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Effect of Internal Control Systems on Financial Performance of Selected Commercial Banks in Selected Counties in Kenya

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Abstract- Internal control systems in every organization are paramount., both profit and not-for-profit organizations. The trend of many banks in Kenya collapsing puts into question the ability of the internal control systems to steer the commercial banks stability and performance. The recent failures have put pressure on the industry regulators and players to rethink how best the institutions can align their internal control systems and compliance as tools of ensuring stability and positive performance. This study assesses the effect of internal control systems on financial performance of selected commercial banks in selected counties in Kenya. The researcher adopted correlation research design. Using questionnaires, the study collected primary data from the fifteen selected commercial banks Bomet and Kericho Counties; distributing the questionnaires to 19 branch managers, 13 assistant managers, 09 credit managers and 45 tellers making a total of 86 target respondents for this study. The findings of the study are beneficial to commercial banks from where the data was collected, as various important recommendations touching on internal control systems are made.

Index Terms- Commercial Banks, Control Environment, Financial Performance, Internal Control Systems, Risk Assessment

I. INTRODUCTION

Banking organizations all over the world operate under rules, policies and guidelines which direct them to achieving their financial and non-financial goals. Those rules are formulated inside the banks by management while other policies and guidelines are initiated by other governing laws such as the Companies Act prevailing in every country. Rules that are instituted within the banks and other organizations are known as internal controls.

As defined by Internationally Organized Supreme Auditing Institutions (INTOSAI) (2004), Guidelines relating Internal Standards of Control targeting the public sector defines internal control as an important process that is initiated by the management

of an entity and personnel which is devised to manage risks as well as to provide such reasonableness and assurance as to orderliness in execution, fostering ethics, acting economical, operating with efficiency and effectiveness, being accountable to obligations, being compliant to laws applicable as well as regulations and keeping resources safe against theft, damage and misuse. All these assurances are directed towards improving performance of organizations. INTOSAI (2004), recognizes the five types of control systems in an organization and they are monitoring of activities, assessment of risk, control environment, Control activities as well as information and communication. AICPA (1949), defines internal control as the steps and harmonized methods of an organization as well as measures applied within a concern to keep safe its assets, ensure its accounting data is accurate and reliable, promoting efficiency in operations and encouraging compliance to written management policies. ISA 315 defines the systems of internal control as the management policies as well as procedures, that's, internal controls applied by the management of a concern to assist in realizing management's objectives of ensuring in as far as practicable, the orderliness and efficiency in conduct of its business operations, complying with policies by management, keeping the assets safe, preventing and detecting of fraud and error, keeping the accounting records accurately and complete and preparing timely and reliable accounting information.

Certified Accountants of Kenya follow ISA 315 while undertaking their professional work from time to time. ISA 315 which explains the standards on identification as well as assessment of risks relating to significant and material misstatement by understanding the organization with its environment, states that internal controls of a going concern need to be understood by auditors. To obtain some assistance through this process, ISA 315 provides with the five constituents of an internal control system: the control environment, the entity's assessment of risk, the information and communication system, control activities and the monitoring of controls.

Commercial banks and other companies have measures, rules, policies and guidelines that do support internal operations as to

drive those organizations towards achieving their strategic plans and objectives they have set. Commercial banks in Bomet and Kericho Counties comply with prudential guidelines set by the main bank of Kenya (CBK) in line with the Act governing the banks Cap 488. ISA 315 applies to all the banks in the region. The National Bank in its Financial Report for the year ended 2017 coined that the internal control system's main objective for banks is to continuously check the banking practices and operations to ensure they are compatible with international auditing standards, banking laws, regulations and rules to solve problems that may arise where necessary.

Corporate governance is becoming the first concern of the board in exercising its authority because it is accountable and make reports to all shareholders as well as stakeholders of the bank concerning the systems, controls and procedures which they have established and are in place to safeguard and protect their interests and investment in according to the highest corporate governance standards prevailing. The board of directors of the banks is devoted to ensuring that all relevant and applicable laws, the Banking Act, the new code of practices relating to corporate governance for the public companies which are listed in Kenya and those which are issued by various regulatory bodies like the Capital Markets Authority and the Central Bank of Kenya (CBK) Prudential Guidelines including all the bank's internal policies are fully complied with. The bank has a strong board charter in place as well as critical policies which include conflict of interest and code related to ethics and conduct upon which operations of the board and management in the stewardship of the bank are governed within the scope of the articles and memorandum of association of the banks. As the centre of corporate governance the board is fully committed in making sure that all business and operations of the bank are undertaken with the highest level of integrity and in full adherence to the law, principles which are accepted internationally and corporate governance best practices together with business ethics. The board ensures that the bank is adhering to all of its related laws as well as regulations, including the provisions relating to the Banking Act and the prudential regulations issued by the Central Bank of Kenya.

Internal accounting control systems are applied in all organizations in accordance with the key risks in the operations. Cunningham (2004), explained that internal accounting control system should be able to give feedback to the dynamic risks both from internal and external environment of the firm and that they are a means to an end, not an end in itself. The scholar added that the systems of internal controls are affected by human beings and not just the policy manuals or forms. Positive performance in respect to financial aspects of a firm can be realized through removal of waste in the systems. The degree to which a firm fulfills the objectives and mission which have been set in terms of efficiency, effectiveness and economical is known as the critical success factor. The information which is received through a good system of internal control as a reflection from accounting statements will give an information on financial performance of a firm and its financial position to various consumers of such reports for evaluating the leadership and using it in making investment decisions (Davies, 2005).

The purpose of internal accounting control is to reasonably assure the leaders of an organization that there is achievement of efficiency in operations, timely accounting reporting and adherence to the relevant regulations; promotion of orderliness, economical; ensuring that resources are protected against loss as a result of waste, misuse, misappropriation, errors and fraud, (Kaplan, 2008). Internal controls boost adherence to laws and regulations, contracts and directives by management as well as the developing and maintaining reliable accounting and management data and presenting accurately that data through timely reporting.

II. STATEMENT OF PROBLEM

Internal control systems in the banking sector are the mechanisms and the basis upon which commercial banks streamline their operations towards the direction of achieving their objectives. Most of the bank stakeholders believe that control systems are present and working properly, efficiently and effectively. Most commercial banks are seen to have incorporated the aspects of internal control systems to deter, detect and prevent fraud and errors that might be encountered during banking operations. However, several organizations including banks have been declared defunct and their assets being sold to generate cash to pay for outstanding debts due to creditors or being subjected to take-over by competitors which arise because of their reported low ability to settle financial liabilities as a result of liquidity problems. In Kenya, the recent case of Imperial Bank which reported a loss of Kshs 80 billion through fraud and currently taken over by KCB is also another example. The most recent case on headlines involved Kshs 11.6 million cash stolen in broad daylight at Barclays Bank's Branches situated in South B (1million), Kenyatta Hospital (4.3 Million) and Buruburu (6.3 million) in Nairobi between 20/4/2019 and 21/4/2019. Another most recent bank on headlines is the National Bank whose operations are in the process of being taken over by the KCB because it is facing liquidity problems and most shareholders are contemplating selling out their holdings in it. Lastly, Chase Bank which was placed under receivership in April 2016 has been ordered for liquidation by the Central Bank of Kenya on 16/04/2021. Concerns have been raised by various stakeholders and mainly shareholders as to the roles and the extent to which the internal processes are effective and efficient in the industry of banking. Shareholders speculate that presence of ineffective and inefficient internal control mechanisms in banking sector are the cause of firms' financial problems such as loss of money which is being registered in the banking sector. This triggered the need for a study to establish the effect of internal control systems on financial performance of selected commercial banks in selected counties in Kenya.

III. OBJECTIVE

The purpose of this study was to determine the effect of internal control systems on financial performance of selected banks in selected counties in Kenya.

IV. HYPOTHESIS

H₀₁: Control environment has no significant effect on financial performance of selected banks in selected counties in Kenya.

H₀₂: Risk assessment has no significant relationship with financial performance of selected banks in selected counties in Kenya.

H03: Information and Communication has no significant effect on financial performance of selected banks in selected counties in Kenya.

H04: Control activities have no significant effect on financial performance of selected banks in selected counties in Kenya.

H05: Monitoring has no significant effect on financial performance of selected banks in selected counties in Kenya.

V. METHODOLOGY

The study adopted the correlation design to establish the nature and magnitude of effect and relationship existing between independent and dependent variables. The correlation design provided proper recommendations to the management of selected commercial banks in Kenya that would enable them to realize better financial performance upon working on such recommendations. The study targeted fifteen selected commercial banks across in Bomet and Kericho Counties, from which a sample of 86 respondents was drawn comprising of branch managers, assistant managers, credit managers and tellers. The study employed the quantitative techniques for analyzing data. Regression and Correlation analyses were incorporated to analyze the variables and their relationship with each other. Internal control systems and financial performance relationship was modeled using the following multiple linear regression model:

$$Y = \alpha + \beta_1 CA_i + \beta_2 RA_i + \beta_3 CE_i + \beta_4 Mon_i + \beta_5 ICS_i + \varepsilon$$

Where:

Y = Financial Performance

α = the constant term

β = Regression Coefficients of independent variables

CA= control activities

RA= risk assessment

CE= control environment

Mon = monitoring

ICS = information and communication systems

ε = Error Term

VI. FINDINGS

Control Environment

Table 1: Control Environment

	Mean	Std. Dev
The level of integrity practiced by operating personnel can influence financial performance in the bank.	4.0641	0.94443
Strict adherence to the general values of ethics in the bank influences financial performance of the bank.	4.1410	0.75118
Financial performance of the bank depends so much on the level of commitment to work by the staff.	3.9872	0.98684
Management competency in handling the banking system influences the bank financial performance.	3.7821	1.14696
Control environment generally influence the financial performance of commercial banks.	3.9231	0.95031
The board is competent and strongly committed to implementation of	3.8974	0.92005

recommendations from the internal audit department for the betterment of the bank's financial performance.

The respondents agreed (mean= 4.0641; std. dev. = 0.94443) indicating that the level of integrity practiced by operating personnel can influence financial performance of banks. The respondents strongly agreed that strict adherence to the general values of ethics in the bank influences financial performance of the bank. This is evidenced by a mean of 4.1410 and the standard deviation of 0.75118. The financial performance of the bank depends so much on the level of commitment to work by the staff. This is shown by a mean of 3.9872 and the standard deviation of 0.98684, indicating that the respondents agreed with the statement. From the table, the findings also indicated that the respondents agreed (mean= 3.7821; std. dev. = 1.14696) with the statement that management competency in handling the banking system influences the bank financial performance. The study findings are in agreement with Nyaga (2007) findings that the frequency of board meetings and board composition influenced financial performance. The findings also concur with Magara (2013) findings that control environment influences financial performance.

Risk Assessment

Table 2: Risk Assessment

	Mean	Std. Dev
Risk identification in a proper manner by the organization has the influence on the financial performance of the bank.	3.8333	1.01183
Management has criteria for identification of which risks to the bank are most critical and this has influenced financial performance to great extent.	3.9103	0.88547
Management has put in place mechanisms for mitigation of critical risks that may lead to bank's loss and therefore influencing the financial performance of the bank.	3.4872	1.20328
The general risk assessment exercise in the bank has resulted in improved financial performance of the bank.	3.9487	0.93832
Management commitment to installation of risk management techniques help in boosting the financial performance of the bank.	3.6795	1.13382

The respondents agreed with the statement that risk identification in a proper manner by the organization has the influence on the financial performance of the bank. This agreement is supported by a mean value of 3.8333 and a standard deviation of 1.01183. As per the findings provided in the table, management has criteria for identification of which risks to the bank are most critical and this has influenced financial performance to great extent. This is indicated by a mean value of 3.9103 and a standard deviation of

0.88547 which shows that the respondents agreed with the statement. The banks' management has put in place mechanisms for mitigation of critical risks that may lead to bank's loss and therefore influencing the financial performance of the bank (mean=3.4872; std. dev. =1.20328). Further, it is depicted by the findings that general risk assessment exercise in the bank has resulted in improved financial performance of the bank. The respondents agreed with the statement as supported by a mean value of 3.9487 and a standard deviation of 0.93832 which is a small value of dispersion from the mean.

Information and Communications System

Table 3: Information and Communications System

	Mean	Std. Dev
Management has good system of information and communication across all the bank departments and as a result, influences financial performance of the bank.	3.6410	1.05651
Relevant information to the relevant department in the bank has a great tendency to influence the overall financial performance of the bank.	3.6667	1.01504
Financial performance of the bank depends on reliability of information and communication made by top management in the department of financial preparations.	3.7821	0.87753
The accuracy of the bank financial performance is greatly depended upon the availability of accurate information and communication within the bank.	3.4744	1.06569
There exists the relationship between bank financial performance and timely report of information.	3.4744	1.14783

It is evidenced that the respondents agreed (mean=3.6410; std. dev. =1.05651) indicating that management has good system of information and communication across all the bank departments and as a result, influences financial performance of the bank. With the mean of 3.6667 and a standard deviation of 1.01504, it is agreed by the respondents that relevant information to the relevant department in the bank has a great tendency to influence the overall financial performance of the bank. The financial performance of the bank depends on reliability of information and communication made by top management in the department of financial preparations (mean 3.7821; std dev. = 0.87753) indicating that the respondents agreed with the statement. The findings also indicated that the accuracy of the bank financial performance is greatly dependent on the availability of accurate information and communication within the bank. This is with

respect to the mean of 3.4744 and a standard deviation of 1.06569 indicating that the respondents agreed with the statement. The study findings match with the findings which were drawn by Kariuki and Muthusi (2017) that information and communications system is positively and significantly related with financial performance of banks.

Control Activities

Table 4: Control Activities

	Mean	Std. Dev
Good policies established in the bank, observed by all departments accordingly and implemented properly can influence financial performance of the bank in one way or the other.	3.9359	0.93057
Strict adherence to the laid down rules by all staff of the bank can result in better financial performance and vice versa.	3.8718	0.90251
Properly designed procedures of handling various documents in the bank can lead to desirable financial performance of the bank.	4.0256	0.75549
Guidelines observed by the staff in daily banking operations have some relationship with financial performance of the bank.	4.1026	0.71332
Segregation of duties in the banking sector has resulted to employee improved efficiency thus, translating to positive influence on financial performance.	3.8974	0.90582

It is established from the mean of 3.9359 and a standard deviation of 0.93057 that the respondents agreed to the statement of the control activities that good policies established in the bank and observed by all departments accordingly and implemented properly can influence financial performance of the bank in one way or the other. The findings as well illustrate that the respondents agreed with the statement of control activities that strict adherence to the laid down rules by all staff of the bank can result in better financial performance and vice versa. This is confirmed by the mean of 3.8718 for agree and a standard deviation 0.90251. Further findings supported with a mean of 3.8974 and a standard deviation of 0.90582 established that segregation of duties in the banking sector has resulted to employee improved efficiency thus, translating to positive influence on financial performance. The findings presented in table 5 concur with the findings of Wu and Rezende (2014) which state that frequent examination of banks operations encouraged reduction of risk by way of safer assets being held and that reduced the loss on loan provisions and it boosted profitability which was measured by Return on Equity; and Ngari (2017) who suggested that vouching, segregation of duties and internal audit have

influence on financial performance. The findings also agree with Naibei and Kipyego (2017) findings that performance of tier 1 banks significantly related to internal accounting control system.

Monitoring

Table 5: Monitoring

	Mean	Std. Dev
The overall regular monitoring of the bank operations and alignment to objectives greatly influences the financial performance of the bank.	3.5897	1.11000
Frequent evaluation of the bank internal control systems has significant influence on the financial performance of the bank.	3.7179	1.09185
There is a significant relationship between frequent performance reviews and financial performance of the bank.	3.6026	1.17705
Routine audits of financial statements of the bank and processes by external independent auditor have a great influence on financial performance of the bank.	3.6410	.12786
Management has proper tools for monitoring and evaluation which can assist in boosting financial performance of the bank.	3.5128	1.20328

The overall regular monitoring of the bank operations and alignment to objectives greatly influences the financial performance of the bank. The mean of 3.5897 and the standard deviation of 1.11000 suggest that the respondents agreed to the statement. The findings as are presented by the table also indicate with the mean of 3.7179 and a standard deviation of 1.09185 that the respondents agreed to the statement that frequent evaluation of the bank internal control systems has significant influence on the financial performance of the bank. Monitoring of banks operations as indicated by the level of agreement by the respondents suggest that monitoring has some association with the financial performance of institutions. The findings agree with the findings by Mosago (2013) which state that financial monitoring by organizations contributed to better programs.

Regression Analysis

Table 6: Coefficient of Determination results

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.671 ^a	.540	.512	.67759

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), monitoring, control environment, information and communication systems, control activities, risk assessment

The R-coefficient is 0.671 indicating that the predictor variables (independent variables) have a moderate positive association with the performance of selected commercial banks. The coefficient of determination (R-Square) indicates that the predictor variables used in the study can be relied on to explain 54% (0.540) of the variability in performance of banks. Therefore, basing on the findings presented in the table while holding other factors constant, the monitoring, control activities, information and communication systems, risk assessment, and control environment contribute to 54% growth in the performance of banks.

Table 7: Analysis of Variance and F-Test Results

Model	Sum of Squares	Df	Mean Square	F	Sig.
1 Regression	27.059	5	5.412	11.787	.000 ^b
Residual	33.057	72	.459		
Total	60.115	77			

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), monitoring, control environment, information and communication systems, control activities, risk assessment

The significance value in testing the reliability of the model for the relationship between financial performance and internal controls was obtained as 0.01 which is less than 0.05 the critical value at 5 % significance level. Therefore, the model is statistically significant in predicting the relationship between financial performance and internal controls in the commercial banks.

Table 8: Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	1.057	.587		1.801	.076
Control Environment	-.930	.496	-.971	-1.874	.065
Risk Assessment	1.460	.560	1.662	2.608	.011
Information and Communication System	.370	.358	.420	1.034	.305
Control Activities	1.931	.558	1.774	3.462	.001
Monitoring	-2.508	.390	-3.179	-6.440	.000

a. Dependent Variable: Financial Performance

Control environment and monitoring have a negative effect on the performance while risk assessment, information and communication system and control activities showed positive beta coefficients indicating that they have positive effect on performance. It is further observed from the table that control environment does not have a significant effect on financial performance, $t(72) = -1.874$, $P=0.065$; risk assessment has a significant effect on financial performance, $t(72) = 2.608$, $P<0.05$; information and communication system have no significant effect on financial performance, $t(72) = 1.034$, $P=0.305$. Control activities have significant effect on financial performance, $t(72) = 3.462$, $P<0.05$ as well as monitoring, $t(72) = -6.440$, $P<0.05$.

According to the findings, with one-unit increase in control environment, financial performance decreases by 0.93. A one-unit increase in risk assessment increases performance by 1.46. A unit increase in information and communication system leads to an increase in performance by 0.37, a unit increase in control activities results in an increase in performance by 1.93 while with one-unit increase in monitoring results in a decrease in performance by 2.51. Based on the coefficients, the regression model, $ROA_i = \alpha + \beta_1 CE_i + \beta_2 RA_i + \beta_3 ICS_i + \beta_4 CA_i + \beta_5 Mon_i + \varepsilon$ therefore becomes;

$$ROA_i = 1.06 - 0.416 CE_i + 1.46 RA_i + 0.37 ICS_i + 1.93 CA_i - 2.51 Mon_i.$$

This clearly shows either positive or negative relationship between the predictor variables and the performance of selected commercial banks.

VII. SUMMARY

The study aimed at determining the effect of internal control systems on financial performance of selected commercial banks in selected counties in Kenya. The study found that most of the banks' staffs were undergraduate degree holders. Most of the staffs had worked more than two years in the respective selected commercial banks whereby majority indicated that internal control system review was done annually. Most of the staff gave the opinion that presence of internal control systems boosts financial performance and that the internal controls function as intended. Majority of the responses indicated that internal control system in the selected commercial banks was effective.

Descriptive statistics findings showed that all the components of internal control system affected financial performance of selected commercial banks in the selected counties. The findings indicated that guidelines observed by the staff in daily banking operations have relationship with financial performance. Correlation findings indicated that control environment, risk assessment, information and communication system, control activities and monitoring individually had very weak positive and insignificant relationship with financial performance of selected banks.

Correlation findings also indicated that the relationship between the independent variables was positively strong. This indicated that the relationship between the variables in determining financial performance was significant. This is evidenced in table 4.9 by the

highest and positively strong correlation between control environment and control activities with correlation coefficient (r) of 0.982.

The outcomes of the multiple regression model indicated that there is either a positive or negative relationship between internal control and financial performance of selected commercial banks in selected counties in Kenya. The study findings also indicated that internal controls influenced financial performance to some extent.

VIII. CONCLUSION

Basing on the findings obtained in chapter four, the conclusion is that control environment in the selected commercial banks negatively influence the financial performance of the commercial banks, but it is not significant. The negative effect of the control environment though not significant, requires the selected commercial banks management to look for better ways to improve the control environment measures to cause positive influence on financial performance.

Risk assessment measures incorporated by selected commercial banks also has positive and significant relationship with the level of the commercial banks' performance. Banks with effective measures of risk assessment in their undertakings portray better financial performance. These banks are able to detect risks in their operations which could contribute to negative results and therefore help in devising techniques in place to contain and manage these risks. Minimum risks in operation guarantee a commercial bank improved financial performance.

There is a positive but insignificant relationship between information and communication and the financial performance of selected commercial banks in selected counties in Kenya. The accessibility of relevant and reliable information in commercial banks by the clients and other stakeholders may guarantee improved financial performance through informed decision making based on the relevant and reliable information. Control activities as per the findings contribute positively and significantly to the financial performance of selected commercial banks in the selected counties in Kenya. The management should ensure that implementation of measures such as segregation of duties, approval and authorization as well as internal audit is done and strengthened.

The negative effect of monitoring which is significant on financial performance of selected commercial banks needs to be rectified by the management. It is the responsibility of the management to ensure that every aspect of internal control in the organization contributes to the general performance of the

IX. RECOMMENDATIONS

Based on the study findings and conclusions which have been made, the researcher recommends the following measures to be implemented by the selected banks in the selected counties, for better objectives to be realized. Control environment has a negative effect which is insignificant to financial performance.

The management of the commercial banking institutions in the selected counties should ensure that every aspect of control environment which causes the negative influence on financial performance is given proper attention and measures be put in place to address the negative influence of such aspects. Management should find the possible alternative ways of improving on control environment in order to achieve a positive effect of it on financial performance.

Risk assessment has a positive significant relationship with financial performance. The management of the selected banking institutions in the selected counties should continue encouraging and strengthening the measures which are put in place to mitigate possible risks of losses in the banking sector. The management should continue investing more on research concerning the possible cause of technical risks in order to find effective ways to deal with such risks should they arise.

Information and communication has a positive but insignificant effect on financial performance. Every organization must implement effective and efficient information and communication system in order to realize their desired objectives. The management of the selected commercial banks in the selected counties should ensure that their information and communication systems are effective and efficient in delivering the desired results. They must ensure that they invest in the systems which can help them to achieve positive and significant financial performance.

Control activity has a positive significant effect on financial performance. The management of the selected commercial banks should continue strengthening and implementing properly all aspects such as segregation of duties, vouching, proper approval and authorization of transactions in the organization. This will ensure that risks of distorting financial information are reduced to as minimum as possible and that guarantees improved the accuracy and reliability of financial performance.

Monitoring has a negative significant effect on financial performance. There is need for the management to implement proper monitoring strategies which will ensure that the commercial banks in the selected counties achieve positive and significant improvement in their financial performance.

X. SUGGESTION FOR FUTURE STUDIES

The banking sector continues to experience more new regulations worldwide. These regulations as well are deemed to influence the way commercial banks undertake their operations. The study suggests that in future, the researchers may consider undertaking a research on the effect of new banking regulations on financial performance of commercial banks.

IX. CONCLUSION

A conclusion section is not required. Although a conclusion may review the main points of the paper, do not replicate the abstract as the conclusion. A conclusion might elaborate on the importance of the work or suggest applications and extensions.

APPENDIX

ACKNOWLEDGMENT

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