EFFECT OF INTERNAL CONTROLS ON FINANCIAL PERFORMANCE OF DEPOSIT TAKING SAVINGS AND CREDIT COOPERATIVE SOCIETIES IN KENYA

BY:

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DECLARATION

This research project is my original work and has not been presented for examination to any university.

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DEDICATION

This study is dedicated to my dear wife Jacky for her encouragement and patience while I took time to undertake the research and complete the study report.

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ABSTRACT

The purpose of this study was to find out the effect of internal controls on the financial performance of deposit taking Savings and Credit Cooperative Societies (SACCOs) in Kenya.

This study is significant because SACCOs make a critical contribution to the economic development of this nation through funds and savings mobilization. However, these SACCOs face a number of challenges, key among them being the issues of management which is largely occasioned by the existence of poor or weak internal controls. Financial performance of these institutions is thus seriously impacted as a result of the existence or lack thereof of the necessary internal controls that would lead to effective financial management within the SACCOs.

The findings of this study conducted on 122 deposit taking SACCOs in Kenya relied on both primary and secondary data which was obtained from the annual reports of the SACCOs. Regression analysis was mainly used to reveal that the financial performance of SACCOs in Kenya is largely influenced by the level of internal controls instituted by the management of these institutions. If the SACCOs improve the effectiveness of their internal controls, then the financial performance of these SACCOs improves drastically.

The regression analysis conducted established that the independent variables have a positive strong correlation with the dependent variable. Each of the independent variables namely, the control environment, risk assessment, control activities and monitoring mechanisms contribute positively to the financial performance of SACCOs in Kenya.

It is also evident from the study that without the presence of strong internal controls within these institutions, the SACCOs would be performing poorly with the risk of eventual collapse as a result of poor financial performance.

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LIST OF ACRONYMS AND ABREVIATIONS

CA	Current Assets
CaR	Cash Ratio
CEO	Chief Executive Officer
CE	Control Environment
CL	Current Liabilities
CoA	Control Activities
COSO	Committee of Sponsoring Organizations
CR	Current Ratio
EBIT	Earnings before Interest and Tax
FOSA	Front Office Service Activities
FP	Financial Performance
IC	Internal Controls
ICS	Internal Control System
MOCDM	Ministry of Co-operative Development and Marketing
OECD	Organization for Economic Co-operation and Development
QR	Quick Ratio
RA	Risk Assessment
ROA	Return on Assets
ROE	Return on Equity
SACCOs	Savings and Credit Co-operatives
SASRA	SACCO Societies Regulatory Authority
SOX	Sarbanes - Oxley
WOCCU	World Council of Credit Unions

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

The increasing number of business failures and some widely publicized frauds has encouraged firms to put more emphasis on their internal control systems, which are specific to their particular operating environment. Management is under increased pressure to enhance the effectiveness of internal control and to effectively communicate this to the board of directors and shareholders (Kuhn and Sutton, 2010). Reference groups like auditors, suppliers and customers are also interested in internal controls since they may affect long term confidence in reporting, accountability and in the corporate form of organization (Rittenberg and Schwieger, 2001).

Response to financial scandals such as Enron or WorldCom has resulted in bringing into the law the "Public Company Accounting Reform and Investor Protecting Act" commonly known as the "Sarbanes-Oxley Act (SOX Act)". The SOX Act requires management to take full responsibility for internal control system over financial reporting within the company and provide assessment of its effectives (Institute of Internal Auditors, 2008). Internal control is a process that guides an organization towards achieving its objectives. These objectives include operational efficiency and effectiveness, reliability of financial reporting, and compliance with relevant laws and regulations (COSO, 1994/2004). Absence of these variables often results in organizational failure. The findings of the Treadway Commission Report of 1987 in the

United States (USA) confirmed absence of, or weak, internal controls as the primary cause of many cases of fraudulent company financial reporting.

According to Agency Theory as initially put across by Jensen & Meckling, (1976), a company consists of a nexus of contracts between the owners of economic resources (the principals) and managers (the agents) who are charged with using and controlling those resources (Jensen & Meckling, 1976). Agency theory posits that agents have more information than principals and that this information asymmetry adversely affects the principals' ability to monitor whether or not their interests are being properly served by agents. Furthermore, an assumption of agency theory is that principals and agents act rationally and use contracting to maximize their wealth. A consequence of this assumption may be the 'moral hazard' problem (Jensen & Meckling, 1976), indicating that in an effort to maximize their own wealth, agents may face the dilemma of acting against the interests of their principals. This Theory will guide this study because "studies have shown that *effective* internal control reduces agency costs" (Abdel-khalik 1993; Barefield et al., 1993) and again, due to the fact that "Internal control is one of the many mechanisms used in business to address the agency problem" (Jensen and Payne 2003).

1.1.1 Concept of Internal Controls

Understanding the concept of internal control is essential for developing an understanding of its impact on the performance of an organization. For many centuries, the concept of internal control was limited to that of internal check. An internal control system encompasses the policies, processes, tasks, behaviours and other aspects of a company that, taken together: facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks with a focus to achieving the company's objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud, ensuring that liabilities are identified and managed, as well as helping to ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation; help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business (Manasseh, 2007).

The internal control system of an entity is closely interrelated to the structure used by management to oversee the activities of an organization, or what is defined as the entity's corporate governance. "Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently" (OCED Principles of Corporate Governance). The board of directors is thus responsible for providing guidance and oversight for senior management and ensuring that an appropriate Internal Control System is in place and effective, meaning it ensures that the expected objectives are attained (Solomon, *et al*. 2000).

Internal control is not one event or circumstance, but a series of actions that permeate an entity's activities. These actions occur throughout an entity's operations on an ongoing basis. They are pervasive and inherent in the way management runs the organisation. Internal control is therefore different from the perspective of some observers who view it as something added on to an entity's activities, or as a necessary burden. The internal control system is intertwined with an entity's activities and is most effective when it is built into the entity's infrastructure and is an integral part of the essence of the organisation (Manasseh, 2007).

1.1.2 Savings and Credit Cooperative Societies (SACCOs) in Kenya

In Kenya, Cooperatives are established under the Cooperative Societies Act (Cap. 490). The advent of the co-operative movement in Kenya can be traced to the first few years after the country's independence when a number of societies were formed. Presently, the Cooperative movement contributes over 31 per cent of the country's national savings, having mobilized over 200 billion shillings in domestic savings. Up to 63% of the country's population also derive their livelihood, in one way or the other from the co-operative movement (MOCDM, 2008).

The Kenya SACCO sub-sector comprises both deposit taking (FOSA operating SACCOs) and non-deposit taking SACCOs. There were 6,007 registered SACCOs in Kenya as at December 2010 of which 2,959 were active (active SACCOs are those whose annual accounts have been audited and the audits registered by the Commissioner for Co-operatives as well as the newly registered SACCOs during the year under review). Of the active SACCOs, 218 were deposits taking (SACCOs operating FOSAs) while 2,011 SACCOs were non-deposit taking (Non-FOSA operating SACCOs). The total membership of SACCOs as at December 2010 was 1,857,566 accounting for about 4.8% of the total population (SASRA SACCO Supervision Report, 2011).

In the recent past Savings and Credit Co-operatives (SACCOs) have witnessed faster growth than other co-operatives. The establishment of SACCO Societies Act 2008 places the licensing, supervision and regulation of deposit taking under the armpit of the SACCO Societies Regulatory Authority (SASRA). Through this new legal framework, prudential regulations have been introduced to guide SACCO's growth and development. The Cooperative Societies Act has governed all SACCOs and their apex structure since 1966 with several amendments. Recognizing the difficulty of supervising the operations of the SACCOs under the Co-operative Societies Act, given the dynamism in their operations, the government enacted the SACCO Societies Act 2008, which established the SACCO Society Regulatory Authority (SASRA) to license, regulate, supervise and promote SACCO societies development in Kenya (SASRA SACCO Supervision Report, 2010).

The establishment of SASRA falls within the Government of Kenya's reform process in the financial sector which has the dual objectives of protecting the interests of SACCO members and ensuring that there is confidence in the public towards the SACCO sector. This is in addition to spurring Kenya's economic growth through the mobilization of domestic savings (SASRA SACCO Supervision Report, 2011), hence keeping SACCOs in toes to enhance internal controls within their institutions.

1.1.3 Financial Performance

There is a general perception that institution and enforcement of proper internal control systems will always lead to improved financial performance. It is also a general belief that properly instituted systems of internal control improve the reporting process and also give rise to reliable reports which enhances the accountability function of management of an entity (Spira and Page, 2003). According to Verschoor (1999) properly instituted systems of internal control will ensure; completeness of all transactions undertaken by an entity, that the entity's assets are safeguarded from theft and misuse, that transactions in the financial statements are stated at the appropriate amounts, that all assets in the company's financial statements do exist, that all the assets presented in the company's financial statements are recoverable and that the entity's transactions are presented in the appropriate manner according to the applicable reporting framework.

A review on performance of SACCOs for a period of 5 years, that is, from 2006 to 2010 shows that, deposits for deposit taking and non-deposit taking SACCOs grew with impressive rates. The deposits grew by an average of 25% for the last five years, whereas non-deposit taking SACCOs realized an average growth of 5.6% in the last five years. The deposit taking category SACCOs loans grew by an average 16%, while loans for non-deposit taking SACCOs grew by 4%. The share capital for both deposit taking and non-deposit taking SACCOs grew steadily in the last five years. SACCOs offering deposit taking services realized an average growth of 28% while non-deposit taking realized an average of 256% (SASRA reports, 2010).

SACCOs operating deposit taking and non-deposit taking activities performed well in income generation, where both categories grew by an average of 16% and 63.9% respectively. The total assets for deposit taking SACCOs grew by an average of 12.9% per year; while the non-deposit taking grew by an average of 14.25%. The overall asset growth for both categories for the last five years increased by an average of 12.9% (SASRA reports, 2010).

The improved performance has been attributed to the new regulatory framework which has put a lot of emphasis on SACCOs internal controls which includes existence of internal and external audit functions, measures to minimize risks exposure and standardized reporting norms (PROCASUR Africa Report, 2012).

1.2 Research Problem

SACCOs in Kenya have been marred with inadequate internal management capacity and operational controls. Poor control systems in SACCOS has led to huge investments lost through fraud and misuse of assets that are used to generate revenues while members and institutions have suffered big losses. Inadequate controls have also led to corruption and collusion of management and external auditors leading to organizations failing to achieve their set objectives. Technological changes have also brought with them challenges in control systems and this has necessitated the development of new ways of controlling organizations (PROCASUR Africa Report, 2012).

The recent regulation of SACCOs which includes establishment of SACCO Society Regulatory Authority (SASRA), is meant to respond to growing challenges affecting SACCOs which include: inadequacy of existing legislation to accommodate diversified products e.g. FOSA, inadequate governance structures with no clear distinction between executive functions and non executive, weak internal control systems, inadequate performance standards, lack of disclosure requirement standards, low adoption of Information and computer technologies, poor human resource management practices leading to poor quality of staff and high staff turnover as well as stiff competition from commercial banks (Kenya Financial Sector Stability Report, 2010).

Despite the fact that internal control is an essential factor affecting the firm, the evidence of the actual performance of an internal control structure within the organizational environment is almost non-existent and the topic remains relatively unexplored by researchers as noted by Kinney (2000). This is the same case in Kenya as very little evidence is available to ascertain the effects that the internal controls have on the profitability levels of the newly licensed SACCOs by SASRA.

Internationally, Mawanda (2008) conducted a study to establish the effects of internal control systems on financial performance in an institution of higher learning in Uganda while Jones (2008) compared internal control, accountability and corporate governance in Medieval and modern Britain. The studies aimed at establishing if there exists a link between the effectiveness of internal controls and the financial performance of an institution and also seek to establish the duration of time that internal controls have been in existence. Mawanda carried out the study on Uganda's institutions of higher learning and did a case study on Uganda Martyrs University during the year 2008 and concluded that there was a significant positive relationship between internal control system comprising control environment, internal audit and control activities on one hand, and financial performance as measured by liquidity, accountability and reporting on the other hand.

Locally, Keitany, (2000) conducted a study on the internal audit control function and its implication for risk assessment by the external auditor while Kibet, (2008) did a survey on the role of internal audit in promoting good corporate governance in state owned enterprises with special focus on a case of quoted companies. However, none of these studies have looked at the relationship between internal controls and financial performance of firms in the financial sector, particularly the SACCO sub-sector. It is against this background therefore that the study seeks to establish a response to the dominant question; what is the effect of internal controls on financial performance of licensed Savings and Credit Cooperative Societies (SACCOs) in Kenya?

1.3 Objectives of the Study

The objective of this study was to investigate the effects of internal controls on financial performance of licensed Savings and Credit Cooperative Societies (SACCOs) in Kenya.

1.4 Importance of the Study

The study will be of great significance to management of SACCOs in Kenya since it will highlight the major internal controls being adopted by the institutions and their effect on the financial performance of the SACCOs. Through the study findings and recommendations which have been given, the management from these institutions will be in a better position to implement effective solutions to the internal control challenges. This will in turn contribute towards delivery of better and quality services to their customers and also help to enhance performance. The study will also be of great significance to future researchers since it acts as a source of information and adds value to the body of knowledge in the field of internal controls in SACCOs. The study will also help future researchers to have a ready and reliable literature which they could review and form a basis for future studies.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter focuses on literature review. Section 2.2 discusses the theoretical literature. Section 2.3 discusses the empirical review; Section 2.3 reviews the local researches that have been conducted in the field of internal controls, while Section 2.5 contains the summary of the literature review.

2.2 Theoretical Orientation

2.2.1 Agency Theory

Agency Theory explains how to best organize relationships in which one party determines the work while another party does the work. In this relationship, the principal hires an agent to do the work, or to perform a task the principal is unable or unwilling to do. Agency theory assumes both the principal and the agent are motivated by self-interest.

It has been argued that firms have an economic incentive to report on internal control, even without the requirements of SOX (Deumes and Knechel 2008). Their argument assumes that providing this additional information to the principal (shareholder) about the behavior of the agent (management) reduces information asymmetry and lowers investor risk and, therefore, the cost of equity capital.

Internal controls have also been reported to play a major role in moderating the agency problem in corporations for many years. Accordingly, Samson et al. (2006) document several internal control procedures used by the Baltimore and Ohio Railroad as early as 1831.

Internal control is one of many mechanisms used in business to address the agency problem. Others include financial reporting, budgeting, audit committees, and external audits (Jensen and Payne 2003). During the 1980s, several high-profile audit failures led to creation of the Committee of Sponsoring Organizations of the Treadway Commission (COSO), organized for the purpose of redefining internal control and the criteria for determining the effectiveness of an internal control system (Simmons 1997). Other studies have also shown that internal control reduces agency costs (Abdel-khalik 1993; Barefield et al. 1993). They studied the causal factors that can lead to fraudulent financial reporting and developed recommendations for public companies, independent auditors, educational institutions, the Securities Exchange Commission (SEC), and other regulators (COSO 1985).

Agency Theory describes firms as necessary structures to maintain contracts, and through firms, it is possible to exercise control which minimizes opportunistic behavior of agents (Jensen and Meckling, 1976). Accordingly, Barlie and Means (1932) posit that in order to harmonize the interests of the agent and the principal, a comprehensive contract is written to address the interest of both the agent and the principal. They further explain that the relationship is further strengthened by the principal employing an expert to monitor the agent. This position is also supported by Coarse (1937) who maintains that the contract provides for conflict resolution between the agent and principal, where the principal determines the work and agent undertakes the work. He however, proposes that the principal suffers shirking which deprives him or her from benefiting from the work of the agent.

Nevertheless, the theory recognizes the incomplete information about the relationship, interests or work performance of the agent described as adverse selection and moral hazard. Coarse (1937) explains that moral hazard and adverse selection affects the output of the agent in two ways; not doing exactly what the agent is appointed to do, and not possessing the requisite knowledge about what should be done. This therefore, affects the overall performance of the relationship as well as the benefits of the principal in form of cash residual.

It can thus be concluded that agents have more information than principals and that this information asymmetry adversely affects the principals' ability to monitor effectively whether agents are properly serving their interests. Therefore, these firms are necessary structures to maintain contracts, and through firms, it is possible to exercise control which minimizes opportunistic behavior of agents.

2.2.1 Contingency Theory

Contingency theory is an approach to the study of organizational behaviour in which explanations are given as to how contingent factors such as technology, culture and the external environment influence the design and function of organizations. The assumption underlying contingency theory is that no single type of organizational structure is equally applicable to all organizations. Rather, organizational effectiveness is dependent on a fit or match between the type of technology, environmental volatility, the size of the organization, the features of the organizational structure and its information system. Contingency theories were developed from the sociological functionalist theories of organization structure such as the structural approaches to organizational studies by Woods (2009), Chenhall, (2003), and Reid and Smith (2000).

Contingency theory is used to describe the relationships between the context and structure of internal control effectiveness and organizational performance, especially reliability of financial reporting. Empirical study suggests that internal auditors who are specialized and higher in internal audit ability will achieve internal control effectiveness analysis and that the firm will benefit from the organizational effectiveness via internal control mechanism efficiency (Cadez and Guilding, 2008).

Cadez and Guilding (2008) identified some factors, which impact management control systems; these are: external environment, technology, structure and size, strategy and national culture. It suggests that the demands imposed by technical tasks in the organization encourage the development of strategies to coordinate and control internal activities. The location of information in relation to technology and environment has an important influence on organization structure. In uncertain environments with non-routine technology, information is frequently internal. Where environments are certain, or where technology is routine, information is external. The dimensions of structure and control include authority structure and activities structure, i.e., rules and procedures that determine the discretion of individuals. Authority relates to social power. In the contingency model, decentralized authority is more appropriate where uncertain environments or non-routine technology exist. Centralized authority is more appropriate when environments are certain.

Contingency theory states that “the design and use of control systems is contingent upon the context of the organisational setting in which these controls operate” (Fisher, 1998). Therefore the idea of contingency theory is that the selection and use of a management control system is contingent on a variety of internal and external factors.

It is therefore clear that, factors such as external environment, technology, structure and size, strategy and national culture impact Management Control Systems. The theory suggests that the demands imposed by technical tasks in the organization encourage the development of strategies to coordinate and control internal activities.

2.2.3 The Theory of the Firm

In simplified terms, the theory of the firm aims to answer these questions: Existence, Boundaries, Organization - Why are firms structured in such a specific way, for example as to hierarchy or decentralization? Heterogeneity of firm actions/performances - What drives different actions and performances of firms? And lastly, the Evidence - What tests are there for the respective theories of the firm? (Thomas, 2008). The theory of the firm consists of a number of economic theories that describe, explain, and predict the nature of the firm, company, or corporation, including its existence, behaviour, structure, and relationship to the market (Kantarelis, 2007).

This theory affirms that a firm is a “black box” operated so as to meet the relevant marginal conditions with respect to inputs and outputs, thereby maximizing profits, or more accurately, present value. The theory helps to explain: i) why an entrepreneur or manager in a firm which has a mixed financial structure (containing both debt and outside equity claims) will choose a set of activities for the firm such that the total value of the firm is *less* than it would be if he were the sole owner and why this result is independent of whether the firm operates in monopolistic or competitive product or factor markets; ii) why his failure to maximize the value of the firm is perfectly consistent with efficiency and; iii) why accounting reports would be provided voluntarily to creditors and stockholders, and why independent auditors would be engaged by management to testify to the accuracy and correctness of such reports.

This study will thus be guided by three theories, namely; agency theory, contingency theory and the theory of the firm. Agency theory shows the relationship between the principal and agent and the agent's responsibilities which include financial reporting, budgeting and providing any other additional information to the principal. The contingency theory on the other hand explains that organizations' behavior and functions are dependent on factors such as technology, culture and the external environment that the organizations operate in while the theory of the firm asserts that, a firm is operated so as to meet the relevant marginal conditions with respect to inputs and outputs, thereby maximizing profits, or more accurately, present value.

2.3 Empirical Review

Elder, *et.al* (2010) used a sample o f 2350 firms to study auditors' client risk management in the first year of the Sarbanes- Act Oxley (SOX) 404 implementation, and found that a pecking order exists among auditors' strategies to manage and control risk resulting from internal control weaknesses. They examined the relationship between internal control weaknesses and audit fees, modified opinions, and auditor resignations, respectively, and established that these are viable strategies to manage control risk on a stand-alone basis. They also found out that changes in audit fees and changes in modified opinions are positively associated with changes in reported internal control weaknesses.

When they investigated these strategies simultaneously, descriptive evidence suggests that a pecking order exists among auditors' client risk management strategies. Their comprehensive evidence suggested that auditors use an array of ordered strategies to manage client-related control risk.

Amudo and Inanga (2009) also carried out a study in Uganda to evaluate the internal control systems that the regional member countries of the African Development Bank Group institute for the management of the Public Sector Projects that the Bank finances. There are 14 projects of the Bank's Public Sector Portfolio in Uganda. The data received and analyzed is for eleven projects. Three projects were omitted because they were not fully operational to install effective internal control systems. The study identified the following six essential components of an effective internal control system: control environment, risk assessment, control activities, information and communications, monitoring and information technology. The outcome of the evaluation process was that some control components of effective internal control systems were lacking in those projects. These rendered the control structures ineffective.

Wee Goh (2009) studied 208 firms on audit committees, boards of directors, and remediation of material weaknesses in internal control. He measured the effectiveness of the audit committee by its independence, financial expertise, size, and meeting frequency, and the effectiveness of the board by its independence, size, and meeting frequency, and by the duality of the chief executive officer (CEO) and chair positions (CEO duality). He also examined other factors that can affect firms' timeliness in the remediation of material weaknesses, such as the severity of material weaknesses, firms' profitability, the complexity of firms' operations, and so on. He found out that the proportion of audit committee members with financial expertise is positively associated with firms' timeliness in the remediation of material weaknesses. Second, firms with larger audit committees are more likely to remediate material weaknesses in a timely manner. Third, that a more independent board is less susceptible to the undue influence of management and more likely to exert pressure on management to remediate material weaknesses.

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

Zhang *et al.* (2007) surveyed a sample of firms that disclosed internal control deficiencies after the enactment of SOX and found that these firms are more likely to have audit committees that have less financial expertise. If audit committee quality is associated with the quality of internal controls, it seems reasonable to believe that a more effective audit committee will ensure timelier remediation of material weaknesses in order to maintain the effectiveness of internal controls.

The three major categories of management objectives comprise; effective operations, financial reporting and compliance (Hayes et al., 2005). Effective operations are about safeguarding the assets of the organization. The physical assets like cash, non physical assets like receivables, important documents and records of the company can be stolen, misused or accidentally destroyed unless they are protected by adequate controls. The goal of financial control requires accurate information for internal decision because management has a legal and professional responsibility to ensure that information is prepared fairly in accordance with applicable accounting standards. Organizations are equally required to comply with many laws and regulations including company laws, tax laws and environment protection laws. The authoritative 1994 Principles of Corporate Governance of the American Law Institute recommends that “every large publicly held corporation should have an audit committee that would review on a periodic basis . . . the corporation’s internal controls.”

According to Hayes et al., 2005 internal control comprises five components; the control environment, the entity’s risk assessment process, the information and communication systems, control activities and the monitoring of controls. However, for purposes of this study, the research will narrow down to only three components of the internal control system. These are; the control environment, internal audit and control activities. The other components of the internal control systems will be held constant.

A case study by Romar & Moberg, (2003) showed the following could have contributed to WorldCom scandal in 2002: unrealistic growth targets when expectations were low, management philosophy was aggressive; inadequate assessment of internal and external factors, and objectives before setting aggressive targets; poor segregation of duties; access to data entry and manipulation was not properly segregated and there was a lack of stringent monitoring of the internal control system and therefore quality of the controls around the posting of journal entries to the general ledger was not identified as weak.

Gupta (2001) drawing from Statements of Standard Auditing Practices No. 6 (SAP 6) defines Internal control as “the plan of organization and all the methods and procedures adopted by the management of an entity to assist in achieving management objectives of ensuring as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of fraud and error, the accuracy and completeness of accounting records and the timely preparation of reliable financial information".

According to Verschoor (1999), internal control is the term generally used to describe how management assures that an organization does meet its financial and other objectives. Internal control systems not only contribute to managerial effectiveness but are also important duties of corporate boards of directors. He goes further to report that approximately three-quarters of the 500 largest publicly held U.S. corporations voluntarily make a public assertion of management's responsibilities for properly reporting financial results and also maintaining an effective system of internal control. These management statements on internal control are contained in the company's annual report to shareholders. He asserts that; virtually all of these companies report using the same strategies to execute management's internal control responsibilities. These include references to segregation of functions, programs of selection and training of personnel, the results of an internal auditing function, oversight from the audit committee of the board of directors, and the work of the company's external auditors.

Hitt, Hoskisson, Johnson, and Moesel (1996) argued that there are two types of major internal controls associated with the management of large firms, particularly diversified firms, which have an important effect on firm innovation, these are; strategic controls and financial controls. Strategic controls entail the use of long-term and strategically relevant criteria for the evaluation of business-level managers' actions and performance. Strategic controls emphasize largely subjective and sometimes intuitive criteria for evaluation (Gupta, 1987). The use of strategic controls requires that corporate managers have a deep understanding of business-level operations and markets. Such controls also require a rich information exchange between corporate and divisional managers (Hoskisson, Hitt, & Ireland, 1994).

On the other hand, financial controls entail objective criteria such as return on investment (ROI) in the evaluation of business-level managers' performance. They are similar to what Eisenhardt (1985) and Ouchi (1980) referred to as outcome controls. Thus, top-level managers establish financial targets for each business and measure the business-level managers' performance against those targets. Such an approach can be problematic when the degree of interdependence among business units is high. Thus, emphasis on financial controls requires each division's performance to be largely independent.

As a firm grows especially through acquisition, it also grows in complexity and the number of units that corporate executives must oversee and manage grows (thereby increasing their spans of control). Clearly, each acquisition increases corporate managers' need for information processing, sometimes dramatically so. These changes make it difficult for corporate managers to use strategic controls. To reduce information-processing demands, they may change their emphasis from strategic to financial controls (Michael, et al 1996).

According to Dixon et al (1990), appropriate performance measures are those which enable organizations to direct their actions towards achieving their strategic objectives. On the other hand Stoner (2003), refers to performance as the ability to operate efficiently, profitably, survive, grow and react to the environmental opportunities and threats. This study used profitability levels of the SACCOs over a specified period of time to establish any changes in the profit levels that would be attributed to internal controls in the organizations.

In summary, a review of the empirical literature shows that properly instituted systems of internal control will ensure; completeness of all transactions undertaken by an entity, that the entity's assets are safeguarded from theft and misuse, minimizes risks, and that the entity's transactions are presented in the appropriate manner according to the applicable reporting framework, hence contributing to managerial effectiveness and segregation of duties.

2.4 Review of the Local Research Carried Out

Locally, a number of studies have been conducted in the field of internal controls. Olumbe, (2012) conducted a study to establish the relationship between internal controls and corporate governance in commercial banks in Kenya. The researcher conducted a survey of all the 45 commercial banks in Kenya. It was concluded that most of the banks had incorporated the various parameters which are used for gauging internal controls and corporate governance. This 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 that there is a relationship between internal control and corporate governance.

Wainaina, (2011) did an evaluation of the internal control function. He established that, other than the prevention and detection of fraud, internal controls should reflect the strength of the overall accounting environment in an organization as well as the accuracy of its financial and operational records.

Kibet, (2008) did a survey on the role of internal audit in promoting good corporate governance in state owned enterprises: a case of quoted companies. Keitany, (2000) conducted a study on the internal audit control function and its implication for risk assessment by the external auditor.

A review of prior local studies conducted shows that, most studies tend to focus on aspects of controls that relate to performance reporting, organization structure, behaviour and external auditors' work with no focus on financial performance. Moreover, no such study has been conducted on deposit taking SACCOs which are now under a new regulatory framework (SASRA) which has enhanced better internal controls within SACCOs; that is in terms of governance, accountability and financial reporting.

2.5 Summary

A review of the literature established that effective systems of internal control within an organization ensures completeness of all transactions undertaken by an entity, entity's assets are safeguarded from theft and misuse, that transactions in the financial statements are stated at the appropriate amounts, that all assets in the company's financial statements do exist, and that the entity's transactions are presented in the appropriate manner according to the applicable reporting guidelines and framework.

However, it's worth noting that, there is little research that that has been done to establish the relationship between internal controls and organizations' financial performance both internationally and locally. This is particularly so in the field of Savings and Credit Cooperative Societies (SACCOs) in Kenya, which in the recent past have had a new regulatory body (SASRA) which licenses, regulates and supervises the institutions. The expectations from the new regulatory framework are that SACCOs would pay more emphasis on their internal controls; however, little attention has been given to establish whether the internal controls of these SACCOs have an effect on their financial performance. Hence this study sought to fill this gap by investigating the effects of internal controls on financial performance of licensed Savings and Credit Cooperative Societies (SACCOs) in Kenya.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the research methodology for the study. Section 3.2 discusses research design while 3.3 discusses the population, sampling procedure and sample size to be used. Section 3.4 presents the data and data collection instruments to be used and lastly, section 3.5 deals with data analysis.

3.2 Research Design

Research design refers to the way the study is designed, that is the method used to carry out the research (Mugenda and Mugenda, 2003). Descriptive Research is the investigation in which quantity data will be collected and analysed in order to describe the specific phenomenon in its current trends, current events and linkages between different factors at the current time.

Further studies have also shown that descriptive research is preferred while conducting research studies. Descriptive research portrays an accurate profile of persons, events, or situation (Robson, 2002). It has also been shown that surveys allow for collection of a large amount of data from a sizeable population in a highly economical way. It allows one to collect quantitative data, which will be analyzed quantitatively using descriptive and inferential statistics (Saunders et al 2007). Causal research design is chosen because it enables the researcher to generalise the findings to a larger population. This study will therefore be able to generalise the findings to all the SACCOs in the country.

3.3 Population and Sample

3.3.1 Population

The study population consisted of all 4,233 SACCOs registered under the Societies Act in Kenya (SASRA Survey Report, February 2011). The list of the SACCOs was obtained from the Ministry of Cooperatives, Development and Marketing. The study targeted the 122 SACCOs registered by SASRA as at 31st December 2012.

3.3.2 Sample

The sample of the study was drawn from the senior managers in these organizations who mainly comprise the Chief Executive Officers and other Senior Managers. The research deliberately targeted the senior managers of the SACCOs since they were in a better position to analyze the position of their organizations and the effects that the laid down regulations have on the performance of their organizations.

The sampling method chosen for this study was purposive sampling which is a form of non-probability sampling employed to select 40 SACCOs mainly based in Nairobi County. Purposive sampling involves a deliberate selection of particular units of population to constitute a sample representing the population (Kothari, 2004). In terms of this study, purposive sampling was chosen for convenience purposes.

3.4 Data and Data Collection Instruments

The study used both primary and secondary data. Primary data was collected from the SACCOs by way of administering questionnaires to respondents within the SACCOs.

Secondary data was obtained from the financial statements of the SACCOs and books of account which included the balance sheet and profit and loss accounts. This allowed for collection of information on annual earnings and financial performance of the SACCOs. The data collected covered three years, from 2010 to 2012.

3.5 Data analysis

Analysis of data involves inspecting, cleaning, transforming and modelling data with the aim of highlighting useful information, suggesting conclusions and supporting decision making. The secondary data collected was analyzed using Statistical Package for Social Science (SPSS Version 17).

A multiple regression model was adopted to check the form of relationship between the dependent and the independent variables. Tables and charts have been used to present the analysed data for easy of understanding.

3.5.1 Conceptual Model

The study sought to establish whether internal controls (IC) have an effect on financial performance (FP) of SACCOs in Kenya. The independent internal controls evaluated were control environment (CE), risk assessment (RA), control activities (CoA) and monitoring mechanisms (MM). Therefore;

$$Y = f\,(CE, RA, CoA, MM) \qquad (1)$$

Table 3.1 Measurement of Variables

Variables	How to Measure
Financial performance	**Liquidity** - measured by: i) Current Ratios, CR = CA/CL ii) Quick Ratios, QR = (Cash + Equivalents + Short Term Investments + Account Receivables)/Current Liabilities iii) Cash Ratios, CaR = (Cash + Cash Equivalents + Invested Funds)/Current Liabilities **Profitability/Operating efficiency** - measured by: i) Return on Equity, RoE = Net Income/Shareholders Equity ii) Return on Assets, RoA = Net Income/Assets **Accountability** - measured by: i) Presence of appropriate internal monitoring of financial affairs such as availability of competent personnel, internal auditing and availability of adequate records and equipment ii) assignment of responsibility and division of work iii) Reporting frequency and quality of reports generated
Control environment	Presence of integrity and ethical values, commitment to competence, human resource practices and organization structure.

	Parameters of control environment used were: i) a strong presence of tight budgetary controls and; ii) an effective audit function with the right number of staff iii) number of members in the organization's audit function/committee
Risk assessment	Entails risk identification, risk evaluation and risk response. This was mainly measured by the presence/absence of mechanisms within the organization to undertake: i) Credit Risk assessment ii) Fraud Risk assessment iii) Customer Risk assessment iv) Operational Risk assessment
Control activities	Entails the presence/absence of mechanisms for: i) approval & authorization of transactions, ii) verifications, iii) reconciliation and reviews iv) segregation of duties These will be measured by; (a) the frequency of reconciliations done within a certain period of time, (b) the levels of authorization required for authorization of transactions and (c) the number of people required to undertake verification of a given transaction

	(d) the number of variance reports generated with explanations
Monitoring mechanisms	Measured by the presence of: i) a strong internal audit function ii) ongoing monitoring iii) continuous self-assessment The measure of a strong internal audit function was done by analyzing; (a) the number of qualified personnel under the internal audit function and (b) the number (frequency) of internal audits within a given period of time.

Morris (2011) believes that Enterprise Resource Planning systems provide a mechanism to deliver fast, accurate financial reporting with built-in controls that are designed to ensure the accuracy and reliability of the financial information being reported to shareholders. This therefore enhances accountability within the organization.

This view is supported by other findings such as Cadez and Guilding (2008) who identified some factors which impact management control systems; these are: external environment, technology, structure and size, strategy and national culture. Their study suggests that the demands imposed by technical tasks in the organization encourage the development of strategies to coordinate and control internal activities. Whittington & Pany (2001), talk about the comprehensiveness of internal controls in addressing the achievement of objectives in the areas of financial reporting, operations and compliance with laws and regulations. They further note that “Internal control also includes the program for preparing, verifying and distributing to the various levels of management those current reports and analyses that enable executives to maintain control over the variety of activities and functions that are performed in a large organization".

Hitt, et al (2001) mention current ratio (current assets/current liabilities) as a standard measure of liquidity in organisations. Baysinger, (1989) equally emphasized the importance of current ratio as a measure of an organisation's liquidity.

Therefore, the researchers seem to concur that liquidity, reporting and accountability can be measures of financial performance of an organization.

3.5.2 Analytical Model

The model will take the following form;

$$Y = a + B_1 X_1 + B_2 X_2 + B_3 X_3 + B_4 X_4 + \epsilon \qquad (2)$$

Where Y is financial performance

a - Constant

X_1 - Control environment

X_2 - Risk assessment

X_3 - Control activities

X_4 - Monitoring mechanisms

$B_1 – B_4$ = Measure of sensitivity of variable x to changes in y

ϵ = Error term

The study conducted F- test to establish the significance of the independent variables (control environment, risk assessment, control activities, monitoring mechanisms) against the dependent variable (Financial Performance). The significance of variables was observed at 95% confidence level whereby, variables with a 'p' value of 0.05 and below were deemed significant while those with 'p' values above 0.05 were deemed insignificant. ANOVA was also conducted to test the appropriateness of the model as a whole.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the data analysis and interpretation of the results. Section 4.2 provides the Summary Statistics which include demographic details of the SACCOs in data and analysis of key responses. Section 4.3 provides the estimated model, Section 4.4 presents the discussion of the findings while Section 4.5 provides the summary of this chapter.

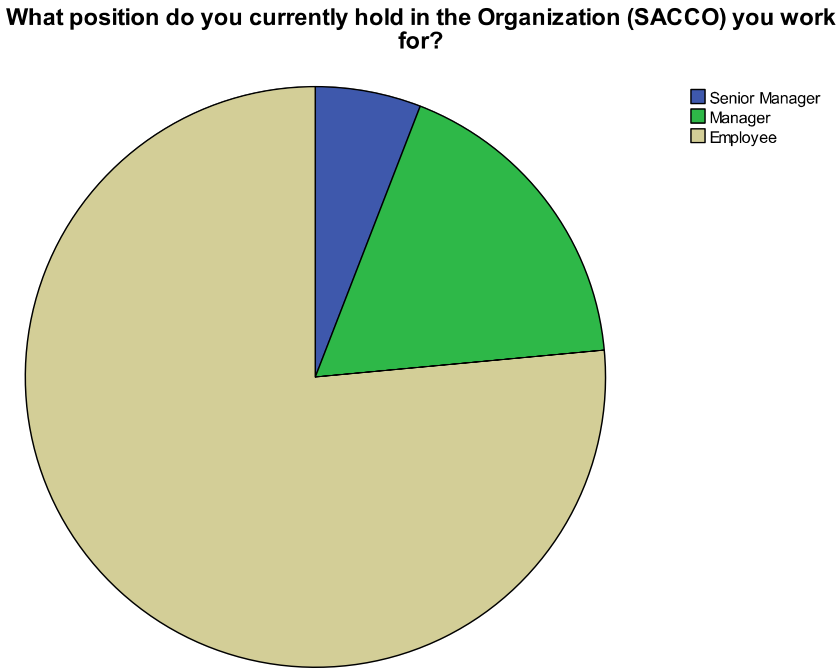
4.2 Summary Statistics

Primary data spanning a period of 2010 to 2012 was collected from respective SACCOs by form of questionnaires, and also from their respective books of accounts. The data was analyzed and descriptive statistical findings and frequency results of respondents' feedback presented in table forms as below. Further, to determine the relationships between the factors that affect the performance indicator - ROA, regression was done for the entire period under study on the parameters of the model under the same study. This was done in order to come up with the model parameters’ coefficients that would further give direction and their relations to the performance parameter of scheme, whether direct or inverse relationship.

4.2.1 Position in the Organization

The respondents were asked to disclose their position in the organization. Figure 4.1 below shows the study finding.

Figure 4.1 Position held in organization

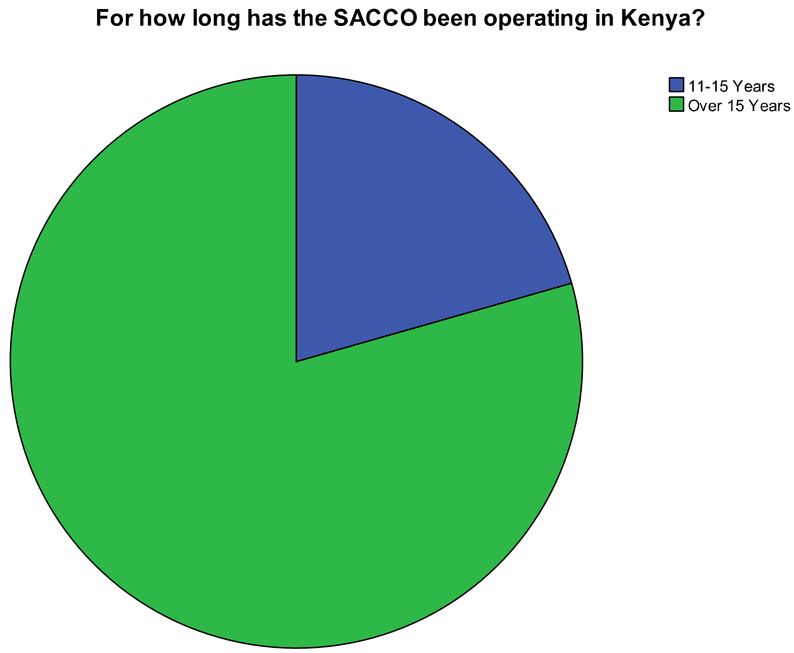


Of the 34 respondents interviewed, 5.9% were senior managers, 17.6 Managers, and 76.5 were employees.

4.2.2 Length of SACCO Existence in Kenya

The respondents were asked to indicate the number of years the SACCO which they work for has been in existence in Kenya. Figure 4.2 below shows the result of the study of which 20.6% had existed for 11-15 years and 79.4% for over 15 years.

Figure 4.2 SACCO's Existence in Kenya

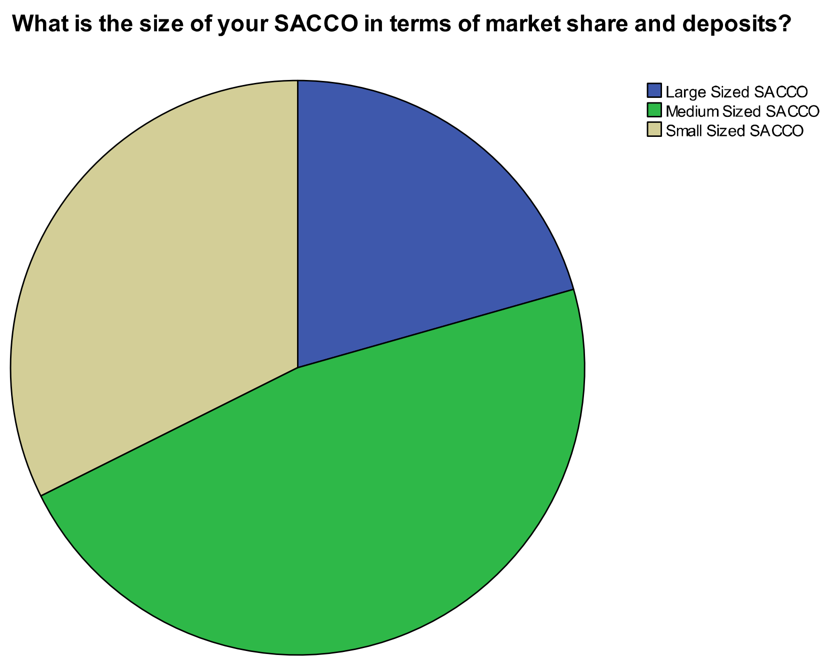


It was established that most SACCOs had been in existence for a period of more than fifteen years with several of the SACCOs having existed for between 11-15 years. None of the SACCOs studied was noted to have been in existence for less than ten years.

4.2.3 Size of the SACCO based on Market Share

The respondents were asked to estimate the size of their SACCOs based on Market Share. Figure 4.3 shows the study findings where 20.6% were Large sized SACCOS, 47.1% Medium sized, and small sized SACCOs being 32.4%.

Figure 4.3 Size of SACCO based on Market Share



4.2.4 Descriptive Statistics

The study sought to establish relevant statistics including the mean, standard deviation and variance. This section therefore, presents the analysis information on findings to determine the effect of internal controls on financial performance of Deposit Taking Savings and Credit Cooperative Societies in Kenya.

Table 4.1 - Descriptive Statistics

	N	Mean	Std. Deviation	Skewness	
	Statistic	Statistic	Statistic	Statistic	Std. Error
Financial Performance (ROA)	3	.118088832333333	.012436862930324	1.730	1.225
Control environment (number of members in the organization's audit function/committee)	3	3.33333333	.577350269	1.732	1.225
Risk assessment	3	.33333333	.577350269	1.732	1.225
Control activities	3	5.66666667	1.154700538	1.732	1.225
Monitoring mechanisms (the number (frequency) of internal audits within a given period of time.)	3	4.66666667	.577350269	-1.732	1.225
Valid N (list-wise)	3				

Mean for Financial Performance (ROA), Control environment, Risk assessment, Control activities and Monitoring mechanisms were found to be .11809, 3.3333, 0.3333, 5.6667 and 4.6667 respectively and of skewness 1.730, 1.732, 1.732, 1.732 and -1.732 respectively as per Table 4.1. The rest of the variables had positive skewness, except Monitoring mechanisms.

Table 4.2. Correlations

		Financial Performance (ROA)	Control environment (number of members in the organization's audit function/committee)	Risk assessment	Control Activities	Monitoring mechanisms (the number (frequency) of internal audits within a given period of time.)
Financial Performance (ROA)	Pearson Correlation	1	-.513	1.000**	1.000**	.513
	Sig. (2-tailed)		.657	.010	.010	.657
	N	3	3	3	3	3
Control environment (number of members in the organization's audit function/committee)	Pearson Correlation	-.513	1	-.500	-.500	-1.000**
	Sig. (2-tailed)	.657		.667	.667	.000
	N	3	3	3	3	3
Risk assessment	Pearson Correlation	1.000**	-.500	1	1.000**	.500
	Sig. (2-tailed)	.010	.667		.000	.667
	N	3	3	3	3	3
Control Activities	Pearson Correlation	1.000**	-.500	1.000**	1	.500
	Sig. (2-tailed)	.010	.667	.000		.667
	N	3	3	3	3	3
Monitoring mechanisms (the number (frequency) of internal audits within a given period of time.)	Pearson Correlation	.513	-1.000**	.500	.500	1
	Sig. (2-tailed)	.657	.000	.667	.667	
	N	3	3	3	3	3

**. Correlation is significant at the 0.01 level (2-tailed).

Bivariate Pearson Correlation between the variable were as presented in Table 4.2, all at 95% confidence interval except for the relationship between Financial Performance and Risk Assessment, Financial performance and Control activities, Control activities and Risk Assessment, Control environment and Monitoring mechanism that were at 99% confidence interval. The rest of the bivariate correlations were found to be positive except for the relationship between Financial performance and Control environment, Control environment and Risk assessment, Control environment and Control activities, Control environment and Monitoring mechanisms which were found to be negative.

4.3 Estimated or Empirical Model

Table 4.3 Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.056	.000		.	.
	Control Activities	.011	.000	.991	.	.
	Monitoring mechanisms (the number (frequency) of internal audits within a given period of time)	0.000365	.000	.017	.	.

a. Dependent Variable: Financial Performance (ROA)

After a regression of the variable under study for the period 2010-2012 coefficients for the independent variable in the model were as in Table 4.3 above and thus the model fit as shown below:

$Y = 0.056 + 0.011 X_3 + 0.000365 X_4$

Where: X_3 - Control activities, X_4 - Monitoring mechanisms and Y is financial performance

Over the three year period of study, two variables were found not to have an effect on the performance indicator variable ROA in the multivariate relation and thus never fitted in the model as per Table 4.4; these other internal control variables were Control environment and Risk assessment.

Table 4.4 Excluded Variables[b]

Model		Beta In	T	Sig.	Partial Correlation	Collinearity Statistics
						Tolerance
1	Control environment (number of members in the organization's audit function/committee)	.[a]	.	.	.	.000
	Risk assessment	.[a]	.	.	.	.000

a. Predictors in the Model: (Constant), Monitoring mechanisms (the number (frequency) of internal audits within a given period of time), Control Activities

b. Dependent Variable: Financial Performance (ROA)

4.4 Discussion

Mean for Financial Performance (ROA), Control environment, Risk assessment, Control activities had a positive skew, or rather skewed to the right meaning their Mode is less than the Mean, and Mode is less than the Median, i.e. Mode<Median<Mean, however Monitoring mechanisms had a negative skew, that is skewed to the left meaning its Mode is more than the Mean, Mode is more than the Median, i.e. Mode>Median>Mean.

Other than financial performance and control environment, control environment and risk assessment, control environment and control activities, control environment and monitoring mechanism; all the other variables under study had a direct exclusive bivariate relation as calculations on their Bivariate Pearson correlation returned positive values.

Of the internal controls studied, only Control activities, and Monitoring mechanisms were found to have a positive relation on the financial performance ROA, meaning a unit increase on one would result in an increase on the financial performance. Other two internal control parameters such as Control environment and Risk assessment had no effect on the financial performance over the study period of 2010 – 2012 and thus the model fit was found to be:

$$Y = 0.056 + 0.011 X_3 + 0.000365 X_4$$

Majority of the SACCO staff interviewed were mainly employees with a few of those interviewed being in the management and the senior management cadres. Most of the SACCOS had been in existence for over 15 years with only 20.6% responding to be large sized SACCOS, 47.1% as Medium sized and 32.4% as small sized SACCOS.

All the SACCOS confirmed to be having and implementing the control environment, control activities and internal audit activity parameters as majority ranked the measure questions per parameter to either Strongly Agree or Agree.

4.5 Summary

All the other variables under study had a direct exclusive bivariate relation as calculations on their bivariate Pearson correlation returned positive values except financial performance and control environment, control environment and risk assessment, control environment and control activities, control environment and monitoring mechanism.

Only Control activities and Monitoring mechanisms were found to have a positive relation on the financial performance indicator, which in the case of this study was ROA.

Staff members of the SACCOs were interviewed along with the Senior Managers within the organizations. It was also noted that most of the SACCOS had been in existence for over 15 years while most of them are medium sized.

CHAPTER FIVE

SUMMARY AND CONCLUSION

5.1 Introduction

This chapter presents a summary of the study in Section 5.2 which gives an overview of the study, the conclusion in Section 5.3 that provides a wrap up of the findings and what they mean and how they can affect policy making. Study limitations in Section 5.4 expounds on the challenges which were encountered in the course of the data collection, analysis and presentations of results and the assumptions made. Section 5.5 concludes with recommendations for further research.

5.2 Summary of the Study

The study collected data by way of questionnaires and also secondary data from the SACCOs' financial statements from 34 deposit taking SACCOs in Nairobi, for a study period spanning the years 2010 through 2012. With regard to data collected on the questionnaires, of pertinent importance to this study included details on the position of the interviewee in the SACCO, time that the SACCO has been in existence, size of the SACCO based on market share, and the respondents ranking of their SACCOS on indicators of Control environment, Control activities, and Monitoring activities. Data was analyzed, using SPSS version 17, upon which results were presented using tables and charts. Inferences of the findings were then discussed in the succeeding sections.

Another significant aspect from the study was the model fit of the financial indicator and the independent parameters as discussed extensively in Chapters three and four.

5.3 Conclusion

Based on the findings of the study, it is evident that SACCOs which have effective internal controls have a relatively stronger and better financial performance unlike those which are not keen to implement internal controls based on Control activities and Monitoring mechanisms

However, implementation of some of the controls studied was observed to be a challenge in some SACCOs considering that their capacities recruit and retain the right and sufficient numbers of personnel was limited. This might partly explain the reason why the internal control parameters of Control environment and Risk assessment were not found to have a significant effect on the financial performance, ROA.

This is guided based on the fact that, of the independent variables thought to be affecting the performance indicator ROA, every other variables under study had a direct exclusive bivariate relationship as calculations on their bivariate Pearson correlation returned positive values except Financial performance and Control environment, Control environment and Risk assessment, Control environment and Control activities, Control environment and Monitoring mechanism;

Control activities and Monitoring mechanisms were found to have a positive relation on the financial performance indicator, ROA whereas Control environment and Risk assessment were found not to have a direct or indirect effect on the financial performance indicator, ROA as they were excluded from the model fit in the regression analysis.

Overall, the key conclusion of this study is that there is a significant positive relationship between the internal controls effected by the Deposit Taking SACCOs in Kenya, and their financial performance as measured by their Return on Assets (RoA).

5.4 Limitations of the Study

The study looked at the variables under study for a limited period between the years 2010-2012; a period of three years, which might not necessarily be a period long enough to justify a representative conclusion of the findings. The study has assumed that the independent variables under study, which were to be studied if they had an effect on the financial performance, are independent, but the bivariate Pearson correlation shows some extent of relations between them on an exclusive bivariate relationship.

The study also focused on 34 registered Deposit Taking SACCOs that are within Nairobi County. This was occasioned by lack of sufficient resources and time on the side of the researcher that would be required to cover the entire population of SACCOs in Kenya. As such, the findings would mainly be limited to Nairobi County and this is subject to contention if such findings can be representative of the whole country. The study also looked at only four parameters of financial controls and their effects on the financial performance, assuming that these are the only financial controls that would affect the financial performance. This might not necessarily be the case.

Further, the study, centred on the ROA as the measure of financial performance in relations to the studied corporate governance aspects, but did not explore other measures of financial performance such as Earnings before Interest and Tax (EBIT), Return on Investment (ROI), among other measures. It would have been beneficial to see how they relate to the independent variables hence the findings are not conclusive as to whether the relations between the independent variables relate the same way to other measures of financial performance.

The study also majored on the deposit taking SACCOS, and thus the findings may not reflect clearly as to whether they can also apply in a similar manner to the Non-deposit Taking SACCOS.

5.5 Recommendations for Further Research

As much as the study presents very insightful findings and hopes for the contribution and recommendation to the current body of knowledge, the following areas of further researcher are thus suggested. Further research is recommended to establish other factors related to internal controls which influence financial performance of SACCOs. Given that the study was limited to four variables, further research can be conducted incorporating other relevant variables.

Given that most of the studied SACCOS were in Nairobi, a similar study should be done on the effect of the internal controls on the performance of all the SACCOs in Kenya, so as to establish the overall effect and allow for generalization on the effect of the internal control structures on the financial performance of SACCOs.

The study period was limited to only three years, 2010-2012. Further study is recommended with a study period longer than three years so as to determine the effect of internal controls on financial performance. It will also be necessary to confirm if the findings of this study still hold for a longer period of time span, or if findings vary with the period under study.

Further research should also be conducted using other measures of financial performance other than Return on Assets such as Ratio of Total Loan Delinquency to Gross Loan Portfolio and the ratio of Savings to Deposits as recommended by the World Council of Credit Unions (WOCCU).

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APPENDICES

Appendix I - Introductory Letter

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
MBA PROGRAMME

Telephone: 020-2059162
Telegrams: "Varsity", Nairobi
Telex: 22095 Varsity

P.O. Box 30197
Nairobi, Kenya

DATE 07/10/2013

TO WHOM IT MAY CONCERN

The bearer of this letter MR. CLIFF NYANDORO MAGARA

Registration No. D61/73452/2012

is a bona fide continuing student in the Master of Business Administration (MBA) degree program in this University.

He/she is required to submit as part of his/her coursework assessment a research project report on a management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate your assistance to enable him/her collect data in your organization.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
07 OCT 2013
MBA OFFICE
P.O. Box 30197 – 00100, NAIROBI

PATRICK NYABUTO
MBA ADMINISTRATOR
SCHOOL OF BUSINESS

Appendix II - Questionnaire

SECTION A: Organizational Demographics

Please provide the required information by filling in the blanks where space has been provided or by ticking [√] against the most appropriate answer.

Respondents name...[Optional]

1. What position do you currently hold in the Organization (SACCO) you work for?

a) Chief Executive Officer [ ]

b) Senior Manager [ ]

c) Manager [ ]

d) Employee [ ]

2. For how long has the SACCO been operating in Kenya?

a) Less than 5 years [ ]

b) 5 - 10 years [ ]

c) 11 - 15 years [ ]

d) Over 15 years [ ]

3. What is the size of your SACCO in terms of market share and deposits?

a) Large sized SACCO [ ]

b) Medium sized SACCO [ ]

c) Small sized SACCO [ ]

4. What is the current membership of you SACCO? [_______]

SECTION B

This section examines the functionality of Internal Control Systems of SACCOs in Kenya.

Please rank the following statements on Likert Scale ranging from Strongly Disagree to Strongly Agree, where;

1 = Strongly Disagree

2 = Disagree

3 = Not Sure

4 = Agree

5 = Strongly Agree

5. Please rank the extent to which you organization controls the environment.

CONTROL OF ENVIRONMENT	STRONGLY AGREE [5]	AGREE [4]	NOT SURE [3]	DISAGREE [2]	STRONGLY DISAGREE [1]
Our firm has an accounting and financial management system					
Management is committed to the operation of the system					
Management closely monitors implementation of Internal Control Systems in our organization					
Management provides feedback to the junior officers about the operation of the system					
Appropriate measures are taken to correct misfeasance in operation of our Accounting and Finance Management System					
Management acts with a great degree of integrity in execution of their roles					
Ethical values are upheld in all management decisions					
Our institution has an objective, independent audit committee					
Our Board of Directors and its Committees are independent of Management					

6. Please rank the extent to which your organization practices the following control activities.

CONTROL ACTIVITIES	STRONGLY AGREE [5]	AGREE [4]	NOT SURE [3]	DISAGREE [2]	STRONGLY DISAGREE [1]
Our organization has clear separation of roles					
Every employee's work is checked by others					
There is appropriate supervision by senior staff on the work done by their juniors					
Corrective action is always taken to adress weaknesses					
Staff are trained to implement the accounting and financial management systems					
Our SACCO has a well developed Chart of Accounts					
It is impossible for a member of staff to have access to all valuable information without the consent of senior staff					
Controls are in place to avoid incurring expenditure in excess of allocate funds					
Departments have budget reviews where actual expenditure is compared with budgeted expenditure and explanations for the variances given					
Our security system identifies and safeguards the organization's assets					

7. Please rank the extent to which your organization practices the following internal audit activities.

INTERNAL AUDIT ACTIVITIES	STRONGLY AGREE [5]	AGREE [4]	NOT SURE [3]	DISAGREE [2]	STRONGLY DISAGREE [1]
Our SACCO has an internal audit department					
Our internal audit function is sufficiently staffed					
Internal audit staff conduct regular audit activities in our organization					
Internal audit reports address weaknesses in our internal control system					
Internal audit reports are produced regularly					
Management discusses internal audit reports frequently					
Internal auditor makes appropriate recommendations for management to improve upon					
Internal audit staff visit up-country branches often					
Internal auditor issues reports on up-country branches regularly					
Internal auditor performs his duties with a greater degree of autonomy and independence from management					

Thank you for your participation and time.

Appendix III - List of Licensed SACCOs in Kenya

DEPOSIT-TAKING SACCO SOCIETIES LICENSED BY THE SACCO SOCIETIES REGULATORY AUTHORITY (SASRA) AS AT 31ST DECEMBER 2012

NO.	*NAME OF SOCIETY*	*POSTAL ADDRESS*	*DATE LICENSED*
1.	STIMA SACCO SOCIETY LTD	P.O. Box 75629 – 00100 NAIROBI	19/12/2011
2.	BARINGO TEACHERS SACCO SOCIETY LTD	P.O. Box 80-20103 ELDAMA RAVINE	19/12/2011
3.	TAI SACCO SOCIETY LTD	P.O Box 718 – 00216 GITHUNGURI	19/12/2011
4.	U.N. SACCO SOCIETY LTD	P.O. Box 30552 -00100 NAIROBI	19/12/2011
5.	SOUTH IMENTI TEA GROWERS SACCO SOCIETY LTD	P.O. Box 511 – 60202 NKUBU	19/12/2011
6.	KENYA HIGHLANDS SACCO SOCIETY LTD	P.O. Box 2085 – 002000 KERICHO	19/12/2011
7.	BANDARI SACCO SOCIETY LTD	P.O. Box 95011 – 80104 MOMBASA	19/12/2011
8.	GUSII MWALIMU SACCO SOCIETY LTD	P.O. Box 1335 -40200 KISII	19/12/2011
9.	WAKENYA PAMOJA SACCO SOCIETY LTD	P.O. Box 829 – 40200 KISII	19/12/2011
10.	MERU SOUTH FARMERS SACCO SOCIETY LTD	P.O. Box 514 – 60400 CHUKA	19/12/2011
11.	KILIFI TEACHERS SACCO SOCIETY LTD	P.O. Box 712 – 80108 KILIFI	19/12/2011
12.	KITUI TEACHERS SACCO SOCIETY LTD	P.O. Box 254 – 90200 KITUI	19/12/2011
13.	NDEGE CHAI SACCO SOCIETY LTD	P.O. Box 857 – 20200 KERICHO	19/12/2011
14.	TENHOS SACCO SOCIETY LTD	P.O. Box 391 -20400 BOMET	19/12/2011
15.	NYAMIRA TEA FARMERS SACCO SOCIETY LTD	P.O. BOX 633 – 40500 NYAMIRA	19/12/2011
16.	NYERI TEACHERS SACCO SOCIETY LTD	P.O. Box 1939 – 10100, NYERI	19/12/2011
17.	KAKAMEGA TEACHERS SACCO SOCIETY LTD	P.O. Box 1150-50100 KAKAMEGA	19/12/2011
18.	KITE SACCO SOCIETY LTD	P.O. Box 2073 – 40100 KISUMU	19/12/2011
19.	KIPSIGIS TEACHERS SACCO SOCIETY LTD	P.O. Box 682 – 20200 KERICHO	19/12/2011
20.	MOMBASA TEACHERS SACCO SOCIETY LTD	P.O. Box 86515 – 80100 MOMBASA	19/12/2011
21.	BORABU SACCO SOCIETY LTD	P.O. Box 42 – 40502 NYANSIONGO	19/12/2011
22.	CHAI SACCO SOCIETY LTD	P.O Box 278 – 00200 NAIROBI	19/12/2011
23.	MOMBASA PORT SACCO SOCIETY LTD	P.O. Box 95372 – 80104 MOMBASA	19/12/2011

24.	MURAMATI SACCO SOCIETY LTD	P.O. Box 1145 – 10200 MURANG'A	19/12/2011
25.	BINGWA SACCO SOCIETY LTD	P.O. Box 434 – 10300 KERUGOYA	19/12/2011
26.	KMFRI SACCO SOCIETY LTD	P.O. Box 80862 MOMBASA	19/12/2011
27.	NAKURU TEACHERS SACCO SOCIETY LTD	P.O. Box 1931 – 20100 NAKURU	19/12/2011
28.	NACICO SACCO SOCIETY LTD	P.O. Box 34525 – 00100 NAIROBI	19/12/2011
29.	BARINGO FARMERS SACCO SOCIETY LTD	P.O. Box 660 -20103 ELDAMA RAVINE	19/12/2011
30.	NANDI HEKIMA SACCO SOCIETY LTD	P.O. Box 211 – 30300 KAPSABET	19/12/2011
31.	MURANG'A TEACHERS SOCIETY LTD	P.O. Box 789 – 10200 MURANG'A	19/12/2011
32.	MWITO SACCO SOCIETY LTD	P.O. Box 56763 – 00200 NAIROBI	19/12/2011
33.	MUHIGIA SACCO SOCIETY LTD	P.O. Box 83 – 10300 KERUGOYA	19/12/2011
34.	IRIANYI TEA SACCO SOCIETY LTD	P.O. Box 3080 –40200 KISII	19/12/2011
35.	THARAKA NITHI TEACHERS SACCO SOCIETY LTD	P.O. Box 15 – 60400 CHUKA	19/12/2011
36.	MUNGANIA TEA GROWERS SACCO SOCIETY LTD	P.O. Box 2032 – 60100 EMBU	19/12/2011
37.	COMOCO SACCO SOCIETY LTD	P.O Box 30135- 00100 NAIROBI	19/12/2011
38.	TAIFA SACCO SOCIETY LTD	P.O Box 1649 -10100 NYERI	19/12/2011
39.	FARIJI SACCO SOCIETY LTD	P.O. Box 589 – 00216 GITHUNGURI	19/12/2011
40.	DIOCESE OF MERU SACCO SOCIETY LTD	P.O. Box 1207 – 60200 MERU	19/12/2011
41.	WAKULIMA DAIRY SACCO SOCIETY LTD	P.O. Box 232 – 10103 NYERI	19/12/2011
42.	UNIVERSAL TRADERS SACCO SOCIETY LTD	P.O. Box 2119 – 90100 MACHAKOS	19/12/2011
43.	WANANCHI SACCO SOCIETY LTD	P.O.Box 910 – 10106 OTHAYA	19/12/2011
44.	BARAKA SACCO SOCIETY LTD	P.O. Box 1548 -10101 KARATINA	19/12/2011
45.	MWALIMU NATIONAL SACCO SOCIETY LTD	P.O. Box 62641- 00200 NAIROBI	19/12/2011
46.	CHEPSOL SACCO SOCIETY LTD	P.O. Box 81 – 20225 KIMULOT	19/12/2011
47.	WANANDEGE SACCO SOCIETY LTD	P.O. Box 19074 – 00501 NAIROBI	19/12/2011
48.	KENYA POLICE STAFF SACCO SOCIETY LTD	P.O. Box 51042 – 00200 NAIROBI	19/12/2011
49.	K-UNITY SACCO SOCIETY LTD	P.O. Box 268 – 00900 KIAMBU	19/12/2011
50.	BIASHARA SACCO SOCIETY LTD	P.O. Box 1895 – 10100 NYERI	19/12/2011
51.	NATION STAFF SACCO SOCIETY LTD	P.O. Box 22022 – 00400 NAIROBI	19/12/2011
52.	ORTHODOX DEVELOPMENT SACCO SOCIETY LTD	P.O. Box 43582 – 00100 NAIROBI	19/12/2011
53.	KURIA TEACHERS SACCO SOCIETY LTD	P.O. Box 208 – 40413 KEHANCHA	19/12/2011

54.	KONOIN SACCO SOCIETY LTD	P.O. Box 83 – 20403 MOGOGOSIEK	19/12/2011
55.	KIAMBAA DAIRY RURAL SACCO SOCIETY LTD	P.O. Box 669 – 00219, KARURI	19/12/2011
56.	SIMBA CHAI SACCO SOCIETY LTD	P.O. Box 977 – 20200 KERICHO	19/12/2011
57.	GITHUNGURI DAIRY & COMMUNITY SACCO SOC LTD	P.O. Box 896 – 00216 GITHUNGURI	19/12/2011
58.	KINGDOM SACCO SOCIETY LTD	P.O. Box 8017 – 00300 NAIROBI	19/12/2011
59.	SOT TEA GROWERS SACCO SOCIETY LTD	P.O. Box 251 – 20400 BOMET	19/12/2011
60.	NYANDARUA TEACHERS SACCO SOCIETY LTD	P.O. Box 259 – 20303 OL'KALOU	19/12/2011
61.	METROPOLITAN TEACHERS SACCO SOCIETY LTD	P.O. Box 871 – 00900 KIAMBU	19/12/2011
62.	KEIYO TEACHERS SACCO SOCIETY LTD	P.O. Box 512 – 30700 ITEN	19/12/2011
63.	MUMIAS OUTGROWERS SACCO SOCIETY LTD	P.O. Box 295 – 50102 MUMIAS	19/12/2011
64.	AFYA SACCO SOCIETY LTD	P.O. Box 11607 –00400 NAIROBI	19/12/2011
65.	EMBU TEACHERS SACCO SOCIETY LTD	P.O Box 696 – 60100 EMBU	19/12/2011
66.	HARAMBEE SACCO SOCIETY LTD	P.O. Box 47815 – 00100 NAIROBI	19/12/2011
67.	JAMII SACCO SOCIETY LTD	P.O. Box 57929 – 00200 NAIROBI	19/12/2011
68.	WARENG TEACHERS SACCO SOCIETY LTD	P.O. Box 3466 – 30100 ELDORET	19/12/2011
69.	BURETI SACCO SOCIETY LTD	P.O. Box 601 – 20210 LITEIN	19/12/2011
70.	SHERIA SACCO SOCIETY LTD	P.O. Box 34390 – 00100 NAIROBI	19/12/2011
71.	KENYA CANNERS SACCO SOCIETY LTD	P.O. Box 1124 – 01000 THIKA	19/12/2011
72.	ASILI SACCO SOCIETY LTD	P.O. Box 49064 00100 NAIROBI	19/12/2011
73.	SAFARICOM SACCO SOCIETY LTD	P.O. Box 66827 – 00800 NAIROBI	19/12/2011
74.	MATHIRA FARMERS SACCO SOCIETY LTD	P.O. Box 1936 – 10101 KARATINA	19/12/2011
75.	MAGADI SACCO SOCIETY LTD	P.O. Box 13 – 00205 MAGADI	19/12/2011
76.	NITHI TEA GROWERS SACCO SOCIETY LTD	P.O. Box 467 – 60400 CHUKA	19/12/2011
77.	KENPIPE SACCO SOCIETY LTD	P.O. Box 314 – 00507 NAIROBI	19/12/2011
78.	MAUA METHODIST HOSPITAL SACCO LTD	P.O. Box 469 – 60600 MAUA	19/12/2011
79.	BUNGOMA TEACHERS SACCO SOCIETY LTD	P.O. Box 1199 – 50200 BUNGOMA	19/12/2011
80.	SIAYA TEACHERS SACCO SOCIETY LTD	P.O. Box 605 – 40600 SIAYA	19/12/2011
81.	NAROK TEACHERS SACCO SOCIETY	P.O. Box 158 – 20500 NAROK	19/12/2011

	LTD		
82.	TRANS-NZOIA TEACHERS SACCO SOCIETY LTD	P.O. Box 2274 – 30200 KITALE	19/12/2011
83.	CHEMELIL SACCO SOCIETY LTD	P.O BOX 14 – 40112 AWASI	19/12/2011
84.	MURATA SACCO SOCIETY LTD	P.O. Box 816 – 10200 MURANG'A	19/12/2011
85.	AIRPORTS SACCO SOCIETY LTD	P.O. BOX 19001-00501 NAIROBI	19/12/2011
86.	NDOSHA SACCO SOCIETY LTD	P.O. BOX 532 – 60401 CHOGORIA-MAARA	19/12/2011
87.	SIRAJI SACCO SOCIETY LTD	P.O. BOX PRIVATE BAG,NANYUKI	19/12/2011
88.	CHUNA SACCO SOCIETY LTD	P.O BOX 30197-00100 NAIROBI	19/12/2011
89.	MERU MWALIMU SACCO SOCIETY LTD	P.O BOX 1694-60200 MERU	19/12/2011
90.	UKULIMA SACCO SOCIETY LTD	P.O BOX 44071-00100 NAIROBI	19/12/2011
91.	WANA-ANGA SACCO SOCIETY LTD	P.O BOX 34680-00100 NAIROBI	19/12/2011
92.	NYAMBENE ARIMI SACCO SOCIETY LTD	P.O BOX 493-60600 MAUA	19/12/2011
93.	NAKU SACCO SOCIETY LTD	P.O BOX 78355-00507 NAIROBI	19/12/2011
94.	WAUMINI SACCO SOCIETY LTD	P.O BOX 66121-00800 NAIROBI	19/12/2011
95.	THIKA DISTRICT TEACHERS SACCO SOCIETY LTD	P.O BOX 1842-01000 THIKA	19/12/2011
96.	MERU NORTH FARMERS SACCO SOCIETY LTD	P.O BOX 353-60600 MAUA	19/12/2011
97.	JIJENGE SACCO SOCIETY LTD	P.O. BOX 6222 – 01000 THIKA	22/12/2011
97.	FORTUNE SACCO SOCIETY LTD	P.O. BOX 559 – 10300 KERUGOYA	30/01/2012
99.	MARAKWET TEACHERS SACCO SOCIETY LTD	P.O. BOX 118 – 30705 KAPSOWAR	08/03/2012
100.	TEMBO SACCO SOCIETY LTD	P.O. BOX 91 – 00618 RUARAKA	08/03/2012
101.	SUKARI SACCO SOCIETY LTD	P.O. BOX 841 – 50102 MUMIAS	08/03/2012
102.	SOTICO SACCO LTD	P.O. BOX 959 – 20406 SOTIK	08/03/2012
103.	LENGO SACCO SOCIETY LTD	P.O. BOX 371 – 80200 MALINDI	16/03/2012
104.	IMENTI SACCO SOCIETY LTD	P.O. BOX 3192 – 60200 MERU	16/03/2012
105.	HAZINA SACCO SOCIETY LTD	P.O. BOX 59877 – 00200 NAIROBI	16/03/2012
106.	MARSABIT TEACHERS SACCO SOCIETY LTD	P.O. BOX 90 – 60500 MARSABIT	16/03/2012
107.	KENYA BANKERS SACCO SOCIETY LTD	P.O. BOX 73236 – 00200 NAIROBI	16/03/2012
108.	NTIMINYAKIRU SACCO SOCIETY LTD	P.O. BOX 3213 – 60200 MERU	16/03/2012
109.	WASHA SACCO SOCIETY LTD	P.O. BOX 83256 – 80100 MOMBASA	16/03/2012
110.	TAITA TAVETA TEACHERS SACCO SOCIETY LTD	P.O. BOX 1186 – 80304 WUNDANYI	16/03/2012

111.	NASSEFU SACCO SOCIETY LTD	P.O.BOX 43338 – 00100 NAIROBI	15/06/2012
112.	FUNDILIMA SACCO SOCIETY LTD	P.O.BOX 62000 – 00200 NAIROBI	15/06/2012
113.	MAISHA BORA SACCO SOCIETY LTD	P.O.BOX 30062 – 00100 NAIROBI	15/06/2012
114.	COUNTY SACCO SOCIETY LTD	P.O.BOX 21 – 60103 RUNYENJES	15/06/2012
115.	MUDETE FACTORY TEA GROWERS SACCO SOCIETY LTD	P.O.BOX 221 – 50104 KAKAMEGA	15/06/2012
116.	SAMBURU TRADERS SACCO SOCIETY LTD	P.O.BOX 271 – 20600 MARALAL	15/06/2012
117.	NAFAKA SACCO SOCIETY LTD	P.O.BOX 30586 – 00100 NAIROBI	15/06/2012
118.	BUSIA TESO TEACHERS SACCO SOCIETY LTD	P.O.BOX 448 – 50400 BUSIA	15/06/2012
119.	KENVERSITY SACCO SOCIETY LTD	P.O.BOX 10263 – 00100 NAIROBI	15/06/2012
120.	EGERTON SACCO SOCIETY LTD	P.O.BOX 178 – 20115 EGERTON	15/06/2012
121.	DIMKES SACCO SOCIETY LTD	P.O.BOX 886 – 00900 KIAMBU	15/06/2012
122.	MAGEREZA SACCO SOCIETY LTD	P.O.BOX 53131 – 00200 NAIROBI	15/06/2012