THE EFFECTS OF INTERNAL CONTROLS ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA CASE STUDY: EQUITY BANK BOMET BRANCH

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ABSTRACT

In the recent past, a number of commercial banks in Kenya have stopped operating and others put into receivership. The main reason for this failure has been cited as poor financial performance and major frauds committed within the banks. Weakness in the internal control paves way for committing these frauds and thus negatively affects the financial performance of these commercial banks. This research was done to seek to identify the roles played by the internal controls in preventing these frauds and hence positively impacting the financial performance of commercial banks in Kenya and in this case Equity bank was the case study. The internal controls focused on the control environment, risk assessment, and monitoring activities. Secondary and primary data were both collected for the purpose of this research. A research questionnaire was issued to the respondents to collect their views and the information they know concerning the internal controls system. A descriptive research design will be used for the same process. A total of 48 respondents were targeted who were both employees of Equity bank Bomet branch. A sample of 30 individuals was taken as a sample across all levels of management. The study found that Equity Bank reviewed its internal controls on a need basis and the research found out that the staff of Equity bank is trained to implement accounting and financial management systems and safeguard the organizational assets. The study recommended that: the control environment has a positive relationship with the financial performance of the commercial bank

Key words: Internal control systems, financial performance, Control environment and Risk assessment

INTRODUCTION

Kenya has a large banking sector with 44 banks; 31 locally owned and 13 owned by the non-locals. Competition is very high and therefore good financial performance is the key to survival and growth of each industry. Internal control systems were limited to; control environment, internal audit and control activities, and monitoring activities; on the other hand financial performance was analyzed at basically from three perspectives of liquidity, accountability and reporting (Donald and Delno 2009). Internal controls help the organizations especially the banking sector in Kenya to achieve effectiveness in financial performance. Internal controls are processes designed and affected by those charged with governance, management and other personnel to provide reasonable assurance about achievement of an entity's objectives with regard to reliability of the financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations (David, 2001).

Internal controls can be defined as measures put in place by an organization so as to ensure achievement of the entity's objectives, goals and missions (Brennan & Solloman, 2008). Internal controls have become of paramount importance in Kenyan banks. The reason being that the control systems in any organizations are pillar of an efficient accounting system (Wanemba 2010). The institute of chartered accountants of England and Wales (ICAE & W) define internal controls system as a review of operations and records, sometimes continuous undertaken with a business by specially assigned staff. An internal control plays a crucial role in enhancing financial effectiveness of the commercial banks.

Efficient performance entails achieving goals of an organization or a firm with minimum wastage of resources that is making the best use of resources, for instance making the best use of money, time materials and people (Lewin and Johnson, 2000). Fraud and errors has been a major fall in financial performance in Kenya. There are steps and processes put in place to curb these problems and one of them being internal controls. Internal controls therefore play an important role in financial effectiveness of a company. Financial performance refers to the ability of the firm to operate efficiently, profitably, survive, grow and react to environmental opportunities and threats (Sebbowa 2009).

Equity bank is one of the quickest growing bank in Kenya and this is attributed to efficiency in its operations. Equity bank therefore was used in this project to examine the role played played by internal controls in financial performance of a firm.

According to Kotey, Reid and Ashelby, (2002) said that performance can be measured using subjective or objective criteria. Whittington and Kurt (2001) indicated that objective measures of financial performance included financial metrics such as profit growth, revenue, and the return on capital employed. The most efficient way to improve net income is by reducing the level of irregularity and fraud through the improvement of firm's system of financial control (Wainaina 2014).

Every bank in Kenya contains risks attached to it and thus effective internal control is crucial in attaining this. This study sought to find out the role played by the internal controls in ensuring achievement of good financial performance.

Statement of Problem

Internal control plays a crucial role in the banking sector since they are prone to a number of risks arising from their operations. The internal control is an important corporate governance mechanism of the firm based on internal control statement quality that it should be to control effectiveness and also enhances the reliability of financial reporting both in internal and external's firm (Skaife et al 2007). organizations establish systems of internal control to help them achieve performance and organizational goals, prevent loss of resources, enable productions of reliable reports and ensure compliance with laws and regulations (Emasu, 2010). According to Kirsty (2008) efficient internal controls creates an organization's confidence in it's ability to perform or undertake a particular tasks and helps prevents and detects errors and losses through monitoring and enhancing organizational and financial reporting processes as well as ensuring compliance with pertinent laws and regulations. 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 greatest effect on corporate governance within Kenya government ministries followed by risk management while compliance and consulting had the least effect.

In addition to weakness in internal control system unsatisfactorily service delivery has a negative impact in financial performance of every organization. Despite the guidelines set out in central bank of Kenya in accordance with the banking Act Cap, there has been numerous cases of bank failures in performance due to fraud and lack of elaborate internal controls as well as compliance with internal and external regulations within industry (FLSTAP, 2011). For instance in Kenya several banks in Kenya have been put to receivership like Imperial bank and Dubai bank of Kenya. Chase bank was also put to receivership in what was termed by the liquidator as unsafe financial conditions. This research was done to examine the role played by internal controls in enhancing effectiveness in financial performance. The role of internal control system in detecting the fraud has been looked into by this research and showing how it affects the financial performance of the commercial banks.

Internal control systems has a great impact on the financial performance of commercial bank. According to Efozie (2010), the management should familiarize themselves with internal control procedures that will ensure effective service delivery and the desired financial performance. Internal controls play an integral part in ensuring good financial performance. According to Abu-Musa (2004) he found out that there exist a relationship between effective internal controls and financial performance of the firm. This study was carried therefore with the aim of identifying the effect of internal controls on financial performance of financial institutions in Kenya.

The general objective of the study was to assess the effect of internal controls on the performance of the commercial banks.

LITERATURE REVIEW

Internal control system is broadly defined as a process, affected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; and compliance with laws and regulations. (Graham, 2008). Internal controls are process designed by the entity's management board of directors and other personnel designed to provide a reasonable assurance regarding the attainment of the entity's objectives. Internal controls play a major role in detecting and preventing fraud at various levels of the organization right from strategic management to the operational management. Internal control systems has various components that affect the performance of the firm in different ways like the control environment, risk assessment, monitoring activities control activities and information and communication. According to Hightower (2008) there are many definitions of internal controls, as it affects the various stakeholders of an organization in various ways and at different levels of aggregation.

This study is based on a number of theories; agency theory, reliability theory, stakeholders' theory and attribution theory.

Conceptual Framework.

Independent variable **dependent variable**

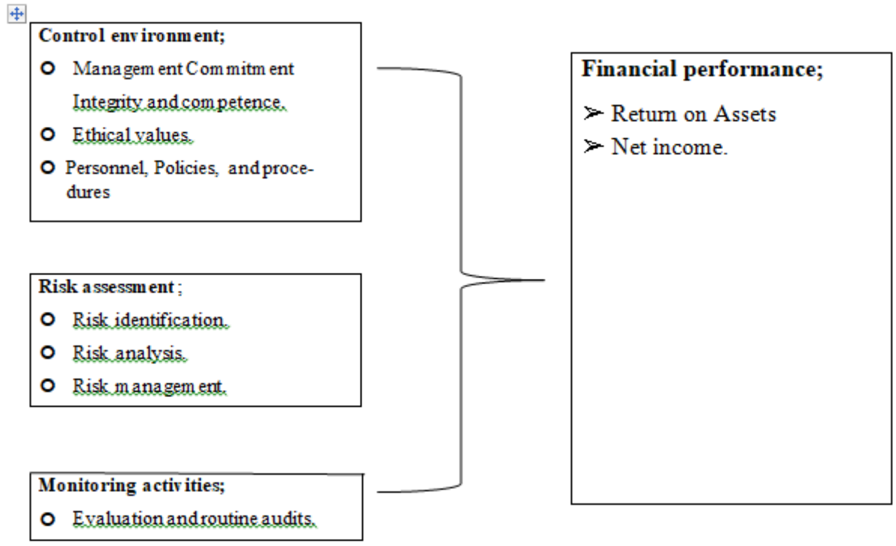


Figure 2.1: The conceptual Framework

RESEARCH METHODOLOGY

Research Design

According to Babbie (2002) research design refers to arrangement and utilized with an aim of solving a research problem. This research therefore was done using descriptive research method. Descriptive research method was appropriate since according to Cooper and Schindler (2000), descriptive research discover and measure cause and effects relationships among variables. According to Kothari (2005) this research design attempts to collect data from members of the population and attempts to explain an existing with reference to audit function. McNabb (2006) also claimed that descriptive method helps to obtain information concerning current status and obtaining in depth information about the company. To obtain those information questionnaires were used.

Target Population

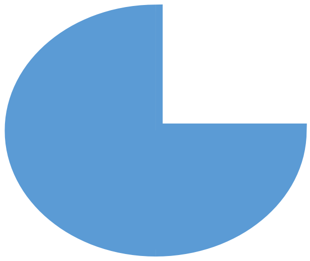
According to Smith (2011) population refers to a large collection of all subjects where a sample is drawn. Sekaran (2008) also defines population as the total collection of elements which inferences are made to all possible cases which are of interest to a particular study. In our case the study targeted 50 employees of Bomet branch. The employees was issued with questionnaires to obtain information concerning the internal controls and how it influence revenue generation in general financial performance of the company.

RESEARCH FINDINGS AND DISCUSSION

Response Rate.

A response rate for the research is highly important so as to ensure the research findings are a representative of the entire population. According to Sheehan, K. (2001)

he said that a survey must have a good response rate in order to produce accurate, useful results. The figure below shows the analysis of the response rate.



N=38(79%)

Non response= 10(21%)

Figure 4.1 response rate.

According to the above figure, the study yielded the findings of 79% with the response of 38 participants of the Equity Bank. 10 of the targeted individuals did not respond giving a non response to 21%. therefore the study achieved a good response rate as recommended by Mugenda and Mugenda (2003) that a response rate of 50% is good enough and that a response rate of 70% is excellent.

Majority of the respondents 72% have been working in the bank for more than four years 6.3% have been working for 1-2 years, 6.4 have been working for 3-4 years and
15.3% have been working for 2-3 years.

Effectiveness of internal controls in financial performance.

It is perceived that internal controls have a great impact on the financial performance of every organization. Strong internal controls are therefore very essential in analyzing the performance of every company. According to Mawanda (2008) states that institution and enforcement of proper controls systems always leads to improve revenue generation.

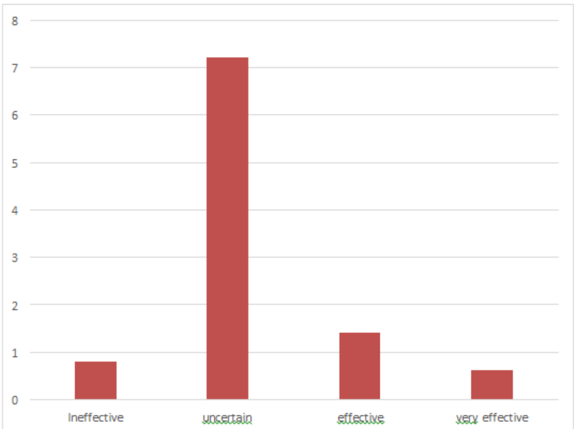


Figure 4.2 effectiveness if internal controls on financial performance.

According to the above findings majority of the respondents were uncertain on the effects of internal controls 72% percent. 14% ranked their internal control as effective and 6% ranked them as very effective while 8% ranked it as ineffective.

Performance of Commercial Banks.

This section discusses the results of the study on the performance of commercial banks. The performance of the commercial banks is measured by analyzing the return om assets (ROA). The data collected was analyzed and then the means statistics of each year presented in the table 4.3 below.

Table 4.1 Return on Assets.

	Mean	standard deviation	maximum	minimum
2015	0.04	0.02	0.7	-0.6
2016	0.03	0.05	0.13	-1.4
2017	0.04	0.07	0.21	-0.12
2018	0.02	0.05	0.17	-0.18
2019	0.02	0.06	0.31	-0.7

According to the findings of the table above it showed that the financial performance of Equity bank was low in 2015 and this was attributed to the financial distress in the banking sector. This is the year in which most banks were placed into receivership. The variance in financial performance is attributed to the fluctuations and changes of the economic environment.

Summary of the findings.

The study found out that Equity Bank reviewed its internal controls on need basis. Most of the staff who participated in this research study ranked effects of internal controls on financial performance as uncertain since most were not aware of the effects of internal controls on the financial performance of the organization.

According to the results of the multiple regression test it showed that there is positive relationship between the internal controls and financial performance of the bank. Therefore internal controls affect the financial performance of commercial banks to a greater extent. Based on our findings the results showed that the control environment factors influence financial performance. The research found out that the staffs of Equity bank are trained to implement accounting and financial management system and safeguarding the organizational assets. These key factors have a great impact on the financial performance of any company.

The research showed that the bank has ways of identifying potential risks that may affect the banks operations and also have means of analyzing those risks and their potential consequences. The results of the study also showed that the potential frauds are detected earlier before they affect the operations of the bank. Poor risk management is known to negatively affect financial performance of any institution. Equity bank has effective ways of identifying the risks, analyzing them and also managing those risks so as not to adversely affect the operations of the firm.

Monitoring activities greatly affect the financial performance for instance budget preparation and financial planning have a great impact on the financial performance. The findings of this research study showed that monitoring activities of the institution are set to avoid incurring unnecessary expenditure. Most of the staff members were seen to understand the concept of monitoring activities and how it operates. Internal reviews are being done by the bank also to access the issues in the internal controls of the bank. The research showed that there are independent checks normally conducted on the monitoring activities to check their performance.

Conclusions

Based on the findings obtained in chapter four it showed that there is a great relationship between the internal controls and the financial performance of the commercial banks. The effectiveness of banks internal controls determines the level of financial performance and its ability to meet customer's needs and henceforth overall performance of the organization.

Risk assessment strategies also have a great impact on the financial performance of commercial banks and with minimal risks the bank is in a position to have a good financial performance. Banks should therefore have effective ways of identifying potential risks, measuring them and analysis of the impact of the risks in order to prevent adverse effects on the financial performance of banks.

Control environment and monitoring activities have a positive relationship with financial performance of banks and also monitoring activities influence how the operations of the banks are run. Budgeting, planning and financial control have a great impact on financial performance of banks and should be done appropriately. The presence of internal control reduces chances of committing fraud among the staff and other members of the organization.

The management of every commercial bank has a duty of setting up internal control system and monitoring their performance. The system should work effectively for the purpose of identifying and preventing frauds from happening when this happens the bank is in a better position of performing well financially. The system should be well accessed and its performance scrutinized over time by the management for effective performance. The internal controls play a major role in providing accurate measurements of data.

Recommendations

According to the above findings and conclusions the following recommendations were arrived at:

The control environment has a positive relationship with the financial performance of the commercial bank. It is therefore the responsibility of the management to ensure that there is a suitable working environment. Both the upper and the lower management have the mutual responsibility of ensuring that this happens. This should be done for security reasons and hence protecting the assets of the organization from misappropriation.

Risk assessment has a significant impact on the financial performance of the commercial bank. Banks should therefore implement a proper risk assessment technique so as to ensure that risks and threats are detected at the earliest period. The management has a responsibility of identifying the potential risk with the significant influence on the financial performance of the commercial bank. Then secondly analyzing those risks and coming up with ways of managing the risks. Effective and regular assessment of risks helps in the prevention of those risks from adversely affecting the performance of the institutions.

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