

**IMPACT OF INTERNAL AUDITORS' REPUTATION ON MANAGERS' RELIANCE
DECISION**

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Declaration

We researchers of the year 2020 declare that the work in this management research paper is our own work and has not been previously submitted by us for a degree at any other university or institution

Signature: _____ Date: _____

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This management research paper has been submitted for examination with my approval as university supervisor

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Signature: _____ Date: _____

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Abbreviation and acronyms

IAF - Internal audit function

SPSS - Statistical Package for Social Sciences

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Abstract

This study sought to investigate the existing relationship between the internal audit function and decision making by management. The study focused on mid-size manufacturing firms in Nairobi County, Kenya. To fulfill its objective the study operated a descriptive research approach. The target population in the study was the medium size manufacturing firms. 30% of the medium size manufacturing firms in Nairobi were selected for the study. This generated 30 firms.

Primary data was collected using a quantitative approach. The respondents were either of the three (3) business unit heads designated as CEOs or senior Managers, general managers and functional heads from each of the firms who are responsible for day to day operations of the enterprises. The data obtained was mainly quantifiable in nature and hence was analyzed by descriptive analysis. The researcher conducted inferential analysis which included a multiple regression analysis. The study concludes that internal audit functions have a significant effect on the management's decision and as a result financial performance of mid- size manufacturing firms in Nairobi.

There was a strong positive relationship between financial performance of mid-size manufacturing firms and internal audit aspects of functions. There is therefore the need for mid-size manufacturing firms to adopt effective internal processes and practices that address key internal auditing practices for effectiveness of audit quality. In order to implement good internal audit independence, managers need to know that they should be concerned about the interrelationships between internal audit independence and financial performance.

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CHAPTER ONE

1.1 Introduction.

Brody and Lowe,(2000).Carcello et al,(2005). Allergini et al, (2006). Observe that the Internal audit function (IAF) is a major component in the organization structure. The role of internal auditors has been evolving and continues to expand to a wider variety of activities. From previous studies, the work done by internal auditors was only limited to auditing and assurance services. However the need to add value to the organization has caused a change in their role to providing consulting services. Moreover, internal auditors should give ideas and solutions concerning decisions made by the management. (Brody and Lowe, 2000; Sarens and De Beelde, 2006)

This study investigates how past performance information is used to foresee future performance in the same field in a business. (Smither et al, 1988; Sumer and Knight, 1996; Reilly et al, 1998).It is however not known whether one's performance in one field affects their performance in another field. Therefore, for auditor's independency it is mandatory to change its firm or its audit partner after a period of time (Arel et al, 2005). Changing the auditor is necessary and even required by law in different countries for mainly two reasons; first, in order to maintain the auditor independence which otherwise would be eroded due to the personal attachments between the client. Second, is to enhance the audit quality through promoting the creativity in audit testing approaches and methods which might be restricted due to increased familiarity with the client and staleness in performing the audit (Carey and Simnett, 2006). Changing the auditor is necessary and even required by law in different countries for mainly two reasons; first, in order to maintain the auditor independence which otherwise would be eroded due to the personal attachments between the client. Second, is to enhance the audit quality through promoting the creativity in audit testing approaches and methods which might be restricted due to increased familiarity with the client and staleness in performing the audit (Carey and Simnett,

2006). There are two functions of internal auditors; assurance and consulting, which differ from each other in their objectives and require special skills. (Brody and Lowe, 2000)

1.2 Background Of The Study

The Internal Audit Function (IAF) initial function was majorly compliance-based auditing, while internal auditors evaluated the adequacy and effectiveness of internal controls. Selim et al., (2003) observes that major firms have been undergoing changes which have increased pressures on the IAF, making internal auditors to take on responsibilities beyond their capabilities. This in turn made the internal auditors focus more on activities that add value to the business which include examining business activities and helping organizations improve their functionality. (Burton et al., 2014).

A few recent studies examine issues related to managers' dependence on information provided by the internal auditors. Sarens and De Beelde (2006) perform a qualitative analysis to broadly explore the relationship between the IAF and management, as well as their expectations of each other. They find that managers expect the IAF to provide assurance on how effective internal controls should be, to help in improving those controls and to take part in the development of risk management systems. Managers agree more with internal auditors who organize their arguments and are likable even if an auditor's position is not supportive in the management's position. (Fanning & Piercey, 2014).

A report by Tang et al. (2017) insinuates that internal auditor engagement reputation has positively impacted managers' reliance on consulting recommendations in the decision making process. An auditor's previous reputation influences how other people judge them which have also been used to influence their judgment in accounting setting. (Smither et al., 1988; Sumer and Knight, 1996; Reilly et al., 1998)

According to (alias et al 2019) IAF has a very important role in helping the management to deal with fraud and irregularities. Mihret et al (2010) gives evidence that suggest IAF effectiveness may not be

achieved for various reasons. Previous studies have been using tax complexity as a contextual variable in various domains (arena and serens 2015, wegge et al 2008 and gerger et al 2014). Auditor's reputation has received less attention in auditing research (Mohd-sanusi and Mohd-iskander 2007).

According to Park et al(2019), a few studies have been conducted on IAF. Moreover, Arena and Azzone (2009), Endaya and Hanefah (2016), Madawaki et al. (2017) and Mihret et al. (2010), have voiced the need for further research to evaluate the factors influencing IA effectiveness. In this case, there is need for adequate theories to be utilized to support research on IA effectiveness

1.3 Problem Statement

Internal auditors ensure efficient financial management and assurance services of an organization. They promote transparency and accountability. However, according to Otley and Pierce (1996) auditors tend to report below their expected standards due to time constraints. Herbach, (2005) insists on the importance of having a time frame and due dates associated to audit planning. Also, in the internal audit process, there is a rise in cases connected to fraud and corrupt practices which bring about inefficiency in the management resources.

1.4 General objectives

- To establish the impact of internal audit reputation on managers reliance decision.

1.4.1 Specific objectives..

- To determine how past experience of auditors influences the managers reliance decision making.
- To determine how auditors performance reputation affects the managers reliance decision making.

- To determine how the internal audit functions have an effect on managers reliance on decision making.

1.5 Significance of the study.

This study examines how auditor's performance reputation affects and impacts the management function in the organization. It will enable policy makers who are also the management in the organization to make rules and regulations that will enhance effectiveness of the internal auditors. They will also be able to know when to rely on information given by internal auditors to make decision.

The researchers will be able to understand how to conduct themselves and enhancing their reputation as auditors so that managers or their employees will not misjudge them.

1.6 Scope of the study.

The study ought to establish how internal auditors reputation, the past experience and auditors performance affects managers reliance in decision making in the Kenyan private banking sector. This study will be conducted from February 2020 to March 2020 and will focus on the private banks around Nairobi that are listed in the Nairobi Securities Exchange for easy access of information.

1.7 Limitations of the study.

The research will be hindered by the fact that bank organizations may not be welcoming to disclose all the information about their internal audit process. Moreover, the researchers will consume a lot of time when gathering information about the research. Financial constraints could also hinder the success of the research while trying to get all the necessary requirements for the research to be successful .

CHAPTER TWO.

2.1 Introduction

This chapter focuses on the type of theory adopted to carry out the research. The researchers opted to use the agency theory that assumes principle and agent work rationally to optimize their wealth. (Jensen & Meckling, 1976). In this case it shows how managers rely on internal auditors work in the decision-making process. This comes with variables that affect the decision-making process in an organization which may include auditors past experience, internal audit function and performance reputation. Auditors past experience looks at the history of the auditors which therefore determines both the present and future performance as well as the auditors continuous stay in the business. The internal audit function examines the auditor's effectiveness, efficiency and capability in the business so as to perform the right duties and tasks that are legible to the auditors. Auditors performance reputation looks at the auditor's character in terms of their past experiences in the field and how they performed.

2.2 Theoretical Review

Agency theory posits that a company has a nexus of contracts between the owners of the economic resources (the principals) and managers (the agents) who are appointed by using and controlling the owners resources (Jensen & Meckling, 1976). Agency theory assumes that principals and agents work rationally to maximize their own wealth. According to Jensen and Meckling (1976), this assumption holds a threat of moral hazard problem, in the aim to maximize their profits, agents may act against the interests of their principles. To reduce the likelihood of the moral hazard problem, principals and agents engage in contracting to achieve Pareto-optimality, including the establishment of monitoring processes such as an IAF (Adams, 1994). Sherer and Kent (1983), look at IAF as the bonding cost borne by managers to satisfy the owners demands for accountability. IAF plays an important role in reducing information asymmetries between principals and agents. As information asymmetries increases, the need for people taking up monitoring roles arises. Therefore the company will hire

internal auditors and in turn have more employees. Conflicting goals between principals and agents are common for organizations, which in turn affect inter-relationships on an organizational footing. The agency theory has had little attention in the internal auditing field, yet is fundamental to relationships and communication. (Parker et al. 2018). However, it is argued that the principal, by employing the agent to represent his interests, must overcome a lack of information about the agent's performance of the task. It might be dangerous as we get to see that auditor's reputation or rather, the agents performance should be considered while employing internal auditors. If not treated well, IAF might bring about agency loss, which comes about when the principal suggests a loss happened due to an agents actions that were not in the best interest of the principal.

2.3 Empirical Literature Review

2.3.1 Internal Auditing Function.

The Institute of Internal Auditors (IIA) 2015, has described internal auditing as an autonomous, objective assurance and consultancy practice designed to add value and enhance the operations of an organization. It helps an organization achieve its objectives by offering a structured, disciplined approach for evaluating and enhancing the effectiveness of risk management, control and governance IAF is recognized as a provider of both assurance and consulting services, its initial role was primarily centered on compliance-based auditing, and evaluating the adequacy and effectiveness of internal controls was the internal auditors' most important job. The study emphasizes the need for internal audit function in enhancing the performance of the corporate manager's reliance in the decision making in an organization. IAF aims at examining and bettering the effectiveness of risk management, control and management functions, thereby providing objective assurance to the interested party International Federation of Accountants(IFAC, 2010). Currently the internal audit function is considered to be an independent tool for appraisal of internal control effectiveness to help the

management process in achieving set corporate and organizational objectives and goals (Haron et al., 2010). The internal audit function is supported by its efficiency, follow-up and its independence. Internal audit helps the organization to achieve its objectives by evaluating a systematic and methodical approach to its risk management processes, control and management of the entity and making proposals to strengthen their effectiveness. Internal and external auditors reduce the business risk of a company and ensure that its financial statements fairly depict the economic stability of a business (Moizer, 2005; Nerantzidis, 2015). Internal auditing improves business's performance and it is a tool for the achievement of competitive advantage (Karagiorgos et al., 2010). Sawyer (2003) stated that internal auditing function is a sensitive, objective by internal auditors of the different operations and controls within an organization to determine whether ; financial and operating information is accurate and reliable, risks to the business are identified and minimized, external regulations and acceptable internal policies and procedures are followed, satisfying operating procedures are met, the resources are used efficiently and economically and the organization's objectives are effectively achieved all for the purpose of the efficient and effective management on reliance of decision making process in the business. The performance standards describe the internal audit activities and provide criteria for the evaluation of audit process (Moeller, 2009).

2.3.2 Managers Reliance Decision.

Sarens and De Beelde (2006) perform a qualitative analysis to broadly explore the relationship between the IAF and management, and the expectations they have. The researchers find that managers expect the IAF to provide assurance of internal controls being effective. Internal auditor assurance engagement reputation has a positive impact on managers' reliance on consulting recommendations. (Tang et al. 2017). According to the model of rational decision making, managers behave similarly as actors when they enter decision situations with known objectives. The actors gather appropriate

information and develop a set of alternative solutions. They select the optimal alternative. Near cognitive ability makes managers more myopic and cautious in perceiving information and interpreting it further. However, managers make incorrect assumptions about the information available, what happens in practice due to a lack of free time comfort. We can't forget managers often act under the pressure of time. Hence, we agree with a view of Shah, Horne, and Capella (2012), who argued that even good data would not guarantee good company decisions. The information and data sources, no matter how detailed or well made, clear analysis, in different possible contexts, and sound decision based on logic need to be complemented. Therefore, the only way to have an effect on managerial decision-making and learning processes is for marketing researchers to only provide reliable, open, detailed, relevant information of superior quality, information which is accurate, transparent, comprehensive, relevant and which reduces managerial uncertainty by providing direct responses to managerial questions.

2.3.3 Performance Reputation.

A study in psychology and organizational behavior by (Reilly et al., 1998) alludes that an auditor's previous reputation influences how other people judge them which has also been used to influence their judgment in accounting contexts. Previous papers indicate that one's prior performance may be used to foresee the future performance in one field but it is not clear if an auditor's reputation in a specific field will reflect reliance in a different field. An internal auditor may be better at evaluating internal control but poor in formulating business processes to increase productivity. However, it is a learning process. This shows the transfer of knowledge occurs across fields where auditors give non-audit and audit services, and that such knowledge helps in evaluating audit risks (Joe and Vandervelde, 2007). It is necessary to comprehend whether performance reputation in the internal auditing function influences managers' while making decisions in the organisations or not. The signaling theory

expounds how performance reputation in the audit process affects the reliance of managers on their consulting recommendations. Researchers have used this theory to understand decision-making in various departments such as accounting (Balvers et al., 2002; Merkl-Davies and Brennan, 2007), marketing (Boulding & Kirmani, 2001; Gammoh et al., 2006), entrepreneurship (Certo et al., 2001; Busenitz et al., 2005) and management (Bergh et al., 2010; Suazo et al., 2011). Managers are more likely to rely on information provided by internal auditors in regards to their performance reputation.

2.3.4 Past experience

The study researches on the past experience of the internal auditors in regards to the managers decision making. It concentrates on the assurance and auditing role described by the IAF. A previous study by Goodwin and Yeo (2001) shows that internal auditors' equitability is compromised in IAF, being used as management training platform. Brody et al. (2014) study how audit reforms influence the objectives of the auditors and finds that the internal auditors consulting services provided is biased favouring the position of the clients. Asare et al. (2008) state that the internal auditors are precise in the performance rewards and the plans are altered accordingly. Pizzini et al. (2015) describe that IAF quality helps decrease slow audit performance as per the IAF fieldwork quality and competence. (DeZoort et al., 2001) state that internal auditors are consultants while external auditors view them as being less objective in performing their roles. There is less research done on factors influencing the managers dependence on the internal auditors functionality. Fanning and Piercey (2014) show that managers agree with the internal auditor if the information is amiable and engages reasonable discussions, despite the information being supportive or not. Consulting advice is based on the managers reliance on information given by the internal auditors whether it can influence the decisions made or not in the organization

2.4 Conceptual Framework.

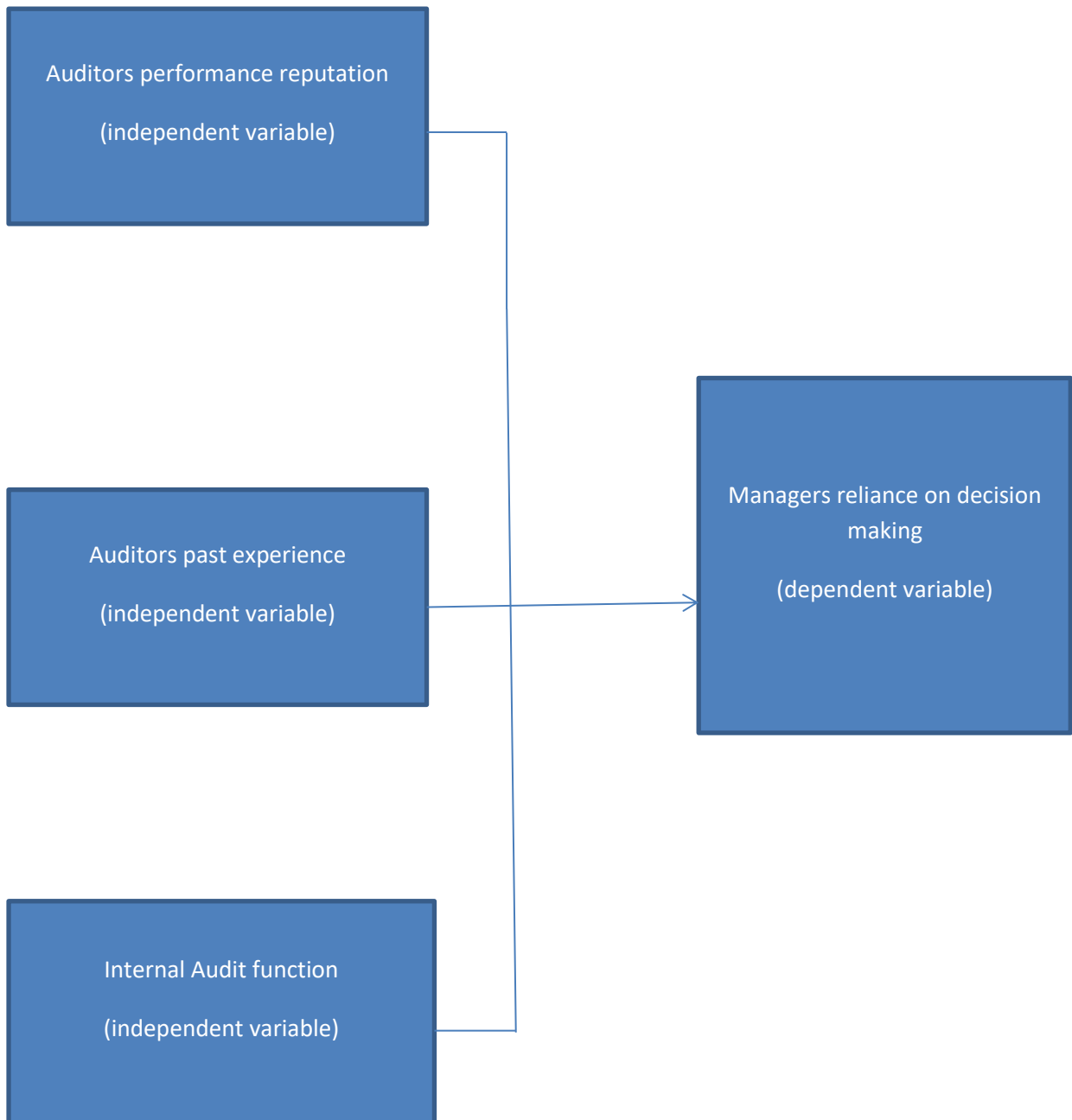


Fig 2.1 conceptual Framework. Source:Authors

2.5 Research gaps.

The audit function has become an integral part of organization financial management and an instrument of improving performance in business entities (AlShammari, 2010). Thus, the internal auditing function gauges the usefulness of manufacturing firms in accomplishing approved purposes and thereby stimulating resilient authority and responsibility in firms. The recommendations made by internal audit for improvement helps management in manufacturing sector entities to improve their risk management, control and governance processes (Van Gansberghe, 2005). The internal audit function offers an unfailing, objective and impartial service to the management, board of directors, and audit committee, while stakeholders are interested in return on investments, sustainable growth, strong leadership, and reliable reporting on the financial performance and business practices of a company (Ljubisavljević & Jovanovi, 2011). Hutchinson and Zain (2009) explored the relationship between internal audit quality (audit experience and accounting qualification) and firm performance (ROE) in Malaysia. The results showed a strong relationship between internal audit quality and firm performance with opportunities of high growth and that this positive link is decreased by the increasing independence of audit committee.

Locally, Gaturu and Ngahu (2015) did a study on the effect of computerized audit system on financial management at Water Resources Management Authority in Nairobi County. Their study found that computer-assisted audit techniques and internal controls influenced financial management in WRMA. Their main focus was on computerized audit system and its effect on financial performance of WARMA whose orientation in the sectors of economy is different from that of mid-size manufacturing firms in Kenya. Kiema, Ahmed and Ndirangu (2015) investigated the influence of internal audit independence on the financial performance of small and medium enterprises in the Construction Industry in Mombasa. Kiema et. al., (2015) found 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. The study did not give a clear direction of the relationship between internal audit function as a whole with the financial performance of firms in the mid- size manufacturing sector. Ondieki (2014) conducted a survey of the effects of internal audit on financial performance of commercial banks in Kenya and found that internal audit standards, independence of internal audit, professional competency and internal control had a positive relationship with financial performance of commercial banks. Ondieki looked at internal audit in the context of banking firms and did not link the internal audit function to the financial performance of the banks and therefore could be interesting to link the internal audit function and financial performance in the midsize manufacturing firms.

As evidenced from the foregoing studies, there is unanimous agreement that if left unexploited internal audit is most likely to affect the financial performance of mid- size manufacturing firms. There have been no published studies on the relationship between the internal audit function and financial

performance of mid- size manufacturing sector organizations in Kenya hence the research gap. To this end the study sought to respond to the following research question: What is the relationship between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi County?

CHAPTER THREE.

3.1 Introduction

This chapter focuses on the research methodology on how the managers' reliance on decision making upon the performance reputation and past experience on the internal auditors giving the research design, study on the population, sampling procedure and the data analysis found. Internal auditors should recommend ideas and solutions on various functions to managers (Brody and Lowe, 2000; Sarens and De Beelde, 2006), this will make it easier to create a relationship between the managers' reliance on decisions making and the performance reputation and the past experience of internal auditors. How managers are willing to accept internal auditors' recommendations, ideas and solutions is important, as the factors that influence managers' perception and reliance on decision making.(Burton, 2012; Trotman, 2013).

3.2 Research Design

The study adopts an exploratory design of independent variables; the auditors' reputation and the past experience of the internal auditors in regards to reliance of managers' decision making. A case study adapted from Kadous et al. (2005) and (Burton et al., 2012) has been used to study managers' reliance on internal auditors on the past experience. The performance reputation occurs when auditors are questioned on engaging themselves in wrongdoing or undesirable acts in the society (Randall and Fernandes, 1991; Arnold and Feldman, 1981). Audit research examining and questioning to gain insight into factors that bring about the occurrence of such behavior that is hard to discuss about (Alderman and Deitrick, 1982; Willett and Page, 1996; Coram et al., 2004, 2008). The insight on how the performance of the auditors and past experience, will whether affect the managers reliance on decision making or not, if it is bad or good . This research investigates the different effects of internal auditors' recommendations in an operational setting.

3.3 Study population

A researcher has to have a specific number as his population target upon which he makes all his inferences regarding validity of what he/she is researching on. A population frame is a comprehensive itemized list of all subjects, which comprises the study population, from which a sample was taken (Mugenda & Mugenda, 2008). The study targets private enterprises that have been listed in the Nairobi Securities Exchange.

3.4 Sampling Procedure

Sampling is selecting some of the instruments in a population from which a researcher draws conclusions about the whole population. A population group is the subject on which measurements are obtained; it is the entity of study (Cooper & Schindler, 2010). The empirical analysis is performed on all the audited private banks between 2010 and 2018 in Kenya. The research obtains audit related information from banks' financial information in regards to managers' reliance on auditors reputation and past experience. Studying a sample selection allows for greater accuracy of results, greater speeds of data collection, lower cost of research and availability of the population elements (Mugenda, 2011)

Stratified random sampling technique has been used to select members of the audit committee and senior internal audit staff. Random sampling was used to select individual members to take part in the study ensuring every member of the population was accorded an equal chance of being included in the study thus eliminating biasness. (Mugenda, 2008)

3.5 Data collection methods.

Primary data collection method will be used. Data will be collected using a structured questionnaire for both quantitative and qualitative information. The questionnaire will be developed based on the variables. The questionnaires will contain five sections. Section A will seek to establish the

respondent demographic information, section B will seek to establish auditors reputation in the organisation, section C will seek to establish how the auditors performed in the previous years, section D will seek to know about the performance of the internal auditors while section E will seek to establish how often the managers rely on the auditors information in making their decisions The questionnaires will be structured to answer the inquiry questions based on a 5 point Likert scale questions which will be close ended to give the respondents limited and pre-determined responses to choose from.

3.6 Data analysis methods

This study is to use qualitative method of data analysis. This method targets non-numerical data where the data collected from the respondents who filled the questionnaire gets to be analyzed to get results. Statistical Package for Social Sciences (SPSS) is to be used to analyze data for accurate results..

3.7 Ethical Considerations

The research will be conduct in banks therefore official permission will be sought from the respective management before giving questionnaires to the employees. The respondents identity will be hidden by labeling them with numbers. Information gathered from the research will only be used exclusively for academic purposes and not disclosed anywhere else.

Appendix I

A study questionnaire was put out to employees of a bank to determine the impact of internal audit function.

QUESTIONNAIRE

(Select where appropriate)

1. Gender

- Male
- Female

2. Department

- Finance
- IT
- Human resource
- Marketing

3. Years of experience

- 0-5
- 6-10
- 11 and above

4. What is the take on internal auditors in private banks

- Excellent

- Above average
- Average
- Below average
- Poor

5. How do internal auditors demonstrate courtesy, professionalism and constructive positive approach

- Excellent
- Above average
- Average
- Below average
- Poor

6. Are internal auditors fair, reasonable and objective in providing assessments?

- Excellent
- Above average
- Average
- Below
- Poor

7. How convenient is an auditors prior experience in determining managers decision

- Excellent

- Above average
- Average
- Below average
- Poor

8. Do you feel that the audit processes are sufficient and key risk areas are covered?

- Excellent
- Above average
- Average
- Below average
- Poor

9. How beneficial is the internal audit function in your department

- Excellent
- Above average
- Average
- Below average
- Poor

10. Do you consider that communication between the internal auditors and the management is efficient

- Excellent

- Above average
- Average
- Below average
- Poor

Appendix II

Budget Proposal

Budget Category	Units	Total cost
Transport	800*4	3,200
Printing of Questionnaire	100*10	1,000
Indirect costs	500*8	4,000
Personal Services	200*4	8,000
TOTAL COSTS		16,200

Table 3.1 Budget proposal

Appendix III

Time Frame Activities

Time frame activities	Week 1	Week 2	Week 3	Week 4
Topic Selection				
Data collection from books and journals				
Formulating Research design				
Selection of research techniques				
Data collection, analysis and interpretation				
Analysis of findings and conclusions				

Final submission of the report				
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Table 3.2 Time frame activities

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND DISCUSSION

4.1 Introduction

This section is concerned with analyzing the results of the study on the relationship between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi, Kenya. The results presented here show the discussion of the findings in comparison with relevant theory and literature as established by other authors in the same field of study. The data was collected through semi-structured questionnaire specifically designed to generate data relevant to the research objective and analyzed through descriptive analysis. Secondary data was used to supplement the data collected from the questionnaire. The questionnaire was designed in line with the objectives of the study. The data obtained was fed into SPSS version 20.0 and used to analyze the relationship between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi Kenya.

4.1 Response Rate

The study involved 30 CEOs or senior managers, general managers and functional heads of the 30 selected medium size manufacturing firms in Nairobi Kenya as they understand the relationship between internal audit function and financial performance of mid-size manufacturing firms in Nairobi Kenya. The questionnaire return rate results are shown in Table 4.1.

Table 4.1: Response Rate

Response	Frequency	Percentage
Responded	27	90.0
Not responded	3	10.0
Total	30	100.0

Source: Research Data, 2020

As shown in Table 4.1, 27 out of the 30 questionnaires were received back from the respondents fully filled which accounts to 90.0% response rate. On the other hand 3 of the questionnaires (contributing to 10.0% of the sample) were not received and therefore were not

considered in the analysis. According to Kothari (2006), a 50% response rate is adequate, 60% is good, while 70% and above is rated to be very good. This also collaborates with Bailey's (2000) assertion that a response rate of 50% is adequate, while a response rate greater than 70% is very good. From the foregoing, the response rate provides adequate data to proceed with the analysis.

4.2 Background Information

The study targeted to collect data from the staffs comprising of CEOs or senior managers, general managers and functional heads. As such, the study sample included managers, assistant managers, supervisors and general staff. This was relevant to assess the distribution of the respondents across the management levels. According to the results shown in Figure 4.1, majority (41.0%) of the respondents were assistant managers, 25.6% of them were supervisors, 23.1% of them indicated that they were general staffs, while 10.3% of the respondents comprised of managers. From these results, the respondents that participated in the study are mainly those involved in the formulation and implementation of the decisions concerned with the internal audit function and financial performance of mid-size manufacturing firms and hence their insights are viewed as more resourceful for knowledge and policy recommendations.

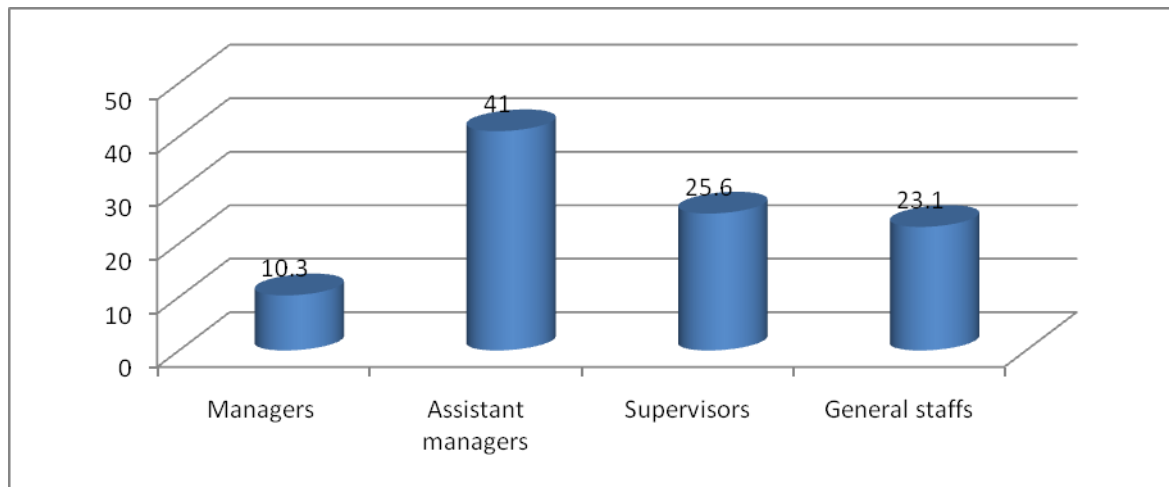
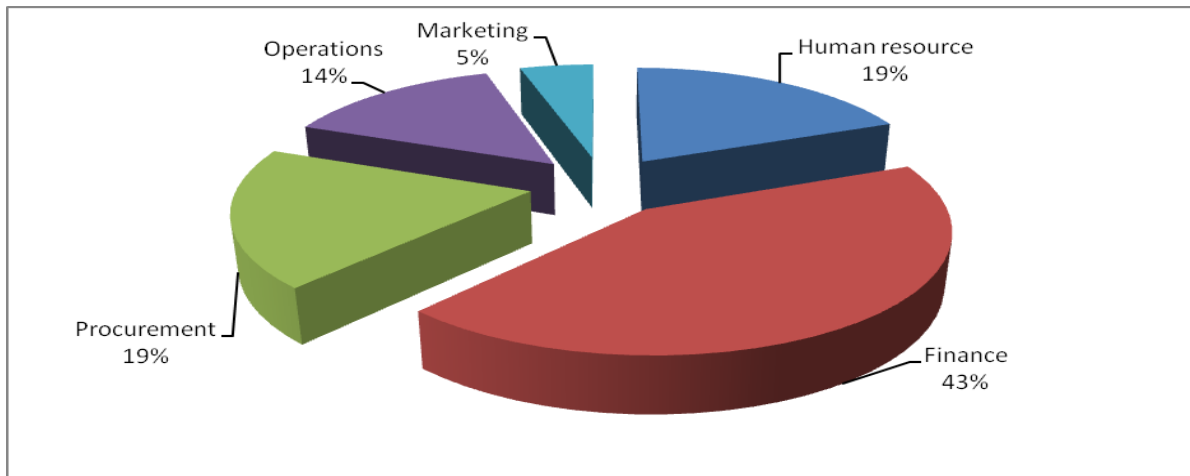


Figure 4.1: Designation of the Respondents

The study sought to establish the length of time that the respondents had been working in the mid-size manufacturing firms. From the results shown in figure 4.3, 42.9% of the respondents were working in the finance departments, 19.0% of them were working in the human resource

departments, 19.0% worked in procurement department, and 14.3% worked in the operations department, while 4.8% worked in marketing departments. This implies that all departments that were targeted by the study were involved and that the findings are not biased hence representative of the various departments' views on relationship between internal audit function and financial performance of mid-size manufacturing firms in Nairobi Kenya. The results are presented in Figure 4.2.

Figure 4.2: Respondents' Departments



The study sought to establish the length of time that the respondents had been working in the mid-size manufacturing firms in Nairobi. The results are as demonstrated in Table 4.2.

Table 4.2: Duration Worked in Medium Size Manufacturing Firms in Nairobi

Length of Service	Frequency	Percentage
Less than one year	4	15.0
1- 5 years	9	34.0
5-10 years	10	38.0
11 to 15 years	4	13.0
Total	27	100.0

Source: Author, 2020

From the study, 38% of the respondents indicated that they had worked with the medium size manufacturing firms in Nairobi for a period of 5 - 10 years, 34% of them had been working in

the selected medium size manufacturing firms in Nairobi for 1-2 years, 15% of them had been working in the medium size manufacturing enterprises in Nairobi for less than one year whereas 13% of them had worked in the medium size manufacturing firms in Nairobi for a period of 11 to 15 years. This implies that most of the staffs participating in this study had been operating for an ample time thus they were conversant of the information that the study sought pertaining to the relationship between internal audit function and financial performance of mid-size manufacturing firms in Nairobi Kenya.

The study further sought to ascertain the length of time that the firms have been in operation within the area. Table 4.4 shows the results.

Table 4.3: Firms' Length of Operation

Length of Operation	Frequency	Percent
0-5 years	6	23
6-10 years	12	45
Over 10 years	9	32
Total	27	100

Source: Author, 2020

From the study, 45% of the respondents indicated that their firms have been in operation for a period of 6-10 years, 32% of the firms had operated in the mid-size manufacturing industry for more than 10 years, while 23% of them indicated that their firms had been in operation for 0-5 years. This is a clear indication that most of the firms sampled had been operating in the industry for a long time hence are better placed to respond to the issues sought by this study concerning the relationship between internal audit function and financial performance of mid-size manufacturing firms in Nairobi. This is an indication that the companies have gone through several stages of transformation in the internal audit.

4.3 Internal Audit Function and Financial Performance

The main purpose of this study was to determine whether a relationship exists between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi County, Kenya. In this regard the respondents were required to indicate the extent to which internal audit functions affect the financial performance of the mid- size manufacturing firms

in Nairobi.

Table 4.4: Extent to which Internal Audit affects Firms' Financial Performance

Extent	Frequency	Percent
To a very great extent	3	11.9
To a great extent	6	23.8
To a moderate extent	14	52.4
To a little extent	3	11.9
Total	27	100.0

Based on the results as tabulated in table 4.4, 52.4% of the respondents unanimously indicated that internal audit functions affect the financial performance of the mid- size manufacturing firms in Nairobi to a moderate extent and 23.8% of them indicated to a great extent. Further, 11.9% reiterated that internal audit functions affect the financial performance of the mid- size manufacturing firms in Nairobi to a very great extent, while another 11.9% of the population studied reported that internal audit functions affect the financial performance of the mid- size manufacturing firms in Nairobi to a little extent. The results are an indication that the internal audit functions have a significant effect on the financial performance of the mid- size manufacturing firms in Nairobi.

The respondents were required to indicate the various aspects that represent the scope of work for internal audit in the mid- size manufacturing organizations. Table 4.5 shows the results of the study.

Table 4.5: Scope of Work for Internal Audit in the Organizations

Aspect	Frequency	Percentage
Verification of financial transaction (Financial audit)	25	92.6
Assessing and promoting the adequacy of corporate governance	24	88.9
Assessment of internal control	26	96.3
Evaluates projects/ programs accomplishments (effectiveness)	24	88.9
Operational audit	22	81.5
Compliance audit	24	88.9
Assessment of organizational risk	23	85.2
Fraud investigation	20	74.1
Information system audit	21	77.8

According to Table 4.5, 96.3% of the respondents agreed that assessment of internal control represents scope of work for internal audit in their firms, followed by 92.6% who indicated verification of financial transaction (Financial audit), 88.9% of the respondents indicated assessing and promoting the adequacy of corporate governance, 88.9% of them indicated evaluating projects/ programs accomplishments (effectiveness), 88.9% indicated compliance audit, 85.2% of them reported assessment of organizational risk, 81.5% indicated operational audit, 77.8% of the respondents indicated information system audit and 74.1% of the respondents indicated that fraud investigation represents scope of work for internal audit in the mid- size manufacturing firms in Nairobi.

The respondents were further required to indicate their level of agreement with the various statements provided regarding the internal audit function in the mid- size manufacturing firms in Nairobi. A scale of 1-5 was provided where; [1] is strongly disagree; [2] is disagree; [3] Neutral; [4] Agree; and [5] Strongly Agree.

Table 4.6: Agreement with Statements on Independence of Internal Audit

Independence of internal audit	Strongly disagree	Disagree	Neutral	Agree	Strongly agree	Mean	Std. Dev.
Independence of internal audit affects the financial performance of this organization	0	3.7	37	59.3	0	3.546	0.5905
There is independence of internal auditors in operations and structure	0	14.8	44.5	40.7	0	3.249	0.7078
This firm has formalized principles of internal audit providing for its position and powers in the framework of the firm	0	3.7	40.7	51.9	3.7	3.516	0.6197

From the study, majority of the respondents agreed that independence of internal audit affects the financial performance of this organization as shown by a mean score of 3.546 and that their firms have formalized principles of internal audit providing for its position and powers in the framework of the firms as shown by a mean score of 3.516. On the other hand the respondents indicated neutrality on that there is independence of internal auditors in operations and structure as shown by a mean score of 3.249.

Table 4.7: Agreement with Statements on Professional Competency

Statements on Professional Competency	Strongly disagree	Disagree	Neutral	Agree	Strongly agree	Mean	Std. Dev.
Professional competency affects the financial performance of this firm	0	7.4	40.7	51.9	0	3.467	0.6322
The internal audit staff is remaining current with changes in accounting and financial reporting requirements	0	7.4	37	55.6	0	3.533	0.6190
The internal auditor has an un-limited access to information they are supposed to audit before	0	3.7	40.7	44.5	11.1	3.583	0.7725
There are procedures in place for checking auditors' qualifications by the management	0	25.9	7.4	40.8	25.9	3.5528	1.1843

The auditors in this organization are qualified to undertake internal audit function	0	11.1	33.3	25.9	29.7	3.3322	1.4923
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According to Table 4.7, most of the respondents settled that the internal auditor has an unlimited access to information they are supposed to audit before as shown by a mean score of 3.583. They also agreed that there are procedures in place for checking auditors' qualifications by the management as shown by a mean score of 3.5528 and that the internal audit staff is remaining current with changes in accounting and financial reporting requirements as shown by a mean score of 3.533. In addition, they remained neutral on that professional competency affects the financial performance of these firms and that the auditors in the organizations are qualified to undertake internal audit function as shown by a mean score of 3.467 and 3.3322 respectively. These results show that changes in financial performance of the studied manufacturing firms could be accounted for by changes in internal audit professional competency.

Table 4.8: Agreement with Statements on Internal Control Systems

Statements on Internal Control Systems	Strongly	Disagree	Neutral	Agree	Strongly	Mean	Std. Dev.
Internal controls affects the financial performance of mid-size manufacturing organizations	0	7.4	37	51.9	3.7	3.5937	0.6582
Internal audit identifies and evaluates the organization's internal control system as a basis for reporting upon its adequacy and effectiveness	0	3.7	37	51.9	7.4	3.6146	0.7162
Management of the firm has been responsive to internal auditor's previous findings and recommendations	0	3.7	48.2	44.4	3.7	3.4896	0.6323
Internal auditors are considered as advisors to management on matters related to internal controls and governance	0	7.4	37	51.9	3.7	3.5521	0.6938
Controls audits in the organization have features built into them to ensure that fraudulent transactions are flagged or made difficult to transact	0	7.4	40.7	44.5	7.4	3.5104	0.7677

With regard to internal control systems, most of the respondents agreed that internal audit identifies and evaluates the organization’s internal control system as a basis for reporting upon its adequacy and effectiveness, internal controls affects the financial performance of mid-size manufacturing organizations, internal auditors are considered as advisors to management on matters related to internal controls and governance and controls audits in the organization have features built into them to ensure that fraudulent transactions are flagged or made difficult to transact as shown by mean scores of 3.6146, 3.5937, 3.5521 and 3.5104 respectively. On the other hand majority of the respondents neither agreed nor disagreed that management of the firm has been responsive to internal auditor’s previous findings and recommendations as shown by a mean score of 3.4896. As such, the scope of internal audit includes examination of the effectiveness of the internal control systems with the use of the financial management information systems to check the accuracy and reliability of the accounting records in use by the organization.

Table 4.9: Agreement with Statements on Internal Audit Standards

Statements on Internal Audit Standards	Strongly disagree	Disagree	Neutral	Agree	Strongly Agree	Mean	Std. Dev.
Internal audit standards affects the financial performance of this firm	0	3.7	33.3	63	0	3.582	0.572
The structure of internal audit in enhancing its objectivity is strong	0	7.4	29.6	63	0	3.525	0.658
Internal audit demonstrate that it recognizes its accountability to the audit committee	0	3.7	29.6	66.7	0	3.615	0.566
internal audit evaluate and contribute to the improvement of risk management, control and governance using a systematic and disciplined approach in the industry	0	7.4	29.6	63	0	3.533	0.645

The results of this section are analyzed in line with a scale of 1 to 5 where 1 is strongly disagree, 2 is disagree, 3 is neutral, 4 is agree and 5 is strongly agree. To obtain the corresponding measure of agreement, the calculated weighted mean is rounded off to the nearest whole and the result counter-checked against the matching number in the key provided in the questionnaire. The highest ranking mean score was 3.615. This mean score corresponds

to a measure of 4 which means that majority of the respondents indicated strong agreement with that internal audit demonstrate that it recognizes its accountability to the audit committee. The respondents further indicated strong agreement that internal audit standards affect the financial performance of these firms as shown by a mean score of 3.582, internal audit evaluate and contribute to the improvement of risk management, control and governance using a systematic and disciplined approach in the industry as shown by a mean score of 3.533 and that the structure of internal audit in enhancing its objectivity is strong as shown by a mean score of 3.525. This implies that internal audits standard affect the financial performance in the mid-size manufacturing firms in Nairobi significantly.

CHAPTER FIVE:

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This is the final chapter in this study which gives the summary of the findings, the conclusions and recommendations of the study based on the objective of the study. It comes after identifying the background, problem at hand and the objectives in chapter one, literature review was done in chapter two, chapter three set out the methodology that the study used to collect data and chapter four analyzed the data obtained from the study. The chapter finally presents the suggestions for further studies on relationship between the internal audit function and financial performance of mid-size manufacturing firms in Nairobi, Kenya.

5.2 Summary

The study found that internal audit functions affect the financial performance of the mid-size manufacturing firms in Nairobi to a moderate extent. From the findings, assessment of internal control has the greatest representation of the scope of work for internal audit, followed by verification of financial transaction (Financial audit), then assessing and promoting the adequacy of corporate governance, evaluating projects/ programs accomplishments (effectiveness), compliance audit, assessment of organizational risk, operational audit, information system audit and finally fraud investigation represents scope of work for internal audit in the mid-size manufacturing firms in Nairobi.

The study found that there was agreement on that independence of internal audit affects the financial performance of this organization and that their firms have formalized principles of internal audit

providing for its position and powers in the framework of the firms. However, there was neutrality on that there is independence of internal auditors in operations and structure. Accordingly, internal audit function played a role in governance which affects the financial performance providing for its position and powers in the framework of the firms.

On professional competency, the study established that the internal auditor has an un-limited access to information they are supposed to audit before, there are procedures in place for checking auditors' qualifications by the management and that the internal audit staff is remaining current with changes in accounting and financial reporting requirements. On the other hand there was impartiality on that professional competency affects the financial performance of these firms and that the auditors in the organizations are qualified to undertake internal audit function. This is an implication that changes in financial performance of the studied manufacturing firms could be accounted for by changes in internal audit professional competency.

With regard to internal control systems, the study found that internal audit identifies and evaluates the organization's internal control system as a basis for reporting upon its adequacy and effectiveness, internal controls affects the financial performance of mid-size manufacturing organizations, internal auditors are considered as advisors to management on matters related to internal controls and governance and controls audits in the organization have features built into them to ensure that fraudulent transactions are flagged or made difficult to transact. However there was neutrality on that management of the firm has been responsive to internal auditor's previous findings and recommendations. These results denote that the scope of internal audit includes examination of the effectiveness of the internal control systems with the use of the financial management information systems to check the accuracy and reliability of the accounting records in use by the organization.

On internal audit standards, the study found that internal audit demonstrate that it recognizes its accountability to the audit committee, internal audit standards affect the financial performance of these firms, internal audit evaluate and contribute to the improvement of risk management, control and governance using a systematic and disciplined approach in the industry and that the structure of internal audit in enhancing its objectivity is strong.

According to the multiple regression analysis, if all the independent variables (internal control systems, professional competency, independence of internal audit, internal audit standards, size of the firm and firm liquidity) were kept constant at zero, the financial performance of mid-size manufacturing firms in Nairobi will be 2.837. At 5% level of significance and 95% level of confidence, firm size had a 0.032 level of significance, firm liquidity had a 0.029 level of significance, independence of internal audit had a 0.020 level of significance, professional competency had a 0.028 level of significance, internal audit standards had a 0.024 level of significance, independence of internal audit had a 0.020 level of significance, while internal control systems had a 0.015 level of significance hence the most significant factor for financial performance of mid-size manufacturing firms in Nairobi.

5.3Conclusions

The study concludes that internal audit functions have a significant effect on the financial performance of the mid- size manufacturing firms in Nairobi. Where the internal audit function is emphasised, clearly, it can impact positively on financial performance of the firms. From the findings, internal audit standards, independence of internal audit, professional competency and internal control had a positive relationship with financial performance of mid-size manufacturing firms, the study found that a unit

increase in internal audit standards would lead to increase in financial performance of mid-size manufacturing firms, a unit increase in independence of internal audit would lead to increase in financial performance of mid-size manufacturing firms, a unit increase in professional competency would lead to increase in financial performance of mid-size manufacturing firms and further unit increase in internal control would lead to increase in financial performance of mid-size manufacturing firms.

The study also established that there was a strong positive relationship between financial performance of mid-size manufacturing firms and internal audit standards, independence of internal audit, professional competency and internal control. The study further concludes

that manufacturing firms that had invested on effective internal control systems had more improved financial performance as compared to those manufacturing firms that had a weak internal control system. From the findings, it was revealed that those mid-size manufacturing firms that observed integrity, ethical values, risk assessment, control activities, monitoring and information communication technology recorded high financial performance. The manufacturing firms face challenges in effective implementation of internal control systems due lack of sufficient resources to hire competent staff and to invest in modern technologies for example information communication technology. The findings of the study found that control activities had a significant positive relationship with financial performance indicators.

5.4 Recommendations

The study established that internal auditors play a very important role in enhancing the financial performance of mid-size manufacturing firms. There is therefore the need for the mid-size manufacturing firms to adopt effective internal processes and practices that address key internal auditing practices for effectiveness of audit quality. Audit quality is not primarily about auditing

standards but about the quality of people, their training and ethical standards. As such the mid-size manufacturing firms should consider skills, personal qualities of audit partners and staff, and the training given to audit personnel as the important factors that determine auditor quality.

The study also established that in order to implement good internal audit independence, managers need to know that they should be concerned about the interrelationships between internal audit independence and financial performance. As such, there is need for the internal auditors to continuously update themselves with the changing times and technologies and sharpen their skills. By applying skills to the most critical points, building personal and professional credibility and recognising and responding to the needs, internal auditors can become indispensable thus speeding good governance and enhancing efficiency of internal audit.

The management of the firms should keep organizing seminars and workshops whereby these internal auditors would be trained frequently by experts either internally or externally.

Internal Auditors must have sufficient proficiency and training to carry out the tasks assigned to them. The auditor's work must be carefully directed, supervised and reviewed. The amount of supervision required corresponds to the experience and skill of the auditor. The head of the internal audit department should be responsible to the management/board in the organisation with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action on audit recommendations.

5.5 Limitations of the Study

The researcher was likely to encounter various limitations that might have hindered access to information sought by the study. The main limitation of study was its inability to include more organizations in the Country. This was a study focusing on med- size manufacturing firms in Nairobi

which is the business hub in the region. The study could have covered more enterprises across the Country so as to provide a more broad based analysis. The study countered this problem by carrying out the study in mid- size manufacturing enterprises across the various sectors and served as a representative.

The respondents approached were likely to be reluctant in giving information fearing that the information sought would be used to intimidate them or print a negative image about them or their enterprises. The researcher handled the problem by carrying an introduction letter from the University and assured them that the information they give would be treated confidentially and it would be used purely for academic purposes.

There were likely to be cases of acquiescence bias, where some staff would answer questions with an incline that does not represent the absolute truth. The answers could therefore be misinterpreted or falsified. The data collected was therefore likely to be inaccurate. The researcher therefore found it necessary to insist to the respondents to only give the real scenario in the organization. The researcher overcame this problem by urging the respondents to be truthful by writing the right information.

5.6 Recommendations for Further Studies

The same study should be carried in medium size enterprises with operations in other industries such the financial sector, service sector, ICT sector among others to compare the

findings. This would be a modest attempt to enhancing formulation of policies regarding relationship between the internal audit function and financial performance of firms in Kenya. Further studies can be conducted with an aim of establishing the effects of the specific factors on the financial performance of the firms in Kenya. The specific intention would be to establish how firms endure the challenges in the internal audit functions and make a difference in their activities.

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