THE RELATIONSHIP BETWEEN INTERNAL CONTROLS AND CORPORATE GOVERNANCE IN COMMERCIAL BANKS IN KENYA

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DECLARATION

This project is my original work and has not been presented for a degree in any other University.

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DEDICATION

I dedicate this study to my wife and my children for the support, understanding and encouragement that they have provided during all the years of my studies and as I prepared and worked on this project. **I LOVE YOU ALL.**

This work is also dedicated to all people of goodwill who believe in education and the pursuit of knowledge and are inspired by hard work, forethought and merit. Foremost among them is my mother who inspired me early on in my life and has lived to see the fruits of her effort. She always remains in my heart for her efforts and determination was never in vain.

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ABSTRACT

The study sought to establish the relationship between internal control and corporate governance in commercial banks in Kenya. Within commercial banks of Kenya; there could be many problems such as unreasonable equity structure, enterprise internal and external supervision vacancy, "inside control" phenomenon, ineffectiveness of board of directors and board of supervisors the above factors result in many problems in enterprises internal control. In order to promote the rapid development of commercial banks in Kenya through internal control perfection, it is important to study internal controls based on corporate governance. This study also highlight the importance of internal controls as a bedrock of corporate governance based on which various organizations can review their policies to revamp their internal control systems in order to achieve good corporate governance. In practice, Internal Control and Corporate Governance are basic assurance systems to maintain the systems efficiency and to protect corporate from failure.

The study adopted a descriptive research design in investigating the relationship between internal controls and governance in commercial banks in Kenya. The researcher conducted a survey of all the 45 commercial banks in Kenya and because they are not many, all were considered for the study. The primary data was collected by use of a structured questionnaire and an unstructured interview guide. Data was analysed on the basis of descriptive statistics and performance comparison done across time between the years 2009-2011.

From the study it was concluded that most of the banks had incorporated the various parameters which are used for gauging internal controls and the corporate governance as was indicated by the means which were obtained enquiring on the same and this showed that the respondents agreed that their banks had instituted good corporate governance with a strong system of internal controls and there is a relationship between internal control and corporate governance.

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ABBREVIATIONS

AC	-	Audit Committee
BOD	-	Board of Directors
CAE	-	Certified Association Executive
CBK	-	Central Bank of Kenya
CCG	-	Code of Corporate Governance
CEO	-	Chief Executive Officer
CFO	-	Chief Finance Officer
CGI	-	Common Gateway Interface
CGQ	-	Capital Gains Income Streams Corporation
CGR	-	Corporate Governance Rating
CLSA	-	California Land Surveyors Association
CMA	-	Capital Markets Authority
COSO	-	Committee of Sponsoring Organizations
CS	-	Company Secretary
FTSE	-	Financial Times Stock Exchange
HIA	-	Head of Internal Audit
IBCG	-	International Business Consultancy Group
IC	-	Internal Control
IFAC	-	Industry Functional Advisory Committee
KLSE	-	Kuala Lumpar Stock Exchange
NSE	-	Nairobi Security Exchange
OECD	-	Organization for Economic Co-operation and Development
OLS	-	Ordinary Least Squares
PABC	-	Pan Asia Banking Corporation
RBA	-	Reserve Bank of Australia
ROA	-	Return on Asset
S&P	-	Standard & Poor's
SEBI	-	Securities & Exchange Board of India
SECP	-	Securities and Exchange Commission of Pakistan
SPSS	-	Statistical Packages for Social Sciences

SWX	-	Swiss Stock Exchange
UK	-	United Kingdom
US	-	United States
VIF	-	Variance Inflation Factor

CHAPTER ONE
INTRODUCTION

1.1 Background of the Study

The many financial scandals that have shaken financial markets and investors worldwide have certainly contributed to the recognition of the key role of the Internal Control System in the governance of firms CoSO, (1992). The concept of the relationship between internal control and corporate governance can be defined as the process and structure used to direct and manage business affairs of the bank towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders' long-term value while taking into account the interest of other stakeholders CMA, (2002).

Good governance and internal control became a highly pertinent and topical business issue at the beginning of the 21st century following a series of large corporate scandals and failures PABC (2006). However internal controls have existed from ancient times. In Hellenistic Egypt there was a dual administration with one set of bureaucrats charged with collecting taxes and another with supervising them. The sacking of Troy was a classic example of the failures of internal controls.

1.2 Internal Control

CoSO (1992) defines internal control as a process, carried out at various organizational levels, aimed at providing reasonable certainty regarding the achievement of the objectives of efficiency and effectiveness of operating activities, reliability of accounting information, compliance with laws and regulations. In the light of this definition, an internal control system is effective when it provides adequate protection against risks that can compromise the achievement of firm's objectives, the basis on which I model this study along the agency theory among others.

According to the CoSO (1992) Framework, the internal control system can be judged effective when all its components are present and properly functioning. As the internal control system is composed by internal managerial processes that cannot be directly observed from outside, disclosure about internal control system is crucial for investors to make their own assessment on its effectiveness. The recent trend in European regulation shares this view, asking for disclosure covering both the structural components of an internal control system and its processes and functioning such as control environment, risk assessment, control activities, information, and communication and monitoring.

Internal control systems are therefore fundamental to the success and survival of organizations. They keep the organizations on the rails. But organizations sometimes go off the rails. This was the problem (US corporate failure) that resulted in the report of the Treadway Commission (on fraudulent financial reporting) and in the formation of the Committee of Sponsoring Organization of the Treadway Commission (COSO).

The auditing profession has widely accepted the COSO report titled; the Internal Control Integrated Framework as a general definition of internal control. The COSO report defines internal control as a process, affected by an entity's board of directors, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following three categories; effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations.

According to the agency theory framework, independent directors increase the monitoring ability of the board as they are less likely to be aligned with management and they may be more inclined to encourage firms to disclose more information to stakeholders. Nevertheless previous literature on board composition and disclosure provides mixed empirical results. Ho and Wong (2001),

using indirect measures of disclosure based on analysts' perceptions, are unable to confirm a significant relation between the level of disclosure and board independence.

1.3 Corporate Governance

According to Mayer (1997), corporate governance is concerned with ways of bringing the interests of (investors and managers) into line and ensuring that firms are run for the benefit of investors. Corporate governance is concerned with the relationship between the internal governance mechanisms of corporations and society's conception of the scope of corporate accountability Deakin and Hughes, (1997).

Keasey et al. (1997) has also defined it to include the structures, processes, cultures and systems that engender the successful operation of the organizations. Corporate governance is also seen as the whole set of measures taken within the social entity that is an enterprise to favour the economic agents to take part in the productive process, in order to generate some organizational surplus, and to set up a fair distribution between the partners, taking into consideration what they have brought to the organization Maati, (1999). The Cadbury Committee (Cadbury, 1992, p. 15) defines corporate governance as the system by which companies are directed and controlled.

Generally, the different systems of corporate governance embody what are considered to be legitimate lines of accountability by defining the nature of the relationship between the bank and key corporate constituencies. Corporate governance systems may be therefore thought of as mechanisms for establishing the nature of ownership and control of organizations within an economy. In this context, corporate governance mechanisms are economic and legal institutions that can be altered through the political process – sometimes for the better Shleifer and Vishny, (1997).

Company law, along with other forms of regulation (including stock exchange listing rules and accounting standards), both shape and are shaped by prevailing systems of corporate governance. The impact of regulation on corporate governance occurs through its effect on the way in which companies are owned, the form in which they are controlled and the process by which changes in ownership and control take place Jenkinson and Mayer, (1992). Ownership is established by company law, which defines property rights and income streams of those with interests in or against the business enterprise Deakin and Slinger, (1997). The definition of ownership is problematic in this context Njoya, (1999). At the bottom, differences in conceptions of ownership lead to differences in forms of control and, therefore, differences in the formulation and implementation of corporate strategy Deakin and Hughes, (1997).

1.4 The Relationship Between Internal Controls and Corporate Governance

Theoretically, effective internal control system increases good corporate governance since it is a built-in part of the management process (i.e., plan, organize, direct, and control). Internal control keeps an organization on course toward its objectives and the achievement of its mission, and minimizes surprises along the way. Internal control promotes effectiveness and efficiency of operations, reduces the risk of asset loss, and helps to ensure compliance with laws and regulations. Internal control also ensures the reliability of financial reporting (i.e., all transactions are recorded and that all recorded transactions are real, properly valued, recorded on a timely basis, properly classified, and correctly summarized and posted). Theoretically therefore, an Organization with effective system of internal control is expected to achieve its objective efficiently and effectively hence good corporate governance while an Organization with weak system of internal control will experience bad corporate governance.

Mensah et al, (2003) found empirical evidence in Ghana that effective internal control improves good governance practices and decreases the corruptions. Pratolo (2007) found that effective internal control has positive link with good corporate governance at State owned enterprises in Indonesia. Similar with these findings Nila and Viviyanti (2008) also found that internal control has a positive relationship with good corporate governance at State owned enterprises in West Java Indonesia.

Many factors constitute the yardsticks by which this relationship is measured in an organization. In this study, the aspect of corporate governance mechanism that is examined is the board of directors characteristics, that is, board independence, board diligence, board expertise and board size. The board of directors has been identified as one of the most important components of internal control mechanisms for monitoring management's activities Vafeas, (2005); Carcello, (2009), and is responsible for the oversight of an organization's performance, with the purpose of maximizing shareholder value Denis and McConell, (2003).

Larcker et al., (2007), assert that corporate governance mechanisms influence the decisions made by managers when there is separation of ownership and control, in order to enhance accountability and efficiency, and to ensure quality of the financial reporting process. Due to this separation of corporate ownership from management, an information gap is created Berle and Means, (1932), and as such, this necessitates the demand for forms of control and monitoring, both internally, through the board of directors, and externally, through the report of the external auditors Walsh and Seward, (1990).

The quality of board oversight has received increasing attention in recent years, with emphasis on the need for strong corporate governance McConomy and Bujaki, (2000). A study by Cadbury,

(1997), shows that countries around the world put emphasis on good corporate governance mechanisms and have drawn up guidelines and codes of practice to strengthen corporate governance mechanisms. The International Federation of Accountants states the rationale for this emphasis on good corporate governance is due to increased concerns over the integrity of securities markets IFAC, (2010).

Good corporate governance practices by boards of directors influence the quality of financial reporting, which in turn have impacts on investor confidence Adeyemi and Fagbemi, (2010). Saudagaran, (2003), suggests that improving the integrity of financial reporting through greater accountability and the restitution of resources devoted to the audit function can be done by better corporate governance policies. Fama, (1980), states that the essences of good corporate governance are the outcomes of logical and rational decisions taken at the board level.

1.5 Commercial Banks in Kenya

McDonough (2002), President of the Basle Committee specifies that the financial stability can be realized with the interaction of many factors: "Financial stability begins with good corporate governance, able and experienced directors and management. So, the aim of this paper consists of exploring the impact of the board of directors' size and diversity on the insolvency risk of Kenyan commercial banks. The model described by Jensen (1993) constitutes the base in developing the study assumptions. To test the impact of board of directors' diversity on insolvency risk of Kenyan banks, the study will measure the demographic and cognitive diversity by the proportion of foreign and institutional administrators, respectively.

The Central Bank of Kenya oversees the operations of all commercial banks. During the on-site inspections all risks are evaluated and necessary remedial actions are recommended. Off-site

surveillance is also conducted by reviewing data received from institutions on a regular basis. Corporate governance issues have also taken a center-stage in the supervising process CBK,(2003). According to Ng'ang'a et al., (2003) report, the governance and efficacy of listed companies had improved in the years prior to the report, making it comparable to "any other market in the world. By introducing and enforcing the necessary regulations, the Capital Market Authority (CMA) and Nairobi Security Exchange (NSE) have improved governance.

1.6 Statement of the Problem

Since the onset of the financial crisis bank stability has been yet again at the top of policy makers' agenda across advanced and developing countries. Concerns about the stability of banks of different sizes and ownership have dominated the public debate around the world over the past two years. While some point to the failure of private banks as evidence for the fragility of short-term and profit-oriented banking, others point to governance failures and distorted business models in state-owned banks that came to light during the crisis, such as in Germany and elsewhere.

The recent scandals and corporate failures in the United States and in Europe have led to a renewed interest in research of corporate governance. Scandals are simply manifestations of a number of structural reasons why corporate governance has become a central issue in the last two decades. Formal econometric studies show that banks exert a strong impact on economic development Levine,(2005). Since banks exert corporate governance on firms, as creditors of firms and, in many countries, as equity holders, the corporate governance of banks becomes crucial for growth and development. Since internal controls and corporate governance are basic assurance systems to maintain the system efficiency and to protect corporate from failure, it is necessary to carry out a study on the relationship between internal controls and corporate governance.

Internal control is the way to achieve the corporate governance goals, managerial auditing journals, (25-4-2010). The management dilemma being how to set up an efficient and effective internal control system in light of agency theory i.e. diverse interested parties and their willingness, pose a challenge to the quality of many internal control systems in an organization.

There is an over focus on the financial dimensions of bank performance, with some attention being given to systematic performance and very little attention being paid to social dimensions of bank performance Zahra and Pearce, (1989); Maassee (1999). Ndemo and Makali (2005,2008) examined the relationship between the size of the board of directors and the performance (measured by the tobin's Q) of the banks in Kenya and they did not find a negative relation between the size of the board and the performance of the banking firm.

More recent study by Ndibe, (2010) examined the same relation within the framework of simultaneous equations model, to take into account the endogeneity of the various internal mechanisms of corporate governance and did not find that the size of the board of directors has an impact on the performance of the banks. He concluded that the restrictions on the size of the board of directors cannot be fruitful; I note that these is contrary to the findings of Ndemo and Makali, as sited in the previous paragraph hence creating a gap that requires further research. Moreover Ndibes' (2010) study also showed that on average the board of directors of listed companies meet five (5) times in a year hence conclusion that listed companies took the issue of board meetings seriously and that this aspect of corporate governance improved, but I have not seen any collaboration of the same in his literature review: this too, requires further research.

Surprisingly enough, despite the importance of the topic, there are only a few studies on the corporate governance of banks. Further, to my knowledge, so far no study has established the link between

corporate governance, internal control and insolvency risk in Kenya. This study therefore seeks to fill this gap by seeking answers to the question, what is the relationship between internal control and corporate governance in commercial banks in Kenya? There is a need for a study that would keenly look at the moderating factors such as; defect of control environment, weakness of risk consciousness, unsuitable control activities and invalid supervision among others.

1.7 Objective of the Study

The study seeks to establish the relationship between internal control and corporate governance in commercial banks in Kenya.

1.8 Importance of the Study

This study will contribute to the agency theory in which the shareholders expect the agents to act and make decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interest of the principals Padilla, (2000). Within commercial banks of Kenya; there could be many problems such as unreasonable equity structure, enterprise internal and external supervision vacancy, "inside control" phenomenon, ineffectiveness of board of directors and board of supervisors the above factors result in many problems in enterprises internal control. In order to promote the rapid development of commercial banks in Kenya through internal control perfection, it is important to study internal controls based on corporate governance.

This study may also highlight the importance of internal controls as bedrock of corporate governance based on which various organizations can review their policies to revamp their internal control systems in order to achieve good corporate governance. In practice, Internal Control and Corporate Governance are basic assurance systems to maintain the systems efficiency and to protect corporate from failure. As a self-adjusting and restricted internal mechanism, internal controls are an important

position of the enterprise’s central system worthy a study such as this, to collaborate the relationship between internal controls and corporate governance and establish its significance as a contribution to the knowledge base for the would be interested parties such as commercial banks, body corporate and resource for institutions of higher learning.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

Contemporary discussions of corporate governance tend to refer to principles raised in three documents released since 1990: The Cadbury Report UK, (1992), the Principles of Corporate Governance OECD, (1998 and 2004), the Sarbanes-Oxley Act of 2002 US, (2002). The Cadbury and OECD reports present general principals around which businesses are expected to operate to assure proper governance. The Sarbanes-Oxley Act, informally referred to as Sarbox or Sox, is an attempt by the federal government in the United States to legislate several of the principles recommended in the Cadbury and OECD reports.

There are many different models of corporate governance around the world. These differ according to the variety of capitalism in which they are embedded. The Anglo-American "model" tends to emphasize the interests of shareholders. The coordinated or multi-stakeholder model associated with Continental Europe and Japan also recognizes the interests of workers, managers, suppliers, customers, and the community.

Beyond contemporary discussion and different models of the relationship between internal controls and corporate governance around the world, this literature review mainly looks at the theoretical followed by empirical findings and to identify gaps if any.

2.2 Theoretical Review

The relationship between Internal Controls and Corporate Governance is in all types of firms and could extend to cover all of the economic and non-economic activities. Literatures in corporate governance provide some form of meaning on governance, but fall short in its precise meaning of

governance. Such ambiguity emerges in words like control, regulate, manage, govern and governance. Owing to such ambiguity, there are many interpretations. It may be important to consider the influences a firm has or affected by in order to grasp a better understanding of governance. Owing to vast influential factors, proposed models of corporate governance can be flawed as each social scientist is forming their own scope and concerns.

Hence, this chapter reviews various fundamental theories underlying corporate governance. These theories range from the agency theory and expanded into stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory, political theory and ethics related theories such as business ethics theory, virtue ethics theory, feminists ethics theory, discourse theory and postmodernism ethics theory.

2.2.1 Agency Theory

Agency theory having its roots in economic theory was exposited by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976). Agency theory is defined as "the relationship between the principals, such as shareholders and agents such as the bank executives and managers". In this theory, shareholders who are the owners or principals of the bank, hires the agents to perform work. Principals delegate the running of business to the directors or managers, who are the shareholder's agents Clarke, (2004). The agency theory shareholders expect the agents to act and make decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals (Padilla, 2000). Such a problem was first highlighted by Adam Smith in the 18th century and subsequently explored by Ross (1973) and the first detailed description of agency theory was presented by Jensen and Meckling (1976). Indeed, the notion of problems arising from the separation of ownership and control in agency theory has been confirmed by Davis, et al., (1997).

In agency theory, the agent may be succumbed to self-interest, opportunistic behavior and falling short of congruence between the aspirations of the principal and the agent's pursuits. Even the understanding of risk defers in its approach. Although with such setbacks, agency theory was introduced basically as a separation of ownership and control Bhimani, (2008). Holmstrom and Milgrom (1994) argued that instead of providing fluctuating incentive payments, the agents will only focus on projects that have a high return and have a fixed wage without any incentive component. Although this will provide a fair assessment, it does not eradicate or even minimize corporate misconduct. The positivist approach is used where the agents are controlled by principal-made rules, with the aim of maximizing shareholders value. Hence, a more individualistic view is applied in this theory Clarke, (2004). Indeed, agency theory can be employed to explore the relationship between the ownership and management structure.

However, where there is a separation, the agency model can be applied to align the goals of the management with that of the owners. Due to the fact that in a family firm, the management comprises of family members, hence the agency cost would be minimal as any firm's performance does not really affect the firm performance Eisenhardt, (1989). The model of an employee portrayed in the agency theory is more of a self-interested, individualistic and are bounded rationality where rewards and punishments seem to take priority Jensen & Meckling, (1976). This theory prescribes that people or employees are held accountable in their tasks and responsibilities. Employees must constitute a good governance structure rather than just providing the need of shareholders, which maybe challenging the governance structure.

2.2.2 Stewardship Theory

Stewardship theory has its roots from psychology and sociology and is defined by Davis, et al., (1997) as "a steward protects and maximizes shareholders wealth through firm performance,

because by so doing, the steward's utility functions are maximized". In this perspective, stewards are bank executives and managers working for the shareholders, protects and make profits for the shareholders. Unlike agency theory, stewardship theory stresses not on the perspective of individualism Donaldson and Davis, (1991), but rather on the role of top management being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained.

Agyris (1973) argues agency theory looks at an employee or people as an economic being, which suppresses an individual's own aspirations. However, stewardship theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust Donaldson and Davis, (1991). It stresses on the position of employees or executives to act more autonomously so that the shareholders' returns are maximized. Indeed, this can minimize the costs aimed at monitoring and controlling behaviors Davis, et al., (1997). On the other end, Daily et al. (2003) argued that in order to protect their reputations as decision makers in organizations, executives and directors are inclined to operate the firm to maximize financial performance as well as shareholders' profits. In this sense, it is believed that the firm's performance can directly impact perceptions of their individual performance. Indeed, Fama (1980) contend that executives and directors are also managing their careers in order to be seen as effective stewards of their organization, whilst, Shleifer and Vishny (1997) insists that managers return finance to investors to establish a good reputation so that they can re-enter the market for future finance.

Stewardship model can have linking or resemblance in countries like Japan, where the Japanese worker assumes the role of stewards and takes ownership of their jobs and work at them diligently. Moreover, stewardship theory suggests unifying the role of the CEO and the chairman so as to reduce agency costs and to have greater role as stewards in the organization. It was evident that

there would be better safeguarding of the interest of the shareholders. It was empirically found that the returns have improved by having both these theories combined rather than separated Donaldson and Davis, (1991).

2.2.3 Stakeholder Theory

Stakeholder theory can be defined as "any group or individual who can affect or is affected by the achievement of the organization's objectives". Unlike agency theory in which the managers are working and serving for the stakeholders, stakeholder theorists suggest that managers in organizations have a network of relationships to serve – this include the suppliers, employees and business partners. This group of network is important other than owner-manager-employee relationship as in agency theory Freeman, (1999). On the other end, Sundaram and Inkpen (2004) contend that stakeholder theory attempts to address the group of stakeholder deserving and requiring management's attention. Whilst, Donaldson and Preston (1995) claimed that all groups participate in a business to obtain benefits. Nevertheless, Clarkson (1995) suggested that the firm is a system, where there are stakeholders and the purpose of the organization is to create wealth for its stakeholders.

Freeman (1984) contends that the network of relationships with many groups can affect decision making processes as stakeholder theory is concerned with the nature of these relationships in terms of both processes and outcomes for the firm and its stakeholders. Donaldson and Preston (1995) argued that this theory focuses on managerial decision making and interests of all stakeholders have intrinsic value, and no sets of interests are assumed to dominate the others.

2.3 Mechanism Internal Control Systems and Management

There are several banks that have closed in Kenya due to lack of proper controls in place. Trade Bank was closed several years ago due to mismanagement of customers' funds as a result of failing to ensure certain controls are followed. We have also seen chartered Bank that was involved in money laundering which is a process of converting 'dirty money' to clean money. Dirty money could be stolen cash which normally involves huge sums of money sent to our country to be used for legitimate business .Bank employees are expected to conduct themselves with consistently high professionalism and observing ethical standards. There is no conflict between behaving ethically and making money for shareholders since a bank that decides to drop its ethical standards may deliver more profit in the short term but over time the values that bind its people together will be eroded, customer trust diluted, and the bank's brand damaged Barclays Magazine, (2009).

2.4 The Interaction of Different Governance Mechanisms and Internal Control

Corporate governance comprises many dimensions. Based on the U.K. Code, it can be divided broadly into the role of directors, directors' remuneration, the role of shareholders, and accountability and audit. Some of the structures are complements while others are substitutes to certain extent. The previous research has found different governance patterns. For example, Peasnell et al. (2001) find evidence of a convex association between the proportion of outside board members and the level of insider ownership in the U.K. corporate control process. Shivdasani and Yermack (1999) observe, using U.S. data, that when the CEO serves on the nominating committee or no nominating committee exists, firms usually appoint fewer independent outside directors and more grey outsiders. Similarly, Vafeas (1999) discover that the likelihood of engaging a nominating committee is related to board characteristics such as inside ownership, number and quality of outsider directors for U.S. firms.

Board structure is an important governance mechanism. Kenneth et al. (1995) note the substitution effects between outside directors, block holders, and incentives to insiders using eighty one U.S. bank-holding companies in his study. Both Dedman and Elisabeth (2002) and Young (2000) investigate the board structure determinants before and after Cadbury Report. They either find managerial entrenchment is reduced or non-executive directors are increased following the imposition of new standards of "best practice" regarding board structure.

2.5 Relationship between Internal Control, Governance Mechanism and Firm Performance

This study borrows from Himmelberg et al. (1999) who use panel data to show that managerial ownership is explained by key variables in the contracting environment. A large fraction of the cross-sectional variation in managerial ownership is explained by unobserved firm heterogeneity. Moreover, after controlling for both observed firm characteristics and firm fixed effects, changes in managerial ownership do not affect firm performance statistically. The Audit committee system plays an important role in the internal auditing practices since the internal auditors might be considered as being specialists in management control Chambers et al., (1987). Internal auditing practices appraise the effectiveness of internal control systems, which is a definition of internal auditing and which also includes an appraisal of the actions by management to correct situations, which are at variance with planned outcomes. The definition of internal control systems reveals that it is not fundamentally different from management control, which has an essential component of control such as planning, organizing, staffing and directing Chambers et al., (1987).

Senior management and the audit committee normally expect that the CAE will perform sufficient audit work and gather other available information during the year so as to form a judgment about the adequacy and effectiveness of the control processes. The CAE should then communicate that

overall judgment about the organization's system of controls to the senior management and the audit committee. This is necessary since internal auditors play an intermediary role and assist in the discharge of the oversight function of audit committee. If the above internal audit function is not available, the management needs to apply other monitoring processes in order to assure itself and the board that the system of internal control is functioning as intended. In these circumstances, the board of the bank will need to assess whether such processes provide sufficient and objective assurance or regular review and appraisal of the adequacy and the integrity of the internal control systems in the bank.

Bursa Listing Requirements has established industry taskforce which formulated the "Statement on Internal Control: Guidance For Directors of Public Listed Companies" to fulfil the above circumstances. The aim of this guidance is to assist listed companies in making disclosures in their annual reports on the state of internal control, in compliance with the Listing Requirements of the KLSE.

Pursuant to the requirements of the Code in relation to the Internal Audit Function, in May 2001, the Securities Commission was appointed to establish a separate industry taskforce to formulate these Guidelines to assist the board of public listed companies in effectively discharging their responsibilities in relation to establishing an Internal Audit Function. Risk assessment, control environment, control activities, information and communication and monitoring are five important characteristics in this guideline.

Previous local researches use available ratings developed by rating agencies. For example, Obosi (2006) analyzed the relationship between different governance standards measured by the Demeanor Corporate Governance Ratings and stock returns, firm value and operating performance

for most firms included in the NSE 20 index. Demeanor is a rating which evaluates approximately 300 different governance criteria per firm, which can be attributed to four broader categories that are: Rights and duties of shareholders; Range of takeover defense; Disclosure on corporate governance; and Board structure and functioning. The result of the Pearson Correlations findings used in the study provided evidence that all measures of return except for one-year return; and all measures for profitability are significantly positively correlated with the CGQ scores that represent quality of corporate governance and that bank would enhance their corporate governance when the bank's performance is poor because changes in corporate governance structure are expected to bring out positive result on their performance.

Ndemo and Makali (2005, 2008) examined the relation between the size of the board of directors and the performance (measured by the Tobin’s Q) of the banks by using a sample of 35 large commercial banks in Kenya over the period going from 2002 to 2005, and they did not find a negative relation between the size of the board and the performance of the banking firm..

In another study, Kemboi (2006) reported evidence on the relationship between corporate governance and the market value of Kenyan quoted public firms. Comparing prior studies that using other corporate governance index, the corporate governance index used in the study is based on responses to objective questions on a 2001 survey by the commercial banks in Kenya, reducing the problem of omitted corporate governance variables in the construction of index. The index composed of six sub-indices, based on a total of 39 separate elements. Quite similar study was done by Moraa, (2009) using data from all manufacturing companies in Kenya.

The dependent variables in their study were corporate governance index and additional variables of control mechanism; ownership structure, board characteristics, and leverage. This provided

comprehensive description of firm-level corporate governance for a broad sample of firms listed in NSE. These study findings also proved that better-governed firms might have more efficient operations, resulting in a higher expected future cash-flow stream.

Kombe,(2009) who developed corporate governance rating (CGR) based on responses on questionnaires sent out to all firms in the four principal segments of the Nairobi stock exchange. The survey questions were constructed based on the firm's Corporate Governance Code and other ratings such as Deminor Ratings, and was tested from a legal and regulatory prospectively. It managed to collect 30 governance proxies under five categories from 55 listed firms. Equal weighting scheme was used for the different proxies in order to be transparent and also to allow easy interpretations. The study established that the association between quality of corporate governance and firms' profitability is quite major focus in corporate governance studies, but one cannot predict much on the direction as prior literatures show mixed results. The study moreover found out that use return on assets as measure for performance found evidence that firms with better governance have higher operating performance and that on average board independence was 0.7146 (71.46%), which indicates that the listed companies adhered to the requirement that a balance of executive directors and non-executive directors be maintained

Finally, a more recent study by Ndibe, (2010) examined the same relation within the framework of a simultaneous equations model to take into account the endogeneity of the various internal mechanisms of corporate governance. On a sample of 10 blue chip companies in Kenya, the author does not find that the size of the board of directors has an impact on the performance of the banks. Consequently, they concluded that the restrictions on the size of the board of directors cannot be fruitful. The results of the study also showed that on average the boards of directors of the listed

companies meet 5 times in a year. The implication for this is that listed companies took the issue of board meetings seriously and as such this aspect of corporate governance improved.

2.6 Empirical Review

Corporate governance ratings are foreseen to help attract and retain capital in the stock market. This is because financial markets operate on the basis of investors' confidence, which can be enhanced with the continuing practice of good, fair and transparent corporate behaviour. The ratings are expected to have an impact on companies' credit ratings. As such, poor corporate governance rating would affect the agency's credit rating for a bank while conversely; those with high ratings could be better rewarded. Companies with better corporate governance ratings would see higher profitability and productivity as good governance involves improved processes and systems as well as enhancement of trust and accountability.

Previous researches use available ratings developed by rating agencies. For example, Bauer et al. (2004) analyzed the relationship between different governance standards measured by the Deminor Corporate Governance Ratings and stock returns, firm value and operating performance for most firms included in the FTSE Eurotop 30. Deminor is a rating which evaluates approximately 300 different governance criteria per firm, which can be attributed to four broader categories that are: Rights and duties of shareholders; Range of takeover defense; Disclosure on corporate governance; and Board structure and functioning.

Similarly, the analysis of 40 years of data from 159 studies, carried out by Dalton and Daily (1999), concluded that there is no clear evidence of a substantive relationship between board composition and financial performance, irrespective of the type of performance indicators, the size of the firm or the manner in which board composition is measured. For example, a board could be

completely independent and, at the same time, fail in its expertise, counsel and resource-dependency roles Dalton and Daily; (1999). On the other hand, a board dominated by inside and affiliated directors could fall short in its ability to monitor and control Daily and Dalton, (1994; 1999). Hence, reliance on the independence of board members or any one dimension of board roles and attributes will not ensure high levels of corporate financial performance, especially if it is at the expense of other director roles (Johnson et al., 1993; Dalton and Daily, (1999).

Besides that, there are researches that use self-developed rating generally constructed using recommendations and suggestions contained in Code of Corporate Governance. In Korea, Black et al. (2003) report evidence on the relationship between corporate governance and the market value of Korean public firms. Comparing prior studies that use other corporate governance index such as S&P and CLSA ranking, the corporate governance index used in the study is based on responses to objective questions on a 2001 survey by the Korea Stock Exchange, reducing the problem of omitted corporate governance variables in the construction of index. The index is composed of six sub-indices, based on a total of 39 separate elements. Quite similar study is done by Beiner et al. (2004) using data from Switzerland. The dependent variables in their study are corporate governance index and additional variables of control mechanism; ownership structure, board characteristics, and leverage. This provides comprehensive description of firm-level corporate governance for a broad sample of firms listed in Swiss Stock Exchange (SWX). The corporate governance index is mainly based on the recommendations and suggestions contained in the Swiss Code of Best Practice.

The same analysis is done in Germany by Drobetz et al. (2004) who developed corporate governance rating (CGR) based on responses on questionnaires sent out to all firms in the four principal segments of the German stock exchange. The survey questions are constructed based on

the German Corporate Governance Code and other ratings such as Deminor Ratings, and were tested from a legal and regulatory perspective by Deutsche Borse AG. It managed to collect 30 governance proxies under five categories from 253 listed firms. Equal weighting scheme is used for the different proxies in order to be transparent and also to allow easy interpretations.

Mohanty (2002) differentiates firms with good and poor governance by developing a corporate governance index in a way, which is quite distinctive from others. Instead of looking at the process of governance, the measures of corporate governance are based on observation to the outcome of good corporate governance. The index is developed based on the definition by SEBI committee report which defines the objective of corporate governance as the maximization of shareholder's wealth by keeping in mind the interests of other stakeholders. Thus, if a firm has got appropriate corporate governance in practice, it must get reflected in how the firm deals with its seven types of stakeholders.

The association between internal control and corporate governance is quite major focus in corporate governance studies, but one cannot predict much on the direction as prior literatures show mixed results. Jensen and Meckling (1976) have proven that better-governed firms might have more efficient operations, resulting in a higher expected future cash-flow stream. In Brown and Caylor (2004), the result of the Pearson Correlations used in the study provides evidence that all measures of return except for one-year return; and all measures for profitability are significantly positively correlated with the CGQ scores that represent quality of corporate governance. Klapper and Love (2003) that use return on assets as measure for performance found evidence that firms with better governance have higher operating performance. Contrast results are seen in Gompers et al. (2003), Beiner et al. (2004) and Bauer et al. (2004). According to Cho and Kim (2003), bank

would enhance their corporate governance when the bank's performance is poor because changes in corporate governance structure are expected to bring out positive result on their performance.

2.7 Conclusion

Although there is a growing focus on governance issues, such as specific board composition configuration or board leadership structure, the results are unclear with respect to firm performance Dalton et al., (1998). According to agency theory, good corporate governance should lead to higher stock prices or better long-term performance, because managers are better supervised and agency costs are decreased. Poor corporate governance on the other hand is fertile soil for corruption and corruptive symbiosis between business and political circles Manyuru, (2005).

Zahra and Pearce (1989), identify a number of shortcomings in previous research and urge cautious interpretation of results on board roles and attributes. Using the same constructs of board roles and attributes for measuring impact on firm's performance, Maassen's (1999) came to similar conclusions. Moreover, both studies concluded that there is an over-focus on the financial dimensions of bank performance, with some attention being given to systemic performance and very little attention being paid to social dimensions of bank performance Zahra and Pearce, (1989); Maassen (1999). This is an area of study with as many conflicting views as there are researchers, both locally and internationally, with many of them giving emphasis on financial performance with little if any, attention being paid to social, cultural religious, environmental and political considerations. There is room for more focused collaborative research to fill the identified gaps. In this context, corporate governance mechanisms are economic and legal institutions that can be altered through the political process – sometimes for the better. Shleifer and Vishny, 1997).

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the methodology that the researcher employed in the study. The methodology include the research design, the target population, the sampling design and the sample size, the data collection instruments as well as the data analysis techniques that was used to analyze the data.

3.2 Research Design

The study adopted a descriptive research design in investigating the relationship between internal controls and governance in commercial banks in Kenya. The descriptive research, also known as statistical research, describes data and characteristics about the population or phenomenon being studied. It classifies phenomena as factual, accurate and systematic. The researcher conducted a survey of all the 45 commercial banks in Kenya. Descriptive research design allowed the researcher to study the elements in their natural form without making any alterations to them. The design also allowed the researcher to come up with descriptive statistics that can assist in explaining the relationship that exists among variables. Descriptive research design is the most applicable for the study, as the study focused on describing independent variables. This scientific method of investigation involved collection and analysis of data in order to describe a phenomenal in its current condition or status, Kothari (2001) continues to indicate that this design is preferred because it is time saving, it is possible and easy for the researcher to obtain current factual information from the employees in the organization.

3.3 Population of the Study

The researcher conducted a survey of all the 45 commercial banks in Kenya. Descriptive research design allowed the researcher to study the elements in their natural form without making any alterations to them. The researcher was able to sample the ones that were considered for the study.

3.4 Data Collection

Both qualitative and quantitative primary and secondary data for the years 2009 up to 2011 was used for the study. Primary data is information gathered directly from the respondents (Kothari, 1990). The primary data was collected by use of a structured questionnaire and an unstructured interview guide. The questionnaire is considered appropriate because it is easy to administer. The questionnaire contained both open and closed ended questions; it was self-administered through a drop-and-pick method. The interview guides was also used to gather data from those in senior management positions in charge of internal control and may have crucial information on corporate governance. The questionnaire was divided into two sections. Section A contained questions corporate governance information of the respondents while section B sort data that was relevant to internal controls. Secondary data collected include annual reports and financial statements.

3.4.1 Data Validity

Validity of a research instrument is concerned with the accuracy with which the instrument measures what it is supposed to. This study used a questionnaire and will tested its validity by use of content validity, which is a process of logical analysis that involves careful and critical examination of items in the research questionnaire. A few managers from selected bank were given the questionnaires to fill in order to ensure that they carry valid content.

3.4.2 Data Reliability

The research questionnaire used in this study gave reliable information that has been used in decision making. It should therefore be able to produce the same results if used by other researchers. To determine the reliability of the research questionnaire, a pre-test of the same was done among few commercial banks.

3.5 Data Analysis

Prior to secondary data analysis, primary data was analysed using descriptive statistics to establish the relationship between internal controls and corporate governance. Data was analysed on the basis of descriptive statistics and performance comparison done across time between the years 2009-2011. Statistical Package for Social Sciences (SPSS) version 17 was used as an aid to analysis. SPSS was preferred because of its ability to cover a wide range of most statistical and graphical data analysis and is systematic. In order to determine the relationship between the internal controls and corporate governance a multiple regression model was used

3.5.1 Variable Definition and Model Specification

a) Independent Variables

The following corporate governance practices constitute the independent variables for the study. They are: Board Structure: That is whether the Manager or CEO Plays a duality role as CEO and Board chair or whether the CEO is only CEO and not board chair. That is, whether top management members are also members of the Board of Directors

Board Size: that is, the number of members who constitute the board or are present at given meeting. Audit Committee: that is whether the Board of Director has an audit committee

responsible for monitoring financial and compliance activities of Management. Composition: This is the makeup of the board, quality of board, qualification of members.

Multiple Directorships: That is whether Board Director(s) serves on Board of other entities.

The independent variables were measured as follows:

Board Structure = Board that has the CEO as its Chair was assigned a value of 1; a board with an Independent chair was assigned a value of zero

Board Size = total number of members serving on the board at any particular period

Audit Committee = proportion of total AC members to total board membership

Multiple Directorship = proportion of board members who also serve on board of other firms to total number of board members.

b) Dependent Variable

This is the variable whose state can be altered by the independent variables. The dependent variable constitutes the internal controls attributes i.e. Control Environment, Risk Assessment, Control Activity, Accounting Information and Communication and Monitoring.

For Internal Controls the regression equation is: {IC = fn(CE, RA, CA, AIC,M)}

For Corporate Governance, the regression equation is: {CG = fn(CEOD, AUC, BC, NX)}

To test the relationship between two variables (corporate governance and internal control), the study adopted Chi-Square Test to test the significance of association between the two.

Model specification:

The model is made up of two types of variables: the dependent variable, and control variables. The dependent variable is internal control, which in the model was used as the natural log of internal control.

The Regression model is

$$LNFEE_{it} = b_0 + \sum_{t=1}^{n} \beta_t CG_{it} + \varepsilon_{it}$$

Whereby:

$LNFEE_{it}$ = the natural log of internal controls for bank i at time t; 1,2,3 … , 45 bank

b_0 = measures the intercept

β_t = the coefficients of CG_{it} variable

CG_{it} = the different independent and controls variables for corporate governace

mechanism of bank i at time t

t = the time period where $t = 1,2 \ldots \ldots, 3$ years

$b_{0=}$ constant term

$b_1 \dots \dots \dots \dots b_n$= the coefficient of corporate governance and control variables

IC = Internal Control

$LNFEE_{it}$ = natural log of internal control for bank *i* at time *t; I* = 1, 2, 3….., 45 bank

CE_{it} = Natural log of control environment for bank *i* at time *t;* i = 1, 2, 3….., 45 bank

AIC_{it} = accounting information and communication for bank *i* at time *t; i* = 1, 2, 3….., 45 bank

RA_{it} = Risk Assessment for bank *i* at time *t; i* = 1, 2, 3….., 45 bank

CG = Corporate governance

$CEOD_{it}$ = CEO Duality for bank *i* at time *t; i* = 1, 2, 3….., 45 bank

AUC_{it} = Whether there is Audit committee for bank *i* at time *t; i* = 1, 2, 3….., 45 bank

BC_{it} = number of board committees (board size) for bank *i* at time *t; i* = 1, 2, 3….., 45 bank

NX_{it} = Ratio of Non-Executive Board Members to Total Board for bank *i* at time *t; i* = 1, 2, 3….., 45 bank

e_i = standard error of estimation (represents the unexplained variation)

Internal control = the amount of internal control as measured by internal control attributes.

4 Testing Significance of the Regression Model

We tested the significance of the regression model at a level of significance of say 95%.

H_O: $\hat{\beta}_1$ =0 (i.e. The relationship is not significant)

v/s H_1: $\hat{\beta}_1 \neq 0$ (i.e. The relationship is significant)

CHAPTER FOUR

RESEARCH FINDINGS AND DISCUSSIONS

4.1 Introduction

This chapter analyses the results of the data obtained through the questionnaire, discusses those results and the interpretation. This chapter presents the analysis and findings with regard to the objective and discussion of the same.

4.2 The Response Rate

A total of 45 questionnaires were issued out. The completed questionnaires were edited for completeness and consistency. Of the 45 questionnaires used in the sample, 42 were returned and represented a response rate of 93.3%, which the study considered adequate for analysis. However, 3 questionnaires were not returned making 6.7% non-response. The findings are presented in percentages and frequency distributions, mean and standard deviations.

Testing the relationship between Corporate Governance and Internal Control using Chi-Square Test in testing the significance of association between the two

This study operationalized corporate governance using board of directors' characteristics in identifying the variables that influence the relationship between internal controls and corporate governance in commercial banks in Kenya.

4.3 Regression Analysis

The descriptive statistics for the variables used in the model are presented. The mean for the natural log of internal control was 6.5748. While corporate governance averaged 52.91%.

Table 01: Descriptive statistics across all banks

	Mean	Std. Deviation	N
IC	6.5748	.34600	42
CE	9.6000	.70224	42
RA	.5291	.17436	42
AIC	.1700	.15568	42
CEOD	.7146	.15382	42
AUC	5.1376	4.28532	42
BC	.3053	.16091	42
NX	8.2751	2.57411	42

Source: Research data, author's computations

4.4 Pearson Correlations Coefficients for the Variables in the Model (2-tailed)

Internal control as measured by the natural log of internal control (IC), was positively correlated to the natural log of control environment (CE) at 0.673 and was significant at the 1% level. This is in conformity with prior studies by Simunic, (1980), Francis and Stokes, (1986), Palmrose, (1986), and Francis and Simon, (1987), which suggested client size to be the most dominant determinant of

Risk Assessment (RA) was negatively correlated to the natural log of internal control (IC), at -0.079 and was not significant at either the 5% or 1% level. The negative correlation implied that as the value of Risk Assessment decreased, the natural log of internal control increased. The study by Johnstone and Bedard, (2001) indicated that after controlling for the planned audit hours, the auditor's proposed fees for an engagement was significantly affected by the client's fraud and error risk factors.

All the independent variables were positively correlated to the natural log of internal control (IC). A few governance variables were significantly correlated with each other, although their correlations do not indicate multicollinearity as a serious problem. Multicollinearity is an undesirable situation when one independent variable is a linear function of other independent

variables. Table 02 shows that the correlations between independent variables range from 0.175 (whether there is audit committee) and 0.328 (CEO Duality).

Table 02: Pearson correlations coefficients for the variables in the model (2-tailed)

	IC	CE	RA	AIC	CEOD	AUC	BC	NX
IC	1							
CE	0.673**	1						
RA	-0.079	-0.169*	1					
AIC	0.009	-0.078	-0.007	1				
CEOD	0.220**	0.274**	0.062	0.028	1			
AUC	0.163*	0.317**	-0.080	-0.131	0.236**	1		
BC	0.094	0.039	0.061	0.205**	0.318**	-0.123	1	
NX	0.386**	0.466**	-0.052	-0.166*	0.328**	0.175*	-0.073	1

The significance (2-tailed) of the coefficients is obtained using the p-values with * and ** denoting significance at the 5% and 1% levels respectively.

Source: Research data, author's computations

4.5 Linear Regression

The hypotheses were tested using three ordinary least squares (OLS) regression models with the natural log of internal control (IC) as the dependent variable. First, the regression was run with only the independent variables. The second model was run with only the control variables. The third model was run with the inclusion of the independent and control variables.

The R-squared for model 1 was 0.177 meaning that 17.70% of the variance of the dependent variable was accounted for by model 1, the independent variables model. The adjusted R-squared was 0.159 for model 1. The Durbin-Watson was conducted to test for autocorrelation in error terms. The Durbin-Watson value was 1.760, which is slightly below 2, indicating that the data does not suffer from autocorrelation in error terms.

The R-squared for model 2 was 0.458 meaning that 45.80% of the variance of the dependent variable was accounted for by model 2, the control variables model. The adjusted R-squared was 0.449 for model 2. The Durbin-Watson value was 2.180, which is slightly above 2, indicating that the data does not suffer from autocorrelation in error terms.

The R-squared for model 3 was 0.472 meaning that 47.20% of the variance of the dependent variable was accounted for by model 3, the independent and control model. The adjusted R-squared was 0.451 for model 3. The Durbin-Watson value was 2.128, which is slightly above 2, indicating that the data does not suffer from autocorrelation in error terms.

Table 03: Linear regression results for model 1, model 2 and model 3

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.421[a]	.177	.159	.31730	.177	9.885	4	184	.000	1.760
2	.677[a]	.458	.449	.25684	.458	52.118	3	185	.000	2.180
3	.687[a]	.472	.451	.25633	.472	23.075	7	181	.000	2.128

Source: Research data, author's computations

4.6 Summary Statistics

The *p*-values for the intercept at 5.987 for model 1, 3.275 for model 2 and 3.340 for model 3 were all significant at the 1% level. The F-statistic values for the three models were 9.885, 52.118 and 23.075 respectively, and they were highly significant ($p<0.001$). The control environment variable was highly related to internal control, and was significant with $p<0.001$, for model 2 and model 3. The board size variable was significant for model 1 ($p=0.000$), but was not significant for model 3 ($p=0.089$).

In testing the validity of the models, the internal control model was used and the natural log of internal control was regressed on the control variables only. Model 1 shows the results of regression between the natural log of internal control and board of directors' characteristics. The adjusted R-squared was 0.159 and the model was significant with $p=0.000$. The reported

coefficients ranged from 0.008 to 0.260 with *p*-value range from 0.000 to 0.632. The validity of the model is presented in model 2.

Model 3 shows the results of regression between the natural log of internal control and board of directors' and control variables. The board size, was positively related with internal control, with *p*=0.000. The adjusted R-squared of 0.451 shows that board of directors' characteristics and the control variables explained 45.10% of the variance in internal control. The reported coefficients ranged from -0.010 to 0.317 with *p*-value ranging from 0.000 to 0.945.

Overall, the regression results were consistent with prior studies. Testing the hypothesized variables in different models strengthened the results because the models show the same significant results, with the overall adjusted R-squared being 45.10% for model 3. Table 4.6 presents the results of the regression for testing the hypotheses.

Table 04: Regression results for internal control on board of directors' characteristics (independent variables) and control variables

	Dependent variable = Internal control (IC)		
Independent/ control variables	**Model 1** Board of directors' characteristics	**Model 2** Control variables	**Model 3** Board of directors' characteristics and control variables
Intercept	5.987 {0.000}** [50.307]	3.275 {0.000}** [11.725]	3.340 {0.000}** [11.403]
CE		0.337 {0.000}** [12.418]	0.317 {0.000}** [9.925]
RA		0.074 {0.496} [0.682]	0.059 {0.594} [0.535]
AIC		0.141 {0.245} [1.167]	0.136 {0.279} [1.086]
CEOD	0.085 {0.632} [0.480]		-0.010 {0.945} [-0.069]
AUC	0.008 {0.139} [1.486]		-0.003 {0.480} [-0.708]
BC	0.260 {0.101} [1.650]		0.127 {0.330} [0.977]
NX	0.049 {0.000}** [5.021]		0.015 {0.089} [1.711]
Adjusted R^2	15.90%	44.90%	45.10%
F-value	9.885	52.118	23.075
P-value	0.000	0.000	0.000
Durbin Watson	1.760	2.180	2.128

The p-values are shown in the form { } with * and ** denoting significance at the 5% and 1% levels respectively, while the t-values are shown in the form [ ].

Source: Research data, author's computations

4.7 Empirical Findings

Multivariate Statistics

Results for the regression analyses appear in Table above, where the dependent variable is the natural log of internal control. Three models are presented and all are significant with F-statistics 9.885, 52.118 and 23.075 for each model respectively, and with the *p*-values of 0.000 for the three models. The explanatory power is moderate with adjusted R-squared for the three models being 15.90%, 44.90% and 45.10% respectively.

The F-test is a model test statistic that investigates the significance of the model. The results show that the F-test statistic was significant, for all the three models. Model 1 had F-statistic value of 9.885 and was significant (*p*=0.000). Model 2 had F-statistic value of 52.118 and was significant (*p*=0.000), and Model 3 had F-statistic value of 23.075 which was significant (*p*=0.000). Table 4.7 shows the analysis of variance for the three models.

Table 05: Analysis of variance for the three models

Model		Sum of Squares	df	Mean Square	F	Sig.
Model 1 (Independent variables)	Regression	3.981	4	.995	9.885	.000[a]
	Residual	18.525	184	.101		
	Total	22.506	188			
Model 2 (Control variables)	Regression	10.309	3	3.436	52.118	.000[a]
	Residual	12.198	185	.066		
	Total	22.506	188			
Model 3 (All variables)	Regression	10.613	7	1.516	23.075	.000[a]
	Residual	11.893	181	.066		
	Total	22.506	188			

Source: Research data, author's computations

The explanatory power of the model is moderate, at 45.10%. The overall model is also significant as shown by F-statistic value of 23.075 and *p*=0.000.

4.8 Relationship between Corporate Governance and Internal Controls

The Corporate governance variable as measured by the corporate governance attributes showed a negative Pearson correlation with the natural log of internal control at -0.078, and was not significant at either the
5% or 1% level. Studies in prior years have used corporate governance to explain the variations in the internal control. A risky Bank is expected to run the risk of audit failure. As a result this would require intensive audit testing and thus an increase in the internal control Simunic, (1980).

Johnstone and Bedard, (2001), indicates that after controlling for the planned audit hours, the auditor's proposed fee for an engagement was significantly affected by the client's fraud and error risk factors. The riskiness of audit increases the internal control because the accounting firm will have to undertake more detailed work so as to resolve or mitigate the risk and/or as a premium for accepting more risk Firth, (1993).

4.9 CEO Duality (CEOD) and Internal Controls

The alternative hypothesis H_1 predicted a relationship between CEO Duality and internal controls. The CEO Duality was measured and found to be positively related to the natural log of internal control, the Pearson correlation coefficient was 0.220 and significant at 1% level with (*p*=0.002). This is consistent with the theoretical predictions, where several studies have reported a positive relationship between board independence and the demand for external audit. These studies include (O'Sullivan, (2000); Carcello et al.,(2002); Abbott et al., (2003); Hay and Knechel, (2004). Clause

2.1.4 stipulates that the board should compose of a balance of executive directors and non-executive directors. The findings showed that on average board independence was 0.7146 (71.46%), which indicates that the listed banks adhered to the requirement that a balance of executive directors and non-executive directors be maintained. The findings of the study, therefore, reject the null hypothesis and accept the alternative hypothesis.

4.10 Whether there is Audit Committee

The alternative hypothesis H_2 predicted that audit committee was related to internal controls. Audit committee was measured as number of board meetings held during the financial year and was found to be positively related to the natural log of internal control. The Pearson correlation coefficient was 0.163 and significant at the 5% level with p=0.025. This therefore means that the existence of audit committee is likely to enhance internal control. The findings of the study reject the null hypothesis and accept the alternative hypothesis.

4.11 Ratio of Non – Executive Board Members to Total Board (NX) and Internal Controls

The alternative hypothesis H_3 predicted that board expertise was related to external internal control. Board expertise was measured as the average number of outside directorships held in other listed banks by non-management directors. The Pearson correlation coefficient was 0.094 (p=0.199). This coefficient was not significant at either the 5% or 1% level. Where multiple directorships are common, one expects there to be support for high external audit services and hence higher internal control. On the other hand, it can be argued that multiple directorships shows enhanced quality of oversight by the board. This enhanced oversight may substitute increased auditor effort and reduce auditor's assessment of control risk, resulting in decreased internal control.

The results showed that on average non-management directors held 0.3053 (30.53%) additional outside directorship. The implication is that most of the non-management directors do not hold other directorships in listed banks, meaning that board expertise is limited in Kenya. Based on the findings of the study, the null hypothesis is rejected and the alternative hypothesis accepted.

4.12 Number of Board Committee (BC) and Internal Controls

Board size was measured as the number of directors on the board, and was found to be positively related to the natural log of internal control. The Pearson correlation coefficient was 0.386 with p=0.000. This coefficient was significant at the 1% level. The size of the board significantly affects the likelihood of financial frauds (Beasley, 1996). This is as a result of the presumption that the larger the boards are, the less effective they are in monitoring the financial reporting process. In this respect, the external auditor considers the control environment to be weak, and hence a higher internal control is charged. stipulates that the size of the board should not be too large to undermine an inter-active discussion during board meetings or too small such that the inclusion of a wider expertise and skills to improve the effectiveness of the board is compromised.

4.13 Test for reliability of the Models

In addition, sensitivity analysis was performed in order to test for multicollinearity. The results are shown in the collinearity statistics as tolerance and variance inflation factor (VIF). The collinearity tolerance values appear normal with values ranging between 0.726 and 0.897 for model 1, 0.965 and 0.993 for model 2, and 0.695 and 0.954 for model 3. Menard, (1995), suggested that a collinearity tolerance value less than 0.1 almost certainly indicates a serious collinearity problem. In this study, this problem does not arise because the tolerance values are higher than 0.1.

The variance inflation factor (VIF) indicates the reciprocal of the tolerance. Where the VIF values are large, this indicates multicollinearity. VIF measures how much the variance of an estimated regression coefficient increases if the predictors are correlated (that is, multicollinear). When the VIF is greater than 5-10, the regression coefficients are poorly estimated. In this study, the collinearity VIF values range between 1.115 and 1.377 for model 1, 1.007 and 1.036 for model 2, and 1.048 and 1.440 for model 3. Myres, (1990), suggests that a VIF value of greater than 10 calls for concern. However, in this study the collinearity VIFs are less than 10, indicating that multicollinearity amongst observed variables was absent. Table 4.8 shows the collinearity statistics for the three models.

Table 06: Collinearity Statistics for independent and control variables

Model	Collinearity Statistics	
	Tolerance	VIF
(Constant)[Model 1]		
CEOD	.726	1.377
AUC	.897	1.115
BC	.830	1.205
NX	.853	1.172
(Constant)[Model 2]		
CE	.965	1.036
RA	.971	1.030
AIC	.993	1.007
(Constant)[Model 3]		
CE	.695	1.440
RA	.954	1.048
AIC	.925	1.081
CEOD	.715	1.398
AUC	.827	1.209
BC	.803	1.245
NX	.697	1.434

Source: Research data, author's computations

CHAPTER FIVE

SUMMARY OF THE FINDINGS, CONCLUSION AND RECOMMENDATION

5.1 Introduction

This chapter shows the summary of the findings, conclusion and the recommendation for further study.

5.2 Summary and Discussion of the Findings

It was determined that the respondents agreed on the statement that minority shareholders contest election for a Director's slot on the board of your organization as indicated by the mean of 4.0470 while the a mean on the same individual holding the posts of Chairman and Chief Executive in your organization was 4.5217 which showed they agreed to it. On the statement that the functions of Chairman/CEO clearly defined by the Board of Directors (BOD), the respondents indicated a mean of 4.3261 which signified that they agreed while the respondents were neutral on the statement that some of banks directors serving more than ten BODs of listed Companies as a mean of 3.1522 was obtained.

It was determined that the respondents strongly agreed that meetings of the BOD have taken place regularly over the last 12 months as indicated by the mean of 4.8913 while they agreed on the fact that the management ensured that the notice is sent seven days prior to the meeting (except in case of emergency) as the mean of 4.1957 was obtained. On the statement that the minutes of the meeting were properly recorded in the minute's book & subsequently circulated to the directors within 30 days of the meeting for their comments, the respondents were undecided as indicated by the mean of 3.1522 while they also undecided on the view that notes of dissention by the directors have been recorded in the minutes over the last 12 months. Concerning the statement that

some director had filed any objection with the SECP, in case a note of dissention has not been recorded in minute book, the respondents disagreed as was indicated by the mean of 3.0432 while they agreed on the statement that all significant issues placed at Board meeting for their consideration, as per terms of clause (viii) of CCG indicated by the mean of 4.5435.

Respondents agreed on the statement that the Directors' report contain all the statements as required under Sec 236 of Bank's Ordinance1984 & as per guidelines under clause (xiv) of Code of Corporate Governance as indicated by the mean of 4.5642 while quarterly unaudited financial statements are circulated to the shareholders after approval by the BOD within 30 days was indicated by the mean of 4.9416 which indicated they strongly agreed to it. On the statement that half yearly accounts are subjected to a limited scope review before approval by the BOD and circulated to the Shareholders, the respondents agreed as the mean of 4.5682 was obtained while the respondents strongly agreed that annual accounts are circulated not later than four months from the closing of the financial year. The respondents were undecided on the view that their bank circulated the required information to the Stock Exchange immediately after approval of the Accounts by the BOD as was indicated by the mean of 3.4783 while they too were undecided. On the statement pertaining to the statement of Accounts being signed by the CEO & CFO, after approval & authorization by the BOD before circulation to the Shareholders, the respondents agreed as was indicated by the mean of 4.0432, while they were undecided on the statement regarding 'Disclosure of interest by a Director Holding Bank Shares', are the requirement of clause (xxvi) of CCG being met by the Bank. The respondents were undecided on the statement that External Auditors or any partner of the firm or his/her spouse or minor children hold any position in the shares of your bank.

Regarding if Audit Committee has been established in Banks, the respondents agreed on the statement as a mean of 4.0470 with SD of 0.3534 was obtained while the respondents agreed on the statement that regular meetings of the Audit Committee took place during the last 12 months as was indicated by the mean of 4.5217. Regarding the statement that CEO and CFO also attended the Committee meetings in the last 12 months, the respondents agreed to it as a mean of 4.3261 was obtained while they were undecided on the statement that the Committee meet the External Auditors without CFO and the Head of Internal Audit as indicated by the mean of 3.1522. The respondents agreed that the Committee met the HIA and other members of the Internal Audit function without CFO and the external Auditors.

It was established from the study that the implementation of the Code of Corporate Governance contributed to improvement in operational and organizational efficiency, as the respondents agreed to it indicated by mean of 4.033, while they indicated that they were not facing problems in implementing the requirements of the Code of Corporate Governance (CCG) as the mean of 3.98 was obtained. On the statement that their organization had proposals to overcome these impediments to make CCG more effective, a mean of 2.2608 was obtained which indicated that they disagreed, meaning that there were no any impediments. It was determined that the respondents agreed that the board and management appropriately evaluate risks when the bank is planning and approving new products or implementing the requirements of the Code of Corporate Governance (CCG) as the mean of 3.98 was obtained.

The study sought to determine the level of respondents' agreement on the control environment. It was established that the respondent strongly agreed that the policies and procedures periodically reviewed by the board to ensure that appropriate Internal Controls have been established, as a mean of 4.880 was obtained while a mean of 4.660 on if there was a monitoring system in the Companies

to determine compliance with internal controls and if there are instances of noncompliance reported to the board, the mean of 4.194 was obtained while the statement that the board and management appropriately discussed and plan for control systems when the bank is planning and approving new products or activities, the respondents agreed to it as indicated by the mean of 4.610. Pertaining the statement that internal audit staff, or other internal control staff, are involved in discussions about appropriate controls when the bank is developing new products and activities, the respondents strongly agreed as was indicated by the mean of 4.722 while statement that the bank's board and management involve internal audit staff, and other internal control staff, in the risk assessment process showed that the respondents agreed to it by the mean of 4.210. The respondents were undecided on the statement that the banks board and management consider and appropriately address technology issues in the risk assessment process indicated by the mean of 3.500 while they strongly agreed on the statement on staff members has been provided with adequate resources to manage these bank risk management activities as the mean of 4.680.

The study determined that the respondents agreed on the statement that policies and procedures exist to provide that decisions are made with appropriate approvals as a mean of 4.160 was obtained while the strongly agreed on the view that internal controls exist to provide independent verification of a sufficient sample of transactions to ensure integrity of the decision making process as was indicated by the mean of 4.720. On if the decision-making authorities for all risk taking areas separate from the reconciliation activities for those areas, the respondents agreed as shown by the mean of 4.493 while they agreed on the statement that policies and procedures exist to provide that all exceptions to policy are minimal and are reported to management in each instance of exception indicated by the mean of 4.391. The respondents strongly agreed on statement that the the personal leave policy for all bank staff provide that each employee has an absence for two

consecutive weeks at least once annually as was indicated by the mean of 4.757 while on the statement that there provisions in the personnel policies of the bank to provide for periodic rotation of staff duties**,** the respondents were undecided as indicated by the mean of 3.493. On the statement that if dual controls over bank assets and separation of duties is provided for in the bank's organizational structure, the respondents agreed as the mean of 4.436 was obtained.

Respondents agreed on the statement that the bank's accounting systems properly manage and report bank transactions in accordance with the proper accounting standards as was indicated by the mean of 4.234 while the statement on the if appropriate and sufficient reports produced by the bank for the proper management and control of the bank, a mean of 4.281 was obtained which indicated that the respondents agreed while the fact that the bank's accounting, information and communication systems able to identify whether all risk taking activities within the bank are within the bank's policy guidelines, the respondents agreed as the mean of 4.354 was obtained.

The respondents agreed on the statement that all bank personnel in the areas of control understand their roles as was indicated by the mean of 4.469 while concerning the statement that bank personnel in the areas of control understand how their activities relate to others, the respondents agreed as indicated by the mean of 4.012 while the respondents agreed on that bank personnel in the areas of control understand their accountability for their activities as shown by the mean of 4.746. The respondents strongly agreed that internal control were used in banks as shown by the mean of 4.934.

5.3 Conclusions

From the study it can be concluded that most of the banks had incorporated the various parameters which are used for gauging internal controls and the corporate governance as was indicated by the means which were obtained enquiring on the same and this showed that the respondents agreed that their banks had instituted good corporate governance with a strong system of internal controls.

Zahra and Pearce (1989), identify a number of shortcomings in previous research and urge cautious interpretation of results on board roles and attributes. Using the same constructs of board roles and attributes for measuring impact on firm's performance, Maassen's (1999) came to similar conclusions. Moreover, both studies concluded that there is an over-focus on the financial dimensions of bank performance, with some attention being given to systemic performance and very little attention being paid to social dimensions of bank performance (Zahra and Pearce, 1989; Maassen (1999). This is an area of study with as many conflicting views as there are researchers, both locally and internationally, with many of them giving emphasis on financial performance with little if any, attention being paid to social, cultural religious, environmental and political considerations. There is room for more focused collaborative research to fill the identified gaps. In this context, corporate governance mechanisms are economic and legal institutions that can be altered through the political process – sometimes for the better. Shleifer and Vishny, (1997).

5.4 Recommendations

From the research findings, most banks do practice good corporate governance in an environment of an enhanced system of internal controls but it would be interesting if such practice is directly linked to the banks performance index. Whereas there is emphasis for corporate governance, hence internal controls, it is not known how much of this should be practiced by the bank to avoid firms

indulging in corporate governance structure to a level that they start experiencing negative efficiency.

Corporate governance is good for banks, but small banks seem to practice it at their own leisure. Beyond central bank, there is need to create a central regulatory body to enhance corporate governance within a specified code of ethics to safeguard public interest. The various organizations such as the banks, parastatals and private firms should incorporate internal controls and corporate governance parameters so as to increase their level of accountability and performance

5.5 Suggestions for further Study

This area still needs further research as various studies have produced conflicting results. Moreover, there are several mediating attributes such as bank size, political, cultural, social and regional factors that play a role in influencing corporate governance and its relationship with internal control. Although there is growing focus in governance issues such as specific board composition configuration or board leadership structure, there is need for further research to theories effect of good corporate governance on stock prices or better long-term performance.
This is an area of study with as many conflicting views as there are researchers, both locally and internationally, with many of them giving emphasis on financial performance with little if any attention being paid to social, religious, environmental and political consideration hence there is need to assess key dimensions of the relationship between internal control and its effect on a firms performance in a predefined environment. There is room for more focused collaborative research to fill the identified gaps. In this context, corporate governance mechanisms are economic and legal institutions that can be altered through the political process – sometimes for the better. Shleifer and Vishny, (1997).

5.6 Limitation of the Study

The study has been limited by the following reasons: First, the available time and resources to conduct a more detailed study were limited. Second, some respondents did not answer some of the questions as they were too conscious of disclosing too much information. From the responses, the effect of this guardedness could not be quantified. In some cases, some information was only disclosed after a lot of verbal persuasion.

Third, this research is based on responses from the banks touching on corporate governance and internal control that is both at the core of management and in light of agency theory, some of the results may be misleading given the vested interest as it was taken from the face value, moreover, no attempt was made to find out if corporate governance led to better performance or not. Also the benefits and cost of implementing internal controls was neither quantified nor directly assessed.

It was not clear what factors led some banks to practice good corporate governance and others not. It is therefore suggested that further studies be carried out to find out why some banks did not practice corporate governance and how grossly that affects their internal control and resultant risk exposure.

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APPENDICES

APPENDIX 1: QUESTIONNAIRE

BANK INFORMATION
Name of the Organization:
Contact Person's Name and Telephone Number:
Date of completing the questionnaire:

Section A: Corporate Governance

i) BOARD OF DIRECTORS' APPOINTMENT

1) To what extent do you agree with the following statements on board of directors' appointment?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	2	3	4	5
Minority shareholders contest election for a Director's slot on the board of your organization					
same individual holding the posts of Chairman and Chief Executive in your organization					
the functions of Chairman/CEO clearly defined by the Board of Directors (BOD)					
Some of our Directors serving more than ten BODs of listed Companies					
Our Directors meet requirement of qualification as per clause (iv) & (v) of the Code of Corporate Governance (CCG)?					
We have 'Orientation Courses' for our Directors in order to acquaint them with their responsibilities as per requirement under the Code of Corporate Governance (CCG) & the Bank Ordinance 1984?					

ii) DUTIES AND RESPONSIBILITIES

2: To what extent do you rate the following statement on the duties and responsibilities?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	**2**	**3**	**4**	**5**
Statement of Ethics and Business Practices been has been issued by the BOD & has it been signed by all the Directors & employees					
the BOD adopted a vision/mission statement					
the BOD has formulated Corporate Strategy & announced significant policies					
Complete records of particulars of significant policies are being maintained					
Are all significant matters brought to the attention of the board e.g. investments, divestments, writing off bad debts, inventories etc?					
the BOD ensured implementation of an effective system of Internal Control					
the terms of appointment & remuneration package of the CEO & the Executive-Directors approved by the BOD					
In the case of Modaraba or a Non-Banking Financial Institution, is an ‘Investment Policy’ clearly defined & reported in the Annual Report-as per clause viii(f) of CCG					

iii) MEETINGS OF THE BOARD:

3: To what extent do you agree with the following statement on meetings of the board?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	**2**	**3**	**4**	**5**
meetings of the BOD have taken place regularly over the last 12 months					
The management ensure that the notice is sent seven days prior to the meeting (except in case of emergency)					

The minutes of the meeting properly recorded in the minutes book & subsequently circulated to the Directors within 30 days of the meeting for their comments?					
Notes of dissention by the Directors been has been recorded in the minutes over the last 12 months					
Some Director has filed any objection with the SECP, in case a note of dissention has not been recorded in minute book?					
all significant issues placed at Board meeting for their consideration, as per terms of clause (viii) of CCG					

iv) APPOINTMENT OF CHIEF FINANCIAL OFFICER (CFO) & BANK SECRETARY (CS) and THE HEAD OF INTERNAL AUDIT (HIA)

4: To what extent do you agree with the following statement on the appointment of chief financial officer (CFO) & bank secretary (CS) and the head of internal audit (HIA?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	**2**	**3**	**4**	**5**
The appointment of the following been approved by the Board on the recommendation of CEO?					
CFO is Member of a recognized body of professional accountants					
CFO is Graduate from a recognized university and 5 years of experience					
CS is a Member of body of professional accountants/corporate secretaries					
CS is a Lawyer or a recognized university graduate with 5 years' experience					
CFO & CS attend all the meetings of the Board					

v): CORPORATE & FINANCIAL REPORTING FRAMEWORK

5: To what extent do you agree with the following statement on corporate & financial reporting framework?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	**2**	**3**	**4**	**5**
the Directors' report contain all the statements as required under Sec 236 of Bank's Ordinance1984 & as per guidelines under clause (xiv) of Code of Corporate Governance					
quarterly unaudited financial statements are circulated to the shareholders after approval by the BOD within 30 days					
half yearly accounts are subjected to a limited scope review before approval by the BOD and circulated to the Shareholders					
annual accounts are circulated not later than four months from the closing of the financial year					
Our bank circulate the required information to the Stock Exchange immediately after approval of the Accounts by the BOD					
all our statement of Accounts signed by the CEO & CFO, after approval & authorization by the BOD before circulation to the Shareholders					
Regarding 'Disclosure of interest by a Director Holding Bank Shares', are the requirement of clause (xxvi) of CCG being met by the Bank					
External Auditors or any partner of the firm or his/her spouse or minor children hold any position in the shares of your bank					
the external Auditors held any shares in your Bank before their appointment, the shares has been divested					

vi): AUDIT COMMITTEE:

6: To what extent do you agree with the following statement on audit committee?

How many Directors are members of the Audit Committee?

Executive

Non-Executive

Is the Chairman of the Committee an

Executive Director

Non-Executive Director

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	2	3	4	5
Audit Committee has been established in your Bank					
regular meetings of the Audit Committee took place during the last 12 months					
CEO & CFO also attend the Committee meetings? During the last 12 months:					
the Committee meet the External Auditors without CFO and the Head Of Internal Audit					
the Committee meet the HIA and other members of the Internal Audit function without CFO and the external Auditors					
many Internal Audit Reports were presented to the Audit Committee by the Head of Internal Audit					

vii): INTERNAL AUDIT FUNCTION

7: To what extent do you agree with the following statement on internal audit function?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	2	3	4	5
There is an in-house Audit Department					
CEO & CFO also attend the Committee meetings During the last 12 months:					
The Committee meet the External Auditors without CFO and the Head Of Internal Audit					
The Committee meet the HIA and other members of the Internal Audit function without CFO and the external Auditors					
In addition to review of financial statements, how many Internal Audit Reports were presented to the Audit Committee by the Head of Internal Audit					

viii): EXTERNAL AUDITORS:

8: To what extent do you agree with the following statement on external auditors?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	2	3	4	5
External Auditors been appointed as per guidelines contained in clause (xxxvii-xxxix) of CCG					
the bank has appointed separate Management Consultants to advise on matters other than audit					
After the last annual audit, Management letter was provided to the BOD within 30 days from the date of the Audit Report					
the Management letter discussed at the Audit Committee/BOD and response was sent to the Auditors					
Partners representing the External Auditors attend the last Annual General Meeting, when the Accounts were discussed?					

ix) SUGGESTIONS AND PROBLEMS REGARDING CODE OF CORPORRATE GOVERNANCE

9: To what extent do you agree with the following statement on suggestions and problems regarding code of corporate governance?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	2	3	4	5
The implementation of the Code of Corporate Governance contributed to any improvement in operational and organizational efficiency					
You are facing problems in implementing the requirements of the Code of Corporate Governance (CCG)					
Your bank has proposals to overcome these impediments to make CCG more effective					

INTERNAL CONTROLS

i) CONTROL ENVIRONMENT

1: To what extent do you agree with the following statement on control environment?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	**2**	**3**	**4**	**5**
The policies and procedures periodically reviewed by the board to ensure that appropriate Internal Controls have been established?					
There is a monitoring system in the Companies to determine compliance with internal controls and are instances of noncompliance reported to the board					
The board takes appropriate follow-up action in instances of noncompliance that are reported to it					
Companies' management allow access to all retirement benefits records to the board of trustees or trustee's representative					
Board decisions made collectively and not controlled by a dominant individual or group					
The board receive appropriate and current information from the bank's accounting, information and communication systems to make informed and timely decisions					
Board receives sufficient information about the bank's internal risk assessment process?					
The board reviews the qualifications and the independence of the bank's internal auditors					
The board review the qualifications and the independence of the bank's external auditors					
The bank's internal auditors report their findings directly to the board or to a board committee					
The bank's external auditors report their findings directly to the board or to a board committee					
The bank's internal auditors periodically assess the adequacy of the bank's internal control systems					
The bank's external auditors periodically assess the adequacy of the bank's internal control systems					
Internal control policies communicated to all of the bank's employees					
Staff conduct policies communicated to all of the bank's employees					
Policies on staff ethics or codes of conduct exist					
Audit procedures or other control systems exist to test on a periodic basis for staff compliance with ethics policies or codes of conduct					

ii) RISK ASSESSMENT

2: To what extent do you agree with the following statement on risk assessment?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	2	3	4	5
The board and management appropriately evaluate risks when the bank is planning and approving new products or activities					
The board and management appropriately discuss and plan for control systems when the bank is planning and approving new products or activities					
Internal audit staff, or other internal control staff, are involved in discussions about appropriate controls when the bank is developing new products and activities					
The bank's board and management involve internal audit staff, and other internal control staff, in the risk assessment process					
The bank's board and management consider and appropriately address technology issues in the risk assessment process					
There sufficient personnel who are competent and knowledgeable to manage current and proposed bank activities in all areas					
Staff members has been provided with adequate resources to manage these bank risk management activities					

iii) CONTROL ACTIVITIES

3: To what extent do you agree with the following statement on control activities?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	2	3	4	5
Policies and procedures exist to provide that decisions are made with appropriate approvals					
Processes exist to provide independent verification of a sufficient sample of transactions to ensure integrity of the decision making process					
Processes exist to provide that there is ongoing and independent reconciliation of all bank balances, both asset and liability and on- and off balance sheet items					
The decision-making authorities for all risk taking areas separate from the reconciliation activities for those areas					

Policies and procedures exist to provide that all exceptions to policy are minimal and are reported to management in each instance of exception					
The personal leave policy for all bank staff provide that each employee has an absence for two consecutive weeks at least once annually					
There provisions in the personnel policies of the bank to provide for periodic rotation of staff duties					
Dual controls over bank assets and separation of duties is provided for in the bank's organizational structure					

iv)ACCOUNTING, INFORMATION AND COMMUNICATION SYSTEMS - QUESTIONNAIRE

4: To what extent do you agree with the following statement on accounting, information and communication systems?

Key: 5 strongly agrees, 4 agree, 3 undecided, 2 disagree, 1 strongly disagree (please put an X as appropriate)

	1	2	3	4	5
The bank's accounting systems properly manage and report bank transactions in accordance with the proper accounting standards					
Appropriate and sufficient reports produced by the bank for the proper management and control of the bank					
The bank's accounting, information and communication systems able to identify whether all risk taking activities within the bank are within the bank's policy guidelines					
All bank personnel in the areas of control understand their roles					
All bank personnel in the areas of control understand how their activities relate to others					
All bank personnel in the areas of control understand their accountability for their activities					
Internal control is used in your bank					

Data Presentation and Analysis

Readings Score for each respondent Bank

Table 4.2 Evaluation of Commercial banks internal controls measures 2009 - 2011

	Control environment	Risk assessment	Control Activity	Information and communication	Monitoring	Overall evaluation
Kenya Commercial Bank	3.25	2.83	4.04	4.12	5.012	3.8504
Standard Chartered Kenya	5.03	2.8	4.915	3.65	4.35	4.149
Trans National Bank Kenya	3.71	2.13	3.92	2.68	4.248	3.3376
National Bank of Kenya	2.4	3.86	4.13	2.78	5.22	3.678
Prime Bank (Kenya)	5.55	4.28	5.915	3.57	1.283	4.1196
Habib Bank AG Zurich	3.1	2.344	3.722	0.67	1.795	2.3262
Chase Bank (Kenya	2.7466	2.435	3.5908	0.94	1.234	2.18928
Ecobank	2.529	2.146	3.3375	0.356	1.743	2.0223
Citibank	1.778	4.35	4.064	4.49	0.724	3.0812
Family Bank	5.34	2.14	4.74	2.57	4.284	3.8148
Barclays Bank	3.26	3.13	4.195	3.35	3.28	3.443
Commercial Bank of Africa	4.34	4.93	5.635	4.8	5.22	4.985
NIC Bank	2.931	2.08	3.5055	2.45	4.62	3.1173
Jamii Bora Bank	3.729	3.04	4.3845	3.02	3.35	3.5047
Middle East Bank Kenya	2.66	4.11	4.385	4.18	3.28	3.723

United Bank for Africa	5.327	3.25	5.2885	4.86	0.914	3.9279
Victoria Commercial Bank	1.273	2.314	2.7935	2.193	1.535	2.0217
HDFC Bank Limited	4.57	3.11	4.84	4.64	4.647	4.3614
FirstRand Bank	5.553	5.23	4.3915	3.24	0.743	3.8315
Consolidated Bank of Kenya	1.62	2.143	2.8815	1.27	1.29	1.8409
K-Rep Bank	5.51	2.08	4.795	4.45	4.231	4.2132
ABC Bank (Kenya)	3.4	2.63	4.015	3.342	4.37	3.5514
Bank of Africa	3.2	4.09	4.645	4.35	4.273	4.1116
Bank of Baroda	3.74	3.22	4.48	4.86	0.923	3.4446
Equity Bank	5.01	4.08	3.545	2.74	5.172	4.1094
Bank of India	1.69	2.13	2.91	4.63	3.034	2.8788
CFC Stanbic Bank	2.67	4.82	4.745	3.51	3.22	3.793
I&M Bank	4.45	3.24	4.845	4.384	5.3	4.4438
Jamii Bora Bank	1.81	2.13	2.97	2.6	4.33	2.768
Middle East Bank Kenya	4.1	4.59	5.345	4.662	5.28	4.7954
Oriental Commercial Bank	3.527	3.59	4.5585	2.47	4.268	3.6827
Paramount Universal Bank	4.66	3.68	5.17	2.57	3.78	3.972
First Community Bank	4.553	4.27	5.4115	4.42	0.83	3.8969
Giro Commercial Bank	3.66	4.03	4.845	3.36	4.42	4.063

Guardian Bank	4.7	3.56	5.13	2.764	4.3	4.0908
Gulf African Bank	2.216	4.22	4.218	5.15	0.913	3.3434
Habib Bank	2.522	2.344	0.64	0.37	4.399	2.055
Imperial Bank Kenya	2.56	3.45	3.57	4.2	4.27	3.61
Oriental Commercial Bank	5.4	4.23	4.46	4.26	0.922	3.8544
Paramount Universal Bank	1.522	2.347	3.47	1.47	2.241	2.21
Development Bank of Kenya	3.66	4.2	5.15	2.48	4.83	4.064
Cooperative Bank of Kenya	3.355	5.01	4.86	4.42	1.72	3.873
Importance of component	30%	15%	35%	20%	35%	100%

The findings in Table 4.2 indicates that banks Barclays bank, Kenya commercial bank, ECO bank, Kenya cooperative bank, Equity bank and Commercial bank of Africa, K rep and Family bank have the most overall internal control performance with Gulf African Bank with Habib Bank, Oriental Commercial Bank, Paramount Universal Bank, ABC Bank (Kenya) and Bank of Baroda registering lowest internal control performance. On the importance of the internal control components, monitoring is indicated the highest, followed by control environment, information and communication and risk assessment.

Table 4.3 Evaluation of Commercial banks corporate governance measures 2009 - 2011

	CEO Duality	AUC-whether there is Audit committee	BC-Number of Board committees	NX-Ratio non executive Board Members to total Board	Overall evaluation
Kenya Commercial Bank	4.39	3.28	3.95	4.58	4.20
Standard Chartered Kenya	4.99	3.08	4.45	5.08	4.63
Trans National Bank Kenya	2.81	2.13	2.75	3.36	2.89
National Bank of Kenya	3.66	4.11	3.58	4.22	3.16
Prime Bank (Kenya)	4.553	4.22	3.22	0.922	2.679
Habib Bank AG Zurich	1.522	1.344	0.96	1.399	3.647
Chase Bank (Kenya	1.7466	1.354	0.67	1.388	3.974
Ecobank	1.663	1.146	0.93	1.398	4.687
Citibank	4.553	4.22	3.99	0.922	3.767
Family Bank	4.99	3.08	4.45	5.08	4.63
Barclays Bank	2.81	2.13	2.75	3.36	4.89
Commercial Bank of Africa	3.66	4.11	3.58	4.22	3.16
NIC Bank	4.99	3.08	4.45	5.08	3.63
Jamii Bora Bank	2.81	2.13	2.75	3.36	3.84
Middle East Bank Kenya	3.66	4.11	3.58	4.22	3.33
United Bank for Africa	4.553	4.22	3.22	0.922	2.653
Victoria Commercial Bank	1.522	1.344	0.96	1.399	2.622
HDFC Bank Limited	3.66	4.11	3.58	4.22	3.16

FirstRand Bank	4.553	4.22	3.22	0.922	1.677
Consolidated Bank of Kenya	1.522	1.344	0.96	1.399	1.678
K-Rep Bank	4.99	3.08	4.45	5.08	4.634
ABC Bank (Kenya)	2.81	2.13	2.75	3.36	2.89
Bank of Africa	3.66	4.11	3.58	4.22	3.16
Bank of Baroda	4.553	4.22	3.22	0.922	1.633
Equity Bank	4.99	3.08	4.45	5.08	4.644
Bank of India	2.81	2.13	2.75	3.36	2.892
CFC Stanbic Bank	3.66	4.11	3.58	4.22	3.33
I&M Bank	4.99	3.08	4.45	5.08	4.52
Jamii Bora Bank	2.81	2.13	2.75	3.36	2.84
Middle East Bank Kenya	3.66	4.11	3.58	4.22	3.14
Oriental Commercial Bank	4.99	3.08	4.45	5.08	4.64
Paramount Universal Bank	3.66	4.11	3.58	4.22	3.18
First Community Bank	4.553	4.22	3.22	0.922	2.688
Giro Commercial Bank	3.66	4.11	3.58	4.22	3.132
Guardian Bank	3.66	4.11	3.58	4.22	3.25
Gulf African Bank	4.553	4.22	3.22	0.922	1.632

Habib Bank	1.522	1.344	0.96	1.399	1.891
Imperial Bank Kenya	3.66	4.11	3.58	4.22	3.462
Oriental Commercial Bank	4.553	4.22	3.22	0.922	2.637
Paramount Universal Bank	1.522	1.344	0.96	1.399	2.646
Development Bank of Kenya	3.66	4.11	3.58	4.22	4.171
Cooperative Bank of Kenya	4.553	4.22	3.22	0.922	4.644
Importance of component	30%	15%	20%	35%	100%

The findings in Table 4.2 indicates that banks Barclays bank, Kenya commercial bank, ECO bank, Kenya cooperative bank, Equity bank and Commercial bank of Africa, K rep and Family bank have the most overall internal control performance with Gulf African Bank with Habib Bank, Oriental Commercial Bank, Paramount Universal Bank, ABC Bank (Kenya) and Bank of Baroda registering lowest internal control performance. On the importance of the internal control components, monitoring is indicated the highest, followed by control environment, information and communication and risk assessment.

APPENDIX 2: POPULATION

LIST OF LICENCED COMMERCIAL BANKS IN KENYA

(From Wikipedia)

1. ABC Bank (Kenya)
2. Bank of Africa
3. Bank of Baroda
4. Bank of India
5. Barclays Bank
6. CFC Stanbic Bank
7. Chase Bank (Kenya)
8. Citibank
9. Commercial Bank of Africa
10. Consolidated Bank of Kenya
11. Cooperative Bank of Kenya
12. Credit Bank
13. Development Bank of Kenya
14. Diamond Trust Bank
15. Dubai Bank Kenya
16. Ecobank
17. Equatorial Commercial Bank
18. Equity Bank
19. Family Bank
20. Fidelity Commercial Bank Limited
21. Fina Bank
22. First Community Bank
23. Giro Commercial Bank
24. Guardian Bank
25. Gulf African Bank
26. Habib Bank
27. Habib Bank AG Zurich

28. I&M Bank
29. Imperial Bank Kenya
30. Jamii Bora Bank
31. Kenya Commercial Bank
32. K-Rep Bank
33. Middle East Bank Kenya
34. National Bank of Kenya
35. NIC Bank
36. Oriental Commercial Bank
37. Paramount Universal Bank
38. Prime Bank (Kenya)
39. Standard Chartered Kenya
40. Trans National Bank Kenya
41. United Bank for Africa
42. Victoria Commercial Bank
43. HDFC Bank Limited
44. FirstRand Bank
45. Bank of China