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Abstract

Financial reporting quality remains a critical concern for deposit-taking savings and credit cooperative societies (SACCOs) in Kenya, with recent scandals highlighting significant deficiencies in financial disclosure and transparency. This study examined the effect of internal audit function's independence on financial reporting quality in deposit-taking SACCOs in Kenya. Grounded in agency theory, the research adopted a cross-sectional design targeting 176 deposit-taking SACCOs regulated by SASRA. Simple random sampling was employed to select 122 respondents from finance, accounting, and internal audit departments. Data was collected using structured questionnaires and analyzed using descriptive statistics, correlation analysis, and multiple regression analysis. The study achieved a 76% response rate with 93 usable questionnaires. Findings revealed that internal audit function's independence had a moderate positive correlation ($r=0.458$) with financial reporting quality. Regression analysis demonstrated that IAF independence significantly predicted financial reporting quality ($\beta=0.335$, $p<0.05$, $t>1.96$), explaining 58.2% of the variance in financial reporting quality. The study concluded that strengthening the independence of internal audit functions is crucial for enhancing financial reporting quality in deposit-taking SACCOs. The study recommends that senior managers of deposit-taking SACCOs should remain committed to strengthening the independence of the internal audit function through clear organizational structures, adequate resource allocation, and protection of internal auditors from managerial interference. This research contributes to the understanding of governance mechanisms in cooperative financial institutions and provides practical insights for regulators and SACCO management.

Keywords: Internal Audit Independence, Financial Reporting Quality, Deposit-Taking SACCOs, Agency Theory, Kenya

1.0 Background of The Study

Worldwide, financial misreporting by financial institutions represents a persistent challenge affecting stakeholder confidence and market stability. A 2018 PricewaterhouseCoopers report indicated that almost 50% of financial reports by these entities failed to meet quality standards (PWC, 2019). Financial reporting quality is of immense concern and interest to shareholders, investors, lenders, suppliers, and other stakeholders who rely on accurate information for decision-making. In developed countries including the United States, United Kingdom, Australia, Malaysia and Spain, monitoring attributes constitute the main determinants of financial reporting quality in financial institutions (Sahi et al., 2022). The internal auditors' role is increasingly influenced by dynamics brought about by changes in regulations, especially corporate standards, including financial reporting requirements. This has necessitated reinforcing both internal controls and financial audit mechanisms to ensure transparency and accountability (Bilal et al., 2018).

In financial institutions in underdeveloped nations like Yemen, the internal audit function is essential to strengthening relationships between stakeholders. The key internal audit function aspects in these institutions are objectivity, independence, professional ethics, and the size of the internal audit function (Alyazidi et al., 2022). Using evidence from Montenegro, Laković et al. (2016) demonstrated the significant link between internal audit function and financial reporting quality. Independence arises when no conflict of interest is evident between stakeholders, allowing auditors to make decisions without external pressure (Raiborn et al., 2017). Independent auditors do not base their auditing decisions on considerations other than professional judgment and ethical standards. To avoid managerial conspiracies and in line with agency theoretical lens, auditors and directors are required to be diligent with greater independence to protect stakeholder interests.

Developing countries in Africa like Zambia have weak enforcement mechanisms for accounting standards compliance, creating opportunities for financial misreporting (Kabwe et al., 2020). Although financial reporting quality is determined by corporate governance, weaknesses in enforcement mechanisms necessitate the need to interrogate the role of the internal audit function (Kabwe, 2023). Financial misreporting is a common occurrence in many Ugandan financial institutions where the financial reporting quality is significantly shaped by internal audit function characteristics. It follows that the internal auditors' expertise and independence determine financial reporting quality of financial institutions in this country (Kaawaase et al., 2021). In Zimbabwe, Jachi and Yona (2019) sought to link internal audit function independence and how auditors remain transparent and accountable in their roles. It was noted that internal audit function independence directly allows auditors to be accountable and transparent in their undertakings.

The deposit-taking SACCOs in Kenya have been facing challenges reflected in their financial reports which touch on the internal audit function and financial reporting quality. These SACCOs are required by the Sacco Societies Regulatory Authority to adhere to prudent financial reporting standards (SASRA, 2023). Yet, there are apparent issues that point to compromised financial reporting quality reflected in financial scandals in several deposit-taking SACCOs in Kenya. Fraudulent dealings and scams are some of the issues that have led to the collapse of some of these financial institutions in Kenya (Serem et al., 2020). Internal auditing procedures are crucial to monetary goals of deposit-taking SACCOs in Kenya, however, empirical insights suggest questions regarding how independent internal auditors influence the financial reporting quality in these institutions. The performance of the internal

audit function in Kenyan SACCOs involves priority areas and risk levels among other measures (Ng'endo, 2020).

1.1 Statement of The Problem

The deposit-taking SACCOs in Kenya have been facing the challenge of ensuring financial reporting quality, with evidence of creative accounting in some of these financial institutions. Though Metropolitan National SACCO had been reporting huge surpluses, for instance in FY 2019 it reported retained earnings amounting to Ksh 109.47 million, an audit report indicated that the DTS lost approximately Ksh 15 billion between 2021 and 2023 through theft and embezzlement (Okoth, 2024; Rotich, 2024). This means that the SACCO's financial reports were hitherto being manipulated, hence misleading and reflecting poor financial reporting quality as the reports were not factual. Such instances underscore the critical need to examine the mechanisms that should ensure accurate and transparent financial reporting in these institutions.

The studies conducted hitherto have not adequately and clearly illustrated the link between the internal audit function's independence and financial reporting quality, particularly in deposit-taking SACCOs in Kenya. A study among deposit-taking SACCOs in Kenya examined how managing of risks, expertise of senior managers and quality of internal audit shape financial reporting quality (Kinyenze & Ondabu, 2023), however, the study did not centre specifically on internal audit function's independence. Another study conducted in Kisii County linked audit committee characteristics to the financial reporting quality of SACCOs (Machora & Oluoch, 2019), but fell short of explicitly addressing the internal audit function's independence. A study on Metropolitan National Sacco evaluated key issues shaping the internal audit function (Ng'endo, 2020), yet it did not attempt to link the stated independence to financial reporting quality. Therefore, there are knowledge and research gaps on the internal audit function's independence and financial reporting quality in deposit-taking SACCOs in Kenya.

1.2 Objective of The Study

To examine the effect of the internal audit function's independence on financial reporting quality in deposit-taking SACCOs in Kenya.

1.3 Research Hypothesis

H₀₁: Internal audit function's independence has no significant effect on the financial reporting quality in deposit-taking SACCOs in Kenya.

2.0 Literature Review

The section reviews theoretical foundations and empirical evidence linking internal audit function's independence and financial reporting quality. The reviewed studies are summarized and critiqued with the view of establishing potential research gaps that justify the current investigation.

2.1 Theoretical Framework

This study was anchored on agency theory developed by Jensen and Meckling (1976), which provides the basis of interaction between agents and principals. Various researchers have employed the agency theory to explore the nature of nexus between the aforesaid parties in actualization of common goals of entities (Basu & Lederer, 2004). Oftentimes, there is a likelihood of principal-agent conflict when the agent prioritizes their interest to the detriment of the principal party. This agency problem is known as 'opportunism' by the agent and results when the principal is not in position to confirm if or not the agent has carried out actions in line with assigned contractual terms (Eisenhardt, 1989). To minimize this conflict and maximize

the performance of the agents, the principal can consider offering incentives to the agents or establishing monitoring mechanisms.

The agency theory is easily applicable to demonstrate the linkage between firms and their employees, particularly the managers, and illustrates the vendor-client relationship (Basu & Lederer, 2004). In the study by Adams (1994), the agency theory provides an insightful theoretical framework concerning the internal audit function by exploring roles of internal auditors. It is documented that the principal-agent mistrust raises pertinent queries on the effectiveness of the internal audit function. Like directors, the agency theory holds that internal auditors may pursue their interests, and in cahoots with the management, the auditors may compromise their scope of work. Consequently, this negatively impacts not only their reports but also the organization's financial reporting quality (Institute of Chartered Accountants, 2005).

The agency theory anchors the financial reporting construct by explaining how management of firms may compromise the quality of their financial reporting through, for instance, creative accounting. Creative accounting deters transparency and financial disclosure, thus negating financial reporting quality (Abed et al., 2022). This may stem from the desire of the senior management and directors to present an image of a highly-performing entity with the desire to be acknowledged, appreciated and rewarded, for instance, through bonuses. The agency theory can be applied to illustrate the independence of the internal audit function in deposit-taking SACCOs, demonstrating how an independent internal audit function aligns the needs of stakeholders. In tandem with the agency theory's stipulations, an independent internal audit function is characterized by accountability and transparency (Jachi & Yona, 2019).

2.2 Empirical Review

Internal audit effectiveness was the focus of an empirical study carried out in Vietnam where Ta and Doan (2022) used both quantitative and qualitative insights. With data from first hand sources, processing noted that the level of effectiveness of internal audit is directly and significantly shaped by their independence. However, financial reporting quality was unexplored in this study, a gap that the present study addressed. Another study conducted among Malaysian public sector organizations linked the independence of internal audit function and capability of internal audit (Yusof et al., 2019). The study was conducted against a backdrop of ostensibly scarce research on these constructs. A majority of the surveyed organizations had level 1 capability which was considered to be minimal. Evident was that limited independence of internal audit constrains financial reporting quality, yet this study contextually centred on the public sector entities as opposed to financial institutions.

In Zimbabwe, Jachi and Yona (2019) sought to link internal audit function independence and how auditors remain transparent and accountable in their roles. It was noted that internal audit function independence directly allows auditors to be accountable and transparent in their undertakings. Evident gap was that local authorities rather than SACCOs were central in this inquiry, and it also fell short of relating the internal audit function independence to financial reporting quality. A local study examined the key issues that shape realization of goals of the internal audit function with Metropolitan National Sacco as the point of reference (Ng'endo, 2020). Clear from results was that independent level of internal auditors and internal audit function performance were significantly linked with each other. However, the study did not link the internal audit function independence to financial reporting quality.

Another study evaluated the level of independence of internal auditors and nexus with monetary performance of deposit-taking SACCOs in Kenya (Luvisi et al., 2024). Insights from first hand sources were obtained from 223 respondents, and according to the study findings,

51.2% of the variability in the deposit-taking SACCOs performance could be attributed to internal auditors' independence. Although the study linked auditors' independence to the performance of deposit-taking SACCOs, it did not address financial reporting quality as the outcome variable. In their study on financial reporting quality among deposit-taking SACCOs in Kenya, Kinyenze and Ondabu (2023) established that financial reporting quality was impacted by enterprise resource planning, internal audit quality and top management expertise, but did not specifically focus on internal audit function's independence.

2.3 Conceptual Framework

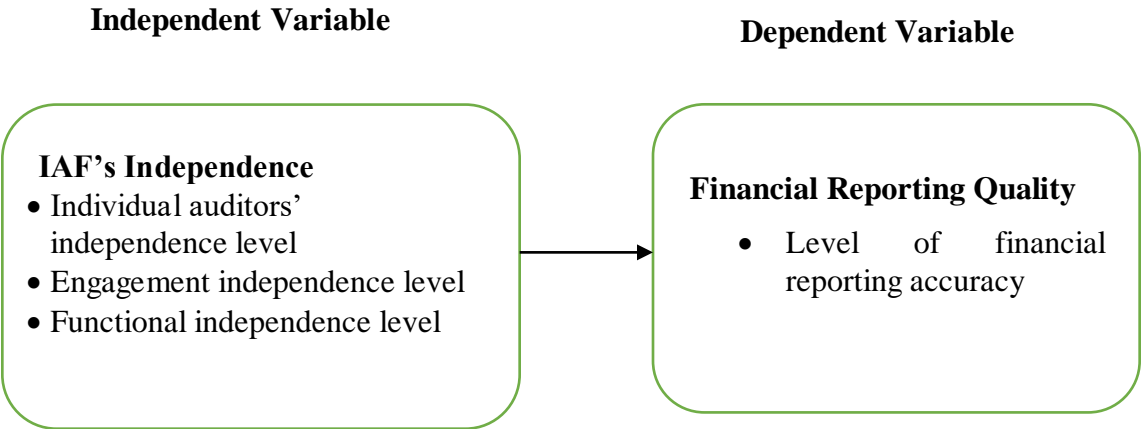


Figure 1: Conceptual Framework

3.0 Research Methodology

This study adopted a cross-sectional research design supporting quantitative methods. The target population comprised 176 deposit-taking SACCOs in Kenya regulated by SASRA (2024), with each SACCO having a single representative heading either the finance, accounting or internal audit departments. Using Yamane's formula at 95% confidence level, a sample size of 122 respondents was determined and selected through simple random sampling technique to enhance representativeness and accuracy of the collected data. Data was collected using structured questionnaires containing closed-ended questions following a five-point Likert scale ranging from 'Strongly Disagree' to 'Strongly Agree'. The questionnaire was pilot tested using 11 respondents from deposit-taking SACCOs in Kericho County to determine its reliability and validity. After obtaining authorization from Kenyatta University and research permit from NACOSTI, Google Forms were developed and administered virtually to collect data from respondents. Data analysis entailed descriptive statistics (means and standard deviations) and inferential statistics (correlation and multiple regression analysis), with diagnostic tests including linearity, multicollinearity, normality and heteroscedasticity conducted to validate the assumptions of regression analysis.

4.0 Findings and Discussion

This chapter presents the findings from data analysis. From the 122 questionnaires administered to employees from finance, accounting or internal audit departments drawn from deposit-taking SACCOs in Kenya, 93 were completed and returned representing a 76% response rate, which is ideal for analysis (Sammur et al., 2021). Respondents were drawn from various departments: 43.0% from internal audit departments, 35.5% from accounts department, and 21.5% from finance departments, enhancing diversity of information. While 51.6% had worked in the SACCO sector for over 10 years, 45.2% had worked in their present institution

for 3-5 years, indicating that participants had substantial knowledge and experience in the sector.

4.1 Descriptive Statistics

Descriptive statistics were computed to determine the extent of internal audit function's independence in deposit-taking SACCOs in Kenya. Table 1 presents the findings.

Table 1: Internal Audit Function's Independence

Propositions	1	2	3	4	5	Mean	Std Dev
Internal auditors in our DTS are absolutely independent in their work	5.4%	11.8%	6.5%	58.1%	18.3%	3.72	1.067
There are no reported cases alluding to the compromise of the work of individual internal auditors	3.2%	15.1%	12.9%	53.8%	15.1%	3.62	1.021
Internal auditors in our DTS demonstrate a high level of engagement independence	6.5%	10.8%	17.2%	47.3%	18.3%	3.60	1.105
There is no interference with the audit tasks each internal auditor is engaged to undertake	3.2%	14.0%	15.1%	53.8%	14.0%	3.61	1.000
The IA department has a high degree of functional independence	9.7%	14.0%	18.3%	44.1%	14.0%	3.39	1.180
Average						3.59	1.075

The findings in Table 1 indicate that 76.4% of respondents with mean of 3.72 shared that internal auditors in the deposit-taking SACCOs were absolutely independent in their work. Furthermore, 68.9% with mean of 3.62 argued that there were no reported cases alluding to the compromise of the work of individual internal auditors, demonstrating individual auditor independence. While 67.8% with mean of 3.61 noted that there was no interference with the audit tasks each internal auditor was engaged to undertake, 65.6% with mean of 3.60 indicated that internal auditors in the deposit-taking SACCOs demonstrated a high level of engagement independence. Additionally, 58.1% with mean of 3.39 shared that internal audit department had a high degree of functional independence. On overall, the mean value in Table 4.1 is 3.59, implying that respondents agreed that to some extent, there was independence in the internal audit function in their institutions. The overall standard deviation value is 1.075, which means that there were divergent views shared by respondents as far as internal audit independence in their institution was concerned. The fact that there was independence in the internal audit function in the studied firms is consistent and aligned with the agency theory developed by Jensen and Meckling (1976) that regards such independence as strategies in countering conflicting views between managers and owners of the entity.

4.2 Correlation Analysis

Correlation analysis was conducted to determine the relationship between internal audit function's independence and financial reporting quality. Table 2 presents the findings.

Table 2: Correlation Matrix

Variables	Financial Reporting Quality
Internal Audit Function's Independence	$r = 0.458^{**}$ $p = 0.000$

**Correlation is significant at the 0.01 level (2-tailed)

Table 2 shows that internal audit function's independence had $r=0.458$, implying that it had a moderate but positive relationship with financial reporting quality. This finding suggests that as the independence of the internal audit function increases, the financial reporting quality in deposit-taking SACCOs also improves. The positive correlation aligns with Ta and Doan (2022) who noted that independent internal auditors are effective in their duties. Similarly, Jachi and Yona (2019) established that there was a direct link between the internal audit function independence and transparency and accountability, which are key components of financial reporting quality.

4.3 Regression Analysis

Multiple regression analysis was conducted to test the hypothesis and determine the effect of internal audit function's independence on financial reporting quality. Tables 3, 4 and 5 present the model summary, ANOVA, and coefficients respectively.

Table 3: Model Summary

R	R Square	Adjusted R Square	Std. Error of the Estimate
.775	.601	.582	1.114

Table 3 indicates value of R as .775, meaning that internal audit function's independence exerts a strong and positive relationship on financial reporting quality in deposit-taking SACCOs in Kenya. The adjusted R square value is .582, deducing that 58.2% change in financial reporting quality in deposit-taking SACCOs in Kenya can be attributed to internal audit function's independence. This leaves unexplained variance of 41.8% which justifies future research on other factors influencing financial reporting quality.

Table 4: ANOVA

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	164.031	4	41.008	33.081	.000b
Residual	109.088	88	1.240		
Total	273.118	92			

Table 4 shows that the F-calculated (33.081) exceeds F-critical at $p=0.000$, implying significance of the regression model. This means that internal audit function's independence is a good predictor of financial reporting quality in deposit-taking SACCOs in Kenya.

Table 5: Beta Coefficients and Significance

Variable	Unstandardized Coefficients B	Std. Error	Standardized Coefficients Beta	t	Sig.
(Constant)	7.744	1.335		5.800	.000
IAF's Independence	.335	.079	.055	4.241	.000

The findings in Table 5 show that internal audit function's independence ($\beta=0.335$, $p<0.05$ & $t>1.96$) had a significant positive effect on financial reporting quality. This means that a unit enhancement in internal audit function's independence can result into 0.335-unit improvement in financial reporting quality in deposit-taking SACCOs in Kenya. At 5% significance level, the study rejects H_{01} and thus infers that internal audit function's independence was a significant predictor of financial reporting quality. These insights are in line with past empirical inquiries. Jachi and Yona (2019) noted that internal audit function independence directly allows auditors to be accountable and transparent in their undertakings. A local study by Ng'endo (2020) indicated that internal audit independence and internal audit function performance were significantly linked with each other. Another study by Luvisi et al. (2024) showed that 51.2% of the variability in the deposit-taking SACCOs performance could be attributed to internal auditors' independence. In their study on financial reporting quality, Kinyenze and Ondabu (2023) established that internal audit quality significantly impacted financial reporting quality, supporting the current findings.

5.0 Conclusion

The study concluded that internal audit function's independence has a positive and significant effect on financial reporting quality in deposit-taking SACCOs in Kenya. The findings demonstrate that deposit-taking SACCOs in Kenya have embraced independence in their internal audit functions to some extent, with internal auditors being relatively independent in their work with minimal interference from management. The correlation analysis revealed that internal audit function's independence is positively correlated with financial reporting quality, while regression analysis confirmed that internal audit function's independence is a critical driver of financial reporting quality, explaining 58.2% of its variance. The study validates the agency theory's proposition that independent monitoring mechanisms such as internal audit functions help align the interests of principals and agents, thereby enhancing the quality of financial reporting. Therefore, strengthening the independence of internal audit functions in deposit-taking SACCOs is essential for ensuring accurate, transparent, and reliable financial reports that serve the information needs of members, regulators, and other stakeholders.

6.0 Recommendations

Based on the finding that internal audit function's independence critically shapes financial reporting quality, senior managers of deposit-taking SACCOs should remain committed to strengthening the independence of the internal audit function. This can be achieved by establishing clear organizational structures where the internal audit function reports directly to the board of directors or audit committee rather than to management, thereby minimizing potential conflicts of interest. Management should ensure adequate resource allocation to the internal audit department including sufficient staffing, training opportunities, and technological tools to enable auditors to perform their duties effectively without undue pressure. There should be protection of internal auditors from managerial interference through formal policies that guarantee their autonomy in planning, executing, and reporting audit findings. The SACCO Societies Regulatory Authority (SASRA) should develop and enforce regulations that mandate structural and functional independence of internal audit functions in all deposit-taking

SACCOs, including requirements for direct reporting lines to governance bodies. Regular assessments of internal audit independence should be conducted by audit committees to identify and address any threats to auditor objectivity. Additionally, deposit-taking SACCOs should establish whistleblower protection mechanisms that allow internal auditors to report concerns without fear of retaliation, thereby fostering an environment where independence is valued and protected.

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