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An Assessment of Internal Control System on Financial Performance in Tertiary Training Institutions in Kenya: A Case Study of African Institute of Research and Development Studies

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Abstract: ***The study was guided by the Agency Theory to test empirically the effects of internal control on financial performance in tertiary institutions in Kenya. The study used a case study research design. The target population of the study comprised all the employees of the institution who totalled 68 and due to the finite number census was used. Data was collected using structure questionnaires. The data was subjected to analysis by the aid of Statistical Package for Social Science (SPSS) using simple descriptive methods such as percentages, means, median, mode and standard deviations. Further, to assess the nature and strength of relationship between the independent variables and dependent variable, the Pearson's Product Moment Correlation Coefficient (PPMC) was used. The findings showed that the institutions Internal Audit Department was not sufficiently staffed. It was recommended that The Internal Audit Department should be sufficiently staffed and the recruitment process of the auditors should be free from the management influence.***

Keywords: Internal Control System, Internal Audit, Financial Performance, Tertiary Institution.

1. Introduction

Worldwide organizations have been faced with both internal and external forces that require initiative to remain competitive and relevant. According to Sagwa [4], most organizations have minimum internal control over external factors. Such organizations only remain with one appropriate solution, which is creation of Internal Control. There is a common belief that organizations that institute and enforce proper Internal Control will have and lead to improved financial performance. It is also a general perception that properly instituted systems of internal control will always enhance financial reporting process, which will ultimately lead to reliable reports being produced, which willin turn enhance the accountability role of management of an enterprise. Despite the institution of strong Internal Control, available literature still alludes that, in organizations, financial performance is and has been elusive.

In the study, Internal Control is construed to mean, a process effected by the entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the categories; reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations [3].

The study was guided by The Agency Theory as initially put across by Jensen and Meckling, [2] and later expounded on by Sarens and Abdolmohammadi [6]. An agency relationship is defined as one in which, one or more persons, the principal(s) engages another person, the agent, to perform some services on their behalf, which involves delegating some decision- making authority to the agent [2].

In Kenya, many learning institutions are faced with financial challenges due to mismanagement of funds. Despite having a sizeable population of youth who have enrolled in tertiary institutions, many institutions end up closing shop or are merely surviving due to inability to meet their financial obligations [5]. The study mainly centered on middle level colleges, herein referred to as Tertiary Institutions, which cater for form four (4) school leavers who did not attain the minimum grade to be admitted directly to the university or those waiting to join the university and the working class who want to sharpen their skills for both career and self-development.

2. Statement of the Problem

Many middle level colleges in Kenya herein referred to us tertiary institution 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. It is not strange to hear of Tertiary Institutions which are unable to pay their staff in good time or staff salaries are in arrears for several years. For some, servicing their bank loans as per the agreement with financial institutions is problematic besides difficulties to pay for their suppliers when they are due. The situation has led to a number of tertiary institutions operating on bank overdrafts, which adds to the financial burden because of the relatively higher cost of borrowing. The study, therefore, endeavoured to investigate the persistent poor financial performance from the perspective of internal controls which had hitherto been ignored.

3. Research Objectives

3.1 General Objective

The general objective of the study was to establish the relationship between internal control and financial performance in Tertiary Institutions in Kenya.

3.2 Specific Objectives

To analyse the effectiveness of internal audit that African Institute of Research and Development uses in the internal control initiative

4. Research Questions

What measures do the internal audit department take to ensure that internal controls established by the management of African Institute of Research and Development are being adhered to by all staff?

5. Conceptual Framework

The conceptual framework is shown in figure 1.

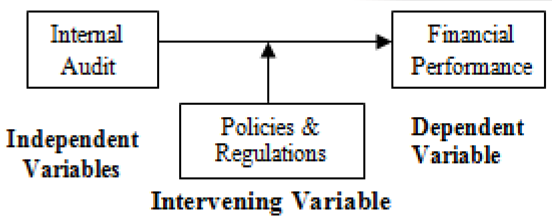

Figure 1: Conceptual Frame work

6. Literature Review

6.1 The Agency Theory

Agency Theory describes firms as necessary structures to maintain contracts, and through firms, it is possible to exercise control which minimizes opportunistic behaviour of agents. Accordingly, Berle and Means [1] posited that 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. They further explained that the relationship is further strengthened by the principal employing an expert to monitor the agent.

Internal control is one of many mechanisms used in business to address the agency problem. Others include financial reporting, budgeting, audit committees, and external audits [2]. Their argument assumed that providing this additional information to the principal (shareholder) about the behavior of the agent (management) reduces information asymmetry and lowers investor risk and, therefore, the cost of equity capital.

7. Research Methodology

This study employed a case study design. The target population for the study was the administration and teaching staff at the African Institute of Research and Development Studies in Eldoret town. The staff was estimated to be 68 in total. Thus a census of all the staff was conducted.

7.1 Research findings

7.1.1 Internal Audit

The researcher sought to establish the existence of an internal audit department in the institutions under study. He purposed to find out about the staffing and other pertinent issues regarding internal auditing.

Table 1: Internal Audit

	N	Min	Max	Mean	Std. Dev
Institution has Internal Audit Department	51	3	5	3.8431	0.61229
Internal Audit Sufficiently Staffed	51	1	3	2.0784	0.65858
Internal Audit Staff Conduct Regular Audit Activities	51	2	4	2.7843	0.80781
Internal Audit Report Address Weaknesses in Internal Control System	51	1	5	2.9312	1.02785
Internal Audit Reports Produced Regularly	51	1	4	2.6667	0.90921
Internal Auditor Performs Duties with Greater Degree of Autonomy & Independence form Management	51	1	4	2.2157	1.10116

With the proposition 'Institution has Internal Audit Department' returning a mean of 3.8 and the smallest deviation at 0.6, it would be very rational to assert that the respondents agreed that their institutions indeed had an internal audit department. Interestingly none of the respondents under the study thought otherwise given than none of them returned 'disagree' and/or 'strongly disagree' responses. However, with a mean inclined towards 2 (disagree) respondents were largely of the view that their respective institution's audit departments were substantially understaffed.

Moreover, most of the respondents (mean of 2.2) believed that the internal auditors were not autonomous in their work and as such they were interfered with especially by the management. Given that the same proposition had the largest deviation at 1.1, meant that though there was averagely admission to the interference of the internal auditors' work, few respondents especially the managers gave extremely contrary viewpoints such as there was absolutely no such interference with the internal auditors' work. Nonetheless, respondents were to a great extent "not sure" whether regular audit activities were done regularly, internal audit reports addressed weaknesses in internal control system and whether internal audit reports were produced regularly. These arguments are supported by the fact that the findings returned a mean which was inclined towards 3 (not sure).

The researcher also sought to examine the relationship between the various Internal Audits' propositions and financial performance of the institutions under the study. The findings of the study are illustrated in Table.2.

Table 2: Relationship between Internal Audit and Financial Performance

		Institution has Enough Cash to Meet its Obligations (Financial Performance)
Institution has Internal Audit Department	Pearson Correlation	.061
	Sig.(2-tailed)	.672
	N	51
Internal Audit Sufficiently Staffed	Pearson Correlation	.202
	Sig.(2-tailed)	.155
	N	51
Internal Audit Staff Conduct Regular Audit Activities	Pearson Correlation	.028
	Sig.(2-tailed)	.845
	N	51
Internal Audit Report Address Weaknesses in Internal Control System	Pearson Correlation	.262
	Sig.(2-tailed)	.063
	N	51
Internal Audit Reports Produced Regularly	Pearson Correlation	.118
	Sig.(2-tailed)	.409
	N	51
*. Correlation is significant at the 0.05 level (2-tailed).		
**. Correlation is significant at the 0.01 level (2-tailed).		

According to the study findings as outlined in Table 2, the relatively strong relationship ($r = 0.262$) was between the statement 'Internal Audit Report Address Weaknesses in Internal Control System' and 'financial performance'. This meant that the respondents opined that reports of internal auditing addressed internal control system's weaknesses which would enhance institution's financial performance. There was a significant belief ($r = 0.202$) that staffing of the internal audit department determined financial performance of the institution in question.

8. Summary, Conclusions and Recommendations

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 (about 75%) were of the view that indeed there was a relationship between internal control and financial management. In this light, therefore, the institutions that had entrenched prudent internal control strategies were most likely to manage their finances better hence meeting their financial and other pertinent obligations almost seamlessly.

The study concludes that most training institutions had an internal audit department which was largely understaffed. The researcher concluded that staffing of the internal audit department determined financial performance of the institution in question. However, the staff in this department could not work expeditiously due the management interference. The recruitment of these staff was highly determined by the institution's managers who wielded a lot of control over them hence lack of autonomy of the former.

The study recommended that training institutions should not only establish an Internal Audit Department but also ensure that it is adequately staffed. The recruitment of the internal auditing staff should be overboard and possibly should be conducted by independent human resource agencies. This would consequently ensure that the management interference with the auditors' work is hugely minimized and possibly completely eradicated, thus minimizing the weakness in the Internal control System.

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Ndiwa. G. Chebungwen received B.com (hons). and M.B.A degrees Finance option from Kabarak university in 2011 and Jomo Kenyatta University of Agriculture and Technology (yet to graduate) in June 2013, respectively. He is a certified public accountant. He has worked at Kenya school of law as an Internal Audit officer. Currently works with the Judiciary of Kenya as an Accountant.