

**A SURVEY OF THE IMPACT OF INTERNAL CONTROLS ON OPERATIONAL
EFFICIENCY AMONG NON-GOVERNMENTAL-ORGANIZATIONS IN NAIROBI**

BY:

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DECLARATION

This management Research Proposal is my original work and has not been presented in any other University.

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D61/7266/2006

Signed.......... Date.....

This Management Research Project has been submitted for examination with my approval as University Supervisor.

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DEDICATION

I dedicate this research project to my loving mother. Her encouragement and support propelled me to achieve my goal.

ACKNOWLEDGMENT

This Research Project would not have been possible without the cooperation and support of a number of people, who in one way or the other steered me towards my ultimate goal. I would like to express my appreciation to them and especially to the following:-

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To all, I remain forever grateful

ABSTRACT

The study aimed at investigating the impact of internal control on the operational efficiency of NGOs based in Nairobi. A sample of fifty NGOs was selected and interviewed to form the basis of this project. Information was collected by use of a questionnaire which made use of both open and closed ended questions. The questionnaire used a three point likert scale which ranged from 'Yes', 'No', and 'I don't know'. The collected data was entered into a statistical package for social sciences for analysis.

The analysis indicated that internal controls in the NGOs based in Nairobi were determined largely by the organization structure. It is the top management that decided on how the resources received from donors and other financiers were to be allocated and distributed to the beneficiaries. Cash management was ranked second internal control factor affecting NGOs operational efficiency. NGOs with good cash management were in a position to attract many sources of funds for their operations and as such, this called for proper use of resources at their disposal. They ensured this by putting in place proper policies and procedures to guide their operations. NGOs with well structured organizational structures had well structured policies and procedures on how activities were run. Higher operational efficiency was registered in big well known NGOs which lead to controlled internal controls by the funding partners.

The findings indicate that the five factors which include organization structure, payroll management, procurement, cash management and asset management affect operational efficiency to 82.5% as depicted by the correlation and coefficient of determination. The other factors not investigated in this study, constitute the remainder 17.5%. From these findings, it is clear that internal control impacts operational efficiency.

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CHAPTER ONE

INTRODUCTION

1.1 Background to the study

Management control in nonprofit organizations is a topic about which very little information exists in the accounting literature. Most studies dealing with management control have been conducted in for-profit businesses, where management control techniques were originally developed. Although the manner in which managers may apply the concepts of management control may differ in some respects, the basic concepts of management control are the same for both for-profit and nonprofit organizations (Anthony and Young, 1994).

As with for-profit entities, a non-profit organization prepares and adopts documents such as articles of incorporation and bylaws that set forth the organization's basic mission, governance structure, and overall operating procedures. Most non-profit organizations establish a governing board, elect officers, and appoint various committees. These individuals are responsible for hiring a chief executive who directs the work of paid staff and volunteers in order to achieve the overall goals of the organization (Langan, 1998).

Unlike for-profit organizations, non-profit organizations are incorporated as nonstock entities where ownership rests with the members or supporters of the organization. Several characteristics that are unique to nonprofit organizations affect the management control process. One of these unique characteristics is the absence of stock ownership. Managers might not consider themselves as accountable to donors as they would to

owners. In addition, the absence of a single measure of overall performance such as net income creates a problem for managers of non-profit entities in evaluating the effectiveness and efficiency of the organization. Furthermore, non-profit organizations are often managed by the professionals who provide the services offered by the organization. Traditionally, the educational background of these professionals contains little or no training in business management or accounting. The governance of nonprofit organizations is vested in some type of governing board. Members of this board are often chosen for reasons other than their ability to exercise sound judgement about the management of the non-profit organization. The members of the board do not always know their responsibilities and are often insufficiently informed. Therefore, the decisions they make are not always optimal. All of these characteristics of nonprofit organizations indicate that an adequate system of internal control is vital for proper management of nonprofit organizations (Anthony and Young, 1994).

When companies suddenly collapse, the often-resounding question is, “what went wrong?” A breakdown in the internal control system is the usual cause. Internal control is a process that guides an organization towards achieving its objectives. These objectives include operational efficiency and effectiveness, reliability of financial reporting, and compliance with relevant laws and regulations (COSO 1992). Absence of these variables often results in organizational failure. The findings of the Treadway Commission Report of 1987 in the United States (USA) confirmed absence of, or weak, internal controls as the primary cause of many cases of fraudulent company financial reporting.

In the NGO sector, the relationship between the provider and users of information is not clearly defined. NGO managers have reporting responsibility to their donors and Governments in most cases, concerning the discharge of resources provided. The developmental and service oriented nature of NGO operations mean that management must report on financial and non- financial aspects of operations. It means the accountability of the NGO sector is potentially widespread and complex. Accountability must weigh the interests of provider and users and is bi-directional rather than unidirectional (Ijiri, 1983).

Accountability in its broadest sense refers to the giving and demanding of reasons for conduct (Roberts, 1991). In this sense, accountability is "a chronic feature of daily conduct" (Giddens, 1979). Edwards and Hulme (1995) define accountability as "...the means by which individuals and organizations report to a recognised authority (or authorities) and are held responsible for their actions". Gray et al. (1996) define accountability as: "The duty to provide an account (by no means necessarily a financial account) or reckoning of those actions for which one is held responsible."

From the definitions above, the following aspects of accountability are prominent. First, the acceptance of stewardship of resources; second, to undertake (or refrain from taking) actions) to protect resources; and, finally, to provide an account of these actions (for success and failure) and to be held responsible for these. Accountability, therefore, involves two major elements - to account and being held to account (Stewart, 1984). For accountability to be clear and enforceable, the relationship between the accounter and accountee must be explicit.

Accountability is seen as a pre-condition for responsible behaviour in business, government or any other major centre of power. The conventional view of accountability is essentially legalistic; it states that accountability is necessary because of the separation that exists between principals and their agents. A frequent feature of an economic entity either in the public/nonprofit or private sector is the separation of the power of owners of the resources from the management group entrusted by the owners to manage these resources on their behalf. This separation of ownership and control gives rise to the possibility of the mismanagement of resources by management at the expense of the owners' interest.

Therefore, the owners/trustees tend to scrutinize the management operations to assure themselves of the continuing custodianship of their resources. So, the responsibility of management to account for the effective utilisation of resources is not optional but an obligation one and failure to do so will entail sanctions. Lee (1993) views accountability as a societal control mechanism to hold individuals or organisations in society accountable for their actions. His view echoes the common concern about the welfare of the society in general and the individual parties in particular. Much earlier, researchers emphasized social stewardship and accountability by arguing: "in accepting control over the resources combined in an enterprise, whether privately or publicly owned, management also accepts a stewardship responsibility to utilise the resources effectively and to protect them from waste and inefficiency. This is a matter of general social concern because any society, regardless of its political, economic, religious or other philosophies is affected by the way in which resources are utilised".

Najam (1996a) identifies three main groups to whom NGOs are accountable to: patrons (who provide the NGO with goods and services), clients (to whom NGOs provide goods or services), and NGOs themselves (to employees). Control systems can meet demands for two principal types of accountability; short term functional accountability, (such as accounting for resources, resource use and immediate impacts); and strategic accountability (accounting for the impact of NGO actions in society and on other organizations) (Leat, 1988; Najam, 1996a, 1996b; Edwards & Hulme, 1995; Kramer, 1981; Tandler, 1982; Clark, 1991; Cernea, 1998). Highly unstable political situations, social disorder, religious strife, and economic malaise may lead to mismanagement of resources in some developing countries. The role of control in this context is significant and has been described as a tool for advancing accountability (Gray et al 1996; Roberts, 1991). NGO sector accountability is complex as operations involve the attainment of non- financial and financial objectives.

Two classes of internal controls namely; administrative controls and accounting controls can be identified from the foregoing description of internal control system. Administrative controls comprise of, but not limited to, the plan of organisation, procedures and records that are concerned with the decision making process, leading to management authorization of transactions. Such authorization is the management function directly associated with the responsibility for achieving the objectives of the organization and is the starting point of establishing accounting controls of transactions (Esmailjee, 1993).

The internal administrative controls have little bearing on the financial statements of a business concern. These controls are established by management to provide for operational efficiency and for adherence to corporate policies in all departments of the organization. Accounting controls are those that have a direct bearing upon the reliability of the accounting and financial statements. They comprise of the plan of the organization, procedures and records that are concerned with safeguarding of assets and reliability of financial records.

The control environment sets the tone of an organization and provides the foundation for effective system of internal control. Management attitude should be committed to ethical business practices and to following the established control procedures. An effective control system enables management to be apprised of, monitor and manage significant risk. Employees should be adequately trained and supervised. Rotate job duties or require mandatory vacations. Clearly define job responsibilities and to keep employees accountable. Separate responsibilities for related operations. Separate operations, custody of assets, and accounting (Keitany, 2000).

Internal control system should be assessed and monitored by line management on an on-going basis and subjected to periodic evaluation. Watching for warning signals indicating dishonesty or fraud. Properly organized and effectively operated internal auditing can give management a way to help monitor the reliability and integrity of financial operating information (Keitany, 2000).

The term, "non-governmental organization" or NGO, came into use in 1945 because of the need for the UN to differentiate in its Charter between participation rights for

intergovernmental specialized agencies and those for international private organizations. At the UN, virtually all types of private bodies can be recognized as NGOs. They only have to be independent from government control, not seeking to challenge governments either as a political party or by a narrow focus on human rights, non-profit-making and non-criminal (NGOs Act 19 of 1990).

An NGO has been defined in the Act (NGOs Act 19 of 1990) to mean “a private voluntary grouping of individuals or associations not operated for profit or for other commercial purposes but which have organized themselves nationally or internationally for the benefit of the public at large and for the promotion of social welfare development, charity or research in the areas inclusive but not restricted to health relief, agricultural, education, industry and supply of amenities and services.”

Internal control means a system and a process established and operated within a small and medium sized enterprise for it to carry out its operation in a proper and efficient manner.

Major examples of its objectives are ensuring compliance (abiding by laws and regulations), ensuring trust in financial reporting and increasing operational efficiency (COSO, 1992,).

Operational efficiency is defined as the ability for an organization to execute its tactical plans while maintaining a healthy balance between cost and productivity. For NGOs, operational efficiency refers to a situation where the resources available are utilized maximally to generate economic resources (Lewis, 2001).

1.2 Statement of the Problem

In the NGO sector, the relationship between the provider and users of information is not clearly defined. NGO managers have reporting responsibility to their donors and Governments in most cases, concerning the discharge of resources provided. The developmental and service oriented nature of NGO operations mean that management must report on both financial and non- financial aspects of operations. It means the accountability of the NGO sector is potentially widespread and complex. Accountability must weigh the interests of provider and users and is bi-directional rather than unidirectional (Ijiri, 1983).

Sound internal control system consists of detailed procedures and records adopted by management and primarily concerned with the reliability of financial records and reports and with safeguarding of assets. The fundamental elements of a sound system of internal controls are:- an organizational plan and structure which ensures the adequate separation of duties and functions, (i) A system of authorization and procedures which provide reasonable accounting control (ii) A firmly established system which prescribes the details and functions of each organizational unit and applies sound practices and adequate procedure (iii) Trained, experienced and adequate staff capable of carrying out the responsibilities (iv) Prescribed standard of performance and (v) a complete internal audit unit possessing the maximum independence

An internal control system that fulfills all this is very important to Non-Governmental-Organizations reason being that NGOs are recipients of huge amounts of donor funding

and assets which require a sound internal control system for proper care and management of these resources. In order to fulfill this responsibility, the management of the NGOs establish procedures to be followed in their day today operations which among other things are meant to safeguard NGOs' assets and ensure reliable recording of the monetarily transactions. The need for an effective system of internal control is therefore evident (Esmailjee, 1993).

Effective Internal control is of paramount importance for the NGOs. It could serve many purposes such as; reducing frauds and errors, makes information available that can be used as a basis for making financial and administrative decisions. It assists management in policy formulation and in the operational control of the organization. It emphasizes the need for well defined standard operating procedures (SOPs) (Mohammed, 1983)

In recent years, funding constraints, calls for accountability, media exposure and the development of a contract culture have brought demands for increased performance measurement within the development sector. Donors place greater emphasis on effectiveness and sustainability. As a consequence, NGOs are currently under pressure to undertake increased monitoring and evaluation and present measurable indicators of output, impact and capacity (Edwards, 1999; Lewis, 2001; Hailey, 2000; 2003). Thus, in general, greater attention has been given to the management challenges NGOs face with the main challenge being establishment of efficient and effective internal control mechanisms.

Several studies have been carried out in the area of internal control including Esmailjee (1993): he documented and evaluated internal control system of Nyayo Bus Services

Corporation, Nairobi; Salim (1983) evaluated internal control in Ethiopian Airlines; Nairobi Branch. Keitany (2000) studied internal audit control function and its implication for risk assessment by the external auditors; a case study of quoted companies. Ali (2009) studied financial controls in public secondary schools in Mombasa district. There is no study that has studied internal controls in NGOs especially how it impacts the operational efficiency. This study attempts to fill this information gap by studying control systems and its impact on operational efficiency in NGOs.

1.3 Objective of the study

The objective of the study was to establish the impact of internal control systems on the operational efficiency of NGOs operating in Nairobi.

1.4 Significance of the study

The findings of this study were important to a variety of interested parties such as:

1.4.1 Management:

By highlighting the impact of internal controls on the operational efficiency of NGOs, the management teams were motivated to increase their monitoring function and overall evaluation of their internal control system for sustained higher operational efficiency.

1.4.2 Funding agencies

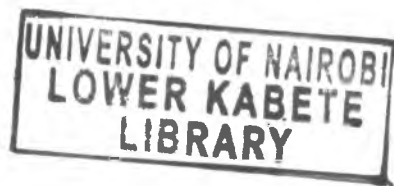
The study enabled donor agencies in establishing the controls that NGOs had put in place to monitor their activities and ensure minimal misuse/misappropriation of such funds.

1.4.3 NGO regulators

Regulators learnt on the best way to regulate operations of NGOs to ensure sound internal control systems are maintained.

1.4.4 Scholars and researchers

Scholars and researchers found this study important for the purposes of further research based on the findings of the current study as a source of reference.



CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter reviews existing literature on internal controls. This review is done with the purpose of providing a theoretical framework that enables answering the research question which is to establish the impact of internal controls on operational efficiency of Nongovernmental organizations in Nairobi

2.2 Review of Theories

2.2.1 Value Theory

According to Catton (1956) an individual's preferential behavior shows certain regularities and this pattern can be attributed to some standard or code, which persists through time. Values provide a basis by which people can order their intensities of desiring various desiderata (something desirable). Based on available choices, people make preferences grounded in their values. In an organizational context, knowledge of such preferences of individuals provides a context for managerial decision-making. Keeney (1992) argues that values are guiding principles to evaluate the desirability of a particular consequence. "Values are what we care about and they should be the driving force for our decision making (Keeney, 1992)".

Value is not a property of an object but is a quality of relationship (Catton, 1956.). A person's desire for something under a given situation depends on "selective perception" of that person. Selective perception directs valuation by substituting final goals with other

intermediary goals i.e. a goal may be pursued in order to attain some higher ultimate goals. Thus the nature of the major goals accepted by individuals together with notions of ways in which these goals might be affected by future events, are the determinants of values of people. Value Theory provides a theoretical platform to affirm that values are important for decision making and incorporating values in developing decision objectives helps individuals accept the results of such decisions.

2.2.2 Control Theory

Control theory and experience suggests that a person who abuses a system of controls is more likely to act alone than to collude with another. According to Rotter (1966), internal locus of control (ILOC) versus external locus of control conceptualizes how individuals see their own actions affecting events that surround their lives. Individuals with ILOC tend to believe that events are the results of their own actions (Rotter, 1966), while individuals with external locus of control tend to attribute events to external environmental factors, such as powerful others or chance (Levenson, 1973).

If we put the concept of ILOC in the context of an entrepreneur running their business in a competitive environment, we can imagine that an entrepreneur with a strong ILOC would believe that they can make things happen, and that the success or failure of their business is the result of their own actions. In contrast, an entrepreneur with an external locus of control might consider that the external environment is the main reason for their business success or failure.

2.2.3 Agency Theory and Agency Costs

Since Jensen and Meckling (1976) proposed a theory of the firm (Agency Theory) based upon conflicts of interest between various contracting parties – shareholders, company managers and debt holders – a vast literature has been developed in explaining both aspects of these conflicts. Jensen and Meckling (1976) further specified the existence of “agency costs” which arise owing to the conflicts either between managers and shareholders (agency costs of equity) or between shareholders and debt holders (agency costs of debt). Financial markets capture these agency costs as a value loss to shareholders.

Jensen and Meckling (1976) defined the agency relationship as a contract under which one party (the principal) engages another party (the agent) to perform some service on their behalf. As part of this arrangement, the principal will delegate some or all of the decision-making authority to the agent. In practice, shareholders from most corporations delegate the decision-making authority to the board of directors (BOD). In turn, the BOD delegates power to the chief executive officers (CEO). The agency problems arise because of the impossibility of perfectly contracting for every possible action of an agent whose decisions affect both his own welfare and the welfare of the principal.

The agency theory argues that an agency relationship exists when shareholders (principals) hire managers (agents) as the decision makers of the corporations. The agency problems arise because managers will not solely act to maximize the shareholders' wealth; they may protect their own interests or seek the goal of maximizing

companies' growth instead of earnings while making decisions. Jensen and Meckling (1976) suggested that the inefficiency may be reduced as managerial incentives to take value maximizing decisions increased. Agency costs are arising from divergence of interests between shareholders and company managers. "Agency costs" are defined by Jensen and Meckling as the sum of monitoring costs, bonding costs and residual loss.

2.3 Internal Controls

A review of literature on internal control system reveals that the most widely used reference framework is the American document published in 1992 entitled Internal Control Integrated Framework, more commonly referred to as COSO, an acronym of Committee of Sponsoring Organizations of the Tread way Commission, derived from the name of the committee which conceived the reference framework (Aldridge & Colbert, 1994). Inputs of COSO have evolved since then into various aspects of internal control. It is now recognized worldwide for providing guidance on critical aspects of organizational governance, business ethics, enterprise risk management, fraud, and financial reporting (COSO, 1992).

Its objective is to present a framework which allows a common understanding of internal control among interested parties. Control criteria are specified and tools are suggested to assist management in evaluating internal control and in improving the control of the entity.

Finally, the COSO Report offers guidelines for preparing reports on internal control for use by external parties (Aldridge & Colbert, 1994)

Since the approach to internal control recommended by COSO in its Internal Control Integrated Framework is widely used all over the world, this research adopts the definition

of this framework to designate what internal control means. COSO defines internal control as “a process, affected by an entity’s board of directors, management and other personnel”, this process is designed to provide reasonable assurance regarding the achievement of objectives in effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations (COSO, 1992)

Effective internal control is a system of internal control whereby the designs, functions and programs of internal control achieve their intended results (Aldridge & Colbert, 1994.) Although internal control systems operate at different levels of effectiveness, a system of internal control is said to be effective when there is existence of sound control environment, risk assessment process, sound operational control activities, effective information & communication system and effective monitoring & evaluation system (COSO, 1992). These five interrelated components of internal control need to be present to conclude that internal control is effective.

The literature on internal control commonly acknowledges that the three main objectives that an enterprise should follow in order to design an effective internal control system are: reliability of financial reporting, efficiency and effectiveness of Operations, and compliance with laws and regulations (COSO, 1992). Reliability of financial reporting is the preparation of reliable published financial statements. The report includes interim and condensed financial statements and selected financial data derived from such statements.

Reliability refers to the quality of information, to what extent the information is free from error in reasonable terms. Such assurance is possible with the establishment of effective internal control system (Bushman, 2007).

Performance and profitability goals as well as safeguarding of resources are the major objectives to be attained by effective and efficient operations. This implies that operations are performed so as to attain their intended effect. Such objectives can be assessed through biannual or quarterly performance audits (Bushman, 2007,). Compliance with laws and regulations deals with those laws and regulations which the enterprise is subject to. The company must be aware of all laws and regulations to which it is subject such as generally accepted accounting principles (GAAP), corporate governance rules, and other specific ones. Therefore, the system of internal control must be designed in such a way that it complies with the requirements of applicable laws (Bushman, 2007).

As indicated in the Internal Control - Integrated Framework of COSO, the control environment sets the tone of a company or enterprise, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment encompasses the ethical values of the staff, management's philosophy and operating style, assignment of authority and responsibility, and finally the leadership and direction of the Board of Directors (COSO, 1992). An effective control environment is an environment where competent people understand their responsibilities, the limits to their authority, and are knowledgeable, mindful, and committed to doing what is right and doing it the right way.

They are committed to following an organization's policies and procedures and its ethical and behavioral standards. The control environment encompasses technical competence and ethical commitment; it is an intangible factor that is essential to effective internal control (Sampson, 1999).

Researches prove that a commitment to strong internal control by the top management is often translated into a better performance. However, not only at the top management level but building a strong consciousness of control mechanisms throughout the organization's culture is one of the ways to ensure effective control environment in the enterprise (Sampson, 1999). Risk assessment is a vital exercise for all-size companies since every entity faces a variety of risks from external and internal sources that must be assessed. A requirement for a sound risk assessment is the identification of clear objectives. Operations of the enterprise can be put in danger and its objectives remain unattained by uncontrolled risk-taking. This is why the management must assess all risks. Risk assessments are considered effective if they help determine what the risks are, what controls are needed, and how they should be managed (Keitany, 2000)

It is important that risk identification be comprehensive, at the department level and at the activity or process level, for operations, financial reporting, and compliance objectives.

Risk assessment entails that after risks have been identified, a risk analysis is performed to prioritize those risks. A complete risk assessment encompasses the assessment of the likelihood of risk occurring as well as the estimation of quantitative and qualitative costs

of the potential risk. In addition, also included is the determination of how to manage the risk (Keitany, 2000).

Control activities, are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the company's objectives. Control activities occur throughout the organization, at all levels and in all functions – be it in small or large companies. According to the purpose or intention of the type of control desired, there is a need to differentiate between preventive and detective controls. Preventive controls seek to prevent undesirable events from occurring. Such types of controls deter losses and they include proactive measures. Examples of preventive controls are separation of duties, proper authorization, adequate documentation, and physical control over assets. Detective controls, on the other hand, attempt to identify undesirable acts. Such controls make it evident that a certain loss has occurred but they do not prevent a loss from occurring. These types of control activities include reviews, analyses, variance analyses, reconciliations, physical inventories, and audit (Esmailjee 1983).

Control activities are summarized below as follows: (i) separation of the custody of assets from accounting. A custodian of an asset should not perform an accounting function relating to that asset. The reason for not permitting this is to protect the entity against malpractices. When one performs both functions, there is an excessive risk of that person disposing off the asset for personal gains and adjusting the records to relieve oneself of responsibility. (ii) Separation of the authorizations of transactions from the custody of related assets. Where possible it is desirable to prevent persons who authorize

transactions from having control over the related assets and being in possession of ownership documents of such assets. The authorization of a transaction and the handling of the related assets and ownership documents by the same person increase the possibility of malpractices within the organization. (iii) Separation of the operational responsibility from record keeping responsibility. If each department or division in an organization were responsible for preparing its own records and reports, there would be a tendency to bias the results to improve its reported performance. In order to ensure unbiased information, record keeping is typically included in a separate department under the chief accountant (Keitany, 2000).

There also should be adequate separation of duties within the accounting function. An effective system of internal control should not allow an employee to process a transaction from its original to its ultimate posting and preparation of the financial statements. This would allow for non detection of intentional or unintentional errors and sloppy performance of duties. (v) Proper authorization and approval of transactions. The system in operation should make provisions for proper authorization or approval of all transactions by appropriate individuals whose authorization limits are clearly outlined. Authorization can either be general or specific. General authorization means that the management establishes policies for the organization to follow. Subordinates are instructed to implement these general authorizations by approving all transactions within the limits set by the policy (Keitany, 2000). Specific authorization has to do with individual transactions. Management is often unwilling to establish a general policy of authorization for some transactions. Instead it prefers to make authorizations on a case by case basis.

Documents and records are the physical objects upon which transactions are entered and summarized. They include such diverse items as sales invoice, purchase orders, sales journals and employee time sheets. Both documents of original entry and records upon which transactions are entered are important but the inadequacy of documents normally causes greater control problems. Documents perform the functions of transmitting information throughout the organization and between different organizations. The documents must be adequate to provide reasonable assurance that all assets are properly controlled and records well maintained. Certain relevant principles dictate the proper design and use of documents and records. Documents and records should be: Pre numbered serially so as to facilitate control over missing documents as well as easy retrieval when needed, prepared as soon as transactions takes place, sufficiently simple to ensure that they are clearly understood, designed for multiple uses whenever possible and constructed in a manner that encourages correct preparation (Esmailjee, 1983).

Independent checks on performance involve careful and continuous review of the other control activities. The need for independent checks arises because an internal control structure tends to change over time unless there is a mechanism for frequent review. The basic essentials of a good system may all be present but unless internal controls receives attention, 'short cut ' will appear causing some procedures to be unnecessary and others inadequate. The use of an internal auditor a person trained in accounting systems and auditing is an approach adopted in maintaining and improving internal control systems. Conceptually the internal auditor should report to the highest office in the organization. This could be a committee of the board of directors (Keitany, 2000).

For an internal control to be effective one, pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities reports are produced by the information systems. Thus, operational, financial, and compliance related information contained in such reports ensures effective control over the business. Effective communication is central to effective internal control. Employees are expected to participate in the internal control activities as much as they are kept informed of what is expected of them, and how their specific duty fits into the grand picture. Therefore, controls are standardized by the use of information technology and effective communication system (Esmailjee, 1983).

The quality of internal control needs to be assessed overtime through monitoring mechanisms such as on-going monitoring and separate evaluations. The purpose of such activities is to ensure that internal control is well designed and duly applied. Monitoring is the glue that links the 5 components of effective internal control. Monitoring activities are relevant to all aspects of these components. Ongoing monitoring activities include various management and supervisory activities that evaluate and improve the design, execution, and effectiveness of internal control. Separate evaluations, on the other hand, such as self-assessments and internal audits, are periodic evaluations of internal control components resulting in a formal report on internal control (Esmailjee, 1983).

2.4 Non Governmental Organizations (NGOs)

A non-governmental organization (NGO) is any non-profit, voluntary citizens' group which is organized on a local, national or international level. Task-oriented and driven by people with a common interest, NGOs perform a variety of service and humanitarian

functions, bring citizen concerns to Governments, advocate and monitor policies and encourage political participation through provision of information. Some are organized around specific issues, such as human rights, environment or health. They provide analysis and expertise, serve as early warning mechanisms and help monitor and implement international agreements. Their relationship with offices and agencies of the United Nations system differs depending on their goals, their venue and the mandate of a particular institution (Mendelson et, al., 2002)..

According to Roberts (1991), NGOs can be distinguished into two groups: Operational and advocacy NGOs. This may be interpreted as the choice between small-scale change achieved directly through projects and large-scale change promoted indirectly through influence on the political system. Operational NGOs have to mobilize resources, in the form of financial donations, materials or volunteer labor, in order to sustain their projects and programs. This process may require quite complex organization (Sunder 1997). Finance obtained from grants or contracts, from governments, foundations or companies require time and expertise spent on planning, preparing applications, budgeting, accounting and reporting. Major fund-raising events require skills in advertising, media relations and motivating supporters. Thus, operational NGOs need to possess an efficient headquarters bureaucracy, in addition to the operational staff in the field (Lindsay, 1976)

According to Rhodes and Southwick (1986) Advocacy NGOs carry out much the same functions, but with a different balance between them. Fund-raising is still necessary, but on a smaller scale and it can serve the symbolic function of strengthening the donors' identification with the cause. Persuading people to donate their time is necessary, but, in

addition to a small number of people giving a great deal of time, it is also necessary to be able to mobilize large numbers for brief periods (Ashbaugh et, al., 2005). External donors may not impose onerous administrative burdens, but supporters still have to be supplied with information on an efficient regular basis. Major events will aim to attract favorable publicity rather than raise funds (Cernea, 1998). Therefore, despite their differences, both operational and advocacy NGOs need to engage in fund-raising, mobilization of work by supporters, organizing special events, cultivating the media and administering a headquarters. Only the defining activities – implementing projects or holding demonstrations – serve to differentiate them. In reality, the distinctions are not as sharp as the labels suggest (Edward and Halume, 1995). Operational NGOs often move into advocacy when projects regularly face similar problems and the impact of the projects seems to be insufficient. All the large development and environment operational NGOs now run some regular campaigns, at least by supporting campaigning networks. Similarly, advocacy NGOs often feels they cannot ignore the immediate practical problems of people in their policy domain. Human rights NGOs and women's NGOs end up having programs to assist the victims of discrimination and injustice (Edwards, 1999).

Until very recently, the capacity of the state to provide basic services has been on the decline owing to sluggish economic growth. When growth was high in the 1960s and 1970s, Kenya had a developmental state that was at the centre of service provision. Poor growth in the 1980s and donor conditionalities occasioned the introduction of Structural Adjustment Programmes (Clark, 1991). These subsequently reduced the government's ability to provide services. NGOs filled the gaps in service provision throughout the 1990s. Though not in relation to all the different kinds of NGOs, poor economic

management and governance resulted in donors shifting their attention and increasing funding to NGOs from the early 1990s. Increased disbursements through NGOs led to the mushrooming of NGOs, who in turn used local community organisations as their entry point for development work at the grassroots. This resulted in proliferation of organisations in the development space (Duncan et, al., 1999).

2.5 Operational Efficiency

Operational efficiency is the ability for an organization to execute its tactical plans while maintaining a healthy balance between cost and productivity. This is affected by the productivity of the organization which is measured by examining the amount of output (product or service) for a given amount of input (assets, employee work hours, and other inputs) (Lindsay, 1976). In order to increase operational efficiency, an organization should strive to increase the output without a change in input of a similar order of magnitude. This is done in one of two ways: (i) changing the underlying processes to eliminate unnecessary steps with the aim of Six Sigma and other process oriented frameworks and (ii) Adding capabilities to the underlying processes that increase output without increasing input. It is nearly impossible to increase output without affecting the input requirements, so an organization must realize that it is simply trying to get a higher ratio of output: input than simply higher numbers (Rhodes and Southwick, 1986).

Improving operational efficiency is one objective of internal controls. Unlike business organizations where shareholders are the major class of stakeholders and profitability is the primary objective, NGOs serve the society and thus have a diffuse group of shareholders thus efficiency rather than profitability becomes an important measure of

performance. As a consequence internal controls are no less important for NGOs than for businesses (Sunder 1997).

Nongovernmental organizations have to seek funds themselves and therefore have more incentive than other businesses to operate efficiently. Lindsay (1976) compared efficiency of public sector and private counterparts and found out that public sectors are ‘unobservably’ less efficient. Sisk (1981) extended the argument to higher education and suggested that private universities are more responsive to student needs and produce more graduates with earned degrees. By examining the efficiency of public and private universities in the US, Rhodes and Southwick (1986) argue that public universities rely on the support from the government while private universities need to meet the test of the marketplace. Therefore, public universities are less efficiency conscious and have less incentive than private universities in efficiently managing the universities resources. Their results show that efficiency ratings of public universities are lower than that of private universities.

2.6 Empirical studies

Haylas and Ashton (1982) in their effort to provide evidence on the effectiveness of particular audit techniques in detecting errors that affect the financial statements suggested that all intentional errors are concentrated in relatively few audits and these are fairly predictable by industry. The great majority of such errors affect income but the direction of effect may either be an understatement or over statement. Regarding the signaling of an error, they found that the large portion of financial statements errors are initially signaled by less rigorous audit procedures such as analytical review and

discussions with the client. Client personnel problems such as inexperience, incompetence and insufficient knowledge and inadequate control follow up or reviews were found instrumental in causing the errors

Salih (1983) evaluated the internal controls of Ethiopian Airlines in Nairobi branch and concluded that the lack of segregation of accounting and custodian functions was the greatest weakness of the branch office. He argued that there is need to centralize cash receipts, establish an audit unit, separate accounting unit from sales section, separate duties of purchase activities and establish a perpetual inventory system for the tickets. He further emphasized that the existence of control is very crucial especially under today's condition with severe competition which place premium on reliable customers' services, on consideration of cash, on realization of capital assets and manpower and on other reduction costs.

Esmailjee (1993) studied the internal controls of Nyayo Bus Service Corporation – a state corporation. He observed that cash receipts as well as cash disbursements bear fairly strong controls attributed to the fact that the government accounting system is still in operation. However, the payroll and the stores accounting systems had a lot to be desired. Regarding the Organizational chart, a lot of information was missing. The internal auditor was being underutilized as he was charged with the responsibility of performing routine control checks which were also performed by the examination section. This led to duplication of efforts and down playing of the internal auditor's effective role.

Keitany (2000) in a study of internal audit control functions and its implications for risk assessment by the internal auditor: A case of quoted companies concluded that even

though the extend of reliance on internal control is not sensitive to the strengths of audit departments, companies should not do away with it. This is because as a management tool it should assist management in its day to day operations and not necessarily of any relevance to the external auditor. This may be attributed to the fact that external auditor may have specific considerations which may be beyond the strength of internal controls. However, though the system of internal control was ranked as the most important factor in obtaining audit evidence other indicators followed. It therefore implies that once the auditor establishes the strength of the audit department, other risk indicators come into play notwithstanding the strength of internal control.

Control systems are designed to assist managers to achieve their firms' goals and desired outcomes. An internal control system potentially enhances a firms monitoring and reporting processes as well as ensuring compliance with laws and regulations. On a study on internal control material weakness and analyst forecast accuracy Ashbaugh –skaife, Collins, Keeney and la fond (2006) posit that weak internal controls allow or introduce both intentional and unintentional misstatements into the financial reporting process that lead to lower quality accruals. They concluded that poor internal controls that result in less reliable financial reporting increase the information risk faced by investors that manifests in higher cost of equity.

Studies examining why NGOs need control systems have identified both internal and external influences and pressures to do so. NGOs need control mechanisms in order to improve decision making, service provision and promote organizational learning (Tabot and Sharp 1994). Lewis (2001) posits that NGOs need control systems to acquit

accountability to funders and meet requirements of regulators as well as enhance legitimacy. Lewis (2001) argues that NGOs require control systems to allow comparisons between NGOs and it is a response to the influence of professional bodies.

Management controls in NGOs and Non for profit organizations do not automatically follow similar paths, as the objectives of NGOs and non for profit organizations are more diverse. Common problems faced by NGOS are the tendency for vague organizational objectives, difficulties of monitoring performance effectively, the need to balance multiple accountabilities of a range of stakeholders inside and outside the organisation, the evolution of intricate management structures designed to do this, the centrality of the difficult concept of voluntarism and the need to maintain organizational values over time whilst demonstrating effective actions (Ahmed 2004).

In a study surveying financial management practices among development NGOs in Kenya (Nzalu,2006) Posits that financial management practices of development NGOs partially conform with the laid down procedures of international financial reporting standards. Inadequate budget forecasts was notably present which results in poor financial planning. The study also revealed inadequate regulatory financial structures in which NGOs operate and key weaknesses in financial management practices of internal controls namely fiscal policies and financial oversight, analysis of service cost on regular basis, establishment of guidelines to invest idle funds, implementation of audit recommendations for systems and procedural improvements that covers financial compliance.

Ong Hock Chye (2007) in a study to establish the impact of oversight mechanism on quality internal control and its relationship with firm operating performance found that although small firms had a higher incidence of financial reporting problems than the larger firms, the incidence was lower when senior management at such companies published internal control reports. Mc Mullen et al (1996) offered two reasons why internal control disclosures can enhance internal control. First, it can increase the internal control awareness of management which in turn leads to greater attention being paid by management to internal control. Second it can lead to better internal control because it helps to communicate the tone at the top by sending a clear message within the organisation about the expected control environment.

In a study to investigate whether internal control structure is dependent on the size of the organization. Duncan et al (1999) examined differently sized nonprofit organizations and found that the larger the organization the more internal controls were used. The size of an organization is related to the availability of resources and internal differentiation, therefore a need arises for more sophisticated control system.

In a study investigating the effects of internal control deficiencies on firms risk and cost of equity capital, Ashbaugh, Collins, and Kinney (2006) concluded that firms that disclose an internal control problem experience a significant increase in market-adjusted cost of capital and firms that subsequently improve their internal control systems exhibit a decrease in their market-adjusted capital. This study provides evidence that internal control risk matters to investors and that firms reporting strong internal controls or firms

that correct prior internal control problems benefit from lower costs of equity capital beyond that predicted by other internal control risk factors.

Findings by Schneider and Church (2004) on the effect of auditor's internal controls opinion on loan decisions suggested that an adverse internal control opinion can underpin the assurance provided by unqualified opinion on financial statements taken as a whole and have a negative effect on lenders assessment. Adverse internal control opinion weakens the importance assigned to the balance sheet and income statement in lending decisions and that it reduces lenders confidence that financial statements are presented fairly in conformance with the generally accepted accounting principles.

2.7 Conclusions

The objectives of effective internal control are evident in the literature. They are Reliability of financial reporting, efficiency and effectiveness of operations, and compliance with laws and regulations. The major components that are found in the various internal control systems and that enable effective achievement of these objectives come out of the review of the relevant literature. These are control environment, risk assessment, control activities, information and communication systems, and finally Monitoring.

The purpose of internal control is to prevent errors or mistakes in accounting work, whether these mistakes are accidental or fraudulent. It is therefore the responsibility of management to device, install, and supervise the systems of internal controls mentioned in this chapter in order to implement the decisions and goals and to regulate the activities

for which they have the ultimate responsibility to the government, owners, public, creditors and donors.

Nonprofit organizations need internal controls to properly administer federal programs. Inadequate, poorly designed, or improperly applied internal controls could lead to the misappropriation of federal resources or the failure to ensure the program objectives, procedures and compliance requirements have been met. These failures could prevent or deny eligible individuals from receiving needed services. Weakness in internal controls could also lead to the federal government imposing sanctions in the form of fines, suspension or debarment. (OMB 2 CFR PARTS 180& 215).

The literature suggests the need for effective internal control for Organizations. It is considered to be an efficient tool for management of risks for organizations. Lack of an effective internal control system has been shown to be one important cause for fraud and, in extreme cases, bankruptcy. The literature review therefore casts no doubt on the importance of an effective system of internal control for organizations.

CHAPTER 3: RESEARCH METHODOLOGY

3.1 Introduction

This chapter contains the research methodology and procedures to be followed in the execution of the research work, which entails the research design, population intent for the study, the sample size coupled with sampling technique, means of data collections, data analysis, reliability and validity.

3.2 Research Design

This was a descriptive survey design. This research design was appropriate due to the fact that only a proportion of the population was studied and the findings thereof generalized and deemed to apply for the entire population. According to Cooper et al, (2003), a descriptive study is concerned with explaining the who, what, when and how of a phenomenon. The survey research method has also got more advantages than other methods of data collection. Survey research method is probably the best method available to social scientists and other educators who are interested in collecting original data for purposes of describing a population which is too large to observe directly.

3.3 Population of the study

The population of the study constituted all Non- governmental Organizations (NGOs), both local and international, based in Nairobi as at July 2010. According to the NGO Directory (2010), there are up to 6, 800 registered NGOs operating in Kenya. Of these NGOs, 596 were based in Nairobi. These Organizations carried out their various

activities in various parts of the country targeting different groups of people and communities.

3.4 Sample Design and Size

A sample of 50 Non-Governmental Organizations (NGOs) was drawn from the NGOs based in Nairobi. Mugenda and Mugenda (2003) indicate that a sample size 30 and above of the population is usually sufficient for a study. Nairobi was selected as it was the centre of NGOs activities in Kenya. The NGOs were selected using a skip interval of 12. The sampled NGOs engage in a number of programs/projects across the City, both local and international. The sampled NGOs were deemed to be representative of the population and their activities characterize those carried out by a typical NGO.

3.5 Data collection Method

The study collected data that was largely descriptive and quantitative in nature. A structured questionnaire was used to collect the various sets of data about the nature of internal controls among NGOs in Nairobi. The target respondents in this study were finance and program managers because they were considered to be the ones involved in preparation of proposals and budgets of the various projects/programs through which the organizations delivered services to their clients. The questionnaire was administered through hand delivery and through electronic mail (e-mail) for those respondents whose emails were obtainable.

3.6 Data Analysis

The data collected was edited for accuracy, uniformity, consistency and completeness and arranged to enable coding and tabulation before final analysis. The data was then inputted into Statistical Package for Social Sciences (SPSS) Statistics for analysis version 17. The data was analyzed by generating descriptive statistics such as percentage and measures of central tendency. The data was presented using tables, charts and cross tabulations. The following model was used to compute the effects of internal controls on operational efficiency.

To obtain the operational efficiency, the following model was used:

$$Y = B_1X_1 + B_2X_2 + B_3X_3 + B_4X_4 + B_5X_5 + \epsilon$$

Where B_1 – represents the weight of organizational structure

B_2 - Represents the weight of cash controls

B_3 - Represents the weight of procurement controls

B_4 – Represents the weight of payroll controls

B_5 – Represents the weight of asset controls

X_1 represents the score of the Organizational controls

X_2 represents the score of cash controls

X_3 represents the score of the procurement controls

X_4 represents the score for the payroll controls

X_5 represents the score for the asset controls

ϵ Represents the error term

The error is the difference between the calculated dependent variable value and actual value.

Operational efficiency was measured in terms of input/ output ratio whereby the input was the number of employees in the NGOs and the output was the number of clients/ services rendered. The independent variables were measured using Likert Scale of 0 to 2.

3.7 Data Reliability and validity

Mugenda and Mugenda (2003) asserted that, the accuracy of data largely depended on the data collection instruments in terms of validity and reliability. Validity as denoted by Robinson (2002) in the degree to which results obtained from the analysis of the data actually represents the phenomenon under study. Validity was ensured by having objective data. This was achieved by pre-testing the questionnaire to a sample of two respondents of the information to be collected to determine the accuracy of the instrument. Reliability on the other hand refers to a measure of the degree to which research instruments yield consistent results (Mugenda and Mugenda 2003). In this study, reliability was ensured by pre-testing the data with a selected sample of two NGOs.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter covers data analysis and findings of the research. The data is summarized and presented in the form of tables and pie-charts. The collected data has been analyzed and interpreted in line with the aim of the study which is to determine the effects of internal control on the operational efficiency among nongovernmental organizations in Nairobi.

4.2 Response Rate

A total of 50 questionnaires were distributed to the NGOs forming part of the sample. 31 filled the questionnaire giving a response rate of 62%. The information was collected from finance managers, finance officers, and accounts officer managers, human resource managers, procurement managers and other managers as the organizations felt appropriate. The NGOs that did not respond gave various reasons including the sensitivity nature of the information required; only senior officers of the organizations could authorize release of the information and they were based out of the country, some NGOs feared misuse of the information required.

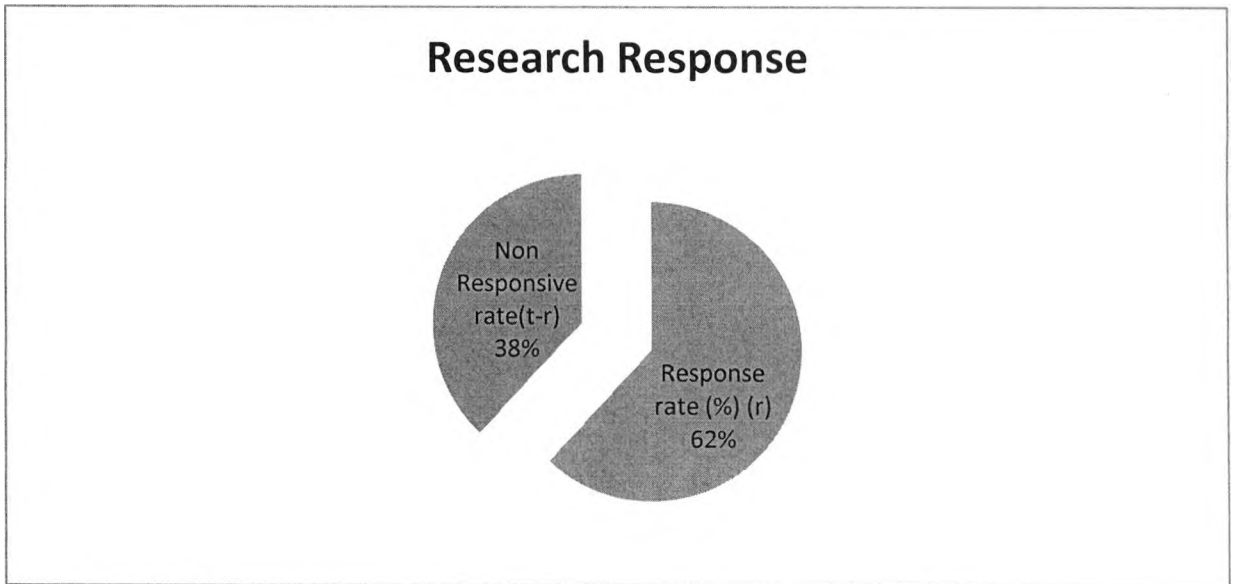
Table 4.1: Overview of Data Collected

Institutions	Population (t)	Sample size (S)	Response rate (r)	Response rate (%) (r)	Non Responsive rate(t-r)
NGOs in Nairobi	596	50	31	62%	38%
Total	596	50	31	62%	38%

Source: Research Data

Key: t= Population (100%); S= Sample size; r= Response Rate (62%); t-r=Non-responsive error (38%)

Figure 4.1: Research Response



Source Research data

Of the 50 questionnaires that were administered, 31 were dully filled and returned. This represents 62%, which is considered significant enough to provide a basis for valid and reliable analysis with regard to the impact of internal controls on the operational efficiency among NGOs in Nairobi. This is well explained in table 4.1 above.

4.3 General Information

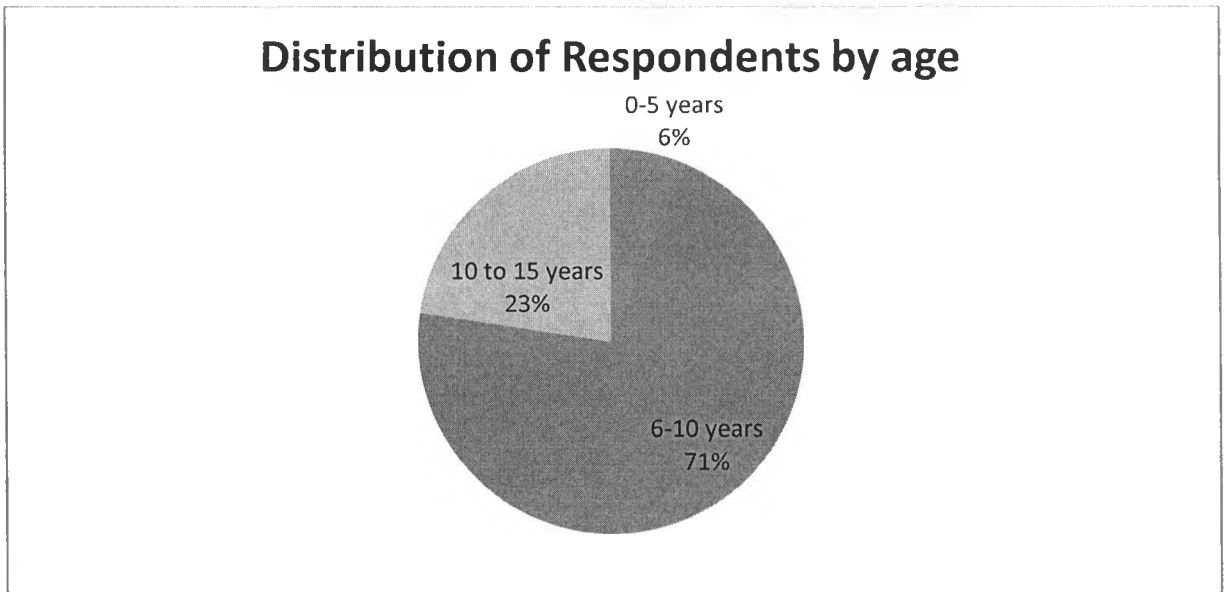
The respondents were distributed across the various years of operations. 2 NGOs representing 6.5% had been in operation for between 0-5 years. Majority (22) of the NGOs had been in operations for a period of between 6-10 years making up 71% of the NGOs. 7 NGOs representing 22.6% had been in operation for a period of between 10-15 years.

Table 4.2: Distribution of the respondents by length of service

	Frequency	Percent	Cumulative Percent
0-5 years	2	6.5	6.5
6-10 years	22	71.0	77.4
10-15	7	22.6	100.0
Total	31	100.0	

Source: Research Data

Figure 4.2: Distribution of the respondents



Source : Research data

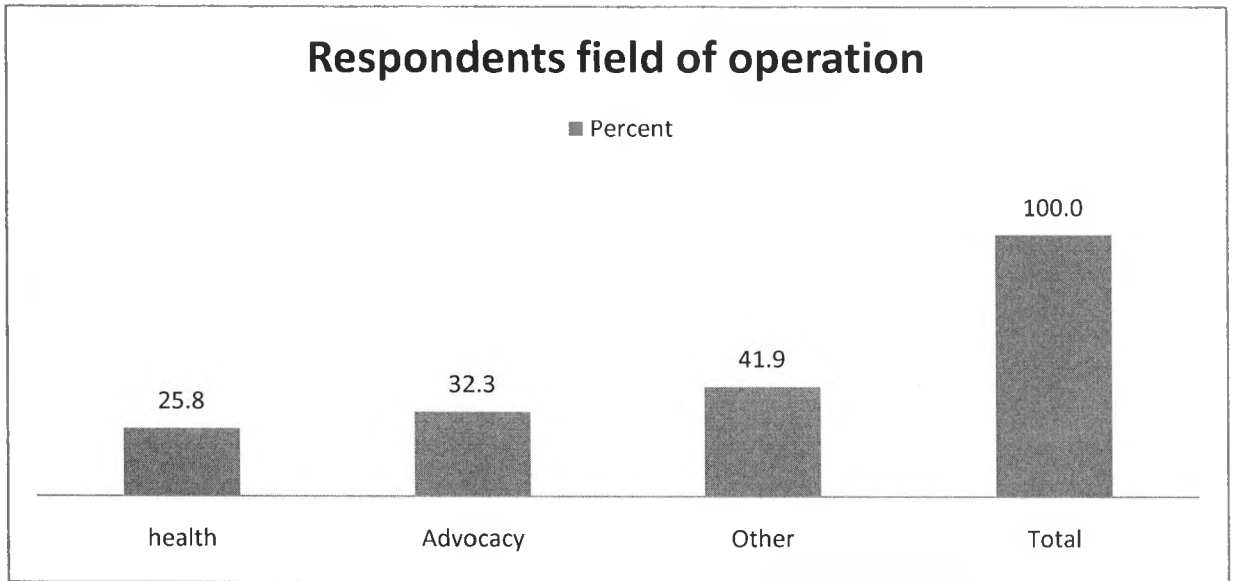
The researcher further sought to establish the field of operation for the respondents. The areas of operation were classified into four main categories comprising of health, advocacy, and environment and other. 8 NGOs were engaged in health related activities making up 25.8% of the respondents used in this study. 10 NGOs were engaged in advocacy making 32.3% of the respondents and other areas had 13 respondents making up a majority with 41.9% of the respondents. Environmental NGOs were not represented by any respondent. These findings are well represented in table 4.3 and figure 4.3.

Table 4.3: Field of operation of the respondents

Area of operations	Frequency	Percent	Cumulative Percent
health	8	25.8	25.8
Advocacy	10	32.3	58.1
Other	13	41.9	100.0
Total	31	100.0	

Source: Research Data

Figure 4.3: Field of operation of the respondents



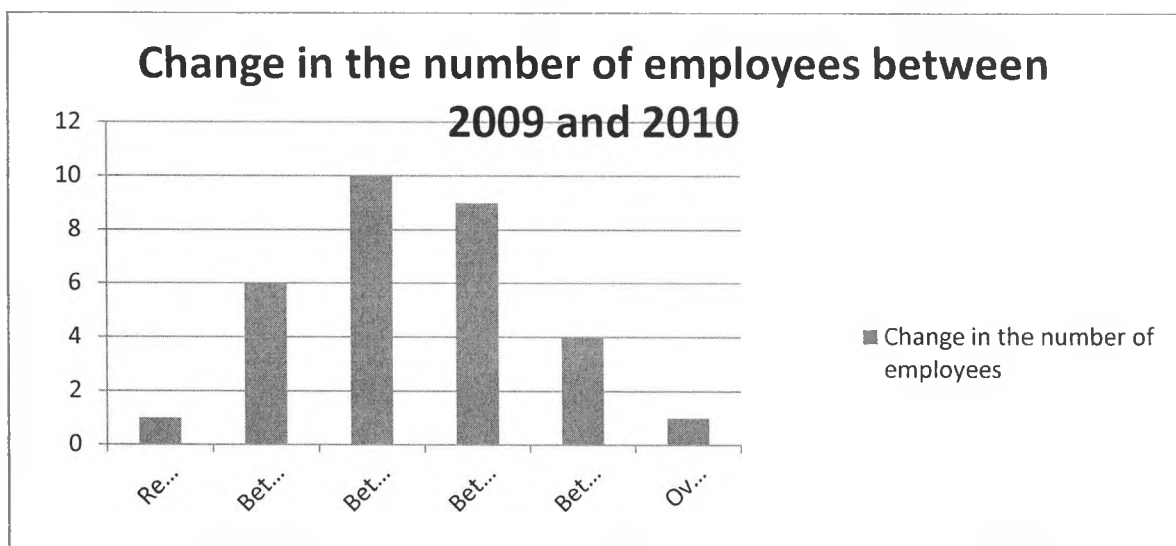
Source: Research Data

Table 4.4: Change in the number of employees

Range	Change in the number of employees
Reduction between 1-10	1
Between 1 - 10	6
Between 11 - 20	10
Between 21 - 30	9
Between 31 - 40	4
Over 41	1
Totals	31

Source: Research data

Figure 4.4: Change in the number of employees



Source: Research data

The respondents were asked to indicate their number of employees in the years 2009 and 2010. One NGOs had a decrease in the number of employees of between 1 and 10. The rest experienced an increase in the number of employees. 6 NGOs experienced an increase of between 1 to 10 employees, 10 NGOs had an increase in the number of

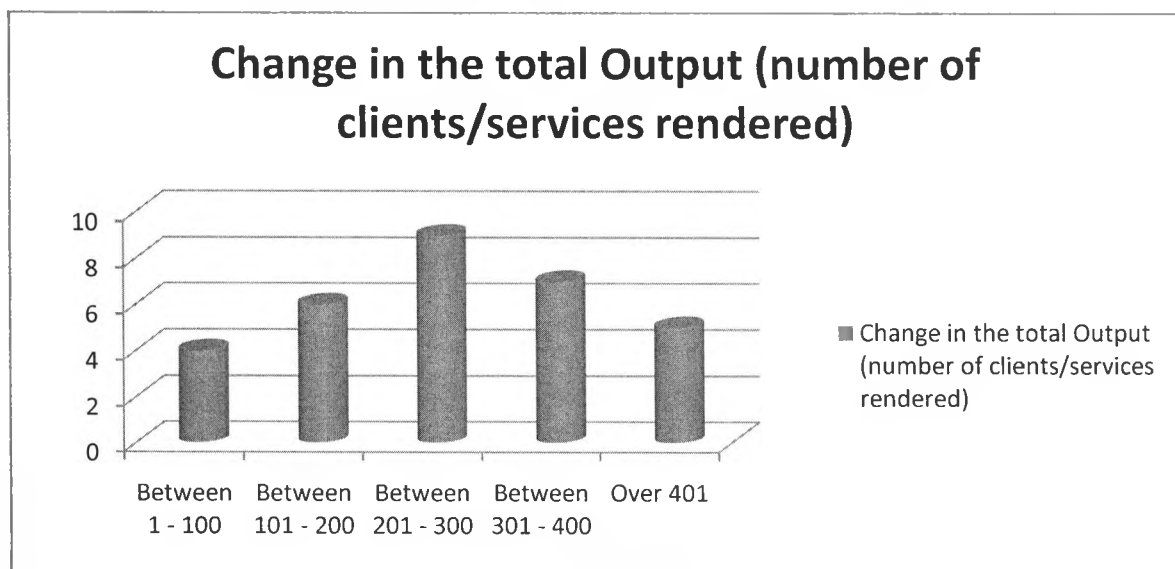
employees of between 11 and 20. 9 NGOs had a change in employees of between 21 and 30. 4 NGOs had an increase in their number of employees of between 31 and 40. One NGO had an increase in the number of employees of above 41. This data is well explained in table 4.4 and figure 4.4.

Table 4.5: Change in number of clients

Range	Change in the total Output (number of clients/services rendered)
Between 1 - 100	4
Between 101 - 200	6
Between 201 - 300	9
Between 301 - 400	7
Over 401	5
Totals	31

Source Research data

Figure 4.5: Change in total number of clients between 2009 and 2010



Source: Research data

The study further sought to establish the changes in the total number of clients who sought services to the NGOs. 4 NGOs experienced an increase in clients of between 1 and 100. 6 NGOs saw an increase in clients of between 101 and 200. 9 NGOs experienced an increase in clients of between 201 and 300. Between 301 and 400 clients category had 7 NGOs while 5 NGOs experienced an increase in client of over 401. This data is well presented in table 4.5 and figure 4.5

4.4 Organization structure

Table 4.6: Organization structure

Statements	Responses			
	yes		No	
	Frequency	Percent	Frequency	Percent
Does your organization have a current organization structure	31	100	0	0
Is the organizational structure appropriate for the size and complexity of the NGO?	31	100	0	0
Are the lines of authority and responsibility clearly defined for the NGO?	31	100	0	0
Are there formalized policies and procedures for major operations for the NGO?	31	100	0	0
Do the NGO officials stress adherence to such policies and procedures?	31	100	0	0

Source: (Research data, 2011)

The respondents were asked to agree to the statements about the organization structure of their organization. All the 31 respondents said they had an organization structure and that it was appropriate for the size and complexity of their NGOs. They also said they had well defined lines of authority and responsibility and that they had formalized policies and procedures for all major operations within their organization. Asked whether their officials stressed adherence to such policies and procedures, all the 31 respondents gave positive responses. These findings are well explained in table 4.6 above.

4.5 Cash Controls

The study sought to establish the respondents agreement with the statements on cash management. Several statements were presented to which the respondents answered differently. Asked as to whether the cheques made to the organization are written in the name of the organization, 21 respondents answered yes making up 67.7%, 8 respondents answered no while 2 respondents did not know how such cheques were treated.

In addition, the research sought to establish whether a separate bank account was maintained for each donor or project. 30 respondents constituting 97% answered yes while 1 respondent (3%) answered no. There was no respondent who did not know how the projects were accounted for.

On whether all bank and investment accounts were maintained in the name of the organization, 23 respondents (74%) agreed to this statement, 8 representing 26% said no and none did not know how the bank and investment accounts were treated.

On whether cash receipts are kept in a secure safe until deposited, 30 respondents representing 96.8% indicated to have a secure safe for cash receipts until deposited. 1 respondent said they did not have a safe for safe keeping of the cash receipts.

Table 4.7: Cash controls (n=31)

Statements	Responses			
	yes		No	
	Frequency	Percent	Frequency	Percent
Are all cheques received made payable to the name of the organization?	21	67.7	8	25.8
Each donor /project has a separate bank account	30	96.8	1	3.2
All bank and investment accounts are in the name of the organization	23	74.2	8	25.8
Cash receipts are kept in a secure safe until deposited?	30	96.8	1	3.2
Cash receipts are recorded and reconciled to the general ledger monthly?	31	100. 0	0	0
Cash receipts are used only for the purpose for which they were received?	27	87.1	4	12.9
Bank reconciliations are prepared by someone different from the one receiving, processing and recording activities?	31	100. 0	0	0
Petty cash funds are maintained on an imprest basis?	27	87.1	4	13
A cash voucher is signed for all petty cash disbursements?	31	100. 0	0	0
The cash voucher pre-numbered	30	96.8	1	3

Source: Research data.

Asked whether cash receipts are recorded and reconciled to the general ledger monthly, 31 respondents responded yes making up 100% there was no respondent who either disagreed or expressed lack of enough information on this statement.

On whether cash receipts are used only for the purpose for which they were received, different NGOs gave different responses. 27 NGOs agreed while 4 disagreed. This represented 87.1% yes and 12.9% no.

All respondents agreed to the statement that Bank reconciliations were prepared by someone different from the one receiving, processing and recording activities thus giving 100% acceptance of separation of duties. On whether petty cash funds were maintained on an imprest basis, 27 NGOs expressed agreement with this statement while 4 disagreed by saying no.

All respondents agreed to a cash voucher being signed for all petty cash disbursements with 30 respondents saying the petty cash vouchers are pre-numbered and one saying their petty cash vouchers was not pre-numbered.

4.6 Procurement Controls

Table 4.8: Procurement controls (n=31)

Statements	Responses					
	yes		No		I don't know	
	Frequency	Percent	Frequency	Percent	Frequency	Percent
All tenders are advertised openly?	5	16.1	22	71.0	4.0	12.9
Bids are assessed objectively	11	35.5	15	48.4	5.0	16.1
The winning bidder is the one who is awarded the tender?	11	35.5	15	48.4	5.0	16.1
The tendering process is free of manipulations	11	35.5	15	48.4	5.0	16
Tender payments are authorized by authorized persons	11	35.5	16	52	4.0	13

Source: Research data

The study set out to establish the respondents' treatment of the procurement process. Respondents were asked whether all tenders were openly advertised. 16.1% of the respondents answered yes, 71% answered no and 12.9% answered 'don't know'.

The research further asked whether the bids for the projects were assessed objectively to determine the tender winner. 35.5% of respondents answered 'yes', 48.4% answered 'no' and 16.2% indicated they did not know how the bids assessment process was undertaken.

Asked whether the tender was awarded to the winning bidder, 35.5% answered 'yes' 48.4% 'no' and the remainder 16.1% were not aware of how the tenders were awarded.

Asked whether the tendering process was free of manipulations, many respondents 48.4% answered 'no' while 35.5% of the respondents answered 'yes'. And 16% did not know whether the tendering process was free from manipulation or not.

On whether tender payments were approved by authorized persons, 52% of the respondents answered 'no', 35.5% of the respondents agreed with the statement and 13% did not know.

4.7 Payroll controls

Table 4.9: Payroll controls

Statements	Responses					
	yes		No		I don't know	
	Frequency	Percent	Frequency	Percent	Frequency	Percent
Current job descriptions are on file for each employee in the organization?	31	100.0	0	0.0	0.0	0
Personnel policies are maintained and distributed to all staff?	22	71.0	9	29.0	0.0	0
Salary review systems are working	25	80.6	6	19.4	0.0	0
Are reported overtime hours verified for reasonableness and proper pre-approval?	21	67.7	10	32.3	0.0	0
Are all changes to employee status or pay rate authorized and approved by an appropriate official?	27	87.1	4	12.9	0	0
Is documentation of this approval maintained in each employee's personnel file?	25	80.6	6	19.4	0	0

Source: Research data

The study sought to establish the respondents view on the payroll controls. The respondents provided various responses to the questions asked. Asked if current job descriptions were on file for each employee in the organization, all the respondents answered yes.

On whether personnel policies were maintained and distributed to all staff, 71% of the respondents answered 'yes', 29% answered 'no' and none seemed not to know.

The study also asked whether salary review systems were working. Majority (80.6%) of the respondents indicated the salary review systems were working, and the remainder, 19.4% were not having a working salary review system

The study further sought to establish whether reported overtime hours were verified for reasonableness and proper pre-approval sought before they were compensated. 67.7% of the respondents indicated that reported overtime hours were verified for reasonableness and proper pre-approvals sought before compensation was made. 32.3% of the respondents did not have a system to pre-approve overtime hours before compensation was made. There was no respondent who did not know.

Asked as to whether all changes to employee status or pay rate were authorized and approved by an appropriate official, 87.1% of the respondents answered 'yes' while 12.9% answered 'no'. There was no respondent who answered 'don't know'

The section finally sought to establish whether documentation of the approval process was maintained in each employee's personnel file. 80.6% of the respondents answered 'yes' while 19.4 answered 'no'.

4.8 Asset Controls

Table 4.10: Asset controls

Statements	Responses					
	Yes		No	No	I don't know	
	Frequency	Percent	Frequency	Percent	Frequency	Percent
Does your organization have a policy on asset purchase	31	100	0	0	0	0
Does your organization have a policy on asset use	25	80.6	6	19.4	0	0
Does your organization have a policy on asset Disposal	21	67.7	10	32.3	0	0
Are all assets in the organization tagged	26	83.9	5	16.1	0	0
Are all assets in the organization well serviced	21	67.7	10	32.3	0	0
Are all assets insured against fire& burglary	26	83.9	5	16.1	0	0
Are equipment audits done to verify the assets	30	96.8	1	3.2	0	0
Do you have an asset movement register	21	67.7	10	32.3	0	0

Source: Research data

The study sought to establish internal control measures on fixed assets within NGOs. Respondents were asked whether their organization had a policy on asset purchase. All the respondents included in this survey confirmed to have a policy governing the purchase of fixed assets.

The study further sought to establish whether the NGOs had a policy on asset use. The findings disclosed that 80.6% of the respondents had a policy on the use of assets while 19.4% did not have.

Asked whether all assets in the organization were well serviced, 67.7% of the respondents answered 'yes' while 32.3% answered 'no'. There was no respondent who answered 'I don't know'

The study further sought to establish whether the assets were insured against fire and burglary. 83.9% of the respondents had their assets insured against the said perils while 16.1% of NGOs had not insured their assets against the fire and burglary.

The study further sought to establish whether equipment audits were done to verify the assets. 96.8% of the respondents answered 'yes' while 3.2% answered 'no'. Finally, the section sought to establish whether the NGOs had asset movement registers. 67.7% of the respondents answered 'yes' and 32.2% of the respondents answered 'no'.

4.9 Factors Weights

The respondents were asked to rank the factors in the order of importance in affecting operational efficiency among Non Governmental organizations. The respondents were to rank on a scale of 1-5 with 5 representing the most important and 1 representing the least important factor. A score of 5 means that the factor is of great importance in affecting operational efficiency. The respondents ranking was as shown in the table 4.11 below. 12 respondents ranked asset controls as the most important factor, followed by 11

respondents who ranked organization structure and cash controls as important followed by payroll administration controls at 8, and finally procurement controls at 5.

Table 4.11: Factor Weight

Factors	Rankings by respondents				
	1	2	3	4	5
Organization structure	0	0	5	15	11
Cash controls	0	1	8	11	11
Procurement controls	3	3	11	9	5
Payroll controls	2	12	3	6	8
Asset controls	6	3	3	7	12

Source: Research data

From the above responses, the researcher proceeded to determine the weights attached to each factor. The findings were as shown in table 4.11 above.

Table 4.12: Factor Weight Determination

Factor	Total Score	Factor Weight
Organization structure	130	23%
Cash Controls	125	22%
Procurement Controls	103	18%
Payroll Controls	99	17%
Asset Controls	109	19%
Total	566	100%

Source: Research data

A product of all the scores was calculated and the results were as shown in table 4.12. The calculated weights were as shown in table 4.12. Organization structure was ranked

the most important with 23% followed by cash controls at 22%. Asset controls was ranked third with 19% followed by procurement controls at 18% and finally payroll controls at 17%.

4.10 Operational Efficiency

The researcher sought to determine the impact of internal controls on operational efficiency among NGOs in Nairobi. The analysis was as shown in the table below.

Table 4.13: Computation of operational efficiency

Factor	Factor Weight (B)	Factor Score (X)	Contribution to operational efficiency
Organization structure	0.229681979	0.8387097	0.192636498
Cash Controls	0.220848057	0.8064516	0.178103271
Procurement Controls	0.181978799	0.6645161	0.120927847
Payroll Controls	0.174911661	0.6387097	0.11171777
Asset Controls	0.192579505	0.7032258	0.135426878
Total	1	0.7303226	0.730322581

From the above analysis, 73.03% of the operational efficiency among the NGOs in Nairobi was attributed to the five independent variables (organizational structure, cash controls, payroll controls, procurement control and asset controls) considered in this study. A further 26.97% of the operational efficiency is attributed to other factors not considered in this study. This study therefore suggests that another study be carried out to determine these factors causing the 26.97 of the operational efficiency among NGOs operating in Nairobi.

4.11 Summary and interpretations of findings

The study looked at the effects of internal control on the operational efficiency of NGOs in Nairobi. A total of 50 questionnaires were administered to respondents at their offices using drop and pick method. Others requested for online administration and the same was forwarded to them in soft via emails. A total of 31 questionnaires were received back. This was analyzed to give the findings in this report. This constituted 62% response rate. Some respondents refused to fill in the questionnaires. Most of the respondents were too busy throughout and had to continuously be reminded and even persuaded to provide the required information.

Analysis of the respondents revealed that majority 71% of the respondents had been in operation for between 6-10 years followed by those who had operated for between 10-15 years at 22.6% and finally 0-5 years at 6.5%.

The study sought to establish the area of operation for the respondents. 25.8% of the respondents were engaged in health activities, 32.3% were involved in advocacy and 41.9% were engaged in other operations not enumerated in the survey.

The research identified five independent variables for the purpose of establishing the relationship between the internal controls and operational efficiency among NGOs in Nairobi. These included: organization structure, cash controls, payroll controls, procurement controls and asset controls. Several statements were fronted under each variable to which the respondents were to express their level of agreement. To facilitate

the analysis, the respondents were asked to rank the independent factors according to the degree in which they affected the operational efficiency among NGOs operating in Nairobi. The respondents ranked organization structure as the most important factor at 23% followed by cash controls at 22%. Asset controls was ranked third at 19%, procurement controls was ranked fourth at 18% and finally payroll controls at 17%.

On the organization structure, it was clear that most NGOs had a well defined and functional organization structures according to their size and complexity. This is inferred from the 100% agreement to the statements raised under this section.

On cash controls, many NGOs had strict rules and procedures as expressed by the high percentages of the respondents who answered yes to the statements. All the 'yes' responses were more than 60% with the highest being 100%. Very few NGOs had not streamlined their cash management process as witnessed by the low frequencies of the NGOs who answered 'No'.

On procurement controls, most respondents had either not established a procurement office or did not have a procurement office at all except for a few big and well known NGOs. Majority of the respondents were either not conversant with the statements under procurement controls or deliberately decided to withhold information for fear of misuse.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The study aimed at investigating the operational efficiency of NGOs based in Nairobi. The population of interest included all the 596 NGOs. A sample of 50 NGOs was selected and questionnaires administered to them. A total of 31 questionnaires were filled and returned giving a response rate of 62%. The operational efficiency in NGOs is determined largely by their organizational structure followed by cash controls, asset controls, procurement controls and finally payroll administration controls. NGOs with well structured organizational structures had well structured policies and procedures on how activities should be run. Higher operational efficiency was registered in big well known NGOs which lead to controlled internal controls by the funding partners. The funding partners determined the internal control measures that should be put in place through their pre-requisite requirements to awarding of donations.

Ability to manage cash was emphasized. NGOs accounting was not governed by the International Accounting standards (IAS) thus making it difficult to measure the operational efficiency among NGOs since accounting policies are managed by the donor. Some measures were endorsed specifically for the satisfaction of the donor or the funding agencies. This made comparison difficult as different NGOs reported to different funding partners.

5.2 Conclusions

Internal controls help put structures in place that help in evaluating the processes and procedures. Policies and procedures are periodically reviewed by the NGO management to ensure that appropriate internal controls have been established. At the same time, the NGO's external auditors periodically assess the adequacy of the NGO's internal control systems; the management allow access to all retirement benefits records to the board of trustees or trustees representatives

The donors receive appropriate and current information from the company's accounting, information and communication systems to make informed and timely decisions while policies on staff ethics or codes of conduct exist.

Internal controls affect operational efficiency. It improves organizational workflows such as planning and budgeting, communication within different cadres of the organization, financial reporting and compliance to different NGO stakeholders.

Organizational structure has the greatest impact on the operations efficiency of NGOs followed by cash controls, asset controls, procurement controls and finally payroll controls. Organization structure was ranked the greatest simply because it determines how the other functions in the NGO were to function. Cash control was ranked second because NGOs deal with donated money and the donors will want to grant money to organizations that have good management skills. Asset control was ranked third. Many respondents indicated that some funding is done in the form of equipment which forms part of the huge funding support for a given project. Due to this magnitude of support,

proper asset management was called for so as to convince other donors to continue supporting different projects in the country through equipment donation as capital.

Payroll control is key to the operational efficiency of NGOs in Nairobi. Donors determine the payroll structure of NGOs by defining the positions to be in existence in the NGOs before releasing the funds. They even go as far as determining how much each position holder is supposed to be remunerated. NGOs are not regulated by a standard body in terms of how much of internal controls they should put in place. The internal controls are majorly reinforced by the funding agency or donor.

5.3 Policy Recommendations

Management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. Management should consistently apply the internal control standards to meet each of the internal control objectives and to assess internal control effectiveness. When assessing the effectiveness of internal control over financial reporting and compliance with financial-related laws and regulations, management must continuously monitor and assess the control activities. Management must provide assurances on internal control in its Performance and Accountability Report to the funding agencies and also including a separate assurance on internal control over financial reporting, along with a report on identified material weaknesses and corrective actions.

For any NGO, the external auditors report their findings directly to the board or to a board committee or to the donor as the case may be. The board/donor should review the qualifications and the independence of the NGO's external auditors to establish whether to continue funding a given project or not.

Policies and procedures should be periodically reviewed by the NGO management to ensure that appropriate internal controls have been established. The NGO's external auditors should periodically assess the adequacy of the NGO's internal control systems.

Processes should exist to ensure that there is ongoing and independent reconciliation of all NGO balances, both asset and liability and on- and off balance sheet items. Policies and procedures should also exist to ensure that decisions are made with appropriate approvals. Also to provide independent verification of a sufficient sample of transactions to ensure integrity of the decision making process.

The procurement policy for all NGO purchases should be put in place to provide direction in all NGO procurements so as to eliminate any chances of fraudulent behaviour of the procurement staff. There should be appropriate and sufficient reports produced by the NGO for the proper management and control.

5.4 Limitations of the Study

A limitation for the purpose of this research was regarded as a factor that was present and contributed to the researcher getting either inadequate information or responses or if otherwise the response given would have been totally different from what the researcher expected.

The main limitations of this study were: Some respondents refused to fill in the questionnaires. Most of the respondents were busy throughout and had to continuously be reminded and even persuaded to provide the required information.

Further some respondents decided to withhold information which they considered sensitive and classified. This reduced the probability of reaching a more conclusive study. However, conclusions were made with this response rate.

The small size of the sample could have limited confidence in the results and this might limit generalizations to other situations. Time- Due to official duties time was a major concern.

5.5 Recommendation for Further Studies

The study recommends that research into the impact of internal control on the operational efficiency be repeated after a period of ten years to measure the change with passage of time. This will pave way for new theoretical advancements to enable application of theory into practice in the NGOs.

The study also suggests that further research should be conducted on all the NGOs based in Kenya regardless of the locality to establish the level of internal controls and their effects on the operational efficiency of NGOs.

Future research may consider studying the effect of internal controls on transparency of financial reports of NGOs. In view of the importance of corporate governance, future research may examine the association between NGO governance and internal controls.

The levels of internal control implementation are based on self-evaluation. While it took multiple procedures to ensure the quality of the data, subjective responses may be open to biases. Future research may consider using the evaluation by independent institutions such as audit firm reports as the measure of internal control implementation.

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Appendix 1: Cover Letter to the Respondents

University of Nairobi

School of Business

Nairobi Kenya

Dear Sir/Madam,

RE: MBA RESEARCH PROJECT

I am a postgraduate student undertaking a master of Business Administration (MBA) degree at the School of Business, University of Nairobi. I am currently carrying out research on internal controls in Non Governmental organizations in Nairobi.

I would be grateful if you could spare sometime from your busy schedule and fill the attached questionnaire.

The information you provide will be treated with utmost confidentiality and will be used solely for the research project; however, the findings of this study can be availed to you upon request on completion of this project.

In case you have any query or need further clarification on any of the questions, please do not hesitate to contact me on 0722-635-590

Thank you very much for taking your time to fill out this questionnaire

Yours Faithfully

Pauline W Michino

Appendix 2: Questionnaire

1) Organization name

(optional) _____

2) What is your area of operation?

Health Environment Advocacy other

3) Number of years in operation:

0-5 years 6-10 years 10-15 years Over 15 years

Section B:

please tick (✓) as appropriate your agreement with each of the following statements

	Yes	No	Don't know
ORGANIZATION STRUCTURE			
4) Does your organization have a current organization structure?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5) Is the organizational structure appropriate for the size and complexity of the NGO?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6) Are the lines of authority and responsibility clearly defined for the NGO?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
7) Are there formalized policies and procedures for major operations for the NGO?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
8) Do the NGO officials stress adherence to such policies and procedures?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Please provide further details /comments on organization structure in your organization

CASH CONTROLS

9) Are all cheques received made payable to the name of the organization?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
10) Each donor /project has a separate bank account	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
11) All bank and investment accounts are in the name of the organization	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

- | | | | |
|---|--------------------------|--------------------------|--------------------------|
| 12) Cash receipts are kept in a secure safe until deposited? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 13) Cash receipts are recorded and reconciled to the general ledger monthly? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 14) Cash receipts are used only for the purpose for which they were received? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 15) Bank reconciliations are prepared by someone different from the one receiving, processing and recording activities? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 16) Petty cash funds are maintained on an imprest basis? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 17) A cash voucher is signed for all petty cash disbursements? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 18) The cash voucher pre-numbered | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |

Please provide further details/comments on cash management in your organization

PROCUREMENT CONTROLS

- | | | | |
|--|--------------------------|--------------------------|--------------------------|
| 19) All tenders are advertised openly? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 20) Bids are assessed objectively | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 21) The winning bidder is the one who is awarded the tender? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 22) The tendering process is free of manipulations | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 23) Tender payments are authorized by authorized persons | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |

Please provide further details/comments on procurement management in your organization

PAYROLL CONTROLS

- | | | | |
|--|--------------------------|--------------------------|--------------------------|
| 24) Current job descriptions are on file for each employee in the organization? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 25) Personnel policies are maintained and distributed to all staff? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 26) Salary review systems are working | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 27) Are reported overtime hours verified for reasonableness and proper pre-approval? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 28) Are all changes to employee status or pay rate authorized and approved by an appropriate official? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 29) Is documentation of this approval maintained in each employee's personnel file? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |

Please provide further details/comments on payroll management in your organization

ASSET CONTROLS

- | | | | |
|---|--------------------------|--------------------------|--------------------------|
| 30) Does your organization have a policy on asset purchase? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| 31) Does your organization have a policy on asset use? | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |

- 32) Does your organization have a policy on asset Disposal? [] [] []
- 33) Are all assets in the organization tagged? [] [] []
- 34) Are all assets in the organization well serviced? [] [] []
- 35) Are all assets insured against fire& burglary? [] [] []
- 36) Are equipment audits done to verify the assets? [] [] []
- 37) Do you have an asset movement register? [] [] []

Please provide further details/comments on assets management in your organization

38) Below are factors that are important to NGOs in internal control. On a scale of 1-5 please score them in the order of importance in affecting internal control. (5 represent the most important).

Factor	Score (1-5)
Organization structure	
Cash Controls	
Procurement Controls	
Payroll Controls	
Asset Controls	

39) Please provide the human resource used and the total output for the organization for the years below:

	December 2009	December 2010
Number of employees		
Total Output (number of clients/services rendered)		