

# Factors Affecting Internal Audit Independence: A Case Study of Technical University of Mombasa

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## Abstract

The main objective of the study was to establish the factors affecting internal audit independence at the Technical University of Mombasa and the various variables that compromised it. Literature review has been conducted on the various independent variables that affect the dependent variable. A descriptive technique was used as the research design. The sampling procedure that was used is stratified sampling technique. Primary data was collected by use of self-administered questionnaire and it was purely quantitative. Data collected was analyzed with the aid of Statistical Package for Social Scientist (SPSS) and the findings of the study has been presented in pie charts, bar graphs, diagrams and figures. Tables were used to summarize responses for further analysis and facilitate comparison.

The study concluded that internal audit independence is crucial to the institution to help to enhance accountability and performance the institution by its employees.

**Keywords:** Accountability, Audit, Independence, Governance.

## 1.0 Background Information and purpose

Independence has been described as “avoidance of situations which would tend to impair objectivity or permit personal bias to influence delicate judgment” (Carey et al., 1966). Auditor independence, in particular, implies “absence of influence or control in the matter of the auditor’s conduct, action and opinion” (AAA, 1973). It simply refers to the auditor’s ability to express his conclusions honestly and impartially. Auditors’ independence has been termed the building block of the auditing profession, since it forms the foundation for the public’s trust in the attest function of ascertaining whether the financial statement show a fair and true position of the financial status of an organization (Caswell & Allen 2001).

Independence permits internal auditors to render the impartial and unbiased judgments essential to the proper conduct of engagements. Audits have existed since the development of business corporations in 1200 (Watts & Zimmerman, 1983). Audit services are demanded as a monitoring mechanism because of the potential conflicts of interest between as well owners and managers as owners and other different classes of security holders in an organization (DeAngelo, 1981). This monitoring role means that auditors are used as a mechanism to enhance credibility of the financial statements so that the general public who are not involved in the day today running of the organization can have some level of confidence in the reported financial position. The quality of audit services, audit quality, is defined by DeAngelo (1981) and Watts and Zimmerman (1981) as the probability that a discovered breach is reported and corrected in time to ensure that the reported financial statements represent a true and fair view of the financial position of the firm.

Audit independence must be viewed within the totality of corporate governance and the accountabilities of organizations to their stakeholders. This implicitly incorporates the public interest, however defined. This paper is therefore undertaken a critical survey of existing analysis as concerns the relationship between the organization and its internal auditors within the context of the totality of corporate governance. The review has been expanded to international experience and studies where felt appropriate.

### 1.1 Statement of the Problem

Auditor independence is a cornerstone of the auditing profession, a crucial element in the statutory corporate reporting process and a key prerequisite for the adding of value to an audited financial statement (Mautz & Sharaf, 1961). The economic dependence resulting from the provision of non-audit services and personal relationships built through alumni employees have been alleged to contribute to this erosion of internal auditor independence.

According to Raja Tun Uda, (2002) the increase of corporate scandals including WorldCom and Parmalat to name a few have ended to focus heavily on the issue of auditor independence. These financial scandals and corporate failures are proven to have had a detrimental effect on the public’s perception of auditors. As raised by O’Malley (1993), the issues related to independence are threatening the survival of accounting firms of all sizes and it has the power to destroy the accounting profession as a whole. It is therefore, vital that auditors maintain their independence and ensure that they provide a high quality of auditing to ensure the credibility of financial information not only for the purpose of reducing the number of corporate scandals but most importantly the survival of their profession and the development of healthy financial and capital market (Abu Bakar, 2006).

The research is conducted against the backdrop of increased regulation of public audit Act (2003), public officer ethics Act (2003) and other corporate Governance issues addressing the widespread public outcry on financial mismanagement. Corporate local scandals have led to ill-informed comments on the audit profession, particularly as regards audit independence. The Goldenberg scandal, Anglo leasing scandal, the phantom Ken Ren sale of Fertilizer Factory, sale of grand regency hotel to foreigners, the recent scandals in the ministry of education and the transport sector over the delay in the new ferries has heightened the debate on integrity and independence of auditors in public entities.

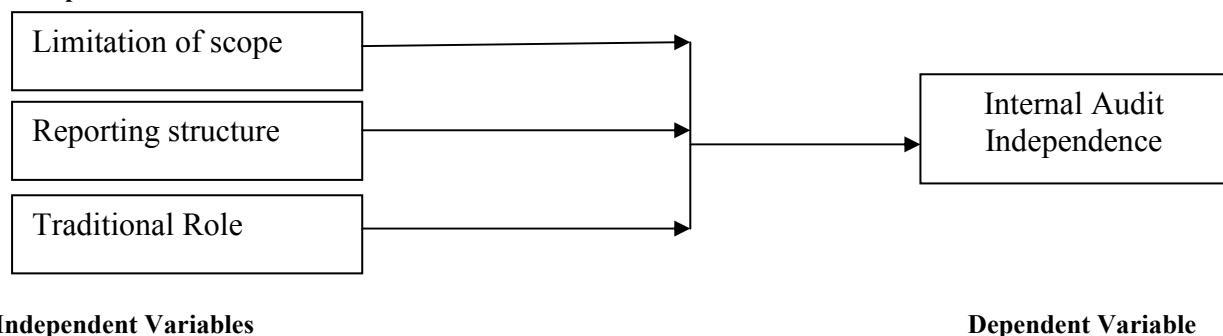
The increased recognition of internal auditors has resulted in the services of the Internal Audit Function being expanded from essentially an accounting-orientated service, to a much broader management-orientated service. Recent demands by stakeholders of organizations for greater accountability from management, be it the board of directors, audit committee, executive management or other levels of management, will likely further augment the services of Internal Audit Functions. Despite all of the above, internal auditors in practice may be falling short of expectations (IIARF 2007).

## 2.0 Literature Review

### *Conceptual Framework*

For the purposes of this research, the independent variable will be the indicators affecting internal audit independence while the dependent variable will be internal audit independence as illustrated with the aid of the conceptual model below.

### **Conceptual Framework**



**Figure 2.0 Conceptual Framework**

**Source: Researcher 2014**

### 2.1 Limitation of scope

Limitation of scope occurs when the auditor cannot audit one or more areas of the financial statements, and although they cannot be verified, the rest of the financial statements are audited and they conform to the Generally Accepted Accounting Principles. Examples of this include an auditor not being able to observe and test a company's inventory of goods. If the auditor audited the rest of the financial statements and is reasonably sure that they conform to GAAP, then the auditor simply states that the financial statements are fairly presented, with the exception of the inventory which could not be audited (Millichamp, 2008).

Internal auditors are in a unique position in terms of their status as employees of an organization with responsibility to act as internal assurance providers. This requires internal auditors to assess and monitor various governance decisions made by management and also to advise management on the adequacy and effectiveness of internal controls (Sarens, 2006). It is thus no surprise that internal auditors can face considerable familiarity and social pressure threats stemming from their relationship with management. In more recent years, audit committees have undertaken an important governance role in coordinating and overseeing the communications between management, internal auditors, and external auditors.

According to the Basel Committee's Internal Audit Paper (2002), the scope of internal audit, from a general point of view, includes the following: the examination and evaluation of the adequacy and effectiveness of the internal control systems; the review of: the application and effectiveness of risk management procedures and risk assessment methodologies, the management and financial information systems, including the electronic information system and electronic banking services, the accuracy and reliability of the accounting records and financial reports, the means of safeguarding assets, the bank's system of assessing its capital in relation to its estimate of risk, and the systems established to ensure compliance with legal and regulatory requirements, codes of conduct and the implementation of policies and procedures, the appraisal of the economy and efficiency of the operations; the testing of both transactions and the functioning of specific internal control procedures; the testing of the reliability and timeliness of the regulatory reporting; and the carrying-out of special investigations.

## 2.2 Reporting Structure

Management often calls upon internal auditors to help provide them with assurance that (a) risks are effectively identified and monitored, (b) organizational processes are effectively controlled, and (c) organizational processes are efficient or effective. In this structure, the IAF plays a unique role. The early internal audit literature, Levitt (1999), often portrayed internal auditors as the “eyes and ears of management.” Internal control has taken on a broader meaning to include the crucial role played by top management in setting the tone at the top. Thus, internal auditors may find themselves conflicted in helping management to assess the effectiveness of their governance processes while reporting to the audit committee on the tone at the top. The internal audit function has evolved in many organizations to a position where it is often called upon to take leadership in helping the organization implement, assess, or conceptualize risk management and control processes within an organization. In other words, internal audit has played an active role in implementing effective governance and controls while being asked to assess the effectiveness of management’s control practices.

In a few cases, internal audit is performing management functions that could impair the independence and objectivity of the internal audit department. There are also three cases where internal audit departments’ independence is compromised as internal audit leaders either do not report directly to audit committees, or do not meet regularly with their audit committees. Internal audit departments should be organizationally independent of management and report directly to audit committees.

## 2.3 Traditional Role

Traditionally, people understand internal audit as an activity of self imposed internal check and audit which also supposedly involved the activity of going around telling people what they were doing wrong. However even if one sees it in a narrow sense, the contribution of the activity of internal audit is potentially of major importance as an effective internal audit system leads to improved accountability, ethical and professional practices, effective risk management, improves quality of output and supports decision making and performance tracking (Kevin 1992).

Historically it was always held that internal auditing is confined to merely ensuring that the accounting and allied records have been properly maintained, the assets management system is in place in order to safeguard the assets and also to see whether policies and procedures are in place and are duly being complied with. With changing times this concept has undergone a sea change with regard to its definition and scope of coverage. Modern approach suggests that it should not be restricted to financial issues alone but also on issues such as cost benefit analysis, resource utilization and their deployment, matters of propriety, effectiveness of the management e.t.c (Monks 2001).

The key role of internal audit is to assist the board and/or its audit committee in discharging its governance responsibilities by delivering: An objective evaluation of the existing risk and internal control framework, systematic analysis of business processes and associated controls, reviews of the existence and value of assets, a source of information on major frauds and irregularities, ad hoc reviews of other areas of concern, including unacceptable levels of risk, reviews of the compliance framework and specific compliance issues, reviews of operational and financial performance, recommendations for more effective and efficient use of resources, assessments of the accomplishment of corporate goals and objectives, feedback on adherence to the organization's values and code of conduct/code of ethics (KPMG, 2003).

The internal auditors are expected to provide recommendations for improvement in those areas where opportunities or deficiencies are identified. While management is responsible for internal controls, the internal audit activity provides assurance to management and the audit committee that internal controls are effective and working as intended. The objectivity, skills, and knowledge of competent internal auditors can significantly add value to an organization's internal control, risk management, and governance processes. Similarly an effective internal audit activity can provide assurance to other stakeholders such as regulators, employees, providers of finance, and shareholders (IIA Research Foundation, 2004).

## 3.0 Research Methodology

This section discusses the methodology used in gathering, analyzing and reporting the data. The section entails research design, target population, sample size, sampling procedure, and data collection instruments and data analysis techniques. A descriptive research was used to obtain information. The target population consisted of TUM employees from the audit council members, management, auditors and other staffs who comprise of section heads from both teaching and non teaching staff. Stratified sampling was used because there are four different strata which include audit council members, management, auditors and other staff which includes sections heads both in teaching and non-teaching staff. Stratified random sampling technique was used since population of interest is not homogeneous and is divided into four strata to obtain a representative sample. Once the strata are established simple random sampling was used to obtain the required sample. Data collection involved a self-administered questionnaire. The researcher dropped the questionnaires physically at the respondents’ place of work. The researcher left the questionnaires with the respondents and picked them up later.

Each questionnaire was coded and only the researcher knew which person responded. The coding technique is only used for the purpose of matching returned, completed questionnaires with those delivered to the respondents.

#### 4.0 Data Analysis and Presentation of Findings

Data collected was purely quantitative and it was analyzed using the Statistical Package for Social Sciences (SPSS) since it is mostly used in survey authoring and deployment especially of statistical analysis.

The findings of the study have been presented in pie charts, bar graphs, diagrams and figures. Tables were used to summarize responses for further analysis and facilitate comparison. The variables used in the study were the reference points used in order for the researcher to find out if the objectives will be achieved from conducting the study.

##### *Profile of the Respondents in the institutions.*

The researcher targeted 50 respondents where only one questionnaire was given to each respondent, out of 50 questionnaires administered to these respondents in Technical University of Mombasa, 5 questionnaires were not returned. Therefore out of 50 questionnaires 5 were not filled only 45 were filled.

The response rate was  $45 \div 50 \times 100 = 90\%$

#### Part A

This section is the first objective which is to determine how limitation of scope affects internal auditor's independence at the Technical University of Mombasa.

**Table 4.8 Auditing involves all components of financial reports**

		Frequency	Valid Percent	Cumulative Percent
Valid	Yes	38	84.4	84.4
	No	7	15.6	100.0
	Total	45	100.0	

The analysis in Table 4.8 shows whether the audit in the organization involve all the components of financial report, the finding was that majority said yes that auditing actually involve all the components of a financial report, this is evidently shown by the high frequency of 38 out of 45 of the response rate which is equivalent to 84.4%. Very few respondents said no that auditing in their organization doesn't involve all the components of financial and its shown in the above table with the least frequency of 7 and a percentage of 15%.

**Table 4.9 Examining limitation of the scope Descriptive Statistics**

	N	Minimum	Maximum	Mean	Std. Deviation
Considering internal auditors as advisors to management on matters relating to internal controls and governance	45	1	3	1.58	.621
The internal auditor identify and evaluate the organization internal control system as a basis for reporting upon its adequacy and effectiveness	45	1	3	1.78	.704
The r/ship between management, Audit committee and internal audit function provide for internal audience independencies	45	1	3	1.58	.621
Valid N (list wise)	45				

The statistics in table above shows that in examining the limitation of the scope on the factors affecting internal auditors independence in TUM, it was found out that the internal auditor identifying and evaluation of the organization internal control system as a basis for reporting upon its adequacy and effectiveness was a critical factor that needed most to be considered with a mean of 1.78 from a scale of 1 to 5 and the Std. Deviation of 0.704. The other two factors which are internal auditors as advisors to management on matters relating to internal controls and governance and the relationship between management Audit committee and internal audit function provide for internal audience independencies were second factors that was to be considered with a means of 1.58 and a standard deviation of 0.621 each.

Therefore in conclusion of the above analyzed statistics internal auditor identifying and evaluation of the organization internal control system as a basis for reporting upon its adequacy and effectiveness was a critical

factor that needed most to be considered.

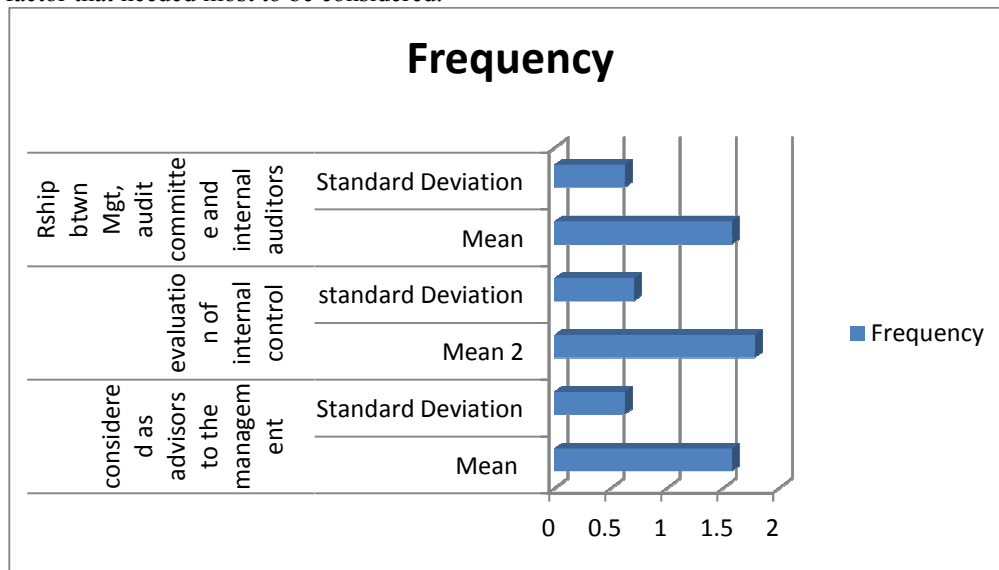


Figure 4.7 Limitation of scope

**Part B**

The second objective in these study was about to examine the effect of the reporting structure on internal auditor's independence at the Technical University of Mombasa.

**Table 4.10 Independence of internal audit department**

	Frequency	Valid Percent	Cumulative Percent
Valid very independent	15	33.3	33.3
Somehow Independent	27	60.0	93.3
Not independent	3	6.7	100.0
Total	45	100.0	

In determining the rate of the independence of internal audit department in terms of operation and structural, the findings in Table 4.10 shows that internal audit department is somehow independent with a frequency of 27 out of 45 and a percentage of 60% making it the highest response rate. A frequency of 15 with a percentage of 33.3% indicated that the internal audit department is very independent. Very few response rates showed that internal audit department was not independent and this makes 6.7%

The conclusion from the findings is that the internal audit in Technical University of Mombasa is not as independent as it should be.

How do you rate the independence of internal audit department in terms of operation and structural

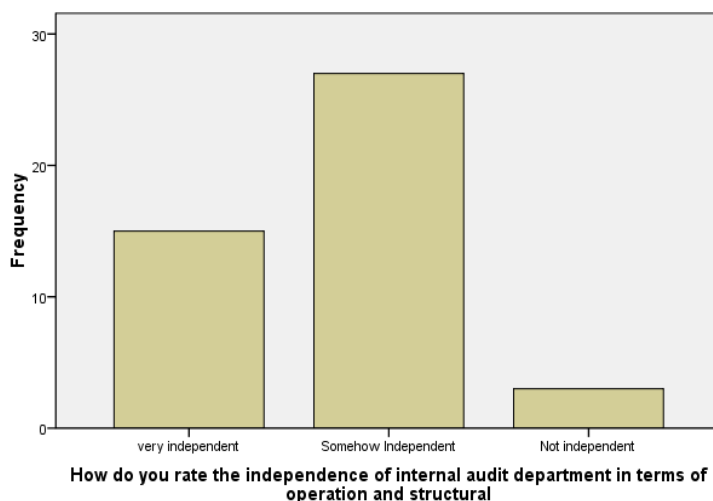


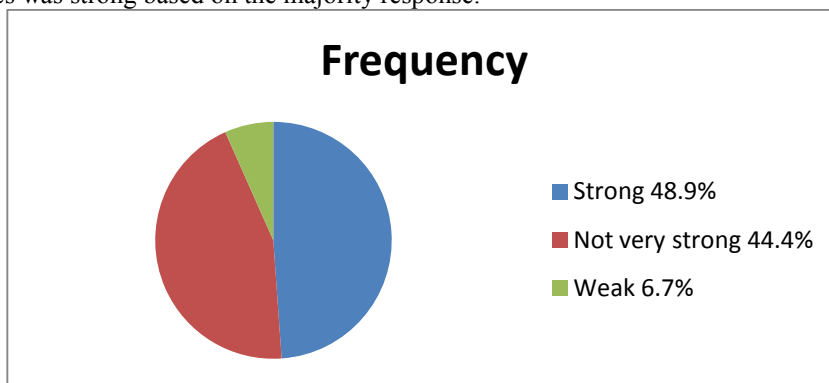
Figure 4.8 Independence of internal audit department

**Table 4.11 Assess the structure of internal audit in terms of enhancing its objectives**

		Frequency	Valid Percent	Cumulative Percent
Valid	Strong	22	48.9	48.9
	Not very strong	20	44.4	93.3
	Weak	3	6.7	100.0
Total		45	100.0	

The above Table 4.11 analyses the assessment of the structure of internal audit in terms of enhancing its objectives and the findings was that the internal audit strongly assess the structure in terms of enhancing its objective with a response rate of 22 out of 45 and a percentage of 48.9%. A frequency of 20 with a percentage of 44.4% said that the structure of internal audit was not strong, and a few respondents said it was weak giving a percentage of 6.7%.

Therefore the conclusion here is that the assessment of the structure of internal audit in terms of enhancing its objectives was strong based on the majority response.



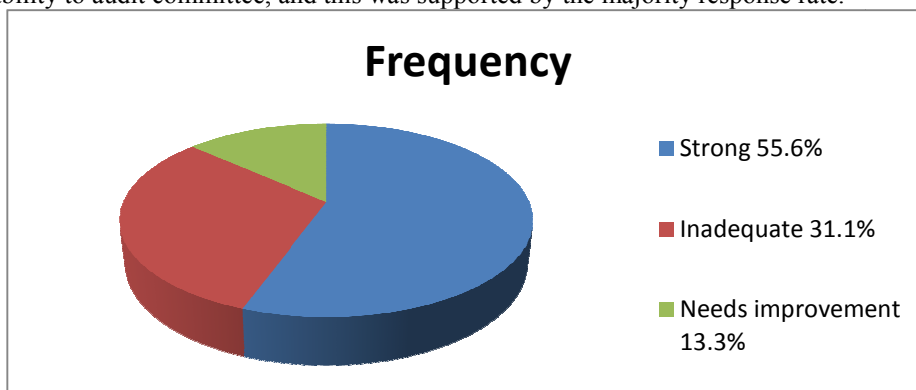
**Figure 4.9 assess the structure of internal audit**

**Table 4.12 Accountability to audit committee**

		Frequency	Valid Percent	Cumulative Percent
Valid	Strong	25	55.6	55.6
	Inadequate	14	31.1	86.7
	Needs improvement	6	13.3	100.0
Total		45	100.0	

The above Table 4.12 analyses how well does the internal audit demonstrate that it recognizes its accountability to audit committee and the findings was that the internal audit strongly demonstrate that it recognizes its accountability to audit committee with a response rate of 25 out of 45 and a percentage of 55.6%. A frequency of 14 with a percentage of 31.1% said that internal audit is inadequate to demonstrate that it recognizes its accountability to audit committee, and a few respondents said it needed improvement giving a percentage of 13.3%.

Therefore the conclusion from the findings is that the internal audit strongly demonstrated that it recognizes its accountability to audit committee, and this was supported by the majority response rate.



**Figure 4.10 Accountability to audit committee**

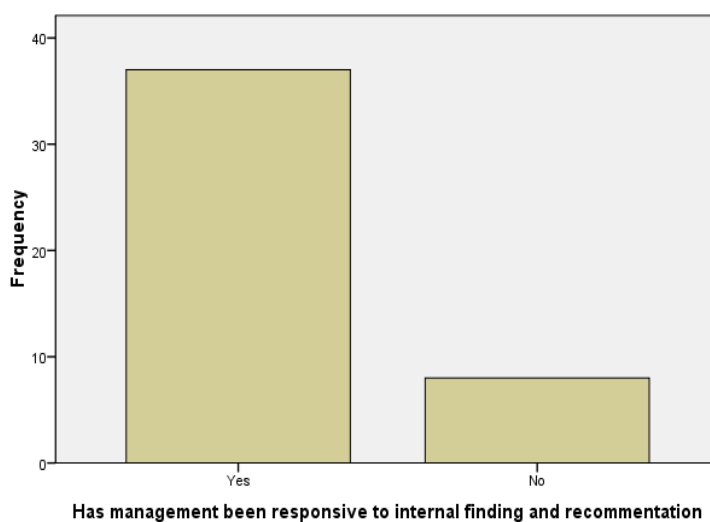
**Table 4.13 Management responses to internal Auditors previous finding and recommendation**

		Frequency	Valid Percent	Cumulative Percent
Valid	Yes	37	82.2	82.2
	No	8	17.8	100.0
	Total	45	100.0	

Table 4.13 above shows the response rate on whether the management of the Technical university of Mombasa has been responsive to internal Auditors previous findings and recommendations, the finding was that the management is actually very responsive to internal Auditors previous findings and recommendations giving a response rate of 37 out of 45 and a percentage of 82.2%. Those respondents that opposed had a response rate of 17.8% which is 8 out of 45 of the respondents.

The conclusion is that the management of the TUM has been responsive to internal Auditors previous finding and recommendation following the majority response form table 4.14

**Has management been responsive to internal finding and recommendation**



**Figure 4.11 Management responses to internal audit finding and recommendations**

**Part C**

The fourth objective was to investigate how the traditional role of the internal auditors affects their independence at Technical University of Mombasa.

**Table 4.19 Unlimited accesses to information audited before**

		Frequency	Valid Percent	Cumulative Percent
Valid	Always	18	40.0	40.0
	Sometimes	25	55.6	95.6
	Never	2	4.4	100.0
Total		45	100.0	

Table 4.18 give analyses of whether internal audit have unlimited access to information they are supposed to audit before, from the analysis the findings are internal auditors sometimes have unlimited access to information they are supposed to audit, this is shown in the above table with a frequency of 25 out of 45 and a percentage of 55.6%, there are those respondents who said that the internal auditors always have unlimited access to information they are supposed to audit with a response rate of 40% and finally some few 4.4% said never.

The conclusion is that internal auditors sometimes have access to the information that they audit before the exercise begin in order to gather necessary information for auditing.

**Table 4.19 Importance of internal auditors**

		Frequency	Valid Percent	Cumulative Percent
Valid	Very Important	40	88.9	88.9
	Somehow important	3	6.7	95.6
	Not Important	2	4.4	100.0
	Total	45	100.0	

The analyses in Table 4.19 find out the importance of internal auditors in the organization and the response was that internal audit is very important with response rate of 88.9% and a frequency of 40 out of 45.

The other response rate stated that internal audit was somehow important giving 6.7% and a frequency of 3 out of 45 while not important was 4.4% and a frequency of 2 out of 45.

**Table 4.20 Evaluation of internal audit independence**

		Frequency	Valid Percent	Cumulative Percent
Valid	Strong	15	33.3	33.3
	Adequate	27	60.0	93.3
	Need improvement	3	6.7	100.0
	Total	45	100.0	

The above Table 4.20 Evaluate internal audit independence from the activities it audit and the findings was that the internal audit independence was adequate with a response rates of 27 out of 45 and 60% making it a leading response rate. The second in the response rate was those who said the internal audit was independence with response rate of 33.3% and a frequency of 15 out of 45. Finally there those who said that internal audit independence needed improvement and had a frequency of 3 and 6.7% response.

Therefore the conclusion from the findings is that the internal audit independence was adequate from the activities it audits; this was supported by the majority response rate.

**Table 4.21 Assessment of internal audits overall performance**

		Frequency	Valid Percent	Cumulative Percent
Valid	Strong	7	15.6	15.6
	Adequate	28	62.2	77.8
	Need improvement	10	22.2	100.0
	Total	45	100.0	

The above Table 4.21 assess internal audits overall performance and the findings was that the internal audits overall performance was adequate with a response rates of 28 out of 45 and 62.2% making it a leading response rate. The second in the response rate was those who asses the internal audits overall performance with response rate of 22.2% and a frequency of 10 out of 45. Finally there those who said that internal audits overall performance needed improvement and had a frequency of 7 and 15.6% response.

Therefore the conclusion from the findings is that the internal audits overall performance was adequate from the activities it audit, this was supported by the majority response rate.



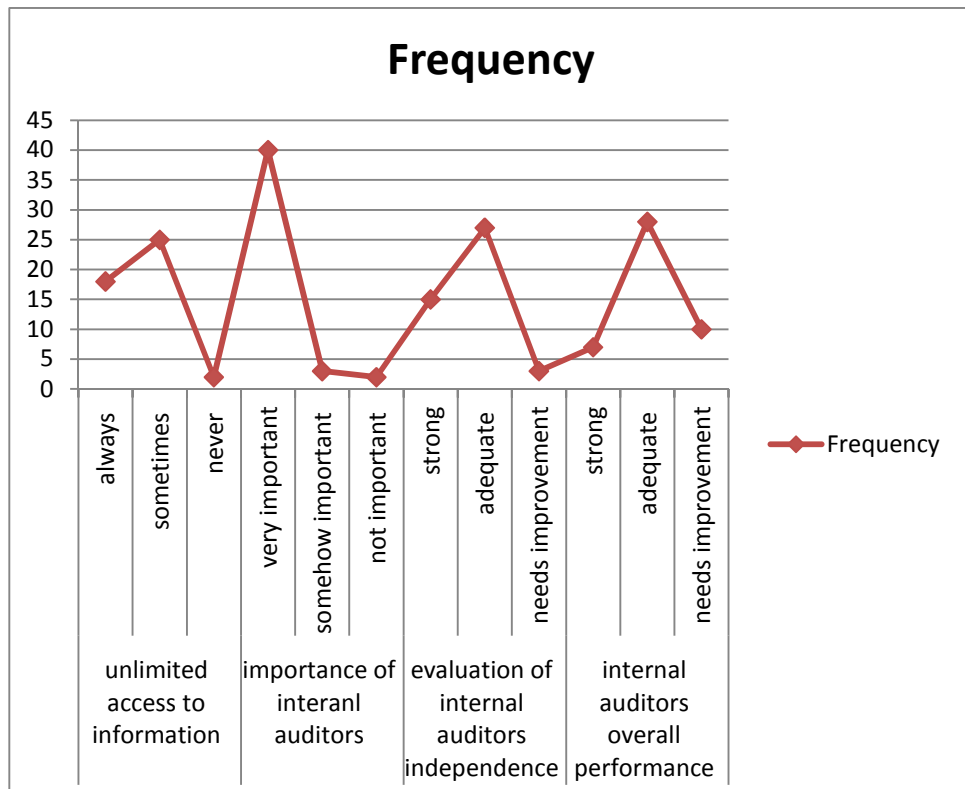


Figure 4.13 Traditional Role

### Conclusion

After an in depth of the analysis of the data the study reveals that internal auditor's independence was crucial to the institution to help to enhance accountability and performance the institution by the employees. Most of the institutions are still in the process of acknowledging the importance of internal audit independence in their systems.

In determining how limitation of scope affects internal auditor's independence majority of the response admitted that internal auditing actually involve all the components of a financial report unlike some organizations where the audit reports are restricted to a specified user and the auditor includes this restriction in the report but in Technical University of Mombasa that is not the case. Also it was found that internal auditor identify and evaluate the organization internal control system as a basis for reporting upon its adequacy and effectiveness was a critical factor that needed most to be considered, the internal audit function is to monitor the performance of an entity's controls by obtaining an understanding of internal control.

In examining the effect of the reporting structure on internal auditor's independence at the Technical University of Mombasa, it's found that the internal audit in TUM is independent. It was also found out that the assessment of the structure of internal audit in terms of enhancing its objectives was strong based on the majority response. A further finding was that the internal audit strongly demonstrated that it recognizes its accountability to audit committee and this was supported by the majority response rate. The audit committee meetings are held on a frequency that facilitates the oversight to the internal audit department and it's held four times a year at a minimum, with additional meetings held by audit committee and other council members during the full council meeting.

The findings of how the traditional role of internal auditor's affects their independence revealed that the effect of internal audit needs continual improvements and refinements to the internal control system as a contribution to proper, economic, efficient and effective use of government resources. The internal audit independence was adequate from the activities it audits; this was supported by the majority response rate. It was also found out that the internal audits overall performance was adequate from the activities it audit, this was supported by the majority response rate.

In conclusion it is clearly evident that internal audit independence and objectivity is a rich and fruitful area of investigation where researchers can make a valuable contribution to the on-going development of the profession.

### Recommendations

Given the findings of the study, it has been suggested that the following recommendations be considered for

adoption so as to assist in the assessment of factors affecting internal audit independence at the Technical University of Mombasa.

- 1) The auditor should obtain an understanding of the internal audit function sufficient to identify those internal audit activities that are relevant to the organization. The extent of the procedures necessary to obtain this understanding will vary, depending on the nature of those activities.
- 2) Coordinating internal auditing activities and plans with other assurance providers to minimize duplication of effort and demands on departmental management.
- 3) Development of sound working relationships with management and staff at all levels of the organization is fundamental to the effectiveness of the internal audit function. The internal audit activity's knowledge and understanding of the organization assist in building effective relationships and in evaluating and improving the effectiveness of risk management, internal control, and governance processes.
- 4) Require management to respond formally, and in a timely manner, to significant adverse audit findings by taking appropriate corrective action.
- 5) Internal Audit may be required to undertake pre-audit by only undertaking pre-audit on larger payments or those that are particularly vulnerable to fraud or irregularity.
- 6) Establish a clear and formally defined responsibilities and authorities of internal auditing in an audit charter.
- 7) Evaluation of adherence to legal and regulatory requirements and approved policies and procedures.
- 8) Evaluation of effectiveness of existing policies and procedures and give recommendations for improvements.
- 9) Ensure through tracking that management implements the agreed control improvements on a timely basis to ensure the improvements are adequate, effective and timely.
- 10) Establish rules of Conduct that describe behaviour norms expected of internal auditors.

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