

---

# *INTERNATIONAL JOURNAL OF SCIENCE ARTS AND COMMERCE*

---

## **AUDITING CHALLENGES FACING MICROFINANCE INSTITUTIONS IN ADVANCING MICRO-CREDIT**

**Ogilo Fredrick \*    Kariithi Alexander\*\***

\*Lecturer, School of Business, University of Nairobi: BCOM student, University of Nairobi.

---

### **ABSTRACT**

*This study sought to determine auditing challenges facing microfinance institutions in advancing micro-credit. The study used descriptive survey research design. The population of the study consisted of microfinance institutions in Kenya. Regression analysis was used to analyze the data. The study concluded that financial limitation and creditworthiness had a positive effect on lending microcredit and therefore an increase in it will increase the lending microcredit to low income clients in Kenya. Growth limitation, System mismanagement and methodological failure had a negative effect on lending microcredit to low income customers' in Kenya, and thus an increase in it will lead to a decrease in lending microcredit. The study recommended that the management of the microfinance institutions should focus more on auditing challenges and control and measures taken since they have a positive and negative effect on lending microcredit to low income clients in Kenya. The study further recommended that microfinance institutions need to explore ways of increasing member savings either by churning out products that entice the members to save more or by bringing on to board more clients for the savings to rise.*

Key words: Auditing challenges, Microfinance institutions, Micro-credit.

### **1.1 Introduction**

Auditing is an independent, objective assurance and consulting activity designed to add value and improve organization operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (IIA, 2016). According to KPMG (2015) auditing may result to improved financial performance through strict adherence to its auditing

aspects. Internal audit standards will lead to improved financial performance as a result of auditors carrying out the functions within the criteria approved, being professional and objective for improved risk management. Through independence of auditors, financial performance can be improved since the auditors are independent from the activities which they evaluate and must likewise be independent from the routine internal control processes and perform their activities objectively and impartially without conflict of interest (Fadzil, Haron & Jantan, 2015).

There are several big challenges facing audit departments and still more facing the internal audit. Some of them represent opportunities as well as obstacles to overcome. The difficulty in filling audit positions with talented candidates, for example, has led to increases in pay for many internal auditors. The need to do a better job leveraging technology has the potential to free audit up to do more valuable and higher-level jobs, raising internal audit's profile in the organization (Institute of Internal Auditors Research Foundation, 2015). Adel (2011) indicated that there is inadequate staffing of internal accounting and auditing departments in organizations and specifically the internal audit function is generally under resourced and this affects the performance of the internal auditors in financial management hence exposing organizations to face threats of misuse of funds. Rezaee (2012) noted that financial reporting is ineffective due to corruption, frauds, and ineffective regulations. Weak internal auditing procedures have increasingly become a major problem in detecting loss of funds in organizations and are an indication of ineffectiveness of auditors (Otieno, 2010).

Microfinance has evolved by providing micro credits to respond to the furthestmost financial and non-financial needs of the citizens, to eradicate poverty and increase financial inclusion (Abate Grant & Stewart 2014). The microfinance movement has received enthusiasm as a poverty alleviation tool that has eventually become a self-sustaining industry. Microfinance institutions (MFIs) worldwide have been seen and identified as vital institution for the nations quest for solutions to the development challenge (Imani, 2013).

## **1.2 Research Problem**

Worldwide, transforming MFIs into deposit taking financial institutions has become more and more appealing to an increasing number of MFIs. This is due to the anticipated benefits to the MFIs, their clients and other stakeholders. The anticipated benefits include the ability of the transformed MFIs to mobilize public deposits, access private sources of capital, and improve their governance and transparency, reaching significant scale and financial sustainability, and ultimately being able to help in improving the level of financial inclusion in the country (Hishigsuren, 2006).

Kamau (2013) on the determinants of audit expectation gap indicated that there are certain factors that significantly affect the audit expectation gap. Kamau (2013) further posited that, the main reason behind the audit practice is to capacitate the pertinent stakeholders to express an

opinion whether or not the financial statements presented reflect a factual and fair picture. As such, the object of any audit is to ensure that financial records on which the auditor is reporting illustrate a true and fair view and are not misleading. In her study on determinants of adoption of risk-based audit in Kenya's public, Lutta (2012) found that, risk-based audit enhances transparency, accountability and responsiveness to public expenditure policy priorities. She further observed that, risk-based audit covers all aspects of financial management, as indicated above. From the above analysis of previous studies, it can be observed that few studies have been done of this similar area. This study therefore sought to answer the question: how do audit challenges facing microfinance institutions in advancing micro-credit?

### 1.3 Objective of the study

To determine auditing challenges facing microfinance organizations in advancing micro-credit.

## 2.0 METHODS

This study used descriptive survey research design. This study used 6 active Microfinance institutions in Kenya, whose financial information was available 5 years. The study used secondary data which was obtained from financial reports of the association of microfinance institutions in Kenya for a period of Five years. Data was collected from secondary source. Regression analysis was used to analyze the data. The following Regression equation was used to analyze the challenges facing microfinance institutions in advancing micro-credit.

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \epsilon$$

**Where:** Y= Lending microloans to low-income clients in Kenya. Lending capacity ratio was used to analyze.

$\alpha$  - Constant term

$X_1$ - Financial limitation

$X_2$ - Growth Limitation

$X_3$ - System mismanagement

$X_4$ - Creditworthiness

$X_5$ - Methodological failure

$\epsilon$ - Error term

### 3.0 RESULTS

**Table1: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.803 <sup>a</sup>	.645	.572	70.47523

From the above table, the value of R square was found to be 0.645 which is equivalent to 64.5%. From the value of R square, we can conclude that the independent variables that are; financial limitation, growth limitation, system mismanagement, creditworthiness, methodological failure; accounted for 64.5% of the variability. The remaining 35.5% of the total variation is not explained in this study. This means that there are other variables apart from the five covered in this study that affect lending capacity in microfinance institutions in Kenya

**Table 2: Regression Coefficients**

Model	Unstandardized coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	-28.618	22.394		-1.278	.214
Financial limitation	2.121	.962	.304	2.204	.037
Growth Limitation	-.001	.006	-.014	-.106	.916
System mismanagement	4.173	2.340	.225	1.783	.087
Creditworthiness	5.931	.923	.862	6.426	.000
Methodological failure	-.073	.049	-.180	-1.478	.152

a. Dependent Variable: Lending Capacity

From table 2 above the regression equation is as follows;

$$Y = -28.618 + 2.121x_1 - 0.001x_2 + 4.173x_3 + 5.931x_4 - 0.073x_5$$

The regression equation above imply that when the independent variable (Financial Limitations, Growth Limitation, System Mismanagement, Creditworthiness and Methodological Failure) are held at zero the level of achievement of lending capacity would be at -28.618. Lending Capacity in Microfinance Institutions indicated that financial limitation had a  $p=0.037$  which is less than the significance level of 0.05 connoting a strong relationship between financial limitation and lending capacity. Secondly, Growth Limitation had a  $P=0.916$  which is greater than the

significance level of 0.05. This shows a weak relationship between Growth Limitation and lending capacity. The study findings indicated that system mismanagement had a  $p=0.087$  which is greater than the significance level of 0.05 which indicated a weak relationship between system mismanagement and the lending capacity. The study also found out that creditworthiness had a  $p=0.000$  which indicates a strong relationship between creditworthiness and lending capacity. Finally, methodological failure had a  $p = 0.152$  indicating a weak relationship between methodological failure and lending capacity as p-value was more than 0.05.

## **4.0 Conclusion and Recommendations**

### **4.1 Conclusion**

The result of regression indicated that challenges had a positive and negative effect on lending microcredit to low income clients in Kenya. Financial limitation, had a positive effect on lending microcredit and therefore an increase in it will increase the lending microcredit to low income clients in Kenya. Growth limitation had a negative effect on lending microcredit to low income customers' in Kenya, and thus an increase in it will lead to a decrease in lending microcredit. System mismanagement had a positive effect on lending microcredit and therefore an increase in it will increase the lending microcredit. The coefficient of determination,  $R^2$ , indicated that, challenges diversification, financial limitation, growth limitation, system mismanagement, creditworthiness, methodological failure explained 57.2% in the variation of lending microcredit while the remaining was explained by other factors other than named before. The results of F test indicated that, challenges diversification, financial limitation, growth limitation, system mismanagement, creditworthiness, methodological failure were statistically significant at level of significance.

### **4.2 Recommendations**

Based on the findings from the study, a number of recommendations are to be considered. The management of the microfinance institutions should focus more on auditing challenges and control and measures taken since they have a positive and negative impact on the lending microcredit to low income clients in Kenya. Secondly, they should audit challenges, control and measures taken to affect positively lending microcredit to low income clients in Kenya. Microfinance institutions need to explore ways of increasing member savings either by churning out products that entice the members to save more or by bringing on to board more clients for the savings to rise. The government should increase their efforts in encouraging microfinance banks and institutions to support the small businesses. Microfinance institution should expand the repayment period of their customer's asset loans, make use of the collective group-based loan disbursement strategy, as this will minimize the rate at which clients default in payment and the level of portfolio at risk.

## REFERENCES

- Abate, J.A., Grant, J.L., & Stewart III, G.B. (2014). The EVA style of investing: Emphasizing the fundamentals of wealth creation. *The Journal of Portfolio Management*, 30(4), 61-72.
- Adel S. M. (2011). Internal audit effectiveness: an expansion of present methods, *Managerial Auditing Journal*, 16(8):89-112.
- Alfo, M. and Trovato, G. (2015): *Credit Rationing and The Financial Structure of Italian Small and Medium Enterprises*. CEIS Tor Vergata-Res. Paper Series, 27(80): 1-20.
- Atieno, L. (2015) 'Access to Financial Services and Poverty Reduction in Rural Kenya'. Namibia. The Kenya Economic Policy Research Unit, 2015
- Aveh, F. K., Dadzie, P. S., & Krah, R. Y. (2013). Success of microfinance institutions: The Ghanaian Experience. *International Business and Management*, 6 (2), 91–97.
- Ayuso, S., & Argandona, A. (2007). *Responsible Corporate Governance: Towards a Stakeholder Board of Directors?* Navarra: IESE Business School -University of Navarra.
- Deakins, D., North, D., Baldock, R. and Whittam, G. (2014). Is There Adverse Selection in the Credit Market, *Venture Capital: An International Journal of Entrepreneurial Finance*, 3 (3), 215-238.
- Donaldson, L., & Werhane, P. (2013). Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns. *Australian Journal of Management*, 49-65.
- Fama, E. F., & Jensen, M.C. (2008). Agency Problems and Residual Claims. Michael C. Jensen. *Foundations of Organizational Strategy*, Harvard University Press, 2008; *Journal of Law & Economics*, 26.
- Fama, E.F. (2013). Agency Problems and the Theory of the Firm. *The Journal of Political Economy*, 88(2), 288-307.
- Fadzil, F.H., Haron, H. and Jantan, M. (2015) "Internal auditing practices and internal control system", *Managerial Auditing Journal*, Vol. 20, No.8, pp. 844-66.
- Fofack, H. (2015). Non-Performing loans in sub-Saharan Africa: Causal Analysis and Macroeconomic implications, World Bank Policy Research Working Paper no. WP3769.
- Freeman, F. R. (2008). *Strategic Management: A Stakeholder Approach*. Boston: Pitman.
- Galema, R., Lensink, R., & Mersland, R. (2009). *Do Powerful CEOs have an Impact on Microfinance Performance?* Nottingham: Centre for International Banking, Insurance and Finance (CIBIF), University of Groningen.
- Hishigsuren, G. (2006). *Transformation of microfinance operations from NGO to regulated MFI*. *Microcredit Summit*, 9, 91-107.

- Imali, A.J. (2013). *Determinants of performance of microfinance institutions in Nairobi Kenya*. Unpublished Masters project in Banking and Finance. Moi University, Eldoret, Kenya
- Jensen, M. c. (2011). Agency costs of Free Cash Flow, Corporate Finance and Takeovers. *American Economic Review*,323-329.
- Kibet, P. (2008). A survey on the role of Internal Audit in promoting good Corporate Governance in SOEs. *Unpublished MBA Project*, University of Nairobi.
- Kipngetch, D. (2012). *Relationship between Risk Based Audit and Corporate Governance of State Corporation in Kenya*. Nairobi: University of Nairobi.
- KPMG's Audit Committee Institute (2015). An Approach to Effective Audit Committee Self-evaluation
- Kumar, A., & Conteh, A. (2015). Common frauds in micro finance institutions (MFIs). *Internal Journal of Advanced Rural Management*, 1(1), 11–18.
- Leonardi, L. (2011). *Social and Financial Performance in Medium -Sized Enterprises: An Italian Perspective*. Trento: Univeristy of Trento.
- Lin, S., Pizzini, M., Vargus, M., &Bardhan, I. R. (2013). The role of the internal audit function in the disclosure of material weaknesses. *The Accounting Review*, 86(1), 287-323.
- Microfinance Act (NO. 9 of 2016, Laws of Kenya).
- Mori, N., & Olomi, D. (2012). The Effect of Boards on the Performance of Microfinance Institutions: Evidence from Tanzania and Kenya. *Research Report for Development*,12 (2), 157-167.
- Munene, P. (2014). The Role of Micro-Finance Institutions to the Growth of Micro and Small Enterprises (MSE) in Thika, Kenya (Empirical Review of Non-Financial Factors. *International Journal of Academic Research in Accounting, Finance and Management Sciences*, 252.
- Mwangi, J.M. (2014). *The Effect of Financial Innovation of Financial Returns of Deposit Taking Microfinance Institutions in Kenya*. MBA research project, University of Nairobi, Kenya.
- Njeri, M.M. (2014). *The effects of liquidity on performance of deposit taking microfinance institutions in Kenya*. Unpublished MSc project. University of Nairobi, Kenya
- Njeru M. E. (2013). *The Relationship between Internal Audit Independence and Corporate Governance among Commercial Banks in Kenya*. Nairobi: University of Nairobi Press.
- Network, E. M. (2011). The use of Technology in Microfinance. *The Journal of Economic Perspectives*, pp. 167-192.

Otieno, C. W. (2010). A survey of internal auditors' risk management practices in the banking industry in Kenya. Unpublished MBA Project, University of Nairobi.

Ogindo. (2016). *Relationship between financial innovations and financial performance of MFIS companies in Kenya*. Unpublished MBA project, University of Nairobi, Kenya.

Rezaee, W. (2012). An Assessment of the Newly Defined Internal Audit Function. *Managerial Auditing Journal*, 17(3), 130-137