Internal Control System and Financial Performance of Deposit Taking Savings and Credit Co-Operative Societies in Makueni County, Kenya

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ABSTRACT

Positive financial performance can be attained by eradicating misuse of funds through internal audits. Inadequate controls have also resulted in management and external auditors colluding, resulting in firms failing to meet their goals. Financial performance of DT-Sacco’s in Makueni County is plagued by severe deficiency in internal financial control due to continued lending of more than the deposits, which consequently destroy their liquidity. Majority of the Sacco’s are pushed to lend from the external sources so that they counter the shortfall that may arise. This study sought to investigate the influence of internal control system on financial performance of deposit taking Savings and Credit Cooperative Societies in Makueni County. The specific objectives of the study are; to examine the influence of monitoring on the financial performance of deposits taking Savings and credit cooperatives in Makueni County, to establish the influence of control environment on the financial performance of Deposit taking Savings and credit cooperatives in Makueni County, to determine the effect of control activities influences the financial performance of deposit taking Savings and credit cooperatives in Makueni County, to investigate the effect of risk assessment on the financial performance of Deposit Taking Savings and credit cooperatives in Makueni County and to determine the influence of information and communication influences the financial performance of deposit taking Savings and credit cooperatives in Makueni County. The study is anchored on the reliability, Contingency, agency, stewardship, shareholders and cost management and efficiency theory. The study further adopted the census technique due to the low number of deposit taking Savings and credit cooperatives numbering 17. Data was collected using Semi-structured questionnaires using the drop and pick afterwards method. Data was analyzed using Statistical Packages for Social Sciences version 26.0 software. The results were presented in tables, frequencies, median, mean scores and standard deviation. From the analysed data the researcher derived conclusions and make recommendations. This study has highlighted the importance of internal control system on financial performance of deposit taking Savings and credit Cooperatives. Internal control systems that are effective are those that encourage staff to embrace high financial integrity with great diligence on values of financial propriety and high observance of ethics. This also requires the staff to have the prerequisite competence and capacity to enhance productivity through adequate segregation of duties, frequent job rotations and adequate processes to do internal checks, for example, authorizations and verifications for each transaction. Therefore, management of deposit taking Savings and credit Cooperatives should thoroughly concur with the commendations of our internal audit report, making each effort to make sure that all the financial books are orderly for external audit. Additionally, the management should make sure their organizations have installed appropriate Information Communication Technology controls, like, password access and pertinent software to control information access to permitted people only.

Key Words: Internal Control Systems, Sacco Performance, Risk Assessment

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1. Introduction

A positive financial performance can be attained by eradicating misuse of funds through internal audits (Kamau, 2014). A sound financial performance is reflected in the financial statement concerning the DT-SACCOs financial performance. Financial performance can be improved by reducing fraud and irregularities in the DT-SACCOs system of internal financial control as this ensures the stakeholders and shareholders’ resources are used proficiently and excellently to provide the need services at the lowest cost possible. According to SASRA report (2019) the principal parameters for measuring growth and performance of financial institutions such as DT-SACCOs that mobilize deposits and issue credit facilities include their gross loans, total assets, allowance for loan losses, total deposits and core capital. Farmers who used to gather together to till the land, for plantations, and during harvesting periods were traced back to the Sacco movement in North America. Nearly a quarter-century before the signing of the Declaration of Independence, the US launched its first Cooperative Movement in 1752. Cooperatives have exploded in popularity in recent years. In 2004, the International Monetary Fund calculated that cooperative assets accounted for 14% of the entire banking industry market share (IMF, 2007). As a result of their resiliency during financial catastrophes, cooperative movements were rated more fairly than commercial banks (Cook, Chaddad & Iliopoulos, 2004). This was justified by the fact that, in comparison to commercial banks, cooperative banks' investments were less predictable, resulting in more steady returns (IMF, 2007). Cooperatives in industrialized countries had a reliable source of capital and were not adversely affected by monetary policy or financial market prices. Furthermore, when compared to commercial banks in industrialized countries, the cooperatives' three interest rates were more attractive (World Council of Credit Unions [WOCCU], 2009).

According to Kiaritha (2015), African Saccos have risen significantly in recent years, with at least 7% of the African population adhering to one. In spite of their success, the Saccos came across obstacles such as inadequate presentation of people in society. According to Pollet (2009), as cited in (Kiaritha, 2015), there is a split of society into classes as a result of economic capacities, which acts as a barrier to further expansion. However, by 2008, Sacco savings in Sub-Saharan Africa had grown by 31.9 percent on average, a slower rate than in previous years. Credits were given out at a rate of 12 percent on average, a lower rate than in previous years (WOCCU, 2009) Credits given to Saccos, for example, grew by 35.3 percent in 2007, whereas they increased by 21.2 percent in 2006. In Kenya, Saccos are established under the Cooperative Societies Act (Cap. 490). Currently SACCOs are the leading sources of credit to members for socio-economic development. In early 1908 the first cooperative was established in Kenya in Kipkelion area of the present Kericho County, much later in 1944 the colonial officers allowed Africans to form and join cooperative societies (Chimkono, Muturi, & Njeru, 2016). A report released by SASRA (2013), showed that at least in every family in Kenya one or two members directly or indirectly depend on DT-SACCO for livelihood and survival. Initially cooperative movement was predominantly oriented to agriculture. However, currently there is a lot of diversification in the sector and the non-agricultural based cooperatives have joined and invested in areas such as building and construction, transport sector such as Public Service Vehicles (PSV) (SASRA, 2013).
Internal control system is a closely associated entity that helps a firm achieve its goals in the best interests of its shareholders by permitting effective monitoring (Magara, 2013). It is a series of actions rather than just an event or a circumstance but occurs throughout the operation of an entity and most effective when it is incorporated into the organization structure and forms an integral part of this organization. The primary aspects of an internal control system are risk assessment, control activities, monitoring, control environment, and information and communication (Ogetange, 2017). Further, it is argued that an effective internal control is a cornerstone to company’s growth and development implying that effective internal control greatly contributes to the performance of companies or organizations financially. The control environment, integrity values, ethical values, and staff commitment and competency were all used to assess the internal control system in this study. The variable of control activities had indicators such as: physical control, policies and procedures, information processing, performance reviews, and segregation of duties. Monitoring was measured through; compliance checks accountability quality checks annual self-assessments and evaluation. The variable of risk assessment had indicators such as; risk definition, risk evaluation and risk mitigation.

Financial performance of deposit taking SACCOs is determined by two major factors; financial institutions related factors and the macroeconomic factors (Mwaniki, 2018). The financial institution related factors are SACCOs ownership structure, Sacco size, internal control and risks management capacity while macroeconomic factors are economic growth, inflation, political instability and interest rates offered by the Sacco. Chen, Dong, Han and Zhou (2013), asserts that these financial institutions factors are within the control of the management and can easily be manipulated for the better financial performance of the SACCOs. Asset quality, Capital Adequacy, Earning ability, Management Efficiency and Liquidity (CAMEL) framework is commonly used to measure overall financial performance of the financial institutions such as SACCOs. Macroeconomic factors are not within the control of the SACCOs management but adversely affect the performance of the SACCO financially. These factors are not within the scope of the current study but are worth mentioning.

According to SASRA report (2019) the principal parameters for measuring growth and performance of financial institutions such as DT-SACCOs that mobilize deposits and issue credit facilities include their total assets, total deposits, gross loans, allowance for loan losses and core capital. The Saccos’ financial performance shows an increase in the total asset base of DT-SACCOs from Kshs 495.25 Billion in 2018 to Kshs 556.71 Billion in 2019 representing a 12.41% growth. The total deposits on the other hand grew by 11.27% from Kshs 341.91 Billion in 2018 to 380.44 Billion in 2019, thereby depicting a scenario in which the rate of growth of total deposits was much lower than the rate of growth of total assets which was at 12.41%. The gross loans on the other hand grew by 12.09% to reach 419.55 Billion in 2019 from Kshs 374.29 Billion recorded in 2018. Once again, the growth rate of the gross loans portfolio exceeded that of the total deposits which grew by 11.27%. The foregoing implies that the demand for loans by members of DT-SACCOs in the aggregate exceeds the rate at which the DT-SACCOs are able to mobilise deposits and savings from their members. This is however an undesirable situation as DT-SACCO’s are forced to fund the deficit from external sources, which often than not turns out to be quite expensive. The allowance for loan loss which represents the total amount provisions made for loans that have been defaulted throughout 2019 increased to kshs, 19.38 Bn from kshs. 15.27 Billion recorded in 2018, and reflected a 26.95% increase compared to a 42.46% increase recorded in 2018 and 23.44% increase recorded in 2017. The large increase in provisions recorded in 2018 was largely due to the introduction of International Financial Reporting Standard (IFRS) which
was first applied to DT-SACCOs in respect of the 2018 audited financial statements. Conversely, the number of medium-tiered DT-SACCOs marginally increased by one DT-SACCO to 58 DT-SACCOs from 57 DT-SACCOs that were reported in 2018. But the total asset base for these medium-tiered DT-SACCOs substantially shrunk from 27.37% of the total assets recorded in 2018 to 24.38% recorded in 2019. A similar trend is seen in the small-tiered DT-SACCOs whose proportion of the total assets shrunk from 6.83% in 2018 to 5.52% in 2019.

Makueni County is divided into six constituencies and thirty wards. As of July 31, 2015, the county administration had supported the development of Saccos in each ward, resulting in a total of 30 registered Saccos. Each Sacco has a Management Committee that serves as a supervisory body and serves as a conduit between the Sacco and the County Cooperate headquarters (Makueni County Government, 2019). In Kenya, Saccos are formed under the Cooperative Society Act (Cap.490). Savings Credit and Cooperatives in Kenya are the leading sources of income for economic development. During that period, Kenya government realized that Cooperative organization’s is a means of Africa socialism in strengthening economic activities and enabling environment for economic growth. As at 1963, there were about one thousand Cooperatives, which have since grown at an increasing rate. Currently, DT-SACCO’s directly or indirectly acts as tools of livelihood to many households in Kenya. Unlike the past years, Cooperative movements was meant for Agricultural production only, the Cooperatives in Kenya has experienced impotent diversification of activities and monitoring mainly in credits and savings (SASRA, 2013). Presently, the number of registered cooperative societies is over 14,000, which over 5,000 being registered DT-SACCOs, which account for over 33 per cent of the national savings (SASRA report, 2019).

1.1 Statement of the Problem

Positive financial performance can be attained by eradicating misuse of funds through internal audits. Unsatisfactory controls have also contributed to management exploitation and cooperation with external auditors, resulting in firms failing to meet their goals. Financial performance of DT-Sacco’s in Makueni County is plagued by severe deficiency in internal financial control due to continued lending of more than the deposits, which consequently destroy their liquidity. Majority of the Sacco’s are pushed to lend from the external sources so that they counter the shortfall that may arise (Ministry of Co-operative Development & Marketing, 2013). Financial performance of DT-Sacco’s is poorly managed in most of the developing countries in the world. Inadequate controls have also resulted in managerial corruption and cooperation with external auditors, causing firms to fall short of their goals. (PROCASUR Africa Report, 2018). According to SASRA, Report (2016), as at 2016 only, 69 Saccos were able to meet the threshold ratio of the main capital deposits of 8 per cent with the remaining falling below the set threshold. The report further indicates that out of the total 175 deposits taking Sacco’s, only 69 are fully licensed and met, the set minimum institutional capital standard ratio of 8 per cent (SASRA, 2019). Meaning that the rest of the Sacco’s risk being closed-down due to breaching the internal control finance performance of the Sacco’s in Kenya.

Literature on DT-Saccos’ performance in Makueni County is very limited and usually scantily found in Government document like the County integrated development plan (CIDP) and the Annual Development Plan (ADP) of the County Government of Makueni. Disclosure of some of the Saccos is limited since they are not registered under SASRA and are in the process of doing so. For example, Bett and Membna (2017) investigated the impact of internal control on the financial performance of Kenyan processing enterprises, while Mary, Albert, and Byaruwanga
focused on the sugar industry, specifically out grower companies. Ogetange (2017), focused on the financial performance of supermarkets in Kajiado County and a study by Mawanda (2008), looked into Uganda’s institutions of higher learning. None of the above studies reviewed focused on the effect of internal control system on financial performance in Savings and Credit Cooperatives Societies (SACCOs) in Makueni County that the current focuses on. Therefore, the current study forms part of post 21st century in order to investigate the effect of internal control system on financial performance of deposit taking Sacco’s for the case of Makueni County, as no other similar study has been conducted in Makueni County, Kenya. Therefore, there exists conceptual, contextual, and methodological gaps and thus this study there strives to understand the internal control system and financial performance of deposit taking Saccos in Makueni County, Kenya.

1.2 Objectives of the Study

The general objective was to investigate the interrelationship amongst internal control system and financial performance of deposit taking Sacco’s in Makueni County.

Specific objectives were:

i. To examine the influence of monitoring on the financial performance of deposits taking SACCO’s in Makueni County.
ii. To establish the influence of control environment on the financial performance of Deposit taking SACCO’s in Makueni County.
iii. To determine the effect of control activities influences the financial performance of deposit taking SACCO’s in Makueni County.
iv. To investigate the effect of risk assessment on the financial performance of Deposit Taking SACCOs in Makueni County.
v. To determine the influence of information and communication influences the financial performance of deposit taking SACCO’s in Makueni County

2.0 Literature Review

2.1 Theoretical Literature

The current study considers theories that link the DT-financial SACCO's performance to its internal control system. The theories considered are reliability theory, contingency theory and agency theory.

2.1.1 Reliability Theory

The proponent of the reliability theory is John von Neumann in 1944. The chance of a system performing its anticipated role within a stipulated time interval is described by reliability theory (Gavrilov & Gavrilova, 2001). Insurance and life insurance companies have utilized the idea as a model for calculating lucrative rates to charge their consumers. Internal control systems, according to theory, are primarily designed to analyze and control risks. The idea goes on to say that a lack of internal control leads to more substantive work and thus higher costs (Kinney, 2000). The determination of any internal control system's "weakness," according to Gavrilov and Gavrilova (2001), is essentially judgmental. Comparison of financial data from the organization's past performances with the process and system dependability estimations may give a more concrete basis for judging the influence of an internal control system on the firm's income risk. One out of many key advantages of the reliability theory, according to Messier Jr. and Austen (2000), is its tight relationship to the demands of an organization in terms of comprehending the internal control
system and control risk assessment. This theory is relevant to this study, especially in terms of the risk assessment variable, because it is founded on the idea that a system that has been established should be able to perform as predicted. The theory is anchored on the impact of risk assessment on financial performance of organizations, specifically SACCOs in Makueni County, Kenya.

2.1.2 Contingency Theory

Reid and Smith (2000) first put the theory forward, from the sociological functionalist theories of organization structure. Later the theory was advance by Chenhall (2003) and Wood (2009) to be used to study the behaviour of organizations when implementing internal control system in order to maximize profits. The theory is applicable to DT-SACCOs to help analyze the financial performance of DT-SACCOs as it explains how contingency factors like culture, technology, policies and external environment (control environment) influence financial performance of DT-SACCOs (Magara, 2013). The underlying assumption is that the contingency theory cannot be applied to all organizations equally but the organization effectiveness in implementation of the theory depends on the fitness of technology type, volatility of the environment, organization structure and its communication and information system to its financial performance. The theory is mainly used to illustrate the relationship amid the effectiveness of internal control and (Olumbe, 2012; Kamau, 2013 and Nsubuga, 2019) supported DT-SACCOs’ financial performance, the same sentiments. The theory is suitable to this study since it looks into the information and communication variable. The information centre in relation to technology and the surrounding has a significant influence on the structure of the organization. In situations where the technology is uncertain, information is internal while where technology is certain, information is external. Under contingency model, uncertain environment or uncertain technology calls for decentralized authority while certain environment or routine technology calls for centralized authority. Contingency theory opines that the design and use of control system is upon context in which the organization set up in which the control activities function.

2.1.3 Agency Theory

The theory was put forward by Jensen and Meckling (1976), later on advanced by Fama and Jensen (1983) in early 21st century by Kamau (2014) and Asiligwa and Rennox (2017), integrated the theory while carrying out a study exist on the effect of internal control on the financial performance of SACCOs. The theory suggests the existence of a relationship between principal who are the shareholders and the agents who are the DT-SACCOs executive. Jensen and Meckling (1976) posits that theory study relationship that between the principal and the agent when one performs some activities or services on behalf of the other. The principal delegate duties to the agent, the theory suggests strong separation of ownership and control since both parties are utility maximizers. The principal-Agent conflict is what is referred to as the agency problem. The solution to agency problem has given rise to agency cost such as monitoring expenses and risk assessment. According to Kamau (2013), the theory address the problem that exist when the objectives or the goals of the principal contradicts with those of the agents and also when the principal and agents differ in opinion and attitude on how to address the risk the SACCOs are likely to involve in agency problem. Agency problem may be solve by effective internal control by minimizing agency cost and doing away with information asymmetric that occurs between the principal and agent. The theory suggests that principal cannot involve in profit maximizing behaviours (financial performance) without strictly being monitored by the shareholders. This theory is of importance to the current research because it directs the variable on control activities. Kamau (2014), opined that the theory provide richer and meaningful research in internal control of the financial
institutions. The agency problem cannot only explain the chances of occurrence of internal control but also explain how the components of internal control work in relationship to realize proper financial performance of SACCOs. Asiligwa and Rennox (2017), believes that internal controls which are related with improved incomes management, which is related to agency problem.

2.2 Empirical Literature Review

This section looks at studies done by different authors/researchers on internal control systems and business financial performance. Relationships between monitoring, control environment, control activities, risk assessment, information and communication, and financial performance are among the topics that require special attention.

2.2.1 Monitoring and Financial Performance of Deposit Taking Savings and Credit Co-operative Societies

Kivuvo and Olweny (2014) used the altiman Z score model to analyze the financial performance of Kenya’s SACCOs. They discovered that frequent monitoring of SACCOs leads to improved financial performance, as 24 of the 30 SACCOs studied had a strong positive financial position and only 6 had a negative financial position. The study employed a quantitative research design with a longitudinal data for a period of six years. To analyze the financial position of the SACCOs in Nairobi, Kenya, the study used the Capital adequacy, Asset quality, management, Earnings, Liquidity, and Sensitivity (CAMELS) and Protection, Effective Financial Structure, Asset Quality, Rates of Return and Costs, Liquidity, and Signs of Growth (PEARLS) monitoring systems. The study further revealed that most of the SACCOs had extremely weak financial performance and shows signs of weakness in other areas such as; internal controls, risks management, financial soundness, Sacco’s operations and fiscal discipline. The study suggested that proper financial analysis need to be done to safeguard the investment of the members. Ratios such as retained earnings to total assets, working capital to total assets, earnings before interest and taxes to total assets, sales to total assets, and market value equity to book value of total debt were used to analyze the study findings as independent variables, with overall index of Z-score as the dependent variable.

The study has methodological, conceptual and contextual gaps. The study looks at financial analysis while this study looks at financial performance, it looks at the Kenyan Saccos while this study looks at Makueni DT-Saccos and the variables used in that study are different from the ones in this study.

A study conducted by Duncan, Njeru and Tirimba (2015), on the effect of loan repayment on financial performance of deposit taking SACCOs in Mount Kenya region reported that monitoring the sector help reduce credit risks and credit exposure on guarantors among SACCOs leading to upward trend on growth, the study emphasized on the need to strengthen the sector through the implementing better and and more effective credit management system to ensure competitiveness in the financial sector. Using self-administered questionnaires, the study used a descriptive survey research approach to obtain quantitative primary data. The study further opined that gross loans were very high during the period of study signifies greater risks on the financial performance of the SACCOs calling for precautionary measures by the management to control the level of gross loans as this would reduce the dangers of having huge gross loans on the SACCOs that would affect the financial performance to a larger extend. The study also exposed that due to inadequacy of control, the rate of loan default was higher affecting cash management hence negatively impacting on the financial performance. However, this could be addressed by using guarantors to
advance loans thereby reducing the rate of loan defaulters but the study failed to highlight how the
use of loan guarantees would be effective in reducing the credit risks of the SACCOs. The study's
independent factors were gross loan portfolio, loan delinquency, loan products, and credit
management, while the dependent variables were financial performance as evaluated by profit
margin and operational expense levels.

Keitany (2013), studied the interrelationship amid loan default and the financial performance of
SACCOs in Kenya, concluded that there is a strong relationship amongst the loan default and the
financial performance of the SACCOs as this affect future potential borrowers and hence
repayment of the advance loans are affected that could have been used to advance other loans to
the potential borrowers enabling the SACCOs to earn interest leading to growth financially.
Further, the study opined that adequate control measures need to be put in place to monitor or
weed out such defaulters to avoid putting the SACCOs into such an awkward state, putting such
measures ensured that loans are repaid in advance facilitating the advancement of loans to others
boosting the financial performance of the SACCO. The study adopted descriptive research design
which was explanatory in nature to survey SACCOs within Nairobi City County on liquidity,
earnings, turnover as independent variables and return on equity (ROE) as the dependent variable
to analyze the study.

The influence of credit risk management methods on the performance of Matatu SACCOs in Kisii
County was studied by Hesborn, Onditi, and Nyagol (2016), who discovered that SACCOs' exposure
to credit risk had a negative impact on their financial performance. The study suggested for
strong credit policy, increased client appraisal and increased credit monitoring to realize
increased financial performance of the SACCOs. Further the study found that management need
to put in place good credit policies to govern loan advancement to members such as borrowing
limits with specific maturity period as this help monitor the financial performance of the SACCOs
in the transport sector. The study adopted descriptive survey research design with purposive
sampling technique to collect data on credit policies, credit risk monitoring method, collateral
substitute and client appraisal methods as independent variables and financial performance as
dependent variable.

2.2.2 Control environment and Financial Performance of Deposit Taking Savings and Credit
Co-operative Societies

Mumanyi (2014) carried out a study on challenges and opportunities facing SACCOs in the current
devolved system of government in Mombasa County found that inadequacy of finance, members
and staff discrimination by staffs from other financial institutions, poor access to justice, low level
of education were some of the challenges in the control environment facing SACCOs in Mombasa
County. The study also found that despite the challenges facing SACCOs, there were also
opportunities for growth emanating from capital accumulation and government funds for youth
and women groups transmission. The study further revealed that some of the control environment
affecting the financial performance of the SACCOs is; weak regulation, inadequate human
resource or capital and inadequate supervision which when put in place prosper financial
performance. It was also found that technology and innovation which continues to drive the
financial performance of SACCOs leading to economic growth of the county.

Kiaritha, Gekara and Mung’atu (2014), did a research to establish the effect of operating cost on
the financial performance of SACCOs, found out that SACCOs have policies that effectively
govern the operating cost and running of the SACCOs. The study also found that SACCOs within
the banking sector continues to thrive despite the fact commercial banks offers good packages for their staffs to the extent of advancing employee loans to them, which are at lower interest rates due to control measures that governed the operations. The study used a descriptive survey methodology using stratified and random sampling procedures; main data was acquired from SACCO personnel via questionnaires, while secondary data on the SACCOs' performance was collected over a six-year period. Further, the study revealed that salaries and wages to staffs were not the major cost to the SACCOs as it can be controlled by the management, rent and rates were found to be the main costs that were outside the control by the management, therefore, SACCOs need to put in place strategic policies and plan to control these variables to enable SACCOs perform financially. Factors such as economic, social and political constitute are within the control environment of SACCOs and that these factors contributes to the success or failure of the SACCOs as they depend on the control or operating environment of SACCOs.

A study by Ibrahim, Diibuzie and Abubakari (2019), on the impact of internal control activities on the financial performance of SACCOs in the health sector in Ghana, found that control environment affect the financial performance of the SACCOs positively as detection and prevention of fraudulent activities in the Sacco easier. The study also discovered that only three of the five components of internal control are significant (control activities, monitoring, and internal activities such as auditing) and positively influence the Sacco’s financial performance. Furthermore, the study discovered that implementing internal control efficiently and effectively has a significant impact on financial performance. The study adopted descriptive research design with purposive sampling technique, structured questionnaire was used to collect primary data from the sampled Sacco.

Njenga and Mwangi (2012), did a study on the relationship between agency cost and the financial performance of the SACCOs in Githuguri sub-county found that agency cost which is a control activity had no relationship with the financial performance of SACCOs but a control variable hence performance of SACCOs financially is indirectly influenced. Further, the study found that close monitoring of control activities of the SACCOs by management may not necessarily lead to financial performance, therefore, the activities that are within the control of the board members like the hired management, policies making and implementation, and management system and structure need to be under the control by the board to ensure improved financial performance of the SACCOs. The study adopted descriptive research design with exploration techniques to collect secondary data from 2007-2011 which was used to analyze the study findings.

Kiragu (2014), carried a study to determine the effects of society’s regulatory authority on financial performance of SACCOs in Nairobi County and found that there is a positive relationship between regulation and financial performance of SACCOs. The study also revealed that the variation in financial performance of the SACCOs was due to differences in the management of the control activities and implementation of the policies and regulations put in place by SASRA by most SACCOs in different sectors. Further, the study revealed that compliance by SACCOs to implement these regulation boost financial performance while non-performing loans had a negative association with financial performance. The study adopted descriptive research design with census technique to collect a cross-sectional data across the SACCOs that existed before and after SASRA was in operational. Financial performance was measured by return on asset (ROA) as the dependent variable while liquidity, non-performing loans, cost of income ratio and managerial quality as the independent variables to determine the effect of societies’ regulation on the financial performance of the SACCOs.
2.2.3 Control activities and Financial Performance of Deposit Taking Savings and Credit Co-operative Societies

In a study on the impact of liquidity risk mitigation methods on SACCO financial performance in Kisumu County, Omino (2014) discovered that the approaches used by SACCOs to mitigate liquidity risk have a significant impact on financial performance. The approaches adopted by the SACCOs are to ensure that the current liabilities are sufficiently covered by the operating cash flows over short-term obligations over the period of operations. Further, the study revealed that longer debt collection period significantly impacts the financial performance of the SACCOs negatively and also voluntary membership boost the growth of the SACCOs financially as it increases the capitation of the SACCOs. The study adopted descriptive research design with cross-sectional data across the 62 SACCOs spread in Kisumu. The study used questionnaire to collect primary data from top financial managers and the managing directors on various variables which was supplemented with secondary data.

According to a study done by Mwangi, Nyachwaya and Cheruyoit (2015), on the effect of corporate governance practice on financial performance of SACCOs in Kericho county, found that corporate governance significantly influences financial performance of SACCOs. Board of director who are involve in governance ensure that SACCOs funds are properly utilized, staff management are properly supervised to ensure internal control are properly put in place. The study also revealed that regular financial reporting positively influences the growth of the SACCOs financially in terms of shareholders and stakeholder’s growth. The study adopted descriptive research design with stratified sampling technique. Self-administered questionnaires to collect primary data from sampled 4 SACCOs. Further, the study revealed that corporate policies put place by the board of directors significantly and positively influence financial performance of the SACCOs within Kericho County as their election during Annual General Meeting (AGM) is based on performance and this is easily transformed into financial performance of the SACCOs.

Muteke (2015), carried out research on the interrelationship amid financial innovation and financial performance of SACCOs in Mombasa County found that financial innovation positively affect financial performance of the SACCOs as the SACCOs are currently using digital money transfer such as M-Pesa, Airtel Money to advance loans to the members and other debtors, the study revealed that most SACCOs integrate information technology in the daily operation to reach to the member, this enables them to growth membership base and also their financial growth. Further, the study revealed that SACCOs that implemented Information Communication and Technology (ICT) infrastructure in their system remain ahead of the others in the financial performance and also market share. SACCOs that are innovative in terms of branch network, increasing expenditure in ICT and mobile banking financially perform better than those that do not embrace financial innovation in their operation. The study adopted causal research design to study association among financial innovation and financial performance, secondary data was collected across the 44 SACCOs for a period between 2008-2012 on branch network, expenditure in ICT, customer mobile banking and the number of Automated Teller Machines (ATMs) as independent variables while financial performance as dependent variable to analyze the study findings. These are policies, mechanisms and procedures that are indicators of controls activities put in place by the management to influence the financial performance of the SACCOs. The study revealed that all these control activities have a positive correlation with the financial performance of the SACCOs. The same sentiments were also echoed by Oyugi (2014), that SACCOs that introduced internet banking in the SACCO, ATM service reduced overreliance on the branch
network as a service delivery system. The study further revealed that these control activities positively affect financial performance of SACCOs.

Abdullahi and Muturi (2016) conducted research to determine the impact of internal control on the financial performance of higher education institutes in Putland. They discovered a strong link between internal control and financial performance of higher education institutions, as well as the fact that active monitoring and frequent supervision of control activities improve financial performance of these institutions. However, there are insufficient security measures in place to prevent fraud. Further, classification of expenditures and revenues assist in ensuring growth of the institutions financial sector. The study adopted quantitative survey research design with purposive sampling technique using structured questionnaire to collect primary data in Putland of Somalia to analyze the study findings. Further the study showed that information and communication, monitoring, control activities and control environment positively influence the financial performance of higher institutions.

2.2.4 Risk Assessment and Financial Performance of Deposit Taking Savings and Credit Cooperative Societies

COSO (2013) opines that risk assessment is an effectual and sequential procedure for pinpointing and analyzing risks in order to realize the entity's goals, and it also serves as a foundation for deciding how risks should be directed. It likewise mentioned that management assesses prospective alterations in the external environment as well as in its own business model that might block the company's capability to realize its objectives. The framework goes on to say that most companies are using a risk-based approach to internal control, and that risk assessment includes procedures for risk identification, risk analysis, and risk response; that risk tolerance and acceptable levels of performance variation should be taken into account when determining admissible risk levels; and that the discussion of risk extremity includes, among other things, velocity and persistence. A system of internal control over financial reporting is also created and executed, according to the document, in order to intercept or discover a substantial error from the misstatement of the financial statement due to error or fraud in a timely manner. A company's risk assessment process, in addition to the outcomes, is the process of recognizing and responding to business risks. Management assesses the likelihood of risks associated with the preparation of financial statements that present a true and fair picture (or are presented fairly in all material respects) in accordance with the entity's applicable financial reporting framework, estimates their importance, and makes decisions on how to manage them for financial reporting purposes. For example, the entity's risk assessment strategy could involve how it categorizes and forecasts critical financial statement projections, or how it evaluates the potential of unrecorded transactions (KASNEB Newsline, 2011).

According to Kibui and Moronge (2014), who conducted a study on the effect of credit risk management on the financial performance of harambee SACCOs, specifically on modern credit risk monitoring and control methods, credit risk management monitoring improves the financial performance of SACCOs, and the use of guarantors, insurance, and collateralization strategies aid in the management of loan defaulter risk. Further, the study revealed that the use of computer based monitoring techniques help detect overdue loans in the shortest time possible thereby reducing credit risk leading to financial growth of the Sacco. The research used descriptive research design with random sampling technique to collect primary data from 178 credit officers using semi-structured questionnaires. The existence of favourable internal controls enables monitoring of the loans possible and encourages setting of appropriate loan limits that facilitates monitoring hence
boosting financial performance of SACCOs, there is also need to train the implementing officers on risk management to enable SACCOs overcome the shortcomings posed by credit risks mismanagement through good monitoring techniques.

2.2.5 Information and Communication and Financial Performance of Deposit Taking Savings and Credit Co-operative Societies

Information and communication is defined by Jones (2008) as a company's strategies for locating, acquiring, processing, and reporting critical and trustworthy information in a timely manner so that employees can efficiently carry out their jobs. Furthermore, these systems deal with data generated/required both internally and outside, and data flows vertically and horizontally inside the company. According to Gaskill (2000), the identification, acquisition, and communication of key information in an appropriate form and time to meet financial reporting objectives is the information and communication component. To allow information to flow across the business and into the financial statements, open lines of communication are vital, and management must address the identification, capture, and flow of financial information in its report (COSO, 2004).

2.2.6 Financial Performance of Deposit Taking Savings and Credit Co-operative Societies

Financial performance measurements are essential for accountability and strategic planning. Performance measurement deals with a measure on how well firms are managed in relation to set targets and the generate values to the firm’s stakeholders (Han, 2014). There exists different ways that SMEs can adapt to in order to improve their financial performance, though all these systems adopted should be considered in aggregation. Items like revenue, income from operations or firm’s cash flows, total sale units and so on. The deposit-taking Sacco's financial performance improved in 2016. Kshs 393.49 billion was the total asset base, up from Kshs 342.84 billion in 2015 and Kshs 301.5 billion in 2014. This represents a 14.8% increase over 2016 and a 13.7% increase over 2015. Deposits, capital reserves, and the portfolio of loans and advances all increased in both years, which aided. In 2016, relative core capital increased over 2015, whereas relative core capital increased over 2014 in 2015. DTS fell from 184 in 2014 to 177 in 2015, before returning to 176 in 2016. (Saccos' Annual Supervision Reports, 2015 and 2016).

According to the Saccos annual supervision report, individual Saccos' financial performance varied depending on their concession with predetermined capital adequacy ratios such as core capital of 10 million, core capital to total assets ratio of 10%, core capital to total deposit ratio of 8%, and prescribed institutional capital to total assets ratio of 8%. (2016). There were only 69 DTSs with a capital-to-total-assets ratio of 8% or above. According to the research, DTS' most important asset, loans, were also at risk, as the ratio of non-performing loans to gross loans rose to 5.23 percent in 2016 from 5.12 percent in 2015, owing to an increase in non-performing loans from Kshs 13.21 billion in 2015 to Kshs 15.57 billion in 2016. In 2016, total liquidity declined to 49.95 percent, down from 55.90 percent the year before. According to the study, despite having good liquidity indicators that exceeded the legal threshold for multiple years in a row, several DTSs were unable to meet their short-term responsibilities to their affiliates, notably loan disbursement.

2.4 Conceptual Framework

The research employed the conceptual framework illustrated in Figure 2.1 to investigate the impact of internal control systems on the financial performance of SACCOs in Makueni County. Monitoring, control environment, control activities, risk assessment, information, and
communication were all independent factors, but financial performance, as assessed by return on equity, was the dependent variable.

**Independent Variables**

**Monitoring**
- Compliance checks
- Accountability quality check
- Annual self-assessments
- Evaluation

**Control Environment**
- Integrity Values
- Ethical Values
- Commitment and competence of personnel

**Control Activities**
- Policies and procedures
- Performance reviews
- Information processing
- Physical control
- Segregation of duties

**Risk assessment**
- Risk identification
- Risk evaluation
- Risk mitigation

**Information and Communication**
- Relevance of Information
- Reliability of Information
- Form of Information

**Dependent variable**
- Financial performance
  - Return on Equity

**Figure 2.1: Conceptual Framework**

*Source: Researcher, 2020*

### 3.0 Research Methodology

The research employed a descriptive research approach to determine the impact of internal control systems on the financial performance of DT-SACCOs in Makueni County. According to the design, the researcher was able to collect both quantitative and qualitative data in order to investigate the correlation between the internal control system and SACCO financial performance. The research target population was all SACCOs engaging in deposit-taking and credit activities in Makueni County. There were seventeen (17) Deposit-Taking SACCOs in Makueni County as
authorized or licensed by SASRA (SASRA report, 2019). Therefore, the population of the study was 17 Deposit-Taking SACCOs in Makueni County. This also formed the unit of analysis. All 17 Deposit-Taking SACCOs in Makueni County were surveyed using a census technique. The data was collected from the head of departments (HODs) of the SACCOs. Purposive sampling was used to select four (4) departments in each SACCO (finance, credit; auditing and administration departments). This formed the unit of observation. The choice of these departments was informed by the fact that, the departments are mandated with role of internal control audit and thus heads of these departments were in a position to adequately address the research objective which is to investigate the relationship between internal control system and financial performance of deposit taking savings and credit co-operative societies in Makueni County, Kenya. This implies the resultant questionnaires were 4 respondents per DT-Sacco and totaling to 68 questionnaires for the data collection.

The study used self-administered questionnaires to collect primary data on independent variables; monitoring, control environment, control activities, risk assessment, information and communication. The study also used secondary sources of data to obtain data on financial performance of the registered SACCOs under study that was measured using Return on equity (ROE). The choice of self-administered questionnaires is due to the ease of administration and cost-effective in monetary terms and time. According to Kothari (2004), a questionnaire is a manuscript consisting of a number of questions printed explicitly on a set of forms. The questionnaires that were adopted by the study is open and close ended questions, as this guaranteed reliability of the questionnaire. Data was collected both qualitatively and quantitatively, with descriptive statistics being utilized to examine the data using correlation and regression analysis. After the data was obtained, it was entered in raw form, cleaned, sorted, and coded before being analyzed with the Statistical Package for Social Science (SPSS version 26.0). The quantitative data was analyzed using descriptive statistical methods such as frequencies, mean, percentages, standard deviations, correlation coefficients, and regression. The findings were presented in the form of tables, graphs, and charts to help evaluate the impact of internal control systems on the financial performance of DT-SACCOs in Makueni County so that reasonable conclusions and recommendations could be drawn.

All data acquired via surveys was coded and then revised in order to discover any erroneous omissions and ensure data accuracy. The data was examined using descriptive and inferential statistics, which allowed the researcher to not only describe but also investigate the relationship between variables. For the panel data (addressing the performance the SACCOs), data was collected for 5 years covering years 2016 – 2020. Triangulation between the primary data and secondary data collected was done through linear extrapolation where the panel data was extrapolated to a five-point likert scale using minimum value (scaled to 1) and maximum value (scaled to 5). The relationship model was represented by the linear equation.

4.0 Data Analysis Results

Responses were averaged across all internal control system and financial performance parameters in order to obtain inferential statistics. This was performed by calculating the average score for each respondent and using the results as raw data for inferential statistics like R-Square, analysis of variance, and regression coefficients. Also performed was an autocorrelation test.

Table 1: Model Summary of Internal Control System and Financial Performance
Results in Table 1 show a strong R-Square (0.980) with the standard error of estimate being 0.151. This implies that internal control system explains variation in financial performance by 98%. The remaining 2% is explained by factors that were not considered in this study. This is an indication that the model used in explaining the relationship between internal control system and financial performance was suitable.

Table 2: ANOVA for Internal Control System and Financial Performance

<table>
<thead>
<tr>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>63.575</td>
<td>5</td>
<td>12.715</td>
<td>502.657</td>
</tr>
<tr>
<td>Residual</td>
<td>1.265</td>
<td>50</td>
<td>0.025</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>64.839</td>
<td>55</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

As shown in Table 2, F-Calculated (5, 50) = 502.657 which is greater than F-Critical (5, 50) = 2.400 at 5% significant level (2-tailed test) and p-Value = 0.000 < 0.05. This shows that internal control system significantly influences financial performance.

Table 3: Model Coefficients

<table>
<thead>
<tr>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Std. Error</td>
</tr>
<tr>
<td>(Constant)</td>
<td>-0.658</td>
</tr>
<tr>
<td>Monitoring</td>
<td>0.432</td>
</tr>
<tr>
<td>Control Environment</td>
<td>0.865</td>
</tr>
<tr>
<td>Control Activities</td>
<td>0.202</td>
</tr>
<tr>
<td>Risks Management Control</td>
<td>0.460</td>
</tr>
<tr>
<td>Information and Communication System</td>
<td>0.476</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Financial performance

From the findings, when all the components of internal control system are held constant, financial performance will be -0.658 units. When monitoring is enhanced among the deposit taking SACCOs by a single unit, the SACCO will likely grow by 0.432 units. A positive financial performance will also be realized when control environment (0.865 units), control activities (0.202 units), risks management control (0.460 units), information and communication system (0.476 units). The extent of increase as a result of each factors was found to be significant (p-Value<0.05). This implies that in the absence of all the considered aspects of internal control system (monitoring, control environment, control activities, risks management control, and information and communication system), financial performance will be negative (loss). The model summarizing this relationship can be stated as follows:
\[
Y = -0.658 + 0.432X_1 + 0.865X_2 + 0.202X_3 + 0.460X_4 + 0.476X_5
\]

Where \(X_1, X_2, X_3, X_4, \text{and} X_5\) represents monitoring, control environment, control activities, risks management control, and information and communication system respectively.

In general, the outcomes of this study show that all aspects of the internal control system play a role in explaining financial success. The findings are consistent with Ibrahim, Diibuzie, and Abubakari’s (2019) findings on the impact of internal control activities on financial performance of SACCOs in Ghana's health sector, which found that a positive control environment improves SACCO financial performance by making detection and prevention of fraudulent activities in the Sacco easier. The study also found that among the five components of internal control only three were found to be significance (control activities, monitoring and internal activities such as auditing) and positively influence financial performance of the Sacco. Further, the study revealed that implementation of internal control efficiently and effectively impact financial performance greatly.

5.0 Conclusions and Recommendation

5.1 Conclusions

Monitoring is an important aspect of internal control system that in efforts to improve financial performance of Saccos. These Saccos normally achieve this by designating different personnel to exercise monitoring activities different departments including carrying periodic monitoring of the internal controls installed for their efficacy. This results to all redundant processes and exercises being installed to make sure effectiveness and the SACCO has a financial monitoring and evaluation policy. Control environment, as an aspect of internal control system is also key in influencing financial performance of deposit taking Saccos. This is attainable by ensuring Saccos have staff with the requisite competence and capacity and who are committed to the performance of their duties, and their productivity is high. In addition, it is important for Saccos to have tradition of proper financial management that is founded on diligent values of financial. The study further established that deposit taking SACCO staff in Makueni County do embrace high financial integrity, with high observance of ethics.

Control activities are another important component of the internal control system in driving deposit-taking Saccos' financial performance. As shown in this study, adequate job segregation among employees makes every attempt to make sure all of our financial records are ready for an external audit. Saccos must have suitable procedures to carry on internal checks, like approvals and verifications for each transaction, and actively follow the recommendations of our internal audit report. Furthermore, implementing proper ICT controls, like related software and password access, to limit access of information to only approved individuals is a critical control activity. Findings in this study advocates for presence of a risk management team in deposit taking SACCO. With risk management control, this study has found that a Sacco can identify risks in time, the risks are always controlled, there are risk evaluation procedures to inform preparedness and decision making, the SACCO is always prepared for risks, and thus the SACCO will always have an effective risk mitigation. Deposit-taking Saccos must use management techniques to guarantee all essential information is communicated accurately, clearly, reliably, and on time. As a result, the management of these Saccos usually inspires capture of data where conceivable for forthcoming consideration, while also making use of communications and information technology to improve communication and information exchange among departments. Besides, deposit-taking
SACCOs often encourage open lines of contact at all levels of our business, with our management being extremely available to all.

### 5.2 Recommendations

Deposit-taking administration SACCOs should follow the suggestions in their internal audit report to the letter, making each and every effort that ensures all financial books are in order for external audit. Moreover, management should verify that their firms have implemented adequate ICT controls, such as password access and related software, to limit information access to only authorized individuals. The government through the relevant SACCO regulators should ensure that having an effective internal control system is mandatory for every deposit taking SACCO. This effectiveness should be evaluated based on the adequacy of the system in terms of monitoring, control environment, control activities, risk management controls as well as information and communication system. Deposit taking SACCOs should encourage sharing of information across departments is in their organizations to ensure that goals for each department is harmonized to those of the organization. This would include having an open line of communication is invigorated at all levels in our firm. Additional SACCOs should always be prepared for risks and thus should identify a risk management team to ensure that risks are identified in time and are always controlled to the desired level.

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