

**EFFECT OF INTERNAL CONTROLS ON FINANCIAL PERFORMANCE OF
DEPOSIT TAKING SAVING AND CREDIT COOPERATIVE SOCIETIES IN KISII
COUNTY, KENYA**

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Abstract: *Internal Control Systems play an important role in every firm as it assist in realization of their financial performance goals as well as compliance to the set down laws and regulations. Most SACCOs in Kenya licensed under SASRA as at December 2016, have not met the prescribed minimum institutional capacity adequacy ratio hence risk being suspended due to breach of the compliance law. The study will be of great significance to management of DT-SACCOs in Kenya since it will highlight the major internal controls being adopted by the institutions and their effect on the financial performance of the SACCOs. The main objective of the study was to determine the effect of internal control systems and financial performance of deposit taking SACCOs in Kisii, Kenya. The target population for the study was 10 Deposit Taking SACCOs in Kisii County. The research found out that DT-SACCOs had a functional audit department as well as an audit manual management identifies appropriate objectives for the SACCO as well as risk that affect achievement of those objectives however some respondents felt that their SACCOs did not put in place mechanisms for mitigation of risks. Management did also ascertain fraud related risks. It was evident that the management identified people responsible for coordinating activities of the SACCO, communication helped evaluate how well guidelines and policies are being implemented. However the reporting system for some SACCOs did not spell out the responsibilities of each entity. The coefficient of determination proved that internal controls contributed to 43.3% of the variation in financial performance as explained by adjusted R² of 0.433% which shows that internal controls influence Performance of DT-SACCOs.*

Keywords: *Internal Controls, Financial Performance, Deposit Taking SACCO*

Background of the study

Internal control is a process effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of a firms objectives in the effectiveness and efficiency of operations, reliability of financial and management reporting, compliance with applicable laws and regulations and protect the organization reputation (COSO, 2013).

Despite the fact that internal control system is expensive to install and maintain, it gradually evolved over the years with the greatest development occurring at the beginning of 1940's. Not only have the complexities of the business techniques contributed to this development but also the increased size of business units, evolution

of information technology, legislation and regulatory requirements which have encouraged the adoption of methods which while increasing efficiency of business act as a safeguard against errors and frauds.

The Kenya SACCO sub-sector comprises both deposit taking (FOSA operating SACCOs) and non-deposit taking SACCOs. The general trend is that SACCO start as non-deposit taking Sacco business and grow to deposit taking Sacco business (DT-SACCO) to expand the range of financial services to members. SACCOS that operate front office services are licensed, supervised and regulated by Sacco society regulatory authority (SASRA).

Savings and Credit Cooperative Societies in Kenya

A Savings and Credit Cooperative (SACCO) is a type of cooperative whose objective is to pool savings for the members and in turn provide them with credit facilities (UN-HABITAT, 2010). The general objective of SACCOs is to promote the economic interests and general welfare of its members. Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity. Co-operative members believe in the ethical values of honesty, openness, social responsibility, and caring for others (Bibby& Shaw, 2005).

The pioneers of modern cooperation emerged in working- class environments in European Industrial cities of the 19th Century. In the 1840s, the first to industrialize countries (Great Britain and France), pioneers of co-operative invented models of the consumer cooperative and the labor cooperative to defend and promote the interests of working-class families in the face of the social disasters caused by industrial revolution (Mumanyi,2014)

The second generation of the pioneers of modern cooperation emerged, in certain European rural environments in the late 19th century. In the 1860s, these pioneers created the models of agricultural cooperatives and savings and credit cooperatives inspired by the success of the consumer cooperatives formula in Great Britain and based on old traditions of rural solidarity aimed to meet the primary economic needs, which went unsatisfied. (Mumanyi, 2014).

Agricultural cooperatives then enabled families of farmers and livestock raisers to organize their own supply systems of agricultural inputs and market their products and no longer depended on merchants and businessmen in the cities. The SACCOs helped them to stop depending on moneylenders and to find the credit necessary to modernize their agricultural cooperatives (Mwakajumilo, 2011).

As of December 2016 there were 68,882 credit unions in the world, having a total of 235,762,076 members and a total penetration of 13.55% Penetration rate which is calculated by dividing the total number of reported credit union members by the economically active population age 15-64 years old (World Council of Credit Unions (WOCCU,2016).

In Kenya, Cooperatives are established under the Cooperative Societies Act (Cap. 490). SACCOs in Kenya are currently among the leading sources of the co-operative credit for socio-economic development.

Cooperatives in Kenya were started in 1908. The first cooperative was established at Lumbwa, present day Kipkelion area. In 1944 colonial officers allowed Africans to form and join cooperatives (Gamba & Komo, 2012).

The post-independence era saw the rapid increase the in number of producer organizations and consolidation of the ones that already existed. At this time, the government saw the cooperative movement as a means for

African socialism, and strengthening common ties between the people from different regions of Kenya. In 1963 there were about 1000 cooperatives, which rapidly grew in number since then.

The co-operative movement now every two Kenyans directly or indirectly derives his/her livelihood from the co-operative movement. Over the years, the co-operative movement remained predominantly agriculturally oriented. However, in the recent past, the co-operative movement has experienced significant diversification in activities and interests notably savings and credit. Other non-agro-based co-operatives have also emerged and ventured into areas such as housing; "Jua-Kali", building and construction, handicrafts, transport, small scale industries, etc. (SASRA,2013).

Statement of the problem

The fact that deposit taking Sacco's have continued to lend much more than the deposits that they mobilize continues to hamper their liquidity, as many DT-SACCOs are forced to borrow from external sources in order to meet the shortfall (SASRA Report, 2016). As of 2016 only 169 DT-SACCOs were able to fully maintain the prescribed ratio of core capital to total deposits ratio of 8%, with the rest having ratios of below the prescribed threshold. Only 69 of the 175 deposit taking Sacco in the licensed to operate in the country as of SASRA Report (2016) met and maintained the prescribed minimum Institutional Capital Adequacy ratio of eight per cent, meaning that 106 Sacco's risk being suspended for breaching compliance law. Effective internal controls should ensure that a firm is compliant to the set down laws and regulations.

Objectives of the study

The study was guided by the following objectives

- i. To determine the effect of internal audit controls on the financial performance of DT-SACCOs in Kenya.
- ii. To determine the influence of internal risk assessment controls on the financial performance of DT-SACCOs in Kenya.
- iii. To establish the influence of internal information system controls on financial performance of DT-SACCOs in Kenya.
- iv. To determine the influence of internal corporate controls on the financial performance of DT-SACCOs in Kenya

Research Design

The study used a descriptive research design. The target population for this study was all of the 10 DT-SACCOs licensed to operate in Kisii county as of 2016. The sample of the study was drawn from senior managers from the organizations who mainly comprise the branch managers and other senior managers of the various departments. Data was collected by use of a questionnaire. descriptive statistics included frequencies and percentages while inferential statistics included correlation analysis and regression. Correlation analysis established the association between the variables while a multiple linear regression model was used to test the significance of the influence of the independent variables on the dependent variable.

Findings and Discussion

Response Rate

The study sought to collect data from 60 respondents, a total of 60 respondents responded constituting 100% of the respondents’ rates. The study was carried out to establish the effect of internal controls on the financial performance of deposit taking SACCOs in Kisii county Kenya.

Descriptive Statistics

Descriptive statistics are concerned with explaining the sample of data that the researcher is concerned with. They are used to describe the main features of a collection of data quantitatively below are the findings

Functionality of Internal Controls Of DT-Saccos In Kisii Kenya

The respondents were requested to determine the extent of functionality of internal controls in the following aspects of financial performance in a five point Likert scale. The range was „strongly agree extent“ (5), „disagree“ (1). The scores of „strongly agree “ and to disagree ;“ were taken to present a variable which had an effect to a small extent (S.E) (equivalent to mean score of 0 to 2.5 on the continuous Likert scale ;($0 \leq S.E < 2.4$). The scores of „to agree ;“ was taken to represent a variable that had an effect to a moderate extent (M.E.) (equivalent to a mean score of 2.5 to 3.4 on the continuous Likert scale: $2.5 \leq M.E. < 3.4$). The score of „neutral; and very great extent“ were taken to represent a variable which had an effect to a large extent (L.E.) (equivalent to a mean score of 3.5 to 5.0 on a continuous Likert scale; $3.5 \leq L.E. < 5.0$). A standard deviation of > 1.5 implies a significant difference on the effect of the variable among respondents.

Internal Audit

The researcher examined the effect of internal audit controls on the financial performance of deposit taking Sacco’s in Kenya, below are the findings

Table 1: Internal Audit

Descriptive Statistics	N	Mean	Std. Deviation
Our sacco has a functional audit department	60	5.00	.000
Audit is completed on a timely basis	60	4.87	.352
Management closely monitors implementation of ICS	60	4.47	.640
Has an audit manual that guides audit operations	60	5.00	.000
Audit findings are directly reported to top management and audit committee	60	4.67	.488
Internal audit recommendations are taken seriously by the organization	60	4.60	.507
Internal audit department conducts its work independent of the management	60	4.87	.352
Valid N (listwise)	60		

From the findings are the firms under study had a functional audit department as well has an audit manual that guides audit operations. However, audit was seen to not be completed on a timely basis for some Saccos evident by (M=4.87, SD=0.352), on weather management closely monitored implementation of ICS (M=4.47, SD=0.640), internal audit recommendations were taken seriously by the organization (M= 4.60, SD=0.352). From the findings above, it is evident that DT-SACCOs observe internal audit as one of the

functionality of internal controls of organization that greatly impacts on the financial performance of DT-SACCOs in Kenya.

Risk Assessment

The researcher examined the effects of risk assessment as functionality internal controls of the organization affects the financial performance of DT-SACCOs in Kisii Kenya. Below are the results of the findings

Table 2: Risk Assessment

	N	Mean	Std. Deviation
management has defined appropriate objectives for the60 SACCO		4.87	.352
management identifies risks that affect achievements of the60 objectives		4.73	.458
Management has a criteria for ascertainment of which fraud60 related risks are most critical		4.27	.594
Management has put in place mechanisms for mitigation of60 critical risks		4.33	.724
Management effectively communicates risks to the60 employees and the shareholders		4.33	.724
The SACCO has adequately implemented any inspection60 plans to reduce the inherent risks		4.53	.743
Management uses instruments for risk transfer	60	4.73	.458
Valid N (listwise)	60		

From the above findings, it was observed that most of the DT-SACCOs carried out regular risk assessment procedures. From the results, DT-SACCOs defined appropriate objectives for the organization, this had (M=4.87, S.D=.352), the management identifies risks that affect achievement of the objectives (M=4.73,S.D=.458), the management has a criteria for ascertainment of which fraud-related risks to the organization are most critical had (M=4.27, S.D=0.594), the management has put in place mechanisms for mitigation of critical risks that may result from fraud had (M=4.33, S.D=0.724).It was also established that the management had put in place mechanisms for mitigation of critical risks that may result from fraud. These results are clear indication that most DT-SACCOs under study observed risk assessment procedures as functionality of internal control of the DT-SACCO firms.

Information and Communication System

The study sought to establish the effect of information and communication on financial performance of DT-SACCOs in Kisii, Kenya. The results of this analysis are as provided below in table 3.

Table 3: Information and Communication

	N	Mean	Std. Deviation
management has identified individuals who are responsible for co-coordinating various activities within the SACCO	60	4.87	.352
all employees understand the importance and concept of IC including the division of responsibility	60	4.60	.507

communication helps to evaluate how well guidelines and policies of the SACCO are working and being implemented	60	4.80	.414
the reporting system on entity structurers spell out all the responsibility of each unit	60	3.47	1.516
Valid N (listwise)	60		

From the above findings, it was revealed that information and communication was carried out regularly by DT-SACCOs. The findings revealed that information communication was conducted by DT-SACCOs as a functionality of internal control. The findings to a large extent exhibit that most manufacturing firms identified individuals who are responsible for coordinating the various activities within the entity (M=4.87, S.D=.352), the employees understand the concept and importance of internal controls including the division of responsibility (M=4.60, S.D=.507). Communication helps to evaluate how well guidelines and policies of the organization are working and being implemented (4.80, S.D=.414).The study concluded that most DT-SACCOs especially large asset sized implemented information and communication in their activities and functions through established policies and procedures.

Corporate governance

The study sought to establish the effect of corporate governance on financial performance of DT-SACCOs in Kisii Kenya. The following are the findings.

Table 4: Corporate Governance

	N	Mean	Std. Deviation
succession, planning and remuneration of the board of directors and issues of significant interest	60	4.73	.458
the SACCO has a well-developed policy on conflict of interest and procedures on how to handle any conflict of interest cases that may arise	60	4.60	.632
different members of the board bring unique experiences and expertise to the management of the SACCO	60	4.27	1.033
the SACCO has a well-established and effective board	60	4.53	.743
Recruitment of board members is approved by the shareholders during the AGM	60	4.67	.488
the SACCO has a well-established policies and procedures that guide the affairs of the SACCO	60	4.53	.640
Valid N (listwise)	60		

From the above findings, succession, planning and remuneration of board of directors was done by the DT-saccos under study (M=4.27, SD=0.458) The saccos had well established policies and procedures that guide the affairs of the sacco (M=4.53,SD=0.640) the SACCOs had well developed policy on conflict of inters and procedures on how to handle any conflict of interest cases that may rise from time to time (M= 4. 60 ,SD=0.632). The SACCCOs had well established corporate policies (M-4.67, SD= 0.488). Different members of the board had unique expertise and experiences (M=453, SD=0.640). The findings show that the organizations incorporated corporate governance as a functionality of internal control system.

Regression Analysis

A study was conducted on the relationship between internal control and financial performance of DT-SACCOs in Kenya, the analysis applied the statistical package for social sciences (SPSS) to compute the measurements of the multiple regression for the study. The study evaluated the independent variables and the dependent using questioners, the findings are below.

Model summary

The model summary shows the summary of the regression analysis as shown in the regression model below

Table 5: Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Change	Square Change	F Change	df1	df2
1	.666 ^a	.443	.221	.456	.443	1.991	4	10	.172

In order to explain the percentage variation in the dependent variable financial performance as explained by the independent variables, the researcher used coefficient of determination that was obtained from the model summary in the table 1 coefficient of determination was used to explain that the model is a good predictor.

From the above findings of table 5, R2 was 0.443 implying that 43.3% of the dependent variable (financial performance) was explained by the independent variables while 56.7% of variations were due to other factors not in the study.

Analysis Of Variance

The study conducted an Analysis of Variance in order to test the impact of the relationship between internal controls and financial performance of deposit taking SACCOs in Kisii Kenya. The findings were as shown below.

Table 6: ANOVA^a

Model		Sum Squares	ofdf	Mean Square	F	Sig.
1	Regression	1.655	4	.414	2.991	.172 ^b
	Residual	2.078	10	.208		
	Total	3.733	14			

ANOVA statistics of the processed data at 5% significance shows that the value of calculated F is 2.991 and the value of F critical at 5% level is 2.62 since F calculated is greater than the F critical (2.991>2.62), this shows that the overall model was significant.

Test for Coefficients

The table below shows the level of significance on the variables. it also provides the standard and unstandardized coefficients as shown below.

Table 7: Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	5.575	1.355		4.114	.002
Internal audit	.341	.417	.422	.817	.043
1 Risk Assessment	-.642	.232	-.900	-2.772	.020
Information and communication systems	-.257	.442	-.257	-.581	.057
Corporate Governance	.302	.291	.374	1.036	.034

Dependent Variable: asset turnover in SACCO over the last 5 years has been increasing steadily due to good performance

From the above table, the researcher sought to establish the extent to which internal control impact on financial performance of DT-SACCO. The following regression equation was obtained

$$FP = 0.341X_1 + 0.642X_2 + 0.257X_3 + 0.302X_4$$

From the above regression model holding all the other factors constant, financial performance is measured by the efficiency and effective implementation of internal controls. The results of the multiple linear regression model shows that there is a positive relationship between internal controls and financial performance of DT-SACCOs in Kisii Kenya. This implies that a single increase in any of the independent variable results into a corresponding increase in financial performance of the firms.

The regression analysis was taken under 5% significance level. The criteria for comparing whether the predictor variable were significant in the model was through comparing the corresponding probability value and $\alpha = 0.005$. if the probability value was less than α , then the predictor variables was significant but from the above analysis the results above shows that the variables were significant since their corresponding predictor Values were below 5% apart from information and communication which had 5.7% meaning that an inverse relationship existed between internal control and financial performance of DT-SACCOs in Kisii, Kenya.

Summary

The first objective of the study was to access the effect of internal audit controls on the financial performance of DT-SACCOs, the study found out that: all the firms under study had a functional audit department as well as an internal audit manual that guides audit operations. it was also evident from the study that audit is usually completed on a timely basis as well as he audit department conducted its work independently. However management for some SACCOs the management did not closely monitor implementation of internal control systems

The second objective of this study was to assess the effect of internal risk assessment of the financial performance of DT-SACCOs in Kenya. The results indicate that risk assessment exists among deposit taking savings and corporative societies. The study found out that risk assessment measures taken by the DT-SACCOs are defining appropriate objectives for the SACCO ,identify risks that affect achievement of the objectives as well as use of instruments of risk transfer such as sharing with other organization .the results also showed that management did not put in place mechanisms for mitigation of critical risks that may result from fraud as well

as management did not have a criteria of ascertainment of which fraud related risks to the SACCO are most critical.

The third objective of the study was to ascertain the effect of information and communication systems on the financial performance of DT-SACCOs, from the findings most respondents agree that their firms had identified individuals who are responsible for coordinating various activities of the SACCO. All employees understood the concept and importance of internal controls.

However it was evident that the reporting system on entity structures did not spells out all the responsibilities of each entity

The fourth objective of the study was to assess the effect of corporate governance on the financial performance of DT-SACCOs from the findings it was evident that most firms had a well-established board of directors, recruitment and appointment of board of directors was approved by the shareholders during the annual general meeting .however it was also determined from the findings that some of the DT-SACCOs did not have a well-established corporate governance policies and procedures that guided the affairs of the SACCO.

Conclusions

From the findings of the study, it is evident that SACCOs which have effective internal controls have relatively stronger and better financial performance unlike those which are not keen to implement internal controls based on information and communication as well as risk assessment.

Large asset sized DT-SACCOs that fully invested in strong internal control systems were able to mitigate fraud. Based on the study findings, the results indicated that some small asset sized SACCOs faced challenges in effective implementation of internal control systems due lack of sufficient resources to hire competent staff and to invested in modern technologies for example information communication technology. The findings of the study found that internal audit had a significant positive relationship with financial performance indicators. Similarly the other variables for internal risk assessment, information communication technology and corporate governance was also found to have a positive relationship with financial performance of DT-SACCOs in Kenya apart from information and communication systems that revealed a negative relationship with financial performance of DT-SACCOs

Recommendations

Internal audit

The study showed that most of the SACCOs have adopted internal audit function .in light of the findings the researcher recommends that the management should closely monitor and the implementation of the internal control systems. This will help ensure ascertainment and mitigation of critical risks that may result from fraud.

Risk assessment controls

As regards to the second objective which was to determine the influence of risk assessment on financial performance of DT-SACCOs the study recommends that the management should always put in place mechanisms to enable it identify risks that affect achievement of the firms objectives as well as mitigation of such critical risks.

Information systems

Based on the third objective which was to determine the influence of information systems on financial performance of DT-SACCOs, the study recommends that the management should ensure that it receives

timely, relevant and reliable reports for decision making and that all relevant and reliable reports from decision making and that all relevant information is communicated to all staffs, and that there is a quick flow of information in time. This will enable them to communicate to all staffs and stakeholders on time.

Corporate Governance

As regards to the effect of corporate governance on financial performance of DT-SACCOs, the study recommends that shareholders should appoint members of the board with unique experiences and expertise, this will ensure that that the help ensure that management does not override the internal controls and help in enhancing performance of the deposit taking SACCOs.

Suggestions for Further Study

Due to the turbulent nature of the business environment a similar study should be conducted after a period of ten years in order to investigate whether there are any areas of commonalities or unique factors this is because the level of technology is very dynamic and keeps on changing.

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