Internal Audit and Profitability of Banking Institutions in Kenya: A Case Study of Commercial Banks in Kericho County, Kenya

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Abstract: - Banking sector faces myriad challenges in delivery of services to its clients. Among these include: ineffectiveness in internal audit and profitability in their mandates in providing banking services. Thus, the aim of this research was to find out the factors that impede effective internal audit and profitability of banking sector in Kenya based on a case study of Commercial Banks in Kericho Town. The study focused on the effectiveness of internal audit in Commercial Banks, to determine factors affecting profitability of Commercial Banks, and to establish the relationship between quality of internal audit and profitability. The data were collected using questionnaire and interview schedule. The study had a sample size of 30 employees sampled from various commercial in Kericho town using stratified random sampling method. The research findings indicated that: internal auditors contribute to profitability of firms mainly through detection of fraud and advising management on internal control system; also it indicated that the major constraints to internal audit effectiveness were lack of independence and lack of enough qualified audit staff. Profitability of Commercial Banks was mainly affected by high tax liability on profits, low productivity per employee and increasing cost of production. Furthermore it established that effective internal audit influence profitability of firms. The study recommends that if the Commercial Banks were provide effective internal audit and real its profitability they should provide a conducive working environment to the internal auditors to enable them executive duties well.

Keywords: commercial banks, conducive environment, internal audit, effective, and profitability.

INTRODUCTION

In today's competitive business environment, internal audit has become a necessity for many organizations. There is need for an organization to perform well in terms of finance, growth and collective needs of society. According to millichamp (2002) internal audit is defined as an independent appraisal function established by management of an organization to review the internal control system as a service to the organization. IAPS 1006 (2003) state that the need for an internal audit function will usually be governed by size, risks and complexity of the business. The role of the board in relation to internal audit is to understand and take responsibility for ensuring that the internal audit function is properly done.

The word auditing comes from a French word "audire" meaning to hear, because in ancient times, the auditors were supposed to hear and determine the accuracy of statements on accountability. Historical records suggest that internal auditors were being utilized prior to the 15^{th} century. Thus control assessment and fraud detection have been known as the "roots" of internal auditing. Ramaswamy (1994) defined internal auditing as the verification of the operations and transactions of the operations and transactions of the business continuously by a specifically assigned staff. Internal audit department provides management with information about appraisals, analyses, recommendations and information concerning the activities reviewed (Simmons, 1995).

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ISA 610 recognizes the work of internal auditors in relation to the revenue performance. Most successful banks have nurtured a good audit function. The organization must ensure that professional rules on independence are not contravened. This may however be difficult to be complied with at all times, as the internal auditors may be required to make executive decisions or be involved in the preparation of the annual financial statements. However in performance of their duties, auditors have to abide by the code of ethics (Accountants' Act 1992). Additionally, those providing audit services must possess the required levels of skill and competence.

Internal auditing frequently involves measuring compliance with the entity's policies and procedures. This helps a firm accomplish its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process. This is aimed at helping firms to meet their core objectives especially profits (Gupta, 1987).The banking industry in Kenya is governed by the Companies Act, the Banking Act, the Central bank of Kenya Act and the various prudential guidelines issued by the Central bank of Kenya (CBK). The banking sector was liberalised in 1995 and exchange controls lifted. There are forty six banking and non-banking institutions.

Internal audit is established as a measure of efficiency and effectiveness of managerial controls as well as advising management on profitability in firms. However, despite the fact that commercial banks have instituted an internal audit department, many cases of frauds, bad cheques, loan frauds, forgery of documents, investment scandals, cash mismanagement and consequently low returns are still emerging. This is evidenced by the steadily growing online theft where commercial banks are estimated to lose shs3 billion to smart thieves every year. A report by the Banking Fraud Investigations Unit (BFIU) shows that banks in Kenya lost Kshs. 27million in November 2011 and nearly Kshs.500million in December the same year. According to Deloitte report of 2010, bank fraud tripled to an estimated KES.3 billion, approximately four percent of the total sector profitability over the same period. This attracted the attention of the researcher to find out the cause of such vices and how effective internal audit affects profitability.

Profitability is defined as surplus of revenue over expenditure. Without profitability, the business will not survive in the long run (Pandey, 1995). It is believed that if the internal audit of a firm is effective, then it will perform well financially. The main way in which internal audit exercises its function is by enabling management to perform proper risk assessments in relations to corporate objectives by means of properly understanding the strengths and weaknesses in all of the control systems in the business (Ramaswamy, 1994)

LITERATURE REVIEW

A governing body, the Institute of Internal Auditors (IIA), operates to bring uniformity and consistency to the practice of internal auditing. The IIA is an international association with chapters operating in approximately 120 countries. The audit regulatory framework that governs the conduct of audits in Kenya includes; International Standards on Auditing(ISAs), the Companies Act, the Accountants Act that regulates the audit in the country and the professional code of ethics.

As it is mentioned before, internal auditing is a critical component of an organization's management and a foundation for its safe and sound operations (Drogalas et al., 2005; Karagiorgos et al., 2010). Banks plays a vital role in economy as they hold the savings of the public provide a means of payment for goods and services and finance the development of business (Siddiqui and Podder, 2002). The growing importance of internal auditing and banking sector has led to systematic research into the impact of effective internal auditing in Banks. In the light of the above, Celal (1989) examined the internal audit function in the Banks of Turkey. To achieve its purpose the following methodology is used: 25 questionnaires were sent in internal auditors in the Banks of Turkey and 14 were answered

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(percentage of answers 56%), while 90 different questionnaires were sent in auditors and 50 were answered (percentage of answers 56%). The analysis of the survey answers indicates that the importance of internal audit in the banking sector is increased by the usage of computers and the international extension of Banks. Furthermore, the results show that the number of internal auditors is related with the size of the Bank. Regarding the education of internal auditors, the results reveal that usually internal auditors have graduated from Universities and have studied Accountancy.

Hence, the study highlights the growing importance of effective internal auditing in banks profitability. Siddiqui and Podder (2002) examine the effectiveness of financial audit of banking companies operating within Bangladesh. For the purpose of this study, the audited financial statements of 14 sample banking companies have been analyzed. The study identifies seven sample companies that have actually overstated their profits. Hence, the research explores the level of independence, objectivity and competence of the auditors assigned for auditing banking companies. Abu-Musa (2004) examined the existence and adequacy of implemented security controls in the Egyptian banking sector. The results of the survey pointed out that the vast majority of Egyptian banks have adequate security controls in place. The results also revealed that the computer departments paid relatively more attention to technical security controls; while internal audit departments emphasized more of the behavioral and organizational security controls.

Finally, the study provides valuable empirical results regarding inadequacies of implemented CAIS security controls, and introduced some suggestions to strengthen and improve the security controls in the EBS. More recently, Koutoupis and Tsamis (2008) via a literature review and three case study approaches analyzed the attitude of Greek banks with regard to the application of “risk- based” approach. The Greek Law, the Bank of Greece and international regulations impose internal audit in the Greek Bank sector. However, the Greek banking credit institutions ignored most regulations. The results of the research show that the standards of internal auditing require the adoption of “risk-based” approach from the internal auditors. Unfortunately, this requirement is not being into practice. Thus, the Greek banks adopt an intermediary approach of internal auditing that takes into consideration the risks, without estimating and managing them.

At the same time Khanna and Kaveri (2008) examined the implementation of risk-based internal audit in Indian Banks. To accomplish the goals of the survey, a structured questionnaire was mailed to 43 banks in India, both in the public and private sectors. A total of 25 banks, all public sector banks and six private sector banks, have responded to the questionnaire mailed The findings of the paper point out that the banks have made sufficient progress in introducing RBIA (Risk-Based Internal Audit). This refers to their understanding of methodology for assessment of risk, audit procedures and implementation of audit report Hence, Palfi and Muresan (2009) examined the importance of a well-organized system of internal control in regard with the bank sector. The sample was based on 25 credit institutions of Romania. The analysis of the survey answers reveals that the continuous collaboration, based on periodical meetings, between all structures of bank, characterizes an effective internal audit department. Finally, Abu-Musa (2010) investigates the existence and adequacy of implemented security controls of computerized accounting information systems in the Saudi banking sector. The results of study reveal that the vast majority of Saudi banks have adequate security controls in place.

The results also enable bank managers and practitioners to better secure their computerized accounting information systems and to champion the security of information technology for the success of their banks.

2.4 Theoretical Framework and Effective Internal Auditing

In order to determine effective internal audit evaluation principles it is important to analyze the conceptual framework of internal auditing (Savcuk, 2007). According to the Institute of Internal Auditors, (IIA, 1991; Taylor and Glezen, 1991; IIA, 1995) internal

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auditing is “an independent appraisal function, established within an organization to examine and evaluate its activities as a service to the organization”.

By measuring and evaluating the effectiveness of organizational controls, internal auditing, itself, is an important managerial control device (Carmichael et al., 1996), which is directly linked to the organizational structure and the general rules of the business (Cai, 1997). Hence, one of the most comprehensive definitions is given by Sawyer (2003) who stated that internal auditing is “a systematic, objective appraisal by internal auditors of the diverse operations and controls within an organization to determine whether, Financial and operating information is accurate and reliable, risks to the enterprise are identified and minimized, external regulations and acceptable internal policies and procedures are followed, satisfactory operating criteria are met, resources are used efficiently and economically and the organization ’s objectives are effectively achieved – all for the purpose of consulting with management and for assisting members of the organization in the effective discharge of their governance responsibilities”. Based on the institutional environment, one can conclude that many standards can be used in order to assess the impact of effective internal auditing.

This research study extends the above studies by presenting empirical evidence that evaluate internal auditing by assessing the components (as described by the COSO Report) of internal control system. In line with the above, the five interrelated components (or criteria) are: (Rezaee, 1995; Konrath, 1996; Yang and Guan, 2004): Control Environment, Risk Assessment, Control Activities, Information and Communication and Monitoring. Specifically, control environment reflects the attitude and the policies of management in regard with the importance of internal audit in the economic unit. On the one hand, control environment is influenced by the history and the culture of economic unit, on the other hand has a pervasive influence on the way business activities are structured that sets a positive and supportive attitude toward internal control and conscientious management (Aldridge and Colbert, 1994). In regard with risk assessment, it can be claimed that it is the identification and analysis of relevant risks associated with achieving the business objectives (Karagiorgos et al., 2009). Hence, control activities are the policies, procedures and mechanisms that enforce management’s directives (Hevesi, 2005). In line with the above, on the one hand the information and communication component refers to the identification, capture, and communication of pertinent information in an appropriate form and timeframe to accomplish the financial reporting objectives (Aldridre and Colbert, 1994). On the other hand, effective communications should occur in a broad sense with information flowing down, across, and up the organization. Finally, it is commonly acceptable that internal control systems need to be monitored in order to assess the quality of the system’s performance over time. Hence by monitoring, it is ensured that the findings of audits and other reviews are promptly resolved (Rezaee et al., 2001).

2.5 Essentials for effective internal auditing

Gupta (1987) outlines the following as essentials for effective internal auditing.

Independence: Implies that the judgment of the internal auditor is not subordinate to the wishes or directions of another person who might have engaged him to his own self interest. The internal auditor should have the independence in terms of organizational status and personal objectivity which permits the proper performance of his duties.

Staffing and training: The internal audit unit must be appropriately staffed in terms of numbers, grades, qualifications and experience, having regard to its responsibilities and objectives. The internal auditor should be properly trained to fulfil all his responsibilities.

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Relationships: The internal auditor should seek to foster constructive working relationships and mutual relationship with management, external auditors and any other review agencies.

Due care: The internal auditor should exercise due care in fulfilling his responsibilities. This involves having high ethical standards and quality performance. The heads of internal audit unit should establish methods of evaluating the work of his staff to ensure that the internal audit unit fulfils its responsibilities and has proper regard to this guideline.

Planning, Controlling and Recording: The internal auditor should adequately plan, control and record his work. This will ensure that work is done effectively and efficiently (Ramaswamy, 1994).

Evaluation of the Internal Control System: The internal auditor should identify and evaluate the organization's internal control system as a basis for reporting upon its adequacy and effectiveness.

Evidence: The internal auditor should obtain sufficient, relevant and reliable evidence on which to base reasonable conclusions and recommendations.

Reporting and follow up: The internal auditor should ensure that findings, conclusions and recommendations arising from each internal audit assignment are communicated promptly to the appropriate level of management and he should actively seek a response. He should ensure that arrangements are made to follow up audit recommendations to monitor what action has been taken on them.

2.6 Types of Internal Audits

Various types of audits are used to achieve particular objectives. The types of audits described below illustrate a few approaches internal auditing may take (Gupta, 1987).

Operational Audit: An operational audit is a systematic review and evaluation of an organizational unit to determine whether it is functioning effectively and efficiently, whether it is accomplishing established objectives and goals, and whether it is utilizing all of its resources appropriately.

Program Audit: A program audit evaluates whether the stated goals or objectives for a project or initiative have been achieved. It may include an appraisal of whether an alternative approach can achieve the desired results at a lower cost. These types of audits are also called performance audits or management audits.

Fraud Audit: A fraud audit investigates whether the organization has suffered through misappropriation of assets, manipulation of data, omission of information or illegal acts. It assumes that deceptions were intentional (Millichamp, 2002).

Ethical Business Practices Audit: This type of audit determines the extent to which an organization, management and employees support established codes of conduct, policies and standards of ethical practices.

Compliance Audit: A compliance audit determines whether a process or transaction is following applicable rules. Such rules can originate internally as corporate objectives, by laws, policies, and procedures or externally as laws and regulations. For each process or transaction examined, the auditor must ultimately decide whether it complies with the rule or not.

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Financial Audit: A financial audit is an examination of the financial planning and reporting process, the conduct of financial operations, the reliability and integrity of financial records and the preparation of financial statements. Such a review includes an appraisal of the system of internal controls related to financial functions.

2.7 Duties of the Internal Auditors

Theoretically there are no restrictions on what internal auditors can evaluate and report on within the organization; but internal audit projects tend to vary from one company to another, reflecting particular objectives of owners, directors and senior management. IIA's statement of responsibilities of internal auditing outlines the following as duties of internal auditors;

i) Review the reliability and integrity of financial and operating information and the means used to identify measure, classify and report such information.

ii) Review the systems established to ensure compliance with the policies, plans, procedures, laws, regulations and contracts which could have a significant impact on operations and reports, and determine whether the organization is in compliance.

iii) Review the means of safeguarding assets and, as appropriate verify the existence of such assets.

iv) Appraise the economy and efficiency with which the resources are employed.

v) Review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned (Ramaswamy, 1994).

2.7.1 How to Detect and Prevent Fraud

Detection of fraud is considered as one of the most important duties of an auditor. Fraud is mainly done through embezzlement of cash and manipulation of accounts. There should be a good internal control system which should be well checked by the internal auditor.

2.7.2 Internal Auditor on Fraud Detection and Prevention

By checking the internal control system, an auditor investigates whether the organization has suffered through misappropriation of assets, manipulation of data, and omission of information or illegal acts. Tests of control and substantive tests can be used by the internal auditor in checking the system. However, due to inherent limitations, there is a possibility that material misstatement of the financial information resulting from fraud and error may not be detected (Ramaswamy, 1994).

2.7.3 Limitations of Internal Auditing

As much as internal audit benefits a bank, there are limitations which make internal audit less effective and thus disadvantageous to a bank. These factors are explained below.

The limitation of internal audit starts when there is a time lag between recording and checking entries. The accounting and internal audit must go side by side with minimum time lag. The limitation here is that the internal auditor may be linked with executive function. In this case he cannot examine the accounting books and other records. This implies that he cannot find out his own weakness (Gupta, 1987).

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There may be lack of experience and training on the part of the internal audit staff. Lack of skills and competence by internal auditors renders their work almost useless to a firm. This is because they may not execute their duties effectively and efficiently. Lack of complete records and financial statements prepared by management. Management of a firm may decide to deliberately refuse to provide the internal auditor with the necessary financial records and books. This affects the scope of work of the internal auditor because he may not easily trace cases of fraud and embezzlement.

2.8 Profitability

According to Pettinger and Richard (2006), profitability is what accrues at the end of an active period of an activity as a result of the difference between the value of sales and cost of raw materials, labour and capital that went into the production of the goods sold.

In the free market system, achieving profitability is of crucial importance, which is the primary objective of a profit seeking enterprise that can be achieved only with due consideration of consumer needs. This overriding objective is usually expressed in quantitative terms. However non-profit seeking firms focus on effective and efficient utilization of resources and cost reduction rather than on profitability. In an economy that is declining, a profit seeking firm too can concentrate on efficiency and effectiveness rather than profitability in order to protect its position until economic conditions improve (Van Horne et al., 1996).

Hence, maximizing profitability means maximizing the income of firms where goods and services in great demand command higher prices. This results in higher profitability levels. However, this has been criticized in recent years, that maximizing profitability assumes perfect competition, and in the face of imperfect modern markets, it is not legitimate. It fails to provide an operationally feasible measure for ranking alternative courses of action in terms of their economic efficiency (Pandey, 1995).

2.8.1 Factors that Affect Profitability

Profitability is affected by changes in sales volume, costs and prices. Increase or decrease of selling price, volume, variable costs, fixed costs or a combination of all has an effect on profitability (Pandey, 1995).

2.8.2 Strategies to Maximize and Increase Profits in a Bank

In order for a bank to maximize its profits, it has to develop strategies that will sustain profits in the long run. These strategies are described below (Van Horne, 1996)

i) Prepare realistic budgets and plans for more accurate forecasting, and provide comprehensive reports on demand.
ii) Capture costs at the activity level to understand the underlying causal relationship and acquire a detailed picture of how the banks resources are used.
iii) Carry out continuous estimation of returns from customers, products, services and channels at the transaction level where costs are incurred (Pandey, 1995).
iv) Align the organization with long term goals by communicating the firm’s mission and vision to employees and allowing them to participate in decision making.
v) Adopt appraisal techniques such as value chain analysis, balanced score card, porter’s five forces and “BCG” matrix.

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vi) The company should strengthen the expenditure control policy. This will reduce on unnecessary expenditures and improve the profit levels.

2.9 Measurement of Profitability

Profitability can be measured using ratio analysis and CVP analysis.

2.9.1 Ratio Analysis

Pandey (1995) observed that ratios act as a benchmark for evaluating the financial position and performance of firms. Generally, two major types of profitability ratios are calculated: profitability in relation to sales and profitability in relation to investment.

Profitability in Relation to Sales

Gross Profit Margin (GPM)

$$GPM = \frac{\text{sales-cost of goods sold}}{\text{Sales}} \times 100\%$$

This ratio reflects the profit of the bank relative to sales after we deduct the cost of producing the services sold. It indicates the efficiency of operations as well as how products are priced (Masembe, 2008).

Net Profit Margin (NPM)

$$NPM = \frac{\text{profit after tax}}{\text{Sales}} \times 100\%$$

This ratio indicates the relative efficiency of the firm after taking into account all expenses and income taxes but not extraordinarily charges. According to Pandey (1995), an analyst will be able to interpret the firm's profitability more meaningfully if he evaluates both ratios –gross profit margin and net profit margin-jointly. To illustrate this, if the gross profit margin has increased over years, but the net profit margin has either remained constant or declined or has not increased as fast as the gross profit margin then it implies that operating expenses relative to sales have been increasing. The increasing expenses should be identified and controlled. The crux of management is that both ratios should be thoroughly investigated to find out the causes of decline in any or both ratios.

Profitability in Relation to Investment

Return on Equity (ROE)

$$ROE = \frac{\text{net profit after tax-preferred stock dividend}}{\text{Shareholder's Equity}}$$

This ratio indicates how well the bank has used the resources of owners. The earning of a satisfactory return is the most desirable objective of a business. The return on owners' equity of the company should be compared with the ratios of other similar companies and the industry average. It is worth noting that profitability of the common share holders' investment can also be measured in many other ways such as earnings per share, dividend per share and dividend payout ratio (Van Horne, 1970).

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2.9.2 Limitations of Ratio Analysis

Despite the fact that ratio analysis is an important tool for evaluating the company's performance, it has some limitations as explained below (Pandey, 1995).

Ratios are tools of quantitative analysis, which ignore qualitative points of view. Ratios do not take into account qualitative factors like changes in demand, tastes and preferences, technology, yet these factors affect the performance of a firm.Ratios are calculated on the basis of past data. They therefore do not provide complete information for future forecasting (Van Horne, 1970).

Effect of price changes; Inflation renders comparison of results over time misleading as financial figures will not be within the same levels of purchasing power. Changes in results over time may show as if the enterprise has improved its performance and position when in fact after adjusting for inflationary changes it will show a different picture.

Changes in accounting policies; Changes in accounting policies may affect the comparison of results between different accounting years. The problem with this situation is that the directors may manipulate results in order to avoid the effects of an old accounting or gain the effects of a new one.

In conclusion therefore, ratio analysis is useful, but analysts should be aware of these problems and make adjustments as necessary.

2.9.3 CVP Analysis –as a Measure of Profitability

An understanding of CVP analysis is extremely useful to management in budgeting and profit planning. CIMA London has defined CVP analysis as, "the study of the effects on future profits of changes in fixed cost, sales price, quantity and mix". The cost of a product or service determines its selling price and the selling price determines the level of profits (Arora, 2001).

2.9.4 Impact of Effective Internal Audit on Profitability

Internal auditing checks the financial performance of a firm and advises management where deviations are likely to occur. This is in line with Pandey (1995) who observed that "profit is the most important measure of performance in a free market.

Banks performance is well enhanced high profit margins when their internal controls are well implemented by the internal audit department. The failure to check internal controls by internal audit department leads to increase in frauds hence a reduction in profitability levels (Balunywa, 1999). Internal auditors trace cases of embezzlement, fraud, waste and cash mismanagement. All these factors impact highly (negatively) on the profitability of a bank.

The internal auditing effective involvement in strengthening internal controls cause the external auditors to reduce the assessed level of control risk. As a consequence, the auditor's reliance on internal controls should result in less substantive testing and hence a lower audit fee (Collier and Gregory, 1996).

Additionally, Internal Auditing Professional Standards (IAS's) require the function to monitor and evaluate the effectiveness of the banks risk management process and its impact on profitability (IIA 2003). This involves determining risk which is acceptable and what actions should be undertaken in order to avoid share or control risk to increase revenue in a firm.

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Conclusion

In conclusion, an effective internal audit unit increases profitability of firms by bringing a systematic, disciplined approach to evaluate the effectiveness of risk management, control and governance process. Internal auditing and internal controls are complementary as far as profitability of a firm is concerned therefore managers should aim at ensuring that the internal audit department is well established and effective. This will help to increase on the level of profits in banks.

Therefore, to address the purpose of the research the study was guided by the following main research objective and research questions:

Research objective:

To establish factors which impede effective internal audit and profitability of the banking sector in Kenya.

Research questions:

i) Does the internal auditor of Commercial banks execute his duties without interference?
ii) Does the internal auditor of Commercial banks reports and follows up findings and recommendations in the company?
iii) Does the internal auditor of Commercial banks evaluate well the internal control system in his work?
iv) Does the management in the company is charged with the responsibility of appointing skilled and competent internal auditors?
v) Do the banks are facing increased cost of acquiring raw materials?
vi) Is there any relationship between quality of internal audit and profitability?
vii) Does effective internal audit reduce on fraud and embezzlement?

METHOD

Materials

To address the research objectives the data were collected using questionnaire and interview. A questionnaire will be issued to a sample of commercial banks in Kericho town. Cohen (1989) defines a questionnaire as a self-report instrument used for gathering information about variables of interest to an investigation. Orodho (2004) defines a questionnaire as an instrument used to gather data, which allows a measurement for or against a particular viewpoint. The questionnaire will use both closed and open questions.

Questionnaires help the researcher to analyze the data easier since the respondents can be directly compared and easily aggravated (Patton,1990), they are versatile. Surveys can be employed among people of all ages and they are replicated from one subject to another (Aakar and Day, 1990; Kotler, 1994) and many questions can be answered in a short time. For the purpose of this research, drop and pick method will be used to distribute the questionnaire. This eliminates chances of non-responses and saves time.

Participants

Mugenda and Mugenda (2003) define population as an entire group of individuals, events or objects having common observable characteristics. The target population of this study will be Kericho town commercial banks. The researcher will engage with 30 employees of the COMMERCIAL BANKS within Kericho town who are audit personnel, accounts and finance personnel, lower

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officials together with top managers. This is because these people have reliable information due to their closer relationship with the organization. The table below shows the various banks within the Kericho town as at the year 2011, as provided by the Kericho county reports:

Table 1 shows sampling of participants

BANK NAME	NO. OF BRANCHES	NO. OF EMPLOYEES	SAMPLE SIZE	PERCENTAGE {%}
Equity Bank	2	41	7	24
National Bank	1	16	3	10
Consolidated Bank	1	15	2	7
Post Bank	1	18	3	10
Family Bank	1	20	3	10
Standard Chartered Bank	1	22	4	13
Kenya Commercial Bank	1	21	4	13
Cooperative Bank	1	21	4	13
TOTAL	9	174	30	100

Ideally one would prefer to study a whole population. However, this is normally impossible and the option is to come up with a sample representative. According to Black and Champion (1976), a sample is a portion of elements taken from a population, which is considered to be representative of the population. For the sake of this study, stratified random sampling will be used. A stratified random sampling technique will be employed to collect the data. A stratified sample is a sample where the parent population is divided into two or more strata from where a random sample is drawn from each stratum using simple random sampling method to ensure an equal chance of representative of participants of the accessible population (Bryman 2008). Using the formula below;

$$\frac{\text{No. of Employees}}{\text{Total no. of Employees}} \times 30$$

For example, to get sample size for Family Bank:

$$\frac{20}{174} \times 30 = 3$$

Data collection is a process of preparing and gathering data which is processed for the purpose of making meaningful information for making important decisions. Data will be collected using a questionnaire due to the busy nature of small and medium entrepreneur.

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Procedure

The questionnaire will be administered by the researcher personally to the respondents for the purpose of collecting data. The researcher will, where possible, explain any matters of ambiguity. The respondents will complete the questionnaire and return to the researcher.

Both qualitative and quantitative tools of data analysis will be used. Under the quantitative data analysis, description statistics such as mean, percentages, median and mode will be used. Data will be analyzed with the help of electronic spreadsheet excel. The information shall be presented in pie charts, bar graphs, figures, tables and any other appropriate technique.

RESULTS

To address question one : on whether the internal auditor of Commercial banks executes his duties without interference , the results of analysis are shown in table 2

Results are shown in the table 2: Responses category in percentage

Strongly agreed	**Agreed**	**Not sure**	**Strongly disagreed**	**Disagreed**
16.7	**12.5**	**8.3**	**37.5**	**25**

From the table 2 it indicates that 16.7% of the respondents strongly agreed that the internal auditor executes his duties independently, 12.5% agreed, 8.3% were not sure, 37.5% strongly disagreed while 25% disagreed. Thus, majority of the respondents strongly disagreed which implies that the internal auditors of Commercial banks do not carry out their duties with freedom and independence due to interference from top management and other people which has led to fraud hence low profits for the company. An effective internal auditing should be done by the Kenya Commercial Bank. By examining the performance operations and a report on the observations of the auditors. It is an act of improving an organization's governance, risk management and management controls by providing recommendations based on analysis and assessment of data and processes.

To address question two : where the participants were asked whether the internal auditor of Commercial banks reports and follows up findings and recommendations in the company **,** the results of analysis were tabulated as shown in table 3.

Results are shown in the table 3. Follow up of findings in percentages

Strongly agreed	**Agreed**	**Not sure**	**Strongly disagreed**	**Disagreed**
25	**12.5**	**8.3**	**45.8**	**16.7**

The results indicate 25% of the respondents to strongly agree that the internal auditor reports and follows up findings, 12.5% agree, 45.8% strongly disagree and 16.7% disagree. This indicates that majority of internal auditor partly reports and follows up some

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recommendations while at the same time does not attend to some which partly explains continuous loss of cash and low profitability in Commercial banks. A follow up is needed because it is one of the important measures of effectiveness of the internal audit function and is successful in achieving a high implementation rate of recommendation made in audit reports.

To address question three: where the participants were asked whether the internal auditor of Commercial banks evaluates well the internal control system in his work. Findings. The results of analysis were tabulated as shown in table 4.

Results are shown in the table 4: Evaluation of Audit Control System in percentage

Strongly agreed	Agreed	Not sure	Strongly disagreed	Disagreed
12.5	8.3	8.3	54.2	16.7

As shown from the table 4 12.5% of the respondents strongly agreed that the internal auditor evaluates well the internal control system, 8.3% agreed, 8.3% were skeptical, 54.2% strongly disagreed while 16.7% disagreed. An indication that majority of the respondents strongly disagreed. This implies that the internal auditor of Commercial banks do not check well the internal control system hence leaving gaps for fraud and embezzlement which directly impacts on profitability.

To address question four: where the participants were asked whether Management in the company is charged with the responsibility of appointing skilled and competent internal auditors. To ascertained whether the internal auditors in Commercial banks are appointed on basis of qualification and experience. As shown by the results of analysis tabulated as shown in table 5.

Results are shown in the table 5. Appointment of skilled auditors

Strongly agreed	Agreed	Not sure	Strongly disagreed	Disagreed
33.3	12.5	8.3	37.5	8.3

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The results indicated that 33.3% of the respondents strongly agreed that the internal auditors in Commercial banks are appointed basing on their qualification and experience, 12.5% agreed, 8.3% were not sure, 37.5% strongly disagreed and 8.3% disagreed respectively. Therefore , majority strongly agreed implying that recruit competent and skilled internal auditors.

To address question five: participants were asked whether banks are facing increased cost of acquiring raw materials as depicted by results in table 6

Results are shown in the table 6: Increased cost of acquiring raw materials in percentage

Strongly agreed	Agreed	Not sure	Strongly disagreed	Disagreed
0	12.5	8.3	37.5	41.7

From the results on table 6, none of the respondents strongly agreed that the cost of acquiring raw materials is reducing, 12.5% agreed, 8.3% were not sure, 37.5% strongly disagreed and 41.7% disagreed respectively. Hence, majority of the respondents disagreed, an implication that Commercial banks are facing increasing costs of acquiring raw materials. This could be from the fact

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that suppliers are few and there are no substitute goods. High raw material costs have negatively affected profitability of the company. Increase in demand for products leads to increased profits, while decrease in demand reduces profits, keeping other factors constant.

To address question six: which asked the respondents whether the there is a relationship between quality of internal audit and profitability as shown by the results of analysis tabulated in table 7.

Results are shown in the table 7

Results are shown in the table 7: Relationship between quality of internal audit and profitability in percentage

Strongly agreed	Agreed	Not sure	Strongly disagreed	Disagreed
45.8	29.2	4.2	12.5	8.3

From the findings, 45.8% of the respondents strongly agreed that there is a relationship between quality of internal audit and profitability, 29.2 % agreed, 4.2% were not sure while 12.5% strongly disagreed and 8.3% disagreed respectively. This shows that quality of internal audit and profitability are related; therefore management of Commercial banks should devote more effort towards improving quality of internal audit in order for the company to perform well.

To address question seven: that asked the participants whether effective internal audit reduces on fraud and embezzlement, the data were analysis and tabulated as shown in table 8.

.**Results are shown in the table 8**

Results are shown in the table 8: Effective control system reduces fraud in percentage

Strongly agreed	Agreed	Not sure	Strongly disagreed	Disagreed
45.8	37.5	12.5	0	4.2

According to the findings, 45.8% of the respondents strongly agreed that effective internal audit reduces on fraud and embezzlement, 37.5% agreed, 12.5% were not sure, none of the respondents strongly disagreed while 4.2% disagreed respectively. An indication that majority of the respondents strongly agreed. This implies that effective internal audit helps to reduce on fraud and embezzlement in the company. Management should therefore provide the internal auditors with the necessary tools in order to execute their duties effectively.

DISCUSSION

From the results of the study it was established that internal auditors were not effective in delivering their services to the company due to many factors. The findings showed that, only 12.5% of the respondents agreed that the internal auditor of Commercial banks executes his duties independently, 8.3% were not sure whether the internal auditor adequately plans, controls and records his work, 37.5% strongly disagreed that the internal auditor reports and follows up findings and recommendations while 25% strongly disagreed that the internal auditor evaluates well the internal control system in his work.

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The study also discovered that most of factors examined had a negative impact on profitability of the company. These factors included: cost of lending money, tax liability on the profits, cost of production and productivity per employee. These factors partly contributed to the decline in profitability of the company.

The findings showed that none of the respondents strongly agreed that the cost of lending money is reducing, 40% agreed that the tax liability on the profits is increasing, 50% agreed that the cost of maintenance and running is increasing while only 3% agreed that maintenance and running costs are increasing. According to the results proved that there was a positive relationship between quality of internal audit and profitability. This implied that the more effort Commercial banks channels towards improving the quality of internal audit, the higher will be its profits.

CONCLUSION

Based on study findings, the internal auditor of Commercial banks is not effective enough in rendering his service to the company. The internal auditor does not execute his duties independently. This could be attributed interference from top management which implies that management can force the internal auditor to take decisions in their favor. This implied that the internal auditor cannot easily trace cases of fraud, embezzlement and cash mismanagement which have affected negatively the profitability of the company.

Additionally, the internal auditor neither follows up findings nor does he adequately plan and record his work. This has led to continuous fraud in the company which is evidenced by the banking fraud investigations unit report.

In regard to Profitability of Commercial banks is mainly affected by high costs of lending money, high tax liability imposed on profits, high costs of maintenance and running the banks. These factors when combined together have contributed to the decline in profitability of the company. However, there were favorable factors like high demand for the banks products and services as revealed by the respondents. These helped to supplement on the profitability of the company. Furthermore, the results revealed that effective internal audit affects profitability of a company. However, this was not solely responsible for the decline in profitability of the company.

This study recommends the following:

i) As a pre-requisite for effective internal auditing, the internal auditor should report and follow up findings and recommendations.
ii) The internal auditor should be obliged to evaluate the internal control system through use of tests of control.

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