MONITORING ACTIVITIES AS A FACTOR OF INTERNAL CONTROL SYSTEMS ON FINANCIAL PERFORMANCE AMONG LISTED COMMERCIAL BANKS IN KENYA

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ABSTRACT

The purpose of the study was to assess the effect of Monitoring Activities as a factor of internal control systems on financial performance among listed commercial banks in Kenya. Descriptive research design was used in the study. The target population was a total of 379 employees while the sample size was a total of 191 employees. Data was collected by use of self-administered questionnaires. Descriptive statistics including means, standard deviation and frequency distribution were used to analyze the data. In addition, the study used correlation and simple regression analysis to assess the effect of the independent variable on the dependent variable. The study found that Monitoring activities positively and significantly influenced commercial bank performance ($\beta 1 = 0.285$; $t = 2.501$; $p < 0.05$). The study concluded that monitoring activities positively and significantly influenced performance of listed commercial banks. The study recommended that in order for a firm to perform effectively implementing appropriate monitoring activities would be pivotal.

Keywords: Internal controls, Monitoring Activities, Return on Assets (ROA).

INTRODUCTION

According to IFAC (2012), Internal control is a crucial aspect of an organization's governance system and ability to manage risk. It ensures the achievement of an organization's objectives and creating, enhancing, and protecting stakeholder value. The (Institute of Internal Auditors (IIA), 2012) also noted that Internal control is a broad concept that covers the entire range of procedures, methods and controls established by an organization to increase the probability to achieve its business goals.

Internal Control Systems play a vital role in every organization to achieve their management objectives. Nowadays public sector organizations have been privatized because of shortcomings of the internal control system is adopted is not satisfactory (Muraleetharan, 2010). Evidently, internal controls are critical towards a firm meeting its objectives. Effective controls reduce the risk of asset loss, and help ensure that information is complete and accurate, financial statements are reliable, and laws and regulations are complied with. When internal control is effective, an organization has reasonable assurance that it is achieving its financial reporting objectives. Internal controls protect a firm in two ways: by minimizing opportunities for unintentional errors or

intentional fraud that may harm the firm; by discovering small errors before they become big problems (AICPA, 2007).

As far back as 4000 B.C., historians believe, formal record-keeping systems were first instituted by organized businesses and governments in the Near East to allay their concerns about correctly accounting for receipts and disbursements and collecting taxes. Similar developments occurred with respect to the Zhao dynasty in China (1122-256 B.C.). The need for and indications of audits can be traced back to public finance systems in Babylonia, Greece, the Roman Empire, the City States of Italy, all of which developed a detailed system of checks and counterchecks. Specifically, these governments were worried about incompetent officials prone to making bookkeeping errors and inaccuracies as well as corrupt officials who were motivated to perpetrate fraud whenever the opportunity arose. The Bible also contains examples of internal controls such as the dangers of dual custody of assets, the need for competent and honest employees, restricted access, and segregation of duties. Historically then, the emergence of double-entry bookkeeping in circa 1494 A.D. can be directly traced to the critical need for exercising stewardship and control (O'Reilly et al., 1998).

In Kenya, Anyanzwa (2013) stated that the recent incidence of corporate failures and accounting frauds are mostly preceded by failure in companies internal control structures. The article also notes that the CMA reckons that fraud is an area of concern for the financial sector due to its potential impact on market's confidence. Data from CMA shows that reported fraud cases rose by 18 per cent to 460 in 2011 from 390 in 2010. An article in the Business Daily (2012) notes that David Muturi, the executive director of Kenya Institute of Management, and serves as a managing trustee of the Management University of Africa, reckons that corporate governance standards must improve for Kenya to become competitive.

Statement of the Problem

The major problems caused by inappropriate or lack of internal controls is fraud and theft. This is largely manifested by corporate scandals and accounting frauds leading to colossal monetary losses often resulting in corporate failure. Waste, inefficient use of resources, poor management decisions, high rates of product errors, loss of records, carelessness and mistakes generally demonstrate poor business practices and ineffective management (Duggan, 2016).

Kenya has also not been spared its share of corporate scandals that have led to colossal monetary losses, in terms of billions of Kenya shillings. Recent examples include CMC Group, Mumias Sugar Co., Uchumi Ltd, NSSF, NYS, Imperial Bank and Chase Bank.

Banking fraud has been detrimental towards banks directly, and the banking industry as a whole, affecting their financial bottom line, customer relations and investor relations. As a result, fraud has had a severe negative impact on banks financial performance; For instance, Ochieng (2016) noted that senior management at Imperial Bank and Chase Bank perpetrated fraud leading to the loss of ksh 38 billion and 8 billion respectively which eventually led to their closure.

Therefore, the study sought to assess the effect of Monitoring Activities as a factor of internal control systems on financial performance among listed commercial banks in Kenya

Objectives of the Study

The specific purpose of the study was to analyze the effect of monitoring activities on financial performance among listed commercial banks in Kenya.

Research Question

How does monitoring activities affect financial performance among listed commercial banks in Kenya?

Theoretical Review

Reliability theory

Reliability theory simply describes the probability of a system completing its expected function during an interval of time (Gavrilov & Gavrilova, 2001). It was originally a tool used to help nineteenth century maritime insurance and life insurance companies in computing profitable rates to charge their customers. According to the reliability theory, an internal control system comprises of components that are interrelated and for each component, there needs to be a defined measure of success. The two potential users of the reliability theory are the external auditor and organization management. Kinney (2000) states that; during the external audit, evidence is gathered to support a professional opinion. According to Stratton (2007), recent developments have increased the value to management of objective methodologies for the evaluation of internal control systems. Firm managers are there-fore required to assure the accuracy of these systems. The reliability theory impacted highly on Monitoring activities.

Institutional Theory

Institutional theory is a widely accepted theoretical posture that emphasizes rational myths, isomorphism, and legitimacy. Institutional theory focuses on the deeper and more resilient aspects of social structure. It considers the processes by which structures, including schemes, rules, norms, and routines, become established as authoritative guidelines for social behavior (Scott, 2004). The institutional theory impacted highly on Monitoring Activities.

Empirical Literature

Monitoring Activities

Nartey, Gyamerah & Ayagre (2014) investigated the effectiveness of internal control systems of banks: the case of Ghanaian banks. The study was guided by the following objectives: To investigate the control environment and monitoring component of the internal control system of the banking industry in Ghana effective. The study concluded that the two components were highly rated by respondents with average means of 4.72 and 4.66 respectively. The study further recommended that boards of banks in Ghana should be very active and ensure continuous ongoing

and separate internal control monitoring to ascertain that controls really exist and are functioning properly. This study looked at only two of the five internal control components, and also recommended further research that will investigate internal control effectiveness involving all control components.

Ndungu (2013) evaluated the effect of internal controls on revenue generation: a case study of the university of Nairobi enterprise and services limited in Kenya. The study was guided by the following objectives: to evaluate the effect of the control environment, risk assessment, information & communication, control activities and monitoring on revenue generation in UNES. The study targeted 45 respondents from UNES employees and analyzed the data using multivariate regression analysis. The study concluded that Monitoring has helped in assessing the quality of performance of the organization and that frequent audits have helped in evaluating and improving the effectiveness of the systems. The study further recommended that policies, procedures, and mechanisms should be put in place to ensure directives of the management are properly carried out. Internal controls need to be adequately monitored in order to assess the quality and the effectiveness of the system's performance over time. Activities like monitoring of customer complaints and feedback and audits conducted periodically by internal auditors should be regularly supervised and managed.

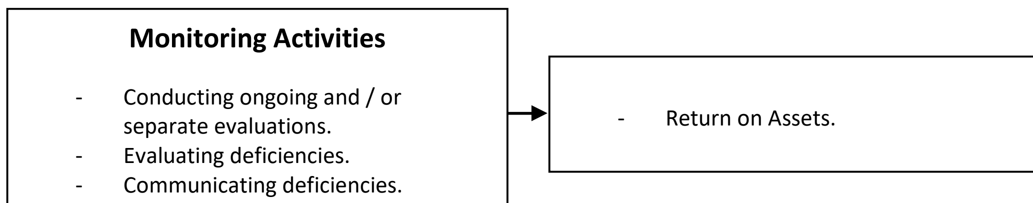
Financial Performance

Nyakundi, Nyamita & Tinega (2014) analyzed the effect of internal control systems on financial performance of small and medium scale business enterprises in Kisumu City, Kenya. The findings depicted a significant positive relationship between internal control system and financial performance.

Muraleetharan (2010) investigated internal control and impact of financial performance of organizations (special reference public and private organizations in Jaffna district, Sri Lanka). The findings showed that control activities and information & communication positively influence financial performance.

Conceptual Framework

Independent Variables **Dependent Variable**



Internal control systems need to be monitored a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two.

Financial performance refers to the degree to which financial objectives are being or have been accomplished. This may be measured using a variety of profitability measures including return on capital employed (ROCE), return on equity (ROE) and return on assets (ROA). In this study financial performance has been measured by ROA. This ratio is calculated as net profit after tax divided by the total assets. This ratio measures the operating efficiency of a company based on the firm's generated profits from its total assets. ROA is a useful measure of how well a bank manager is doing on the job because it indicates how well a bank's assets are being used to generate profits.

RESEARCH METHODOLOGY

Research Design

Descriptive research design was used in the study.

Target Population

The study targeted the managers (heads of department) and assistant managers (assistant heads of department) within the key departments of the banks stated. It also included key accounting personnel and auditors from the stated banks.

Target Population

Name of Listed Bank		No. of Managers & Assistant Managers	No. of key Accounting personnel & Auditors	Total
1.	Barclays Bank	30	9	39
2.	CFC Stanbic Holdings	28	5	33
3.	I&M Holdings	24	6	30
4.	Diamond Trust Bank Kenya	28	6	34
5.	Housing Finance Co Ltd	20	6	26
6.	Kenya Commercial Bank	30	9	39
7.	National Bank of Kenya	28	7	35
8.	NIC Bank Ltd	28	5	33
9.	Standard Chartered Bank	30	6	36
10.	Equity Bank	36	9	45

11.	The Co-operative Bank of Kenya	22	5	27
TOTAL		304	75	379

Source: NSE (2016)

Sample Size

	Name of Listed Bank	No. of Managers & Assistant Managers	No. of key Accounting personnel & Auditors	Total Sample size
1.	Barclays Bank	30	9	20
2.	CFC Stanbic Holdings	28	5	17
3.	I&M Holdings	24	6	15
4.	Diamond Trust Bank Kenya	28	6	17
5.	Housing Finance Co Ltd	20	6	13
6.	Kenya Commercial Bank	30	9	20
7.	National Bank of Kenya	28	7	18
8.	NIC Bank Ltd	28	5	17
9.	Standard Chartered Bank	30	6	18
10.	Equity Bank	36	9	22
11.	The Co-operative Bank of Kenya	22	5	14
TOTAL		304	75	191

Source: NSE (2016)

The sample size was the total of 191 managers (heads of department), assistant managers (assistant heads of department), key accounting personnel and auditors.

Testing for Validity and Reliability

The researcher ensured validity by discussing the data collection instrument with the supervisors. The feedback from the supervisors and the experts helped in identifying any awkward, ambiguous or offensive questions.

Reliability of Data Collection Research Instrument

In this study, the Cronbach's alpha reliability coefficient was used to measure the reliability of the research instrument. According to Sekaran (2003) Cronbach's alpha is a measure of internal consistency, that is, how closely related a set of items are as a group. It is considered to be a measure of scale reliability. In this study a Cronbach's alpha coefficient of 0.82 was obtained showing that the study was reliable.

Data Collection Methods & Procedures

The data used included both primary and secondary data. Primary data was collected by use of questionnaires that were hand delivered to the relevant institutions. A five-point Likert scale was used to analyze the key internal control factors influencing financial performance among listed commercial banks in Kenya. The questionnaire was divided into two sections. The first section was concerned with general information about the respondents while the second section dealt with analyzing the key internal control factors influencing financial performance among listed **commercial banks in Kenya.**

Data Analysis techniques & Procedures

In this regard the data collected was inspected and the completed questionnaires were edited for completeness and consistency. The data was then coded to enable the responses to be grouped into various categories. The responses were tabulated accordingly. As pertains to financial performance, the average financial performance of the period of 2010 to 2014 was taken as the measure of financial performance. Descriptive statistics including means, standard deviation and frequency distribution were used to analyze the data. In addition, inferential statistics including multiple regression analysis were used to assess the influence of the independent variables on the dependent variable. The regression model to be used was:

$$y = \beta_0 + \beta_1 X_1 + \varepsilon$$

Whereby:

y = Financial Performance.

β_0 = constant

β_1 = coefficient of Monitoring Activities

X_1 = Monitoring

ε = Error term

Findings, Analysis & Interpretation

Statements were listed and respondents required to indicate the extent on a five-point likert scale. The scale used was 1 = Very low extent, 2 = Low extent, 3 = Moderate extent, 4 = High extent and 5 = Very high extent. Percentages were used to analyse the responses and results are presented.

Monitoring Activities

Statement	Moderate extent (%)	High extent (%)	Very high extent (%)
Conducting ongoing and / or separate evaluations	1	8	91
Evaluating deficiencies	0	21	79
Communicating deficiencies	0	21	79

Source: Research (2016)

These findings relate with the findings by Nartey et al. (2014) that continuous and separate internal monitoring ensures that systems work as planned which significantly influence financial performance.

Performance of the Banks

An average ROA (%) for five years (2011-2015) was computed.

Performance of the Banks

Bank	**Average ROA (5 years) (%)**
Barclays Bank	4.25
CFC Stanbic Holdings	2.99
I&M Holdings	3.30
Diamond Trust Bank Kenya	3.24
Housing Finance Co Ltd	1.60
Kenya Commercial Bank	3.76
National Bank of Kenya	1.71
NIC Bank Ltd	3.06
Standard Chartered Bank	4.06
Equity Bank	9.51
The Co-operative Bank of Kenya	3.29

Correlation Matrix

		Monitoring Activities	Performance
Monitoring Activities	Pearson Correlation	1	
	Sig. (2-tailed)		
	N	100	
Performance	Pearson Correlation	.676**	1
	Sig. (2-tailed)	.000	
	N	100	100

The results indicate that Monitoring activities was positively and significantly related with bank performance ($r = 0.676$; $p < 0.05$). This positive association implied that monitoring activities at the commercial banks had a significant positive effect on bank performance. Improvement in monitoring activities in the banks would therefore be expected to lead to improvement in bank performance.

Significance of Independent Variables

	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	t	Sig.
(Constant)	.259	.123		2.109	.039
Monitoring activities	.285	.114	.192	2.501	.009

The resulting regression equation was of the form

$$y = 0.259 + 0.285X_5$$

The results revealed that monitoring activities positively and significantly influenced commercial bank performance ($\beta_1 = 0.285$; $t = 2.501$; $p < 0.05$). These findings mean that a unit increase in monitoring would result to a 0.285 improvement in commercial bank performance. Monitoring activities was the third most significant variable in the model as indicated by the t statistic of 2.501. These results agree with the results by Ndungu (2013) that monitoring has helped in assessing the quality of performance of the organization and that frequent audits help in evaluating and improving the effectiveness of the systems as well as the whole organisation.

Conclusion

The study concludes that monitoring activities positively and significantly influenced performance of listed commercial banks. The banks conducted evaluations continuously. The banks also evaluated deficiencies and effectively communicated those deficiencies to relevant units for effective action to be taken. This influenced financial performance to a very high extent.

Recommendations of the Study

Following the findings, the study recommended that implementing appropriate monitoring activities would be pivotal towards a firm's financial performance. These activities include conducting satisfactory ongoing and / or separate evaluations, effectively and efficiently evaluating deficiencies and sufficiently communicating deficiencies. This is recommended because assessing the quality of the internal control system's performance over time is essential towards ensuring the system is functioning appropriately.

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