EFFECTS OF INTERNAL CONTROL SYSTEMS ON THE FINANCIAL PERFORMANCE OF THIRD TIER LICENCED COMMERCIAL BANKS IN KENYA

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ABSTRACT

The review concerned with the internal control system of third-tier banks has responsibility for all the employees who use the internal control system to search for mistakes so as to protect the asset and detect errors and fraud. The overall economic profile of the internal audit function is highly significant, especially in recent years, and some of these factors are involved, what is professional and some are academic. With the growing use of information technology, Third tier banks have worked to take advantage of data processing electrically, so that information technology has become part of the bank's environment and if any information technology continues to affect the operations of different banks and process their data, internal control systems must keep pace with these developments. Third Tier banks contain a set of policies and procedures that are designed to provide management with adequate assurance of the goals to envisage essentials for the bank system. The internal control is carried out by management to determine the efficiency of the internal control, and to determine the possibility of modifying it. The results of the regression model show that there is a positive relationship between internal controls and the financial performance of tier three commercial banks. Holding other factors constant, financial performance is measured by the efficiency and effective implementation of internal controls. The study recommended that: Control environment has a positive significant relationship with financial performance and the tier three commercial banks should therefore ensure a suitable environment to secure their operational activities.
Key Words: **Control environment, financial performance, internal control**

INTRODUCTION

Internal controls have become of paramount importance today in Kenyan banks. The reason being that the control systems in any organization are a pillar of an efficient accounting system (Wanemba, 2010). The increasing volatility in global markets and need for enhanced shareholder returns has motivated the management of firms to foster the internal control mechanisms as an element of enhancing the competitive edge of firms (Rittenberg & Schwieger, 2005). This is particularly important for banks as weak internal control system stands as one of the major causes of dismal performance in banks mainly due to undetected frauds. From a management point of view there is need to ensure that internal control systems are put in place in order to reduce the occurrence of fraud. Internal control is a dynamic integral process that is adapting continuously to the changes facing modern banking industry (Wielstra, 2014). Within every financial institution there is a need to provide products and services at an equitable price that ensures cost efficiency in the production service. In Kenya, third tier commercial banks failures and widespread dip in revenues over the past two decades have been due to ineffective internal control within the formal business sectors (Nyambura, 2013). Internal control, which assures the stability of every organization, therefore, has gained importance today (Rezaee, 2002). This is because the control systems in place are a pillar of an efficient accounting system as well as the achievement of organizational goals.

Etuk (2011) defined internal control system as a means by which an organizations resources are directed, monitored and measured. Internal control systems play an important role in detecting and preventing fraud and protecting the organizations resources. Weak internal control systems are behind poor performance in banks in Kenya mainly fraudulent activities in the organization. Internal control is part of the enterprise management system. That is a plan of enterprise internal control, means and ways to protect property, to check rightness of the performance, guarantee the effectiveness and politics of the performance. Internal control systems help to avoid mistakes and to achieve the goals of the organization (Shim, 2011). Pfister

(2009) suggested that internal control system is a system of avoiding, identifying and correcting mistakes that might appear during information processing.

Cobit (2007) states that internal control is a process including norms, procedures, performance and organizational structure established to ensure reasonable guarantees so as to achieve the settled business goals and avoid undesirable events. Cobit ensures quality, control and reliability of information systems in an organization, which is also the most important aspect of every banking institution it also helps in better-assigning responsibilities, measuring performances, agreeing on common objectives, and illustrating better interrelationships with every other process. Barnabas (2011) supported this notion by suggesting that internal control is a summation of company's components that help the employees to achieve the company's objectives. Internal controls are at the heart of every step in achieving the company's objectives.

Lakis (2007) suggested that internal control is a control system made by enterprise authority to arrange the enterprise performance properly according to the established strategy and to ensure safety and rational use of property, particularity and accuracy in accounting data. Internal control is defined as a system linking up enterprise performance, plans, attitudes, politics, integration of systems and management of human resources that helps the organization to achieve the settled goals and follow its mission (Dinapoli, 2007).

Financial performance is the ability of an organization to run its operations efficiently to be able to create profits (Sebbowa, 2009). Performance can be measured through analysis of the profits by calculating various profitability ratios for instance return on capital employed, return on investment and return on assets.

Verma (2018) states that financial performance is the process of measuring the results of a firm's policies and operations in monetary terms. It is used to measure the firms overall financial health over a given period of time and can also be used to compare performance of firms in the same industry.

Jensen (2003) states that internal control systems are intended to enhance the reliability of financial performance by increasing accountability among information providers in an organization. Internal controls ensure that financial information from various sources is credible. Credible financial information guarantees the preparation of financial statements which reflect the true state of affairs of the organization.

Muio (2012) investigated the effect of internal control systems on financial performance of private hospitals in Kenya. The study indicated that internal control systems had a significant effect on the financial performance of private hospitals in Kenya. Internal control systems are therefore a major determinant of financial performance. Mawanda (2008), states that there is a positive relationship between proper internal control systems and financial performance of organizations. Internal control systems are therefore a major determinant of financial performance. Mawanda (2008), states that there is a positive relationship between proper internal control systems and financial performance of organizations. Internal control systems act as a means of adding credibility to the financial statements. Proper internal control systems lead to the production of reliable reports which enhances the accountability function of management of an entity. Among the key roles of management is to ensure that reliable financial information is prepared.

Statement of the Problem

The internal control is an essential tool for corporate governance to enhance effectiveness and reliability in financial reporting (Skaife et al, 2007). Such controls further provide total assurance that the target set by the organization will be achieved (Gerri & Abdolmohammadi, 2010). Normally, internal control systems are set up by organizations to aid them in meeting their objectives, ensure generation of reliable financial reports, increase organizational compliance to financial regulations as well as prevent loss of organizational resources (Emasu, 2010). Active involvement and proper financial management of financial institutions by their management has fostered growth and prosperity of these institutions. Regardless of the documented benefits of adopting such systems, it remains unclear if such systems significantly affect financial performance of financial institutions in the Kenya.

However, related empirical literature such as Ndiwa (2014) and Ndifon (2014) found that organizational internal controls and financial performance is an understudied area. Some of the challenges experienced concerning internal controls include, low liquidity ratios, untimely financial reporting, low accountability, frauds and mismanagement of funds. Despite the guidelines set out by the Central Bank of Kenya in accordance with the Banking Act Cap, there has been numerous cases of bank failures in performance due to fraud and lack of elaborate internal controls as well as compliance with internal and external regulations within the industry (FLSTAP, 2011). For instance, within a period of nine months, the Central Bank of Kenya put three banking institutions under receivership. Imperial bank of Kenya the 19th largest bank in Kenya was put under receivership due to what the regulator termed as inappropriate banking practices (Kuo, 2015). In another case, the Dubai Bank of Kenya was put under receivership for flouting banking guidelines for a spate of years. Chase bank was later put under receivership in what was termed by the regulator as unsafe financial conditions thus; thus, leaving the questions of the gaps that exist within the banking sector owing to such multiple breaches without any action being taken (Ngigi, 2015).

Njenga and Osiemo (2013) Studied the effect of fraud detection through internal control on the performance of deposit-taking micro finance institutions in Kenya. However, this research did not review in detail all the internal control system aspects. Ochoge (2011) was emphasizing on the internal control and organizational performance, the above research failed to show the direct contribution of internal control to the financial performance.

Therefore, from the mentioned literature above, it is evident that internal control systems influence the performance of organizations, both financial and non-financial. In the current market where the financial institutions have been on the receiving end due to unethical issues and increase in banking fraud, it is imperative to assess the role of internal control systems in order to mitigate the losses and fraud in the banking industry. The scanty evidence on the relationship between internal control systems and performance motivated this study. This research focuses on enhancing the practices and academic knowledge gap. The research intents to fill this knowledge gap by studying the effect of internal control system on financial performance of the 21 licensed third tier commercial banks in Kenya.

The main objective of this study was to find out the effects of internal control systems on the financial performance of licensed third tier commercial banks.

LITERATURE REVIEW

The study focused on the agency theory, stewardship theory, positive accounting theory, attribution theory and reliability theory.

Conceptual Framework

The conceptual framework consists of the independent variables; control environment, control activities, information and communication, monitoring and dependent variable will be financial performance. The figure 1 below shows the conceptual framework of this study;

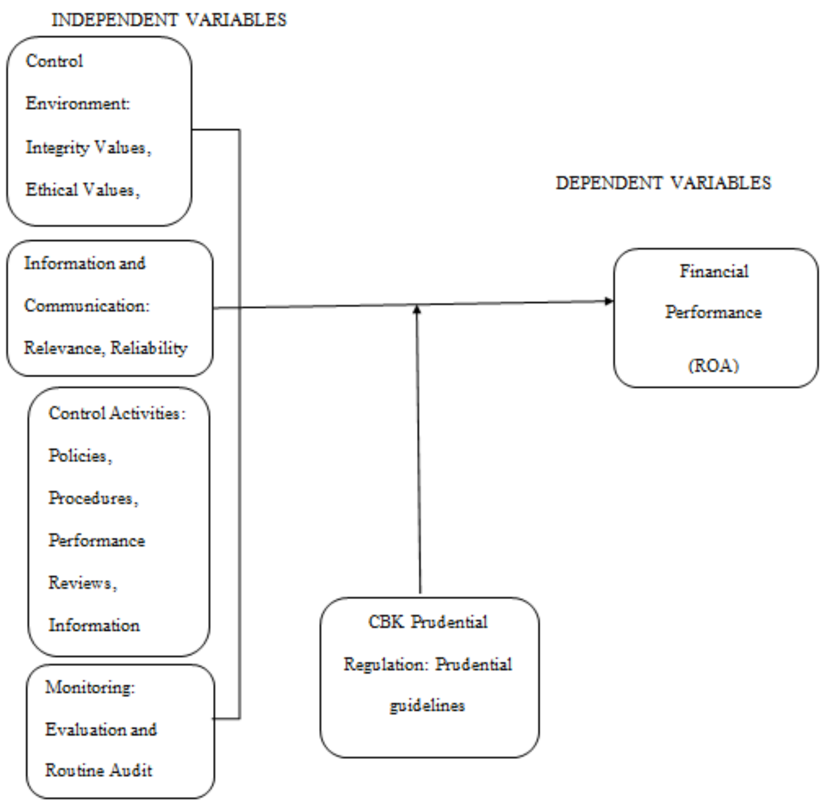

Figure 1 Conceptual Framework

RESEARCH METHODOLOGY

Research design

Research design is necessary in describing the arrangement and procedure utilized with an aim of solving a research problem (Babbie, 2002). Descriptive research design was used in this study because the descriptive statistics discover and measure cause and effect of relationship among variables, Cooper and Schindler (2000). Descriptive design enables the researcher to collect detailed information about the population and also provide recommendations to the management of the tier three licensed commercial banks for better financial performance.

Population

This refers to a complete set of individuals, objects or cases with some observable characteristics. Target population refers to that population to which the researcher wants to generalize the results of the study. The target population for this study comprised of all the 21 licensed tier three commercial banks in Kenya. The target population was appropriate to this study since it essentially provided detailed information to meet the objectives of the study.

DATA ANALYSIS AND PRESENTATION OF FINDINGS

RESPONSE RATE

The study sought to collect data from 20 respondents, a total of 16 respondents responded constituting 80% of the respondent's rate. The study was carried out to establish the effect of internal controls on financial performance of third tier commercial banks in Kenya.

REGRESSION ANALYSIS

The model summary in the table 4.5 below shows the summary of the regression analysis;

Table 4.9

Model	R	R squared	Adjusted R squared	Standard error of the estimates
1	0.950	0.920	0.759	0.252

Source: Research findings

For the research to establish the percentage variation of the dependent variable (financial performance) as explained by independent variables, a coefficient of determination obtained in the table 4.5 was used to explain if the model is a good predictor. From the results of the findings, the independent variables (control environment, risk assessment, control activities, monitoring, information and communication) contributed to 75.9% of the variation in financial performance as explained by adjusted R squared (0.759). This shows that the variable is a good predictor.

ANALYSIS OF VARIANCE

In order to determine the impact of the relationship between financial performance and internal controls of third tier commercial banks in Kenya, an analysis of variance was conducted. The table below 4.6 below shows the analysis of variance;

Table 4.6

Model	Sum of squares	Df	Mean square	F	Sig.
1. Regression	2.311	6	0.5123	2.960	0.002(a)
Residual	1.321	12	0.0921		
Total	3.632	18			

Source; Research findings

The results of the findings from the table 4.6 above indicated that the level of significance was 0.002(a) which implying that the regression model is significant in predicting the relationship between financial performance and internal controls due to the fact that the significance level was less than 0.05.The F value calculated is 2.960 indicating that the model was statistically significant in predicting the relationship between financial performance and internal controls of third tier commercial banks in Kenya.

Summary and Interpretation of Findings

Based on the demographic information, most of the employees in third tier commercial banks were master's degree holders. The respondents were also asked to provide information regarding the length in which they had been working in their respective banks to find out whether they were in position to provide accurate and reliable information in relation to internal controls and financial performance, most of them had worked for their respective banks for a period of between 3-4 years. On whether internal controls function as intended, the results showed that the internal controls of third tier commercial banks did function as intended since they did not meet the functioning requirements. In regard to effectiveness of internal controls, the results revealed that most of the employees were uncertain about the effectiveness of the internal control systems on their respective banks.

On whether the functionality of internal controls affect the financial performance of the third-tier commercial banks, the results revealed that most of the banks had control environment as one of the functionalities of internal controls that significantly contributed to financial performance. The study examined the effects of risk assessment as functionality of internal controls of the organization affect the financial performance of third tier commercial banks, the results indicated that the banks had put in place mechanisms for mitigation of critical risks that may result from fraud. These results show that most of the third-tier commercial banks observe risk assessment procedures as functionality of internal controls. The study also examined the effect of control activities on the financial performance of third tier commercial banks in Kenya. The results showed that the staffs were trained to implement the accounting and finance systems (M=4.70, S.D=0.923), the security system identified and safe guarded the organization assets (M=4.80, S.D=0.410). It was observed that third tier commercial banks carried out control activities as a functionality internal control of third tier commercial banks in Kenya.

The effect of information and communication on financial performance of third tier commercial banks was found to be a common practice. It was implemented in most the activities and functions through established policies and procedures. It was found that most of third tier commercial banks monitored their activities as part of functionality of internal control systems.

The statistical results on the regression model revealed that there is a significant relationship between financial performance and internal controls of third tier commercial banks in Kenya. All the independent variables have a significance level of less than 5% indicating that the variables are statistically significant on the financial performance of third tier commercial banks. The regression results revealed that there is a significant relationship between internal controls and financial performance of third tier commercial banks. The coefficient of determination proved that independent variables contributed to 75.9% of the variation in financial performance as explained by the adjusted R2 0.759% which shows that a model was a good predictor. This supported by Kakucha (2009) who evaluated the level of effectiveness of internal controls of enterprises operating in Nairobi. The data of the study was analyzed using regression model and the results of the analysis revealed that there is a positive relationship between internal controls and financial performance of third tier commercial banks in Kenya.

SUMMARY OF FINDINGS

The main objective of this study was to determine the effects of internal controls on the performance of tier three commercial banks in Kenya. The study adopted descriptive research design. A sample of 21 tier three commercial banks from a targeted population of 21 tier three commercial banks was used for the study. To ensure full representation of all level of employees, stratified random sampling technique was adopted.

Descriptive statistics was adopted in analyzing quantitative data. The quantitative data was coded and entered into statistical packages for social sciences. Analysis was then based on descriptive statistics.

Multiple linear regression analysis was used to establish the relationship between internal controls and financial performance of tier three commercial banks in Kenya. In regard to the level of education, the study findings revealed that most of the respondents were master's degree holders. On the length of service, most of the respondents had worked between 3-4 years in the tier three commercial banks.

The results of the regression model show that there is a positive relationship between internal controls and financial performance of tier three commercial banks. Holding other factors constant, financial performance is measured by the efficiency and effective implementation of internal controls. The results of the multiple regression model show that there is a positive relationship between internal controls and financial performance of tier three commercial banks in Kenya. This implies that a single unit increase in any of the independent variables results into a corresponding increase in financial performance of tier three commercial banks. The study established that internal controls affect financial performance of tier three commercial banks in Kenya to a great extent.

Conclusions

Based on the findings of the study it was concluded that tier three commercial banks that had invested on effective internal control systems had more improved financial performance as compared to those tier three commercial banks that had weak internal control systems. From the findings, it was revealed that those tier three commercial banks that observed integrity, risk assessment, control activities, monitoring and information communication technology registered high financial performance.

The findings indicated that some tier three commercial banks faced challenges in effective implementation of internal control systems due to lack of sufficient resources to hire competent staff and invest in modern technologies. The study found that control activities, control environment, risk assessment, monitoring and information communication technology had a significant positive relationship with financial performance of tier three commercial banks in Kenya.

RECOMMENDATIONS

Control environment has a positive significant relationship with financial performance. The tier three commercial banks should therefore ensure suitable environment to secure their operational activities. The managers of the tier three commercial banks should put in place effective and efficient security networks to reduce on various fraudulent activities.

Risk assessment has a positive significant relationship with financial performance. Tier three commercial banks should therefore implement proper risk assessment to guide their operations. To ensure effective controls, the banks' management should facilitate conduction of regular checks on the internal controls.

Information and communication have a positive significant relationship with financial performance. For tier three commercial banks to realize continued growth and improved performance, their information and communication systems should be efficient and effective. The study recommends that there is need for proper checks and balances in all financial transactions in the banks.

Control activities have a positive significant relationship with financial performance. Tier three commercial banks should implement efficient control activities to guide their operations. The banks' management specifically the human resource management should examine the level of employee integrity in allocating them responsibilities especially employees who handle confidential information.

Monitoring has a positive significant relationship with financial performance. Tier three commercial banks should ensure that their monitoring strategies are geared towards effective operations and achievement of organization goals. The management of each of the tier three commercial banks should ensure that there are policies in place guiding the banks' dealing with threats to the banks' operations.

The Central Bank of Kenya should monitor and supervise tier three commercial banks to ensure that their accountants comply with accounting regulations and requirements as per the Institute of Certified Public Accountants of Kenya to ensure proper implementation and compliance with accounting standards and principles. Tier three commercial banks should develop mechanisms to incorporate relevant feedback from the various stakeholders into their internal control systems.

Tier three commercial banks should transparently report on the structure and performance of their governance, risk management and internal control systems in their various reports to internal and external stakeholders for example through their periodic accountability reports or on the organization's website.

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