relationship, due care, planning, controlling, recording, system control, evidence and reporting frameworks. In the UK, The Public Sector Internal Audit Standards require the chief audit executive to develop and maintain a quality assurance and improvement programme that covers all aspects of the internal audit activity. (HM-Treasury, UK Government, 2013). The improvement programme must include periodic internal assessments and an external review at least every five years. This is also a requirement by the International Standards for the Professional Practice of Internal Auditing.

Fraser and Lindsay (2004) suggest that good internal audit functions also have processes for assessing their own effectiveness. They use the results, together with feedback from the external auditors and other stakeholders, to monitor trends over time and achieve continuous improvement in their practices and performance. The Chief Audit Executive develops performance measures for the internal audit function and agrees them with the Audit Committee. Examples of measurement techniques include: customer satisfaction surveys, post audit debriefing and internal quality assurance reviews.

## **Accounting**

### **Accounting Quality**

Accounting quality has been defined as the ability of accounting measures to reflect the economic position and performance of a firm (Verleun et al., 2011). Because of financial information manipulation, the real financial positions and operating results of firms may not be reflected onto the financial information users. (Yurt & Ergun, May, 2015) A company's earning is believed to be the most important item in the financial statements (CHEN, 2010). It is what most analysts use when

analyzing a company's performance and prospective potential. Since accounting quality revolves around the twin issues of relevance and reliability of the financial statements, measures of accounting quality have been proposed to try and define what really constitutes relevance and reliability, and therefore accounting quality.

There are two major methods of assessing accounting quality. These are earnings management and value relevance. According to Beisland (2009), accounting information is denoted as value relevant if there is a statistical association between the accounting numbers and market values of equity. Accounting amount is deemed to be value relevant if it has a significant association and correlation with equity market value. According to Barth, Landsman, & Lang (2008), firms with higher quality accounting have a higher association between stock prices and earnings and equity book value because higher quality earnings better reflect a firm's underlying economics.

One key limitation of value relevance model of assessing accounting quality is that it is based on market information yet market information is never perfect (Verleun et al., 2011) and is affected in turn by other factors some of which are even non-financial in nature such as speculation. This leaves earnings management as the most viable and practical alternative in measuring accounting quality (Morais & Curto, 2008).

Other indicators of accounting quality are qualitative in nature. Such is the level of adoption of International Accounting Standards. Firms applying IAS generally evidence an improvement in accounting quality between the pre- and postadoption periods (Barth, Landsman, & Lang, 2008). Cross listing in securities exchanges is also an indicator of accounting quality. Cross-listed firms appear to be less aggressive in terms of earnings management and report accounting data that are

more conservative, take account of bad news in a timelier manner, and are more strongly associated with share price. (Lang, Raedy, & Yetman, 2003).

## **Earnings Management**

Earnings Management is an important aspect of evaluating an entity's financial health, yet investors, creditors, and other financial statement users often overlook it. Earnings Management refers to the ability of reported earnings to reflect the company's true earnings (Bellovary, Giacomino, & Ackers, 2005).

In Morais and Curto (2008), Earnings Management has been defined as the degree of conservatism in a firm's reported earnings. Another definition considers sustainability. Quality earnings are viewed as sustainable earnings, that is, earnings that are a good indicator of future earnings. Some use "quality of earnings" to mean the degree to which management's choices of accounting estimates can affect reported income (Roman Weil, 2009). Others use the phrase to mean the degree to which management takes advantage of its flexibility. Still others use the phrase to mean the degree to which managers, when faced with a choice of items that have a high impact on earnings, choose items that result in income recognition that's more likely to lead to recurring patterns of income. For them, the more likely an item of earnings is to recur, the higher its quality will be. Finally, Earnings Management should be measured by how quickly and precisely reported earnings reveal fundamental earnings.

Measuring Earnings Management has however posed several conflicting opinions. There are many and varied ways of measuring Earnings Management yet there is little consensus on the fundamental subject. Bellovary, Giacomino, & Akers (2005), for instance recognize at least eight models of measuring Earnings Management which they synthesize to come up with an Earning Quality Assessment

criteria. According to this criteria, shifting of revenue and expenses to other periods is a mark of low Earnings Management as is low margin ratios, high earning variability, discontinued operations, existence of one-time items, extraordinary items, accounting treatment and policy changes among others.

Verleun et al. (2011) identify three metrics for measuring accounting/Earnings Management as value-relevance, earnings management and asymmetric timeliness of earnings. Earnings management is singled out as the *most frequently* applied metric for measuring accounting quality and has been summarized as the ability of management to use judgment in financial reporting to either mislead some stakeholders or to influence contractual outcomes at their own benefits.

In general, earnings viewed as being of high quality are those that have a lower level of earnings management and/or higher accrual quality (Kamarudin & Ismail, 2014). Earnings Management is the process of taking deliberate steps, within the constraints of generally accepted accounting practice, to bring about a desired level of reported earnings. Earnings management is possible because of the discretion available to managers in preparing financial reports.

There are twelve ways in which managers practice earnings management (Saliza, 2014). The first is the big bath technique which is used when a company had some losses or charges due to operations restructuring, troubled debt restructuring, asset impairment and written-down, discontinued operation of a segment or subsidiary and they want to get rid of it all at once in current or particular period. This technique is based on the belief that if the management want to report a bad news of losses, it is better to report it all at once and get it out of its way. The second is Big Bet for the future technique and principally involves manipulation of Research and Development accounting. The third is changing the GAAP technique like changing depreciation

method from reducing balance to straight line method. The fourth is cookie jar reserve technique which is utilized when a company over-estimates future expenses like warranty costs in order to provide a future reserve that they can tap into. The fifth is discretion around write-off periods. The sixth is early retirement of debts while the seventh is Flushing the Asset portfolio technique where the managers time the sales and write down of impaired investment to manage earnings. The eighth method revolves around the classification of income as operating or non operating income. This is because managers know that financial analysts make forecasts based on operating income and hence they may want to play around with this classification to influence forecasts. The ninth method is sale and leaseback technique where managers to inflate revenues in a particular period, sell an asset and instead of buying another asset after recognizing gain or loss in sales, the lease-back the same asset. The tenth technique is called shrink the ship technique where a company repurchases its own shares to increase earnings per share. The eleventh technique is called 'Throw out the problem child technique' which revolves around the timing of disposing a subsidiary. The last is called 'use of derivatives technique' where managers hedge against future risks like fluctuations in exchange rates and prices changes.

There are many approaches in detecting earnings management but the Accrual-Based Models are the most popular approaches (CHEN, 2010). Analysis of earnings management often focuses on management's use of discretionary accruals. In these accrual-based models, researchers estimate the discretionary components of reported income.

The level of discretion as far accounting judgements are concerned is seen by the securities exchange commission of the United States as affecting accounting quality. To illustrate, SEC officials gave the example of bad debt expense. This

expense is discretionary because it is based on management estimates. Management can push it higher or lower by giving higher or lower estimates of the amount of sales that will be collectible in a given year. (Morris, 2014)

According to McLean (2000), the IBM should be a case study in relation to earning quality. IBM has maintained earnings per share at remarkable average rate of 27% a year since 1994 and market value has ballooned to around \$200 billion from less than \$30 billion. Observation is made to the extent that reported earnings may be an exaggeration and do not really reflect true earnings. When Earnings Management is analyzed, the Chief Executive is accused of ‘pulling earnings rabbits out of his hat’. Declining sales and Gross Profit Margins are some of the indicators that the 27% average growth in earnings per share cannot be as a result of business fundamentals but just brazen earnings management. ‘Even Wall Street, which has applauded Gerstner's performance so far, understands that rapid earnings growth, flat revenues, and shriveling profit margins aren't a lasting combination’. Accounting sleuths identified share buy-backs and pension plan income recognition as some of the ways IBM has employed in misrepresenting its earnings.

### **Healy Model of Accounting Quality**

Healy Model was the first accrual-based model developed to assess accounting quality. Healy stated that the firm's earnings are comprised of cash flows derived from operations, nondiscretionary accruals and discretionary accruals (Yurt & Ergun, May, 2015). Nondiscretionary accruals and cash flows are accounted for in a way that is determined by regulators. Discretionary accruals, on the other hand, can be recorded according to the accounting policies and methods that are determined by managers. The model assumes that managers – within the frame of the provided

opportunities – can influence the earnings amount by playing with discretionary accruals.

Healy assumes that the non-discretionary component of total accruals always remain fairly constant. Hence any change in total accruals must be caused by changes in discretionary accruals (Lee & Vetter, 2015) as shown below;

$$NDA_t = 1/n \sum_t (TA_t/A_{t-1})$$

Where  $NDA_t$  = Estimated non-discretionary accruals;

$TA$  = Total Accruals; and

$A_{t-1}$  = Lagged Total Assets. The figure here is subtracted from total Accruals and the difference is assumed to be discretionary accruals which is taken to be the level of Earnings Management. Total Accruals is arrived at as follows:

$$TAcc = (\Delta CA - \Delta Cash) - (\Delta CL - \Delta STD - \Delta TP) - DA$$

Where;

$TAcc$  = Total Accruals;

$\Delta CA$  = Change in current Assets;

$\Delta Cash$  = Change in Cash;

$\Delta CL$  = Change in Current Liabilities;

$\Delta STD$  = Change in Short term debts;

$\Delta TP$  = Change in Taxes Payable;

$DA$  = Depreciation and Amortization.

Accruals of less than 10% of lagged total assets are normally considered plausible (K.V. Peasnell, 1999).

A disadvantage of this method is that Non-Discretionary Accruals may not be constant as it is bound to change with a change in economic circumstance of the firm (Chaney, 1998). Other models have been developed which control for changes in

economic circumstances like increased sales. However, they require at least ten year financial data of the firm in addition to industry averages (Dechow, Sloan, & Sweeney, 1995).

### **Relationship between Internal Audit and Accounting Quality**

Some studies have been done to find out if there is any relationship between internal audit and accounting quality. Using abnormal accruals as a proxy for accounting quality, Cooper, Juhl, & Juhl (2013) found out that the association between internal audit quality and abnormal accruals is positive. This study is surprising as it denotes a negative relationship between internal audit quality and accounting quality. The researchers however qualify this relationship as dependent on whether firms outsource their internal audit activities and/or whether they are politically linked.

In estimations excluding outsourcing and political connections observations, (Cooper, Juhl, & Juhl, 2013) found out that the association between internal audit quality and abnormal accruals is negative and in particular internal audit organizational independence, financial focus audit activities and investment are associated with lower income-increasing (opportunistic) abnormal accruals.

Gary and Abbott (2016) found that internal audit quality affects financial statement quality. Further, internal audit functionality is primarily a function of internal auditor independence. Indeed auditor independence, as measured by fee ratio and total fee, is also a deterrent to earnings management. (Mark & Lin, 2010). In Nigeria Okolie, (2014) found that audit tenure and auditor independence exert significant effects and exhibit significant relationship with the amount of discretionary accruals of quoted companies. Douglass and Wood (2008) provided evidence that

earnings management is somehow moderated when internal audit function is deemed to be of high quality.

# **CHAPTER THREE**

## **RESEARCH METHODOLOGY**

This chapter describes the methodology employed in conducting the study. It specifies the research design, the study population or the area in which the study is to be conducted, the sampling design, the sample size, data sources, data collection instruments and the validity and reliability of the data collection instruments.

### **Research Design**

The study adopted a mix of evaluation Research Design and Correlational Research Design. It used evaluation design since it sought to evaluate the quality of a given function using a certain criteria. For instance, accounting quality was evaluated based on Healy's Earning Quality Assessment Model while internal audit functionality was evaluated against standards required by the professional body. Correlational research design was also utilized because existence of a relationship between internal audit functionality and accounting quality was explored with an aim to examine possible existence of causation.

### **Study Population**

The study population consisted of internal auditors in all the listed 62 companies which is the total listing of companies at the Nairobi Securities exchange as at May, 2016 according to Capital Markets Authority. This includes several companies from each of the ten industry segments. The industry segments include agricultural, automobile and accessories, banking, commercial and services, construction and allied, energy and petroleum, insurance, investment, manufacturing and allied and telecommunication and technology.

## **Sampling Design**

Purposive sampling design was used for this study. Purposive sampling techniques have also been referred to as nonprobability sampling or purposeful sampling or “qualitative sampling.” Purposive sampling techniques involve selecting certain units or cases “based on a specific purpose rather than randomly” (Teddlie & Yu, January, 2007).

According to Palys (2008), one well placed articulate informant will often advance the research far better than any randomly chosen sample of fifty. The researcher used purposive sampling in selecting companies based on ease of access.

### **Sample Size**

In line with the concept of ‘saturation’ or ‘information power’, (Kirsti, Siersma, & Guassora, 2016), the more information the sample holds, relevant for the actual study, the lower amount of participants is needed. Suggested minimums for sample size include from 3 to 20 times the number of variables in the study (Daniel, Shaw, & Ke, 2009) According to Role (2012), in the Handbook of business research methodology of the University of Eastern Africa, Baraton, correlational research design should have a minimum sample size of thirty. The handbook goes on to state that ‘sample accuracy is more important than sample size’.

Ten companies was the focus of the study. Three respondents were targeted for each of the ten companies to make a total of the thirty minimum required respondents. The respondents were internal auditors in the Internal Audit department of the selected companies. The randomness was to ensure that some level of objectivity is obtained. Internal auditors were selected as they relate directly to the research topic and hence best placed to answer the questionnaire.

The researcher assessed Earnings Management of the ten selected companies based on Healy's Earning Quality Assessment Model. Two year financial statement data was used to estimate Accruals. These were 2014 and 2015 financial statements.

### **Data Source**

Primary quantitative data was collected from the ten selected companies listed at the Nairobi Securities Exchange. This was done by the use of questionnaires designed to answer the research questions of the study particularly those pertaining to internal audit functionality.

To assess accounting quality, secondary data in the form of audited financial statements was used. Access to secondary data did not pose a challenge since such kind of data is normally in the public domain and can be accessed easily through company websites as mandated by Capital Markets Authority. This is because the Capital Markets Authority, which is the regulator of all listed companies, requires listed companies to publish their financial statements regularly. (Nairobi Stock Exchange Limited, 2014).

### **Research Instruments**

For testing Internal Audit Functionality, the research instrument was structured questionnaires with pre-coded answers administered to the respondents. All questionnaires constructed will be closed ended. A four point Likert scale will be used ranging from one to four; where 1=Disagree, 2=Tend to Disagree, 3= Tend to Agree and 4=Agree.

For testing Accounting quality, the Healy Model of Earnings Management was used (See Appendix B).

## **Validity and Reliability of Research Instrument**

The instrument was pre- tested and discussed with relevant research experts and the supervisors. Pilot study was then conducted at the Mumias Sugar Company which is listed at the Nairobi Securities Exchange. The evaluation of reliability of the research instrument was hampered by limited number of respondents. This was expected to be ameliorated by the actual research. The actual research returned fairly satisfactory research instrument reliability measures. For instance internal auditor structure returned a Cronbach's alpha of 0.828, management support returned a Cronbach's alpha of 0.752 while auditor independence returned a Cronbach's alpha of 0.591.

## **Data Gathering Procedures**

Before administering the research instrument, the researcher was given a letter of authorization from the Director of Research at the University of Eastern Africa, Baraton. The researcher went to the organizations selected for study and submitted the authorization letter from the Director of Research. The researcher was to wait for a few days then come and collect the filled-in questionnaires or receive an e-mailed copy of the same especially where his time at the location was limited. All but one of the ten companies returned the three questionnaires. The remaining company returned two instead of the submitted three. In total, twenty nine questionnaires were returned. On accounting quality, the data was easily obtained from the websites of the companies.

## **Statistical Treatment of Data**

The data collected was evaluated and cleared of errors before being analyzed with the use of Statistical Package for Social Sciences (SPSS) and presented in forms of tables and figures. Descriptive statistics such as frequencies, percentages, means,

standard deviations, and Pearson Product-Moment Correlation Coefficient was be used to analyze the data.

### **Ethical Considerations**

The anonymity of the respondents was upheld including the company identity. The respondents free consent to participate in the study was clearly expressed. Additionally, the purpose of the research was well articulated as of purely educational and not for any other reason.

## **CHAPTER FOUR**

### **PRESENTATION OF FINDINGS, ANALYSIS AND INTERPRETATION**

The researcher sought to establish to what extent the internal audit departments are truly functional. Also, the researcher sought to establish the degree to which accounting information as captured in the financial statements can be described as quality. Lastly, this research sought to establish a relationship between internal audit functionality and accounting quality at ten selected companies listed at the Nairobi Securities Exchange.

This chapter presents the statistical analyses, interpretation and observations of the findings of the research questions. The findings, analysis and interpretation followed the sequence of the research questions.

The administration of the questionnaires was 97% successful as only one respondent failed in submitting one questionnaire of the thirty which were administered. This was deemed sufficient enough for analysis.

#### **Profile of the Respondents**

The researcher obtained the profile of the respondents in terms of educational level and length of stay with the company. The choice of educational level and length of stay presupposes ability to understand the organization well and respond appropriately to the research question.

A majority of the respondents were holders of Bachelor's degree at 55.2%. This was followed by those with Master's degree at 31%. Lastly 13.8% of the respondents were holders of diploma certificates as shown in table 1.

Table 1

*Educational Level*

	Frequency	Percent
Diploma	4	13.8
Bachelor's degree	16	55.2
Master's degree	9	31.0
Total	29	100.0

Regarding the length of time with the company, those who have been with the company for periods of between 3 and five years were composed the majority of the respondents at 48.3%. This was closely followed by those who have been with the company for periods which range from 6 to 10 years at 41.4%. There were few fresh employees (those who have been at the company for a maximum of two years) at 10.3% of the total respondents as shown in table 2 below; This is desirable as it lends credence to the fact that majority of the respondents have been in the organization long enough to understand the systems and the processes and hence to respond appropriately to the research question.

Table 2

*Length of Time with the Company*

	Frequency	Percent
1-2 years	3	10.3
3-5 years	14	48.3
6-10 years	12	41.4
Total	29	100.0

The number of respondents at each of the selected companies is tabulated in table 3.

Table 3

*Number of Respondents per Company*

	Frequency	Percent
FIRM A	3	10.3
FIRM B	2	6.9
FIRM C	3	10.3
FIRM D	3	10.3
FIRM E	3	10.3
FIRM F	3	10.3
FIRM G	3	10.3
FIRM H	3	10.3
FIRM I	3	10.3
FIRM J	3	10.3
Total	29	100.0

### **Audit Functionality**

A functional internal audit is an internal audit which is set up and operationalized according to requisite professional standards. The essential ingredients that define the functionality of internal audit as encapsulated in the International Standards for the Professional Practice of Internal Auditing include independence, management support and structure

### **Internal Audit Structure**

The first parameter of assessing internal audit functionality was the internal audit structure. This is premised on the fact that a well-structured internal audit department positively contributes to internal audit functionality. A key barometer in assessing whether the operations and activities of the internal audit are structured is whether an internal audit plan prepared is risk-based, whether the risk areas encapsulated is broad enough, whether the internal audit plan prepared is in line with the goals and objectives of the organization, whether the Internal Audit Plan is

approved by the audit committee of the Board and whether there is a documented risk assessment instrument.

It was re-assuring to note that in all the selected companies, the audit plan prepared is approved by the audit committee of the board. This is as it should be. The research question returned a mean of 4.00 with no standard deviation.

On the flipside, the perception of the scope of risk areas covered in the audit plan showed the lowest mean of 3.00 and a standard deviation of 0.964. While on average, the respondents have a measure of confidence that the risk areas covered in internal audit is broad; their positive response is tinged with some level of reluctance and is not absolute. They don't agree but they 'tend to agree'. This is a pointer to the likelihood that the scope of the risk areas covered is not broad enough.

The focus of internal audit work has shifted over the last decade from systems-based auditing and process-based auditing to risk-based auditing. Internal auditors have responded strongly to management concerns about business risks from being control-driven to being business risk-driven. Internal auditors should play a key role in monitoring a company's risk profile. (Nuno, Rodrigues, & Russel, 2010).

The preparation of risk based audit plans is therefore the bare minimum as far as standards are concerned. Yet at a mean of 3.24, and a standard deviation of 0.83, majority of the respondents still only tend to agree that the internal audit plans prepared are risk-based. One would have expected a higher score of 4 denoting complete agreement, especially as the selected companies are those that are listed at the Nairobi Securities Exchange since listed companies are held to a higher level of compliance with regulatory frameworks, professional standards and best practices.

Internal audit plan should be flexible and adaptable to changing risk-profile of the organization. However, the flexibility of the internal audit plan in the selected companies also shows a ‘tend to agree’ mean of 3.17 as shown in table 4 below:

Table 4

*Internal Audit Structure Perceptions*

	Descriptive Statistics				
	N	Minimum	Maximum	Mean	Std. Deviation
The Internal Audit Plan prepared is risk-based.	29	2	4	3.24	.830
The scope of the risk areas is broad and includes such areas as Legal, Financial, Operational, Information Technology and Going concern.	29	2	4	3.00	.964
The internal audit plan prepared is flexible; matching the organization’s changing risk profile.	29	2	4	3.17	.805
The internal audit plan prepared is in line with the goals and objectives of the organization.	29	1	4	3.48	.688
The Internal Audit Plan is approved by the audit committee of the Board.	29	4	4	4.00	.000
There is a documented risk assessment instrument.	29	2	4	3.34	.553
<b>Internal audit structure</b>	<b>29</b>	<b>2.33</b>	<b>4.00</b>	<b>3.3736</b>	<b>.52261</b>

Today’s internal audit functions are achieving their objectives and improving their operations by being resourceful and flexible, engaging in on-going and meaningful dialogue with management about internal audit activities, and *their alignment with the company’s goals* (Protiviti, 2008) (Emphasis supplied).

As highlighted in table 4 , the perception of alignment of the internal audit plan with the goals and objectives of the organization is not bad at a mean of 3.48 and a standard deviation of 0.688.

On documentation of risk assessment instrument, variability, or standard deviation stood at 0.553 while the mean held at 3.34. Again, this is a parameter where complete agreement was expected bearing in mind that the sampled respondents are companies listed at the Nairobi Securities Exchange.

### **Internal Audit Independence**

Another parameter of assessing internal audit functionality is Internal Audit Independence. The internal audit activity should be independent, and internal auditors should be objective in performing their work.

To maintain internal audit independence, the internal audit department should maintain dual reporting structure both to the executive and the audit committee of the Board of Governors. The Internal Audit staff should never be engaged in routine operational activities. Additionally, there should never be any limitation of scope with respect to the work of internal audit department and they should be guaranteed access to all records and minutes of executive meetings. Lastly, the internal audit department should be removed from political pressures to conduct audits without any fear of reprisals.

According to the findings, the greatest perceived threat to internal auditor independence is the political pressures. On whether the internal audit department is removed from political pressures to conduct audits without any fear of reprisals, there was a disappointing mean of 2.59, which tends towards absolute disagreement. Another distressing finding revolves around the requirement that internal auditors should never be engaged in routine operational activities. At a mean of 2.69 and a

standard deviation of 0.806, the findings reveal an environment where internal auditors are perceived to be engaged in routine operational activities. This may negatively affect their independence and also limit their productivity and effectiveness.

On limitation of scope and access of all required records, the mean of 2.97 is still not desirable especially regarding the nature of the companies selected for this research.

On a brighter side, in all the companies selected, the internal audit department maintains dual reporting structure both to the executive and the audit committee of the Board of Governors. Perceived disclosure credibility was found to be significantly higher when the Chief Audit Executive reported functionally to the audit committee and administratively to the CEO (Travis, 1986). Dual reporting structure of this nature is a requirement by the Institute of Internal Auditors. The practice advisory on internal auditor independence reads that ‘the institute believes strongly that to achieve necessary independence, the Chief Audit Executive should report functionally to the audit committee or its equivalent. For administrative purposes, in most circumstances, the Chief Audit Executive should report directly to the chief executive officer of the organization.’

Table 5 shows a tabulation of the research findings on perceived internal auditor independence.

Table 5

*Perceived Internal Auditor Independence*

<b>Descriptive Statistics</b>					
	N	Minimum	Maximum	Mean	Std. Deviation
The internal audit department maintains dual reporting structure both to the executive and the audit committee of the Board of Governors.	29	4	4	4.00	.000
The Internal Audit staff is never engaged in routine operational activities.	29	1	4	2.69	.806
There is no limitation of scope with respect to the work of internal audit department and they are guaranteed access to all records and minutes of executive meetings.	29	1	4	2.97	.823
The internal audit department is removed from political pressures to conduct audits without any fear of reprisals.	29	1	4	2.59	1.296
<b>Internal audit independence</b>	<b>29</b>	<b>2.25</b>	<b>4.00</b>	<b>3.0603</b>	<b>.58116</b>

**Management Support**

Internal audit department functionality can greatly be enhanced if there is support from the management. In a study among shareholding companies in Jordan, study results demonstrated a positive statistical association between composite dimensions of management support and improvement of internal auditors. Specifically, the study supported a steady association between management support and internal auditor's performance level improvement.

Table 6 shows a tabulation of the findings on management support.

Table 6

*Perceived Management Support*

<b>Descriptive Statistics</b>					
	N	Minimum	Maximum	Mean	Std. Deviation
There is a positive response to the recommendations in the audit findings.	29	2	4	3.03	.421
The Internal Audit Function have an approved, adequate budget.	29	3	4	3.34	.484
There is a competent and diversified skill pool in the internal audit.	29	1	4	3.00	1.102
Continuous professional education is supported and promoted by the executive management.	29	2	4	2.97	.865
<b>Management support</b>	<b>29</b>	<b>2.25</b>	<b>3.75</b>	<b>3.0862</b>	<b>.58354</b>

In this study, management support was evaluated through using four parameters. The first one was whether there is a positive response to the recommendations in the audit findings. Secondly assessment was done on whether the Internal Audit Function have an approved, adequate budget. Another factor was the skill pool in the internal audit; the level of their competence and skill diversification. The last parameter was whether Continuous professional education is supported and promoted by the executive management.

The lowest ranked at a mean of 2.97 and a standard deviation of 0.865 was support for professional education. Management seems not be very keen on professional growth of internal auditors at the selected companies.

At a mean of 3.00 the respondents tend to agree that there is a competent and diversified skill-pool in the internal audit department. On positive response to

recommendations of audit findings, the response had a mean of 3.03 and a standard deviation of 0.421 again showing inclination to agree with the research question. The best performer in this category however was the parameter of adequate and approved budget but still at a mean of only 3.34 which still does not denote complete agreement. Actually in the parameter of management support no single factor returned a response of '4' which would have denoted absolute agreement.

### **Internal Audit Functionality: Summary of Findings**

The parameter that returned the best perception with regard to internal audit functionality was Internal Audit structure with a mean response of 3.37. This was followed by the parameter of Management support at 3.08. Internal audit independence was perceived to be the most unfavorable at 3.06. The overall perception of internal audit functionality was an average of 3.17 as shown below in table 7.

Table 7

#### *Overall Perception of Internal Auditor Functionality*

Internal Audit structure	3.37
Management Support	3.08
Internal Audit Independence	3.06
	9.51
Average of the 3 Parameters (9.51/3)	3.17

This shows that the respondents tended to agree with the perceived fact of internal audit functionality.

## Accounting Quality

Accounting quality has been defined as the ability of accounting measures to reflect the economic position and performance of a firm. (Verleun et al., 2011).

Earnings management is singled out as the *most frequently* applied metric for measuring accounting quality and has been summarized as the ability of management to use judgment in financial reporting to either mislead some stakeholders or to influence contractual outcomes at their own benefits.

Healy Model was the first model developed to measure Earnings Management. Healy stated that the firm's earnings are comprised of cash flows derived from operations, nondiscretionary accruals and discretionary accruals (Yurt & Ergun, May, 2015). Nondiscretionary accruals and cash flows are accounted for in a way that is determined by regulators. Discretionary accruals, on the other hand, can be recorded according to the accounting policies and methods that are determined by managers. The model assumes that managers – within the frame of the provided opportunities – can influence the earnings amount by playing with discretionary accruals.

Healy assumes that the non-discretionary component of total accruals always remain fairly constant. Hence any change in total accruals must be caused by changes in discretionary accruals (Lee & Vetter, 2015) as shown below;

$$NDA_t = 1/n \sum_t (TA_t/A_{t-1})$$

Where  $NDA_t$  = Estimated non-discretionary accruals;

$TA$  = Total Accruals; and

$A_{t-1}$  = Lagged Total Assets. The figure here is subtracted from total Accruals and the difference is assumed to be discretionary accruals which is taken to be the level of

Earnings Management. Total Accruals is arrived at as follows:

$$TAcc = (\Delta CA - \Delta Cash) - (\Delta CL - \Delta STD - \Delta TP) - DA$$

Where;

TAcc = Total Accruals;

$\Delta CA$  = Change in current Assets;

$\Delta Cash$  = Change in Cash;

$\Delta CL$  = Change in Current Liabilities;

$\Delta STD$  = Change in Short term debts;

$\Delta TP$  = Change in Taxes Payable;

DA = Depreciation and Amortization.

Accruals of less than 10% of lagged total assets are normally considered plausible (K.V. Peasnell, 1999).

The following were the findings:

<b>FIRM A</b>			
	2015	2014	2013
<b>Current Assets</b>	2,543,549,000.00	4,353,304,000.00	7,048,364,000
▲	(1,809,755,000.00)	(2,695,060,000.00)	
<b>Cash</b>	18,759,000.00	31,248,000.00	70,923,000
▲	(12,489,000.00)	(39,675,000.00)	
<b>Current Liabilities</b>			
	13,670,007,000.00	10,635,149,000.00	8,408,773,000
▲	3,034,858,000.00	2,226,376,000.00	
<b>Short Term Debts</b>			
Borrowings	5,569,017,000.00	5,245,518,000.00	4,844,672,000
Provision for Service Gratuity	29,093,000.00	17,350,000.00	5,652,000
	5,598,110,000.00	5,262,868,000.00	4,850,324,000
▲	335,242,000.00	412,544,000.00	
Tax Payable	-	-	-
▲	-	-	-
Dep & Amortization	3,653,683,000.00	1,246,083,000.00	1,189,377,000
▲	2,407,600,000.00	56,706,000.00	
<b>Total Accruals</b>	$T_{Acc} = (\Delta CA - \Delta Cash) - (\Delta CL - \Delta STD - \Delta TP) - DA$		
	(8,150,565,000.00)	(5,715,300,000.00)	
<b><math>NDA_t = 1/n \sum_t (TA_t/A_{t-1})</math></b>			
TA	(8,150,565,000.00)	(5,715,300,000.00)	
A(t-1)	20,432,980,000.00	23,563,086,000.00	
TA/A(t-1)	(0.40)	(0.24)	
$1/n \sum_t (TA_t/A_{t-1})$	(0.32)		
<b>Accruals should be less than 10% of lagged total assets</b>			
<i>In this case it is</i>	32%		

<b>FIRM B</b>			
	2015	2014	2013
<b>Current Assets</b>	41,052,000,000.00	29,636,000,000.00	28,608,000,000
▲	11,416,000,000.00	1,028,000,000.00	
<b>Cash</b>	3,267,000,000.00	11,218,000,000.00	14,393,000,000
▲	(7,951,000,000.00)	(3,175,000,000.00)	
<b>Current Liabilities</b>			
	81,753,000,000.00	63,756,000,000.00	50,841,000,000
▲	17,997,000,000.00	12,915,000,000.00	
<b>Short Term Debts</b>			
Borrowings	43,609,000,000.00	38,892,000,000.00	30,544,000,000
Fuel Derivatives	6,928,000,000.00	-	-
	50,537,000,000.00	38,892,000,000.00	30,544,000,000
▲	11,645,000,000.00	8,348,000,000.00	
Tax Payable	30,000,000.00	-	-
▲	30,000,000.00	-	-
Dep & Amortization	12,080,000,000.00	6,886,000,000.00	5,534,000,000
▲	5,194,000,000.00	1,352,000,000.00	
<b>Total Accruals</b>	$TA_{Acc} = (\Delta CA - \Delta Cash) - (\Delta CL - \Delta STD - \Delta TP) - DA$		
	965,000,000.00	(7,250,000,000.00)	
$NDA_t = 1/n \sum_t (TA_t/A_{t-1})$			
TA	965,000,000.00	(7,250,000,000.00)	
A(t-1)	29,636,000,000.00	28,608,000,000.00	
TA/A(t-1)	0.03	(0.25)	
$1/n \sum_t (TA_t/A_{t-1})$	(0.11)		
<b>Accruals should be less than 10% of lagged total assets</b>			
<i>In this case it is</i>	11%		

<b>FIRM C</b>			
	2015	2014	2013
<b>Current Assets</b>	171,259,093,500.00	142,698,033,500.00	115,607,679,000
▲	28,561,060,000.00	27,090,354,500.00	
<b>Cash</b>	29,455,691,000.00	24,335,332,000.00	20,713,169,000
▲	5,120,359,000.00	3,622,163,000.00	
<b>Current Liabilities</b>			
	146,348,810,000.00	121,259,474,000.00	97,315,683,500
▲	25,089,336,000.00	23,943,790,500.00	
<b>Short Term Debts</b>			
	-	-	-
▲	-	-	
<b>Tax Payable</b>	3,944,959,000.00	3,453,288,000.00	1,764,259,000.00
▲	491,671,000.00	1,689,029,000.00	-
<b>Dep &amp; Amortization</b>	2,357,625,000.00	1,707,772,000.00	2,296,101,000
▲	649,853,000.00	(588,329,000.00)	
<b>Total Accruals</b>	TAcc = ( $\Delta CA - \Delta Cash$ ) - ( $\Delta CL - \Delta STD - \Delta TP$ ) - DA		
	(3,514,589,000.00)	(494,342,000.00)	
<b>NDA<sub>t</sub> = 1/n <math>\sum_t (TA_t/A_{t-1})</math></b>			
TA	(3,514,589,000.00)	(494,342,000.00)	
A(t-1)	285,396,067,000.00	228,874,484,000.00	
TA/A(t-1)	(0.01)	(0.00)	
1/n $\sum_t (TA_t/A_{t-1})$	(0.01)		
<b>Accruals should be less than 10% of lagged total assets</b>			
<i>In this case it is</i>	1%		

<b>FIRM D</b>			
	2016	2015	2014
<b>Current Assets</b>	29,940,441,000	32,590,553,000	28,321,468,000
▲	(2,650,112,000.00)	4,269,085,000	
<b>Cash</b>	6,109,493,000	11,916,371,000	17,618,884,000
▲	(5,806,878,000.00)	(5,702,513,000.00)	
<b>Current Liabilities</b>			
	42,443,538,000	52,190,333,000	38,262,587,000
▲	(9,746,795,000.00)	13,927,746,000.00	
<b>Short Term Debts</b>			
Borrowings	-	10,149,218,000	7,513,000,000
Fuel Derivatives	-	-	-
▲	(10,149,218,000.00)	10,149,218,000.00	7,513,000,000
		2,636,218,000.00	
Tax Payable	17,658,215,000	14,278,242,000	11,966,890,000
▲	3,379,973,000.00	2,311,352,000.00	-
Dep & Amortization	27,943,000	25,570,000	25,787,000
▲	2,373,000.00	(217,000.00)	
Total Accruals	TAcc = (ΔCA - ΔCash) - (ΔCL-ΔSTD - ΔTP) - DA		
	6,106,373,000.00	965,852,000.00	
$NDA_t = 1/n \sum_t (TA_t/A_{t-1})$			
TA	6,106,373,000.00	965,852,000.00	
A(t-1)	156,957,626,000.00	135,647,496,000.00	
TA/A(t-1)	0.04	0.01	
$1/n \sum_t (TA_t/A_{t-1})$	0.02		
<b>Accruals should be less than 10% of lagged total assets</b>			
<i>In this case it is</i>	2%		

<b>FIRM E</b>			
	2016	2015	2014
<b>Current Assets</b>	254,876,000,000	235,840,000,000	220,778,000,000
▲	19,036,000,000.00	15,062,000,000	
<b>Cash</b>	13,378,000,000	18,180,000,000	24,568,000,000
▲	(4,802,000,000.00)	(6,388,000,000.00)	
<b>Current Liabilities</b>	108,715,000,000	100,720,500,000	93,880,500,000
▲	7,994,500,000.00	6,840,000,000.00	
<b>Short Term Debts</b>			
Borrowings	1,289,750,000.00	1,283,250,000	544,250,000
		-	-
	1,289,750,000.00	1,283,250,000.00	544,250,000
▲	6,500,000.00	739,000,000.00	
Tax Payable	3,328,000,000	3,673,000,000	3,906,000,000
▲	(345,000,000.00)	(233,000,000.00)	-
Dep & Amortization	1,192,000,000	1,054,000,000	1,070,000,000
▲	138,000,000.00	(16,000,000.00)	
Total Accruals	TAcc = (ΔCA - ΔCash) – (ΔCL-ΔSTD - ΔTP) - DA		
	14,313,000,000.00	14,062,000,000.00	
$NDA_t = 1/n \sum_t (TA_t/A_{t-1})$			
TA	14,313,000,000.00	14,062,000,000.00	
A(t-1)	240,877,000,000.00	225,841,000,000.00	
TA/A(t-1)	0.06	0.06	
$1/n \sum_t (TA_t/A_{t-1})$	0.06		
<b>Accruals should be less than 10% of lagged total assets</b>			
<i>In this case it is</i>	6%		

<b>FIRM F</b>			
	2016	2015	2014
<b>Current Assets</b>	104,225,957,500	90,499,492,500	90,255,898,500
▲	13,726,465,000.00	243,594,000	
<b>Cash</b>	11,350,098,000	9,555,580,000	9,466,550,000
▲	1,794,518,000.00	89,030,000.00	
<b>Current Liabilities</b>	85,043,543,000	72,051,896,000	74,043,003,000
▲	12,991,647,000.00	(1,991,107,000.00)	
<b>Short Term Debts</b>			
Borrowings	3,983,025,000.00	1,126,783,880	1,461,938,000
		-	-
	3,983,025,000.00	1,126,783,880.00	1,461,938,000
▲	2,856,241,120.00	(335,154,120.00)	
Tax Payable	2,453,680,000	2,013,585,000	2,096,849,000
▲	440,095,000.00	(83,264,000.00)	-
Dep & Amortization	503,832,000	556,912,000	623,358,000
▲	(53,080,000.00)	(66,446,000.00)	
Total Accruals	TAcc = (ΔCA - ΔCash) - (ΔCL-ΔSTD - ΔTP) - DA		
	1,732,804,120.00	1,170,340,880.00	
$NDA_t = 1/n \sum_t (TA_t/A_{t-1})$			
TA	1,732,804,120.00	1,170,340,880.00	
A(t-1)	180,998,985,000.00	180,511,797,000.00	
TA/A(t-1)	0.01	0.01	
$1/n \sum_t (TA_t/A_{t-1})$	0.01		
<b>Accruals should be less than 10% of lagged total assets</b>			
<i>In this case it is</i>	1%		

<b>FIRM G</b>			
	2015	2014	2013
<b>Current Assets</b>	7,524,900,000	7,375,000,000	7,566,300,000
▲	149,900,000.00	(191,300,000)	
<b>Cash</b>	2,792,000,000	3,087,500,000	3,500,000,000.00
▲	(295,500,000.00)	(412,500,000.00)	
<b>Current Liabilities</b>	2,783,800,000.00	2,539,600,000.00	2,484,200,000.00
▲	244,200,000.00	55,400,000.00	
<b>Short Term Debts</b>			
Borrowings	38,100,000.00	27,500,000.00	26,400,000.00
		-	-
	38,100,000.00	27,500,000.00	26,400,000.00
▲	10,600,000.00	1,100,000.00	
Tax Payable	600,500,000	1,163,500,000.00	1,053,900,000.00
▲	(563,000,000.00)	109,600,000.00	-
Dep & Amortization	574,900,000	636,300,000	466,900,000
▲	(61,400,000.00)	169,400,000.00	
Total Accruals	TAcc = (ΔCA - ΔCash) - (ΔCL-ΔSTD - ΔTP) - DA		
	(926,100,000.00)	(359,800,000.00)	
$NDA_t = 1/n \sum_t (TA_t/A_{t-1})$			
TA	(926,100,000.00)	(359,800,000.00)	
A(t-1)	11,944,300,000.00	11,444,200,000.00	
TA/A(t-1)	(0.08)	(0.03)	
$1/n \sum_t (TA_t/A_{t-1})$	(0.05)		
<b>Accruals should be less than 10% of lagged total assets</b>			
<i>In this case it is</i>	5%		

<b>FIRM H</b>			
	2015	2014	2013
<b>Current Assets</b>	25,491,155,000	19,807,154,000	18,593,102,000
▲	5,684,001,000.00	1,214,052,000	
<b>Cash</b>	3,005,133,000	1,101,400,000	1,406,091,000.00
▲	1,903,733,000.00	(304,691,000.00)	
<b>Current Liabilities</b>	24,930,769,000.00	27,460,650,000.00	26,606,846,000.00
▲	(2,529,881,000.00)	853,804,000.00	
<b>Short Term Debts</b>			
Borrowings	4,898,623,000.00	12,545,500,000.00	4,951,344,000.00
		-	-
	4,898,623,000.00	12,545,500,000.00	4,951,344,000.00
▲	(7,646,877,000.00)	7,594,156,000.00	
Tax Payable	4,616,027,000	3,541,370,000.00	4,592,719,000.00
▲	1,074,657,000.00	(1,051,349,000.00)	-
Dep & Amortization	3,601,201,000	3,237,389,000	2,976,630,000
▲	363,812,000.00	260,759,000.00	
<b>Total Accruals</b>	$T_{Acc} = (\Delta CA - \Delta Cash) - (\Delta CL - \Delta STD - \Delta TP) - DA$		
	(3,863,272,000.00)	3,970,357,000.00	
$NDA_t = 1/n \sum_t (TA_t/A_{t-1})$			
TA	(3,863,272,000.00)	3,970,357,000.00	
A(t-1)	62,865,943,000.00	57,720,462,000.00	
TA/A(t-1)	(0.06)	0.07	
$1/n \sum_t (TA_t/A_{t-1})$	0.07		
<b>Accruals should be less than 10% of lagged total assets</b>			
<i>In this case it is</i>	7%		

<b>FIRM I</b>			
	2015	2014	2013
<b>Current Assets</b>	1,704,446,000.00	1,491,019,000.00	1,643,577,000.00
▲	213,427,000.00	(152,558,000)	
<b>Cash</b>	34,453,000	32,022,000	19,514,000.00
▲	2,431,000.00	12,508,000.00	
<b>Current Liabilities</b>	1,787,245,000.00	1,222,941,000.00	1,421,651,000.00
▲	564,304,000.00	(198,710,000.00)	
<b>Short Term Debts</b>			
Borrowings	956,929,000	613,534,000.00	613,023,000.00
		-	-
	956,929,000.00	613,534,000.00	613,023,000.00
▲	343,395,000.00	511,000.00	
Tax Payable	-	105,569,000.00	111,187,000.00
▲	(105,569,000.00)	(5,618,000.00)	-
Dep & Amortization	380,663,000	303,590,000	283,101,000
▲	77,073,000.00	20,489,000.00	
Total Accruals	TAcc = (ΔCA - ΔCash) - (ΔCL-ΔSTD - ΔTP) - DA		
	(496,145,000.00)	(275,053,000.00)	
$NDA_t = 1/n \sum_t (TA_t/A_{t-1})$			
TA	(496,145,000.00)	(275,053,000.00)	
A(t-1)	4,101,749,000.00	4,162,469,000.00	
TA/A(t-1)	(0.12)	(0.07)	
$1/n \sum_t (TA_t/A_{t-1})$	(0.09)		
<b>Accruals should be less than 10% of lagged total assets</b>			
<i>In this case it is</i>	9%		

<b>FIRM J</b>			
	2015	2014	2013
<b>Current Assets</b>	2,765,545,000.00	2,872,111,000.00	2,822,531,000.00
▲	(106,566,000.00)	49,580,000	
<b>Cash</b>	506,684,000	361,616,000	482,833,000.00
▲	145,068,000.00	(121,217,000.00)	
<b>Current Liabilities</b>	1,254,205,000.00	1,137,995,000.00	836,561,000.00
▲	116,210,000.00	301,434,000.00	
<b>Short Term Debts</b>			
<b>Borrowings</b>			
	-	-	-
▲	-	-	-
Tax Payable	23,645,000	0.00	26,052,000.00
▲	23,645,000.00	(26,052,000.00)	-
Dep & Amortization	179,000,000	152,000,000	95,000,000
▲	27,000,000.00	57,000,000.00	
<b>Total Accruals</b>	$TAcc = (\Delta CA - \Delta Cash) - (\Delta CL - \Delta STD - \Delta TP) - DA$		
	(523,199,000.00)	(308,689,000.00)	
$NDA_t = 1/n \sum_t (TA_t/A_{t-1})$			
TA	(523,199,000.00)	(308,689,000.00)	
A(t-1)	3,857,392,000.00	3,668,487,000.00	
TA/A(t-1)	(0.14)	(0.08)	
$1/n \sum_t (TA_t/A_{t-1})$	(0.11)		
<b>Accruals should be less than 10% of lagged total assets</b>			
<i>In this case it is</i>	11%		

## Accounting Quality Findings: Summary

In three of the ten companies, the level of accounting quality was found to be undesirable. Total accruals as a percentage of lagged assets was found to be more than the desirable cap of 10% in the three of the ten selected companies. According to Healy Model, all these accruals denote discretionary accruals which are susceptible to management shenanigans and tricks.

Managers have varied ways of tweaking accruals especially discretionary accruals. This include under-provisioning for bad debt expenses, delaying of asset write-offs and opportunistic selection of accounting methods.

This research finding, if it was to be extrapolated, means 30% of firms listed at the Nairobi Stock Exchange show significantly high levels of earnings management and hence poor accounting quality of financial information as captured in the financial statements. The following is a tabulation of the finding;

### Levels of Earnings Management

Company	Level of Earnings Management
A	32%
B	11%
C	1%
D	2%
E	6%
F	1%
G	5%
H	7%
I	9%
J	11%

## Relationship between Audit Functionality and Accounting Quality

Is the relationship between internal audit functionality and accounting quality significant? Table 8 gives the answer. The research findings show a significant relationship between internal audit functionality and accounting quality.

Table 8

### *Correlation between Audit Functionality and Accounting Quality*

			Internal audit structure	Internal audit independence	Management support
Spearman's rho	ACCOUNTING QUALITY USING ACCRUALS/ EARNINGS MANAGEMENT	Correlation Coefficient	-.686**	-.526**	-.617**
		Sig. (2-tailed)	.000	.003	.000
		N	29	29	29

\*\* . Correlation is significant at the 0.01 level (2-tailed).

The negative correlation coefficient implies that the companies with better internal audit departments' functionality tend to have lower accruals percentages hence better accounting quality since accrual level was the measure of accounting quality adopted in the study. This shows that there is indeed a relationship between internal audit functionality and accounting quality.

The null hypothesis was that there is no significant relationship between internal audit functionality and accounting quality while the alternative hypothesis presupposed the existence of a relationship between internal audit functionality and accounting quality. The implication of the correlation measures is that the null hypothesis has been rejected and the alternative hypothesis has been accepted.

Also, among the 3 indicators of internal audit department's functionality, internal audit structure is the best determinant of accounting quality. This shows that the best predictor of accounting quality is internal audit structure. It accounts for 35.5% of the variance in accounting quality as shown below.

Table 9

*Regression Model Summary*

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.615 <sup>a</sup>	.378	.355	6.990

# **CHAPTER FIVE**

## **SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS**

In this chapter, summary of the main findings are presented and conclusions are drawn. Recommendations for action are made and areas for further research are also identified.

### **Summary**

The main aim of the study was to find out whether a relationship exists between internal audit functionality and accounting quality in ten selected companies listed at the Nairobi Securities Exchange.

The indicators of audit functionality were identified as internal audit structure, internal audit independence and management support. Questionnaires were administered at the ten purposefully selected companies. Accounting quality was evaluated using a model which regards high levels of percentile changes in accruals to be a marker of poor accounting quality. The model is called Healy earnings management model.

Descriptive statistics such as percentages, frequencies, means, standard deviations and Pearson product-moment correlation coefficient was used to analyze the data using the SPSS program.

### **Summary of Findings**

1. Research findings on internal audit structure:
  - (a) As pertains to appropriateness of internal audit structure as a measure of internal audit functionality, majority of the respondents tended to agree that

their internal audit departments have correct structures to be functional. This parameter returned a mean of 3.37 with a standard deviation of 0.52.

(b) On the individual measures of internal audit structure; the approval of the internal audit plan by the audit committee of the board was the best perceived performer with a mean of 4.00 indicating total agreement.

(c) In the selected companies, scope of risk areas covered was the least performer as a measure of internal audit structure returning a mean of 3.00.

(d) All the other measures of internal audit structure like preparation of risk based audit plans, flexibility of internal audit plan, alignment of internal audit plan with goals and objectives of the organization and documentation of risk assessment instrument ranged from 3.17 to 3.48.

## 2. Research finding on internal audit independence:

(a) On auditor independence, which is always a standard requirement, the majority of the respondents tended to approve the independence of internal audit departments at an average mean of 3.06.

(b) Of the individual markers of internal audit independence, maintenance of dual reporting structure was the best performer, returning a mean of 4.00. This basically means that all the selected companies maintain a dual reporting structure of the internal audit department both to the audit committee of the board and the executive.

(c) Political pressure was perceived to be the greatest risk of internal auditor independence in the selected companies returning a mean of only 2.59.

(d) There was a marginal approval of the other parameters of internal auditor independence. Non-engagement in routine operational activities returned a disappointing mean of 2.69 showing almost a balance between tendency to

agree and tendency to disagree. Non-limitation of scope stood at 2.97 showing a tendency to agree, albeit on a minimal scale.

3. Research finding on management support:

(a) On management support, majority of respondents tended to agree that internal audit departments receive management support. Management support had a mean of 3.08.

(b) Approval and adequacy of the budget, as a measure of management support, was the most highly perceived indicator but only with a mean of 3.34 which is a tendency to agree. Support and promotion of continuous professional education was the least indicator at a mean of 2.97.

(c) Positive response to audit findings and quality of staff at the internal audit department stood at 3.03 and 3.00 respectively.

4. Of all the parameters of internal audit functionality, internal audit independence was found to be the least perceived at a mean of 3.06

5. Accounting quality was evaluated using an earnings management model. The model assumes that the higher the levels of earnings management as indicated by the percentage increment in discretionary accruals, the lower the accounting quality. The research findings are tabulated below. 10% being the cap, three companies were found to be having accounting quality of levels that are less than satisfactory. This represents 30%.

6. Finally, it was found that companies with better internal audit departments' functionality tend to have lower accruals percentages and hence better accounting quality.

## **Conclusions**

The business environment has witnessed the sudden collapse of companies which had internal audit departments and hitherto showed glowing financial information as captured in the financial statements. The researcher therefore probed the functionality of the internal audit departments and the quality of the financial information presented to the shareholders perceiving that the problem could be lying in those two areas and whether there was a relationship between the two aforementioned areas.

On the basis of the results of the study, the researcher believes that there is still ground to be covered in internal auditor independence especially as regards political pressures that clouds the operation of the internal auditor and the engagement of internal auditors on routine operational activities. These are factors that may be impeding the functionality of internal audit departments and contributing to the financial bubble-bursts.

On the flip-side, the levels of discretionary accruals as an indicator of accounting quality still needs to be managed. This is because thirty percent of the companies showed unacceptably higher levels of accruals management.

There is a significant positive relationship between internal audit functionality and accounting quality as measured by change in accrual levels. This seems to lend credence to an earlier study by Cooper, Johl, & Johl, (2013).

## **Recommendations**

1. Listed companies are required by statute to report annually on corporate governance. There should be a requirement that they should include a statement on internal auditor independence as part of their report on corporate governance. Especially should there be mandated a declaration concerning the

freedom from political pressures, non-engagement in routine activities and the extent of scope. The statement should be signed by the Chief Audit Executive and the chairman of the Audit Committee if the Board.

2. Since management support is a key indicator of internal audit functionality and whereas provision for continuous education is an important marker of management support, in view of the low rating of this indicator, managers should have incentives for supporting continuous education. Expenses in relation to professional development may for starters be recognized as tax deductible expenses.
3. Concerted efforts should be carried out by the capital markets authority and the relevant professional bodies on educating management of listed companies on the importance of internal auditor independence.
4. Ways of managing discretionary accruals should be explored by the International Federation of Accountants and other accounting professional bodies. An example is write-off of bad debts. Listed companies should for instance be allowed to write off bad debts only when a report of a duly registered debt collection agency is annexed.

### **Recommendations for Further study**

This study explored the relationship between internal audit functionality and accounting quality. The level of earnings management as a measure of accounting quality was adopted. Earnings management was predicated on the level of accruals especially discretionary accruals. For this study, a two year analysis of financial statement was done. Studies with shorter time spans may be influenced by the presence of one-off financial events. There is therefore need for a similar study of

listed companies at the Nairobi securities exchange but with time-spans of between 5 to 10 years



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## APPENDIX A: INTERNAL AUDIT QUESTIONNAIRE

**Instructions:** (Please read the instructions given and answer the questions as appropriately as possible). It is advisable you answer or fill in each section as provided. Make an attempt to answer every question fully and correctly.

### SECTION A: BACKGROUND INFORMATION OF RESPONDENTS

1. Educational Level: Diploma ( ) Bachelor Degree ( ) Masters ( ) Doctorate ( ) Any other (Specify).....
2. Length of time with aforementioned company: Less than 1year ( ) 1-2years ( ) 3-5years ( ) Above 6 years ( )

### SECTION B: INTERNAL AUDITOR PERCEPTION

Circle one of the four point scale that best reflects your opinion where **1 represents disagree (D), 2 = Tend to Disagree (TD), 3 = Tend to Agree (TA), 4 = Agree (A).**

**Evaluating internal audit functionality.**

NO	STATEMENT	D	TD	TA	A
	<b>Assessment of Internal Audit Structure</b>				
1	The Internal Audit Plan prepared is <i>risk-based</i> and is based.	1	2	3	4
2	The scope of the risk areas is <i>broad</i> and includes such areas as Legal, Financial, Operational, Information Technology and Going concern.	1	2	3	4
3	The internal audit plan prepared is <i>flexible</i> ; matching the organization's changing risk profile.	1	2	3	4
4	The internal audit plan prepared is in line with the goals and objectives of the organization.	1	2	3	4
5	The Internal Audit Plan is approved by the audit committee of the Board?	1	2	3	4
6	There is a documented risk assessment instrument.	1	2	3	4

	<b>Assessment of Internal Audit Independence</b>				
7	The internal audit department maintains dual reporting structure both to the executive and the audit committee of the Board of Governors.	1	2	3	4
8	The Internal Audit staff is never engaged in routine operational activities..	1	2	3	4
9	There is no limitation of scope with respect to the work of internal audit department. They also access all records and minutes of executive meetings.	1	2	3	4
10	The internal audit department is removed from political pressures to conduct audits without any fear of reprisals.	1	2	3	4
	<b>Assessment of Management Support.</b>				
11	There is a positive response to the recommendations in the audit findings?	1	2	3	4
12	The Internal Audit Function have an approved, adequate budget.	1	2	3	4
13	There is a competent and diversified skill pool in the internal audit.	1	2	3	4
14	Continuous professional education is supported and promoted by the executive management.	1	2	3	4

**Thank You for Participating**

## APPENDIX B: HEALY'S EARNING QUALITY ASSESMENT MODEL

$$NDA_t = 1/n \sum_t (TA_t/A_{t-1})$$

Where  $NDA_t$  = Estimated non-discretionary accruals;

$TA$  = Total Accruals; and

$A_{t-1}$  = Lagged Total Assets. The figure here is subtracted from total Accruals and the difference is assumed to be discretionary accrual which is taken to be the level of Earnings Management. Total Accruals is arrived at as follows:

$$TAcc = (\Delta CA - \Delta Cash) - (\Delta CL - \Delta STD - \Delta TP) - DA$$

Where;

$TAcc$  = Total Accruals;

$\Delta CA$  = Change in current Assets;

$\Delta Cash$  = Change in Cash;

$\Delta CL$  = Change in Current Liabilities;

$\Delta STD$  = Change in Sort term debts;

$\Delta TP$  = Change in Taxes Payable;

$DA$  = Depreciation and Amortization.

Accruals of less than 10% of lagged total assets are normally considered plausible (K.V. Peasnell, 1999).

## **APPENDIX D: LETTER OF INTRODUCTION**

June 10, 2016

Dear Respondent,

I am Jeff Oganga, a postgraduate student in MBA at the University of Eastern Africa, Baraton. I am currently collecting data for my research thesis entitled 'Relationship Between Internal Audit Functionality and Accounting Quality in Ten selected firms at the Nairobi Securities Exchange'.

This study seeks to ascertain how Internal Audit relates to Accounting Quality.

You are considered a resourceful person and therefore requested to spare some time and respond to the questionnaire in a honest and frank manner. Your response will be treated with utmost confidentiality and therefore, you do not need to write your name on the questionnaire nor should you disclose your answers to other respondents.

This research is primarily intended for academic purposes only.

Thank you for accepting to participate in this study.

Sincerely,

Jeff Oganga.

## APPENDIX E: CURRICULUM VITAE

J e f f S t e v e O g a n g a

Box 25892-00100

Nairobi

Kenya

Mobile : +254 0723505961/0724845556

[jkatieno@yahoo.com](mailto:jkatieno@yahoo.com)

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### **K e y S t r e n g t h s**

**Trained and Experienced Accountant** – A Certified Public Accountant with extensive experience within many aspects of accounting functions including Payroll duties and Tax Compliance.

**Experience in External and Internal Audit** – Valuable experience gained as an Auditor with PKF (Kenya) and Internal Audit experience at University of Eastern Africa, Baraton.

### **P e r s o n a l A t t r i b u t e s**

- Loves keeping abreast of professional developments.
- Values honesty.
- I believe in primary accountability to God and also to our fellow men.

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## **B i o g r a p h i c a l   D a t a**

Date of Birth: 4th April 1981

Marital Status: Married

Religion: Christian (Seventh Day Adventist)

## **C a r e e r   O b j e c t i v e s**

To be an established authority on Tax and Financial matters by keeping abreast of professional developments.

## **E m p l o y m e n t   H i s t o r y**

**August 2011 to Current**

**University of Eastern Africa, Baraton**

**University Payroll Accountant**

- Responsible for all university tax matters related to employees.
- Managing the University Payroll system.

**January 2009 – August 2011**

**University of Eastern Africa, Baraton**

## **Internal Auditor**

- Responsible for drawing up annual Audit Plans for approval.
- Responsible for undertaking Risk Based Auditing of various departments within the University to ensure that University policies are adhered to and to test the effectiveness of Internal Control System.
- Carrying out exit interviews with departmental managers.
- Preparing Draft and Final Report on Audit Findings, Recommendations and Manager's comments.
- Carrying out follow-up visits.
- Evaluate the organisation's preparedness for external audits by carrying out a Pre-Audit on the financial statements to highlight areas which may need adjustments as per International Financial Reporting Standards and International Accounting Standards.

## **October 2007 – December 2008**

### **PKF-Kenya**

#### **Audit Assistant**

- Responsible for audit assignments for clients with diverse business backgrounds and giving credible recommendations regarding effectiveness of certain financial operations or system improvements.

## **May 2006 – October 2007**

### **Shah & Associates (Certified Public Accountants), Nairobi, Kenya**

#### **Audit Assistant**

- Responsible for audit assignments for various clients.
- Carry out audit procedures designed to obtain sufficient appropriate audit evidence, in accordance with Auditing Standards, to determine with reasonable confidence whether the financial statements are free of material misstatement
- Preparing the financial statements and ascertaining that they are in accordance with relevant legislation and accounting standards
- Preparing varied returns for the clients e.g. annual returns, Vat returns, PAYE returns
- Carrying out Vat audit.

**June 2006-February 2007**

**Pick A Phone Ltd.**

**Accounts Consultant**

- Preparation of the payroll.
- Maintenance of the accounting system.
- Responsibility for ensuring local compliance with the employee tax deductions.
- Ensuring Compliance with Value Added Tax Department regulations and that all returns are filed e.g. Vat 3, Vat 3a & 3b, and Vat 4.
- Prepare the year-end financial statements and returns.

**December 2005 – February 2006**

**Prestige Management Solutions**

**Accountant**

- Preparation of Abstracts of accounts
- Preparation of Strategic Plans
- All aspects of book-keeping and preparation of financial statements.

**January 2005-April 2005**

**The Nairobi Hospital**

**Finance intern**

- Preparations of Stock take variance analysis.
- Compilation of departmental stock status reports.



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## **E d u c a t i o n   a n d   Q u a l i f i c a t i o n s**

2012 – Current    Master of Business Administration (Accounting); On-going –  
University of Eastern Africa, Baraton

2000 – 2005        Bachelor of Business Administration (Accounting) - Maseno  
University

### **Second Class honors Upper Division**

1995 – 1998        Kenya Certificate of Secondary Education - Kanga High School

### **Mean Grade B+ (Plus)**

1987 - 1994        Kenya Certificate of Primary Education Asego Primary School

### **Mean Grade B+ (Plus)**

## **P r o f e s s i o n a l   A f f i l i a t i o n**

CPA Finalist

## **L e a d e r s h i p   R e s p o n s i b i l i t i e s**

- Served as Secretary to the Supervisory Committee of Baraton University Sacco during the year 2010.

## **C o m m u n i t y   I n v o l v e m e n t**

- Member of Kenya Red Cross Society

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## **I n t e r e s t s**

- Reading Biographies.
- Nature.
- Bible.
- Reading materials containing Business, History and Health issues.

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## **R e f e r e e s**

### **Mr Paul Kirwa**

Senior Accountant; UEA, Baraton

Box 2500 Eldoret, Kenya

Cell: 254-0721-276 281

### **Mr Albert Aseka**

Audit Supervisor,

PKF-Kenya.

Cell: 254-0722 155 271

### **Prof Helen Atieno**

Lecturer, Maseno University

Private Bag, Maseno

Cell: 254-0721-330847