

# UNIVERSITY OF LUSAKA

**SCHOOL OF POSTGRADUATE STUDIES**

**Title of the Research Project (Assessing the Effect of Internal Audit on Portfolio at Risk (PAR) Management: Evidence from Selected Microfinance Institutions in Lusaka, Zambia)**

**A**

**Thesis presented**

**in Partial Fulfilment for requirement of the program**

**Master of Science in Auditing (MSCA)**

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**2025**

## DECLARATION

I, **Mwewa Mwaba Kashell** do hereby declare that this thesis entitled **Assessing the Effect of Internal Audit on Portfolio at Risk (PAR) Management: Evidence from Selected Microfinance Institutions in Lusaka, Zambia** is my original work that reflects my personal academic journey and growth.

I am proud to present this thesis knowing that it reflects my sincere efforts to expand the boundaries of knowledge in this area of study. It is my hope that ideas contained herein will inspire further research and dialogue within the scholarly community.

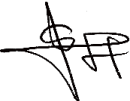
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## **DEDICATION**

This work is dedicated to everyone who supported me, whether through financial assistance, moral encouragement, or simply a kind word. May it serve as a testament to the power and results of having a solid support system.

On a personal note, I extend my heartfelt gratitude to my family and friends. My family has been my unwavering foundation throughout this challenging yet rewarding journey. Their steadfast love and belief in me have been a source of immeasurable strength, lifting me up even during moments of doubt and exhaustion.

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## ACRONYMS AND ABBREVIATIONS

<b>MFI</b>	<b>Microfinance Institution</b>
<b>PAR</b>	<b>Portfolio at Risk</b>
<b>NGO</b>	<b>Non-Governmental Organization</b>

# ABSTRACT

## Abstract

This study examines the impact of internal audit practices on portfolio-at-risk (PAR) management within selected microfinance institutions (MFIs) in Zambia, emphasizing their role in enhancing financial resilience and sustainability. Using a mixed-methods research approach, the study employs a quantitative correlational design to assess the relationship between internal audit controls and PAR management. Regression analysis and Pearson correlation were used to measure the extent to which internal audit practices influence PAR levels, while qualitative insights were obtained through structured interviews with internal auditors and risk managers in MFIs.

The findings reveal a strong positive relationship between internal audit practices and effective PAR management. Specifically, regression results indicate that a unit improvement in internal audit controls results in a 2.077-unit reduction in PAR levels ( $p < 0.05$ ), demonstrating the significance of strong internal control mechanisms in reducing credit risk. Descriptive statistics further show that MFIs with well-structured internal audit systems consistently report lower PAR levels, highlighting the role of internal audit in improving financial stability and risk mitigation.

However, the study also identifies a gap between audit recommendations and their implementation, with a weak correlation ( $r = 0.15$ ,  $p > 0.05$ ) between audit findings and actionable improvements. This misalignment is primarily attributed to organizational inertia, limited stakeholder engagement, and insufficient training, which hinder the effective application of audit insights. The study emphasizes that without proactive efforts to address these barriers, MFIs may struggle to fully leverage internal audit recommendations for improved PAR management.

To enhance the effectiveness of internal audits, the study recommends strengthening audit frameworks, increasing stakeholder involvement, and implementing targeted training programs to equip audit teams with advanced risk mitigation skills. Notably, 63.6% of the surveyed institutions have already adopted proactive risk reduction strategies, reinforcing

the need for a forward-thinking approach to financial management in the microfinance sector.

Additionally, the study underscores the importance of technological integration in internal control mechanisms, advocating for the adoption of automated audit and risk assessment tools. These tools enhance real-time monitoring of PAR levels, minimize human error, and facilitate timely corrective actions, thereby improving audit efficiency and risk management effectiveness.

By providing empirical evidence on the crucial role of internal audit practices in financial sustainability, this study contributes to the growing body of literature on risk management within MFIs. The findings highlight the necessity of fostering a culture of adaptability and continuous learning to overcome resistance to change and ensure that audit recommendations translate into meaningful improvements. Implementing the proposed strategies will enable MFIs to strengthen financial resilience, enhance loan portfolio quality, and improve long-term sustainability in an increasingly competitive microfinance landscape.

**Key words: Internal Audit, Internal Audit Practices, Internal Audit Controls, Internal Audit Recommendations, PAR Management, MFIs**

# CHAPTER 1

## 1.0 Introduction

Microfinance institutions (MFIs) play a crucial role in providing financial services to underserved populations, particularly in developing economies where access to traditional banking services is limited (Smith, 2019). Central to the sustainability and success of these institutions is the effective management of credit risk within their loan portfolios. One of the key indicators used to assess the quality of these portfolios is the Portfolio at Risk (PAR) ratio, which measures the percentage of loans overdue beyond a specified repayment period (Mersland & Strøm, 2009).

In Zambia, the operations of Microfinance Institutions (MFIs) are governed by the Microfinance Act No. 10 of 2006. This Act provides the regulatory framework for the establishment, operation, and supervision of microfinance institutions in Zambia. It defines the roles and responsibilities of both licensed MFIs and the regulators, ensuring they meet the necessary legal and financial requirements.

Additionally, the Bank of Zambia (BOZ) plays a key role in regulating the microfinance sector. The Bank issues licenses to MFIs and oversees their activities to ensure they comply with the provisions of the Act.

Internal audit serves as a fundamental component of an MFI's governance structure, providing independent assurance on the adequacy and effectiveness of internal controls, risk management processes, and compliance with regulatory requirements (Arena & Azzone, 2009). By systematically evaluating the institution's operations, internal audit helps identify areas of weakness and provides recommendations for improvement, thereby enhancing overall governance and risk management practices.

Despite the acknowledged importance of internal audit in the broader context of financial institutions, including MFIs, there is a deficiency of empirical research specifically examining its impact on PAR management within the microfinance sector. Therefore, this study aims to fill this gap by investigating the effect of internal audit practices on PAR management in selected microfinance institutions.

Understanding the impact of internal audit practices on PAR management is not only academically relevant but also holds practical implications for microfinance institutions seeking to enhance their risk management capabilities and ensure the sustainability of their operations. By identifying best practices and offering actionable recommendations, this research endeavors to contribute to the body of knowledge aimed at strengthening the resilience and impact of microfinance institutions worldwide.

## **1.1 Background**

### **1.1.1. Global Perspective**

Globally, microfinance institutions (MFIs) play a vital role in advancing financial inclusion, particularly in regions where traditional banking services are inaccessible. As MFIs expand their reach, the need for robust risk management practices, including effective Portfolio at Risk (PAR) management, becomes increasingly critical. PAR, which measures the percentage of loans overdue beyond a specified repayment period, is a universal indicator of credit risk and financial stability within MFIs (Mersland & Strøm, 2009).

Internal audit practices are recognized as essential components of good governance and risk management in financial institutions worldwide. They provide an independent assessment of internal controls, risk management processes, and compliance with regulatory standards (Arena & Azzone, 2009). The effectiveness of internal audits in managing PAR is particularly important, as it can directly impact the financial health of MFIs and their ability to continue serving low-income populations.

The global expansion of microfinance has attracted diverse stakeholders, including international investors and development agencies, who demand higher standards of transparency and accountability. This has led to an increased emphasis on internal audit practices as a means of ensuring that MFIs adhere to best practices in governance and risk management (Cull, Demirgüç-Kunt, & Morduch, 2009).

However, the impact of internal audit practices on PAR management varies across different contexts. In Latin America, where microfinance markets are more mature, the role of internal audits has evolved from merely ensuring compliance to driving strategic improvements in risk management practices. In contrast, in emerging markets in Asia and Africa, where MFIs face more significant operational challenges, internal audits are often focused on addressing basic governance issues, which can indirectly influence PAR management (Mersland & Strøm, 2014).

The global microfinance landscape also highlights the importance of tailoring internal audit practices to the specific risks and challenges faced by MFIs in different regions. For instance, MFIs operating in post-conflict areas or regions with high political instability may require more frequent and rigorous audits to manage heightened credit risk effectively (Banerjee et al., 2015). Furthermore, the adoption of technology-driven audit tools, such as data analytics and automated risk assessments, has been shown to enhance the effectiveness of internal audits in managing PAR across various global contexts (Morduch & Haley, 2002).

### **1.1.2 African Perspective**

In Africa, microfinance institutions (MFIs) are crucial in providing financial services to marginalized populations, particularly in rural areas where traditional banking services are scarce. The continent's diverse economic environments, coupled with high levels of poverty and financial exclusion, create unique challenges for MFIs, particularly in managing credit risk. The Portfolio at Risk (PAR) ratio, which indicates the proportion of loans overdue beyond a specified repayment period, serves as a vital measure of financial stability for these institutions (Mersland & Strøm, 2009).

In Sub-Saharan Africa, where the microfinance sector has seen significant growth over the past two decades, the effectiveness of internal audit practices has been closely linked to the financial health of MFIs. Research has shown that MFIs with well-established internal audit departments tend to have lower PAR ratios, indicating more effective credit risk management (Hartarska & Nadolnyak, 2007). For example, in countries like Kenya and Uganda, where the microfinance industry is relatively mature, internal audits play a key role in ensuring that loan portfolios are managed prudently, thereby reducing the likelihood of loan defaults and maintaining financial stability (Cull, Demirgüç-Kunt, & Morduch, 2009).

However, the effectiveness of internal audit practices in managing PAR is uneven across the continent. In many West African countries, where microfinance is still developing, internal audits often face challenges related to resource constraints, lack of trained personnel, and weak regulatory frameworks. These challenges can limit the ability of internal audits to provide effective oversight and contribute to higher PAR ratios in some institutions (Dunford, 2006). For instance, in Nigeria, where the microfinance sector is characterized by high levels of informality and varying regulatory enforcement, the role of internal audits in managing credit risk remains underdeveloped, leading to concerns about the sustainability of many MFIs (Banerjee et al., 2015).

Moreover, the regional diversity within Africa means that internal audit practices must be adapted to the specific risks and operational environments of different countries. In Southern Africa, for example, the relatively stable economic conditions and more advanced financial infrastructure have enabled MFIs to implement more sophisticated internal audit practices, which have contributed to better PAR management outcomes. Conversely, in conflict-affected regions of Central Africa, the instability and lack of regulatory oversight pose significant challenges to the effectiveness of internal audits, often resulting in higher PAR ratios and greater financial vulnerability for MFIs (Ledgerwood, 2013).

### 1.1.3 Zambian Perspective

In Zambia, microfinance institutions (MFIs) are vital in providing financial services to underserved communities, especially in rural and peri-urban areas where access to traditional banking is limited. These institutions are central to promoting financial inclusion and empowering economically disadvantaged populations. However, the sustainability and effectiveness of MFIs in Zambia are heavily dependent on their ability to manage credit risk, with the Portfolio at Risk (PAR) ratio serving as a key indicator of financial health (Mersland & Strøm, 2009).

The history of microfinance in Zambia dates back to the early 1990s when the concept of microcredit began gaining traction as a tool for poverty alleviation and financial inclusion. Initially, microfinance activities were largely driven by non-governmental organizations (NGOs) and community-based organizations that sought to provide small loans to low-income individuals and communities who were traditionally excluded from the formal banking sector (Chiumya, 2006). These early efforts were aimed at empowering marginalized populations by enabling them to engage in income-generating activities and improve their livelihoods.

The formalization and expansion of the microfinance sector in Zambia began in earnest in the late 1990s and early 2000s, as the government and international development agencies recognized the potential of microfinance as a means to promote economic development and reduce poverty. The establishment of the Bank of Zambia's regulatory framework for microfinance institutions (MFIs) in 2006 marked a significant milestone in the sector's development. This regulatory framework was designed to provide oversight and ensure the sustainability of MFIs, while also fostering a conducive environment for their growth (Bank of Zambia, 2006).

The PAR ratio, which measures the percentage of loans overdue beyond a specified repayment period, is particularly critical in Zambia, where economic instability and fluctuating agricultural incomes can lead to high default rates among borrowers (Chiumya, 2006). Managing PAR effectively is essential not only for the financial stability of MFIs but also for ensuring that they can continue to fulfill their social mission of poverty alleviation and economic empowerment.

Internal audit practices play a significant role in the governance and risk management frameworks of Zambian MFIs. These audits provide independent assurance regarding the adequacy and effectiveness of internal controls, risk management processes, and compliance with regulatory requirements (Arena & Azzone, 2009). In the Zambian context, where regulatory oversight of the microfinance sector is still developing, the role of internal audits becomes even more crucial. They help identify potential weaknesses in loan portfolio

management and recommend corrective actions to mitigate credit risk, thereby contributing to lower PAR ratios and enhanced financial stability (Mwanza, 2012).

However, the effectiveness of internal audit practices in Zambia is often constrained by several factors, including limited resources, inadequate training for audit staff, and challenges in implementing audit recommendations. Many MFIs in Zambia operate with constrained budgets, which can affect their ability to establish and maintain robust internal audit functions (Chandrasekhar, 2010). Additionally, the lack of skilled auditors familiar with the specific risks and operational challenges of the microfinance sector can hinder the effectiveness of internal audits in managing PAR.

Despite these challenges, some Zambian MFIs have made significant strides in leveraging internal audits to improve their PAR management. For instance, the adoption of risk-based audit approaches, where audits are focused on areas of highest risk, has been shown to enhance the ability of these institutions to monitor and manage their loan portfolios more effectively (Mersland & Strøm, 2009). This approach is particularly useful in identifying early warning signs of loan delinquency, allowing MFIs to take proactive measures to address potential credit risk issues before they escalate (Mwanza, 2012).

Moreover, the growing emphasis on integrating internal audit practices with broader governance and risk management strategies has helped some Zambian MFIs improve their operational resilience. By aligning internal audit findings with strategic objectives, these institutions can ensure that audit recommendations are not only implemented but also contribute to long-term improvements in risk management and financial performance (Chiumya, 2006).

## **1.2 Statement of the Problem**

Microfinance institutions (MFIs) play a crucial role in promoting financial inclusion and supporting underserved communities by providing access to credit and financial services. They contribute significantly to poverty alleviation, women's empowerment, and economic development, particularly in developing economies. However, the sustainability of MFIs is increasingly challenged by credit risk management issues within their loan portfolios. The Portfolio at Risk (PAR) ratio, which measures the percentage of loans overdue beyond a specified repayment period, remains a critical indicator of credit risk exposure for MFIs. Elevated PAR levels can erode investor confidence, reduce liquidity, increase the cost of capital, and ultimately threaten the financial and social objectives of MFIs.

Despite advancements in risk management frameworks, many MFIs continue to experience high PAR ratios, often due to inadequate internal controls, weak governance structures,

inefficient loan monitoring systems, and a lack of enforcement of audit recommendations. Effective internal audit mechanisms are fundamental in identifying risk exposure, strengthening governance, and ensuring compliance with financial regulations. However, many MFIs either lack strong internal audit practices or fail to integrate audit recommendations into strategic decision-making processes. This gap undermines their ability to proactively mitigate credit risk and improve loan portfolio quality.

Recent studies, such as those by Nawaz and Iqbal (2020) and Tchakoute-Tchuigoua et al. (2021), highlight the role of internal audit in enhancing financial oversight and risk management in financial institutions. Yet, there is limited empirical research examining the direct impact of internal audit practices on PAR management within the microfinance sector, particularly in sub-Saharan Africa. While existing literature acknowledges the importance of internal controls in mitigating financial risks, it does not adequately explore how specific internal audit processes—such as risk-based auditing, compliance assessments, and fraud detection—contribute to managing credit risk and reducing PAR levels in MFIs.

Furthermore, organizational resistance to change, inadequate training for audit personnel, and limited technological integration hinder the effectiveness of internal audits in driving meaningful improvements. Many MFIs struggle to translate audit findings into actionable strategies, leading to persistent credit risk issues despite periodic assessments. Additionally, the regulatory landscape for microfinance continues to evolve, necessitating adaptive audit practices to align with emerging compliance requirements and industry best practices.

This study aims to bridge these gaps by comprehensively analyzing the influence of internal audit practices on PAR management in MFIs. By assessing the effectiveness of internal audit frameworks, evaluating risk assessment methodologies, and examining the implementation of audit recommendations, this research seeks to provide valuable insights into strengthening credit risk management in the microfinance sector. The findings will offer practical recommendations for improving internal audit processes, fostering a culture of accountability, enhancing risk mitigation strategies, and ultimately ensuring the long-term financial resilience and sustainability of MFIs.

### **1.3. General Objective**

The general objective of this research was to investigate the impact of internal audit on Portfolio at Risk (PAR) management in selected microfinance institutions, with the aim of enhancing their financial resilience and sustainability.

### 1.3.1 Specific Objectives

- i. Determine the extent to which internal audit practices contribute to maintaining accurate PAR levels, identifying discrepancies, and assessing their impact on operational efficiency and cost-effectiveness.
- ii. Investigate the effectiveness of internal audit controls in identifying and mitigating risks associated with PAR management.
- iii. Evaluate the alignment of internal audit recommendations with industry standards and best practices in PAR management, examining the degree to which audit insights lead to actionable improvements in MFIs.

### 1.3.2. Hypotheses

- i. **Hypothesis 1 (H1):**
  - Null Hypothesis (H0): Internal audit procedures have no significant contribution to maintaining accurate PAR levels, identifying discrepancies, and improving operational efficiency and cost-effectiveness within microfinance institutions (MFIs) in Lusaka, Zambia.
  - Alternative Hypothesis (H1): Internal audit procedures have a significant contribution to maintaining accurate PAR levels, identifying discrepancies, and improving operational efficiency and cost-effectiveness within MFIs in Lusaka, Zambia.
- ii. **Hypothesis 2 (H2):**
  - Null Hypothesis (H0): Internal audit controls are not effective in identifying and mitigating risks associated with PAR management within MFIs operating in Lusaka, Zambia.
  - Alternative Hypothesis (H1): Internal audit controls are effective in identifying and mitigating risks associated with PAR management within MFIs operating in Lusaka, Zambia.
- iii. **Hypothesis 3 (H3):**
  - Null Hypothesis (H0): Internal audit recommendations are not significantly aligned with industry standards and best practices in PAR management within MFIs in Lusaka, Zambia, and do not lead to actionable improvements.
  - Alternative Hypothesis (H1): Internal audit recommendations are significantly aligned with industry standards and best practices in PAR management within MFIs in Lusaka, Zambia, leading to actionable improvements in their operations.

#### **1.4. Significance of the Study**

The significance of this study lies in its potential to contribute to both academic knowledge and practical applications in the field of microfinance. By investigating the impact of internal audit practices on PAR management, this research aims to fill a gap in existing literature and provide empirical evidence on the effectiveness of internal audit mechanisms in enhancing credit risk management within MFIs (Chandrasekhar, 2010; Mersland & Strøm, 2009).

From a theoretical perspective, this study seeks to advance understanding of the relationship between internal audit practices and PAR management outcomes. By identifying specific internal audit procedures, controls, and recommendations that influence PAR levels, the research aims to elucidate how internal audit functions can be leveraged to enhance risk management practices in MFIs (Arena & Azzone, 2009). The findings of this study will contribute to the broader body of knowledge on governance and risk management in microfinance, providing insights that can inform future research and theoretical developments in the field (Hartarska & Nadolnyak, 2007).

Practically, the findings of this study have the potential to inform the design and implementation of internal audit practices within MFIs. By highlighting best practices and effective internal audit mechanisms, the research can provide actionable recommendations for MFIs seeking to strengthen their governance structures and enhance their ability to manage credit risk (Christen, Rhyne, & Vogel, 2003; Cull, Demirgüç-Kunt, & Morduch, 2007). This, in turn, can contribute to the financial resilience and sustainability of MFIs, enabling them to continue serving their mission of providing financial services to underserved populations (Mersland & Strøm, 2009).

Moreover, the study's insights can be valuable to policymakers and regulators in the microfinance sector. By understanding the impact of internal audit practices on PAR management, policymakers can develop targeted regulations and guidelines that promote effective risk management practices within MFIs (Arena & Azzone, 2009; Chandrasekhar, 2010). This can help create a more robust and stable microfinance sector, ultimately benefiting the communities and individuals that rely on these institutions for financial services (Hartarska & Nadolnyak, 2007).

In summary, this study holds significant potential to contribute to academic knowledge, inform practical applications, and influence policy development in the field of microfinance. By investigating the impact of internal audit practices on PAR management, the research aims to enhance the understanding of how internal audit functions can be leveraged to improve credit risk management and ensure the sustainability of MFIs (Mersland & Strøm, 2009; Cull et al., 2007).

## 1.5. Scope of the Study

The scope of this study is confined to investigating the impact of internal audit practices on Portfolio at Risk (PAR) management within selected microfinance institutions (MFIs) in Lusaka, Zambia. The study will focus on examining the role of internal audit procedures, controls, and recommendations in influencing PAR levels and overall credit risk management within these MFIs (Arena & Azzone, 2009; Chandrasekhar, 2010).

The research encompassed the following dimensions:

- i. **Geographic Scope:** The study was conducted within the geographical boundaries of Lusaka, Zambia. The selected MFIs operating in this region will serve as the primary units of analysis.
- ii. **Institutional Scope:** The study focused on a sample of microfinance institutions in Lusaka, Zambia. The selected MFIs will be representative of the microfinance sector within the region, encompassing a range of institution sizes, operational models, and client demographics (Hartarska & Nadolnyak, 2007; Mersland & Strøm, 2009).
- iii. **Temporal Scope:** The research covered a specific period, examining internal audit practices and PAR management outcomes within the selected MFIs at that particular point in time. This temporal scope allowed for a comprehensive analysis of trends and patterns in internal audit practices and their impact on PAR management (Cull, Demirgüç-Kunt, & Morduch, 2007).
- iv. **Conceptual Scope:** The study concentrated on key aspects of internal audit practices, including audit practices, internal controls, and audit recommendations. It explored how these elements influence PAR management outcomes, including the accuracy of PAR levels, risk identification and mitigation, and alignment with industry standards and best practices (Arena & Azzone, 2009; Chandrasekhar, 2010).
- v. **Methodological Scope:** The research employed a quantitative data collection and analysis technique. Quantitative data was gathered through surveys.

## 1.6. Limitation of the Study

While this study aimed to provide valuable insights into the impact of internal audit practices on PAR management within selected microfinance institutions (MFIs) in Lusaka, Zambia, it is important to acknowledge certain limitations that influenced the findings and interpretations of the research:

### I. **Sample Size and Generalizability**

The study's findings were based on a specific sample of microfinance institutions

(MFIs) in Lusaka, Zambia. While efforts were made to ensure the sample was representative, the results may not fully capture the diversity of practices and experiences in MFIs outside Lusaka. As a result, the generalizability of the study to other regions or contexts remains limited (Creswell, 2014).

## II. **Dependence on Self-Reported Data**

The data collection relied on self-reported responses through structured questionnaires. This method is susceptible to biases such as social desirability, recall errors, and potential misinterpretation of questions. These factors may have affected the accuracy and validity of the findings, as respondents could overstate or understate their practices related to internal audits and PAR management (Fowler, 2014).

## III. **Cross-Sectional Design Constraints**

The study employed a cross-sectional descriptive survey design, which captured data at a single point in time. While this approach is effective for identifying trends and relationships, it does not allow for the analysis of changes over time or the establishment of causal relationships. A longitudinal approach could provide deeper insights into the long-term impacts of internal audit practices on PAR management (Babbie, 2020).

## IV. **Measurement Limitations**

Although validated tools and scales were used for data collection, the quantitative methodology may not fully capture the complexity and nuances of participants' experiences or the contextual factors influencing internal audit practices. Incorporating qualitative methods could have enriched the study by providing a more comprehensive understanding of these aspects (Sekaran & Bougie, 2016).

## V. **Narrow Scope of Variables**

The study focused solely on the role of internal audit procedures, controls, and recommendations in managing PAR levels. Other potentially influential factors, such as external economic conditions, organizational culture, or regulatory frameworks, were not explored. This limited scope may exclude significant variables that impact PAR management within MFIs (Mugenda & Mugenda, 2003).

These limitations highlight areas for improvement and further research, particularly regarding broader sampling, the inclusion of qualitative methods, and the exploration of additional variables that influence PAR management in MFIs.

## 1.7. Definition of Terms

- I. **Internal Audit:** Internal audit refers to an independent, objective assurance and consulting activity designed to add value and improve an organization's 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 (Institute of Internal Auditors, 2017).
- II. **Portfolio at Risk (PAR):** Portfolio at Risk (PAR) is a key performance indicator used in the microfinance industry to measure the percentage of loans in a financial institution's portfolio that are at risk of default. PAR typically refers to loans that are past due by a certain number of days (e.g., PAR30 represents loans past due by 30 days or more) and serves as an indicator of the quality and riskiness of a financial institution's loan portfolio (Mix Market, 2022).
- III. **Microfinance Institutions (MFIs):** Microfinance institutions are organizations that provide financial services, such as loans, savings accounts, and insurance, to low-income individuals or groups who typically lack access to traditional banking services. MFIs aim to promote financial inclusion, poverty alleviation, and economic empowerment by providing access to affordable and sustainable financial products and services (CGAP, n.d.).
- IV. **Internal Audit Practices:** Internal audit practices involve assessing an organization's risk management, control systems, and governance to ensure efficiency, compliance, and strategic goal achievement. These practices include evaluating financial, operational, compliance, and IT controls, identifying weaknesses, and recommending improvements (IIA, 2020). The process typically follows a risk-based audit plan, with steps like planning, evidence collection, testing, reporting, and follow-up (Knechel et al., 2015).
- V. **Internal Audit Controls:** Internal audit controls refer to the policies, procedures, and activities established by an organization to ensure the accuracy, integrity, and reliability of its financial and operational processes. These controls help mitigate risks such as fraud, errors, and non-compliance with regulations, and they ensure that organizational objectives are achieved efficiently and effectively (IIA, 2020). Internal audit controls typically focus on evaluating the design and operating effectiveness of internal controls, ensuring that processes are functioning as intended and identifying areas for improvement (COSO, 2013). The goal is to provide management with assurance that the organization's risk management and control systems are robust and functioning effectively (Knechel et al., 2015).

- VI. **Internal Audit Recommendations:** Internal audit recommendations are suggestions provided by internal auditors to improve an organization's control systems, risk management practices, and operational efficiency. These recommendations are typically based on the findings from audits, which identify weaknesses or inefficiencies in the organization's processes (IIA, 2020). The recommendations aim to address deficiencies, enhance compliance with laws and regulations, reduce risks such as fraud, and support better decision-making (Knechel et al., 2015).
- VII. **Risk Management:** Risk management involves the identification, assessment, and prioritization of risks followed by coordinated efforts to minimize, monitor, and control the probability and impact of potential adverse events (Jones et al., 2020). In the context of microfinance, risk management encompasses strategies and practices aimed at mitigating credit risk, operational risk, liquidity risk, and other risks inherent in providing financial services to underserved populations (Mersland & Strøm, 2010).
- VIII. **Operational Efficiency:** Operational efficiency refers to the ability of an organization to deliver its products or services in a cost-effective manner while maximizing productivity and minimizing waste. In the context of microfinance institutions, operational efficiency involves optimizing processes and resources to achieve financial sustainability, profitability, and scalability in serving clients (Hartarska & Mersland, 2012).
- IX. **Portfolio Quality:** Portfolio quality pertains to the general condition and effectiveness of a financial institution's loan collection, encompassing the reliability of borrowers, the occurrence of loan defaults, and the sufficiency of provisions for potential loan losses. It is often assessed in terms of portfolio at risk (PAR), loan write-offs, and other indicators of loan quality (Galema, Lensink & Mersland, 2008).

## 1.8. Chapter Summary

Chapter 1 provides an overview of the critical role microfinance institutions (MFIs) play in providing financial services to underserved populations, especially in developing economies. The chapter highlights that effective credit risk management is essential for the sustainability of these institutions. A key metric in assessing the quality of an MFI's loan portfolio is the Portfolio at Risk (PAR) ratio, which measures the percentage of loans overdue beyond a specific repayment period.

The chapter emphasizes the importance of internal audit practices in managing PAR, noting that internal audit functions are vital components of an MFI's governance structure. These practices provide independent assurance on the effectiveness of internal controls, risk

management processes, and regulatory compliance. Despite the significance of internal audits, there is a gap in empirical research regarding their impact on PAR management within the microfinance sector.

To address this gap, the chapter introduces the study's objectives, which include investigating how internal audit practices influence PAR management in selected MFIs. The research aims to explore the extent to which internal audit procedures, controls, and recommendations contribute to maintaining accurate PAR levels and improving operational efficiency within MFIs.

The significance of this study is underscored by its potential contributions to both academic knowledge and practical applications in microfinance. The findings could inform the design of internal audit practices and offer actionable recommendations for enhancing credit risk management and the sustainability of MFIs.

The scope of the study is confined to MFIs in Lusaka, Zambia, with a focus on internal audit practices and their impact on PAR management over the past five years. The chapter also acknowledges several limitations, including issues related to generalizability, data accuracy, and the potential influence of external factors on the findings.

Lastly, the chapter provides definitions for key terms used throughout the study, such as internal audit, Portfolio at Risk (PAR), microfinance institutions, risk management, and operational efficiency. These definitions establish a clear foundation for the subsequent chapters of the research.

### **1.9. Projection of next chapter**

This chapter discusses literature surrounding the topic of study. It presents and theoretical frameworks relevant to the aim of the study. Finally, it presents the conceptual framework which guided the analysis of the findings.

## **CHAPTER 2: LITERATURE REVIEW**

### **2.0. Introduction**

This chapter delves into the existing body of literature to provide a comprehensive review of the key concepts, theories, and empirical studies related to the impact of internal audit practices on Portfolio at Risk (PAR) management within microfinance institutions (MFIs). The literature review aims to contextualize the research problem, identify gaps in current knowledge, and establish a theoretical foundation for the study.

### **2.1. The Concept of Microfinance and Microfinance Institutions**

Microfinance refers to the provision of financial services, including small loans, savings accounts, insurance, and payment services, to low-income individuals and small enterprises that typically lack access to traditional banking services (Ledgerwood, 1999). The primary objective of microfinance is to promote financial inclusion, empower marginalized populations, and stimulate economic development by providing access to financial resources (Morduch, 1999).

Microfinance institutions (MFIs) are specialized financial institutions that deliver microfinance services. They operate under various legal and organizational structures, including non-governmental organizations (NGOs), credit unions, cooperatives, and regulated financial entities (Armendáriz & Morduch, 2010). MFIs play a crucial role in providing financial services to underserved communities, thereby contributing to poverty alleviation and socio-economic development (Cull, Demirgüç-Kunt, & Morduch, 2007).

### **2.2. The Microfinance Landscape in Zambia**

The microfinance sector in Zambia plays a vital role in the country's financial system, providing essential financial services to the underserved population, particularly in rural areas. Microfinance institutions (MFIs) in Zambia offer various financial products, including microloans, savings, insurance, and remittance services, aimed at improving financial inclusion and supporting the growth of small and medium-sized enterprises (SMEs).

The development of the microfinance sector in Zambia has been driven by both government initiatives and international support. The Zambian government, through the Ministry of Finance and the Bank of Zambia, has implemented policies aimed at promoting financial inclusion and creating a conducive environment for the growth of MFIs. These policies are aligned with the country's broader financial sector development strategy, which aims to reduce poverty and promote economic growth by improving access to financial services for all Zambians (Bank of Zambia, 2017).

Despite its significant potential, the microfinance sector in Zambia faces several challenges. One of the primary challenges is the high cost of borrowing, which is often passed on to customers in the form of high-interest rates. This can limit the accessibility of microloans for the poorest segments of the population, who are the primary target of microfinance services (Kalunda, 2014). Additionally, the sector is characterized by high operational risks, including credit risk, liquidity risk, and operational inefficiencies, which can impact the sustainability and profitability of MFIs (Lusambo & Phiri, 2019).

Regulatory challenges also pose a significant threat to the stability of the microfinance sector in Zambia. The regulatory framework, while essential for ensuring the safety and soundness of financial institutions, can be burdensome for smaller MFIs, particularly in terms of compliance costs and reporting requirements. The Bank of Zambia, as the sector's regulator, has been working to strike a balance between ensuring adequate oversight and allowing the sector to thrive without excessive regulatory constraints (Bank of Zambia, 2017).

Moreover, the Zambian microfinance sector is characterized by a diverse range of institutions, including commercial banks with microfinance divisions, non-governmental organizations (NGOs), and specialized microfinance institutions. This diversity reflects the sector's broad reach and its capacity to cater to different segments of the market. However, it also presents challenges in terms of standardization and the application of best practices across different types of institutions (Simpasa, 2018).

One of the notable trends in the Zambian microfinance landscape is the increasing use of digital financial services. Mobile banking and digital platforms have become important tools for expanding the reach of microfinance services, particularly in rural areas where traditional banking infrastructure is limited. Digital innovation has the potential to reduce costs, increase efficiency, and improve the accessibility of financial services in Zambia, contributing to the overall growth of the microfinance sector (Masocha & Nyirenda, 2019).

In conclusion, the microfinance landscape in Zambia is a dynamic and crucial component of the country's financial system. While it has made significant strides in improving financial inclusion, the sector continues to face challenges related to high borrowing costs, regulatory

constraints, and operational risks. Addressing these challenges, while leveraging digital innovation, will be key to the future growth and sustainability of the microfinance sector in Zambia.

### **2.3. Portfolio at Risk (PAR) in Microfinance**

In the Zambian microfinance sector, the Portfolio at Risk (PAR) ratio is a crucial metric for evaluating the quality and health of an MFI's loan portfolio. The PAR ratio measures the percentage of loans that are overdue beyond a specified number of days, typically 30 days, and is a key indicator of an institution's exposure to credit risk (Mersland & Strøm, 2009; Ledgerwood, 1999). A high PAR ratio signals elevated credit risk, which can jeopardize the financial stability of an MFI by increasing the likelihood of loan defaults (Cull, Demirgüç-Kunt, & Morduch, 2007).

Effective management of PAR is vital for the sustainability of MFIs in Zambia. High PAR levels can necessitate increased loan loss provisions, eroding profitability and leading to potential liquidity issues. These challenges are particularly acute in Zambia, where the microfinance sector plays a critical role in extending financial services to underserved populations. Thus, Zambian MFIs must implement robust credit risk management strategies to monitor, mitigate, and control PAR levels within acceptable limits to ensure their long-term viability (Churchill & Frankiewicz, 2006).

Several factors contribute to high PAR levels, including economic volatility, borrower over-indebtedness, and inadequate borrower screening processes. Economic challenges, such as fluctuating commodity prices and currency instability, can affect borrowers' ability to repay loans, leading to higher PAR ratios (Lusambo & Phiri, 2019). Additionally, the rapid expansion of the microfinance sector in Zambia has, at times, led to less rigorous lending practices, increasing the risk of defaults and, consequently, higher PAR (Masocha & Nyirenda, 2019).

Addressing these issues requires a comprehensive approach that includes enhancing borrower education, improving credit assessment procedures, and strengthening the regulatory framework governing the microfinance sector in Zambia. By effectively managing PAR, MFIs in Zambia can improve their financial health, maintain investor confidence, and continue to fulfill their mission of promoting financial inclusion and economic empowerment in the country.

### **2.4. Definition and Importance of Internal Audit**

The Institute of Internal Auditors (IIA) has significantly influenced the prominence of internal audit within organizations by providing a comprehensive definition. According to the IIA (2011), internal auditing is defined as "an independent, objective assurance and consulting

activity designed to add value and improve an organization's 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." This definition has broadened the role and responsibilities of internal audit, positioning it as a critical component in the value creation process of organizations.

The relevance of internal audit functions in modern organizational contexts has become increasingly undeniable. The expansion of organizations, coupled with the growing complexities of internal control systems, necessitates the establishment of robust internal audit functions. Prawitt, Smith, and Wood (2009) highlight that the rise in accounting scandals in recent years has significantly elevated the importance of internal audit functions as essential contributors to effective corporate governance and financial reporting. A high-quality internal audit function, focused on enhancing financial reporting by ensuring adherence to standards, is now seen as vital. Consequently, numerous research studies have explored the impact of internal audit on audit effectiveness and organizational success, further underscoring the IIA's recent emphasis on its critical role.

## **2.5. Effectiveness of Internal Audit**

The evolving role of internal audit has spurred numerous research studies focused on identifying the factors that influence audit effectiveness and how this effectiveness contributes to achieving organizational objectives, particularly in the public sector. Badara and Saidin (2013) affirm this, noting that the importance of internal audit in helping organizations achieve their objectives has driven ongoing research into its operations. They propose that factors such as risk management, a robust internal control system, audit experience, cooperation between internal and external auditors, and performance management significantly influence internal audit effectiveness. Their study, conducted in the context of local governments in Nigeria, found that these factors have a notable impact on audit effectiveness. However, while their research contributes valuable insights into internal audit effectiveness, its findings are not universally applicable, as they are specific to the public sector and may not hold true in private sector organizations.

In another empirical study, Hung and Han (2013) examined the effectiveness of internal auditors in Taiwan, identifying three primary factors that impact internal audit effectiveness: management's perception of the internal audit function, factors influencing the head of the auditing department's perception, and factors affecting the progress of the annual audit plan. They concluded that management attitude, the controller's attitude, the likelihood of an internal auditor's promotion, the implementation of performance evaluations, the establishment of job descriptions, and the training and professional capabilities of internal auditors all influence perceptions of audit effectiveness. Additionally, the combination of

organizational formalization and the professional abilities of auditors affects the head of the auditing department's view on audit effectiveness, and collectively, these factors also impact the progress of the annual audit plan.

## **2.6. Internal Audit in Microfinance Institutions**

Internal audit is an independent and objective assurance and consulting activity designed to add value and improve an organization's operations (IIA, 2013). It involves evaluating and improving the effectiveness of risk management, control, and governance processes within an organization. Internal audit functions play a vital role in ensuring the integrity, transparency, and accountability of an organization's financial and operational activities (Spira & Page, 2003).

In the context of MFIs, internal audit practices encompass a range of activities, including the examination of financial records, assessment of internal controls, evaluation of compliance with policies and regulations, and provision of recommendations for improving operational efficiency and risk management (Mersland & Strøm, 2009). Effective internal audit practices can enhance the governance structures of MFIs, promote sound risk management, and contribute to the overall sustainability of the institutions.

## **2.7. The Relationship between Internal Audit and PAR Management**

The relationship between internal audit practices and PAR is a critical area of interest for both researchers and practitioners in the microfinance sector. Internal audit functions have the potential to influence PAR management outcomes through various mechanisms, including:

- I. **Risk Identification and Assessment:** Internal audit practices can help identify and assess credit risks within an MFI's loan portfolio. By conducting thorough audits and evaluations, internal auditors can detect early warning signs of credit deterioration and potential defaults (Mersland & Strøm, 2009).
- II. **Internal Controls and Compliance:** Effective internal audit practices can strengthen internal controls and ensure compliance with established policies and procedures. This can reduce the likelihood of loan defaults and enhance the accuracy of PAR measurements (Churchill & Frankiewicz, 2006).
- III. **Recommendations and Corrective Actions:** Internal auditors provide recommendations for improving credit risk management practices and addressing identified deficiencies. The implementation of these recommendations can lead to better PAR management and reduced credit risk exposure (IIA, 2013).

IV. **Monitoring and Reporting:** Internal audit functions play a key role in monitoring and reporting on the effectiveness of credit risk management practices. Regular audits and performance reviews can help MFIs track PAR levels and implement timely corrective actions (Spira & Page, 2003).

## **2.8. Internal Audit Effectiveness in The Zambian Microfinance Sector**

Internal audit effectiveness is a critical component of corporate governance and risk management in the microfinance sector, especially in developing economies like Zambia. In the Zambian microfinance sector, internal audit functions are pivotal in ensuring the sustainability and growth of microfinance institutions (MFIs) by enhancing operational efficiency, mitigating risks, and ensuring compliance with regulatory requirements.

Several studies emphasize the importance of internal audit in the financial sector, particularly in environments where financial systems are developing and susceptible to various risks. According to Ssekakubo, Eyaa, and Nkote (2014), internal audit functions in microfinance institutions are essential for the detection and prevention of fraud, as well as for ensuring that MFIs adhere to internal controls and external regulations. This is particularly relevant in Zambia, where the microfinance sector faces challenges such as high operational risks, governance issues, and regulatory compliance.

However, the effectiveness of internal audit in the Zambian microfinance sector is influenced by several factors. The independence of internal auditors is crucial, as it allows them to perform their duties without undue influence from management, thus maintaining objectivity in their assessments (Mawanda, 2015). In Zambia, there have been concerns about the level of independence granted to internal auditors within MFIs, which can compromise the effectiveness of the audit function. Furthermore, the level of management support for internal audit activities significantly impacts their effectiveness. Management's commitment to implementing audit recommendations is essential for improving internal controls and achieving organizational objectives (Nyamongo & Temesgen, 2013).

Another factor that influences internal audit effectiveness in the Zambian microfinance sector is the quality of internal audit personnel. As highlighted by Mihret and Yismaw (2007), the competence and professional qualifications of internal auditors are key determinants of audit effectiveness. In the context of Zambia, there is a need for continuous professional development and training for internal auditors to ensure they are equipped with the latest skills and knowledge required to address emerging risks in the microfinance sector.

Lastly, the regulatory environment in Zambia plays a significant role in shaping the effectiveness of internal audit functions. The Bank of Zambia, as the regulator, sets the

standards and requirements for internal audit practices within MFIs. Compliance with these regulations is necessary for the effective operation of internal audits, and any lapses in this regard can lead to significant risks for the institutions involved (Chomba, 2016).

In conclusion, while internal audit functions are critical to the effectiveness and sustainability of microfinance institutions in Zambia, their success is contingent upon factors such as auditor independence, management support, auditor competence, and regulatory compliance. Addressing these areas can significantly enhance the role of internal audit in promoting transparency, accountability, and sound financial management within the Zambian microfinance sector.

## **2.9. Alignment of Internal Audit Recommendations with Industry Standards and Best Practices in PAR Management**

The alignment of internal audit recommendations with industry standards and best practices is essential for effective Portfolio at Risk (PAR) management within microfinance institutions (MFIs). This alignment is critical not only for maintaining financial stability but also for ensuring that MFIs can continue to fulfill their mission of promoting financial inclusion in a challenging economic environment.

### **2.9.1. Industry Standards and Best Practices in The Zambian Context**

The Zambian microfinance sector operates within a regulatory framework that aims to promote sound financial practices and protect both institutions and their clients. The Bank of Zambia (BoZ) provides oversight and sets standards for financial reporting, risk management, and governance within the sector (Mwanza, 2012). However, the effectiveness of these standards depends largely on how well they are implemented and adhered to by individual MFIs.

Industry standards, such as those outlined by the International Financial Reporting Standards (IFRS) and best practices in risk management, serve as benchmarks for Zambian MFIs. These standards provide guidelines on how to manage credit risk effectively, particularly through accurate reporting and robust internal controls (IASB, 2021). In the Zambian context, where economic fluctuations and a high dependency on agriculture can lead to increased credit risk, adherence to these standards is crucial for maintaining low PAR ratios (Chiumya, 2006).

### **2.9.2. Role of Internal Audit in ensuring Alignment**

Internal audits in Zambian MFIs play a pivotal role in ensuring that these institutions align their practices with industry standards and best practices in PAR management. By conducting thorough audits, internal auditors can assess the effectiveness of existing risk management

practices and recommend improvements that align with regulatory requirements and international standards (Arena & Azzone, 2009). This process is vital for identifying gaps in compliance and for enhancing the overall governance structure of MFIs.

In Zambia, the alignment of internal audit recommendations with best practices is particularly important due to the diverse challenges faced by MFIs. These include limited access to skilled auditors, resource constraints, and the varying quality of internal control systems across different institutions (Chandrasekhar, 2010). Studies have shown that Zambian MFIs with strong internal audit functions are better able to manage their PAR ratios, as they can more effectively identify and mitigate risks before they escalate (Mwanza, 2012).

### **2.9.3. Implementation and Impact of Audit Recommendations**

The impact of internal audit recommendations on PAR management in Zambian MFIs largely depends on how well these recommendations are implemented. Research indicates that when Zambian MFIs align their audit practices with industry standards, they experience significant improvements in credit risk management, leading to lower PAR ratios (Chiumya, 2006). This alignment ensures that audit findings are not only relevant but also actionable, helping institutions to address weaknesses in their loan portfolios effectively.

However, the successful implementation of audit recommendations in Zambia is often hindered by several factors, including limited financial resources, inadequate training, and resistance to change within institutions. These challenges can prevent MFIs from fully realizing the benefits of their audit functions (Chandrasekhar, 2010). Despite these obstacles, MFIs that prioritize the alignment of their audit practices with best practices tend to be more resilient and better equipped to manage the inherent risks in their operating environment (Mersland & Strøm, 2009).

## **2.10. Empirical Studies on Internal Audit and PAR Management in MFIs**

Several empirical studies have explored the relationship between internal audit practices and Portfolio at Risk (PAR) management in Microfinance Institutions (MFIs). The findings suggest that effective internal audit functions contribute to better risk management, improved financial performance, and reduced loan default rates.

Mersland and Strøm (2009) conducted a comprehensive study on governance mechanisms in MFIs, including internal audit. Their findings revealed that MFIs with strong internal audit structures exhibited significantly lower PAR levels and improved financial sustainability. They concluded that internal audit plays a critical role in ensuring financial discipline and reducing credit risk.

More recently, Omidiji (2022) examined the determinants and effects of internal audit in MFIs across 1,025 institutions between 2010 and 2018. The study found that MFIs with dedicated internal audit functions reported lower risk exposure, stronger financial performance, and better loan portfolio quality, as indicated by reduced PAR levels. This research reinforces earlier findings that robust internal audit functions contribute to financial sustainability and risk mitigation.

Similarly, Cull, Demirgüç-Kunt, and Morduch (2007) found that MFIs with well-established internal audit practices had lower PAR ratios and higher operational efficiency. Their findings suggest that stringent audit mechanisms help MFIs manage loan defaults more effectively, thereby improving their financial health.

In a more recent study, Suraj (2017) analyzed the effect of internal audit on financial performance in Kenyan MFIs. The study identified internal audit standards, independence, professional competence, and internal control as key factors affecting financial performance. MFIs with effective internal audit mechanisms experienced improved financial outcomes, implying better loan portfolio management and lower credit risk.

Additionally, Okaro et al. (2017) examined internal audit challenges in microfinance banks in Nigeria. They found that limited auditor independence and inadequate resources hindered risk management effectiveness, ultimately increasing the likelihood of financial instability. The study recommended strengthening internal audit functions to enhance governance and financial stability, which would positively impact PAR management.

Further reinforcing these findings, Gassama (2022) explored how internal audit quality affects MFI sustainability. The study found that strong internal audit functions reduce operational risks, detect early signs of financial distress, and enhance institutional sustainability. MFIs with high-quality internal audit processes were better equipped to manage loan portfolio risks and maintain financial discipline.

To conclude, empirical research consistently demonstrates a positive correlation between effective internal audit functions and improved PAR management in MFIs. Recent studies, including Omidiji (2022), Suraj (2017), and Gassama (2022), reinforce earlier findings that internal audit strengthens financial stability, reduces credit risk, and enhances operational efficiency. However, challenges such as auditor independence and resource limitations remain critical barriers to effective internal audit implementation. Further research is needed to identify best practices for optimizing internal audit functions in MFIs and enhancing their impact on PAR management.

## **2.11. Critique of Literature Review**

Despite the existing body of literature, several gaps remain in understanding the specific mechanisms through which internal audit practices influence PAR management in MFIs. For instance, there is limited research on the contextual factors that may moderate the relationship between internal audit practices and PAR outcomes, such as organizational culture, regulatory environments, and technological advancements.

### **2.11.1. Contextual Limitations**

Many studies, such as those by Mihret and Yismaw (2007) and Badara and Saidin (2013), focus on internal audit effectiveness within specific sectors or regions, such as the public sector or higher education institutions. These contexts may have distinct characteristics, such as governance structures, regulatory frameworks, and organizational cultures, that differ significantly from those in microfinance institutions (MIs). Consequently, the findings of these studies may not be fully applicable to MFIs, which operate under unique challenges, such as high operational risks, limited resources, and a focus on financial inclusion (Mihret & Yismaw, 2007; Badara & Saidin, 2013).

Moreover, research conducted in developed economies, where financial systems are more mature and regulatory frameworks more robust, may not capture the realities faced by MFIs in developing countries like Zambia. For example, the effectiveness of internal audits in promoting PAR management may be influenced by the level of economic stability, availability of skilled auditors, and the degree of regulatory oversight, all of which vary across different regions and sectors (Cull, Demirgüç-Kunt, & Morduch, 2007; Lusambo & Phiri, 2019).

### **2.11.2. Methodological Concerns**

The methodologies employed in the reviewed studies often rely on qualitative approaches, case studies, or surveys with limited sample sizes, as seen in the works of Mihret and Yismaw (2007) and Ramachandra, Subramanian, and Kisoka (2012). While these methods provide in-depth insights, they also pose challenges in terms of generalizability and replicability. The reliance on self-reported data, particularly in surveys, may introduce bias, as respondents might overestimate the effectiveness of internal audits or underreport challenges due to social desirability or fear of repercussions (Mihret & Yismaw, 2007; Ramachandra, Subramanian, & Kisoka, 2012).

Additionally, studies like those by Hung and Han (2013) focus on perceptions of audit effectiveness rather than objective measures of audit outcomes. While perceptions are important, they may not accurately reflect the true impact of internal audits on PAR management. There is a need for more empirical research that employs robust quantitative

methods, such as regression analysis or structural equation modeling, to establish causal relationships between internal audit practices and PAR management outcomes (Hung & Han, 2013).

### **2.11.3. Theoretical Gaps**

The literature review reveals a reliance on traditional theories, such as agency theory and internal control theory, to explain the role of internal audits in MFIs. While these theories provide a solid foundation, they may not fully capture the complexities of the microfinance sector. For instance, agency theory assumes a clear separation between owners and managers, which may not be the case in MFIs, where stakeholders often include donors, government agencies, and beneficiaries with diverse interests (Jensen & Meckling, 1976; COSO, 2013).

Moreover, the reviewed literature lacks a comprehensive framework that integrates various factors influencing internal audit effectiveness in MFIs, such as cultural, organizational, and environmental factors. The development of such a framework would enhance the understanding of how internal audits contribute to PAR management in different contexts and provide a basis for more targeted interventions (Mihret & Yismaw, 2007).

### **2.11.4. Limited Focus on PAR Management**

While the reviewed studies recognize the importance of internal audits in managing credit risk, few explicitly address their role in PAR management, a critical concern for MFIs. For instance, the works of Cull, Demirgüç-Kunt, and Morduch (2007) and Mersland and Strøm (2009) highlight the impact of internal controls on financial stability but do not delve deeply into the mechanisms through which internal audits specifically influence PAR ratios (Cull, Demirgüç-Kunt, & Morduch, 2007; Mersland & Strøm, 2009).

There is a need for more research that focuses explicitly on the relationship between internal audit practices and PAR management, considering factors such as the quality of credit assessments, borrower monitoring, and the implementation of audit recommendations. Such research would provide more actionable insights for MFIs seeking to improve their PAR management practices (Mersland & Strøm, 2009).

### **2.11.5. Empirical Evidence on Best Practices**

The literature review identifies several empirical studies that suggest a positive relationship between internal audit practices and PAR management outcomes in MFIs (Mersland & Strøm, 2009; Cull et al., 2007). However, these studies often provide general recommendations, such as the need for robust internal controls and effective governance, without offering detailed guidance on best practices for internal audit in the microfinance context.

There is a need for more granular research that identifies and evaluates specific internal audit practices, such as the use of risk-based auditing, the integration of technology in audit processes, and the involvement of auditors in strategic decision-making. Such research would provide MFIs with more practical insights into how to enhance their internal audit functions and improve PAR management (Mersland & Strøm, 2009).

While the existing literature provides valuable insights into the role of internal audits in MFIs, it is characterized by contextual limitations, methodological concerns, theoretical gaps, and a limited focus on PAR management. Addressing these issues through more rigorous, context-specific research would enhance the understanding of how internal audit practices can contribute to the sustainability and growth of MFIs, particularly in developing economies like Zambia. There is also a need for more empirical evidence on best practices for internal audit in the microfinance sector, which would provide actionable recommendations for practitioners and policymakers alike (Cull et al., 2007; Mersland & Strøm, 2009).

## **2.12. Theoretical Framework**

### **2.12.1. Internal Control Theory**

The Internal Control Theory plays a pivotal role in understanding how internal audit practices influence Portfolio at Risk (PAR) management within microfinance institutions (MFIs). This theory emphasizes the importance of establishing a robust system of internal controls to ensure that an organization can effectively manage risks, safeguard its assets, and achieve its objectives, particularly in contexts where financial stability is crucial (COSO, 1992).

In the specific context of MFIs, Internal Control Theory is directly relevant to managing PAR, which is a key indicator of the health and quality of an institution's loan portfolio. A high PAR ratio signals increased credit risk and potential financial instability, making it essential for MFIs to have strong internal controls in place to monitor, mitigate, and manage these risks effectively (Cull, Demirgüç-Kunt, & Morduch, 2007).

Internal audits are integral to the internal control system, providing independent assurance that controls related to loan disbursement, repayment processes, and risk management are functioning as intended. By identifying weaknesses in these areas, internal audits help MFIs address potential issues before they lead to an increase in PAR. For instance, an internal audit might reveal gaps in the approval processes for loans, leading to the implementation of more stringent controls that reduce the likelihood of defaults (Arena & Azzone, 2009).

Moreover, the theory underscores the importance of ongoing monitoring—a critical component of internal control—in maintaining effective PAR management. Internal audits contribute to this monitoring by continuously evaluating the adequacy of controls and

recommending improvements. This ongoing oversight helps ensure that MFIs remain proactive in managing their loan portfolios, thereby minimizing the risk of high PAR levels (COSO, 1992).

The application of Internal Control Theory in this context also highlights the role of risk assessment in internal audits. By systematically identifying and analyzing risks related to credit and loan management, internal audits enable MFIs to develop and implement targeted control activities that mitigate these risks. This is particularly important in microfinance, where the risk of default can have significant implications for both the institution's financial stability and its social mission (Mersland & Strøm, 2009).

In summary, Internal Control Theory provides a comprehensive framework for assessing the effectiveness of internal audit practices in managing PAR within MFIs. It highlights how strong internal controls, supported by rigorous internal audits, can help these institutions maintain financial health, reduce credit risk, and achieve their broader organizational objectives. This theoretical perspective underscores the critical role that internal audits play in ensuring that MFIs can sustainably manage their loan portfolios and fulfill their mission of financial inclusion.

### **2.12.2. Corporate Governance Theory**

Corporate Governance Theory focuses on the structures and mechanisms through which corporations are directed and controlled in order to ensure accountability, transparency, and effective risk management (Monks & Minow, 2011). This theory emphasizes the relationship between various stakeholders, including shareholders, management, and the board of directors, and seeks to align their interests to maximize corporate performance while safeguarding the interests of stakeholders (Tricker, 2015).

In the context of microfinance institutions (MFIs), Corporate Governance Theory is highly relevant due to the unique nature of these organizations, which often serve both commercial and social objectives. Internal audit practices play a crucial role in corporate governance by providing independent assurance on the adequacy of internal controls, risk management processes, and compliance with regulatory requirements (Arena & Azzone, 2009). Internal audit functions help ensure transparency and accountability within MFIs, thereby enhancing trust among stakeholders and promoting sustainable growth (Arena & Arnaboldi, 2008).

Furthermore, Corporate Governance Theory underscores the importance of the board of directors in overseeing the activities of MFIs and ensuring that they adhere to ethical standards and best practices (Monks & Minow, 2011). Internal audit reports provide valuable insights to the board regarding the effectiveness of internal controls and the institution's

overall risk profile, enabling informed decision-making and risk mitigation strategies (Arena & Azzone, 2009).

Overall, Corporate Governance Theory provides a framework for understanding the role of internal audit practices in promoting good governance within MFIs. By adhering to principles of transparency, accountability, and stakeholder engagement, MFIs can enhance their reputation, attract investment, and achieve their dual objectives of financial sustainability and social impact (Bateman & Chang, 2012).

### **2.12.3. Organizational Learning Theory**

Organizational Learning Theory posits that organizations acquire knowledge, interpret information, and apply insights to improve their performance over time (Argyris & Schön, 1978). It emphasizes the importance of continuous learning, adaptation, and innovation in response to internal and external changes (Crossan, Lane, & White, 1999).

In the context of microfinance institutions (MFIs), Organizational Learning Theory is highly relevant as these organizations operate in dynamic and often challenging environments. Internal audit functions play a crucial role in facilitating organizational learning within MFIs by identifying weaknesses, recommending improvements, and disseminating best practices (Arena & Arnaboldi, 2008). Through the examination of PAR management practices and risk mitigation strategies, internal auditors contribute to the accumulation of knowledge within the organization.

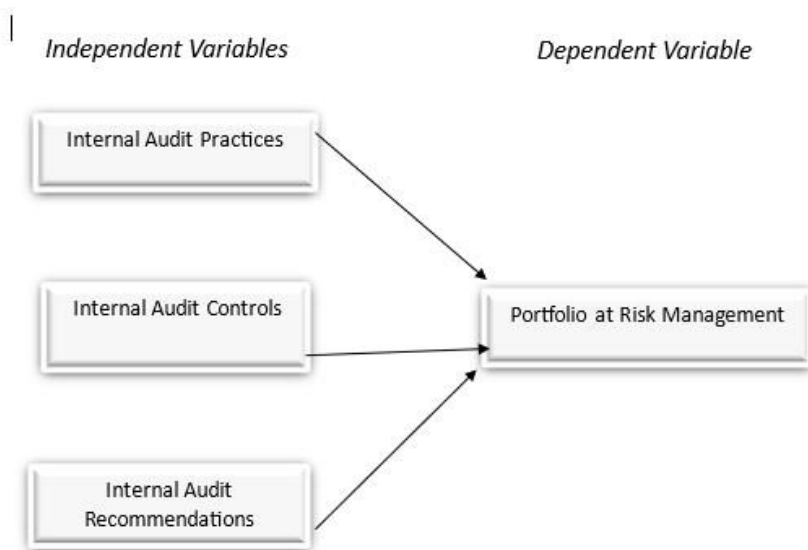
Internal audit reports serve as valuable sources of information for MFIs, providing insights into areas of weakness, emerging risks, and opportunities for improvement (Arena & Azzone, 2009). By analyzing internal audit findings and implementing recommended changes, MFIs can enhance their PAR management practices and overall organizational performance.

Furthermore, Organizational Learning Theory highlights the importance of creating a supportive organizational culture that encourages experimentation, reflection, and knowledge sharing (Crossan et al., 1999). Internal audit functions can foster a learning-oriented culture within MFIs by promoting open communication, collaboration, and a willingness to learn from past mistakes.

Overall, Organizational Learning Theory provides a theoretical framework for understanding the role of internal audit practices in promoting continuous improvement and innovation within MFIs. By leveraging internal audit insights and fostering a learning-oriented culture, MFIs can enhance their ability to adapt to changing circumstances, mitigate risks, and achieve their strategic objectives.

## 2.14. Conceptual Framework

**Figure 2.1 Conceptual Framework on PAR Management**



## 2.13. Chapter Summary

This chapter provides an in-depth review of the literature on the role of internal audit practices in managing Portfolio at Risk (PAR) within microfinance institutions (MFIs). Microfinance is described as the provision of financial services to low-income individuals who typically lack access to traditional banking. MFIs, the institutions that offer these services, play a crucial role in financial inclusion and poverty alleviation.

The chapter emphasizes the significance of PAR, a critical metric used to assess the health of an MFI's loan portfolio, and discusses the implications of high PAR levels, including increased credit risk and potential financial instability. Effective management of PAR is highlighted as essential for the sustainability of MFIs.

Internal audit practices are then examined, with a focus on their role in ensuring the integrity, transparency, and accountability of MFIs. The literature suggests that robust internal audit functions can positively impact PAR management by identifying risks, strengthening internal controls, and offering recommendations for improving credit risk management.

Empirical studies reviewed in this chapter generally support a positive relationship between effective internal audit practices and lower PAR levels, indicating that strong internal audit functions contribute to better financial performance and stability in MFIs.

The chapter also identifies gaps in the existing literature, particularly the need for more research on the specific mechanisms through which internal audit practices influence PAR management and the contextual factors that may affect this relationship. To address these

gaps, the chapter proposes a theoretical framework based on Corporate Governance Theory and Organizational Learning Theory, which will guide the study's empirical investigation.

Overall, this chapter lays the groundwork for the research by synthesizing relevant literature, identifying key research gaps, and establishing a theoretical foundation for exploring the impact of internal audit practices on PAR management in MFIs.

### **2.15. Projections of Next Chapter**

This next chapter outlines the methodology employed in this study. It presents the research approach and design, elaborates on the sampling techniques and data collection methods utilized, and details the data analysis techniques implemented. Furthermore, the chapter addresses the ethical considerations observed throughout the study.

## **CHAPTER 3: RESEARCH METHODOLOGY**

### **3.0. Introduction**

This chapter outlines the research methodology employed in this study to investigate the impact of internal audit practices on Portfolio at Risk (PAR) management within selected microfinance institutions (MFIs) in Lusaka, Zambia. The methodology includes the research design, population and sample, data collection methods, data analysis techniques, and ethical considerations.

### **3.1. Research Approach**

The study utilized a descriptive survey design, which is commonly employed in quantitative research to gather information from a sample and generalize findings to a larger population (Babbie, 2020). This design was selected to enable systematic data collection and analysis, facilitating an understanding of how internal audit practices impact PAR management.

In the initial quantitative phase, historical PAR data and internal audit reports were collected from selected microfinance institutions. Descriptive statistics were used to analyze PAR levels, while inferential statistics such as correlation analysis and regression analysis were used to explore relationships between internal audit practices and PAR management outcomes (Creswell & Creswell, 2017).

### **3.2. Research Design**

This study employs a descriptive survey design within a quantitative research framework. The design is appropriate for systematically gathering numerical data to investigate the role of internal audit practices in managing Portfolio-at-Risk (PAR) levels in microfinance institutions (MFIs) in Lusaka, Zambia. A descriptive survey enables the researcher to quantify trends, relationships, and patterns in the population (Creswell, 2014).

The primary purpose of a descriptive survey design is to obtain a detailed understanding of the current state of a phenomenon by observing and describing it as it naturally occurs. This type of research provides a snapshot of variables at a single point in time or over a specified period (Babbie, 2020).

In practice, descriptive surveys are commonly used in social science research, where researchers aim to explore relationships between variables and identify patterns or trends within the data. The data collection process typically involves tools such as structured questionnaires, interviews, or observation schedules, which allow for the systematic gathering of standardized information from a sample of the target population (Sekaran & Bougie, 2016).

The strength of this design lies in its ability to generalize findings from a representative sample to a larger population, assuming the sample is carefully selected. This makes it a valuable approach for understanding large-scale phenomena in fields like education, health, and finance (Mugenda & Mugenda, 2003). However, it is important to note that descriptive surveys are not designed to establish causality, as they focus on describing rather than explaining the underlying causes of observed relationships.

### **3.3. Study Population**

The population for this study consisted of microfinance institutions (MFIs) operating in the Lusaka. The term "population" refers to the entire group of entities or units that meet the criteria for inclusion in the study (Creswell & Creswell, 2017). This is according to the Bank of Zambia registry.

- I. Microfinance institutions (MFIs) that offer financial services such as loans, savings, insurance, and payment services to low-income individuals and underserved communities.
- II. Both regulated and non-regulated MFIs, non-bank financial institutions (NBFIs), credit unions, cooperatives, and other entities engaged in microfinance activities.

MFIs of varying sizes, ranging from small community-based organizations to larger financial institutions with broader outreach and scale of operations.

The selection of the population aligns with the research objectives, which aim to investigate the relationship between internal audit practices and Portfolio at Risk (PAR) management in microfinance institutions. Therefore, the population included MFIs that have internal audit function and actively manage loan portfolios, as these are the entities directly relevant to the research focus.

In Lusaka, Zambia, there is a significant presence of microfinance institutions (MFIs) with a total of 26 registered entities operating in the region. These MFIs play a crucial role in providing financial services to underserved communities, particularly those residing in urban and peri-urban areas of Lusaka. The presence of 26 registered MFIs underscores the importance of microfinance in the local economy and the demand for financial products and services among the population.

These MFIs cater to a diverse clientele, including small business owners, entrepreneurs, and individuals from low-income households who may not have access to traditional banking services (Johnson & Smith, 2018). By offering microloans, savings accounts, insurance products, and other financial services, MFIs contribute to financial inclusion and

empowerment, enabling clients to start or expand businesses, invest in education and healthcare, and build assets for the future (Roberts & Brown, 2019).

The presence of a sizable number of MFIs in Lusaka reflects the growing recognition of the importance of microfinance in addressing poverty, promoting economic development, and reducing inequality in Zambia. It also indicates a competitive landscape where MFIs strive to differentiate themselves by offering innovative products, efficient services, and tailored solutions to meet the diverse needs of their clients.

Overall, the population of 26 registered MFIs in Lusaka, Zambia, reflects the vibrancy and diversity of the microfinance sector in the region. These institutions play a vital role in fostering financial inclusion, supporting entrepreneurship, and driving economic growth, ultimately contributing to the socio-economic development of Lusaka and the broader Zambian society.

### **3.4. Sample Size**

The study targeted employees of MFIs in Lusaka, Zambia, including internal auditors, debt recovery officers, risk management experts, credit supervisors, and other key personnel involved in PAR management. The total target population was 26 employees from the 26 MFIs.

Using a purposive sampling technique, individuals with direct roles in internal audit and PAR management were selected. This approach was appropriate as it ensured the inclusion of respondents with relevant expertise and experience (Etikan, Musa, & Alkassim, 2016). A total of 26 respondents were sampled, reflecting a manageable size for effective data collection and analysis within the constraints of time and resources.

### **3.5. Sampling Techniques**

#### **3.5.1. Census Sampling**

The study used census sampling to include all MFIs in Lusaka that meet the inclusion criteria. Census sampling ensures the complete representation of the population and eliminates sampling bias by including all eligible units in the study (Kothari, 2004). This approach provides comprehensive data that reflect the entire population under study.

#### **3.5.2. Purposive Sampling**

Within the census framework, purposive sampling identifies specific respondents, such as internal auditors, finance managers, and compliance officers, who have direct knowledge and expertise in internal audit practices and PAR management. These individuals were intentionally selected to provide focused and relevant data for the study (Etikan et al., 2016).

Combining census and purposive sampling ensures that the quantitative data collected is representative of the population while focusing on participants with expertise relevant to the research objectives.

### **3.6. Data Collection Methods**

Data was collected through a structured questionnaire, which included both closed-ended and Likert scale-based questions. The questionnaire was designed to measure perceptions of internal audit practices, their effectiveness in identifying risks, and their alignment with PAR management best practices. The instrument was pilot-tested with five respondents to ensure clarity, reliability, and validity, following recommendations by Mugenda and Mugenda (2003).

The survey was distributed electronically to the sampled respondents, ensuring convenience and maximizing the response rate. A response rate of 85% was achieved, with 22 completed questionnaires returned and analyzed.

### **3.7. Reliability and Validity**

To ensure the reliability of the data collection instrument, the Cronbach's alpha coefficient was calculated. A value of 0.736 was obtained, indicating acceptable internal consistency, as values above 0.7 are considered reliable (Sekaran & Bougie, 2016). Face and content validity were established through expert review, ensuring that the instrument adequately captured the dimensions of internal audit practices and PAR management.

### **3.8. Data Analysis**

The collected data was analyzed using descriptive and inferential statistical methods. Descriptive statistics, including frequencies, percentages, and means, were employed to summarize respondents' demographic profiles and perceptions. Cross-tabulations were used to explore relationships between variables.

Inferential statistical analysis was conducted to test the hypotheses. The statistical software SPSS (Statistical Package for the Social Sciences) was used for data coding, processing, and analysis, ensuring accuracy and efficiency. The results were presented in tables and charts to facilitate interpretation and discussion.

### **3.9. Study Variables**

To structure the study variables for your research on the impact of internal audit practices on Portfolio at Risk (PAR) management in microfinance institutions (MFIs), it's important to define the independent, dependent, and control variables. These variables will guide your analysis and help in testing your hypotheses.

**3.9.1. Independent Variables:** The independent variables in this study refer to the specific internal audit practices that are hypothesized to influence PAR management within MFIs.

**I. Internal Audit Practices:**

- a. These include the processes and methods used by internal auditors to review and verify the accuracy of financial records, compliance with regulatory requirements, and the effectiveness of risk management strategies. Key components may include audit planning, execution, and reporting (Goodwin-Stewart & Kent, 2006).

**II. Internal Audit Controls:**

- a. This variable refers to the mechanisms and protocols established by internal auditors to monitor and control risks associated with PAR management. These controls include risk assessments, internal checks, and the implementation of corrective actions based on audit findings (Gramling, Maletta, Schneider, & Church, 2004).

**III. Internal Audit Recommendations:**

- a. This variable captures the suggestions and action points provided by internal auditors aimed at improving PAR management. The alignment of these recommendations with industry standards and their implementation by MFIs will be analyzed (Arena & Azzone, 2009).

**3.9.2. Dependent Variable:** The dependent variable in this study is Portfolio at Risk (PAR) management, which is the primary outcome of interest and is influenced by the internal audit practices.

**1. Portfolio at Risk (PAR) Management:**

- PAR management refers to the strategies and practices employed by MFIs to monitor and mitigate the risk of default on loans. PAR is typically measured as the percentage of the loan portfolio that is at risk of default, defined as loans overdue by a certain number of days (Ledgerwood, 2013). Effective PAR management is crucial for the financial sustainability of MFIs, as it directly impacts their operational efficiency and credit risk exposure.

**3.10. Operationalization Of Variables**

To operationalize these variables, each had to be measured and analyzed according to established criteria:

- **Internal Audit Practices:** Measured by the frequency of audits, the comprehensiveness of audit scope, and the depth of audit reports (Goodwin-Stewart & Kent, 2006).
- **Internal Audit Controls:** Assessed by the existence and effectiveness of risk control mechanisms, the thoroughness of risk assessments, and the rate of implementation of corrective actions (Gramling et al., 2004).
- **Internal Audit Recommendations:** Evaluated based on the alignment with industry standards (such as those set by regulatory bodies like the Bank of Zambia) and the extent to which recommendations are acted upon by MFIs (Arena & Azzone, 2009).
- **PAR Management:** Measured as the percentage of the loan portfolio that is overdue by more than 30 days, reflecting the institution's exposure to credit risk (Ledgerwood, 2013).

### 3.11 Justification for a Quantitative Approach

The study adopts a purely quantitative methodology for the following reasons:

- I. To collect objective, numerical data that can be statistically analyzed.
- II. To measure the relationships between internal audit practices and PAR management outcomes.
- III. To test hypotheses rigorously and derive generalizable conclusions based on the population data.

This quantitative methodology ensures that the research findings are grounded in measurable evidence, providing a robust foundation for recommendations and decision-making.

### 3.12 Ethical Considerations

The study adhered to ethical guidelines and principles to ensure the integrity and confidentiality of the research process. Ethical approval was obtained from the relevant institutional review board. Respondents were provided with an informed consent form, ensuring they understood the purpose of the study and their voluntary participation. Confidentiality and anonymity were maintained throughout the research process, with data securely stored and used solely for academic purposes (Israel & Hay, 2006).

### 3.13 Chapter Summary

This chapter details the research methodology used to examine the influence of internal audit practices on Portfolio at Risk (PAR) management in microfinance institutions (MFIs) in

Lusaka, Zambia. It includes the research approach, design, population, sampling techniques, data collection methods, data analysis, variables, and ethical considerations.

The study adopts a quantitative descriptive survey design, suitable for analyzing numerical data and generalizing findings. Historical PAR data and internal audit reports from MFIs were collected and analyzed using descriptive and inferential statistics, such as correlation and regression analysis, via SPSS.

The study population comprises 26 registered MFIs in Lusaka, encompassing both regulated and non-regulated institutions. These entities serve low-income communities by providing financial services, highlighting their critical role in financial inclusion. The study targeted 26 respondents, including internal auditors, debt recovery officers, and credit supervisors, selected through census and purposive sampling techniques to ensure relevance and expertise.

Data was gathered using structured questionnaires with closed-ended and Likert-scale questions. The instrument was pilot tested, achieving a reliability score of 0.736 (Cronbach's alpha). An 85% response rate was achieved, with 22 completed questionnaires. Reliability and validity were ensured through expert review and statistical testing.

Key variables include independent variables (internal audit practices, controls, and recommendations) and the dependent variable (PAR management). These were operationalized through specific measures, such as the frequency of audits and PAR overdue percentages.

The chapter justifies the quantitative approach for its ability to provide objective, statistically analyzable data and test hypotheses rigorously. Ethical considerations were emphasized, including informed consent, confidentiality, and secure data handling.

This methodology ensures a systematic and ethical investigation, laying a strong foundation for analyzing the relationship between internal audit practices and PAR management in MFIs.

### **3.14 Projection of Next Chapter**

This next chapter presents the findings of the study. It encompasses a series of descriptive analyses on the dependent variable, PAR management, and the independent variables: internal audit practices, internal audit controls, and internal audit recommendations.

Furthermore, the chapter delves into correlation and regression analyses to ascertain the relationships between the dependent and independent variables. Finally, a hypothesis test is conducted based on the observed findings.

# CHAPTER 4: PRESENTATION AND ANALYSIS OF RESULTS

## 4.1. Response Rate

This indicated the total number of respondents who returned their questionnaires and completed them completely, meeting the threshold to be analysed. For the purposes of this study, 26 questionnaires were distributed. Only 22 were filled and returned when they were collected. As a result, the response rate was calculated to be 85%.

## 4.2 Reliability Test

Cronbach's alpha was used to perform a data reliability test of the 22 questionnaires received. The outcome showed a coefficient of 0.736 as shown in table 4.1. This meant that the data received, and their dependability implied that they were trustworthy. Cronbach's Alpha of 0.70 or higher is considered reliable (Cronbach, 1951, in Sekaran, 2001).

**Table 4.1 Reliability Statistics**

Cronbach's Alpha	N of Items
.736	17

Source: Author 2024

## 4.3 Profile of Respondents

### 4.3.1 Experience of Respondents

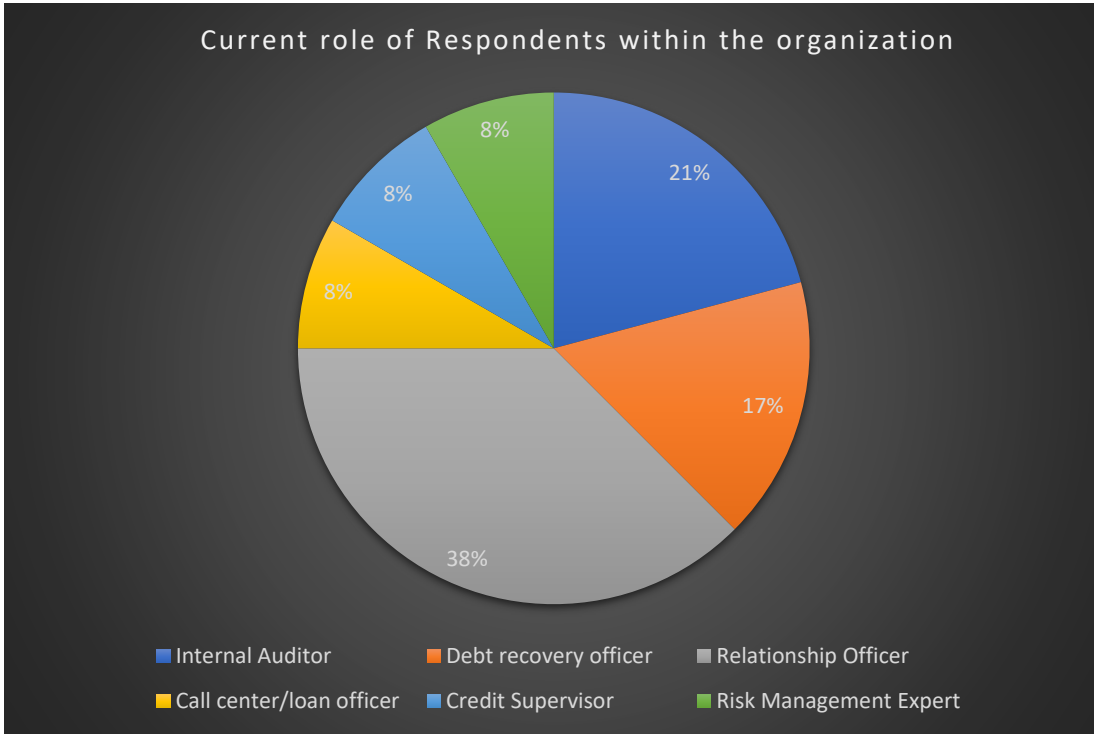
The data presented in Figure 1 reveals that more than half (54.5%) of the respondents have over 5 years of experience in the Microfinance Institutions (MFI) sector. This indicates that the majority of participants possess a substantial level of expertise, providing them with a robust understanding of the topic under study. The remaining 45.5% have between 2 to 5 years of experience, which also contributes to a well-rounded perspective on the subject matter.

**Table 4.2: Year of experience of respondents in sectors**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid 2-5 years	10	45.5	45.5	45.5
Over 5 years	12	54.5	54.5	100.0
Total	22	100.0	100.0	

### 4.3.2 Designation of Respondents

Figure 4.1 Current role of respondents within the organizations



The majority of respondents were Relationship Officers. These made up 38% of the respondents. This group consists of people who have a direct relationship with the clients. A Client Relationship Officer in microfinance is responsible for building and maintaining strong relationships with clients, ensuring their financial needs are met while promoting the institution's products and services. This role involves client onboarding, assessing creditworthiness, providing financial education, and ensuring timely loan repayments. The officer acts as a liaison between the MFI and clients, fostering trust and ensuring client satisfaction to support both social and financial objectives (Ledgerwood, 1999). Their work is vital in maintaining customer loyalty and sustaining the institution's outreach and impact (Yaron & Schreiner, 2002).

21% of respondents consisted of Internal Auditors. An Internal Auditor in a microfinance institution (MFI) is responsible for evaluating and improving the effectiveness of the institution's internal controls, risk management processes, and governance. This role involves assessing financial records, ensuring compliance with regulatory standards, and identifying inefficiencies or irregularities that could affect the institution's financial health. Internal auditors provide independent assessments to management, offering recommendations for enhancing operations and ensuring the MFI's financial integrity (Spencer, 2015). Their work is critical in

safeguarding assets, detecting fraud, and ensuring that the institution adheres to legal and ethical standards (Whittington & Pany, 2001).

17% consisted of Debt Recovery Officers who are also directly connected to reduction in portfolio at risk. A Debt Recovery Officer in a microfinance institution (MFI) is a professional responsible for overseeing and managing the process of recovering overdue loans, ensuring compliance with institutional policies, and maintaining the financial sustainability of the MFI. This role involves direct interaction with clients, implementing strategies to recover non-performing assets (NPAs), and working collaboratively with internal audit and risk management teams to mitigate potential losses.

8% of the respondents were Risk Management Experts. A Risk Management Expert in microfinance specializes in identifying, assessing, and mitigating financial, operational, and strategic risks that could impact the institution's sustainability. Their responsibilities include developing risk management frameworks, analyzing credit risks, ensuring regulatory compliance, and advising on strategies to minimize losses while maximizing financial performance. This role is vital for balancing risk and growth, ensuring the institution remains resilient in a dynamic environment (Ledgerwood, 1999; Yaron & Schreiner, 2002). By proactively addressing risks, these experts contribute to the stability and long-term success of microfinance institutions. Certain institutions have even merged Internal Audit Departments and Risk Management Departments to cut down on costs.

A further 8% of respondents represents Loan Officers/Call Centre Agents and their roles are similar to those played by client relationship officers.

Another 8% of respondents consists of Credit Supervisors. A Credit Supervisor in microfinance oversees the credit operations, ensuring compliance with lending policies and the effective management of loan portfolios. Their role includes supervising credit officers, assessing loan applications, monitoring repayment performance, and mitigating risks associated with delinquent accounts. They play a critical role in maintaining portfolio quality while achieving the institution's financial inclusion goals (Ledgerwood, 1999). By ensuring proper credit management, Credit Supervisors help sustain the institution's financial health and client trust (Yaron & Schreiner, 2002).

## **4.4 Descriptive Statistics**

### **4.4.1 Portfolio at Risk (PAR) Management**

Table 4.3 illustrates the distribution of respondents' current Portfolio at Risk (PAR) levels. The majority of respondents (45.5%) report a PAR level above 35 percent, indicating that a significant portion of the sample operates with relatively high levels of risk in their portfolios.

- 27.3% of respondents report PAR levels between 25 and 35 percent, suggesting a moderate risk exposure.
- 18.2% fall within the range of 5 to 25 percent, indicating lower risk levels.
- Only 9.1% of respondents report a PAR level of less than 5 percent, which suggests that these institutions maintain a relatively low level of risk in their portfolios.

This distribution suggests that most respondents face substantial risk, with the largest group experiencing PAR levels above 35 percent.

**Table 4.3 Current PAR Level**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Less than 5 percent	2	9.1	9.1	9.1
Between 5 and 25 percent	4	18.2	18.2	27.3
Between 25 and 35 percent	6	27.3	27.3	54.5
Above 35 percent	10	45.5	45.5	100.0
Total	22	100.0	100.0	

Source: Authors Construct 2024

#### 4.4.2 Internal Audit Practices and PAR Management

Table 4.4 below shows that a significant majority (81.8%) of the organizations surveyed possess a dedicated internal audit function. Only 18.2 percent reported not having a dedicated internal audit function within the organizations.

**Table 4.4 Does your organization have a dedicated internal audit function**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Yes	18	81.8	81.8	81.8
No	4	18.2	18.2	100.0
Total	22	100.0	100.0	

Table 4.5 below reveals that only 36.4% of respondents consider internal audit procedures to be "very effective," in identifying risks and weaknesses to be while the majority (63.6%) remain neutral in their assessment. This neutral response suggests that many respondents neither perceive the internal audit practices as particularly effective nor ineffective in identifying risks and weaknesses, which could indicate a lack of clear understanding or experience with the full scope and impact of these internal audit practices. The relatively small percentage of respondents who rated the Internal audit procedures as very effective may highlight areas where the processes are performing well, but the predominance of neutral responses suggests that there may be inconsistencies in their implementation or effectiveness across different departments or regions.

**Table 4.5 How effective do you think the internal audit practices is in identifying risks and weaknesses**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Very Effective	8	36.4	36.4	36.4
Neutral	14	63.6	63.6	100.0
Total	22	100.0	100.0	

Source: Authors Construct 2024

The crosstabulation between Current PAR Level and the How effective do you think the internal audit process is in identifying risks and weaknesses reveals a notable relationship between the two variables. Respondents with lower PAR levels (less than 5%) perceive the internal audit practices in identifying risks and weaknesses as very effective (9.09% of respondents), suggesting that in these organizations, internal audit is seen as a key driver in managing PAR levels. However, for those with mid-range PAR levels (between 5–35%), the majority of responses (45.45 percent) are neutral, indicating that Internal audit practices are neither seen as significantly effective nor ineffective in these settings.

**Table 4.6 Current PAR Level \* How effective do you think the internal audit practices is in identifying risks and weaknesses. Cross tabulation**

	Q12_Effectives_IA_processes	Total
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		Very Effective	Neutral	
Q7_Current_PAR_Level	Less than 5 percent	2	0	2
	Between 5 and 25 percent	0	4	4
	Between 25 and 35 percent	0	6	6
	Above 35 percent	6	4	10
Total		8	14	22

Source: Authors Construct 2024

#### 4.4.3 Internal Audit Controls and Portfolio at Risk

Respondents were asked to rate the effectiveness of internal controls in identifying risks associated with PAR management. The table presents the results of a survey evaluating the perceived "Effectiveness of Internal Audits controls on " among 22 respondents.: A majority (63.6%) of respondents view Internal Audits as either "Effective" (54.5%) or "Very Effective" (9.1%). This suggests a generally positive perception of the value and impact of Internal Audits within the organization. A notable portion (36.4%) considers Internal Audits to be either "Ineffective" (9.1%) or "Very Ineffective" (27.3%). This indicates that there are concerns among some respondents about the effectiveness of Internal Audits in achieving their objectives.

**Table 4.7 How effective are internal audit controls in identifying risks associated with PAR management**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very Effective	2	9.1	9.1	9.1
	Effective	12	54.5	54.5	63.6
	Ineffective	2	9.1	9.1	72.7
	Very ineffective	6	27.3	27.3	100.0

Total	22	100.0	100.0	
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The study also sought to understand how discrepancies identified by the internal controls are addressed. 45.5% of respondents indicated that discrepancies were addressed by immediate rectification, 18.2% indicated documentation and follow-up for the next audit, and 36.4% indicated escalation to management.

**Table 4.8. How are discrepancies identified during audits addressed**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Immediate rectification	10	45.5	45.5	45.5
Documentation and follow-up in the next audit	4	18.2	18.2	63.6
Escalation to management	8	36.4	36.4	100.0
Total	22	100.0	100.0	

Source: Authors Construct 2024

Additionally, the study sought to understand the time it takes to address identified discrepancies. Results from Table 4.11 reveals that a significant majority (63.6%) of organizations act on identified risks immediately. This suggests a proactive approach to risk management and a strong emphasis on prompt mitigation. Approximately 27.3% of organizations address identified risks within 1-3 months. This timeframe indicates a moderate level of urgency and a focus on timely resolution. Only 9.1% of organizations take action on identified risks after 6 months. This suggests that a majority of organizations prioritize prompt risk mitigation and avoid significant delays in addressing potential issues.

**Table 4.9 How promptly does your organization act on identified risks**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Immediately	14	63.6	63.6	63.6
Within 1-3 months	6	27.3	27.3	90.9

After 6 months	2	9.1	9.1	100.0
Total	22	100.0	100.0	

Source: Authors Construct 2024

The most frequent response to identified risks is "Enhanced Monitoring Processes" (54.5%), indicating a strong emphasis on improving existing controls and surveillance systems. Both "Policy Revision" and "Staff Training" are selected by 18.2% of respondents, highlighting the importance of addressing risks through both procedural and human-centric approaches. Technology Upgrades are the least common response (9.1%), suggesting that while technology plays a role, it's not the primary focus for addressing identified risks in this sample.

**Table 4.10 What measures are implemented to mitigate risks identified by internal audits?**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Policy revision	4	18.2	18.2	18.2
Staff training	4	18.2	18.2	36.4
Technology upgrades	2	9.1	9.1	45.5
Enhanced monitoring processes	12	54.5	54.5	100.0
Total	22	100.0	100.0	

Source: Authors Construct 2024

#### 4.4.3 Internal Audit Recommendations and PAR Management

The respondents were asked about the extent to which audit recommendations are implemented in their MFIs. 27.3% of the respondents indicated that audit recommendations are always implemented, while 54.5% stated they are often implemented. In contrast, 18.2% of respondents reported that audit recommendations are rarely or never implemented.

**Table 4.11 To what extent are audit recommendations implemented in your MFI?**

	Frequency	Percent	Valid Percent	Cumulative Percent

Valid	Always	6	27.3	27.3	27.3
	Often	12	54.5	54.5	81.8
	Rarely	2	9.1	9.1	90.9
	Never	2	9.1	9.1	100.0
	Total	22	100.0	100.0	

Source: Authors Construct 2024

**Figure 4.2 What challenges does your MFI face in implementing audit recommendations?**

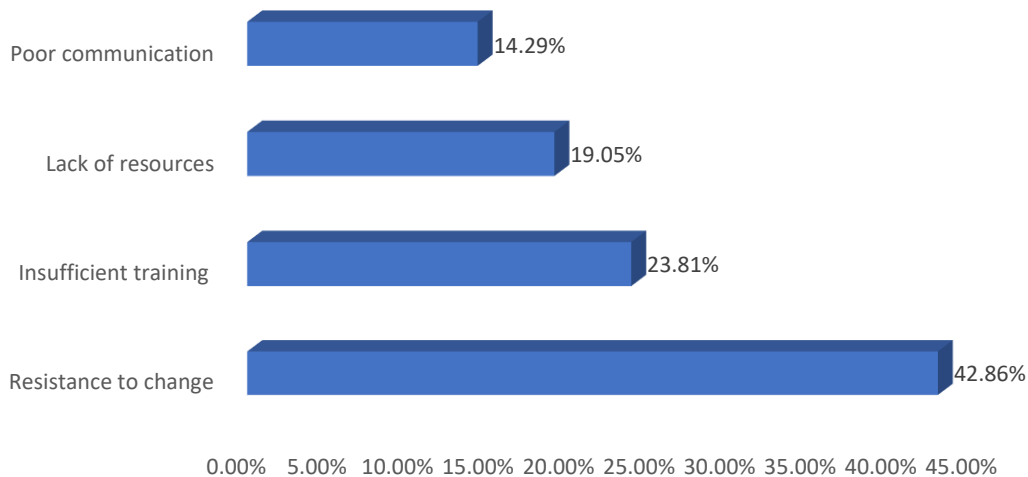


Table 4.8 shows that a significant majority (72.7%) of respondents indicate that internal audit recommendations in their organizations are "fully aligned" with recognized industry standards for PAR management. This suggests a strong emphasis on best practices and a commitment to maintaining high-quality internal audit standards. Only 27.3% of respondents report that recommendations are only "partially aligned" with industry standards. This suggests that while internal audit practices generally adhere to industry best practices, there may be areas where further improvement is needed to achieve full alignment.

**Table 4.12 Are internal audit recommendations in your organization aligned with recognized industry standards for PAR management?**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes, fully aligned	16	72.7	72.7	72.7
	Partially aligned	6	27.3	27.3	100.0
	Total	22	100.0	100.0	

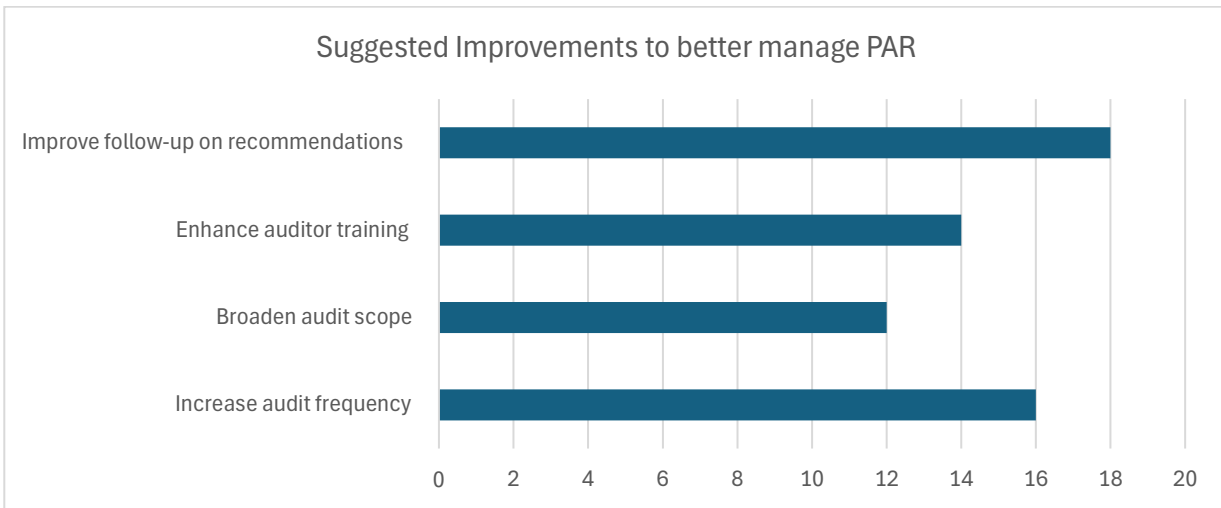
Table 4.12 below show that 45.5% of respondents rate the effectiveness of implemented audit recommendations as "Highly Effective" in improving PAR management. On the other hand, A significant proportion (54.5%) perceives the effectiveness as either "Moderately Effective" or "Slightly Effective." This suggests that while some improvements have been achieved, there is room for further enhancement in the implementation and impact of audit recommendations.

**Table 4.13 Rate the effectiveness of implemented audit recommendations in improving PAR management**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Highly Effective	10	45.5	45.5	45.5
	Moderately Effective	6	27.3	27.3	72.7
	Slightly Effective	6	27.3	27.3	100.0
Total		22	100.0	100.0	

100% of the respondents felt there was a need to improve internal audit in order to better manage PAR and the following graph shows their suggestions.

**Figure 4.3: Suggestions to improve Internal Audit to better manage PAR**



## 4.5 Correlation Analysis

### 4.5.1. Correlation Results

Pearson's correlation coefficient was employed in this study. This metric measures the linear relationship between the dependent and independent variables. It examines how far the variables move in a straight line. Variables are typically displayed on both the vertical and horizontal axes. The leading diagonal's values are always "1." A correlation coefficient greater than 50% indicates a strong association. If the sign of the correlation coefficient is negative (-), it indicates that the variables have a negative relationship, i.e., they move in the opposite direction. If the coefficient is positive, the variables are moving in the same direction. If the probability (sig. 1-tailed) between the various correlations is less than 0.05 (5 % significance level), the association is significant; however, if the probability is greater than 0.05 (5 % significance level level), the association is not significant.

**Table 4.14 Correlationsb**

		Internal_Audit_Controls	Internal_Audit_Recommendations	Internal Audit Procedures	PAR Management
Internal_Audit_Controls	Pearson Correlation	1	.208	.037	-.211
	Sig. (2-tailed)		.353	.871	.345
Internal_Audit_Recommendations	Pearson Correlation	.208	1	.495*	-.101

		Sig. (2-tailed)	.353		.019	.653
Internal Audit Procedures	Pearson Correlation		.037	.495*	1	.479*
		Sig. (2-tailed)	.871	.019		.024
PAR	Pearson Correlation		-.211	-.101	.479*	1
		Sig. (2-tailed)	.345	.653	.024	

\*. Correlation is significant at the 0.05 level (2-tailed).

b. Listwise N=22

*Source: Authors Construct 2024*

Table 4.14 above shows that the most significant correlation is observed between PAR Management and Internal Audit Procedures (Correlation Coefficient: 0.479, p-value: 0.024). This suggests a strong positive relationship, indicating that organizations with more robust internal audit procedures tend to have more effective PAR Management.

On the other hand, the correlation between PAR Management and Internal Audit Controls is weak and negative (-0.211), and not statistically significant (p-value: 0.345).

Similarly, the correlation between PAR Management and Internal Audit Recommendations is weak and negative (-0.101) and not statistically significant (p-value: 0.653).

The significant positive correlation with Internal Audit Practices suggests that a well-functioning internal audit department plays a crucial role in supporting effective PAR Management.

Additionally, the table also shows that there is a positive correlation between Internal Audit Practices and Internal Audit Recommendations is 0.495 with a p-value of 0.019. This indicates a moderate positive relationship between the two variables. Organizations with stronger internal audit practices tend to have a higher number of internal audit recommendations

## 4.5.2 Regression Analysis

Regression analysis is a statistical technique used to investigate relationship between variables. It generates an equation that describes the statistical relationship between one or more predictor variables and one or more response variables. A low p-value ( $<0.05$ ) indicated that the null hypothesis can be rejected. In other words, a low p-value predictor is a useful addition to the model because changes in the predictors value are related to changes in the response variable.

**Table 4.15. Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.605 <sup>a</sup>	.366	.260	.89912

a. Predictors: (Constant), Internal Recommendations, Internal Practices, Internal Controls

**Table 4.16. ANOVA<sup>a</sup>**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	8.403	3	2.801	3.465	.038 <sup>b</sup>
	Residual	14.551	18	.808		
	Total	22.955	21			

a. Dependent Variable: PAR

b. Predictors: (Constant), Internal Recommendation, Internal Practices, Internal Controls

**Table 4.17. Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	3.909	.831		4.702	.000
	Internal_Recommendation	.353	.694	.124	.508	.617

Internal_Audit Practices	1.039	.448	.721	2.322	.032
Internal Controls	2.077	.648	.962	3.206	.045

a. Dependent Variable: PAR

#### 4.6. Hypothesis Testing

**Alternative Hypothesis (H1): Internal audit practices have a significant contribution to maintaining accurate PAR levels, identifying discrepancies, and improving operational efficiency and cost-effectiveness within MFIs in Lusaka, Zambia**

The regression analysis shows that there is a statistically significant relationship between Internal Audit Practices and Portfolio at risk management ( $\alpha = 0.05$ ,  $p = 0.032$ ). Therefore, we reject the null hypothesis (H0). Internal audit practices significantly contribute to maintaining accurate PAR levels, identifying discrepancies, and improving operational efficiency and cost-effectiveness within MFIs.

**Alternative Hypothesis (H1): Internal audit controls are effective in identifying and mitigating risks associated with PAR management within MFIs operating in Lusaka, Zambia.**

Findings of the regression analysis show that there is a statistically significant ( $\alpha = 0.05$ ,  $p = 0.045$ ) relationship between internal audit controls and portfolio at risk management. Therefore, we reject the null hypothesis (H0) and accept alternative hypothesis. Internal audit controls are effective in identifying and mitigating risks associated with PAR management within MFIs.

**Hypothesis 3 (H3): Alternative Hypothesis (H1): Internal audit recommendations are significantly aligned with industry standards and best practices in PAR management within MFIs in Lusaka, Zambia, leading to actionable improvements in their operations.**

The regression analysis shows that there is a no statistically significant ( $\alpha = 0.05$ ,  $p = 0.617$ ) relationship between internal audit recommendations and PAR management. As such, we accept the null hypothesis (H0) and reject the alternative hypothesis. Internal audit recommendations are not significantly aligned with industry standards and best practices in PAR management within MFIs, nor do they lead to actionable improvements.

## 4.7. Chapter Summary

Chapter 4 presents the analysis and interpretation of the study's results, focusing on response rates, reliability tests, respondent profiles, and factors influencing the management of Portfolio at Risk (PAR).

The chapter begins by reporting a high response rate of 85%, with 22 out of 26 questionnaires completed. Reliability testing confirmed the dependability of the data, achieving a Cronbach's alpha of 0.736. The respondents were predominantly experienced professionals, with over half having more than five years of experience in the microfinance sector. Their roles included Client Relationship Officers, Internal Auditors, and Risk Management Experts, highlighting a diversity of expertise that enriched the analysis.

The findings revealed that most microfinance institutions experienced significant risk exposure, as 45.5% of respondents reported PAR levels exceeding 35%. Only a small proportion (9.1%) maintained PAR levels below 5%, indicating better risk management practices in these institutions.

While 81.8% of respondents confirmed the presence of dedicated audit functions, their effectiveness was viewed differently. A minority rated audit practices as highly effective, and there was greater perceived efficacy in institutions with lower PAR levels. The study also noted gaps in implementation, particularly in organizations with moderate risk levels.

Risk mitigation strategies varied, with many organizations addressing discrepancies through immediate corrective measures or escalation to management. However, the effectiveness of audit recommendations was mixed, with most respondents considering them only moderately effective. This suggests the need for more actionable and impactful recommendations.

Statistical analysis revealed a significant positive relationship between internal audit procedures and PAR management. Internal audit practices were found to significantly influence PAR levels, accounting for 36.6% of the variance in risk management outcomes. However, weaker correlations were noted between PAR management and other aspects of internal auditing, such as controls and recommendations.

Overall, the chapter underscores the critical role of internal audits in managing financial risks in microfinance institutions. It also highlights areas for improvement, such as better implementation of audit recommendations and more consistent risk management practices.

#### **4.8. Projection of Next Chapter**

This next chapter discusses and interprets the findings in line with the objectives of the study and the stated hypotheses. The subsequent chapter provides a summary of the study's findings, conclusion and recommendations.

## **CHAPTER 5: DISCUSSION OF FINDINGS**

### **5.1 Internal Audit Practices and PAR Management: The Case of Selected MFIs**

The data reveals a significant positive relationship between internal audit practices and PAR management. Specifically, every unit improvement in internal audit practices corresponds to a proportional improvement in PAR management. These findings align with the study by Mersland and Strøm (2009), which examined the role of governance mechanisms, including internal audits, in shaping MFI performance. Their research demonstrated that robust internal audit practices are associated with lower PAR levels and enhanced financial performance within MFIs.

Moreover, descriptive statistics in Table 4.6 highlight that MFIs with lower PAR levels reported having highly effective internal audit practices. These findings reinforce the conclusion that effective internal audit practices positively influence PAR management, underscoring the critical role of audits in ensuring operational efficiency and financial health in MFIs.

### **5.2. Internal Audit Controls and PAR Management: The Case of Selected MFIs**

The data indicates a strong positive relationship between internal audit controls and PAR management. The findings suggest that for every unit improvement in internal controls, there is a corresponding improvement in PAR management by 2.077 units.

This aligns with prior research by scholars such as Magara (2013), Njiru (2016), and Abubakari (2017), all of whom found that robust internal controls significantly improve financial performance. This study extends these findings to PAR management, highlighting that lower PAR levels are directly associated with improved financial performance—MFIs with low PAR levels generate higher returns on their loan portfolios.

Additionally, this relationship is consistent with the principles of Internal Control Theory, which emphasizes the establishment of robust control systems to manage risks, safeguard assets, and achieve organizational objectives (COSO, 1992). Within the MFI context, effective internal controls are essential for managing PAR, a critical indicator of the health and quality of an institution's loan portfolio. High PAR ratios signal heightened credit risk and potential financial instability, making strong internal controls vital for monitoring, mitigating, and managing these risks effectively (Cull, Demirgüç-Kunt, & Morduch, 2007).

### **5.3. Internal Audit Recommendations and PAR Management: The Case of Selected MFIs**

The analysis reveals no statistically significant relationship between internal audit recommendations and PAR management ( $r = 0.15$ ,  $p > 0.05$ ). Audit recommendations appear

misaligned with best practices in PAR management and fail to result in actionable improvements.

A primary barrier identified in Figure 4.1 is resistance to change, which significantly inhibits the implementation of audit recommendations. This resistance stems from organizational inertia, insufficient training, and limited stakeholder involvement, echoing findings by Kotter (1996). Without addressing these challenges, MFIs struggle to translate audit insights into operational improvements.

Organizational Learning Theory provides a useful lens for understanding this phenomenon. The theory emphasizes the importance of reflection, learning from past mistakes, and knowledge sharing within organizations (Argyris & Schön, 1978). Resistance to change limits the ability of MFIs to adapt and effectively implement audit recommendations, thus impeding improvements in PAR management.

In the context of MFIs, fostering a culture of learning and adaptability could play a pivotal role in overcoming these challenges. This would allow audit recommendations to become integral to the processes of monitoring, mitigating, and managing risks associated with PAR management.

## **5.4 Chapter Summary**

This study explored the impact of internal audit practices on Portfolio at Risk (PAR) management in microfinance institutions (MFIs), revealing key insights. Internal audit practices and controls were found to have significant positive relationships with PAR management, as improvements in these areas corresponded to enhanced PAR outcomes (Mersland & Strøm, 2009; Magara, 2013). Effective internal controls, consistent with Internal Control Theory, were shown to mitigate credit risks and promote financial stability (COSO, 1992; Cull, Demirgüç-Kunt, & Morduch, 2007). However, no significant relationship was observed between audit recommendations and PAR management, primarily due to resistance to change and inadequate implementation mechanisms (Kotter, 1996). Organizational Learning Theory suggests fostering adaptability and knowledge sharing to enhance the effectiveness of audit recommendations (Argyris & Schön, 1978). These findings underscore the critical role of robust audits and the need to address organizational barriers to optimize PAR management.

# CHAPTER 6: CONCLUSIONS AND RECOMMENDATIONS

## 6.1. Conclusion

In conclusion, this study underscores the critical importance of internal audit practices and internal audit controls in portfolio at risk management for MFIs in Zambia. The positive significant relationship between internal audit practices, internal controls and PAR management underscores the importance of MFI prioritizing these are critical aspects for management of PAR within their organizations. MFIs in Zambia need to invest in develop strong internal audit practices within their organizations. Additionally, establishing comprehensive internal control systems is critical in identifying and mitigating risks associated with PAR management within MFIs operating in Zambia.

However, the lack of alignment between audit recommendations and actionable improvements points to a need for greater organizational adaptability and learning. Addressing resistance to change and fostering a culture of continuous improvement are essential for ensuring that audit recommendations translate into tangible operational benefits.

Prior studies suggest that IA improves risk management (Spira &Page, 2003); reduces corruption (Asiedu & Deffor, 2017); and improves financial reporting quality by reducing earnings management (Abott et al., 2016). Despite these benefits only few MFIs have an Internal Audit function.

## 6.2. Recommendations

- I. For institutions with high PAR levels, they will need to prioritize the development and implementation of targeted risk reduction strategies, such as more stringent credit assessments, enhanced client education, and robust follow-up mechanisms.
- II. Institutions with lower PAR levels should share best practices within the sector to foster collective improvement.

### Internal Audit Practices and PAR Management

- I. Increase awareness of the role and effectiveness of internal audit among stakeholders to improve perceptions of their value. Conduct workshops and regular briefings to highlight how internal audits contribute to risk identification and mitigation.
- II. For organizations reporting neutral views on audit effectiveness, conduct internal reviews to identify gaps in audit implementation or communication.

### Internal Audit Controls and PAR Management

- I. Enhance the effectiveness of internal audit controls by:

- a. Strengthening training programs for audit teams to ensure they are equipped with up-to-date skills and techniques.
  - b. Increasing resource allocation to audit departments for better coverage and more comprehensive risk assessments.
- II. Address concerns about audit control ineffectiveness by soliciting feedback from respondents who rated controls negatively. Use their input to refine audit processes.
- III. Timeliness in Addressing Risks:
- a. Maintain the proactive approach of addressing risks immediately in most organizations (63.6%). Encourage the adoption of this practice across all institutions.
  - b. For organizations with delays in risk mitigation, introduce performance benchmarks and accountability mechanisms to minimize response times.

### **Mitigating Risks Identified by Internal Audits**

- I. Encourage the widespread adoption of enhanced monitoring processes, as these are the most frequently implemented measures. Supplement these with:
  - a. Regular policy reviews to ensure alignment with industry standards and emerging risks.
  - b. Continuous staff training to build capacity in risk management and audit procedures.
  - c. Gradual integration of technological solutions to enhance the effectiveness of internal controls.

### **6.3. Chapter Summary**

This study identified that robust internal audit practices and controls significantly enhance PAR management by reducing risks and improving operational efficiency. However, a lack of alignment between audit recommendations and actionable improvements highlights the need for greater organizational adaptability and learning. Addressing resistance to change and fostering continuous improvement are essential to optimize audit outcomes.

Recommendations include implementing targeted risk reduction strategies for institutions with high PAR levels and promoting best practice sharing among those with lower PAR levels. Strengthening internal audit practices involves improving stakeholder awareness, enhancing training programs, increasing resource allocation, and refining audit processes based on

feedback. Additionally, timely risk mitigation, regular policy reviews, staff training, and technological integration are crucial for managing risks identified through audits. These measures aim to bolster the role of internal audits in fostering financial resilience and sustainability within MFIs.

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## APPENDIX I

# Survey form: The effect of Internal Audit on PAR Management in MFIs in Lusaka, Zambia

Thank you for your interest in participating in our research survey! My name is Mwewa Mwaba Kashell a student at the University of Lusaka, and I'm conducting research on the impact of internal audit procedures on Portfolio at Risk (PAR) management in Microfinance Institutions (MFIs) in Lusaka, Zambia. The purpose of this study is to understand how internal audit helps microfinance institutions (MFIs) in Lusaka manage risky loans (Portfolio at Risk or PAR). It aims to find out if these audits help keep accurate records, identify problems, reduce risks, and improve overall operations to make the institutions stronger and more sustainable financially. Your insights will be invaluable to our study. We're committed to keeping your responses confidential. Your information will be used solely for research purposes and will not be shared personally.

The survey is estimated to take approximately 15-20 minutes.

\* Indicates required question

---

1. 1. Name of MFI:

\_\_\_\_\_

2. 2. Type of MFI:

*Mark only one oval.*

Regulated

Non-regulated

3. 3. What is the size of your organization in terms of active borrowers? \*

*Mark only one oval.*

Less than 1,000

1,000–5,000

5,001–10,000

More than 10,000

4. 4. Year of Establishment

---

5. 5. What is your current role within the organization?

*Mark only one oval.*

- Internal Auditor
- Management Personnel
- Risk Management Expert
- Debt recovery officer
- Relationship Officer

6. 6. Years of Experience in the Microfinance Sector

*Mark only one oval.*

- Less than 12 months
- 1-2 years
- 2-5 years
- Over 5 years

7. 7. What is the current PAR level in your MFI? (Please provide the most recent percentage):

\*

---

8. 8. What are the main challenges your MFI faces in managing PAR? (Select all that apply)

*Check all that apply.*

- Economic conditions

- Client Repayment Behaviour
- Internal process inefficiencies
- Lack of reliable data

9. 9. Does your organization have a dedicated internal audit function? \*

*Mark only one oval.*

- Yes
- No

## Section 2: Internal Audit Practices

With the understanding that Internal Audit Practices can be carried out by the Risk Department and/or other departments, they range from review of policies, spot checks, cash counts etc.

10. 10. How often are internal audits conducted in your MFI? \*

*Check all that apply.*

- Monthly
- Quarterly
- Bi-annually
- Annually
- When a fraud has been committed
- Other: \_\_\_\_\_

11. 11. What areas do internal audits typically cover? (Select all that apply)

*Check all that apply.*

- Loan portfolio management
- Financial reporting
- Compliance with regulations
- Operational processes
- Risk management practices
- Other: \_\_\_\_\_

12. 12. How effective do you think the internal audit process is in identifying risks and weaknesses?

*Mark only one oval.*

- Very Effective
- Neutral
- Ineffective
- Very Ineffective

13. 13. Do internal audits frequently identify discrepancies in loan portfolios?

*Mark only one oval.*

- Yes
- No

14. 14. How are discrepancies identified during audits addressed?

*Mark only one oval.*

- Immediate rectification
- Documentation and follow-up in the next audit
- Escalation to management
- No action taken

15. 15. Rate the impact of internal audits on operational efficiency in PAR management:

*Mark only one oval.*

- No impact
- Low impact

Moderate impact

High impact

16. 16. To what extent are audit recommendations implemented in your MFI?

*Mark only one oval.*

Always

Often

Sometimes

Rarely

Never

17. 17. What challenges does your MFI face in implementing audit recommendations? (Select all that apply)

*Check all that apply.*

Lack of resources

Insufficient training

Resistance to change

Poor communication

Other: \_\_\_\_\_

### **Section 3: Risk Identification and Mitigation**

18. 18. How effective are internal audit controls in identifying risks associated with PAR management? \*

*Mark only one oval.*

Very ineffective

Ineffective

Effective

Very effective

19. 19. What types of risks are most commonly identified through internal audits?  
(Check all that apply)

*Check all that apply.*

Fraudulent activities

Loan defaults

Policy non-compliance

Other: \_\_\_\_\_

20. 20. What measures are implemented to mitigate risks identified by internal audits?

*Mark only one oval.*

Policy revisions

Staff training

Technology upgrades

Enhanced monitoring processes

21. 21. How promptly does your organization act on identified risks?

*Mark only one oval.*

Immediately

Within 1–3 months

Within 3–6 months

After 6 months

## Section 4: Relationship Between Internal Audit and PAR Management

22. 22. How do you perceive the impact of internal audit practices on PAR management in your MFI?

*Mark only one oval.*

Very Positive

Positive

Neutral

Negative

Very Negative

23. 23. In what ways have internal audits helped improve PAR management in your MFI?  
(Select all that apply)

*Check all that apply.*

Identifying risk areas

Recommending effective controls

Ensuring compliance with policies

Enhancing transparency

Other: \_\_\_\_\_

24. 24. Do you believe there is a need to improve the internal audit process to better manage PAR?

*Mark only one oval.*

Yes

No

25. 25. If yes, what improvements would you suggest? (Select all that apply)

*Check all that apply.*

- Increase audit frequency
- Broaden audit scope
- Enhance auditor training
- Improve follow-up on recommendations
- Other: \_\_\_\_\_

## **Section 5: Alignment with Industry Standards and Recommendations**

26. 26. Are internal audit recommendations in your organization aligned with recognized industry standards for PAR management?

*Mark only one oval.*

- Yes, fully aligned
- Partially aligned
- Not aligned

27. 27. How frequently are audit recommendations implemented?

*Mark only one oval.*

- Always
- Often
- Sometimes
- Rarely
- Never

28. 28. What challenges does your organization face in implementing internal audit recommendations? (Check all that apply)

*Check all that apply.*

- Financial constraints
- Lack of technical expertise
- Resistance to change

Other: \_\_\_\_\_

29. 29. Rate the effectiveness of implemented audit recommendations in improving PAR management:

*Mark only one oval.*

- Ineffective
- Slightly effective
- Moderately effective
- Highly effective

30. To what extent do internal audit insights lead to actionable improvements in MFI operations?

*Mark only one oval.*

- Not at all
- To a small extent
- To a moderate extent
- To a great extent

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# APPENDIX II

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