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EFFECT OF INTERNAL AUDIT PRACTICES IN PREVENTION OF MATERIAL MISSTATEMENT IN FINANCIAL REPORTS AMONG UNIVERSITIES IN KENYA

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Abstract

Organizations have experienced an increase in the level of operations due to constant changes in the economic conditions. This has necessitated the need for internal audit to monitor the changes, add value and improve the organizations' operations. Despite sustained resource allocations by the government and notable success factors, major challenges such as missing crucial transaction records and unexplained expenditures are still being experienced in universities with little knowledge on how internal audit practices can be used as a tool of ensuring proper management of the resources. The purpose of this study was to examine the effect of internal audit practices in prevention of material misstatement in financial reports among universities in Kenya. The study was guided by the Agency theory, the Fraud Triangle Theory, the Fraud Diamond Theory and adopted a descriptive research design with a target population of the 74 chartered universities in Kenya. Simple random sampling technique was used to sample the 36 universities with the head of internal audit function as the respondents. Primary data was collected by use of closed questionnaires and analyzed with the aid of SPSS (Version 23) software. Data was analyzed by use of descriptive statistics, correlation analysis and regression analysis. The study concluded that internal audit practices had significant effect in prevention of material misstatement in financial reports among universities in Kenya. The study recommended that organizations to follow various internal audit practices in prevention of material misstatement and further research be conducted on practices not covered under study. The study is significant to those charged with governance who will find it useful in determining whether the existing audit practices conform to the relevant laws and regulation and are effective in operation.

***Key words**: Financial reports, Internal audit practices, Material misstatement*

Introduction

Organizations have experienced constant changing economic conditions prompting them to continuously develop their processes in order to adapt, survive and grow. There has been an increase in the level of operations in organizations leading to the need for internal audit to monitor the changes. The internal audit department has a role of providing objective assurance and consulting services designed to add value and improve an organization's operations (Kamau,2012). The efficiency of internal audit helps develop the work of an organization because the financial reports reflect the internal audit department's quality (Al-Matari, 2014).

The recent past has indicated a growing interest in internal audit research being carried out on the contribution of the internal audit function to the success of organizations globally (Puttikunsakon, 2015; Al- Matari et al, 2014). In Nigeria the users of financial reports demand for reports that convey accurate and reliable information relevant for decision making (Nwanyanwu, 2017). While in Kenya these practices vary from organization to organization based on the traditions and legislations of the organizations and the approach by the top management (Chiggai, 2016).

The internal audit department is very important inside a firm that it is regarded as the key element in the application of accounting systems which in turn helps in evaluating the work of the organization. It is the backbone of the business accounting as it is the section that records all businesses transactions and helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance (IIA,2015). As outlined in the guidelines provided by the Institute of Internal auditors through its International Professionals Practices Framework (IPPF, 2016), consistent with its mission, the Internal Audit Department provides the management with information, appraisals, recommendations and counsel regarding the activities examined and other significant issues. The internal audit function is important in assisting the management to address fraud in the organization by determining whether the organization has adequate internal controls and fosters an adequate control environment. This is achieved by the internal audit function's constant review of the accounting and internal controls; detailed testing of transactions, accounting and operating procedures, review of the of compliance with the management policies and carrying out of independent investigations into affairs of the entity where frauds are suspected and communication of the same to the management (Mwindi, 2005). The presence of a strong internal control function supports and promotes effective organizational governance hence a robust monitoring and oversight of risk management (Obonyo, 2017).

The management has the responsibility of putting in place mechanism that will enable it to identify risks that affect the achievement of the organizations objectives (Langat, 2018). It has been noted that organizations which have internal audit functions perform better than those organizations that do not (Badara & Saidin, 2014). Taken together, the internal audit department provides a reliable, objective, and neutral 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 & Jovanović, 2011).

Internal audit activities are accomplished through well-defined audit practices. These are procedures established by auditors to ensure that financial reports communicate relevant and reliable information to members of an organization and the public (Nwanyanwu, 2017). The internal audit plans, internal control analysis, internal audit reviews and monitoring are affected by the competence of the audit committees and the change in the environment (Puttikusankon, 2015). They assure those charged with governance that the systems put in place are appropriate and function in preventing any risks. However these practices vary from organization to organization based on the traditions and legislations of the organizations and the approach by the top management (Chiggai, 2016). To ensure adequate measures are put in place that enable an organization prevent material misstatement on the financial reports, an organization needs to understand the risks that the organization is exposed to and the events that could lead to the occurrence of the risk., analyze the effectiveness of internal control system, conduct periodic internal audit reviews and ensure that the system that have been put in place are operating as intended (Chiggai, 2016).

ISA (450) defines material misstatement as difference between the amounts, classification, presentation or disclosure of a reported financial report item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Financial reports form a reliable tool for investors to make investments decisions and company stakeholders to appraise the company's performance (Al-Matari, 2014). Auditors' inability to assess fraud risks has become a serious concern particularly when most incidences of fraud are uncovered after financial statements are audited (KPMG, 2013). This has led to a decrease in public confidence and trust among audit regulators in relation to auditors' role in assessing risks of material misstatement. In response to the increasing complexity of this matter, the profession urges auditors to comply with the standards on professional skepticism while assessing the risks related to fraud (Sayed et al, 2017). Risk of material misstatement may exist both at the overall financial report level and at the assertions level. The auditor therefore provides reasonable assurance that the financial reports under audit are free from any material misstatements. An effective and efficient audit requires proper assessment of risk and proper allocation of effort subsequent to risk assessment.

There has been an increase in cases of fraud in institutions in Kenya. The Auditor General's report for 2016/2017 cited missing crucial transaction records, unexplained expenditures, and violation of procurement regulations, unsurrendered imprest and abandoned projects in various institutions. This necessitates the active participation of the internal audit function in every step of risk assessment, development of internal audit reviews and not just serving as mere consultant of organizations (Musila, 2018; Boritz, Kotchelova & Robinson, 2008). The university's financial reports are prepared on a going-concern assumption that the universities will continue to receive financial support from the government, bankers, creditors and donors. The government through the Ministry of Education (MOE) has for a long time shown a lot of commitment in developing education and training, continuous allocation of resources to the education sector. However, despite the sustained resource allocations and notable success factors, major challenges such as the missing crucial transaction records and unexplained expenditures are still being experienced in the sector. The missing transaction records and unexplained expenditures eventually affect the reporting of financial items in the prepared financial reports. Financial fraud is increasingly dominant among universities in Kenya (Mahinda, 2012). However these financial crimes are difficult to detect, investigate and even mitigate because the senior organization personnel are unwilling to divulge the information due to the consequences the institutions would suffer from such exposure (Omondi, 2013). Available literature on internal audit practices through many scholars such as (Badara & Saidin, 2014; Al-Matari, 2014; Puttikunsakon, 2015) have shown how internal audit practices have been beneficial to various institutions. However these studies have been conducted in developed countries outside Kenya. Existing literature in the local context (Kirogo, Ngahu & Wagoki, 2014; Kasiva, 2012) showed that risk based audit positively affected the performance of organizations. Based on the reviewed literature, the study identified that few studies have been found to focus on internal audit practices in prevention of material misstatement on financial reports among universities in Kenya. This is the gap the current study is leveraged on. The study sought to answer the research question; what is the effect of internal audit practices in prevention of material misstatement on financial reports among universities in Kenya?

Research Objective

The main objective of the study was to examine the effect of internal audit practices in prevention of material misstatements on financial reports among universities in Kenya.

Research Hypotheses

To achieve the objective, the study tested the following hypothesis:
Internal audit practices have no significant effect in prevention of material misstatement on financial reports among universities in Kenya.

Methodology

This study adopted a descriptive research design. The target population for this study was all universities in Kenya totalling to 74 universities (CUE, 2018). The respondents were the head of department of the internal audit function in each university. The sample size of 36 universities was obtained by use of the Nassiuma (2000) formulae as indicated below:

$$n = \frac{NC^2}{C^2 + (N-1)\, e^2}$$

Where n= Sample size
N= The Target Population
C= The Coefficient of Variation
e =Margin of error which is fixed between 2-5%

According to Nassiuma (2000), Coefficient of Variation of 20% ≤ C≤ 30% and an error term between 2-5% is acceptable. The study sample was therefore calculated at 25% coefficient of variation and a 3% margin of error. The twenty five per cent coefficient of variation was used to ensure that the sample is wide enough to justify the results being generalised for the universities. The sample size was therefore calculated as follows:

$$n = \frac{74x.25^2}{.25^2 + (74-1).03^2} = \frac{4.625}{0.1282}$$
$$= 36 \text{ Universities.}$$

Simple random sampling technique was used to sample the universities under study. Simple random sampling was used since population members are similar to one another and have an equal chance of being selected hence giving an accurate representation. Primary data was collected by use of structured questionnaires using the drop and pick method. Face validity used in the study was to determine the validity of the research instrument and was determined by a panel of experts. A pilot study was conducted in four universities which constituted 10% of the sample size. The results from the Cronbach Alpha (ά) Coefficient of .948 was obtained. The coded data was analyzed with the aid of the SPSS (Version 23) software. The data was analyzed by use of descriptive statistics, correlation analyses and regressions analysis.

The study conducted simple regression on the specific objectives and a multiple regression on the main objective of the study. The main objective was to determine the effect of internal audit practices (risk assessment, internal control analysis, periodic internal audit reviews and internal audit monitoring and control) in prevention of material misstatement in financial reports among universities in Kenya. The objective was represented by the multiple regression model below:

$$\mathbf{Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon} \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \mathbf{2.1}$$

Where Y = Material Misstatement on Financial Reports among Universities in Kenya

β_0 = Constant
$\beta_1, \beta_2, \beta_3, \beta_4$, = Variable Coefficients
X_1 = Risk Assessment
X_2 = Internal Controls Analysis
X_3 = Periodic Internal Audit Reviews
X_4 = Internal Audit Monitoring and Control
ε = Error term

The regression analysis was also used to test the hypothesis at 95% confidence level (level of significance a= .05). Multicollinearity, Linearity and normality diagnostic tests were conducted to determine the accuracy of the statistics in the regression.

Results and Discussion

The main objective of the study was to determine the effect of internal audit practices in prevention of material misstatement on financial reports among Universities in Kenya. 86% response rate was received from the internal auditors who were the respondents to the questionnaires. A normality test was conducted to determine the distribution of the variables inorder to make valid inferences from the regression. The graphical approach was used by comparing the histogram to the normal distribution curve. The results indicated that the variables were normally distributed. The multicollinearity test was conducted to determine the association among the independent variables. The results indicated a Value of Tolerance of 1.972 (VT>0.2) and a Value of Inflation Factor of 8.63 (VIF<10) indicating that the variables under study had no related impact on prevention of material misstatement on financial reports. The linearity test was used to measure the association between the internal audit practices and prevention of material misstatement hence predicting the dependent variable by the independent variables by use of the scatter diagram. The results indicated a linear relationship between the variables since it was aligned along the line of best fit.

A five point likert scale was used to determine the extent to which internal audit practices affect the prevention of material misstatement on financial reports among universities in Kenya. The responses are indicated in Table 1:

Table 1: Internal Audit Practices and Prevention of Material Misstatement

		Percentage %						
	Statement On Prevention of Material Misstatement	**Strongly Disagree**	**Disagree**	**Neutral**	**Agree**	**Strongly Agree**	**Mean**	**Std.Dev.**
1	The university has internal controls policies in place designed to help in prevention material misstatement and misconduct		3.23	3.23	12.9	22.58	3.936	.892
2	The university's internal audit function continuously test the effectiveness of antifraud and prevention controls	3.23	6.45	12.9	61.29	16.13	3.806	.909
3	There is automated controls that capture any antifraud related activities	-	19.35	29.03	41.94	6.5	3.452	.995
4	The management has set the tone at the top in regard to material misstatement prevention	3.23	16.13	32.26	29.03	19.35	3.452	1.091
5	The university management enforces values and ethics and expectation from employees in regard to material misstatement and misconduct	-	16.13	16.13	51.61	16.35	3.678	.945
6	The university internal audit function caries out ad –hoc testing for indicators of material misstatement from time to time	-	9.68	12.9	48.9	29.03	3.968	.912
7	A fraud prevention strategy has been put in place by the university	6.45	12.9	16.13	54.84	9.68	3.484	1.061
8	The University has sensitized it employees on most common fraud within the university functions and how to avoid them.	6.45	9.68	29.03	32.26	22.58	3.548	1.150

Source: Researcher (2020)

According to Table 1 above, universities have internal controls policies in place designed to help in prevention of material misstatement and misconduct (58.06%). This implies that the university internal controls are effective to managing errors and frauds. The university internal audit function continuously tests the effectiveness of antifraud and prevention controls. (61.29%). There exists automated controls that capture any antifraud related activities (41, 94%) implying that opportunities for commuting fraud is minimized. The management has set the tone at the top in regard to material misstatement prevention (32.26%). The study results indicate that the university management enforces values and ethics and expectation from employees in regard to material misstatement and misconduct (51.61%). The study also noted that the university internal audit function caries out ad –hoc testing for indicators of material misstatement from time to time the study (48.9%). A fraud prevention strategy has been put in place by the university (54.84%), the university has sensitized it employees on most common fraud within the university functions and how to avoid them (32.26%).

Correlation analysis between the internal audit Practices and Prevention of Material Misstatement

A correlation analysis was conducted to establish the strength of the relationship between prevention of material misstatement as the dependent variable and the internal audit practices as the independent variables. In this study, the Pearson correlation was used which varies between -1.00 to +1. The negative values indicate negative relations while the positive values indicate positive relations among the variables under study. The results are as indicated in Table 2:

Table 2 Pearson Correlations Matrix

		Risk Assessment	Internal Controls Analysis	Periodic Internal Audit Reviews	Internal Audit Monitoring and Control	Prevention of Material Misstatement
Risk Assessment	Pearson Correlation	1	.401*	.517**	.371*	.598**
	Sig. (1-tailed)		.013	.001	.020	.000
	N	31	31	31	31	31
Internal Controls Analysis	Pearson Correlation	.401*	1	.701**	.713**	.398*
	Sig. (1-tailed)	.013		.000	.000	.013
	N	31	31	31	31	31
Periodic Internal Audit Reviews	Pearson Correlation	.517**	.701**	1	.658**	.527**
	Sig. (1-tailed)	.001	.000		.000	.001
	N	31	31	31	31	31
Internal Audit Monitoring and Control	Pearson Correlation	.371*	.713**	.658**	1	.461**
	Sig. (1-tailed)	.020	.000	.000		.005
	N	31	31	31	31	31
Prevention of Material Misstatement	Pearson Correlation	.598**	.398*	.527**	.461**	1
	Sig. (1-tailed)	.000	.013	.001	.005	
	N	31	31	31	31	31

*. Correlation is significant at the 0.05 level (1-tailed).
**. Correlation is significant at the 0.01 level (1-tailed).
Source: Researcher (2020)

The results from Table 2 above indicate a positive correlation (r=.598) and is statistically significant (p =0 .000<.05) between the risk assessment and prevention of material misstatement. This implies that prevention of material misstatement is associated with an increase in risk assessment. The study further reveals a positive relationship between the internal controls analyses (r=.398) significant (p=.013< .05). The study findings also reveals a positive correlation between the periodic internal audit reviews which is also statistically significant with r= .527 and p=.001<.05. The study further reveals a positive association between internal audit monitoring and control which is also statistically significant (r=.461 and p=.005<.05).

Hypothesis Testing

To establish the relationship between the dependent variable and the independent variable a regression analysis was conducted. A multiple regression was conducted to determine the effect of internal audit practices in prevention of material misstatement on financial reports among universities in Kenya. Four variables that constituted the internal audit practices were used in the study. The variables were the risk assessment, the internal audit control analysis, periodic internal audit reviews and the internal audit monitoring and control. The regression analysis was used to test the hypothesis. The F-statistic and the associated P-values was used in the study to test the fitness of the study model. The decision on whether to reject or accept the null hypothesis was based on P-values at 0.05 significance level. The results are as indicated in table 3 to Table 5

Table 3 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.665[a]	.442	.357	.44722

a. Predictors: (Constant), Risk Assessment, Periodic Internal Audit Reviews, Internal Control Analysis and Internal Audit Monitoring and Control

Table 4 ANOVA[a]

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	4.124	4	1.031	5.155	.003[b]
	Residual	5.200	26	.200		
	Total	9.325	30			

a. Dependent Variable: Prevention of Material Misstatement

b. Predictors: (Constant), Internal Audit Monitoring and Control, Risk Assessment, Periodic Internal Audit Reviews, Internal Controls Analysis

Table 5 Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	.693	.704		.985	.334
Risk Assessment	.455	.178	.439	2.562	.017
Internal Controls Analysis	-.066	.190	-.081	-.349	.730
Periodic Internal Audit Reviews	.159	.170	.216	.939	.356
Internal Audit Monitoring and Control	.207	.214	.213	.967	.342

a. Dependent Variable: Prevention of Material misstatement

Table 3 represents the goodness fit of the model. The coefficient of correlation (R) was 0.665 (r>0.05) indicating a strong positive correlation between internal audit practices and prevention of material misstatement in financial reports among universities in Kenya. The coefficient of determination (R^2) was .442. This means that 44.2% of the variations in prevention of material misstatement in financial reports among universities in Kenya can be explained by internal audit practices. Other factors that have not been studied in this study explain the balance of the prevention of material misstatement in financial reports.

The ANOVA table 4 shows the test for significance of the multiple correlation to prove that the internal audit practices do not significantly contribute to the prevention of material misstatement in financial reports. The results from the table indicate P=.003<.05 and F-Statistics = 5.155>2.74 F-Critical. The result therefore indicates that the overall model was statistically significant and the independent variables good predictors in prevention of material misstatement on financial reports among universities in Kenya.

Based on the ANOVA results in table 4, the F- Statistics= 5.155>2.74, F-critical is 2.74, the P-value =0.003<.05. This indicates a statistical significant relationship between internal audit practices and prevention of material misstatement on financial reports among universities in Kenya. Given that the p-value is less than .05 significant value, the null hypothesis **(HO_0)** was rejected and the alternative hypothesis accepted. The study therefore concluded that internal audit practices have a positive and significant effect in prevention of material misstatement on financial reports among universities in Kenya.

From table 5 on the regression coefficients indicated that the constant, β=0.693 with a P=0.334>0.05, coefficient for risk assessment, β=-0.455; P=0.017<0.05, coefficient for internal control analysis, β=-0.066; P=0.730>0.05, coefficient for periodic internal audit reviews β=0.159; P=0.356>0.05, coefficient for internal audit monitoring and control β=0.207; P=0.342>0.05. The multiple regression is summarized as indicated below;

$$\boldsymbol{\gamma = .693+.455x_1-.066x_2+.159x_3+.207x_4}$$

The results imply that when all variables are held at a constant zero, prevention of material misstatement in financial reports in universities in Kenya will be at .693. Taking all other independent variables at zero, a unit increase in the level of risk assessment leads to .445 increase in the prevention of material misstatements, a unit increase in internal controls analysis will lead to .066 decrease in the prevention of material misstatement, while a unit increase in periodic internal audit reviews will lead to .159 increase in the prevention of material misstatement. Lastly a unit increase in internal audit monitoring and control will lead to .207 increases in the prevention of material misstatement on financial reports among universities in Kenya.

Conclusions

From the study results, the internal audit practices (risk assessment, internal control analysis, periodic internal audit reviews and internal audit monitoring and control) had a positive effect in prevention of material misstatement in financial reports among universities in Kenya. Risk assessment is directly linked to the degree of prevention of material misstatement and is a significant tool. Proper identification of risks, documenting of the risks and providing channels for employees to report the risk provides information that can be shared by the management for action. Coddere (2005) affirms that organizations are exposed to significant errors, frauds or inefficiencies that can lead to financial loss and increased risks. There should be regular communication with those charged with risk assessment in an organization as well as those well as those charged with governance to ensure that risks are management on a timely manner

The study also concluded that internal control analysis has a significant effect in prevention of material misstatement on financial reports among universities in Kenya. Ewa and Uduoyang (2012) concluded that there exists a linkage between the internal control analysis and the prevention of material misstatement where strong internal controls design deters staff from committing fraud while a weak one exposes them to fraud and creates opportunities. Abiola & Oyewele (2013) concluded that poorly constituted controls may lead to scandals, losses, failures and damage to an organizations reputation. This conclusion can therefore be generalized to other institutions and studies.

In addition, the study concluded that periodic internal audit reviews has a significant effect in prevention of material misstatement in financial reports among universities in Kenya. From the empirical review Puttikunsakon (2015) indicates that periodic internal audit reviews leads to risk reduction, operational excellence and fraud detection. The study findings also agree with Kasiva (2012) that proper planning of an audit improves efficiency, accuracy, completeness, timeliness, convenience and clarity of an audit Agoglia, Hatfield & Jackson (2010) agree that periodic audit reviews is carried to ensure that each member is prepared to follow the guidance and provide the adequate and complete evidence. The conclusion can therefore be generalized in other studies and other institutions other than universities.

Finally internal audit monitoring and control has a significant effect in prevention of material misstatement in financial reports among universities in Kenya. This is in line with the existing literature by other scholars. Fadzil (2015) agrees that in performing the internal audit, the internal auditors need to identify better risk management frameworks and risk management policies and procedures which should be installed in monitoring policies and procedures of the organization.

Recommendations

The study recommends that universities to improve on their various internal audit practices in prevention of material misstatement. The management in the universities to adopt the various practices of risk identification, analysis and reporting to control any misstatement on financial statement. The Universities’ Management to put in place properly constituted controls. There should be adequate management policies that should be shared to all employees. The policies to be updated on regular basis. Those charged with governance to ensure that the universities have functional organization structures that ensures adequate segregation of duties hence reducing significantly the opportunity to commit fraud. Charts of accounts for aligning of financial transactions to be put in place by the management. The internal auditors to maintain audit working papers as evidence of the work carried as appoint of reference and audit plans provide guidance to the audit staff on the strategy and their responsibilities. To confirm the accuracy of transactions the study recommends that internal auditors should periodically inspect the financial transactions and the management to visit branches to ensure that the laid down policies are functioning and are being followed.

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