

# **THE EFFECT OF INTERNAL CONTROLS ON FINANCIAL PERFORMANCE OF MICROFINANCE INSTITUTIONS IN KENYA**

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## **ABSTRACT**

This project is on effect of internal control system on financial performance of micro finance institutions in Kenya. The study used descriptive and diagnostic research design on a sample of 21 out of a population of 53 microfinance institutions with respondents being internal auditor, senior accountant and five other staff in accounting department. Stratified and simple random sampling techniques were used to select study sample. Primary qualitative data was gathered using questionnaires and structured interview was administered to employees of the institutions. The data was edited, recorded and analyzed in tables and charts. The study found out segregation of duties is positively related to financial performance. Through institution of stages in accounting process as well as internal check the study concluded there was effect on financial performance thus recommending proper handling of division of labour, job rotation and job description. Similarly authorization and approval of accounting transactions are directly related to financial performance. The study concluded number of people authorizing payments as well as signatories to bank accounts should be

limited as a control. Approval amount in the document go hand in hand with the position of the officer attending to the document. Thus the study recommended relevant training to the staff and sufficient provision of policies and procedure manuals. Internal audit functions improved financial performance especially operational and financial review. The study concluded in reviewing financial reports auditors must familiarize themselves with relevant policies and procedure manuals. It therefore recommended application of audit plans, relevant international auditing and accounting standards while adhering to professional ethics. Further vouching positively affects financial statements. The study concluded officers do thorough enquiries, review support documents, account history of the clients hence recommending training of officers and processing at central point. Additionally the study highlights areas for further research as other institutions besides MFIs' especially for comparison.

**Key Words:** *internal controls, financial performance, microfinance institutions, Kenya*

## **INTRODUCTION**

Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of a firm's objectives in the effectiveness and efficiency of operations, reliability of financial and management reporting, compliance with applicable laws, regulations and protect the organization's reputation (Kaplan, 2008). There are many controls that an MFI can institute to protect its resources against loss to improve performance. A collection of internal controls put in place by the MFI is what forms internal control system (ICS). An internal control is a topic that cuts across a number of disciplines including financial accounting and auditing. It can be traced back to ancient times. In Hellenistic Egypt there was dual administration where one side was involved in collation of taxes while the other supervising them. Sacking of Troy was

one of the examples of weaknesses of internal controls. Internal controls became apparent at the beginning of 21<sup>st</sup> century following major corporate scandals (PABC 2006).

From that time many efforts have been made to streamline corporate governance which in turn guarantees accountability and security of resources. Notable regulations are Sarbanes-Oxley Act of 2002(SOX), Committee of sponsoring organization of the Tread way Commission (COSO 2004), Internal Control Integrated Framework (ICIF March 2013) among others. The widespread accounting scandals that have been witnessed in both public and private sectors have informed this study. Cases of Enron and WorldCom in the U.S.A. Parmalat in Europe and ChuoAoyama in Asia. In Zimbabwe between December 31 2003 and December 31 2004 out of 40 registered financial institutions 29 collapsed representing 27.5 % decline in registered financial institutions. In Nigeria the managing director and the chief finance officer of Cadbury Nigeria plc were dismissed in 2006 for exaggerating profits of the company for several financial years before the company's foreign partner acquired controlling interest.

In Kenya the giant Uchumi supermarket went under in June 2006 due to insolvency and it securities stopped trading at Nairobi stock exchange (N.S.E). It is until the Government of Kenya injected some amount to bail it out of the liquidity trap. The most apparent incident is the fall of two commercial banks in a span of less than five months. Fall of Dubai bank in 14<sup>th</sup> August, 2015 followed by Imperial bank in 13<sup>th</sup> October, 2015. The reason cited in the case of Dubai bank was serious liquidity and capital deficiencies that may render inability to meet financial obligations as and when they fall due. In the case of Imperial bank the CBK reported unsafe or unsound business conditions where the appointed Kenya Deposit Insurance Corporation (KDIC) will manage it for 12 months while investigating inappropriate banking practices. Serious ramifications followed when customers could not get back their deposits, numerous jobs were lost and many creditors could not be easily paid. This happened despite both banks being under supervision of the CBK.

It is imperative for MFI to set up proper systems and controls to guarantee responsibility and accountability (Sarbanes-Oxley Act of 2002). MFI's leadership is responsible for designing systems and internal controls which guide all staff while working. Every MFI designs system that will suit its operational structure therefore ICS varies with different MFI's. Under control policies and procedures MFI can institute vision of the organization, mission statement and core values, departmentalization, decentralization of work among others. The internal control environment is a culture modeled by control policies and procedures and control activities. Under internal control environment MFI can institute integrity and ethical issues, commitment to competence, leadership philosophy, operating style (Hammersley et al 2007) among others. Control activities are the wide range of activities practiced at the middle and low level. Some of those activities include authorization and approvals; segregation of duties and internal audit. Confirmation, reviewing, verification, internal check, observation, analytical review, summation, vouching, reconciliation and other activities that provide more assurance are operations that accompany control activities.

Stone (2003) defines financial performance as the ability to operate efficiently, profitably, survive, grow and react to the environmental opportunities and threats. Financial performance shows level of performance over a specified period of time, expressed in terms of overall profits and losses during that time. These results are reflected in the firms return on investment, return on assets, return on equity and value added. The study will use ROA as dependent variable to establish the effect of internal controls on financial performance of MFI's in Kenya.

Microfinance institutions are financial institutions that provide mode of finance designed to provide low income individuals with the means to become self-sufficient. A microfinance institution issue small loans to those marginalized from normal modes of finance with the intention of helping the poor prosper by allowing them to save or borrow money (Campbell R. Harvey 2012). They earn financial revenue from loans and other financial services in form of interest, fees, penalties and commissions. Financial revenue also includes income from other financial assets, such as investment income. An MFI's financial activities also generate various expenses, from general operating expenses and the cost of borrowing to provisioning for the potential loss from defaulted loans.

The main aim of microfinance in Kenya was and is to address poverty. From 1980 to 2000, NGO's and multinational agencies were behind many MFI's. They were co-financing agencies. The co-financing agencies were concerned with alleviation of poverty and creation of employment as well as increasing income for the poor. They were also concerned with improving social capabilities availability and access to resources and participation in decision making.

Lending by microfinance is either group or individual based or minimalist verses intergraded approach. Group based which take the form of Grameen Model is common. Also unregistered shylocks lend at very high interest rates. Interest rates charged by specialized microfinance institutions are monthly which reflect that they are low but are actually higher than commercial banks. Group guarantee schemes have become inconvenience because each wants to plan his finances and create fear of default among members. Savings of the members become security and sometimes conditions like group registration is a requirement and that the group members must be operating businesses.

Central Bank of Kenya broadly divides the microfinance institutions into deposit-taking and non-deposit-taking microfinance institutions. The deposit-taking microfinance institutions (DTMs) are licensed and regulated by the CBK and are permitted to mobilize and intermediate (or lend) deposits from the public. However unlike commercial banks, DTM's can only engage in a limited range of products. They are not allowed to invest in enterprise capital; undertake retail or wholesale trade; underwrite place of securities; and purchase. On the other hand, non-deposit-taking microfinance institutions are regulated by the ministry of Finance, and are not allowed to mobilize public funds. Thus, they can only lend their own funds or borrowed funds.

The country recently encouraged the regulator to formulate a regulatory system for microfinance through mandated standards of performance that assist the financial sector in moving from a less-regulated to a tightly-regulated one. Kenyan microfinance sector is quite unlike the formal banking sector or like other microfinance sectors in the neighboring countries. In Kenya the sector is regulated and supervised under different jurisdictions and laws. These are banking law and the Microfinance Act, which was issued in 2006 and emended in 2013. Hence the Microfinance Act 2006 and the Central Bank of Kenya Act primarily govern the industry.

The main objective of the Microfinance Act is to provide the legal, regulatory and the supervisory framework for the Deposit-Taking Microfinance Institutions (DTM's). The Act categorizes the Deposit-Taking MFI's as nationwide MFI's with a minimum core capital of Kshs 60 million and community MFI's operating within a specific administrative region whose minimum core capital is Kshs 20 million. The Act makes provisions for MFI license issuance, revocation, and restriction; provides MFI entry into regulated status; defines the minimum core capital requirement and prohibited activities; provides limit for loans and credit activities; defines ownership and management structure; provides for supervision by the CBK; and stipulates the terms for periodic reporting to the CBK.

## **STATEMENT OF THE PROBLEM**

The efficacy of internal control system on financial performance is paramount in every organization. This is because internal controls ensure prevention and detection of errors and frauds. The firm's economic assets generate income which abets growth and sustainability. It is imperative for MFI's to establish water tight controls if at all it is to achieve improved financial performance.

In his study Moraa Ondieki (2003) found out that internal controls can have features built into them to ensure that fraudulent transactions are flagged or made difficult if not possible to transact. Setting of internal controls will involve costs and delays in the accounting cycle. Albeit internal controls have numerous benefits excessive of these can procrastinate growth and development. On the other hand in adequate internal controls have led to corruption and collusion leading to organizations failing to achieve their set objectives. Procasur Africa report (2012) stated that poor control systems has led to huge investment loss through fraud and misuse of assets that are used to generate revenue while members and institutions have suffered big losses. Appropriate internal controls facilitate growth and allows expansion in to new areas. Effective internal controls should enable MFI to tap new businesses whilst safeguarding the already existing portfolio. Therefore MFI should strike a balance between internal controls and efficiency in operations.

The management of the organization should meet regularly to review the affairs of the firm and direct strategic path of the firm and also ensure continued goal congruence (Reid & Smith, 2000). Internal controls check the governance of MFI's to achieve profitability (Cha 2009; Cheng 2007) growth and development. Microfinance Institutions are prone to risks that are life threatening to the existence and sustainability. Operational and strategic risks are of non-financial character and result mainly from human error, frauds, system failure, through

regulatory environment (COSO 2004) however when they materialize they lead to financial losses for the organization. A number of MFI's face collapse or near collapse if they are unable to set up internal controls (COSO 2004). Therefore the study explores the effects of internal controls on financial performance.

## **GENERAL OBJECTIVE**

The general objective of the study will be to establish the effect of internal controls on financial performance of MFI's in Kenya.

## **SPECIFIC OBJECTIVES**

1. To find out the effect of segregation of duties on financial performance of MFI's in Kenya.
2. To find out the effect of vouching on financial performance of MFI's in Kenya.
3. To establish the effect of authorization and approvals of accounting transactions on financial performance of MFI's in Kenya.
4. To establish the effect of internal audit functions on financial performance of MFI's in Kenya.

## **THEORETICAL REVIEW**

### **Agency theory**

This theory was postulated by Alchian and Demsetz(2002) and later developed by Jensen and Meckling (2006).According to Bhimani (2008) it was basically introduced to separate ownership and control of an organization. In it context the principal denote the owners of the organization whilst agents are the people whom the owners charge with the responsibility of managing their organization (Clarke 2004). Agents therefore run the business on behalf of the owners (Clarke 2004). They make the decisions aimed at increasing shareholders wealth. They prepare statements for the shareholders to see financial performance and position of their organization. For this reason the theory advocates for congruency between goals of the agents and those of principals (Jensen and Meckling 2006). Conversely this rarely happens as the agents pursue their personal interest (Padilla 2000). They indulge in risky and high returns projects not minding the corporate image as long as they get fixed wage. In view of agency theory employees are more self-interested, individualistic and are bounded rationality where rewards and punishments seem to take priority (Jensen & Meckling, 2006). This creates conflict of interest between them and principals who are their employers. A good example was revelations by Adam Smith in 18<sup>th</sup> century which was later explored by Ross (2003). This problem of separation between ownership and control has also been confirmed by Davis, et al(1997). The owners through the board of directors need to monitor the activities of the managers by demanding accountability (BBVA Microfinance Foundation, 2011b). Through policy formulation the directors need to develop strong controls and governance mechanisms (Donaldson & Davis 1991; Heenetigala, 2011). Employees are held accountable for their responsibilities and therefore they should be part of good governance structures themselves as opposed to providing the need of shareholders.



The membership of the board of directors varies across the MFI's albeit most of them have non-executive directors and executive director who doubles up as CEO and secretary to the board. Within principal agent setting, CEO's use their own power to make the decision that are less in line with desires of principal (the shareholders in case of for-profit MFI's and stakeholders in case of not-for-profit MFI's). More powerful CEO's can decide to take severe decisions since they leverage from them or take less severe to reduce the risk of bad performance. According to agency theory, when the chairperson of MFI assumes the role of CEO, that is acting as a decision maker and as supervisor, the function of the board to minimize agency costs could weaken further: ultimately corporate performance goes down (Wu, Lin, & Lai, 2009). The directors will ensure Microfinance mission is accomplished whether it has financial benefit or not unlike the agents who are profit minded. Agency theorists suggest that broad and diverse board of directors is a better monitor of managers since diversity enhances independence (Kusyk & Lozano, 2007; Chhaochharaia & Grintesin 2007).

Despite its contribution to the finance and accounting field the theory is castigated on a number of weaknesses. For instance it assumes absolute contracting which is not possible. This is because there are information asymmetries, transaction costs and fraud which are obstacles to efficient contracting (Brennan, 2010). Similarly the theory does not ratify management and director's prowess. Brennan (2010) argues that the agency theory may be suitable for monitoring of managers, role of boards, but does not explain the other board chores.

### **Stewardship Theory**

According to Davis et al (1997) stewardship theory postulate that a steward protects and maximizes shareholder's wealth through firm performance, because by so doing, the stewards utility functions are maximized. A steward compares with the agent in the agency theory, where he is entrusted with the running of the business on behalf of the owner. He prepares the statements to show financial performance and position. He makes the decisions in managing the business to protect the interest of the owner. The sharp contrast between the two theories is on the perception and attitude towards the job. In agency theory, an agent is solely aimed at financial benefits from the organization whereas in stewardship theory a steward derives motivation from his achievement. Unlike in agency theory where agent is viewed as opportunist, a steward is cognizant of the owners' interest in running of the business (Donaldson and Davis 1991). He aligns himself with the organization (Donaldson and Davis 1991) hence his passion is when the organization achieves the objectives. His goals are similar to that of the principal since his aspirations are big, he is motivated to do the good work and takes good care of the corporate assets (Brennan, 2010; Donaldson & Davis, 1991; Aras & Crowther, 2007)

Stewardship theory proposes establishment of the structures that will empower the steward to work independently. He does not require supervision or close monitoring (Donaldson and Davis 1991). Similarly the board of directors of MFI underpin stewardship by granting the steward unlimited authority to run the organization. This reduces the costs that organization

would have incurred while monitoring and controlling the organization (Davis et al 1997). This is a good strategy to optimize the profit for the organization. In so doing the stewards concurrently guarantee prosperity of the organization while protecting their position in the organization. Fama (1998) asserts that executives and directors are also managing their careers so as to be seen as effective stewards of their organization, while Shleifer and Vishny(1997) insists that managers return finance to investors to establish good reputation so as to re-enter the market of future finance.

### **Stakeholders' theory**

This theory strives to meet the interests of different stakeholders of the organization (Freeman 1996). Stakeholders have been defined as any group or individual who can affect or is affected by the achievement of organization goals. According to Leonardi (2011) enterprises implement stakeholder management practices in order to meet expectations of their stakeholders. The MFI board of directors is the highest body responsible for devising policies aimed at taking care of interests of different stake holders (Freeman 1996). In so doing there is no interest assumed to dominate the other. This is because every stakeholder contributes in a different way towards attainment of the organization goals. The wealth created by MFI's is believed to have been contributed voluntarily or involuntarily by population interacting with the MFI. An efficient MFI board that is efficient generates maximum reward for all its stakeholders including financiers, suppliers, employees, customers and other parties affected by institutions' activities (BBVA Microfinance Foundation 2011b). There is an accounting document called Value Added Statement (VAS) prepared by the management to show value added in a particular year is shared out among various stakeholders. A good illustration is the improvement of the society around the organization through corporate social responsibility (CSR)programmes. Jensen (2006), Ayuso and Argandona (2007) asserts that the main object of social responsibility is to create value for stakeholders and fulfill responsibility towards them. Further Mori and Munisi (2009) have given reasons why the organization should concern itself with meeting the interest of different stakeholders. One is that it can be considered that they have intrinsic needs so that MFI meet their legitimate claims. Two is giving back to stakeholders who have contributed in generating profitability.

The major difference between the stakeholders' theory and stewardship theory is that whereas the steward is entrusted with the organization by the principal, the management is viewed as stakeholders who participate in sharing out of the value added. This is vividly manifested in the VAS as payments towards staff inform of salaries and allowances. Clarkson (1995) suggested that the firm is a system; where there are stakeholders and its purpose is to create wealth for its stakeholders. Donaldson and Preston (1995) put it that all groups take part in a business to obtain benefits. The agency theory only recognizes agency and principal in employee-employer relationship whilst stakeholder theory expands the purview of the stakeholders. Instead of agent endeavoring to meet the interests of the principal, he endeavors to meet the interest of all stakeholders that the organization have. Sundaram and Inkpen (2004) argued that stakeholder theory attempts to address the group of stakeholders deserving attention of the management.



The problem with stakeholder's theory is conflicting objectives. The management find themselves sacrificing the interest of some stakeholders to meet interests of others. For example participation in social programmes reduces the whencewal for equity owners. The less the corporate tax paid by the MFI to the Government the more the tax reported in the financial statements but the requirement is tax should be paid in full. This conflict of interests may result in politics which deteriorate organization performance. They need to address this interest fairly before it degenerate into politics (Elbanna 2006). One of the remedies to this problem is balanced power where the decision maker is powerful with clear purview of responsibilities

### **The Management Control Theory**

The management control theory as postulated by Otley (2004) creates unity of purpose between the management and junior staff. The management sets out control mechanisms aimed at creating synergy among staff in realization of the main objectives as anchored in the mission charter of the organization. According to Otley (2004) management control is a means of distribution by the organization to elicit the performance it needs and to check whether the levels of such performances are in accordance with organizational specifications. The management comes up with departments for ease in tracking daily occurrences; hierarchy in form of pyramid is instituted so that information is quickly relied at the top for decision making. The managers coordinate work activities and sub units through systematic rules and procedures (Whright 1999).

According to Whright (1999) the theory ratifies the three elements as controller, controlled and the method of control. The controller represents the top administrative group responsible for making decisions. The controlled is the activities that must be subjected to a controlled output or the behavior with the set rules. With this set up, organization goals are accomplished with minimum use of resources as it organizational effectiveness and congruency of individual and organization goals (Anthony and Govindarajan 1995). It also abet the employees to make decisions and take actions which are in the best interest of the organization (Chow,Shields and Wu 1999).

## **EMPIRICAL REVIEW**

### **Segregation of duties**

In MFI set up accounting processes should be done to completion by separate individuals. This is so important that the research into internal controls and external auditor's judgments' has indicated that the assessment of separation of duties is a dominating factor in an auditors' evaluation of internal control structure (Ashton, 2004; Ashton and Brown, 1998; Hamilton and Wright, 2002). No single individual should have control over all phases of transaction; ideally the incompatible functional responsibilities of initiating transaction, custody of assets and record keeping should be responsibility of separate individuals. Duties are considered incompatible if a single person can carry out and conceal errors in the course of day to day activities.

The accounting department is organized in to different sections which carry out specific tasks despite the fact that all the accountants have expertise to do all functions in the department. Segregation of duties is specifically cited as a control activity in the COSO framework (COSO 2004), PCAOB Audit Standard No.5 (PCAOB, 2007) and in auditing standard AU 414 (AICPA, 2006). Before the next person performs his part he reviews what has previously been done, it is after ascertaining correctness that he proceeds with his part. This concept is referred to as internal check in auditing field. However the staff should be very independent to ensure responsibility and accountability. Ferrilo, Gilbert and Lynch 1992 noted that separation of related duties is used in deterring fraud within financial systems which is a contributing factor to profitability. The stakeholders' theory support segregation of duties since this initiative addresses interest of various stakeholders.

Segregation of duties however faces challenges particularly in small MFI's since it requires adequate staff. Gramling et al. (2010) found that in 2008, a majority of smaller firms with material weaknesses in internal control reported one or more SoD weaknesses. There could also be instances of collusion among staff in the system especially if the number is not big. Theoretical research addressing SoD (Tirole 1996) has used agency theory to focus on collusion. In the accounting process the accountants deployed in various sections are supposed to be objective and independent for the ICS to work.

There are subsequent stages through which a document passes before money is realized (Ashton 2004). This accounting process will vary from one MFI to another. The more these stages are the more they demand more staffers and the more the system is water tight. Chances of misappropriation are lower as the document is reviewed by more people (Tirole 1996). There is humble time to detect possible errors and fraud. On the part of accountability many stages improve the performance of the organization.

Availability of staff or otherwise may render segregation of duties either successful or unsuccessful. In a strong system different officers perform different accounting tasks in the accounting process (COSO 2004). This precludes one person to initiate payment and pay him or herself. The number of the staff in relation to segregation of the duties is a conflicting factor since more staff to do different chores is additional cost to the MFI; on the other hand few staff will make one person to do many tasks (Stone 2009). Therefore management needs to strike a balance between number of staff and extent of segregation of duties.

Volume of work is another consideration which is critical in segregation of duties. The number of transactions handled on daily basis will determine the extent of segregation of duties (COSO 1994). When transactions are much documentation in terms of physical and or electronic records is much. If this is handled by few people they may be overwhelmed by workload increasing the chances of oversight in some documents (Ferrilo, Gilbert and Lynch 1992). There is little time devoted on each document hence thorough scrutiny is not possible. People with ill motives may take advantage of the situation and misappropriate funds. Therefore the more the transactions, the further the segregation should be.

Where transactions are more the system should be bolstered by internal check. This involves reviewing the work done by previous officers who have attended the accounting document to ensure it is correct before subsequent officer does his or her part (Hamilton and Wright 1999). If the document has errors it is reverted back for correction. It is only after correction that it is acted upon and advances to the next level. The theories relevant to segregation of duties and its aspects are agency theory, stewardship theory and stakeholders theory.

### **Vouching**

Vouching is examination of the particulars contained in a document to justify correctness and flush out errors if any before acting on it to proceed to the next stage. According to COSO (2004) vouching is a technical term, which refers to the inspection of documentary evidence supporting and substantiating a transaction, by an auditor. It further asserts success of an audit depends on the thoroughness with which vouching is done hence simple routine checking cannot establish the same accuracy that vouching can. The particulars contained in a document determine action to be taken on that document. Depending on the particulars contained, documents can be treated differently. The officer vouching document should not only look at the details contained but also think about what might be missing from the document (Bonner, et al 2006).

There are support documents which should accompany a payment voucher. The support documents vary depending with the type of transaction being handled. In the case of acquisition of assets various stages in acquisition process should be supported by respective documents (Wallace 2003). Where possible the attachments should not be limited to documents which awarded tender to the supplier, delivery notes, goods acknowledgement note, certificate of inspection that goods were in good condition and invoices.

According to Johnson and Kaplan (2001) attaching support documents will enable the officer attending to the document satisfy himself that the process was authentic. It is after this assurance that the accounting document should advance to the next level of processing. All the support documents have reference numbers which should tally with the ones captured in the payment voucher. Dates on the support documents are very important since they reveal when activity took place. It can also reveal whether the activity being handled belong to current financial year or previous.

The officer vouching a document will also find out whether the process conformed to what is provided for in the policies of the MFI. Contravention of the MFI policies especially procurement procedures may not ensure fairness, good quality and economy which is essential and more so can elicit queries from the auditors. For the vouching to produce expected results in deterring errors and fraud (Turner 2007) the officer involved should possess rich work experience and at the same time apply professional skills. Libby and Tan (2004) put it that consultation from other officers especially when the officer attending to the accounting document was not involved in that process is very important. In some instances the payment voucher may have all necessary support documents and appear to be genuine but still there are parties with intention to defraud the MFI. For this reason the officer vouching the document can enhance consultation and transcend the vouching exercise to physical

verification of the items delivered. This is very important to deter cases of collusion among players in the process.

Where customer account is active there should be history before processing the payment to ensure the officer is properly informed while attending to the document. All correspondences and undertaking concerning a particular customer should be filed in his file (Walo 2005). This abets in enhancing audit trail and also the voucher can move along with the file. All the documents including credit notes and debit notes should be filed since in one way or the other they will affect the customer account. When the customer is repaying loan his portfolio should be handled at central point. This is important since even a new officer will be able to follow the history. According to Entwistle and Lindsay (2004). Careful vouching is paramount since it checks loss of MFI resources as a result of errors and fraud, negligence or omission.

### **Authorization and approval of accounting transactions**

The scope and volume of MFI preclude the owners from authorizing every activity or product in the organization forcing them to hire managers to do that work. This work is essentially done by somebody who is hierarchical superior or in a different organization subgroup. Authorization by peers can also work only that it is marred by some influences. The agency theory support this set up as the agents consider their interest prior to equity owners. Authorizer should not be involved in the custody of the duty they are authorizing to ensure independence. Carmichael 1999 and Tirole 1996 emphasized the importance of authorizer independence to the reporting of the inappropriate transactions. The number of authorizers should be limited to minimize risk of theft or loss associated with numerous sources of authority. Authorization instills discipline for responsibility and accountability in achieving profitability objective.

Where more than one person are authorizing, their specimen signatures should be noted for acceptance throughout the MFI. Most MFI's have organized their procedures such that materiality of the amounts determines the seniority of the officer authorizing especially with loan amounts. Others have increased the number of authorizers to boost the objectivity and security of the amount involved. Segregation of custody and authorization can operate in a preventive or detective manner. Once the manager discerns irregularity in the transaction that has been brought for authorizing he revert it back for correction or reject it altogether. Firms often find that a preventive approach is more cost effective (Protiviti 2007).

Officers have variant responsibilities depending with a particular MFI and position held along the organization structure (Carmichael 1999). The responsibilities partaken in a particular level define the position occupied by the appropriate officer. MFI's have given their officers different levels in terms of approving payments and advancing loans (Protiviti 2007). This system is based on the order of seniority of the officers such that senior officers approve cheques bearing bigger amounts relative to junior officers. There is a sealing for every position such that the holder of that particular position cannot approve cheques more than the sealing put.

A pragmatic example is when in an establishment of senior accountant, principal accountant and chief accountant, the senior accountant approve all cheques worth twenty thousand and below, principal accountant approves cheques above twenty thousand but below fifty thousand whilst chief accountant approves the ones above fifty thousand. This order ensures senior officers bear bigger responsibilities interdem with their position (Tirole 1996). Albeit cheques with higher values are few they carry with them bigger risk and therefore officers need humble time to interrogate them. This order is very common among almost all the MFI's for the benefit it has towards curbing absurd approvals and authorization.

Accounting documents pass through subsequent stages before money is released to the suppliers (COSO 1994). Clearance from the previous stage is a prerequisite to advance in the next level. Among the stages that the document passes through is approval. This is a reserve of the senior officer where the document is cleared for payments. Depending with the availability of the staff MFI can have more than one authorizers so that when one is not present the document can be attended by alternate officer (Wright 2002).

The position of the approving officer can be occupied by the person who has risen along the ranks or outsourced. This position requires somebody who has professional knowhow and experience to work with the system (COSO 2004). Albeit somebody from outside has an independent approach towards work, a person who have grown in the system has more experience and therefore understands it better. The position is cognizance to the fact that the holder needs to have in depth knowledge of the MFI policies including ones touching on human resource aspects (Donaldson and Werhane 2003). That is why some MFI's have position by the name finance and administration manager who cuts across finance and administration departments (Tirole 2009).

This is an important control exercised by the MFI's across the country. It is destined to ensure objectivity in reviewing payments (COSO 2004). It ensures each of the officer's check the authenticity of the payment notwithstanding the fact that it has been attended by other signatories. It is hard for one officer to pass payment single handedly (COSO 2002). This control is also boosted by the mandates given to the bank for transacting the accounts. An MFI can give conditionality after appointing signatories as all to sign, some to sign or mandatory signatories. The agency theory, stewardship theory and management control theories are relevant to authorization and approval of accounting transactions and aspects surrounding it.

### **Internal audit function**

Audit refer to independent examination of financial statements to see whether they portray a true and fair view of company state of affairs and as to whether books of account and vouchers are kept according to company's Act. It is a management control that delves other controls to ensure achievement of profitability. In the audit scope MFI can institute internal auditing, external auditing and even audit committee at the higher level. Standards for the professional practice of internal auditing which are issued by Institute of internal auditors (I.I.A) define internal auditing as an independent evaluation function in an organization which examines and evaluates an organization activity and provides services to the

organization. It is part of the management and it help to advise the management besides detecting errors and fraud. Additionally internal auditors and the audited activities should be independent of each other (DeMarco 2000). Most of big MFI's have fully fledged internal audit department and therefore issues of transactions irregularities are addressed on time.

The work of internal auditors can be evaluated by external auditors (De Lomba 2000). In so doing they can rely on work of internal auditors or otherwise. Mostly if the internal auditors are given considerable independence and establishment comprise of very knowledgeable and experienced staff then external auditor can rely on their work. For MFI's that are registered with the NSE auditing by public external auditor is a requirement in law. External auditors report their findings to the shareholders in an AGM while internal auditors advise the management on the areas with weakness in the accounting system. A comprehensive approach of internal audit looks at a number of areas. Some of these areas explored are operations review, financial review and compliance review.

Operational review is critical review of the operating processes and procedures that mitigate area specific risks (DeMarco, 2000). These reviews examine the use of resources to determine if they are being used in the most effective and efficient manner to fulfill the MFI's mission and objectives (De Lomba 2000). It is very vital to MFI's especially when it done from comprehensive approach. This abets accountability in the utilization of resources which in turn boost performance (Protiviti 2007).

Secondly financial review entails accounting and financial transactions to determine if commitments, authorizations, receipt and disbursement of funds are properly and accurately recorded and reported (COSO 2004). This type of review also determines if there are sufficient controls over cash and other assets and that there are adequate processes controls over the acquisition and use of resources. If acquisition process is not streamlined to seal the loopholes there can be numerous misappropriations (COSO 2004). This is because the process is long and involves large amounts. In acquisition the MFI's should always ensure the asset that has been purchased will be able to provide maximum possible economic benefit (Webley and More 2003). This will translate to improvement in terms of profitability. As the stewardship theory posits that the steward strives to ensure the owner get maximum benefit the agent prepares financial statements minding his own interest.

The other area covered by internal audit is compliance review, these are carried out to determine whether the MFI has complied with the financial regulations issued by the Government agencies and other financial regulatory institutions. Example of these prerequisites is the minimum capital base and the statutory reserves by the CBK, the MFI's registered must also file annual returns with CBK and with AMFI once they voluntarily join membership. In the preparation of the financial reports the MFI's should also adhere to international accounting standards that have been domesticated as a professional requirement. The internal auditors need to have vast knowledge of all regulations affecting MFI's to be able to establish the MFI position in terms of compliance with requisite financial regulations. This is supported by management control theory where boards of directors ensure MFI complies with all the necessary regulations.



## **Size of the MFI**

The size of an MFI is a measure that describes its level of economic activity being fostered by economies of scale and scope (Mueller & Uhde, 2009). The resource dependence theory supports this proposition by arguing that as the size increases, more resources are available to pursue the MFI's objectives. However there are also arguments that as the MFI's grow, they may be more susceptible to deviate from their objectives which may result in a more focus on profitability and sustainability at the expense of reaching more of the poorest of the poor (Mueller & Uhde, 2009). Wu et al (2009) study on the effect of financial performance found that firms with better financial performance and larger size will perform better. Mueller and Uhde (2009) similarly, found that an MFI's size has a high positive impact on the number of clients served as they reap benefits of diversification and economies of scale and scope thus is positively related to performance. Morduch (2007) however support the hypotheses of deviating from the mission, with increase in size by providing empirical evidence those larger micro banks on average exhibit lower measures of outreach. Prior studies relating to the size and performance have used similar measurements (Morduch, 2009).

## **Age of the MFI**

Some MFI's will definitely be older than others and more experienced due to the learning curve effects resulting from learning by doing, the development of operating systems, experience and training of staff, and economies of scale, trial and error processes (Okumu, 2007). On the other hand, more recently established MFI's may benefit from the experiences of pioneers in microfinance and might preempt them (Mueller & Uhde, 2009). The age of an MFI may thus have an effect on MFI performance.

The resource dependence theory supports the proposition that the older MFI's will have access to better resources both capital and human thus will be expected to perform better. It will for example have access to board members who are more experienced. Younger MFI's may however perform as well or better because sometimes they will be established by well experienced people who may be leaving their older MFI's to set up a new one with the benefit of all the experience and knowledge gained in the older MFI's. Hermes, (2008) find empirical support for both propositions, i.e. that an MFI's age negatively and positively affects its performance. Mueller and Uhde (2009) find support for the result that older MFI's may benefit from the learning curve effects but find no support for the argument that recently established MFI's may absorb the experience gained from the older ones and thus perform well. Prior studies have mainly focused on the relationship between financial performance and outreach and the age of the MFI. This study will seek to establish whether the age of an MFI has any relationship with its financial performance.

## **RESEARCH METHODOLOGY**

The study is based on the positivism paradigm. The study used descriptive survey and diagnostic research designs to find out the effects of the internal controls on the financial performance of the MFI's in Kenya. The population comprises of 53 institutions being the members of Association of Microfinance Institutions (AMFI-Kenya, 2012).0020

According to Fraenkel and Wallen (2000) a simple random sample is one which each member of the population has an equal and independent chance of being selected and proportional sample is where the sample size is a fraction of the whole sample size. Simple random sampling method was used from proportional samples in every category of microfinance institutions. Random sampling method is appropriate for the study since the population is homogeneous with uniform characteristics.

The study used both primary and secondary data as well as qualitative and quantitative information. The primary data gathered from the questionnaires and interview was validated, edited and then coded. Validation was to determine return rate of questionnaires whilst editing helped in formatting information so that it can be recorded. It was classified on the basis of common characteristics and attributes. After the mass of raw data was assembled, it was tabulated in form of statistical tables in order to allow further analysis. The analysis was done using descriptive statistics to establish the relationship between the internal controls and financial performance. Descriptive statistics have been widely used in academic research on governance (Heenetigala, 2011).

The study used multiple regression equation.

The regression equation was  $Y = (\beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \epsilon)$

Where;

- i. Y= is the Financial performance
- ii. X1 is the segregation of duties
- iii. X2 is vouching
- iv. X3 is authorization and approval of accounting transactions
- v. X4 is the internal audit function
- vi. X5 is the age of the MFI
- vii. X6 is the size of the MFI
- viii.  $\beta_0$  is the constant (Y-intercept),  $\beta_i$  are the regression coefficients of each  $X_i$  ( $i=1, 2, 3, 4$  and  $5$ )

## **RESEARCH RESULTS**

Out of the 21 questionnaires that were issued out, only 20 were dully filled and returned. This gave a response rate of 73%. On whether their MFIs are governed by board of directors, majority 76.9% of the respondents indicated that their MFIs are governed by board of directors while 23.1% indicated other governing bodies. On the academic qualification of the accounting staff, 2.6% had certificate, 33.3% had diploma and 64.1% had degree. On whether their MFIs have accounting unit key performance indicator, 82.1% of the respondents indicated that they have accounting unit key performance indicator while 17.9% indicated no. On how accounting unit key performance indicator are adhered to, 41% indicated regularly, 30.7% indicated occasionally, 23.1% indicated sometimes and 5.2% indicated not at all. On the number of staff in the accounting department, 12.8% of the respondents indicated between 21-40 staff, 71.8% indicated between 41-60 and 15.4% indicated between 61-80

staff. On the number of accounting documents that are rejected daily on average, 79.5% of the respondents indicated that less than 10 accounting documents are rejected while 20.5% indicated more than 10.

### **Segregation of Duties**

From the finding, tasks are clearly demarcated had a mean of 2.28 with a standard deviation of 0.559, there is a system audit trail for every transaction had a mean of 2.05 with a standard deviation of 0.793, job descriptions are clearly developed with no overlaps had a mean of 3.66 with a standard deviation of 0.955, the reporting structure is clearly communicated had a mean of 4.79 with a standard deviation of 0.469, there is a clear reporting structure had a mean of 3.51 with a standard deviation of 0.756, understand clearly how roles feed into the overall objective of the organization had a mean of 4.69 with a standard deviation of 0.731, communication system in MFI is effective had a mean of 3.30 with a standard deviation of 1.103, staffers share responsibilities had a mean of 3.25 with a standard deviation of 1.185, an officer can properly handle work of another without prior orientation had a mean of 3.29 with a standard deviation of 1.069, an officer properly understands work done by other officers in the department had a mean of 4.71 with a standard deviation of 0.723, division of labour in the organization is reviewed regularly had a mean of 3.28 with a standard deviation of 1.145 and accounting staffers are satisfied with current segregation of duties had a mean of 2.48 with a standard deviation of 0.790.

### **Vouching**

The researcher carefully identified several statements on vouching and respondents were requested to the extent of their agreement with each statement as far as their MFI was concerned. A Likert scale of 1-5 where 1=strongly disagree, 2=Disagree, 3=Neutral, 4=Agree and 5= strongly agree was used. From the findings, as to whether the payment vouchers are accompanied by support documents always; the mean was 2.000 with standard deviation of 0.85840. This implies that respondents disagreed on the statement. On whether reference numbers of the support documents are captured on the payment vouchers; the mean was 2.8974 with standard deviation of 0.85208. Respondents were therefore neutral on the statement.

As to whether the officers involved in the accounting process have sufficient working experience; the mean was 3.6410 with standard deviation of 0.48597 and this implies that respondents agreed on the statement. On whether the officers involved in the accounting process have sufficient professional knowledge; the mean was 3.3333 with standard deviation of 1.10818 and this implies that respondents were neutral on the statement.

On whether the officers involved in the accounting process reject documents in case of errors; the mean was 3.8205 with standard deviation of 1.02268 and this implies that respondents agreed on the statement. Regarding whether the officers take time to study client history; the mean was 4.4872 with standard deviation of 0.50637 and this means that respondents agreed on the statement. As to whether the officers consult widely if need be; the mean was 4.333 with standard deviation of 0.47757 and this implies that respondents agreed on the statement.

In respect to whether the documents processed are complete and accurate; the mean was 4.3590 with standard deviation of 0.48597 and this means that respondents agreed on the statement.

### **Authorization and Approval of Accounting Transactions**

Research findings indicated that officers bear responsibility according to position held had a mean of 3.33 with a standard deviation of 1.154, there is efficiency in signing of accounting documents had a mean of 3.30 with a standard deviation of 1.103, approval of accounting documents is properly controlled had a mean of 2.23 with a standard deviation of 0.484, there are minimal chances of collusion among signatories had a mean of 3.51 with a standard deviation of 1.335, signature/s of approvers of documents are recognized across the MFI had a mean of 2.07 with a standard deviation of 0.579, all documents are approved before payments had a mean of 3.66 with a standard deviation of 1.059, there are limited chances of forgery in processing payments had a mean of 4.46 with a standard deviation of 0.941, accounting documents are properly scrutinized before approval had a mean of 3.12 with a standard deviation of 1.128, documents rejected are unlikely susceptible to double payments had a mean of 3.07 with a standard deviation of 1.222, authorizers and approvers of payments have adequate experience had a mean of 4.17 with a standard deviation of 0.823, and registration of documents in movement registers is strictly adhered to had a mean of 2.79 with a standard deviation of 1.128.

### **Internal Audit Function**

From the finding, internal auditors are frequently trained had a mean of 3.30 with a standard deviation of 1.127, internal audit department is influenced by management had a mean of 3.52 with a standard deviation of 1.151, issues raised by internal auditors are addressed had a mean of 2.41 with a standard deviation of 0.637, audit department is well staffed had a mean of 3.69 with a standard deviation of 1.280, audit department is effective in prevention of errors and fraud had a mean of 3.38 with a standard deviation of 1.041, audit department regularly advise the management had a mean of 2.48 with a standard deviation of 0.756, auditors are given appropriate support had a mean of 3.56 with a standard deviation of 1.119 and audit staffs are competent had a mean of 3.66 with a standard deviation of 1.242.

### **Age of MFIs**

From the responses, 5.2% of the respondents indicated that their institutions had been in operation for less than 5 years, 7.7% indicated a period between 6-10 years, 25.6% indicated period between 11-15 years, 43.6% indicated period between 16-20 years and 17.9% indicated a period over 20 years.

### **Size of MFIs by assets**

The size of the MFIs as indicated by the value of their net assets was ascertained and the results indicated in Table 4.13. The minimum value for the assets was 5.2 million while the maximum was 20.5 billion. The median size of the MFI's was 449.6 million and mean 550 million.

### **Standard Performance Index (SPI) tool interview guide and discussions**

On segregation of duties the interviewees indicated that the payment vouchers are attended by different officers before completion, there is internal check and verifications of vouchers. They also indicated that there is rotation of duties and that every person does different tasks in the accounting system.

On vouching the interviewees indicated that the officers confirm presence of support documents when processing accounting documents, where there is need they also enquire widely amongst themselves and from relevant persons to ensure authenticity of the transaction, they also insist on the voucher being accompanied by the file where the client has been dealing with the MFI.

On authorization and approval of accounting transactions the interviewees indicated that signatories are appointed outside accounting and finance department and those senior officers sign cheques for bigger amount. They also indicated that officers review accounts before approving payment voucher. The interviewees further indicated that there are alternate signatories for cheques and that authorizing officer's get powers from the appointing authority and the payment vouchers are not paid before authority.

On internal audit functions the interviewees indicated that the internal auditor is given independence where the internal auditors do pre and or post audit and the audit recommendations are implemented in full. They also indicated that there is an accountability mechanism in the MFIs and there are no cases of documents manipulation. The interviewees further indicated that the organization employs both post and under graduates in managerial positions, there are in house trainings to equip staff and all the accountants/auditors are members of ICPAK.

The age of an MFI is critical in determining its size. The age of the MFI may be a key determinant of its level of activity and stage of growth. In addition it could also determine the size of MFI measured in terms of the value of its total assets. The size of the MFI could be essential moderating variable since larger firms are likely to have more resources for financial performance relative to small firms

### **REGRESSION ANALYSIS**

The study conducted multiple regression analysis to establish the effect of internal controls on financial performance of MFI's in Kenya. The results are shown in the subsequent sections.

**Table 1: Model Summary**

<b>Model</b>	<b>R</b>	<b>R Square</b>	<b>Adjusted R Square</b>	<b>Std. Error of the Estimate</b>
1	.477 <sup>a</sup>	.227	.110	3.86227

From the findings in Table 1,  $R^2$  was 0.227 implying that only 22.7% of the dependent variable (financial performance) was explained by the independent variables while 77.3% of the variations were due to other factors not in the study.

**Table 2: ANOVA**

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	1478.792	3	295.758	2.768	.034 <sup>b</sup>
Residual	3525.785	17	106.842		
<b>Total</b>	<b>5004.577</b>	<b>38</b>			

ANOVA statistics of the processed data at 5% level of significance shows that the value of calculated F is 2.768 and the value of F critical at 5% level is 2.62 since F calculated is greater than the F critical ( $2.768 > 2.62$ ), this shows that the overall model was significant.

**Table 3: Coefficients**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	3.425	10.037		.341	.035
Segregation of Duties	.123	.236	.097	.520	.007
Vouching	.114	.145	.054	.562	.038
Authorization and Approval	.018	.190	.018	.095	.025
Internal Audit Function	.045	.211	-.034	.215	.031
Size of the MFI	.053	.074	.117	.712	.048
Age of MFI	1.486	.570	.414	2.605	.014

From the findings in table 3, the regression equation is:

$$Y = 3.425 + 0.123X_1 + 0.114X_2 + 0.018X_3 + 0.045X_4 + 0.053X_5 + 1.486X_6$$

Where: Y= Financial Performance,  $X_3$ = Authorization and Approval of accounting transactions,  $X_1$ = Segregation of Duties,  $X_4$ = Internal Audit Function,  $X_2$ =Vouching,  $X_4$ = age of the MFI,  $X_5$  is size of MFIs and  $\varepsilon$  = Error Term.

From the findings in the regression analysis, if the factors (authorization and approval of accounting transactions, segregation of duties, internal audit function, age and size of the MFI) were held constant, performance would be at 3.425. A unit increase in authorization and approval of accounting transactions would lead to an increase in performance by 0.018. A unit increase in segregation of duties would lead to an increase in performance by 0.123. A unit increase in vouching would lead to an increase in performance by 0.114. A unit increase in internal audit function would lead to an increase in performance by 0.045. A unit increase in age of the MFI would lead to an increase in performance by 0.053. A unit increase in size of the MFI would lead to an increase in performance by 1.486.



## **CONCLUSIONS**

The findings from the study formed a suitable basis for concluding that MFI's can improve financial performance by improving segregation of duties, authorization and approval of accounting transactions and internal audit functions. The results confirmed the importance of segregation of duties, authorization and approval of accounting transactions and internal audit functions involvement in achievement of objectives of MFI.

1. The study concludes that segregation of duties influence financial performance of MFI and this could be through setting up appropriate stages in accounting process considering number of accounting staffers in the institution. This ensures negligible chances of collusion and at the same time staffs are not overwhelmed by the workload. This way they will not inadvertently overlook mistakes and fraud. Checking the work done by the staffs who have attended to the document prior, before proceeding to the next task ensures the accuracy of the document. The findings are supported by the management control theory.
2. Secondly the study concludes vouching influence financial performance of MFI. The officers peruse accounting documents for the appropriate support documents. This is to confirm authenticity of the transaction. They also consult widely amongst themselves and from other relevant people before processing. They review the history of the client especially where previous transactions affect current ones.
3. Thirdly the study concludes that authorization and approval of accounting transactions influence financial performance. Through controlling the number of people approving payments as well as signatories to bank accounts. The study revealed authority to approve accounting transactions is related to seniority and different levels along accounting cadre have limits within which they can approve transactions. The findings are supported by agency theory and stewardship theory.
4. Lastly study concludes internal audit functions influence financial performance. The management control theories underpin findings where internal auditors review the policies and procedures that guide activities of the MFI in operation audit. The management must prepare authentic financial reports to communicate clear position and performance of the MFI they are entrusted with by equity owners. This is underpinned by stewardship theory. Preparation of financial statements should disclose all necessary material information that is of interest to various stakeholders as advocated in stakeholders' theory.

## **RECOMMENDATIONS**

To achieve improved financial performance by MFI's the study recommends that;

1. Segregation of duties should be occasionally reviewed to match dynamics in accounting staff. Job rotation should be enhanced to ensure all staff can handle duties in absence of their colleagues. Job description should be modified to include wider range of activities in the accounting department. To ensure accountability at all levels; all employees must have clearly defined and documented job descriptions.

Management can refer to job descriptions to assess and discuss employee performance in order to reinforce individual accountability.

2. Vouching should be conducted thoroughly unlike routine checking. In simple routine checking there is discretionary information and fictitious entries cannot be discerned. The study recommends sensitization of the exercise to the officers so that they do it thoroughly otherwise they will be held liable for negligence. They should also be trained so that they are versed with current dynamics and processing should be centralized to avoid duplication.
3. To ensure that officers appointed from other areas other than finance and accounting are familiar with the accounting documents they are attending to, they should be subjected to the training for non-accountants. This will give them rudimentary knowledge in accounting and be aware of the things they should look for in accounting document. Every activity within the MFI's operations must be guided by policies and procedures without leaving unreasonable grey areas for manipulation. Key policies and procedures that are relevant for MFI's operations are the Credit Policy, Procedures Manual and the Accounting and Finance Manual which detail the steps required for each transaction that must be adhered to. Manuals reduce confusion and ensure standard operating practice. The manuals should be regularly updated to provide for changes in the business operations and environment and must be made accessible to all employees.
4. The internal auditors and accountants should be trained regularly to deal with emerging trends. There should be adequate distribution of policy documents such as credit policy and finance and account manuals. Internal auditors should be autonomous in a way to ensure no undue influence from the management. Accountants and internal auditors should domesticate international standards, professional ethics to guide practice in the profession. The study recommends that management of MFIs in Kenya need to develop and retain adequate quality professionals in order to ensure improved internal auditor's performance, technical, professional skills, readiness to embrace change in auditing standards, proficiency of the internal auditor required knowledge and other competencies needed to perform individual responsibilities.

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