



Internal control activities and financial Performance: Evidence from the banking sector in Kenya

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Abstract

The effectiveness of internal audit functions has gained increasing attention due to their expanding role in risk management, governance, and operational efficiency. Despite reforms, many institutions, especially in developing countries, continue to underperform financially. In the period preceding the study, commercial banks in Kenya experienced erratic but declining growth in Profit Before Tax, with notable institutional failures highlighting weaknesses in internal controls and financial governance. This study aimed to investigate the relationship between internal control governance frameworks and the financial performance of commercial banks. The study examined internal audit practices in 11 NSE-listed banks in Kenya from 2013 to 2017. Data was sourced from CBK reports, with all targeted banks responding. The study confirmed data reliability using Cronbach's Alpha, with all values above 0.7. Results showed institutions with strong control environments had better financial performance, with a key emphasis on management commitment to control activities.

Key words: Control Environment, Internal Audit, Internal Governance, Commercial Banks.

Background to the study:

In recent years, there has been growing interest in the effectiveness of internal audit functions and the various factors influencing their performance. This interest has increased globally across both the public and private sectors, driven largely by the evolving and dynamic nature of internal audit roles. The expansion of internal audit's functional scope has enabled it to contribute significant value to the achievement of institutional objectives (Cohen & Sayag, 2010). However, a paradigm shift has occurred, moving internal audit beyond traditional focus on compliance testing, internal controls, and asset protection. Despite the expanded mandate of internal audit and the implementation of various reforms, many institutions across both sectors continue to underperform (Shamshuddin & Bharathii, 2014). As a result, the capacity of internal audit functions to deliver financially beneficial contributions toward institutional goal attainment remains undocumented in developing economies (Sakour & Laila, 2015).

The Financial Reporting Council in United Kingdom (2014) emphasized that internal management, risk governance, and corporate administration are more effective when supported by robust systems of checks and balances. An effective internal audit function, as noted by CIIA (2015) and Ackermann (2015), provides critical insights into these areas. Internal auditing plays a key role in promoting adherence to the principles of good governance, risk management, and internal controls in both public and private sector organizations (IIA, SA 2011).

Within the context of the internal auditor's operating environment, Tsai et al. (2017) sought to identify the core elements that define internal audit performance. Their findings highlighted the importance of implementing Enterprise Risk Management (ERM), integrating Enterprise Resource Planning (ERP) systems, developing comprehensive audit programs, and employing internal audit information systems (Abdulmunim, 2018).

Consequently, organizations audited by professional internal auditors are at a lower risk of collapse (Chae et al., 2020). Overall, different research concur that high-quality auditing is vital in shielding organizations from the risk of failure: A fundamental objective shared by all institutions.

Statement of the problem:

Since the 1990s, the implementation of various reforms has aimed to enhance the performance of organizations. These reforms primarily targeted financial stability, operational efficiency, and improved access to capital. However, despite these initiatives, the performance of Kenyan banks - measured in terms of growth in Profit Before Tax (PBT) has, over the past decade, fallen short by an average of 20%, and has remained erratic and below desired thresholds. In 2013, Kenyan commercial banks recorded a PBT growth of 16.6%, a decline from 20.6% in 2012 (Onuonga, 2014).

Lumumba (2015) argues that weaknesses in financial governance among Kenyan firms have contributed to flawed accounting practices, and inaccurate financial reporting. The collapse of institutions such as Chase Bank and Imperial Bank in 2015, as well as the earlier insolvency of Uchumi Supermarkets at a time when the global financial crisis of 2007 - 2009 reignited critical questions regarding the effectiveness of internal audit functions, both in terms of monitoring and enforcing internal controls, and in safeguarding economic integrity. This trend remain a concern, despite the numerous reforms introduced to revitalize the banking sector. In response, many banks embraced internal audit practices. Given the strategic role of internal audit as an integral component of risk management frameworks in major financial institutions - both private and public (Alzeban & Gwilliam, 2014), it becomes essential to assess its impact. This study, therefore, sought to investigate the relationship between organizational control frameworks and the financial outcomes of banking institutions.

Objective of the study

To examine the effect of the control environment on the financial performance of commercial banks listed on the Nairobi Securities Exchange. Specifically, the study sought to evaluate the influence of control activities; and independent internal audit function on the financial performance of commercial banks in Kenya.

Literature Review

This study was anchored on attribution theory, which explore how individuals interpret events and how these interpretations influence subsequent behavior. In organizational contexts, attribution theory offer a valuable lens for understanding how internal and external stakeholders assign causes to financial outcomes; whether successes or failures. The theory posits that when performance outcomes deviate from expectations, stakeholders often attribute such variances to controllable internal mechanisms, such as governance structures, risk management practices, and internal control systems. Thus, the design and efficacy of these internal systems, particularly the internal control framework, becomes critical in shaping perceptions of institutional credibility, accountability, and ultimately, financial performance.

Cohen and Sayag (2010) emphasized the evolving nature of internal auditing from a traditional compliance function to a strategic management tool capable of adding value to organizational objectives. The shift is particularly marked by an expansion in the scope of internal audit to include risk management, operational efficiency, and governance enhancement. Despite this evolution, organizational performance in developing countries, often fall short of expectations. Shamshuddin and Bharathii (2014) argue that even with internal audit reforms, institutions in both the public and private sectors continue to underperform. This concern was echoed by Alzeban and Gwilliam (2014), who contended that internal audit functions in developing nations are often marginalized, underfunded, and lacked adequate institutional support, thereby undermining their potential impact on financial performance. Sakour and Laila (2015) further highlight that internal audit functions in such contexts rarely translate into financially beneficial outcomes, primarily due to implementation and contextual challenges.

According to the Financial Reporting Council (UK, 2014), effective organizational governance, in relation to internal controls, depend on structured checks and balances. Similarly, CIIA (2015) and Ackermann (2015) posit that an effective internal audit function provided crucial insights into governance and control systems, thereby strengthening organizational resilience. IIA South Africa (2011) also support the view that internal audit functions serve as a pillar of good governance across both public and private institutions. Cited empirical work further clarified the components that underpinned effective internal audit performance. Tsai et al. (2017) identified several structural and operational factors, including well-defined audit programs, and the integration of audit-

focused information technologies. Abdulmunim (2018) corroborated this, arguing that integration of IT systems enhance audit quality, which is instrumental in safeguarding organizations against financial mismanagement. Chae et al. (2020) reinforced this by documenting organizations subjected to regular, professional audits, affirming they had financial discipline and transparency.

The Kenyan context present a compelling case for examining the link between internal control environment and financial performance. Lumumba (2015) attributed the collapse of several financial institutions, including Chase Bank and Imperial Bank in 2015, as well as the insolvency of Uchumi Supermarkets, to deficiencies in internal governance as internal audit failures, and misleading financial reporting. Similarly, Onuonga (2014) noted that despite numerous regulatory and structural reforms, commercial banks in Kenya had continued to report inconsistent and sub-optimal growth in Profit Before Tax (PBT), suggesting that deeper internal control inefficiencies may have persisted. The reviewed literature demonstrate a consistent link between internal control frameworks and organizational financial outcomes. However, the mixed results in empirical performance in developing countries; underscored the need for a more nuanced understanding of how specific components of internal control systems influenced financial performance. This study, therefore, sought to fill this gap by empirically examining the relationship between the control environment on the financial performance of commercial banks listed on the Nairobi Securities Exchange.

Research Methodology

The study involved NSE listed banks in Kenya that had transacted between 2013 and 2017. The focus of the study was the Internal audit department in these banks. The period was chosen to ensure consistency in comparison at the time of the research study. The data for the stated periods had been audited, published and were available to the public by the CBK annual supervisory reports.

Response rate

All targeted institutions participated in the study, thus rendering the response rate at 100%. The Cooperative Bank of Kenya had the highest representation while I&M Holdings had the lowest representation. There were 3 respondents from ABSA, which is 8.1% of the total representation. The respondents from the Cooperative Bank comprised 16.2% and were the highest in number, while I&M Holdings was the lowest representation with 2.7%. There was only one entry recorded for the bank. The participation was representative for use in drawing conclusions .

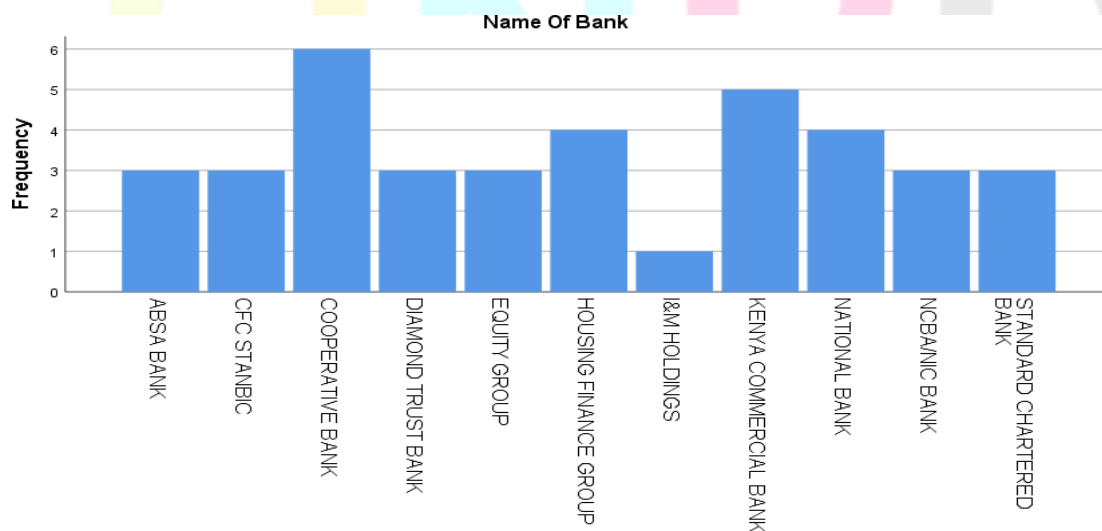


Figure 1: Study Respondents

Respondent's Control Characteristics

Respondents were asked to indicate the extent to which their organizations relied on different control activities as monitoring activities, information and communication systems, risk assessment, and adoption of fully controlled activities.. This is as presented in the table below:

Table 1: Criticality of activities

		Frequency	Percent	%
Valid	Monitoring activities	7	18.4	18.4
	Information and comm	16	42.1	42.1
	Risk assessment	12	31.6	31.6
	Control activities	3	7.9	7.9

Diagonistic tests results:

The study assumed linearity for the variables used hence, sufficient proof for linearity. the plotted PP plots to demonstrate this are as shown.

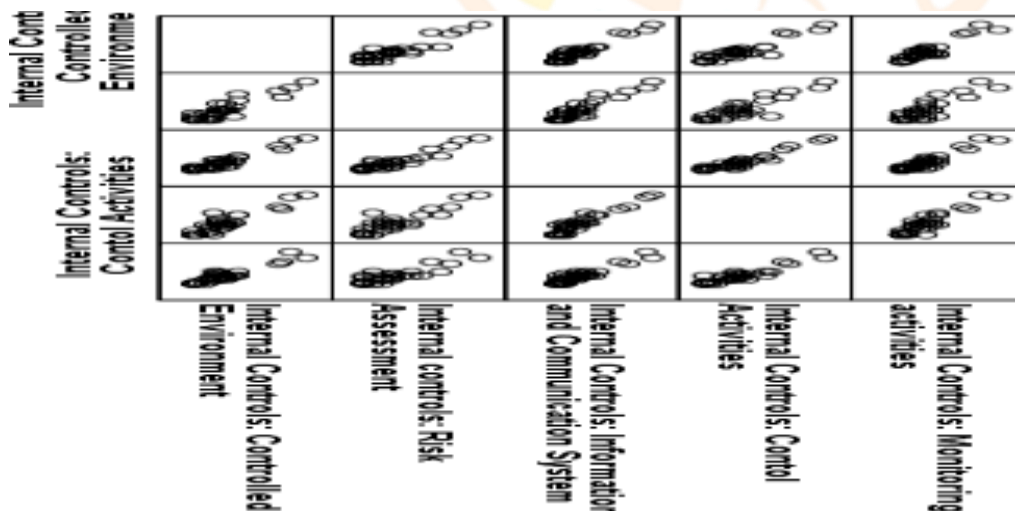


Figure 2: Scatter matrix for Internal Control Systems (ICS)

Reliability of findings

The findings above are supported by the Cronbach's Alpha values, which were all greater than 0.7; an indication of high-level reliability for the five elements used to measure the internal controls of the different banking institutions that participated in the study (Table 3).

Table 2: Reliability tests results

Factor	Cronbach's Alpha	No of items
Control assessment	.871	6
Risk assessment	.963	7
Information and communication systems	.940	3
Control activities	.963	7
Monitoring activities	.946	6

Internal Control measures

In evaluating the effect of internal control measures, the study considered the extent to which the efficacy of the auditors, promoting ethical practices, and the observance of operating standards were applied in the responding institutions. From the results, 55% indicated a great extent, 30% of the respondents indicated to a very great extent whereas 15% of the respondents indicated to a moderate extent.

Table 3: Effects of internal controls on financial performance

	Frequency	%
Very great extent	11.4	30
Great extent	20.9	55
Moderate extent	5.7	15
Total	38	100

The Findings indicated that organizations with a well-established environment with the capability to detect fraudulent activities reported better metrics for financial performance. Those that didn't have mechanisms to manage such occurrences recorded lower values for ROA and ROE, which were 2.95 and 19.45 respectively. Finally, organizations in which management exhibited a commitment to maintaining set standards and ascertaining proper function had a significant influence on the outcomes determining financial performance. In contrast, organizations demonstrating greater consideration to the establishment of proper control environment had enhanced outcomes. Higher correlations values were recorded for audit standards and audit-related services, which were 0.256 and 0.183 respectively. Auditor's added value after adherence to professional standards correlations were 0.045 and 0.079 respectively. The results are as shown in table 4 below:

Table 4: Correlations: Control activities

Indicators	Pearson Correlation	
Internal auditors reporting affects their quality of work and their contribution to the organization	-.034(.843)	-.005(.978)
Over-dependence on management for allocation of resources affects audit work	-.043(.802)	.015(.932)
Management expectations of the duties of Internal audit affect their objectivity	-.046(.787)	-.031(.856)
Internal audit report tracking is cost-effective and adds value to the organization	.028(.869)	.063(.710)
Organizational independence Internal audit function is crucial Internal audit function's effectiveness	-.079(.643)	-.045(.792)
Audit reports are given timely, and recommendations are implemented to arrest control lapses	.502**(.039)	.489**(.044)
Internal audit budgets, recruiting, firing, and pay are all decisions made by the bank's CEO and CFO.	-.162(.339)	-.103(.544)
	N	
	38	38

Conclusion:

The analyzed constructs had a significant role in determining the performance of the banks. This was attributed to their role in enhancing the efficacy the established operating standards. However, the presence of other external factors could not be ruled out given the scope of the study. The policy recommendations revolve around the establishment of enhanced control environment including the need for greater monitoring within the department to ensure that all actions occur according to the defined procedures. Finally, the need for enhanced awareness of the prudential regulations for improved functionality should be promoted.

Limitations of the Study

There was a challenge in obtaining the some information as the occurrence of the COVID-19 pandemic made it difficult to reach reach the respondents physically during the data collection process.

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