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Internal Audit Practices and Financial Performance of Savings and Credit Cooperatives in Kericho County, Kenya

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Abstract:
The declining performance in the SACCOs in terms of declining membership, increase in non-performing loans and low growth and returns, make it necessary to conduct the study. This study sought to establish the effect of internal audit practices on the financial performance of deposit taking SACCOs in Kericho County. The focus was on the internal audit practices including audit committees, internal auditor's independence, risk management and internal controls and their effect to financial performance. The study was anchored on agency theory, capture theory and contingency theory that were linked to the study variables. The study employed descriptive research design and targeted the five licensed deposit-taking SACCOs operating in Kericho and the respondents included only the staff holding management positions. Primary data was collected using questionnaires and the data was then entered into SPSS and analyzed using descriptive, correlation and regression analysis. The findings showed that internal audit practices significantly affected financial performance of the DT-SACCOs in Kericho County. Risk management had the strongest relationship (R=0.655), followed by internal controls (R=0.526), then audit committee (R=0.420) and lastly auditors' independence at (R=0.357). Further results showed that 47.4% of the changes in the financial performance of the deposit-taking SACCOs in Kericho County can be explained by changes internal audit practices. The study concluded that internal audit practices positively and significantly influenced the financial performance of the deposit-taking SACCOs in Kericho County. The study recommends the adoption of internal audit practices in firms that are seeking to improve their financial performance.

Keywords: *Internal audit, Risk management, Internal controls, Audit committee, Auditor's independence, Financial performance*

1. Introduction

The internal auditing to be an autonomous and objective oriented exercise which is intended to detect errors and increased the confidence that can be bestowed on the company information by the insiders and outsiders and in the process enhancing firm's performance. The practice received increasing demand from firms all over the world because of the need to institute an independent verification while trying to minimize errors in book keeping, reduce misappropriation of company assets and business frauds. Fausto (2010) established that, internal audit is well positioned to recognize and increase business progression of a firm while acting as financial performance consultants in reducing risks. The internal audit practice is a wide part of internal management. Several large firms across the globe have appreciated that, it is not possible to run business without being audited which has now been made as the central part of every organization.

Ali (2017)established that several variables that depict internal audit practice such as independence, internal standards set for the audits, internal controls for the audits and professional competence have significant influence on firm performance.Ahmad, Othman, Othman and Jusoff (2009) stated that Malaysian government employs two types of audit; the first is the external audit in which the responsibility rested with the auditor's general office and internal audits which are meant to ensure that, public organizations, strengthens there control and safeguard the assets of the their organizations and the internal audit precedes external auditing. Zhang, Zhou and Zhou (2007) discovered noteworthy relationship of the auditors' independence, audit committee, and internal control weaknesses and firm financial performance. Organizations are more prone to be linked with weaknesses in the internal control when the audit committees have little knowledge on accounting matters and auditors are not given sufficient independence. Stein (2019) revealed that the role of audit committee and board of directors was to provide oversight on the overall accounting process and set the ethical tone that should be followed by the members of an organization.

Ejoh and Ejom (2014) shared the inadequacy of internal audit staffs and influence by top management negatively affected their ability to execute their roles and institutions strictly adhere to budgetary control rule and procedure.Lyambiko (2015) noted that insolvency risks, credit risk and operation efficiency make it necessary to conduct internal audits as a way to improve financial performance of organizations. While Newman and Comfort (2018) concurred and stated that internal audit employed aspects such as independence; competence and support by management support

are the prerequisites aspect for a well-functioning internal audit function of an organization. Magara (2013) noted the value of internal controls in organizations and Bett (2014) talks of the quality of audit work, professional proficiency, career development, organizational and size as elements under the internal audit function. Marete (2014) on risk management shared that it was a prudent element and worked well to reduce risks and improve outcomes. Njiru (2016) and Ondieki (2013) linked internal control measures and financial performances.

Financial performance, according to Sitienei and Ronoh (2017) refers to the quality of services rendered, satisfaction of beneficiaries, organizational sustainability and ability to attract additional funding from donors. Organizational change led to improved level performance due to improvement in effectiveness and efficiency. It is also the degree upon which a firm uses its resources from primary mode of business to generate income. The measure may comprise of accounting based measure including return on assets (ROA), return on equity (ROE), accounting profits, earning per share (EPS), dividend pay-out and stock market based measures. Ganesan, Hwa, Jaaffar and Hashim (2017) argued that internal audit practice may lead to improved company financial performance through stern adherence to auditing best practices.

2. Statement of the Problem

Over the last few years, a number of SACCOs in Kenya have reported many cases of failures as a result of reasons not yet uncovered. For example, Ekeza SACCO shut down its operation in 2017 for reasons related to transparency and painted and negative view of the SACCOs. According to the report by SASRA (2017) the allowance for loan loss or indicator for non-performing loan in the SACCOs surpassed Kshs.10.7 Billion in 2017 indicating a rise of 23.4% from Kshs.8.6 Billion in the previous year. There is also a decline in SACCO membership declined by 1.35% in the same period. SACCO performanceis weakening rate based on growth in total assets, total deposits, and gross loans in 2017 which stood at 12.4%, 11.3% and 12% respectively, when juxtaposed to growth rates of 14.8%, 15.3%, and 14.8% respectively which was registered in 2016.

In order to acquire public confidence, SACCOs ought to be financially sound and paying its shareholders sufficient dividends from their investment. Deepening (2009) argued that performance of SACCOs is dependent on the management and the strength of corporate governance where the internal audit is integral to its function. Generally, SACCOs in Kenya have over the last number of years been facing a downward trend it there performance. A number of SACCOs have immensely reduced in performance paying little dividends to the shareholders while others have shut down there operations completely. This trend in the performance has made some of its members to disinvest from SACCOs. Yet the SACCOs in Kenya and all over the world play a key part in development of the nations. They have tremendously contributed to the economic growth of third world countries in the world. Odhiambo (2018) established that SACCOs have led to an enhanced growth of the economy through funding enterprises that their members for them to engage in various businesses which in turn will create employment generate revenue to the government through taxation and contributing to the country's exports.

These challenges facing the DT-SACCOs in Kenya and the scant knowledge on internal audit practices and financial performance of deposit SACCOs in Kenya, that pushed the researcher to conduct the study. The researcher sought to investigate the internal audit practices and financial performance of Savings and Credit Co-operatives in Kericho County

3. Objectives of the Study

The general objective of the study was to establish the effect of internal audit practices on financial performance of deposit taking savings and credit cooperative societies in Kericho County.

The specific objectives were:

- To assess the effect of audit committees on the financial performance of Savings on Credit Cooperatives in Kericho County
- To establish the effect of internal auditor's independence on financial performance of Savings and Credit Cooperatives in Kericho County
- To examine the effect of risk management on financial performance of Savings and Credit Cooperatives in Kericho County
- To analyze the effect of internal controls on financial performance of Savings and Credit Cooperatives in Kericho County

4. Theoretical Review

4.1. Agency Theory

This theory was established because of the connection that comes between one or more party called principals and another party who is referred to as to execute a task on behalf of the principal. It gives an overview of a relationship where one party is given a responsibility to act diligently on behave of another party; the two come together when one accept to act on behalf of the other and promise that the transactions that will take place benefits the party called principal, (Laffont&Martimort (2009). In this arrangement, on party (the principal) employs the other party (the agent) to discharge some responsibilities on the principal's behalf or to do a duty in which the principal, because of one reason or the other is not able to do it. For instance, in cooperative society arrangement, the shareholders assume the position of the principal whereas the cooperative management is entrusted with the responsibility of running the cooperatives and they are therefore referred to as the agent in which the principal hires to act on their behalf.

In dealing with the agency conflict, one best means is imposing an audit function within the organization (Laffont&Martimort, 2009). The audit department makes sure that management are checked on how they operate and whether they stick to the objective of the principals and other parties having interest in the organization; this theory is applied in the current study in order to give wider view on internal audit practice in the selected cooperatives in Kericho county. This research concentrated on internal audit practices where the following variables will be under consideration; internal controls, risk management, internal auditors' independence and audit committee. Agency theory therefore supports internal controls, audit committee and organizational performance.

4.2. Capture Theory

This theory was first advanced by George Stigler in 1963 who was a Nobel economist (Spiller, 1996). The theory demonstrates the process by which agencies regulating behavior of a particular industry ultimately becomes dominated by the same sector in which they were given the responsibility to regulate. This behavior happens at the time when regulatory agency, which was established to act in general interest, ultimately works in ways that benefits the industry in which it was expected to regulate, instead of the public interest. In the current study, capture theory is used to demonstrate why internal auditing function established to kame sure that management of cooperatives is regulated as well as the aims of the shareholders/members are safeguarded and every decision made is to the benefit of its members in consultation with all other stakeholders.

It is seen when the audit function in an organization is dependent and the avenue applied in reporting are not made favorable to internal audit reporting. The capture therefore makes the internal audit function not able to discharge its roles with competence and being effective and efficient, (Hutchinson & Zain, 2009). In this study, capture theory provided a summary of internal audit practices as adopted in the selected SACCOs. The study independent variable risk management and internal control are anchored on this theory.

4.3. Contingency Theory

The theory models the behavior of an organization. The theory was established by Max Weber and Taylor in 1958. It explains how factor situational like culture, technology and the environment in which an organization operates especially external one affects the plan and functioning of a firm. The main supposition of this theory is that, there is no single one type structure of an organization which is correspondingly appropriate to each and every organization. Instead, effectiveness of a firm depends on how fit an organization matches the technology type, volatility of environmental, the organizational size,organizational structure features and information system (Arslan& Karan, 2007).

This theory is applied to demonstrate the connection in between the setting and the internal audit structure as well as organizational performance, and is generally linked to the reliability of financial reporting of an entity. The need for internal control measures varies and it is according to the organizations characteristics. This concurs with the contingency theory that claims that every firm selects control system which is suitable and appropriate through the consideration of contingent features.

5. Conceptual Framework

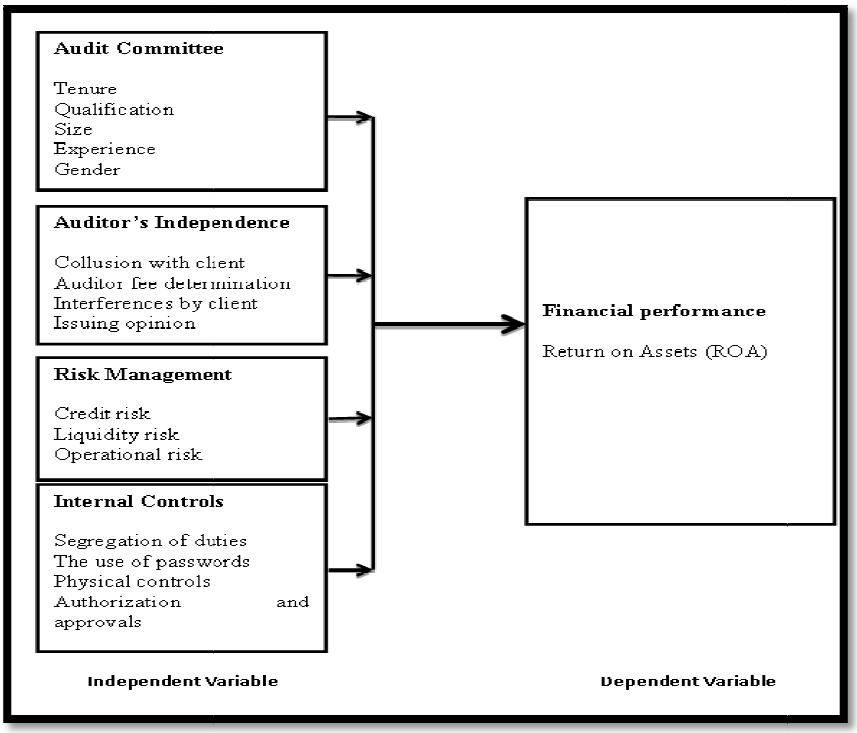

Figure 1

6. Research Methodology

This study adopted the use of descriptive research design and the target population for this study was all the five licensed deposit taking savings and credit cooperatives operating in Kericho County (Imarisha, Ndege Chai, Kenya Highlands, Simba Chai and Patnas SACCOs). The study's target respondents were the employees working in management level who included supervisory committee chairperson, the audit committee chairperson, internal audit manager, finance Manager and operations manager. Primary data sources were collected using semi-structured questionnaires that were first pilot tested to ensure they were valid and reliable. The researcher distributed the questionnaires to the selected participants of the study using a drop- and-pick basis to increase response rate. Once all the data was collected and entered into SPSS softwarefor analysis that was descriptive producing means frequencies and standard deviations. Inferential statistical analysis was carried out using correlation and regression analysis to show how the variables relate.

7. Research Results

7.1. Correlation Analysis

Pearson Correlation analysis was conducted to ascertain the relations between the independent and dependent study variables

		Financial Performance	Audit Committee	Auditors' Independence	Risk Management	Internal Controls
Financial Performance	Pearson Correlation	1				
	Sig. (2-tailed)					
	N	21				
Audit Committee	Pearson Correlation	.420	1			
	Sig. (2-tailed)	.005				
	N	21	21			
Auditors' Independence	Pearson Correlation	.357	.840**	1		
	Sig. (2-tailed)	.000	.000			
	N	21	21	21		
Risk Management	Pearson Correlation	.655**	.613**	.769**	1	
	Sig. (2-tailed)	.001	.003	.000		
	N	21	21	21	21	
Internal Controls	Pearson Correlation	.526*	.586**	.625**	.833**	1
	Sig. (2-tailed)	.014	.005	.002	.000	
	N	21	21	21	21	21
**. Correlation is significant at the 0.01 level (2-tailed).						
*. Correlation is significant at the 0.05 level (2-tailed).						

Table 1: Correlation Analysis Results

The correlation results indicate a positive and strong correlation between internal audit practices and financial performance of deposit-taking SACCOs in Kericho County. This is because of the r value of audit committee at .420 and p-value of 0.005; the auditor's independence had r value of .357 with p-values of 0.000; risk management had r value of .655 and p-values of 0.001 and internal controls had r value of .526 and p-values of 0.014. The results show that two aspects of internal audit practices (risk management and internal controls) were positively and significantly correlated to financial performance and audit committee and auditors' independence had positive but moderate effect to financial performance of the DT-SACCOs in Kericho County.

7.2. Multiple Regressions

Multiple regression analysis was conducted to determine the individual practices of internal audit had on dependent objective of financial performance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.761[a]	0.58	0.474	1.96504
a. Predictors: (Constant), Audit Committee, Auditor's Independence, Risk Management, Internal Controls				

Table 2: Model Summary

This is based on the adjusted R results and shows that 47.4% of the financial performance achieved by the deposit-taking SACCOs in Kericho County is due to internal audit practices of audit committee, auditor's independence, risk management and internal controls. The residual effect of 52.6% of financial performance is explained by factors that are outside the scope of this present study.

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	85.171	4	21.293	5.514	.006[b]
	Residual	61.782	16	3.861		
	Total	146.952	20			
a. Dependent Variable: Financial Performance						
b. Predictors: (Constant), Audit Committee, Auditor's Independence, Risk Management, Internal Controls						

Table 3: ANOVA

The Table 4.8 showed the ANOVA results at significance level of 0.05. The F calculated is at 5.514 which is greater than the F critical at 3.007 (5.514 > 3.007) an indication that the model is a good fit and can be applied in this study. The p-value is at 0.006 which is less than set standard of 0.05 and therefore implies that internal audit practices has a significant effect of financial performance of deposit-taking SACCOs in Kericho County.

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	10.383	3.327		3.120	.007
	Audit Committee	.366	.140	.598	2.614	.000
	Auditors' Independence	.226	.137	-.912	1.649	.030
	Risk Management	.960	.298	1.206	3.221	.005
	Internal Controls	.112	.133	-.259	.843	.012
a. Dependent Variable: Financial Performance						

Table 4: Regression Coefficient

The Resultant Equation:

$$Y = 10.383 + .366X_1 + .226X_2 + .960X_3 + .112X_4$$

The results indicate that when all aspects of internal audit practices are held constant then the financial performance of deposit-taking SACCOs in Kericho County will be at 10.383. All factors held constant a 1% change in the status of audit committees would lead to 0.366% change in thefinancial performance of deposit-taking SACCOs in Kericho County. Holding all factors constant and there is a 1% change in auditors' independence status will result on 0.226% change in financial performance for the deposit taking SACCOs within Kericho County. When all factors are held constant, a 1% change in status of risk management would lead to 0.960% change in financial performance of the SACCOs and a 1% change in internal control when all factors are held constant will lead to 0.112% change in thefinancial performance of deposit-taking SACCOs in Kericho County.

Further results on p-value indicate that audit committee had a significant effect on financial performance of deposit-taking SACCOs in Kericho County since the results are such 0.00 < 0.05. The study results are similar to the findings of Mulgan (2000) who noted that audit committee had significant effect onfinancial performance of SACCOS and Kimani (2006) also found that the role played by audit committees was critical to enhancing good performance in organizations. Stein (2003) established that internal audit committee members role was essential in ensuring transparency of the financial reports and the performance of the SACCOs. Maina (2016) found out that audit committees are charged with overseeing the process of financial reporting in SACCOS that work to improve its performance.

The p-value for auditors' independence is at 0.03 which is < the critical value of 0.05 indicating that it is statistically significant. Hence it can be concluded that auditor's independence does affect thefinancial performance of the DT- SACCOs in Kericho County. This is similar to what Zhang, *et al.*(2007) found out that more independence to the auditors and audit committee improves financial performance by reducing fault lines in the internal control function. At the same time, Baharud, *et al.*(2014) found a positive and noteworthy correlation that exists between independence and internal audit function. Further results shared by Wanyama (2018) found a significant effect that internal audit function had on financial performance of Rift valley bottlers. Contrary results to this were based on findings of Ejoh and Ejom (2014) who shared that internal audit staffs were inadequate and they were not independent in handling their roles because of influence by top managers of the organization.

Risk management had a significant effect to financial performance of these deposit-taking SACCOs based on p-value of 0.005 < 0.05. This is similar to the findings of Lyambiko (2015) who found that operational risks and insolvency risks had positive effect on financial performance. McConnel (2007) found out that abiding by the SACCO guidelines helped in managing risks such that the firms can meet their financial obligations. Musyoka (2008) shared that the management must curtail operations of SACCOs to prevent risks and ensure favorable capital adequacy, liquidity and asset quality ratios.

Internal controls significantly affected financial performance of deposit-taking SACCOs with p-values of 0.012 < 0.05. Similar results are found in the study by Magara (2013) who shared that internal controls were significantly correlated to financial performance of the Kenya DT- SACCOs. Similar results were shared by Marete (2014) who established a linear and significant effect that risk management and internal audit planning had on financial performance. Njiru (2016) found thatinternal control elements positively influenced financial performance of public water companies in Kenya. Ibrahim, *et al.* (2017) similarly revealed positive link of internal controls at health institutions in Ghana to their financial performance. Ondieki (2013) noted that the internal audit elements of professional competency, independence standards and internal controls led to improved financial performance of Kenyan commercial banks.

8. Conclusions

Financial performance in this study was measured through the use of return on assets (ROA). The ROA measures how effective the SACCOs use the assets available to them in enhancing the shareholder's returns from the investment made. It also looked at profitability in terms of margins from the SACCO products and services delivered to the markets and effective operations that realize higher returns. The ROA is an indication of financial leverage based on high profits made from the SACCOs assets.

The study concludes that audit committee enhanced the financial performance of the SACCOs. The study respondents revealed that having long tenures in the audit committee allowed members improve their skills and experiences to discharge their duties, hiring made on merit, having both genders in the committee, regular trainings and the audit committee directly communicating to shareholders resulted in improved financial performance.

The study also concludes that auditors' independence led to improvement of the financial returns for the SACCOs in Kericho County. The study participants noted that separating the audit functions and operational management of the SACCO, high degree of independence with no interference from clients or influence from top management resulted in improved financial performance. The policy guidance stating the audit functions, determining fee charged for services, staff remuneration and where there is constant review of the policies led to improved financial performance in the deposit-taking SACCOs in Kericho County.

Further conclusions were such that risk management and its elements resulted in enhanced financial outcomes for these DT-SACCOs in Kericho County. Risk management involved aspects including the guidelines and measures set to identify and assess any risks that threaten attainment of firm objectives, conducting analysis for firm risks and the response measures and assessing operational risks which led to improved financial performance. Risk management with elements like consideration for potential fraudulent cases and internal and external risk factors resulted in improved SACCO performance.

The study concluded that internal control aspects resulted in improved financial performance of these SACCOs. The study respondents noted that segregation of duties and use of passwords for employee access and frequently changing the passwords resulted in high financial performance. Other internal control measures like controlling organizational assets by getting authorization from the few identified individuals and using the assets for the benefit of the organization led to high financial performance of these deposit-taking SACCOs based in Kericho County.

9. Recommendations

The implication of this study's findings and conclusions is such that internal audit practice aspects of audit committee, internal auditor's independence, risk management and internal controls resulted in improved financial performance of these deposit-taking SACCOs in Kericho County. Therefore, this study recommends adoption and employed of internal audit practices to keep improving the SACCOs' financial performance. These SACCOs should adopt risk management aspects since it had the strongest link to financial performance. The risk management encompasses elements of operational risk, potential for fraud, internal and external risk factors and measures put for identification and assessment of these risks.

The study recommends the setting up of audit committee which improved financial performance but to a slight extent. The audit committee members should be hired on merit, receive regular trainings and include both genders for diversity. The tenure as audit committee members should be long-enough to gain more experience to discharge their duties. Further study recommendations are on auditors' independence where there is no interference from clients or influence from top leadership and separation of duties. There should be policies to guide audit functions and things like remunerations and fees charged to improve SACCO performance. The study also recommends on adoption and employment of internal control measures like segregation of duties, restricted access through using access passwords that are frequently changed. It also involves the management setting a system for control firm assets and obtaining authorization before use of assets and strictly using firm assets for its benefit.

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