EFFECT OF INTERNAL CONTROL SYSTEMS ON FINANCIAL PERFORMANCE OF PUBLIC INSTITUTIONS OF HIGHER LEARNING IN NAIROBI CITY COUNTY, KENYA

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ABSTRACT

Most public institutions in many parts of the world have poor financial performance compared to private institutions. The poor financial performance can be attributed to financial management practice. The sound financial management practices require the institutions of strong internal control systems. However, there are limited empirical research findings regarding the relationship between internal control system and financial performance. In public institutions, there have been a lot of weaknesses in their policies and procedures and also in their Internal Audit, the extent to which employee's in positions handling cash fail to take regular leave and lack of rotation of employees handling very sensitive areas in finance and administration department. The main objective of the study was to establish the effect of internal control systems on financial performance in public institutions of higher learning in Nairobi City County. The study specific objectives were; to determine the effect of control activities, risk assessment, control environment, information and communication and monitoring on financial performance of institutions of higher learning in Nairobi City County. The study was anchored on agency theory, stewardship theory, and positive accounting theory and attribution theory. The study used a descriptive research design. This study took a sample study approach with its target population being the different categories of staff in different departments of Public Institutions of Higher Learning in Nairobi City County, Kenya. It took on a sample of 96 employees. Primary data was collected from sample population using open and closed ended questionnaires. Descriptive statistics was used in the data analysis and information presented in statistical forms. A multiple linear regression was also used to analyze the relationship between the dependent and independent variable. The study realized that the control environment, risk assessment, control activities and information and communication as indicators of internal control systems have a significant influence on the financial performance of the institutions of higher learning in Nairobi City County, Kenya. The variables explained 99.1% of the changes in financial performance of the institutions. The study recommends that internal control systems among the institutions need to be improved and accountability of organizational resources be upheld.

Key Words: *internal control systems, financial performance, public institutions, higher learning, Nairobi City County, Kenya*

INTRODUCTION

Financial performance is the ability to operate efficiently, profitability, survive, grow and react to the environmental opportunities and threats Sebbowa (2009). For purposes of the study I adopted Ray and Kurt's definition of internal control systems. In as much as Internal control Systems are wide and numerous, for the sake of this study, Internal control systems will be limited to; the

Control Environment, Internal Audit, and Control activities whereas financial performance will be looked at basically from the three perspectives of Liquidity, Accountability and Reporting (Donald and Delno 2009). The reliability of financial reporting is effective to internal control efficiency to ensure that transactions and bookkeeping are appropriate and properly authorized, valid, correctly recorded, complete, and on time. Moreover, it is very important that organizations have fairly summarized accounting information data disclosure Sebbowa (2009). However, in general, a quality reporting is affected by internal control mechanism. There is a general perception that institution and enforcement of proper internal control systems will always lead to improved financial performance. It is also a general belief that properly instituted systems of internal control improve the reporting process and also give rise to reliable reports which enhances the accountability function of management of an entity. According to Dixon et al (1990), appropriate performance measures are those which enable organizations to direct their actions towards achieving their strategic objectives.

Internal control ensures effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations to which the company is subject. Institutions of higher learning are where people go to further their knowledge in a specific area, and/or to acquire a diploma, degree, master's degree and PhD. These involve college, universities and technical schools. In Kenya, public institutions are created under the Act of Parliament to carry out research using their variety of qualified staff in different disciplines. The primary purpose of research, outreach and extension constitute the basis on which research goals are set and measures by which fulfilment of these goals are established (Onsongo, 2007).

Saleemi (2008) defines internal control as the whole system of controls, financial and otherwise established by the management in order to carry the business of the enterprise in an orderly and efficient manner, safeguard the assets and secure as far as possible the completeness and accuracy of the records. The components discussed below must be present and functioning effectively for any internal control system to achieve organizational objectives (COSO 1994). Control activities are policies, procedures and mechanisms that ensure management's directives are properly carried out (Aikins, 2011; Rezaee, Elam & Sharbatoghlie, 2001). Proper documentation of policies and procedural guidelines in these aspects help to determine not only how the control activities are to be executed but also provide adequate information for auditors examination of the overall adequacy of control design over financial management practices (Aikins, 2011). These control activities ensure that all necessary actions should be taken with the aim to address risks so that organizational objectives are achieved. Example of control activities include; segregation of duties, daily deposit of cash receipts, bank reconciliations and limiting access to check stock.

It is usually accepted that internal control systems need to be adequately monitored in order to assess the quality and the effectiveness of the system's performance over time. Monitoring provides assurance that the findings of audits and other reviews are promptly determined.

(Theofanis et al, 2011), also notes monitoring of operations ensures effective functioning of internal controls system (Amudo & Inanga, 2009). Hence, monitoring determines whether or not policies and procedures designed and implemented by management are being carried out effectively by employees. According to Gerrit and Abdolmohammadi, (2010), Organizational performance encompasses accumulated end results of all the organization's work processes and activities. Financial Performance measures in public institutions of higher learning can be financial or non-financial. The most effective way to improve financial performance is by reducing the level of irregularity and fraud through improvements in the firm's systems of internal financial control. Shareholders need to be assured that their resources are being used efficiently and effectively in providing the right service at the least cost.

Internal control systems including internal audits are intended primarily to enhance the reliability of financial performance, either directly or indirectly by increasing accountability among information providers in an organization (Jenning et al., 2008). Internal control therefore has a much broader purpose in the organization level. Internal controls provide an independent appraisal of the quality of managerial performance in carrying out assigned responsibilities for better revenue generation (Donald & Delno, 2009). According to Ondieki (2013), fraud is a major enemy of profitability. Control measures are structured in place to avert, detect and eliminate fraudulent occurrence thereby creating an atmosphere for profitability. Effective Internal control system support profitability and growth of an organization by protecting the general assets and resources thereby averting cases of loss. Strong internal control system help to prevent, minimize, transfer or eliminate risks, which may affect a profitable operation (Mugo, 2009)

Effective internal control system prevents waste and inefficiency in the production line and processes of goods and services. Effective internal control systems assist in the formulation and implementation of quality procurement procedures that helps to factor justification for requisition at proper lead-time, quantity and at lowest prices (Ngechu 2004). This will boost profitability than blind ordering which result to loss and waste. It is very important for every section and department of an organization to have an effective internal control system which is involved in blocking the organization's income leakages and loop holes thereby supporting a sustained profitability, growth and other general corporate goals and objectives.

STATEMENT OF THE PROBLEM

According to Kirsty (2008) efficient internal controls creates an organization's confidence in its ability to perform or undertake a particular task and prevents errors and losses through monitoring and enhancing organizational and financial reporting processes as well as ensuring compliance with pertinent laws and regulations. Muio (2012) studied the impact of internal control on the financial performance of private hospitals in Nairobi and established a significant relationship between internal control system and financial performance. Kakucha (2009) evaluated the level of effectiveness of internal controls operating in Nairobi and established that there are deficiencies in the systems of internal controls, with the degree of deficiencies varying from one enterprise to another. Njui (2012) investigated the effectiveness of internal control and audit in promoting good governance in the public sector in Kenya and found that internal control has the greatest effect on corporate governance within Kenya government ministries followed by risk management while compliance and consulting had the least effect. Ngugi (2011) survey of internal control systems among the listed private companies and the public sector companies in Kenya in which the results indicated that the private sector compared to the public sector had a strong internal control system. In Kenya, a number of important trends have recently emerged within the manufacturing sector. It is worth noting that manufacturing sector is a major contributor to the economic development of the country. According to the Economic Survey 2015, Kenya National Bureau of Statistics established that manufacturing sector contribution to Gross. Effectiveness of internal control on financial performance is very important in every organization, because the task of IC is to prevent and detect fraud in the organization. Internal controls help in achieving efficiency and effectiveness of operations. Several studies have been carried out on internal controls globally, regionally and locally on the effect on internal control system on profitability of diverse firms. For example; globally studies by Abu-Musa (2004); Chunlan (2009); Wittayapoom (2011); and regionally Kakucha (2009) and Nyakundi & Nyamita (2014) have established there exist a relationship between effective internal control and financial performance of the firm. However, majority of these studies have concentrated on different industries, while others have concentrated on a mix of listed firms in their localities. In addition, the studies employed different methodologies hence such studies may not be generalized to the study context. Locally, a study by conducted by Simiyu (2011) on effectiveness of internal control system in higher institutions of learning in Kenya clearly indicate that Institutions of higher learning face quiet a number of challenges during internal controls in performance like struggles with liquidity problems, financial reports are not made timely, accountability for the financial resources is still wanting, frauds and misuse of institutional resources. It is for this reason that this study sought to investigate the effects of internal controls on financial performance of institutions of higher learning in Kenya. Therefore, this study sought to investigate the relationship between internal control systems and financial performance of Institutions of higher learning in Kenya, a case of Nairobi City County, Kenya. Mohammed, (2003) researched effect of the internal controls of Ethiopian Airlines Branch office in Nairobi and a case study of internal controls of Nyayo Bus Service Corporations in Nairobi (Esmailjee, 1993). Chira (2009) researched on the analysis of internal controls systems in financial institution. The findings were that though various internal controls systems do exist in the banking industry more weight had been given to operational controls compared to other types of controls. There has been no research done on effects of internal control on performance of public Institutions of Higher Learning in Kenya. This study therefore sought to answer the question “what is the effect of internal control system on financial performance of public institutions of higher learning in Nairobi City County, Kenya?

RESEARCH OBJECTIVES

1. To determine the effect of control activities on financial performance of institutions of higher learning in Nairobi City, County, Kenya.
2. To establish the effect of risk assessment on financial performance of institutions of higher learning in Nairobi City, County, Kenya.
3. To evaluate the effect of control environment on financial performance of institutions of higher learning in Nairobi City, County, Kenya.
4. To establish the effect of information and communication on financial performance of institutions of higher learning in Nairobi City, County, Kenya.
5. To establish the effect of monitoring on financial performance of institutions of higher learning in Nairobi City, County, Kenya.

THEORETICAL REVIEW

Agency theory

Agency theory was developed in 1976 by Jensen and Meckling. This theory is an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent. Agency theory analyses the relationship between two parties: investors and managers. The agent (manager) undertakes to perform certain duties for the principal (investors) and the principal undertakes to reward the agent. As such, the theory describes firms as necessary structures to maintain contracts, and through firms, it is possible to exercise control which minimizes opportunistic behavior of agents (Mwangi, 2012). According to the theory, in order to harmonize the interests of the agent and the principal, a comprehensive contract is written to address the interest of both the agent and the principal. The agent-principal relationship is strengthened more by the principal employing an expert and systems (auditors and control systems) to monitor the agent (Jussi & Petri, 2004).

This theory is applicable to this study simply because internal control is one of many mechanisms used in business to address the agency problem by reducing agency costs that affects the overall performance of the relationship as well as the benefits of the principal (Payne, 2003; Abdel-Khalik, 1993). Internal control enhances the provision of additional information to the principal (shareholder) about the behavior of the agent (management) reduces information asymmetry and lowers investor risk and low revenue.

Stewardship Theory

Stewardship theory has its roots from psychology and sociology and is defined by Davis, Schoorman and Donaldson (1997) as "a steward protects and maximizes shareholders wealth through firm performance, because by so doing, the steward's utility functions are maximized".

Unlike agency theory, stewardship theory stresses not on the perspective of individualism (Donaldson & Davis, 1991), but rather on the role of top management being as stewards, integrating their goals as part of the organization.

Meckling and Jensen (1994) further state the cost incurred to curb agency problems (reducing information asymmetries and accompanying moral hazards) is less when owners directly participate in the management of the firm as there is a natural alignment of owner managers' interest with growth opportunities and risk. It follows from the above that stewardship theory unlike agency theory is a complete contrast and doesn't emphasize on the need to incur monitoring or agency cost which includes establishing an internal audit function. Nevertheless Donaldson and Davis (1991) further note that returns are improved by having both of these theories combined rather than separated which implies that management must strike a balance. In this study the steward theory supports the study by the fact that managers of institutions of higher learning act as stewards of shareholders, suppliers, creditors, consumers and employees of these institutions.

Positive Accounting Theory

In accounting research, it is labeled as either positive research or normative research. Research that tends to predict and find explanations for particular phenomena is categorized as positive research. Theories that are related to such research are called positive theories (Deegan and Unerman, 2006). These kinds of theories are typically based on observations, which can empirically be tested and improved through further observations. Unlike positive theories, other theories are not based upon observations. These kind of theories are normative and grounded upon the beliefs of the researcher. The positive accounting theory itself was developed by Watts and Zimmerman (1986), who states that positive accounting theory is concerned with explaining accounting practice. It is designed to explain and predict which firms will and which firms will not use a particular accounting method but says nothing about which method a firm should use." The theory is based on "the assumption that all individual actions is driven by self-interest and that individuals will always act in an opportunistic manner to the extent that the actions will increase their wealth" (Deegan and Unerman, (2006). From this perspective, the positive accounting theory predicts that organizations will seek to put mechanisms in place to limit actions that are driven by self-interest. This is needed to align the interest of managers of the firm (agents) with that off the owners of the firm (the principles). The costs of dealing with problems concerning the agency relationship and installing appropriate mechanisms are referred to as 'monitoring cost'.

Attribution Theory

Attribution theory is a social psychology theory that explores how people interpret events and behaviors and how they ascribe causes to the events and behaviors. Bonner et al. (1998) found that auditors are more likely to be sued when they fail to detect common misappropriations that would result to decreased revenues, and the evaluators believe that the fraud could have been detected by other auditors. The auditor's accountability for detecting fraud is extended by Reffett's (2007) study which predicted that auditors are more likely to be held accountable by evaluators when the auditors fail to detect fraud after they had identified the fraud occurrence as a fraud risk. The result of Reffett's study shows an increase in auditors‟ liability when an audit fails, after the auditors had identified the perpetrated fraud as a fraud risk and performed procedures to investigate the identified fraud risk. The findings support Reffett's prediction.

According to Bonner et al. (1998), evaluators can use the audit processes as a basis to determine negligence if auditors fail to detect internal control related fraud that may occur. This theory is relevant to the study in that it suggests that when fraud occurs, identified parties should be held accountable and auditors, being the "public watch dogs" are most likely to be held accountable if evaluators determine substandard audit services were provided.

EMPIRICAL REVIEW

Ndiwa (2014) studied the assessment of Internal Control System on Financial Performance in tertiary training institutions in Kenya. Many public institutions in Kenya are faced with poor financial performance which in extreme cases has led to the closure of some of them, despite having the necessary resources to run them. The study, therefore, endeavoured to investigate the persistent poor financial performance from the perspective of internal controls which had hitherto been ignored. The general objective of the study was to establish the relationship between internal control and financial performance in tertiary institutions in Kenya. The study was limited to the African Institute of Research and Development Studies. The findings indicated that most respondents were of the view that indeed there was a relationship between internal control and financial management.

Mwakimasinde, Odhiambo and Byaruhanga (2014) analyzed the effect of internal control systems on the financial performance of sugarcane out grower companies in Kenya. The specific objective of the study was to determine the effect of internal control system components on the financial performance of the sugarcane out grower companies. Internal control system was characterized by control environment, risk assessment process, information system and control activities while financial performance was characterized by cost per unit, goal attainment and profitability or surplus. The regression results also show that internal control system helps increase financial performance of sugarcane out grower companies percent. Based on the findings and conclusions of the study, the following recommendations were made; Internal control system has been found to have a statistically positive effect on performance of sugarcane out grower companies hence there is need for the sugarcane out grower companies to improve on their internal control system. Despite the fact that the study produced meaningful results it was subject to some limitations which provide avenues for further research.

Kinyua (2015) studied the Effect of Internal Control Environment on the Financial Performance of Companies quoted in the Nairobi Securities Exchange. The objective of the study was to establish the effect of internal control environment on financial performance of companies quoted in Nairobi Securities Exchange. The findings indicated that there is a positive significant relationship between internal control environment and financial performance, which corroborates with the findings of Mawanda (2008), states that institution which have enforcement of proper internal control systems will always lead to improved financial performance. The study, therefore, recommends that internal control environment should be enhanced to further improve the financial performance of companies quoted in Nairobi securities exchange.

Kamau, (2014) investigated the effect of internal controls on the financial performance of manufacturing firms in Kenya. The findings revealed that most manufacturing firms had a control environment as one of the functionality of internal controls of the organization that greatly impacts on the financial performance of the firms. The results also revealed that the staffs were trained to implement the accounting and financial management systems, the security system identified and safeguarded organizational assets. The statistical result from the regression analysis shows that there is a positive relationship between internal control and financial performance of manufacturing firms in Kenya. The study recommends that both internal and external auditor should be constantly updated and well-grounded on international financial reporting standards (IFRS) and principles in order to enhance their knowledge and skills in application of accounting practices and to keep them updated on the contemporary issues.

RESEARCH METHODOLOGY

Research design

This study adopted a cross sectional descriptive survey design. The study employed both qualitative and quantitative methods of data analysis most of the findings were quantitatively analyzed.

Target Population

Kombo and Tromp (2011) define a population as a group of individuals, objects or items from which samples are taken for measurement. The target population for the study was the employees in accounting/finance, administration and operations departments in the four public institution of higher learning in Nairobi County who totaled 91.

Sampling Design

Sample of at least 10% to 30% of the entire population is a valid sample size for a considerably small size. A purposive sampling approach was used in this study to allow the research to pick concerned staff especially from the accounts/finance, administration and operations department within Institutions of higher learning in Nairobi. Therefore the sample was 28 staff at the Institutions of higher learning in Nairobi County.

Data Collection Instrument

The study relied mostly on primary data sources which were collected through questionnaires while secondary data was obtained from the analysis of company's audited annual reports.

Data Analysis and Presentation

Descriptive statistics (means and standard deviation) and multiple regression analysis were used to analyze the data. Frequency tables, percentages and means were used to present the findings. Responses in the questionnaires were tabulated, coded and processed by the use of a computer Statistical Package for Social Science (SPSS) program to analyze data. The relationship between the dependent variable (Y) and the independent variable (X) was tested using multiple linear regression model captured below.

$$Y = \alpha + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + \beta_5 x_5 + \varepsilon$$

Where: Y = Financial Performance; x_1 = Control environment; x_2 = Risk assessment; x_3 = Control Activities; x_4 = Information and Communication; x_5 = Monitoring; α = Constant; ε = Error term

RESEARCH RESULTS

As mentioned earlier, out of the selected sample of 28 respondents, 3 (10.71%) did not respond to the questionnaires accordingly, hence only 25(89.29%) questionnaires were used in the subsequent analysis. This correlates with Mugenda and Mugenda (2003) recommendation that a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent.

Control Environment

Research findings indicated that control environment had greatly affected the institutions of higher learning's revenue, operation costs and fees income on capital for the last five years as indicated by a high mean of 4.12, 3.98 and 3.55 respectively. This indicates control environment has a significant influence on financial performance of the institutions of higher learning. Weak and poor control environment negatively affects financial performance and vice versa.

Risk Assessment

Findings indicated that there is a high and significant influence that risk assessment mechanisms and systems have on financial performance of institutions of higher learning. Risk assessment has affected the institutions' revenue, operating costs and fees income for the last five years greatly as indicated by a mean of 3.62, 3.89 and 4.11 respectively. Strong and effective risk management systems have yield strong internal control mechanisms which have resulted to high institution revenue, low operating costs and high fees income while weak and porous ones have led to poor performance of the institutions.

Control Activities

From the findings, control activities have greatly affected the institutions' revenue, operation costs and fees income for the last five years as indicated by mean of 3.59, 4.08 and 3.71 respectively. This indicates that control activities have a significant influence on the financial performance of an establishment. Ineffective control activities result in weak internal control systems and poor financial performance and vice versa.

Information and Communication

From the research findings, information and communication procedures, systems and mechanisms have had a significant influence on the institutions of higher learning's revenue, operating costs and fees income over the last five years as indicated by a high mean of 3.27, 3.88 and 4.09 respectively. This indicates that good information and communication systems lead to high institutional revenue, low operating costs and high fees income

REGRESSION ANALYSIS

Table 1: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.991	0.971	0.921	0.785

The table above indicates the model summary. From the findings, R was 0.991, R square was 0.971 and adjusted R squared was 0.921. An R square of 0.991 implies that 99.1% of changes in financial performance of institutions of higher learning in Nairobi City County, Kenya are explained by the independent variables of the study. There are however other factors that influence performance of the institutions of higher learning that are not included in the model which account for 0.9%. An R of 0.991 on the other hand signifies strong positive correlation between the variables of the study.

Table 2: ANOVA

Model	SS	df	MS	F	Significance
Regression	521.04	5	521.4	676.005	0.0942
Residual	261.40	312	0.950		
Total	782.44	317			

From the ANOVA table above, the value of F calculated is 776.005 while F critical is 499.545. Since the value of F calculated is greater than F critical, the overall regression model was significant and therefore a reliable indicator of the study findings. In terms of p values, the study indicated 0.000 which is less than 0.05 and therefore statistically significant.

Table 3: Regression Coefficients

Model	Unstandardized coefficients		Standardized Coefficients	T	Sig
	B	Std Error	Beta		
Constant	7.47	0.674		8.012	0.000
Control environment	0.955	0.022	0.811	14.15	0.00
Risk assessment	0.986	0.033	0.120	11.04	0.000
Control activities	0.875	0.029	0.127	1.15	0.000
Information and communication	0.961	0.031	0.384	4.42	0.000

The resultant regression equation becomes;

$$\mathbf{Y = 7.47 + 0.955X_1 + 0.986X_2 + 0.875X_3 + 0.961X_4}$$

Where: Y is the financial performance of institutions of higher learning in Nairobi City County, Kenya; β_0, β_1, β_2, $\beta 3$ and β_4 are the regression coefficients and $X_{1,}$ X_2, X_3 and X_4 represent control environment, risk assessment, control activities and information and communication respectively.

This implies that when all the variables of the study are held constant, performance of institutions of higher learning in Kenya will be at the intercept which is 7.47. A unit improvement in control environment while all other factors held constant results in 0.955 increase in performance of the institutions, a unit increase in risk assessment with other factors ceteris paribus leads to 0.986 increase in performance of the institutions. Similarly a unit increase in control activities while other factor ceteris paribus, translates to a 0.875 increase in performance of institutions of higher learning in Kenya while a unit increase in information and communication with other factors held constant leads to a 0.961 improvement in financial performance of the institutions.

CONCLUSIONS

The study concluded that the control environment, risk assessment, control activities and information and communication as indicators of internal control systems have a significant influence on the financial performance of the institutions of higher learning in Nairobi City County, Kenya. The variables explained 99.1% of the changes in financial performance of the institutions. A unit improvement in the control environment led to a 0.955 increase in financial performance of the institutions, a unit improvement in risk management practices led to a 0.986

increase in financial performance of the institutions, a unit improvement in control activities transformed to a 0.875 increase in performance of the institutions while a unit increase in use of information and communication systems led to a 0.961 increment in their financial performance.

There existed internal control systems, mechanisms and procedures but the environment was not favorable, poor assessment of risks and control activities and also diligent use of information and communication systems to reliably improve accountability and prudent use of organizational resources.

RECOMMENDATIONS

It was recommended that for the institutions to perform well financially, their internal control systems need to be improved, cultivated and implemented diligently. There is need for the employees responsible for preparation of financial statements and reporting to be transparent and honest and also be held accountable for any misreporting. The officers entitled with the authority to incur and approve expenditure need also to be accountable for every resource utilized and the organization gets value for its investments. The institutions of higher learning also need to improve their capital expenditure to generate income for them and improve their liquidity. There is need to take legal actions for those who have misused organizational funds and recoveries made.

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