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Internal Auditors Independence on Fraud Detection among Private Firms in Kenya

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Abstract: **The study investigated how the independence of internal auditors affects fraud detection in private firms in Kenya. The study was conducted on selected private firms within Thika subcounty, Kenya and the results generalized for all other private firms in Kenya. Data was collected by use of questionnaires distributed and collected by the researcher himself. This research was based on a descriptive survey and the study population was Thika Sub-County which had a population of 1896 firms. The sample of 110 private organizations representing 5.8 per cent of the entire population was selected from various private organizations as a representative of the whole population using stratified sampling procedure. Internal auditors are independent when they render impartial and unbiased judgment in the conduct of their engagement. To ensure this independence, best practices suggest the internal auditors to directly report to the audit committee. The results show that only 20% of the internal auditors' report to Audit Committee in Kenya's private firms. The internal auditors should have access to records and personnel as necessary, and be allowed to employ appropriate probing techniques without impediment.**

Keywords: **Internal Auditor, Independence and Fraud Detection.**

1. INTRODUCTION

Fraud, According to Brink and Witt (1982), is an ever-present threat to the effective utilization of resources and it will always be an important concern of management. Based on many impacts of fraud in the recent time, we recognize that fraud is potential threats. This is a threat for using of resources, so management must be careful to avoid the fraud in the company. According to the Webster's New Universal Unabridged Dictionary, fraud is "intentional deception to cause a person to give up property or some lawful right". While according to Accounting and auditing definition, fraud is an intentional act that results in the material misstatement in financial statement that is the subject of an audit. The fourth definition comes from the Association of Fraud Examiners. They further define occupational fraud and abuse as a form of abuse to make personal interests through deliberate misuse and misapplication of assets or resources of the company (Report to the Nation on Occupational Fraud and Abuse, 1999). Beside the above definitions, Federal Bureau of Investigation also describes fraud as the deceptive practices of money or property of others in ways such as stealing of assets, larcenies by bailee and bad checks, except forgeries and counterfeiting (FBI 1984:342). After understanding some definitions of fraud above, we realize that the common thing between these definitions of fraud is an intentional deception to the satisfaction of an individual or group.

Fraud causes tremendous losses to the business world and creates morale problems in the workplace. These losses are serious problems to organizations that need to be managed, controlled and monitored. Technology and the criminal law enforcers are continuously leapfrogging each other, as the race continues to build better tools, commit bigger crimes and develop more effective law enforcement (Rittenberg and Schwieger, 2005). Fraud detection is an examination of the facts to identify the indicators of fraud. Reviewing and improving the internal control system is the primary defense against fraud and abuse. This study showed that a strong system of internal control is the most effective way of fraud prevention. Hence, the aim of this effort is to raise the level of security awareness for organizations in order to plan and facilitate a concerted effort to battle fraud, as prevention is better than cure.

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Fraud is expensive in Africa. According to the Association of Certified Fraud Examiners (ACFE) 2018, the average losses for sub-Saharan Africa organizations is Kshs.11,700,000. The study finds corruption and cash on hand reporting 49 percent and 21 percent respectively. This makes the two as the leading types of fraud in sub-Saharan Africa incidents. A point of concern was that 48 percent of fraud cases are committed by employees with an average loss of Kshs. 7,150,000 and then managers at 36 percent with a median loss of Kshs.9,490,000 and by the owners/business executive at 14 percent with an average loss of about kshs.353,080,000.

In Kenya fraud and bribery is used mostly by companies to acquire and retain business. The private sector corruption is so rampant in transactions between business associates, including suppliers and much less when doing business with the government. Other studies have estimated that companies lose between seven and eight per cent of their revenues to corruption, translating to loss of millions of jobs every year (Ernst and Young, 2014).

1.1 Statement of the Problem

Business fraud and bribery in Kenya's private sector has been on the rise (Ernst and Young, 2014). Nearly half of Kenyan firms are at risk of losing money to fraud and corruption incidents, fueling the growth of private investigators contracted to probe or curb the economic crimes. Fraud deprives Kenyan citizens of their capital, which is needed for economic growth of the country and erodes civil confidence in public institutions. Fraud in the private sector is a final link in the chain of violation of business ethics in Kenya. Due to the thrive of fraud where the corruption proceeds create unequal competition of resources in addition to other money kept in offshore accounts, Kenya's high level of poverty remains. This scenario necessitates to explore the significance of internal auditors in fraud detection. The study thus sought to investigates the effect of internal auditor's independence on fraud detection in private firms in Kenya.

1.2 Research Objective

The study sought to explore the effect of internal auditor's independence on fraud detection in private firms in Kenya.

2. LITERATURE REVIEW

2.1 Theoretical Review

The study was done by Jensen and Meckling (1976) and stated that the agency relationship is a contract between the managers (agent) with the owner (principal). Agency relationship arises when one or more persons (the principal) employs another person (agent) to provide a service and then delegate decision making authority to the agent who is morally responsible for optimizing the benefits of the owners (principal), but on the other hand managers also have interests to maximize their welfare (Ujiyanto & Pramuka,2007). Conflict of interest or the difference of interest between principal and agent is what can lead to agency problems that can affect the quality of reported earnings. Earnings management measures taken by the management due to conflict of interest and asymmetric information with the owner is a form of financial statement fraud. The statement is in line with Rezae (2002) which states that the earnings management measures are closely related to financial statement fraud. This will ultimately develop into a fraudulent financial statement materially misleading. Based on the above description, it can be concluded that the agency problem between the owner (principal) and the management (agent) can lead to financial statement fraud.

The theory was critical to the conceptualization of the study especially on the relationship between auditor's independence and fraud detection in private firms in Kenya. Auditors should be aware of areas in which potential conflict of interests may arise and be prepared to test those areas in their work.

2.2 Empirical review

A research by Makkawi and Schick (2003) noted that it is important that auditors are even more vigilant in the execution of their responsibilities by ensuring that due diligence and care at the forefront of their agenda so that fraud can be detected and exposed. This is critically important, if auditors are to protect and preserve their professional reputation and integrity and avoid legal costs

A study by Zayol & Kukeng (2017) on the the effect of auditor independence on audit quality, showed that there is a strong relationship between auditor independence and audit quality. They also showed that the threats to auditor independence includes client importance, non-audit services (NAS), audit tenure, and client's affiliation with Certified Public Accountant firms. The study adopted the ex post facto research design relying on secondary information.

Okolie (2014) examined the relationship and effects of auditor independence measured by the amount of audit fees received on the earnings management of companies in Nigeria. The study employed the use of secondary data derived from the

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Nigerian Stock Exchange fact book on a total of 342 company year observations. The empirical analysis shows that audit tenure and auditor independence shows significant effect and reveals significant relationship with the number of discretionary accruals of quoted companies in Nigeria.

Beattie, Brandt, and Fearnley (1999) opined that the factors that could influence the perceived auditor's independence includes the fees perceived by the auditor for audit and non-audit services, the period of auditors' services and auditor's rotation. The compromise of auditor's independence results in poor audit quality and leads to greater earnings management and lower earnings quality (Okolie, 2014). Auditors independence may be compromised by auditor tenure. As the auditor client relationship lengthens, the auditor may develop close relationship with the client and become more likely to act in favor of management, resulting in reduced objectivity and audit quality. The proponents of mandatory rotation equally argued that the longer the auditor tenure the lesser its objectivity. Davis, Soo, and Trompeter (2000) revealed that there is no empirical evidence about the effect of rotation on auditor cost and quality. Similarly, providing non-audit services, as earlier stressed as in the case of Arthur Anderson, increases the economic bond between the auditor and the client, and there is a widespread belief that auditors might sacrifice independence in order to retain clients who are paying attractive amounts in non-audit fees (DeFond, Raghunandan, & Subramanyam, 2002).

3. METHODOLOGY

The study utilized a descriptive survey design with the aim of achieving the objectives of the study. The reason for using a survey is to collect data from a large number of respondents within a very short period of time and to minimize on the cost of collecting the data. A survey approach also gives respondents an opportunity to think before filling in the questionnaires, thus potentially enhancing the reliability of the data. The study population was Thika Sub-County using a population of 1896 firms. The sample of 110 private organizations representing 5.8 per cent of the entire population was selected from various private organizations as a representative of the whole population using stratified sampling procedure, which is a probability sampling method. This ensured a representation of all the existing subgroups of population. This also implies that the sample captures groups of private organizations. Selection of private organizations to form the sample size was done using simple random sampling procedure from the subgroups. The researcher employed observation techniques with the help of an observation checklist whereby, he visited the sites.

In this study data was collected from both the primary and secondary sources. Primary data was collected by the use of structured questionnaires which addresses both open and closed-ended questions and administered to the respective staff of auditors of private firms. They were dropped off at the respondent's office then picked later after they had been filled. To increase the response, rate a follow-up by the phone followed. Secondary data was used to analyse all private firms' available government sources, commercial sources and research or academic sources.

Data collected was analyzed by descriptive statistics. Data obtained from the questionnaires was processed through editing and coding and then entering the data into a computer for analysis using descriptive statistics with the help of Statistical Package for Social Sciences (SPSS), which offers extensive data handling capabilities and numerous statistical analysis procedures that analyses small to very large data statistics (Bell, 2007). Qualitative data was analysed using content analysis.

4. RESULTS AND DISCUSSION

The total population comprises of 1896 firms. A total of 110 firms were sampled for the in this study.

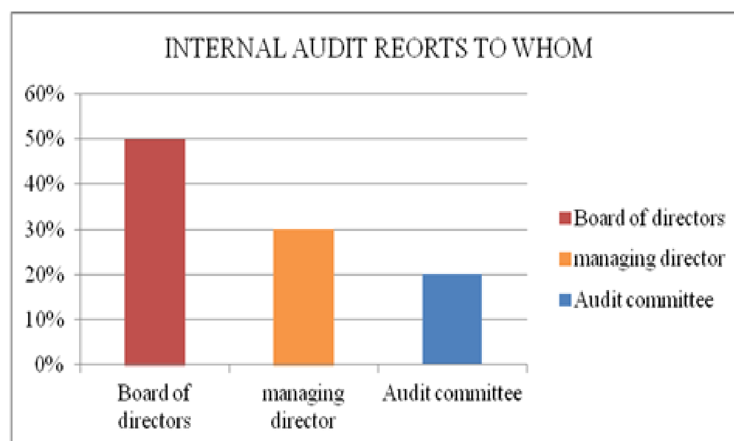

Figure 1: Internal audit reports to whom?

It was indicated that 50% of the internal auditor's report to the Board of Directors, 30% report to managing director, while 20% report to audit committee. Internal auditors are independent when they render impartial and unbiased judgment in the conduct of their engagement. To ensure this independence, best practices suggest the internal auditors to directly report to the audit committee which is not the case in most of Kenya's private firms whereby only 20% report to Audit Committee. In contrast, in Oklahoma Employment Security Commission (OESC), internal audit department is independent of all activities that they audit. The organizational status of the department is sufficient to permit the accomplishment of audit responsibilities. The director of internal audit department reports directly and simultaneously to the Executive Director and the Commission. The audit charter should establish independence of the internal audit activity by the dual reporting relationship to managements and the organizations most senior oversight group. Specifically, the internal auditor should report to the executive management for assistance in establishing direction, support and administrative interface and typically to the audit committee for strategic direction, reinforcement and accountability. The internal auditors should have access to records and personnel as necessary, and be allowed to employ appropriate probing techniques without impediment.

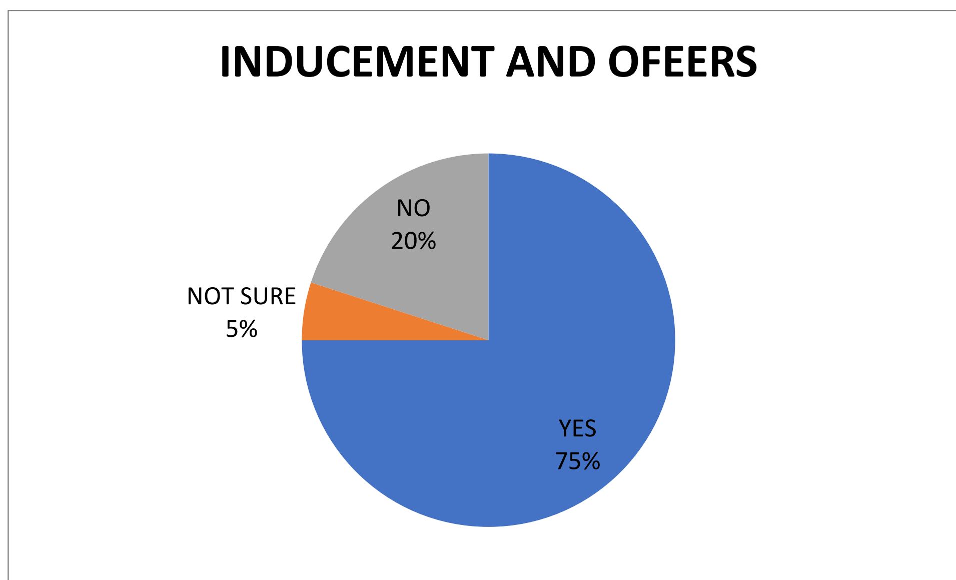

Figure 2: Inducements and offers on the independence of the internal auditors

About 75% of the respondents agree that inducement and offers hinders the independence of internal auditors, 20% disagree that is not true while 5% were not sure of any inducements and offers. Independence if influenced negatively leads to ineffective internal auditing in the private organizations. The influence of inducement and offers may be as a result of low remuneration of the internal auditors.

Table 1: Relationships between peers and supervisors

Relationship	**Very good (%)**	**Good (%)**	**Difficult (%)**
Supervisor	70	19	1
Peers	60	20	0

The table above shows that 89% and 80% of respondents had a good relationship with the supervisors and their peers respectively. A good relationship with colleagues and supervisors enhances performance because it facilitates team work and transparency. Stewart (1993), observes that the relationship between the superiors and their staff will affect efficiency and performance

5. CONCLUSION

The objective was to establish the effect of auditors' independence on fraud detection of private firms in Kenya. The research concluded that auditors' independence is paramount in enhancing fraud detection. Therefore, lack of independence is attributable to factors like: Inducements and offers; Inappropriate organizational and reporting structure of internal audit unit.; Management's intervention on the work of internal auditors.

6. RECOMMENDATION

The study recommended that the competitive recruitment of qualified internal auditors, where merit dictates who is to be hired. This set the minds of internal auditors free from the feeling of being loyal to those who may have helped him/her get the job. There should be an overall change in corporate governance where the internal auditors would be required to report to an audit committee and by extension to a full committee. This would ensure that management is fully checked by policy makers. The internal auditors should not be involved in policy implementation of the state corporation. They should restrict themselves to recommendations and checking on how the policies have been implemented by the management.

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