

Effect of Internal Control Environment on Financial Performance of Public Organisations in Kenya

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Abstract

A conducive internal control environment ensures that there are procedures adhered to and this minimizes financial risks in the institutions. This study focused on establishing the effect of internal control environment on the financial performance of public organisations. Control environment is the key feature of managing an organization. This is because it is a deliberation of the attitude and the policies of management in respect with the significance of internal audit in the economic unit. The study adopted descriptive research chosen because the study aimed at collecting information from respondents in relation to effects of internal control environment on financial performance of public organizations in Kenya. Data collected was collected with a questionnaire and analyzed using descriptive statistics which includes percentages, means, standard deviations and frequencies. The findings revealed that control environments affect the financial performance of public organizations in Kenya to a great extent. The study concluded that there is a significant effect of control environments on the financial performance of public organizations in Kenya and recommend that public organizations should ensure they have effective control environment and ensure that they establish relevant policies to ensure that their internal control environment is effective to enhance the financial performance of public organizations.

Keywords: Internal Control, Environment, Financial Performance, Public Organisations

Introduction

The internal controls environment includes an organization's implemented rules, policies and measures that deliver practical assurance that: an organization's financial reports are dependable, its operations are effective and proficient and that all its activities conform to valid laws and regulations (Tunji, 2013). According to the Committee of Sponsoring Organizations of the Treadway Commission (COSO, 2013) framework, internal control is a procedure, effected by a firm's board of directors, management and other staffs and is envisioned to provide reasonable assurance of accomplishment of goals in the following categories: 1). Efficacy of operations, 2). dependability of financial reporting, 3). conformity with appropriate laws and regulations. The COSO (2013) framework recognizes five main fundamentals of internal control systems upon which the evaluation should take place. The framework consists of control environment, risk valuation, control undertakings, information & communication, and monitoring. There is a common expectation that establishment and implementation of accurate internal

control systems will always lead to enhanced financial performance (Hayali, Dinç, Sarıl, Dizman&Gündoğdu, 2011).

Statement of the problem

Having and effective environment for internal control systems in organizations has been insistently and vastly emphasized, owing to its potential effect on financial performance (Crawford, 2011). A conducive internal control environment ensures that there are procedures adhered to and this minimizes financial risks in the institutions. Posthuma (2013) argues that internal control environment has been so significant to public organization especially in the aspect of assurance of the reliability and accuracy of the financial reports. Similarly, according to Verdina (2011) internal control environment provides a basis for establishing a solid control framework in organizations, and by the controllers of the public sector as a means for assessing the internal control system. From the foregoing, this study establishes the effect of internal control environment on the financial performance of public organisations in Kenya.

Objective of the study

To determine the effect of internal control environment on the financial performance of public organizations in Kenya.

Scope of the Study

The study was conducted across government/public organizations with an aim of establishing how the internal control environment affects the financial performance in public organisations.

Literature review

This study adopted the systems theory which was propounded in the 1940s by a biologist Ludwig von Bertalanffy and advanced by Ross Ashby in his study “Introduction to Cybernetics” in 1956 (Keraro, 2014). Bertalanffy (1968) emphasized that real systems were open to, and interact with, their environments, and that they can acquire qualitatively new properties through emergence, resulting in continual evolution. He argued that rather than reducing an entity or organization to the properties of its parts or elements, systems theory focused on the arrangement of and the inter-relations between the parts which connect them into a whole. Such an organization determined a system that is independent of the concrete substance of the elements (for example, the various departments such as finance, accounting, human resources, research and development). Thus, the same concepts and principles of organization underlie the different disciplines, providing a basis for their unification.

Hartman (2010) observed that the systems theory provides a leader with a tool for analyzing organizational dynamics without providing a specific theory about how an organization should be

managed. He also observed that with the recognition of systems theory, all organizations consist of processing inputs and outputs with internal and external systems and sub-systems helpful in providing a functional overview of any organization. Smit and Cronje (2002) observed that a system is a collection of parts unified to accomplish an overall goal. If one part of the system is removed, the nature of the system is changed as well. The effect of the systems theory in management is that managers look at the organization from a broader perspective. Systems theory has a new perspective for managers to interpret patterns and events in the work place (Keraro, 2014). They recognize the various parts of the organization, and the interrelations of the parts, for example, the coordination of central administration with its programs, supervisors, and workers, among other variables (Smit & Cronje, 2002).

Control Environment and Financial Performance

Bates (2011) deliberates the factors linking to the control environment to consist of; the veracity, moral values, and proficiency of employees and management, management's beliefs and operational style, the method in which authority and duty are distributed, the organization and growth of employees, and the devotion and trend of the board of directors towards organizational success. The control environment starts with the board of directors and management, who regulate the attitude of an organization via policies, behaviors and actual governance (Theofanis, 2011). If the attitude set by management is lax, then fraudulent financial reporting and performance is more likely to occur. Control environment is the key feature of managing an organization. This is because it is a deliberation of the attitude and the policies of management in respect with the significance of internal audit in the economic unit. It has power over organization goals achievement. However, it is the basis for the other mechanisms of internal control and providing structure (Sudsomboon&Ussahawanitchakit, 2009).

Control environment contributes toward decreasing the level fraudulent activities within organizational operation also the value of an entity's internal controls system is contingent on the purpose and value of their control environment (Amudo& Inanga, 2009). Consequently, providing an appropriate control environment for a local government is very vital to the efficiency of their operation. All these activities help the board and management control risks that could adversely affect the company's operations and results (Colbert & Bowen, 2009). The policies that direct these control activities should also provide that the company personnel who are responsible for these control activities do not evaluate their own work in these areas.

Research Methodology

This research design adopted descriptive research chosen because the study aimed at collecting information from respondents in relation to effects of internal control environment on financial

performance of public organizations in Kenya. The target respondents were drawn from the public organizations in Kenya. The target population comprised of the 187 public organizations in Kenya. Simple random sampling method was used to sample 56 per cent respondents in the selected corporations. The study used a questionnaire to collect data from the respondents and secondary data was collected from published material, annual reports, and published data. Data collected was analyzed by the use of descriptive statistics which includes percentages, means, standard deviations and frequencies. To quantify the strength of the relationship between the variables, the researcher conducted a regression analysis.

The regression equation was:

$$Y = \beta_0 + \beta_i X_i + \varepsilon$$

Data Analysis, Presentation, and Interpretation

The response rate achieved for the questionnaire was 86.0%. This response rate was a representative and conforms to Mugenda and Mugenda (2012) stipulation 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.

For the study objective was to establish the effect of control environment on financial performance of public organizations in Kenya. In this respect the respondents were required to rate the extent to which control environment influence the financial performance of their organizations. According to the results shown in Figure 1, 47% of the respondents indicated that control environment influenced the financial performance of their organizations to a great extent, 42% of the respondents to a moderate extent, while 11% of the respondents to a little extent. It is clearly depicted in the results that there is a significant influence of control environments on the financial performance of public organizations in Kenya.

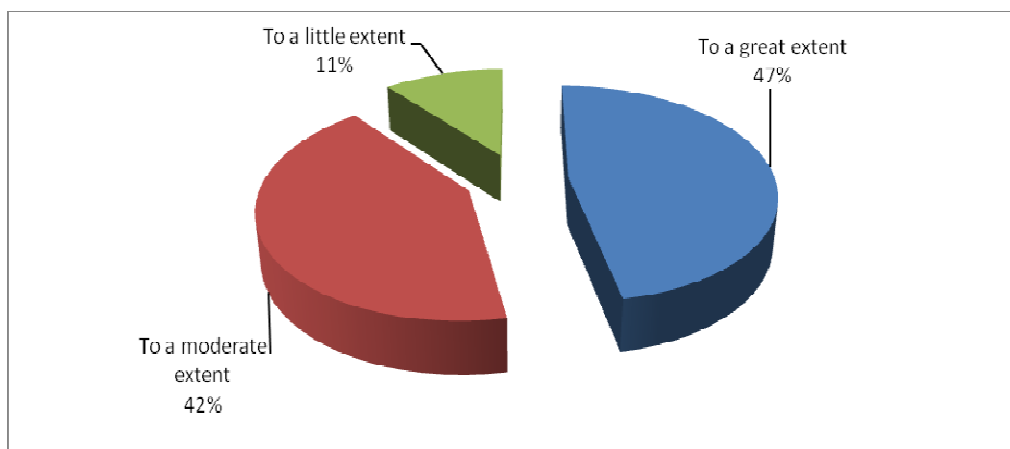


Figure 1: Control Environment on Financial Performance

The respondents were further required to indicate the extent to which various aspects of control environment influenced financial performance in their organizations. The results obtained are presented in Table 1.

Table 1: Aspects of Control Environment

Aspects of control environments	No extent	Little extent	Moderate extent	Large extent	Very large extent	Mean	Std. Dev.
Control policies,	0	5.2	43.8	46.9	4.2	3.5000	0.6649
Control procedures	0	21.2	21.2	34.6	23.1	3.5962	1.0711
Control methods	0	17.6	26.9	47.2	8.3	3.4630	0.8799

In this section, the calculated weighted mean is rounded off to the nearest whole number and the result counter-checked against the matching number in the key provided. Accordingly, majority of the respondents reported that control procedures influenced financial performance of their organizations to a great extent as shown by a mean score of 3.5962 as well as control policies shown by a mean score of 3.5000. The results further showed that control methods influenced financial performance of their organizations to a moderate extent as shown by a mean score of 3.4630. These results reveal that control environment aspects of policies, procedures, and methods have the potential of determining the financial outcome of different activities undertaken by public organizations in Kenya.

The study also sought to establish the extent to which the respondents agreed with various statements with regard to control environment in their organizations. A scale of 1 to 5 was provided where 5= Strongly Agree, 4 = Agree, 3 = neutral/undecided, 2 = Disagree and 1 = Strongly Disagree.

Table 2: Statements on Control Environment

Statements on control environment	Strongly disagree	Disagree	Neutral	Agree	Strongly agree	Mean
The public organizations’ internal control structure is based on the division of labor.	0	7.5	34.3	44.8	13.4	3.6410
Control environment reflect the control policies of the public organizations.	0	3.7	38.9	38.9	18.5	3.2960
The control environment assist toward reducing the level fraudulent activities within organizational operation	0	3.1	49.0	43.8	4.2	3.4940

The quality of an entity’s systems of internal controls depend on function and quality of their environment control	0	13.4	28.4	47.8	10.4	3.5520
The control methods are updated regularly to include specific controls to be performed	0	3.6	48.2	42.0	6.3	3.5130

According to the study results, majority of the respondents concurred that the public organizations’ internal control structure is based on the division of labor as shown by a mean score of 3.6410, the quality of an entity’s systems of internal controls depend on function and quality of their environment control as shown by a mean score of 3.5520 and that the control methods are updated regularly to include specific controls to be performed as shown by a mean score of 5130. On the other hand, the respondents indicated neutrality on that the control environment assist toward reducing the level fraudulent activities within organizational operation as shown by a mean score of 3.4940 and that control environment reflect the control policies of the public organizations as shown by a mean score of 3.2960. From these results, strong and effective control environment system has the potential of strengthening governance, help in achievement of set goals and objectives by the management and risk mitigation.

Table 3:Regression Coefficients

Model	Unstandardized Coefficients	Standardized Coefficients			Sig.
		B	Std. Error	Beta	
(Constant)		1.376	.415		3.316 0.002
Control environment		.289	.070	.301	4.146 0.032

The coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable that is explained by independent variables. The regression model established becomes:

$$Y = 1.376 + 0.289X_1$$

The regression equation above has established that holding all factors (control environment, risk assessment, task control and monitoring and evaluation) constant at zero financial performance of public organizations in Kenya will be 1.376. The findings presented show that a unit increase in ICS

environment would lead to a 0.289 increase in the scores of financial performances of public organizations.

Summary of Findings, Conclusions and Recommendations

The study sought to determine the effect of internal control environment on financial performance of public organizations in Kenya. The study revealed that control environments affect the financial performance of public organizations in Kenya to a great extent. The study found that control procedures and control policies affect the financial performance of public organizations to great extents, while control methods affect the financial performance of public organizations to a moderate extent. There was affirmation on that the public organizations' internal control structure is based on the division of labor, the quality of an entity's systems of internal controls depends on function and quality of their environment control and that the control methods are updated regularly to include specific controls to be performed. However, there was detachment on that the control environment assist toward reducing the level fraudulent activities within organizational operation and that control environment reflect the control policies of the public organizations.

The study concludes that there is a significant effect of control environments on the financial performance of public organizations in Kenya. And recommends that public organizations should ensure there they have effective control environment and ensure that they establish relevant policies to ensure that their internal control environment is effective to enhance the financial performance of public organizations. As such, policies and procedures should be periodically reviewed by the board to ensure that appropriate control environment has been established. There is need to intensify control environment measures to curb fraud and misappropriation of resources in the public sector.

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