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The Role of Internal Audit in Enhancing Corporate Governance for Companies Listed at the Nairobi Stock Exchange

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ABSTRACT
The study examined the role of internal audit in Kenya current corporate governance (CG) system via seeking the views of corporate managers. Despite the fact that the contribution of internal audit has been essential for organizations to achieve their business objectives, very little has been known of corporate managers' perception as to the practical functions of internal audit in the context of CG. Recent events and studies suggest that the benefits of scrutinizing governance extend beyond simply avoiding corporate collapse. Corporate governance is about the way in which boards oversee the running of a company by its managers. The study addressed the following objectives: To assess the auditor's role in corporate governance, to assess the internal audit capacity to achieve its objectives, to suggest how internal auditors' independence can be achieved. The research design used was descriptive design and data collection instrument was questionnaire. The target population was internal audit managers of all the Companies listed at the NSE. The study employed both Stratified and Systematic random sampling procedures where a sample size of 30 companies was selected to represent 50% of the population. Information about audit objectives/functions, accountability, capacity and framework was obtained. Issues relating to and practices of corporate governance and internal audit activities within companies listed at the NSE were examined. It was established that most companies consider internal controls as the most important audit objective and also is the task that takes highest proportion of internal audit time. The study as well found that all respondents strongly agreed that for internal audit to add value to governance process there should be good working relationship, independence, awareness, capacity and professionalism.
Key Words: Internal Audit, Corporate Governance, Nairobi Stock Exchange

INTRODUCTION

Corporate governance is the manner in which power of corporate is exercised in the stewardship of the corporation, to the portfolio of assets and resources with the objective of maintaining and increasing shareholders value to the satisfaction of the stakeholders in the content of its corporate mission (PSCGT, 1999).

During the last decade, policy makers, regulators and market participants around the world have increasingly come to emphasize the need to develop good corporate governance policies and practices. An increasing amount of empirical evidence shows that good governance contributes to competitiveness, facilitates corporate wide spreading and thus helps develop area of participation and spur economic growth

Unfortunately, despite the existence of provisions in the companies act as well as various codes embraced by companies, companies have been characterised by scandals where directors have acted illegally or in bad faith towards their shareholders. Hence corporate governance has become increasingly important topic in the recent years, partly because corporate governance failures were contributing factor to several corporate scandals (OECD, 2006).

In any serious nation, the quality of its corporate governance strongly influences the character of its capital markets. Corporate Governance guidelines (2002) Issued by the NSE actually recognises the important role played by the Internal Audit function and actually gives the various best practices companies can adopt in regards to setting up an audit function.

Most of the companies quoted at the Nairobi Stock Exchange (NSE) have not adopted corporate governance guidelines and those who have, do not enforce them. The confused application of the state corporations Act, Companies act, capital market regulatory Authority Act and various circulars and directives from government authorities often create conflict structures and procedures, (Standard Newspaper March 7, 2010 by Macharia Kamau)

Amidst all the debate over corporate governance and board's supervision of internal mechanism, surprisingly little attention has been given to the role of internal audit and particularly to whom it is ultimately responsible.

According the Institute of Internal Auditors ''internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes." It discharges its responsibility by reviewing the effectiveness of internal control systems and provides assurance to the management and the board that the systems of internal control are adequate, effective and reliable. It's therefore an integral and necessary part of an efficient corporate governance framework. Internal audit should maintain high levels of independence so as to provide an objective and fair opinion on management's dealings.

Good corporate governance of corporations is the one way of creating wealth and employment in a nation. After the collapse of ENRON Corporation in 2002 in the USA the then president Bush noted that ''if nothing is done our debt problem will continue to get worse, millions of jobs will continue to leave our country, small companies will continue to be suffocated, middle class companies will continue to collapse and poverty in the USA will continue to explode ''. In 2002 the significance of good corporate governance hit the world headlines when major corporate failures occurred in the USA, such as ENRON Corporation, WorldCom and Tyco, leading to seven of the twelve largest bankruptcies in US history. This has not been an exception to Kenyan companies listed at the Nairobi stock exchange whereby we have seen major companies having corporate governance issues for example Uchumi Supermarkets and the 2012 CMC Board wrangles'.

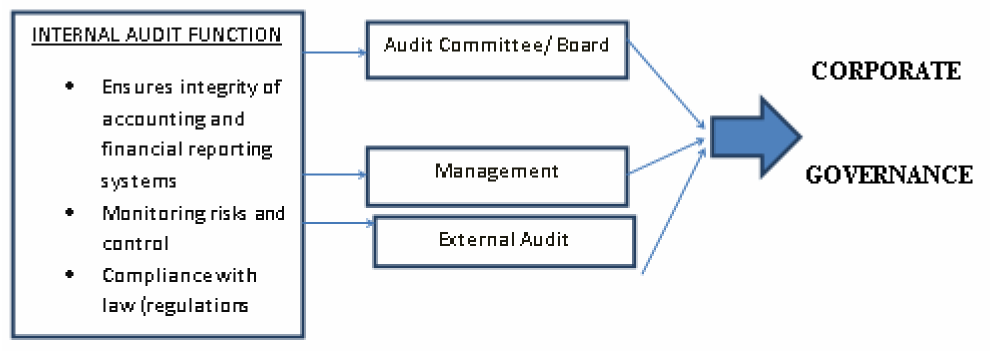
Objectives of the study

1. To assess the auditor's role in corporate governance
2. To assess the internal audit capacity to achieve its objectives
3. To find out how internal auditors' independence can be achieved?

Conceptual model

This section provides the framework or model of relations between the internal audit and good corporate governance.

Fig.1 **Diagrammatic representation of the variables**



Source: *Researcher (2013)*

REVIEW OF RELATED LITERATURE

The Institute of Internal Auditors (IIA) defines internal auditing as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations" (Nagy and Cenker, 2002, p.1). Traditionally the internal auditors were acting as 'policemen' that check and monitor the company's procedures and level of compliances with the rules (Skinner and Spira, 2003). Currently internal auditors can be portrayed as consultants and the internal audit function of companies considered as helping to achieve corporate objectives and add value. As noted by Sarens and De Beelde (2006), internal auditors are currently expected to make things happen rather than waiting to respond to it.

In developed countries, the role of the internal auditor has recently been affected by the dramatic changes in regulations, mainly from corporate governance standards and the emphasis of strengthening the internal controls of organizations of these standards (Holm and Laursen, 2007). Corporate governance involves the obligations of the board of directors in managing their organization's objectives and those towards the shareholders and stakeholders (Pass, 2004 & 2006). Corporate governance is expected to enhance the role of the internal auditor, and at the same time the internal auditor also provides benefits to the external auditor (Holm and Laursen, 2007).

Research suggests that boards are increasingly relying on the internal auditors to monitor the risk management processes (Fraser and Henry, 2007). And as a result, internal auditors can end up getting involved with activities which can damage their objectivity and independence. Fraser and Henry (2007) find that when the internal auditors get involved with these business operations, they usually lack experience and expertise to get the job done properly.

The term "corporate governance" has a clear origin from a Greek word, "kyberman" meaning to steer, guide or govern. From a Greek word, it moved over to Latin, where it was known as "gubernare" and the French version of "governer". It could also mean the process of decision-making and the process by which decisions may be implemented. Henceforth, corporate governance has much a different meaning to different organizations (Abu-Tapanjeh, 2008). In recent years, with much corporate failures, the countenance of corporate has been scared.

Corporate Governance concepts

The 1992 Cadbury Report includes a Code of Best Practice for companies, which is built around the principles of accountability, probity and transparency. These principles, along with the concept of equity, became the benchmark for good corporate governance. They were reinforced by the public sector equivalent; the first report on Standards in Public Life published by the 1995 Nolan Committee.

From these foundations other organisations have developed their own ideas of what good corporate governance looks like. The Organisation for Economic and Co-operation and Development (OECD) Principles of Corporate Governance has gained worldwide recognition as an international benchmark for good corporate governance. The revision of the principles in 2004 takes into account the lessons learnt from a number of governance failures. The OECD has also published a methodology for assessing the implementation of the OECD principles on corporate governance

The UK Independent Commission for Good Governance in Public Services published a Governance Standard in 2005, which sets out core principles of good corporate governance. The document provides a list of supporting principles and a number of practical applications.

Characteristics of good corporate governance

According to Clarke (2004) good governance has eight major characteristics. It is participatory, consensus oriented, accountable, transparent, responsive, effective and efficient, equitable and inclusive and follows the rule of law. It assures that corruption is minimised, the views of the minority are taken into account and the voices of the most vulnerable in society are heard in decision-making. It is also responsive to the present and future needs of the society.

Internal audit charter

Attribute Standard 1000 states that "the purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the Standards, and approved by the Board." The standard goes on to state that the charter should define the nature of the audit and advisory services provided by the internal audit activity.

The Institute of Internal Auditors (IIA) Practice Advisory (1000-1) provides further guidance saying that a formal, written Internal Audit charter should establish the internal audit activity's position within the organization, authorize access to engagements and define the scope of internal audit activities.

The audit charter provides internal auditors with their rights, and authorises them to have direct access to any documents, people and records within the organisation. This involves communication with any member of staff, to examine any activity or entity of the clients, as well as access to any records, files or data of the clients, including management information and the minutes of all consultative and decision-making bodies. The charter usually states the terms and conditions whereby the internal audit activity can be called upon such as consulting or advisory services or other special tasks, and the charter is communicated throughout the organisation. To undertake all the challenges in an organisational setting, the internal auditor relies on the audit charter, for his authority. The audit charter should be re-evaluated periodically, and be sufficiently flexible to incorporate a changing business environment. The audit charter can serve as a tool for keeping internal auditors relevant and up to date, or it can be a hindrance slowing down processes and progress (Charles, 1999).

Previous literature has highlighted that the Internal Audit charter is an important mechanism to formally and indirectly convey the internal audit's scope, role and activities. The Attribute Standard 1000 in the IIA's standards for the Professional Practice of Internal Auditing states that the purpose, authority and responsibility of the internal audit activity should be formally defined in a charter (IIA, 2009). Sarens and De Beelde (2005) formulated specific suggestions to reduce the gaps between the expectations and perceptions related to the interaction between the audit committee (AC) members and the internal auditors in their case study. The authors revealed that both parties would benefit from a clear communication about the specific role and mission of internal auditors through the spread of the internal audit charter or a formal presentation of the function. Cenker and Nagy's (2004) study compared the charters of eight companies with the information gathered from their internal audit directors on the roles and activities of their departments. Their study revealed that properly constructed internal audit and audit committee charters can communicate the department's orientation and role to the appropriate parties. A breakdown in this communication could lead to a misunderstanding of the roles and functions of the internal auditor. Internal auditors should have a reporting line to the audit committee that should be enshrined in internal audit charters (ICAEW, 2000). However, Van Peursem (2004) revealed that the existence of an audit charter does not appear to clarify the differences between role and authority. Therefore, it is unclear to what extent the audit charter helps to define the internal auditor's role in the organisation.

Effective reporting lines for internal audit

The internal audit function should report functionally to the chairman of the audit committee, recognising that on a day-to-day basis it should report administratively to the CEO of the organisation.

The IIA (2002) also suggests that regardless of the reporting relationship the organisation chooses, there are key measures that will ensure that the reporting lines support and enable the effectiveness and independence of the internal audit function. These key measures could be that the head of internal audit should meet privately with the board/audit committee without the presence of management. This will reinforce the independence and direct nature of the reporting relationship. In addition the board/audit committee should have the final authority to review and approve the annual audit plan and all major changes to the plan. Moreover the board/audit committee should review the performance of the head of internal audit and the overall internal audit function at least once a year, as well as approve the compensation levels for the head of internal audit. Finally the charter for the internal audit function should clearly articulate both the functional and administrative reporting lines for the function as well as its principal activities.

Independence guidelines for internal audit

According to KPMG (2003), there are several independence guidelines to keep in mind when considering reporting lines for internal audit. First, the internal audit function must be independent of the activities being audited and must also be independent from everyday internal processes. Secondly, the internal audit department must be able to exercise its assignment on its own initiative in all departments, `establishments and functions of the organization. In addition, the internal audit must be free to report its findings and appraisals and to disclose them internally. Finally, the head of the internal audit department should have clear authority to communicate directly and on his or her own initiative to the board, the chairman of the board, or the chairman and members of the audit committee.

The internal audit role in the modern corporate governance

Recent events have highlighted the critical role of boards of directors in promoting good corporate governance. In particular, boards are being charged with ultimate responsibility for the effectiveness of their organisations' internal control systems.

Traditionally the internal auditors were acting as 'policemen' that check and monitor the company's procedures and level of compliances with the rules (Skinner and Spira, 2003). Currently internal auditors can be portrayed as consultants and the internal audit function of companies considered as helping to achieve corporate objectives and add value. As noted by

Sarens and De Beelde (2006), internal auditors are currently expected to make things happen rather than waiting to respond to it.

In developed countries, the role of the internal auditor has recently been affected by the dramatic changes in regulations, mainly from corporate governance standards and the emphasis of strengthening the internal controls of organizations of these standards (Holm and Laursen, 2007). Corporate governance involves the obligations of the board of directors in managing their organization's objectives and those towards the shareholders and stakeholders (Pass, 2004 & 2006). Corporate governance is expected to enhance the role of the internal auditor, and at the same time the internal auditor also provides benefits to the external auditor (Holm and Laursen, 2007).

An effective internal audit function plays a key role in assisting the board to discharge its governance responsibilities. Yet how does the board – and its audit committee – satisfy itself that internal audit is functioning effectively and efficiently?

The board's responsibility for internal controls

One of the largest audit firms in the world, KPMG has identified a number of best practices in relation to board's responsibility for internal controls. According to KPMG (2003), the role played by the board audit and/or risk management committees includes assessing the scope and effectiveness of the systems established by management to identify, assess, manage and monitor the various risks arising from the organisation's activities. Secondly, it ensures that senior management establishes and maintains adequate and effective internal controls. Thirdly, it should satisfy itself that appropriate controls are in place for monitoring compliance with laws, regulations, supervisory requirements and relevant internal policies.

Finally, it should ensure that the internal audit function is adequately resourced and enjoys appropriate standing within the organisation.

According to Companies Act (s.221) the board of directors is responsible for maintaining adequate accounting records. To meet these responsibilities directors need in practice to maintain a system of internal control over the financial management of the company, including procedures designed to minimize the risk of fraud. There is, therefore, already an implicit requirement on directors to ensure that a proper system of internal control is in place.

RESEARCH METHODOLOGY

The study adopted descriptive research design. The population of interest was the internal audit managers of the 60 companies listed at the Nairobi stock exchange. The subject of study was drawn from all the various sectors that the corporation belongs.

Data was collected by use of a closed ended questionnaire. The study adopted both stratified and systematic random sampling techniques to sample 30 companies representing 50% of the population. 28 copies of questionnaire were successfully filled and duly returned. Both primary and secondary data were used. Secondary data involved collection and analysis of published materials and electronically stored information.

IMPORTANT FINDINGS AND RECOMMENDATIONS

From the findings, it was established that 98% of companies listed at NSE had audit charter and audit committee. Audit committee being part of board of directors is one of the pillars of corporate governance. The establishment of an audit committee and well defined internal audit charter demonstrates the commitment of the board to effective reporting lines and control of the organization.

The finding also indicated staff structures were relatively lean in most institutions with an average of six staff. Internal audit function (10%) reported directly to the CEO and that majority (24%) considers internal controls as there most important audit objectives and also is the task that makes most of the highest proportion of internal audit time. Internal audit functions (10%) are still involved in the organization processes like signing finance documents (payment/ imprest warrants) thus putting at risk the independence and objectivity of audit functions.

The study found that all respondents strongly agreed that for internal audit to add value to governance process there should be good working relationship, independence, awareness and professionalism. It was also found that majority of the institutions used auditing standards when reporting on polices and quality assurance and there is still need for the support of management to improve on its effectiveness. The findings indicate that internal audit function contribute to good corporate governance. It was established that 84% strongly agreed that internal audit role on corporate governance has an influence on governance. The study established that 10% of the respondent belief that they are not fully independent due to involvement in the day to day running activities in the organization. The independent, objectivity and capacity should therefore always be ensured. It is recommended that internal audit should functionally report to audit committee and administratively to the C.E.O of the organization. This will go a long way in making sure audit function is fully independent.

Finally auditing should keep up with the changing technologies and methods of doing business to enable them remain relevant. The board and the entire management should recognize the important role internal audit play and if need be support them with enough resources to enable execute their mandate. This will in turn improve on their independence and professionalism in executing their duties.

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