

EFFECT OF **INTERNAL CONTROL** ON FINANCIAL PERFORMANCE OF
COMMERCIAL BANKS LISTED IN NAIROBI SECURITIES EXCHANGE
IN NAIROBI COUNTY KENYA

ABSTRACT

The latest collapse of some of the largest commercial banks in Kenya such as Imperial and Chase bank that are under receivership has cast doubt on the effectiveness of the current audit practices of these banks to steer them into stability and improved financial performance. The recent failures have put pressure on the commercial banks to rethink how best they can align their **internal audit processes** to ensure stability and improvement in financial performance. This study therefore sought to assess the effect of internal control on financial performance of commercial banks listed on NSE. The theory that guided this study was reliability theory. This study adopted a descriptive survey design with the target population comprising of 10 commercial banks listed on NSE while the unit of observation was 50 respondents from the following category: senior finance manager, credit manager, operations manager, risk manager and internal auditor. The study made use of primary and secondary data. A semi-structured questionnaire of Likert-type was used to collect primary data on internal audit while secondary data collection sheer was used to collect data on financial performance of the commercial banks from their audited financial reports. Data gathered from the questionnaires were analyzed quantitatively using SPSS computer software. The study used both descriptive (mean and standard deviation) and inferential statistics for analysis. Inferential statistics; regression coefficient and bivariate correlation were used to analyze the relationship between the dependent variable and the independent variables. The study found that there was effect between internal control, asset safeguarding, risk management, compliance with laws and the dependent variables; return on assets, net income and liquidity as was indicated in the regression analysis. The study concludes that **internal audit systems** have an effect on financial performance of commercial banks however, **internal control do not have a significant effect on financial performance of commercial banks and attention should be paid on them.** This study recommends that commercial banks listed at the Nairobi Securities Exchange should re-evaluate their internal controls systems and strengthen their weak areas so as to improve their financial performance. The study suggests that researchers may consider undertaking research on the effect of new banking regulations such as Basel Accord III on financial performance of commercial banks

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Key words: Internal control, financial performance, commercial banks

INTRODUCTION

There is a global consensus that internal auditing may provide hitherto unmatched value to management in their day-to-day operations (Tadesse, 2015). Changing focus from just assuring adherence to laws to really providing value takes more than just a shift in organizational priorities. Many financial firms mismanage their assets because of low pay and morale, lax ethics policies, and inefficient management procedures. Kithinji (2017)

claims that commercial banks have realized the importance of internal audit in enhancing the management of bank assets, which has resulted in better financial performance for the banks. Some financial institutions have also implemented an evaluation system for their operations; this system is not meant to replace internal audits, but rather to augment them.

The term "internal audit" refers to the administrative process that include verifying records, taking inventory, and reporting findings to the board of directors, management, or outside auditors (Naimiet al.2020). Organizations are under increasing pressure to show how they are being responsible stewards of shareholder funds and how effectively they are delivering services. Organizations now place a premium on internal audit's expertise and professionalism as a result of resource constraints, with the expectation that the department would maximize the effectiveness of its limited resources in the areas of risk minimization and management (Hoitash, Hoitash&Bedard, 2020). The ability to monitor and analyze data at ever-increasing rates is made possible by technological progress, underscoring the need of sound advice from the internal auditing department (Furnham& Gunter, 2015).

According to Badara and Saidin (2012), internal auditing is an impartial and unbiased kind of consulting that helps businesses succeed. Put simply, it helps by giving a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control, and governance systems, hence enhancing an organization's capacity to fulfill its objectives (Asare, 2009). It's a service that determines how well an organization manages risks, exercises control, and exercises sound corporate governance. The audit's findings are useful not just to the company's top brass, but also to those in charge of running the departments under scrutiny.

Internal audit contributes to the success of an organization by using a rigorous and disciplined approach to evaluating and improving the effectiveness of risk management, control, and the management process. This helps the business get closer to accomplishing its objectives (Asare, 2019). When conducting an internal audit, there are a number of goals and guidelines that need to be adhered to. However, the final decision regarding whether or not the management of the bank makes use of an appropriate and effective internal audit system, a system for assessing the risks associated with banking activity and bank capital, and an appropriate method for ensuring that laws, regulations, and internal policies are followed rests with the board of directors of the bank. The management of the bank is also in charge of developing policies that identify, quantify, track, and manage the risks the bank confronts (Amudo&Inanga, 2019).

There are three fundamental ratios that are used in the process of evaluating the monetary efficiency of an organization. These three measures are the ROA, ROE, and ROI. These are very common tools for evaluating the effectiveness of businesses, particularly commercial banks. ROA and ROE have been used by bank regulators and analysts for a number of objectives, including those in which a measurement of profitability is sought, such as to evaluate industry performance and anticipate developments in market structure. According to Muga (2012), the significance of profitability in the banking industry may be evaluated at both the micro and macro levels of the economy. At the local level, profit is not only the most cost-effective source of finances but also an important criterion for running a competitive financial organization. The maximization of profits should always be the primary focus of a bank's management.

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Commercial banks are financial establishments that take deposits, lend money to businesses, and provide other services linked to these activities. The Central Bank of the Kingdom (CBK) has issued a number of Acts and other rules that regulate these banks. These laws include the Companies Act, the Banking Act, the Central Bank of Kenya Act, and other similar prudential laws. Assets, deposits, profitability, and the variety of banking services and products available in Kenya have all increased during the last several years. This growth may be attributed to a number of factors, including the industry's increased presence in Kenya and the broader East African Community region, the automation of many formerly manual processes, and the change toward catering to the specific needs of each customer. There has been a rise in the importance of internal auditing for banks to strengthen asset management, risk management, and management controls. As of this writing, there are 42 commercial banks in Kenya (CBK, 2017).

Comment [A4]: Coherence problem

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Statement of the Problem

Internal auditing, as stated by Hoitash, Hoitash, and (Bedard, 2009), aids in introducing a systematic, disciplined approach to assessing and enhancing the efficiency of financial operations. A better bottom line is correlated with a more efficient and effective internal audit function that cuts costs, finds methods to increase productivity, and reduces risk from poorly protected assets. Accordingly, a reliable internal audit is a crucial management resource for enhancing fiscal results. This is crucial not only for the reasons stated above, but also for the purpose of increasing the value to the shareholders. Internal auditing techniques help commercial banks detect financial fraud and contribute significantly to improved financial performance.

However, despite the guidelines set out by CBK in accordance with the Banking Act, cases of bank failures in performance due to fraud and lack of elaborate internal controls remain high. This has been aggravated by lack of compliance with internal and external regulations within the banking sector (FLSTAP, 2015). For instance, within a period of nine months, three banking institutions were put under receivership by CBK. Imperial bank of Kenya the 19th largest bank in Kenya was put under receivership due to what CBK termed as inappropriate banking practices. In another case the Dubai Bank of Kenya was put under receivership for violation of banking guidelines. Chase bank was later on put under receivership on grounds of weak financial conditions (Ngigi, 2015). All these cases point to financial hardship in the commercial banking sub-sector over the past few years.

Lack of empirical information on the impact of internal audit on financial performance among commercial banks in Kenya also inspired this research. The majority of previously published research has examined the effects of good corporate governance and risk management on financial results. Yousfi(2015) investigated the impact of risk management practices on financial performance in Jordan, Khan et al. (2017) looked at what factors influence financial performance across different sectors, and Mutua (2012) studied the impact of risk-based auditing on Kenya's commercial banks' bottom lines. This study will deviate from the aforementioned investigations by focusing on internal audit's role in influencing commercial banks' bottom lines in Kenya.

Comment [A6]: Poor reason to conduct research

Research objective

- i. To determine the effect of internal control on financial performance of commercial banks listed in NSE

Scope of the Study

The focus of the study was establishing the role of internal audit on financial performance of commercial banks listed in NSE. The study specifically assessed the effect of internal controls, asset safeguarding, risk management and compliance to laws on financial performance of commercial banks listed in NSE. The choice of commercial banks listed in NSE as the unit of analysis for the study is informed by vulnerabilities and financial risks faced by the banks as a result of ineffective audit processes (CBK, 2017). Descriptive research design will be adopted for the study. This research focused on the 10 commercial banks traded on the NSE, and the unit of observation was made up of employees familiar with these institutions' internal auditing processes and financial standing. Commercial banks listed on the NSE was the focus of this research, namely their operations management,

finance manager, credit manager, risk manager, and internal auditor. The target year for this study's execution is 2019.

LITERATURE REVIEW

Theoretical literature review

Reliability Theory

The likelihood that a system will perform as predicted during a certain time period is described by reliability theory (Gavrilov&Gavrilova, 2001). Companies in the insurance and life insurance industries have utilized the idea as a guide for determining what premiums would provide the most profits. Based on this notion, an organization's internal auditing setup should mainly serve to identify and manage potential threats. More substantive work, and hence higher costs, are predicted from this idea as a consequence of inadequate internal audit systems (Kinney, 2000).

When evaluating the effect of an internal audit system on the firm's revenue risk, it might be helpful to compare the estimates of process and system dependability with financial data from the organization's prior performances. According to Messier and Austen (2000), the reliability theory's direct link to the demands of an organization in comprehending the internal audit system and control risk assessment is one of the theory's key benefits. The core tenet of dependability theory is that a working system will perform as intended. Based on its significance as a key variable in risk management, the dependability theory is directly pertinent to our investigation.

Empirical Literature

Internal Controls and Financial Performance

Researchers used both primary and secondary data, with the latter coming from the SACCOs' annual reports, to complete the study. The findings of the research showed that there is a positive and significant association between good internal control and good financial performance. The financial performance of SACCOs in Kenya is favorably impacted by all of the independent factors, including the control environment, risk assessment, control activities, and monitoring methods. The research demonstrated conclusively that in the absence of robust internal controls inside these institutions, not only would their performance be subpar, but the institutions would also be at danger of going bankrupt in the long run.

Jones (2008) studied the history of corporate governance, accountability, and internal controls in both medieval and contemporary Britain. The evaluation took into account the monitoring and control operations, information and communication, the risk assessment, and the control environment. The internal controls of the royal exchequer and other medieval

organizations were examined through the lens of a referential framework in this research. The research showed that most modern internal checks and balances were already in place in medieval England. The foundations of medieval internal control were identified as stewardship and personal responsibility. The modern idea that people ought to be held to higher standards of responsibility is reminiscent of medieval ideas.

Similarly, Ewa and Udoayang (2012) looked at how the architecture of internal controls for banks affected their ability to identify and prevent fraud. The results of the research show that the way in which internal controls are constructed affects the way in which employees see fraud. Employee fraud may be prevented by implementing stringent internal control mechanisms and making it difficult to commit fraud in the first place. However, when there are holes in the system's defenses, dishonest employees may be able to take advantage of them to steal money. They pushed for the implementation of stringent internal control procedures to prevent and identify fraud.

The RMCs of the African Development Bank Group in Uganda had their internal control systems assessed by Amudo and Inanga (2009). The factors considered were "control environment," "information and communication," "risk assessment," and "monitoring and control actions." According to the results of the research, the existing control structures in these projects are inefficient because they lack certain control components of successful internal control systems. The research concluded that the projects' current internal control mechanisms needed to be strengthened.

Mawanda's (2008) investigation of the effect of internal control systems on the financial performance of Ugandan universities. Liquidity, accountability, and reporting were used to assess financial performance, while the control environment, internal audit, and control activities were used to rate the quality of the internal controls in place. It has been shown via this study that an organization's internal control system has a direct effect on its bottom line. Competency profiling is recommended for the internal audit department in this study, which takes into account the institution's expectations for the internal audit and the required number of people to meet those objectives.

An analysis of the efficiency of the internal control system at a Nigerian bank was conducted by Atuk (2011). From the twenty-four (24) banks already in operation in Nigeria, five (5) were selected. Questionnaires, direct observation, and in-depth interviews were used to collect information from many branches of the banks of interest. Extensive analysis was performed on the collected data. Based on the results of this research, we may be certain that

the banks in Nigeria are operating effectively and efficiently, that financial and managerial reporting can be trusted, and that all relevant rules and regulations are being adhered to.

Independent Variables

Dependent Variable

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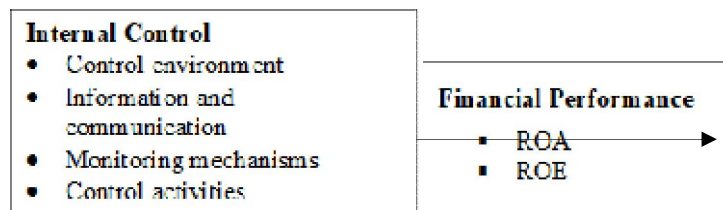


Figure1. Conceptual Framework

RESEARCH METHODOLOGY

Research Design

Research design is the blueprint for collection of required data and methods of carrying out the necessary statistical analysis to find solutions to the problem identified and objectives of the study. A descriptive survey design will be employed in conducting this study (Ritchie, Lewis, Nicholls, & Ormston, 2013). This design is suitable as it discovers and measures cause and effect relationships among variables. Such a study strategy is appropriate here since a complete understanding of the issue prior to its resolution is necessary (Frankfort-Nachmias & Nachmias, 2007).

Target Population

The study population encompasses all the individuals of interest to the research study with similar characteristics (Mugenda & Mugenda, 2003). The target population of the study will comprise of 10 commercial banks listed at NSE which will be the unit of analysis while the unit of observation will comprise of the senior finance manager, credit manager, operations manager, risk manager and internal auditor of the commercial banks listed at NSE. The participants in this survey were selected because they had shown expertise in both internal audit systems and commercial banks' financial performance. The research consisted of a sample of 86 people.

Sampling Procedures and Techniques

Since information was collected from each of the ten commercial banks traded on the NSE, a census sampling technique was employed. Because of the manageable size of the population, a census was used to obtain the necessary information.

Research instruments

The research used both primary and secondary sources of data in its analysis. For the purpose of making the research more unique, primary data was gathered from the respondents, and secondary data was taken from the audited financial statements of the listed commercial banks. For the purpose of gathering primary data on the study's independent variables, the research project made use of a questionnaire with a semi-structured format.

Data Analysis Techniques and Procedures

Response Rate

The researcher administered a total of 86 structured questionnaires to the sampled commercial banks in Nairobi. The targeted respondents were Senior Finance Managers, Credit Managers, Operations Managers, Risk Managers and Internal Auditors. Out of the total 86 questionnaires which were administered to the respondents, 78 questionnaires were returned and the questions were fully answered.

Comment [A8]: 50 in abstract part

Demographic Information

This chapter presents the results which have been obtained from the data collected and analyzed through use of various statistical tools which are the questionnaires and Statistical Package for Social Sciences. Descriptive and inferential statistics have been utilized whereas frequency tables and figures have been used to present the findings of the study for easier interpretation.

Descriptive Statistics

This research sought to establish the duration with which the selected commercial banks take to perform review of their internal control systems. The findings obtained were presented in Table 1.

Table 1: Review of Internal Control Systems

Duration	Frequency	Percent
After 5 years	2	2.6
Annually	33	42.3
Half yearly	21	26.9
When need arises	22	28.2
Total	78	100

Researcher (2023)

From the findings presented in the Table 1, the study shows that majority (42.3%) of the respondents indicated that review of internal control systems was done by banks annually. 28.2% of the respondents indicated that review of internal control systems was done when need arises. 26.9% of the respondents indicated that review of internal control systems was done on a semiannually basis while 2.6% of the respondents indicated that review of internal control systems was done after a period of five years. The findings imply that commercial banks review their internal controls at different times and when there is need to do so.

Effectiveness of internal control systems in relation to financial performance

The study sought the views of the respondents in the selected commercial banks concerning the extent to which internal control systems are effective in relation to financial performance.

Data findings were as presented in Table 2.

Table 2. Internal Control

Statements	N	Mean	Std Deviation
The level of integrity practiced by operating personnel can influence financial performance in the bank	78	4.064	.944
Strict adherence to the general values of ethics in the bank influences financial performance of the bank.	78	4.541	.751
Financial performance of the bank depends so much on the level of commitment to work by the staff.	78	3.987	.987
Management competency in handling the banking system influences the bank financial performance.	78	3.782	1.147
Internal Control generally influence the financial performance of commercial banks.	78	3.923	.950
The board is competent and strongly committed to implementation of recommendations from the internal audit department for the betterment of the bank's financial performance.	78	3.897	.920

Source: Researcher (2023)

From the findings as presented in Table 2, respondents agreed (mean= 4.064; std. dev. = 0.944) 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 4.541 and the standard deviation of 0.751.

It is also evidenced by the findings that 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 3.987 and the standard deviation of 0.987, indicating that the respondents agreed with the statement. From the table, the findings also indicated that the respondents agreed (mean= 3.782; std. dev. = 1.147) with the statement that management competency in handling the banking system influences the bank financial performance.

The findings as well indicated that the respondents agreed with the statement that control environment generally influence the financial performance of commercial banks. The mean of 3.923 and the standard deviation of 0.950 as presented in the table prove the agreement with the statement. It is evidenced by a mean of 3.897 and standard deviation of 0.920 that the respondents agreed with the statement that the board is competent and strongly committed to implementation of recommendations from the internal audit department for the betterment of the bank's financial performance.

From the findings based on the analysis using the means and standard deviation, internal control influences financial performance of banks. The study findings are in agreement with Nyaga (2017) findings that the frequency of board meetings and board composition influenced financial performance. The findings also concur with Magara (2013) findings that internal control environment influences financial performance.

Regression Analysis

This study employed multi regression analysis to determine the relationship of independent variables with the dependent variable. The dependent variable was financial performance of the selected commercial banks measured by return on assets. Independent variables of the study included internal control

Table 3: Analysis of Variance

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression					.000 ^b
	27.059	5	5.412	11.787	
Residual	33.057	73	.459		
Total	60.115	78			

Source: Researcher, (2023)

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), internal control,

From Table 4, the significance value in testing the reliability of the model for the relationship between financial performance and internal control was obtained as 0.000 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 control in the commercial banks.

Table 4: Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.735 ^a	.540	.512	.67759

a. Dependent Variable: Financial Performance

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 financial performance of commercial banks. Therefore, basing on the findings presented in the table while holding other factors constant, the internal control contribute to 54% growth in financial performance of commercial banks.

Table 5: Regression Coefficients

Model	Unstandardized		Standardized	t	Sig.
	Coefficients		Coefficients		
	B	Std. Error	Beta		
(Constant)	1.057	.587		1.801	.076
Internal Control	-.930	.496	-.971	-1.874	.065

a. Dependent Variable: Financial Performance

According to the findings as presented in Table 5, internal control has a negative coefficient indicating negative effect on the performance. It observed from the table that internal control does not have a significant effect on financial performance, $t(73) = -1.874$, $P=0.065$. $Y = 1.057 - 0.930X_1$. Based on the findings it is observed that internal control does not have a significant effect on financial performance, $t(73) = -1.874$, $P=0.065$. On beta coefficient interpretation one-unit increase in internal control, financial performance will decrease by 0.93. This implies that internal control component may not function alone to produce positive results.

Summary of the Findings

Internal Control and Financial Performance

The objective of the study was to determine the effect of internal control on financial performance of commercial banks listed in NSE. According to findings of this study, internal control has a negative and insignificant effect on the financial performance of selected commercial banks.

Conclusions

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

Recommendations

On the basis of the study findings and conclusions which have been made, the researcher recommends the following measures to be implemented by the commercial banks listed in NSE

in Nairobi County for better objectives to be realized. Internal Control has a negative effect which is insignificant to financial performance. The management of commercial banking institutions should ensure that every aspect of internal control which causes the negative influence on financial performance is given proper attention and measures be put in place to address the negative effect of such aspects. Management should find the possible alternative ways of improving on internal control in order to achieve a positive effect of it on financial performance.

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