Internal Audit Function and Financial Performance of Savings and Credit Cooperative Societies (SACCOs) in Kenya

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Abstract

Cancelation of licenses of cash-strapped savings societies thus barring them from taking deposits from the members has received significant attention from regulator and the members. This study sought to establish the relationship between internal audit function and financial performance of saving and credit cooperatives in Kenya. The study used descriptive research design and the target population for this study was 40 respondents. A sample of 10 Sacco’s was taken that was determined using stratified random sampling technique. The study relied on both primary and secondary data. Primary data was collected using structured questionnaires directed to operation managers, CEO’S, accountants and internal auditors of selected Sacco’s. While the secondary data was gathered from financial statements, library materials, internet search engines and media publications based on availability and accessibility of data. Multiple regression models was used to test whether a relationship existed between internal audit function and financial performance of Sacco’s in Kenya. The findings revealed that internal audit function department efficiency is weak due to its failure to conduct regular audit activities thus failing to produce necessary regular audit reports that guides decision making. The study concluded that there exists difficulty in the execution of controls particularly considering that the audit function is not well extended to most of the Sacco’s which clearly has adversely affected their efficiency as revealed by this study. The study recommends that there should be a deliberate attempt to match small Sacco’s so as to enable them put in place vibrant audit department, be able to carry out market research so as to minimize risks and be able to use effective and efficient internal control systems to tame adverse insider dealings.

Key words: Audit Function, Saccos, Financial Performance

1. Introduction

Financial institutions such as banks, microfinance institutions, and Sacco’s face enormous challenges when it comes to assets management and control. There should be in place systems and procedures that ensure that these assets are safeguarded. December 2013 there were over 6,000 registered non-deposits taking Sacco’s in Kenya, 1,995 of which were active. Active in this context means the Sacco’s that filed their audited financial statements with the Commissioner for Cooperative Development as a legal requirement. By close of 2013, there were 215 deposits taking Sacco’s out of which one hundred and thirty-five (135) were licensed by SASRA.

Trebah,(2003) argued that weaknesses in internal control systems that is control over the expenditure, over payroll commitments and over procurement processes) leads to failure to ensure that assets are allocated to definite priorities and to ensure that value for money will be achieved in public spending. Lack of internal controls or the existence of weak internal controls is the prime cause of many cases of deceptive company financial reporting (Coso. 2006). A sound internal control system helps an organization to prevent frauds, errors and minimize wastage.

In South Africa, cases of accounting fraud have been recorded in Randgold and Exploration companies. In Nigeria, the managing director and chief financial officer of Cadbury Nigeria were dismissed in 2006 for inflating the profits of the company for some years before the company’s foreign partner bought controlling interest. These scandals highlight the need to; evaluate, scrutinize, and formulate systems of checks and balances to guide corporate executives in decision-making. These executives are legally and morally obliged to produce honest, reliable, accurate and informative corporate financial reports periodically (Hayes, Dassen, Schilder & Wallage, 2009).

In Kenya, Kenya’s Sacco Societies regulatory authority (SASRA) has barred five credit unions from taking deposits from the public. This is after revoking their operating licenses over serious liquidity problems and other corporate governance challenges. According to Business Daily, among the deregistered Sacco is Ufundi, Transcom Nest Sacco, Green Hills Sacco (Formally Chebosobon) and Maono Daima. Business Daily (2018), commissioner of co-operatives froze the Kes. 3 billion Ekeza Sacco all
bank accounts and stopped operations of across its 23 offices and ordered an audit to ascertain its assets and liabilities following it’s deregistration. Sacco’s are expected to have effective and efficient internal controls to provide reasonable assurance about the achievement of the entity’s objective with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Despite existence of elaborate system of internal controls in Sacco’s, a number of them continue to experience financial distress which has threatened their survival in the business. This study therefore attempts to establish the relationship between audit function (which is an internal control measure) and financial performance of Sacco’s in Kenya.

2. Research Problem

In the aftermath of cancelation of licenses of cash-strapped savings societies effectively barring them from taking deposits from the members, internal control systems in relation to financial performance has received significant attention from regulator and the members. Regulatory responses have focused on improving liquidity and corporate governance challenges and this has in turn driven increased awareness and demand for internal assurance on corporate governance processes, including internal control and risk management (Carol, 2014). Kenya’s Sacco Societies regulatory authority (SASRA) has stopped five credit unions from taking deposits from the public. This is after cancelling their operating licenses over serious liquidity problems and other corporate governance challenges.

Munene (2013) carried out a study and found out that some of the challenges experienced in regard to internal controls include: struggles with liquidity problems, untimely making of financial reports, and inadequate accountability of financial resources, frauds and exploitation of institutional resources have been unearthed and a number of decisions made have yielded unexpected outcome. Ondieki (2013) conducted a study and stated that internal controls can have features built into them to ensure that falsified transactions are flagged off or made difficult, if not impossible to carry out. Internal control audits provide assurance that controls are working, but they do not essentially detect fraud or corruption. Preceding studies have focused on the contribution of internal control systems on financial performance of small and medium scale business enterprises (Nyakundi, Nyamita & Tinega, 2014).

Mawanda (2008) conducted research on effects of internal control systems on financial performance in an institution of higher learning. Khamis (2013) did a research on contribution of internal control systems to financial performance of financial institution. Majority of these studies involving internal controls have focused on finding the characteristics of firms that divulge material weaknesses in internal control. Al-Matari, Al-Swidi, Faudziah and Al-Matari (2012) found that there was notable lack of research in developed as well as developing nations regarding the direct association of internal control systems and firm performance. This study therefore attempted to investigate the persistent poor financial performance of Sacco’s in Kenya from the perception of internal controls which has hitherto been disregarded and which has subsequently led to liquidity problems and in some cases collapse of Sacco’s. The concern of this study is to ascertain if audit function which is an internal control construct affect performance.

3. Study Objective

The main objective of the study was to establish the relationship between internal audit function and financial performance of Sacco’s in Kenya.

4. Review of Literature

Stakeholder’s theory was proposed by Milton (2010) who said in his article that he does not concur with the fact that business should take social responsibilities in terms of responsible in desirable (social) interests. Believing in free-enterprise system, Friedman is of the opinion that the business should be concerned to its shareholders’ interest. He believes only in socialist environment that is, business takes social responsibilities as its priority. The Doctrine of social responsibility would extend the scope of the political mechanism to every human activity. Friedman describes social responsibility as a (fundamentally subversive doctrine) in a free society. He said that in such a society, “there is one and only one social responsibility of business, to use it resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.” This theory is appropriate to this study in that members of a Sacco contribute funds under cooperative movement by pooling funds together through deposits and lending at lower rates to earn profit which is subsequently shared by way of dividends to members as opposed to charitably promotes the well-being of others.

This study was guided by these three theories namely; agency theory, contingency theory and the shareholders theory. Agency theory showed the relationship between the principal and the agent and the agent's responsibilities which include; financial reporting, budgeting, and giving any other additional information to the principal. The contingency theory on the other hand explains that company’s behavior and functions are dependent on factors such as; technology, culture, and the external environment that the company operate in whereas the shareholders theory asserts that, a firm does not have any moral obligations or social responsibilities at all, other than to maximize their own profit.
4.2 Empirical Review

Jones (2008) compared internal control, accountability, and corporate governance in medieval and modern Britain. He used a modern referential framework (control environment, risk assessment, information and communication, monitoring and control activities) as variables to examine medieval internal controls used in the twelfth century royal exchequer and other medieval institutions. He established that most of the internal controls found today were present in medieval England. Stewardship and personal accountability were found to be the key elements of medieval internal control. The recent recognition of the need for the enhanced personal accountability of individuals is suggestive of medieval thinking.

Ewa and Udoayang (2012) did a study to establish the influence of internal control design on banks’ ability to investigate staff fraud and staff life style and fraud detection in Nigeria. Data were collected from 13 Nigerian banks using a four point like Scale questionnaire then analyzed using percentages and ratios. The study established that internal control design has an impact on staff attitude towards fraud such that a strong internal control system is deterrence to staff fraud whereas a weak internal control system exposes the whole system to fraud and creates opportunity for staff to commit fraud.

Amudo and Inanga (2009) in addition did a study in Uganda to evaluate the internal control systems that the regional member countries of the African Development Bank Group institute for the management of the Public Sector Projects that the Bank finances. There are 14 projects of the bank’s public sector portfolio in Uganda. In the study, Mawanda (2008) did a research on effects of internal control systems on financial performance in institution of higher learning in Uganda where he did an investigation and sought to establish the relationship between internal control systems and financial performance in an institution of higher learning in Uganda. He looked at internal controls from the point of; control environment, internal audit and control activities whereas; liquidity, accountability and reporting were used as a measure of financial performance. The researcher was seeking to establish the causes of persistent poor financial performance from the point of view of internal controls. The study found out that there exist a correlation between internal control system and financial performance. The study recommended a competence profiling in the internal audit department which has to be based on what the university expects the internal audit to do as well as appropriate number staff needed to do this job. The study thus acknowledged the role of internal audit department to set up internal controls which have an effect on the financial performance of firms.

Besides the prevention and detection of fraud, internal controls ought to reflect the strength of the entire accounting environment in an organization as well as the accuracy of its financial and operational records’ (Wainaina, 2011).

Olumbe (2012) carried out a study to establish the relationship between internal controls and corporate governance in commercial banks in Kenya. The researcher did a survey of all the 45 commercial banks in Kenya. It was concluded that most of the banks had incorporated the various parameters used for gauging internal controls and corporate governance. This was indicated by the means which were obtained after enquiring on the same which showed that the respondents agreed that their banks had instituted good corporate governance with a strong system of internal controls and that there is a relationship between internal control and corporate governance.

Wee Goh (2009) carried out a study on 208 firms on; audit committees, boards of directors, and remediation of material weaknesses in internal control. He measured the effectiveness of the audit committee by its; independence, financial expertise, size, and meeting frequency, and the effectiveness of the board by its independence, size, and meeting frequencies, and by the duality of the chief executive officer (CEO) and chair positions (CEO duality). He further examined other factors that can have effect on firms’ timeliness in the remediation of material weaknesses; as the severity of material weaknesses, company’s profitability, the complexity of company’s operations, and so forth. He established that the fraction of audit committee members with financial expertise is positively connected with company’s’ timeliness in the remediation of material weaknesses. Again, companies with larger audit committees are more likely to remediate material weaknesses in a timely manner. Furthermore, a more independent board is less prone to the undue influence of management and is more likely to exert pressure on management to remediate material weaknesses.

Barra (2010) used analytical approach to focus on control activities and monitoring, the researcher sought to find the effect of penalties and other internal controls on employees’ tendency to be fraudulent. Data was collected from all levels of organizational structure. The results were that, the presence of the control activities and separation of duties increases the cost of committing fraud. Therefore, the gain from committing fraud should outweigh the cost in an environment of segregated duties for employees to commit fraud. It was also established that segregation of duties is a fraud deterrent (least-cost) and maximum penalties (least-cost) for non-managerial employees and managerial employees respectively. The results suggested that the effectiveness of preventive control activities such as segregation of duties is dependent on detective controls.

Kakucha (2009) evaluated the level of effectiveness of internal controls of enterprises operating in Nairobi. The study was quantitative and was conducted between September 2007 and June 2009 using a sample of 30 small businesses as listed in the National Social Security Fund (NSSF) Register of Kenya. Primary data was collected from the managers of the small business using interviews and examination of documents pertaining to internal controls. The study found out that there are inefficiencies in the systems of internal controls, with the degree of inefficiencies varying from one enterprise to another. The components of
internal control that were found to be missing in most businesses surveyed were; risk analysis, and lack of proper flow of information. Furthermore, the study found out that the sample population had limited information on what made up an effective system of internal control. The study also established that there is a negative correlation between the age of an enterprise and the effectiveness of system of internal control whereas a negative relationship between the resources held by an enterprise and its internal control system weaknesses. They recommended that there was need to inform the operators of small business of what makes up an efficient and effective system of internal control during forums and seminars.

Muhammad (2015) did a research on effect of internal audit function and internal control system on financial performance of an institution of higher education in Pakistan. It was established that there was a positive correlation between internal audit, internal control environment and financial performance of higher education institution. The research paid attention to 3 components of internal control namely: internal audit, internal control environment and information and telecommunication but failed to show the contribution of risk management and corporate governance in the financial performance of a company. The research also focused on a specific institution which limit the application of research to other companies’ which exhibit different operational characteristics. Mugo (2013) researched on effect of internal control on financial performance of technical training institutions. While he found a positive correlation between internal control and financial performance, the study failed to establish the effect of corporate governance and government policy on financial performance of companies. Mawanda (2008) researched on effect of internal control systems on financial performance of an institution of higher learning in Uganda and focused on three components as; internal control environment, internal activities and internal audit. The study did not show the contribution of risk management and corporate governance on financial performance of the company. Kamau (2013) carried out research on effects of internal control on financial performance of manufacturing firms in Kenya. The study did not also clearly illustrate the contribution of corporate governance and government policy on the financial performance of companies. Most of the researches done on internal controls are case studies and focus on specific institutions or companies that exhibit particular characteristics or material weakness in the internal control systems.

5. Research Methodology

This study adopted Survey research design because it will be easy and convenient to be conducted through interviews or questionnaire instruments, or both. The 40 Sacco’s were targeted so as to cover both deposit taking and those dealing with back office activities only within the set period of time. The study chose a sample of 13 Sacco’s from a target population of 40 Sacco’s in the sub county. In every Sacco, 10 employees were picked to represent entire group. Data was collected through the use of questionnaires. The study collected data from both primary and secondary sources. The questionnaire was administered through the “drop and pick later” method. The follow-up was done through Short Message Service (SMS) and phone calls, on arrangements some questionnaires were personally administered to the respondents. The study also used secondary data. A multiple regression analysis was used to test if the relation was significant. As shown in table 3.4.1, the sample of 40 respondents was drawn using stratified random sampling technique.

6. Data Results and Discussion

The data collected largely focused on internal audit functions and financial performance of Sacco’s in Bureti Sub County, Kenya. The study sampled 40 respondents from Sacco’s in Bureti Sub County, Kenya. The analysis of data collected from 40 respondents was done using descriptive statistics and the findings were presented in form of tables and percentages.

It is clearly evident that respondent were almost in total agreement as to whether there exist an Internal audit function in the Institution as reflected by a mean value of 4.0 which is tending towards maximum value of 5 (strongly agreeing). However, the standard deviation of 0.9 suggests variations in responses by the various respondents. Virtually all the writers underscore the significance of an internal audit department in helping an organization achieve its objectives. The findings agreed with Morris (2011). The data collected reveal that respondents seem to disagree as to whether the Internal audit staff conduct regular internal audit activities. This is showed by a mean of 2.79 which is lower than the average of 3. Nevertheless, a standard deviation of 1.069 implies a considerable variation in the responses generated by the respondents. This means that the internal auditor’s role of examining and assessing; the effectiveness, efficiency, and the monetary implication of the management control system as advocated by Dwivedi (2012), may not be achieved. This is however in contrast with findings Management commitment on the operations of the system and Monitoring execution of Internal Control system. Respondents concur with the fact that the Internal audit information address limitations in the internal control system. This is showed by a mean of 3.13, even though the standard deviation of 0.844 seems to suggest variation in the responses generated for the test. This therefore confirms Whittington and Pany (2001)’s suggestion that “internal auditing is performed as part of the monitoring activity of an organization”.

This is also in line with Orodho, (2003) assertion that “the objective of internal audit is to assist members of the organization in the effective discharge of their responsibilities”. Respondents seem to agree with statement regarding internal audit recommendations to management regarding improvement in system of control as reflected by the mean value of 3.34. However, a significant standard deviation figure of 1.072 reveals varied responses from the respondents on the same, implying that they have different opinions about this role played by internal auditor. This could also infer as to whether the internal auditor makes appropriate recommendations for management to improve. The finding is in agreement with Sarens, & De Beelde,
(2006). statement that “the objective of internal audit is to assist members of the organization in the effective discharge of their responsibilities”.

Since there exist a positive correlation between internal audit and net profit with $r = 0.091$ and $p < 0.01$, internal audit is positively related to return on equity with $r = 0.447$ and $p < 0.01$, and positively related to return on assets with $r = 0.389$ and $p < 0.01$. While there is a positive correlation between the internal audit function and the dimensions of financial performance: net profit, return on equity and return on asset; hence hypothesis; an effective internal audit function is not related with the financial performance of Sacco’s in Bureti Sub County, Kenya is rejected.

The correlation table presents the relationship between components of internal control systems measured by internal control environment, internal audit function and financial performance risk management, measured by net profit, equity return and asset return. The result shows that all the components have a positive relationship. In particular, the audit function has a positive relationship with net profit, equity return and asset return ($r= 0.091$, $p < 0.01$; $r= 0.447$, $p < 0.01$; $r= 0.389$, $p < 0.01$). This implies that financial performance is positively related to internal audit function.

### Table 1 Internal Audit Function

<table>
<thead>
<tr>
<th>Internal Audit Function</th>
<th>N</th>
<th>Min</th>
<th>Max</th>
<th>Median</th>
<th>Std. Dev.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit department</td>
<td>37</td>
<td>2</td>
<td>5</td>
<td>4.00</td>
<td>0.900</td>
</tr>
<tr>
<td>Regular audit activities</td>
<td>37</td>
<td>2</td>
<td>5</td>
<td>2.79</td>
<td>1.069</td>
</tr>
<tr>
<td>Audit reports</td>
<td>37</td>
<td>2</td>
<td>5</td>
<td>3.11</td>
<td>0.894</td>
</tr>
<tr>
<td>Recommendations for improvements</td>
<td>37</td>
<td>2</td>
<td>5</td>
<td>3.34</td>
<td>1.072</td>
</tr>
<tr>
<td>Valid N</td>
<td>37</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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### Table 2 Correlation Analysis

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Control environment</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Audit function</td>
<td>0.217</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk management</td>
<td>0.301</td>
<td>0.502</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net profit</td>
<td>0.294</td>
<td>0.091</td>
<td>0.291</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on equity</td>
<td>0.338</td>
<td>0.447</td>
<td>0.411</td>
<td>0.094</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Return on assets</td>
<td>0.276</td>
<td>0.389</td>
<td>0.299</td>
<td>0.179</td>
<td>0.266</td>
<td>1</td>
</tr>
</tbody>
</table>

$\sigma=0.01$ (correlation is significant at 0.01 level)
$\sigma=0.05$ (Correlation is significant at 0.05 level)

7. Conclusions

There is a positive correlation between internal audit function with financial performance. It is concluded that there exists difficulty in the execution of controls particularly considering that the audit function is not well extended to most of the Sacco’s which clearly has adversely affected their efficiency as revealed by this study.

References


Shaw, L. (2006) Overview of Corporate Governance Issues for Co-operatives:


