

# The Influence of Internal Audit Independence on the Financial Performance of Small and Medium Enterprises: A Case of the Construction Industry in Mombasa County

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**Abstract:** The paper examines the influence of internal audit independence on the financial performance of Small and Medium Enterprises in the construction industry in Mombasa County. The specific concern is to determine the effect of four components of internal audit independence namely: records accessibility, reporting structure, internal auditors' qualifications and internal audit roles on the financial performance of Small and Medium Enterprises in the construction industry in Mombasa County. The population was 65 Class 8 National Construction Authority (NCA 8). Systematic sampling is used in getting the sample size of the construction companies from different construction companies and expected sample derived from internal auditors, audit committee members and audit assistants of the sample population. The font size used is between 10 and 24. The research reveals that some construction companies within Mombasa County do not accord the internal auditors the independence they deserved to effectively give their opinion on the financial statements of the organizations. SMEs should be given Public education by the Minister for commerce and industry on the importance of internal audit independence. The government should establish an internal audit unit, which should be independent to ensure that all SMEs in Kenya comply with the laid down audit procedures and rules.

**Keywords:** Internal Audit, Audit Independence, Small and medium enterprises, Construction Industry, Auditing, Financial Performance.

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## I. INTRODUCTION

The auditor's services are needed in organizations to measure the relationship between the management and the users on the information provided by the management and the user perception on the same. Internal audit independence applies when the auditor is free from any conditions that deter his ability of the internal audit event or the chief audit executive (CAE) that could lead to carrying out internal audit responsibilities in an unbiased manner. The main objective of this study was to examine the influence of internal audit independence on the financial performance of Small and Medium Enterprises in the construction industry in Mombasa County. The first part of the objective was to determine the effect of records accessibility on the financial performance of SMEs in Mombasa County. Some respondents agreed that they accessed the records but others denied having access to records. The second part was to determine the effect of the reporting structure on the financial performance of SMEs. Majority of the respondents were satisfied with the internal audit reporting structure in the construction companies. However, some were not satisfied. The third analysis was to determine the effect of the internal auditor's qualification on the financial performance of SMEs. A bigger percentage of respondents depicts that internal audit qualifications were considered in the organizations, but a magnificent percentage of respondents disagreed. The fourth analysis was to determine the effect of internal audit roles on the financial performance of SMEs. Majority of the respondents agreed that there was unlimited access to information they were

supposed to audit before. However, the rest of the respondents agreed that access to records was unlimited. The rest of the paper is organized as follows:-

**1.1 Statement of the Problem:**

Due to increase in various industries in Kenya, there was need for an independent internal audit function in the economy, which should polish the financial records of organizations. Internal audit independence is in an organization to enhance the effective control measures for the management to provide financial reports, which will depict the true position as pertains to the financial statements as (14). In various industries, internal auditors face several obstacles including lack of independence, limited access to records support and recognition by the management.

In (2), it was consented that, auditor independence is a cornerstone of the auditing professional, crucial element in the statutory corporate reporting process and a key prerequisite for the adding of value to an audited financial statement. The economic dependence resulting from the provision of non- audit services and personal relationships built through alumni employees have been alleged to contribute to the erosion of internal auditor independence. Internal audit independence and the financial performance have caused conflict and uncertainty in the organization’s financial reports since the management is unwilling to support the internal audit function fully.

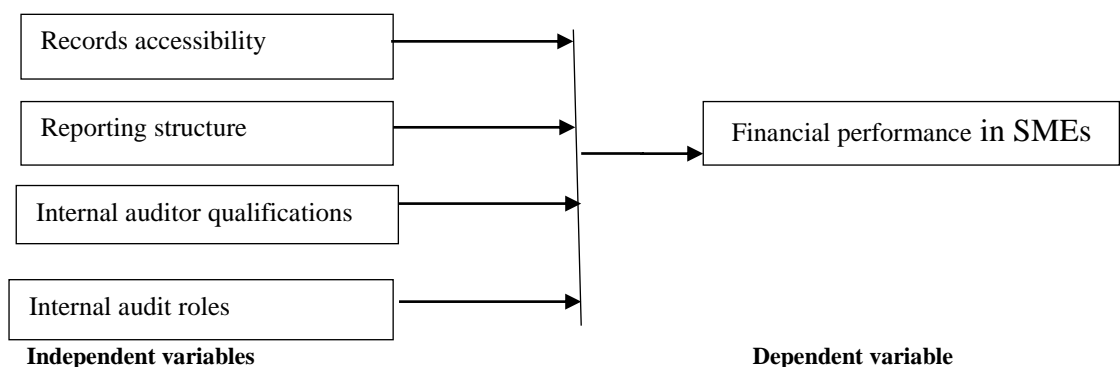
It has been argued that internal audit independence has no deep root on the financial performance of the Small and Medium Enterprises. It has been suggest that if left unexploited audit independence is most likely to affect the financial performance of SMEs as in (4), corporate local scandals in both public and private firms have led to ill-informed comments on the audit profession, particularly as regards to internal audit independence.

Recent demand by the Government on all business oriented organizations for greater accountability from management, be it the board of directors, audit committee, executive management or other levels of management to register and pay taxes appropriately, will likely further argument the services of internal audit functions. Despite all of the above, internal auditors in practice in private sector are falling short of expectations in executing their duties independently as they lack full support of the management since they may be forced to work in favour of them (7). There has been no published studies found that dwelt with the influence of internal audit independence on the financial performance of Small and Medium Enterprises in the construction industry in Mombasa County. This has been an important unresolved issue and one that is further explored in this study. This study seeks to establish the relationship among records accessibility, reporting structure, internal auditor qualifications, internal audit roles and the financial performance of SMEs in the construction Industry in Mombasa County. The financial statements showing true position of the records has helped SMEs in having easy access to financial facilities from the financial institutions.

**2. RECOMMENDATIONS**

**2.1 Conceptual Framework:**

The interconnection of the blocks in the conceptual framework completes the expected outcomes. For the purpose of this research, the independent variables are the indicators influencing internal audit independence, which included records accessibility, reporting structure, internal auditor qualifications and internal audit roles while the dependent variable was financial performance.



**Figure 1: Conceptual Framework**

Records accessibility. The internal auditors are required to assess and monitor various governance decisions made by management and to advice on the adequacy and effectiveness of internal controls (21). In this regard, the internal auditors can face considerable familiarity and social pressure threats emanating from their relationship with management.

Reporting Structure .Management of various organizations always seek help from internal auditors to provide them with assurance that, risks are effectively identified and monitored and processes are effectively controlled and effected. According to (13), the past internal audit literature often portrayed internal auditors as the representatives of the management on all financial matters.

Internal auditors' qualifications. In cases where internal auditors do not meet, the required qualifications may not perform their audit duties effectively hence, this may compromise their independence in the organization. They will do shoddy jobs to correct and cover up clients negatively implicated by the audit reports in the organization. The management is responsible for internal controls as the internal audit operation provides assurance to management and the audit committee that internal controls are effective and working as intended (1).

Internal Audit Roles. The major role of internal audit is to assist the management and its audit committee in discharging its governance responsibilities by offering advises on the financial records of the organization (5). The auditors do this through an objective evaluation of the existing risk and internal control framework, systematic analysis of business processes and associated controls. An effective internal audit activity can provide assurance to interested parties such as regulators, employees, financial institutions, and shareholders (7).

Financial performance. This involves evaluation of the results of a firm's policies and operations in monetary terms. These results are reflected in the firm's return on investment, return on assets, value added, etc. It subjectively measures how well a firm can use assets from its primary mode of business and generate revenues.

Research Gap. This study seeks to examine the influence of internal audit independence on the financial performance of SMEs in the construction industry. The researcher has established that there exists a gap in knowledge, which he seeks to critically examine and fill. In most cases, the internal auditors expressed an unqualified opinion on the financial statements before the irregularities were brought to light. This prompting many including (23) to question the effectiveness of certain aspects of the audit function, particularly issues related to internal audit independence on financial performance. Internal audit independence on financial performance of SMEs especially construction industry is an important, unresolved issue, and one that is further explored in this study.

### **3. METHODOLOGY**

The research design used in this study is a case survey. The procedure involved an arrangement of conditions for collection and analysis of data in a manner that aimed to combine relevance to the research purpose with economy in procedure. The study involved a large and scattered population (construction companies) in the whole of Mombasa County. Thus, it was advantageous to use survey method since it was significant to this study.

Target Population. Generally, a population is a sum of all the organisms of the same group who live in the same area. In this case, a population was internal auditors, audit assistants and audit committee members in various construction companies in Mombasa County. The target population consisted of the internal auditors, audit committee members and audit assistants in the 65 construction companies. There are three categories of registered construction companies namely; Building Contractors, Specialist contractors and Roads and other civil works. In each of the above categories, there are eight classes where by the highest class NCA1 is and the lowest is NCA 8.A list of 65 contractors' class NCA 8 was obtained from the National Construction Authority report September 2014. NCA 8 class of contractors was chosen because it had the lowest financial capability limit of between Kshs 5 million to kshs 10 million. The above limit suited SMEs and it was represented in all the above three categories of the construction companies. Thus, the population was 65 construction companies.

### **4. RESULTS AND DISCUSSIONS**

The contents in this part are the results of primary data collected by use of questionnaires and informal interviews and an analysis of the findings. Data was analysed and presented by use of tables, pie charts, graphs, and bar charts. The data collected was analysed on the basis of five key areas namely; (i) knowledge of records accessibility, (iii) independence of

operations and structure, (iv) consideration of qualifications and the expected roles in operations, and (v) responses to specific questions. The categories of respondents included in the research are presented in the Table 1 below.

#### 4.1 Knowledge of records accessibility:

Under this section, the researcher sought to find out the respondents' knowledge of accessibility of financial records provided by the organization in preparing audit reports. Whether the internal auditors were considered as advisors to the management, evaluation of internal control systems and the audit committee and internal audit function independence contribute to the financial performance of construction companies.

**Table 1: Records provided by the organization for compiling audit records**

Answer	Auditor		Audit assistant		Audit committee member	
	Count	%	Count	%	Count	%
Yes	11	92	8	100	7	100
No	1	8	-	-	-	-
Total	12	100	8	100	7	100

From the above Table 1, out of the 12 auditors who responded, 11 accepted that all records required for compiling audit reports were provided. This represented 92% of the auditors. Only one auditor mentioned that not all records were provided and this was 8% of all the 12 auditors. The audit assistants who accepted that records were provided were eight and this represented 100% since no one disagreed. 7 audit committee members also accepted that records were provided and this was 100% since no one disagreed. Most respondents who returned their questionnaires accepted that they were provided with the appropriate records to enable them compile audit reports. However only one respondent denied that all records were provided. That was evident that not all construction companies provide records to the internal auditors.

**Table 2 Operations and structural in the organization**

Level of independence in terms of operations and structure in the organization	Auditor		Assistant Auditor		Audit committee member		Total	
	Count	%	Count	%	Count	%	Count	%
Very independent	9	75	5	56	3	50	17	63
Somehow independent	2	17	4	44	2	33	8	30
Not independent	1	8	-	-	1	17	2	7
Total	12	100	9	100	6	100	27	100

From the above Table 2, 17 respondents (63%) agreed that internal auditors were very independent in the organizations. 8 respondents representing 30% agreed that internal auditors were somehow independent while two respondents (7%) consented that there was no independence. As per the above findings, 37% of the respondents were not satisfied with the internal auditors' independence in the construction companies. However, 63% of the respondents were satisfied that there was independence. 37% is substantial for the researcher to carry out this study to investigate the internal audit structure and operations and give the way forward.

#### 4.3 Internal audit qualifications consideration:

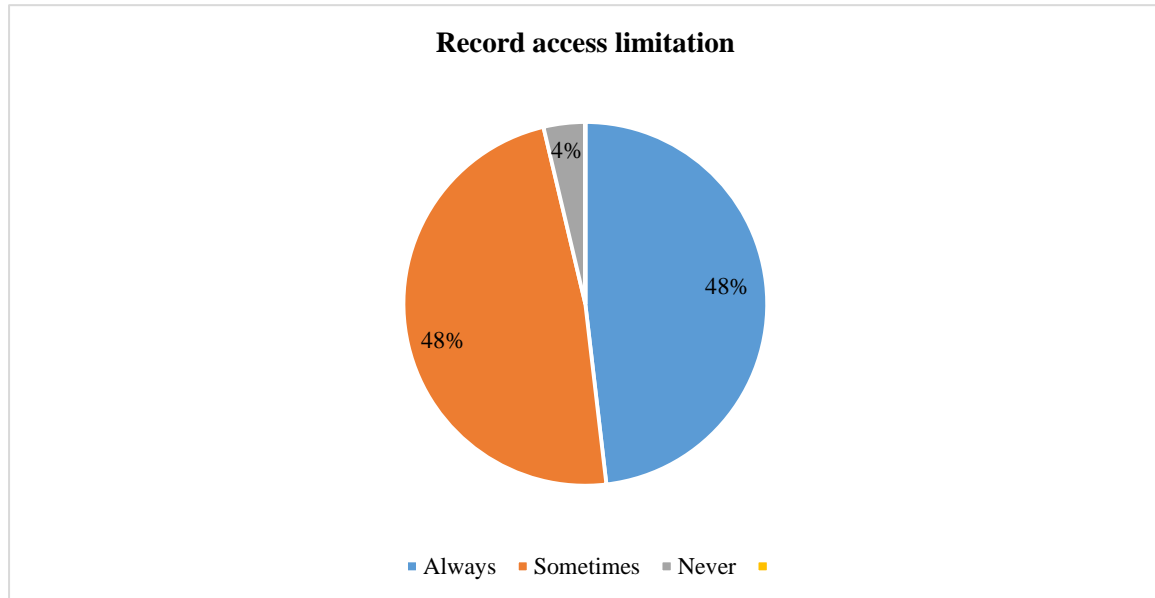
**Table 3: Internal auditor qualifications**

Are internal auditor's qualification considered in your organization?	Auditor		Assistant Auditor		Audit committee member		Total	
	Count	%	Count	%	Count	%	Count	%
Strong	8	67	8	89	5	83	21	78
Partially	4	33	1	11	1	17	6	22
Total	12	100	9	100	6	100	27	100

From the above Table 3, 21 respondents, representing 78% agreed that internal auditors' qualifications were being considered in the organizations. The above respondents comprised of eight auditors, eight audit assistants and five audit committee members. 22% of the respondents partially agreed that internal audit qualifications were considered in the

organizations. Though a bigger percentage depict that internal audit qualifications were considered in the organizations, there was also views from six respondents, which represented 22% that it was partial in some organizations. Internal audit qualification contributes a lot to the organizations operations as it helps in producing sound financial statements.

**4.4 The internal auditors’ access to information:**



**Figure 2: Internal auditor’s records access limitation.**

Generally, from Figure 2 above, 13 out of 27 respondents agreed that there was unlimited access to information they were supposed to audit before. Other 13 respondents gave information that they access was not unlimited but sometimes respondents consented that they never had access to information they were supposed to audit before. Thus 48% of the respondents agreed for unlimited aces, 48% of the respondents did not fully agree and 4% said they never had access. From the findings above, not all organizations allowed unlimited access of information to their internal auditors.

**Table 4: Internal audit independence on the financial performance**

Evaluate internal audit independence on the financial performance from the activities it audits	Auditor		Assistant Auditor		Audit committee member		Total	
	Count	%	Count	%	Count	%	Count	%
Strong	6	50	5	56	-	-	11	41
Adequate	6	50	4	44	4	67	14	52
Needs improvement	-	-	-	-	2	33	2	7
Total	12	100	9	100	6	100	27	100

From the Table 4 above, 11 out of 27 respondents considered internal audit independence on the financial performance of an organization as strong (41%) of the respondents. 14 respondents indicated that internal audit independence was adequate to the financial performance of organizations while two respondents indicated that there was need for improvement. The percentage of 52% and 7% of the respondents indicated that internal audit independence was not strong on the financial performance from the activities it audits. From the above findings, it has been observed that internal audit independence affects the financial performance of organizations on the activities it audits thus it needs some improvement.

**4.5 Measuring the financial performance of organizations:**

The researcher sought to know from the respondents the rating of the financial performance of their organizations. The respondents were asked to use attributes to rank the performance. The highest attribute was one and the lowest was four;

1=improving fast, 2=improving slowly, 3=neutral, 4=declining. The data was analysed using Microsoft Excel and rankings done through mean and standard deviation.

## **5. CONCLUSION AND RECOMMENDATION**

### **5.1 Conclusion:**

From the research, it is evident that some construction companies within Mombasa County did not accord the internal auditors the independence they deserved to effectively give their opinion on the financial statements of the organizations. However, some other construction companies are generally precognitive of the internal audit function independence. In most organizations, internal auditors are not fully recognized for their important roles of checking and reporting on the financial records of the organizations.

### **5.2 Recommendations:**

Among construction companies in Mombasa County, some do not accord internal auditors the independence they require in reporting on the financial statements and other organizational policies to meet their mandate for internal audit. The study reveals that, the general level of internal audit independence in the construction companies is relatively weak and in some cases non-existence.

According to the researcher, the challenges and limitations faced by the internal auditors on independence of their roles and functions in the construction companies could be solved. This could be through Public education by the government to the management of SMEs in the construction industry on the importance of internal audit independence.

The SMEs should employ competent internal audit professionals and set them free to work. Also the government should establish an internal audit unit, which should be independent to ensure that all SMEs in Kenya comply with the laid down audit procedures and rules.

### **5.3 Future Research:**

The research project could be used by the future researchers to enhance the internal audit independence on the financial performance of SMEs on the same industry or a different industry in an economy. The future researchers on the same or related research project should focus on the effects of Public Education on the importance of internal audit independence and the financial performance of SMEs. Other areas could be the effect of internal audit unit on the financial performance of SMEs, or the effect of internal audit qualifications on the financial performance of SMEs.

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