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INTERNAL CONTROLS AND UTILISATION OF FINANCIAL RESOURCES BY STATE CORPORATIONS IN NAKURU COUNTY, KENYA

Ann Warimu Mbugua[1], Joseph M. Theuri[2]

[1]Accounting and Finance Department, School of Business, Kenyatta University, P.O. Box 43844-00100, Nairobi, Kenya, Email:anniembuguah@gmail.com

[2]Accounting and Finance Department, School of Business, Kenyatta University, P.O. Box 43844-00100, Nairobi, Kenya, Email:jmtheuri@gmail.com

Abstract: **In the recent past, Kenya has experienced challenges in efficient utilisation and management of public funds in State Corporations. In the after math of scandals in state corporations and global financial crisis, significant attention from regulators and the public has been received concerning corporate governance. The focus on increasing disclosure requirements by regulators has in turn driven increased awareness and demand for internal assurance on processes including internal control system. Internal controls play an important role in every organisation since it assist in realization of effective utilisation of financial resources. The main objective of the study was to establish the effect of internal controls on utilisation of financial resources by state corporations that have operations in Nakuru County, Kenya. Specifically the study was guided by the following objectives; to determine the relationship between internal controls environment, internal audit function, internal control activities, corporate governance and utilisation of financial resources. The study adopted descriptive research design using both qualitative and quantitative approach. The target population was 52 head of internal audit and chief accountant of the 26 state corporations in Nakuru County. The study relied on primary data. Primary data was collected using structured questionnaires. Data collected was processed with the aid of SPSS software. Both inferential and descriptive statistics were used to analyse data and to test whether control environment, internal audit function, control activity and corporate governance have any influence on utilisation of financial resources. The findings revealed that most State Corporations in Nakuru had internal controls that greatly impacts on the utilisation of financial resources. It was found that internal controls had a significant relationship with utilisation of financial resources. Based on research findings, it can be concluded that internal control system is a positive significant predictor of utilisation of financial resources. The findings of the study suggested that internal control systems especially internal audit function, internal control environment, internal control activity and corporate governance are significant areas that management of State Corporations should give great attention to in order to improve utilisation of financial resources. The study further recommends that management of State Corporations should exert collective efforts in identifying the ideal mix of effective and efficient internal control systems that matches their operation needs and invest in them and also a governing body should ensure that the internal control system is periodically monitored and evaluated.**

Keywords: **Internal Controls, Internal Audit Function, Control Activities, Control Environment, Control Activities, Corporate Governance, Utilisation of Financial Resources and State Corporations.**

1. INTRODUCTION

1.1 Introduction

According to Allis (2004), financial resource is considered as an important resource to many organisations. It is important for this resource to be efficiently and effectively managed so as to bring about the outcome for which the resources were made available. However, sometimes financial resource is not properly managed and misappropriated by people put in charge (Rosen & Gayer, 2010). Many developed and developing countries have embarked on public sector management reforms. ECA (2003) states that the main reasons for commencing public sector reforms were public sector ineffectiveness and inefficiency. There have been constant pressure for the governments to enhance public accountability and improve public services quality while containing costs at the same time (Barret, 2004).

The COSO (2013) Frameworks defines internal controls as set rules, policies and procedures that are designed to provide reasonable assurance concerning the achievement of objectives relating to operations, reporting and compliance Internal controls consist of five components namely: Control environment which consists of aspects such as ethical values and integrity of personnel tasked with establishing, administering and monitoring controls, competence and commitment of staffs performing allocated duties, operating style, management philosophy and organisation structure, assessment of risks which refers to the process of identification and analysis of relevant risks which are associated with achieving the organisation objectives, control activities and corporate governance. An effective system of internal control see to it that the organisation is not unnecessarily exposed to risks and the financial information is only used within the organization (Hayles, 2010). It also contributes towards safeguarding of organization assets, detection and prevention of fraud (ACCA, 2010).Walters and Dunn (2001) observed that acquiring sufficient understanding of the internal control system in both information technology and application controls are required to facilitate the establishment of audit strategy and carry out next steps.

In Kenya, since independence accountability level among public officials has consistently declined in the management of public affairs. Over the period, the rate of annual economic growth of the country has gradually declined. (World Bank, 2012). The effective and efficient delivery of public services to the ordinary citizen has continuously deteriorated at the same time. These two factors combined have resulted to widespread unemployment and poverty in Kenya. Kenya's system of financial management in the public sector has some strengths, notably a sound code of financial regulations, the existence of a core of skilled top level managers, an updated budget framework, the computerization of a number of financial accountability functions as well as the powers and autonomy of the Controller and Auditor General (C&AG) rooted in the Constitution. (World Bank, 2012).

Karanja & Ng'ang'a (2014) asserts that Kenya is deemed to have the largest, most diversified and innovative economy in East Africa. Kenya has the potential to increase employment opportunities not only to its citizens but also to other countries within East Africa and beyond and thus reduce poverty. It has made significant steps in making better the overall economic environment with the performance being above that of Sub-Saharan Africa (Country Policy & Institutional Assessment (CPIA) Reports, 2006-2012). However, Kenya faces a challenge of corruption which is a key constraint towards greater growth and prosperity. There are two forms of corruption, petty and large scale corruption where purchases are overpriced, public benefit paid out to unentitled people; ghost companies and people being paid for contracts that are never executed and therefore value for money is not achieved on public resources.

Kenya has successfully implemented the devolved system of governance as adopted in the constitution of Kenya 2010 (Wanjau, Muiruri & Ayodo, 2012). Furthermore to introducing forty seven (47) county governments with fiscal responsibility, the new constitution also created new PFM institutions such as Salaries and Remunerations commission, Revenue Allocation Commission and office of the Controller of Budget and grew the mandate of the Auditor General. It is necessary for increased efficiency and effectiveness in utilisation of scarce financial resources in order to meet the increased financing demands for the National and 47 counties (Mugambi and Theuri, 2014). Therefore, the study provided useful insights on the effects of internal controls on utilisation of financial resources in State Corporations in Nakuru County.

1.2 Statement of the Problem

In Kenya, a major part of funding is channeled through government owned state corporations. The lack of adequate internal control system exposes the management of financial resources of State Corporations to various risks such as erroneous financial statements, loss of government assets, mismanagement of government essential records, inaccurate and unreliable financial records which might lead to loss of government integrity, and accounting policies implementation inconsistent with the relevant legislations. However, there was a general perception that putting in place of sound internal control system may lead to better utilisation of financial resources. Internal control system that is properly instituted will improve the reporting process and thus give reliable reports that increases accountability of an entity. However, the literature available indicated that despite the fact that there are elaborate control systems in organizations, utilisation of financial resources has been elusive in most of these organizations. (OAG, 2010). State Corporations require a strong internal control system that is supported by effective audit and assurance arrangements. This necessitates this study, where the researcher sought to investigate the effect of internal controls on utilisation of financial resources by state corporations in Nakuru County, Kenya.

1.3 Objective of the Study

1.3.1 General Objective

The main objective of this study was to evaluate the effect of internal controls on the utilisation of financial resources by State Corporation in Nakuru County, Kenya.

1.3.2 Specific Objectives

i. To determine the effect of internal audit function on utilisation of financial resources by State Corporation in Nakuru County, Kenya.

ii. To establish the effect of internal control environment on utilisation of financial resources by State Corporation in Nakuru County, Kenya.

iii. To determine the effect of internal control activities on utilisation of financial resources by State Corporation in Nakuru County, Kenya.

iv. To establish the effect of corporate governance controls on utilisation of financial resources by State Corporation in Nakuru County, Kenya.

1.4 Scope of the Study

The research was limited to State Corporation within Nakuru town. Also the researcher concentrated the study on the head of internal audit and chief accountants of the targeted State Corporations who are assumed to be the most privy with the data being sought.

In this study, internal control system was based on internal audit function, control environment, control activities and corporate governance. Utilisation of financial resources focused on governance and accountability, value management and budget management.

2. LITERATURE REVIEW

2.1 Theoretical Review

2.1.1 Theory of Financial Control

The theory of financial control was propounded in 2009 by Lars Ostman. The fundamental point of reference in this theory is the present and future functions of human beings. The theory stipulates that prevailing and likely functions of financial tools for organisations are most important. It also indicate that financial instruments, payments, control models, accounting, economic calculations and associated aspects, both inside and outside of the organisation should be explored in regards to inmost characteristics and also possible outcomes. It is noted that determining the relationships between different activities and control processes, from a financial control point of view, is a general and fundamental issue (Ostman, 2009).

Firms are viewed from several latitudinal areas in the theory of financial controls for organisations. The first one is about the peoples' functions of what is achieved through organisations, their activities and output. The second relates to organisation structure and activities, and various transactions that parties have with each other. The third latitudinal area deal with recurring methods and procedures which are employed to relate present and future financial functions both internally and externally. The aforestated financial control tools are asserted to be key from an individual organisation's view and also for larger economic systems. The Fourth and last latitudinal area covers the specific processes of individual organisation for specific issues. In addition the theory states that financial control system and structure work together (Ostman, 2009). The theory of financial control is relevant to the study since it will help in better understanding of the complexity surrounding utilisation of financial resources in state corporations.

2.1.2 The Agency Theory

Jensen and Meckling (1976) formulated the agency problem in the governance of firms. The theory defines the relationship between the principal (shareholder) and the agent (Management).The principal dictates their authority to agent who are employed to work maximizing the value of the firm. However, according to the Agency theory, Shareholders wealth maximization may not work because of moral hazard. That is, the agents with whom shareholders have entrusted the operations of their firm, will act opportunistically to attain their own interest rather than of the principals', thus creating the agency conflict. The main concern of this theory in finance management is to develop rules and incentives to eliminate the shareholders and managers conflict of interest. To mitigate the agency problems, Jansen (1983) identifies two steps: efficiently designed principal agent risk bearing mechanism and monitoring of the design through the nexus of the organisation and contracts. This makes the firm incurs agency costs in ensuring that managers' activities are aligned to the shareholders wealth maximization.

Other related reviews include the Sarbanes-Oxley Act of 2002 (SOX) where as part of an effort to minimize fraud and restore integrity in the process of financial reporting, requires organizations to report on internal control effectiveness on financial reporting. It is also noted that software vendors that sells Enterprise Resource Planning (ERP) systems have taken advantage of the new attention on internal controls by emphasizing that an important characteristics of ERP systems is the use of "built-in" controls that match a firm's infrastructure (Morris, 2011).

Internal control system is one of the many methods employed in organisations to address the agency problem. Others include budgeting, financial reporting, external auditors and audit committees. Research studies have indicated that internal control systems minimizes agency costs with some arguing that a firm has an economic incentive to report on internal control, even without the requirement of SOX.

2.2 Empirical Review

2.2.1 Internal Audit Function

Al-Twaijry, Brierley and Gwilliam (2003) carried out a study on development of internal audit function in the public sector of Saudi Arabian using institutional theory. The researchers took a sample of 135 companies listed in the Saudi Arabian stock Exchange. The researchers used interviews and questionnaires schedules to determine the level of compliance of internal audit practices in regards to professionalism of internal audit staffs, internal audit work efficiency and quality, suitable corporate environment and top management support to assess the effectiveness of internal audit function. The findings of the study showed that the internal audit function was ineffective and it's not a value additional service to the corporate sector of Saudi Arabia. However, the study used internal audit function only as a functionality of internal control systems and failed to show the contribution of control activities, control environment and corporate governance in the public sector.

Mihret & Yismaw (2007) studied internal audit function effectiveness in public educational institutions of higher learning in Ethiopia. Their study attempted to introduce a new view for assessment of internal audit effectiveness by using a model that involved four factors that might have an influence on internal audit effectiveness which are quality, support of management, organisational structure and audit characteristics. The study results show that internal audit is ineffective with regards to expertise, planning, recommendations and shortcomings to the scope of work. Moreover, the research disclosed that the quality of audit and support of management are the most important factors affecting internal audit effectiveness respectively.

Yee et al (2008) conducted a study on the role and effectiveness of internal audit function in Singapore. They assessed the perception of managers on internal audit activity. Particularly, they examined whether internal audit is perceived as a partner with the management or as a watchdog mechanism for daily routine compliance. In contrast to study done earlier, they employed Marxist economy theory to the internal audit function. In addition, contrary to Saudi Arabia (Al-Twaijry, Brierley and Gwilliam 2003), Ethiopia (Mihret & Yismaw 2007), Yee et al. (2008) found that there was improvement in internal audit function in Singapore and has become an integral component of the organisations structures as value additional services, managers are contented with internal audit function and thus play an important part in modern entities by enlarging the scope of services to embrace areas of operations.

2.2.2 Control Environment

Khamis (2013) found out that there is a notable positive relationship between financial institution performance and internal control environment. A study by Mawanda (2008) showed that there is a positive relationship between financial performance of institutions of higher learning in Uganda and control environment. Ezzamel et al (1997) found that control internalised in to entity staffs in form of self-discipline so reducing the relevance of prominent hierarchical control. Cohen (2002) restates the significance of the control environment with the results from an auditors survey that attitude at the top and its effect on the behavior of employees, is the key ingredient for effective control. However, the researchers studied internal control environment component and failed to show the contribution of corporate governance and internal audit function in financial performance of higher institutions.

2.2.3 Control Activities

Barra (2010) investigated the effect of internal controls and penalties on employees' tendency to be fraudulent by employing the analytical approach and concentrating on monitoring and control activities. The researcher collected data from managerial and non-managerial staffs. The findings indicated that availability of the control activities in an organization such as separation of roles, maximizes the cost of committing fraud. Consequently, the reward from committing fraud has to supersede the value in an environment of duties segregation for staffs to commit fraud. Moreover, it was determined that duties segregation is a less cost fraud barrier for non-managerial staffs, but for managerial staffs, maximum penalties are less cost for deterring fraud. The findings indicates that preventive controls activities effectiveness are determined by detective controls. However, the researcher did not include all the components of internal control system.

Romar and Moberg (2003) carried out a research that indicated the factors below could have played part to WorldCom scandal in 2002: growth targets that were unrealistic, Inadequate assessment of internal and external factors, aggressive management philosophy, duties segregation not properly done, manipulation and data access entry poorly segregated and internal control system lacked firm monitoring and therefore controls quality in journal entries and general ledger posting were not recognized as weak.

2.2.4 Corporate Governance

Olumbe (2012) carried out a study to determine the relationship between corporate governance and internal controls in commercial banks in Kenya. The researcher carried a survey on all the 45 commercial banks in Kenya. The findings were that most of commercial banks had integrated the various parameters that are employed for measuring corporate governance and internal controls. The respondents concurred that their banks had initiated a strong internal control system and good corporate governance and hence a relationship between corporate governance and internal control.

Kibet (2008) explored the use and role of internal audit function in enhancing good corporate governance in public sector enterprises and the challenges faced by the internal auditors in State Owned Enterprises. The researcher collected a sample of 43 state corporations by way of government shareholding and geographical location. The head of internal audit units were the respondents and data collection was done using questionnaires. The findings suggested that internal audit function played a role in corporate governance. However, the researcher failed to show the contribution of control environment and control activities in enhancing good corporate governance in public sector enterprises.

2.2.5 Utilisation of Financial Resources

Padilla et al (2012) in their study on nonprofit organisations financial sustainability, financial management practices that are effective are crucial in intensifying transparency, accuracy, accountability and efficiency that allow achievement of organizational objectives. Hendrickse (2008) points out that management of finances should involve linking the strategic and operational plans of the firm to the budget and all financial transactions are accuracy kept. Management of finances also requires that accounts records ought to be provided to managers for them to compare their organisation's progression against the budget and then making future decisions. Further utilisation of financial resources demands that there must be checks and balances put in place that aim in protecting the organisation's assets, and also management of risks. There should be an audit department that help to ensure the reliability and quality of employed financial information.

El-Nafbi (2009) sought to determine the role of financial control system and public sector audit in protecting public funds in Sudan. He established that there are a number of elements that promote misappropriation of funds in the public sector. He stated that financial systems of controls and internal checks in most of public sector departments are ineffective and weak. This is caused by shortage of skilled accountants as demonstrated by the claim that in a public department, one or two staffs conduct all the financial activities of the concerned organisation. More so, most government departments lack internal auditing which is an essential element of internal control system. It is further noted that the accounting system has deficiencies in majority of public organizations. Manual accounting system at state and national level, lack of formal training on management of finances are some of the challenges mentioned facing financial system of management.

Jones (2008) compared accountability, corporate governance and internal control in Medieval and Modern Britain. Jones employed the modern referential framework (control environment, information and communication, monitoring, risk assessment and control activities) as a lens to study internal control system in medieval employed in the Medieval organizations and the twelfth century royal exchequer. He established that Medieval England had most of the internal controls found today. Personal accountability and stewardship were established to be the key component of internal control.

3. RESEARCH METHODOLOGY

3.1 Research Design

The researcher adopted a descriptive nature of research with an aim of collecting data on management of public finances. This is because the design establishes and reports the way things are and also tries to describe such things as possible characteristics, attitudes, behaviors and values (Mugenda and Mugenda, 2003). Under descriptive research, the researcher adopted a survey research design in conducting the investigations. The researcher used primary method of collecting data. Primary data was collected using structured questionnaires.

3.2 Target Population

The target population of the study was the 26 state corporations that have operations in Nakuru County. (Regional Coordinator's Office-Provincial Headquarter Nakuru).The target respondents were the 52 head of internal audit and chief accountant.

3.3 Sampling size and Design

The study employed census sampling to select the sample size where all members of the target population constituted the study sample. The study targeted 52 respondents that is head of internal audit and chief accountant in the 26 State Corporation that have operations in Nakuru County.

3.4 Data Collection Procedure

The study used primary data. Primary data was collected using a structured questionnaire which was self-administered to head of internal audit and chief accountant of 26 State Corporations that have operations in Nakuru County. The researcher strategically chose drop-off self-administered questionnaire though costly, directly presenting the questionnaire to the respondents as respondents prefer face to face contact to avoid suspicion.

3.5 Model Specification

The regression model used in the study was;

$Y = \beta 0 + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + e$

Where;

Y - Utilisation of financial resources

$\beta 0$ - Constant

X1 - Internal audit function

X2 - Internal control activities

X3 - Internal control environment

X4 - Corporate governance

e - Error term

To determine the effect of intervening variable on the relationship between the internal controls and utilisation of financial resources, the model was;

$Y = \beta 0 + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + \beta 5X5 + e$

Where;

Y - Utilisation of financial resources

$\beta 0$ - Constant

X1 - Internal audit function

X2 - Internal control activities

X3 - Internal control environment

X4 - Corporate governance

X5 - Government Policy

e - Error term

4. DATA ANALYSIS, PRESENTATION AND DISCUSSION

4.1 Descriptive Statistical Analysis

In this section, the descriptive statistics for study variables were discussed. The study sought to evaluate the effect of internal controls on the utilisation of financial resources by State Corporation in Nakuru County, Kenya. Internal controls was viewed in term of internal audit function, internal control environment, internal control activities and corporate governance controls as the independent variables and utilisation of financial resources as the dependent variable**.**

Table 4.1: Descriptive Statistics of the Study

Variable	N	Min.	Max.	Mean	Std. Dev.
Internal Audit Function	44	3	5	4.4545	.43265
Control Activity	44	3	5	4.3848	.50211
Control Environment	44	2	5	3.9962	.72112
Corporate Governance	44	1	5	4.2273	.54641
Government Policy	44	2	5	4.3409	.62666
Utilisation of Financial Resources	44	3	5	4.1648	.61932

Source (Researcher, 2018)

The results shows that internal audit function had a mean of 4.4545 and standard deviation of 0.43865. Control activity had a mean of 4.3848, standard deviation of 0.50211. Control environment had a mean of 3.9962, standard deviation of 0.72112. Corporate governance had a mean of 4.2273, standard deviation of 0.54641, Government policy had a mean of 4.3409, standard deviation of 0.62666. Lastly, utilisation of financial resources had a mean of 4.1648 and a standard deviation of 0.61932.

4.2 Correlation analysis

Table 4.2: Correlation Matrix

		Internal Audit Function	Internal Control Activities	Internal Control Environment	Utilization of Financial Resources
Internal Audit Function	Pearson Correlation	1	.462**	.339**	.554**
Internal Control Activities	Pearson Correlation	.452**	1	.399**	.513**
Internal Control Environment	Pearson Correlation	.539**	.379**	1	.506**
Utilization of Financial Resources	Pearson Correlation	.554**	.513**	.506**	1

**. Correlation is significant at the 0.01 level (2-tailed).

N=44

Source: Researcher (2018)

As shown in Table 4.2, internal audit function has r-value of 0.554 indicating a strong positive relationship between internal audit function and utilization of financial resources. The p values (<0.001) are below .01 thus leads to rejection that there is no significant relationship between internal audit function on utilization of financial resources, at 1% level of significance. Therefore, internal audit function is positively correlated to utilization of financial resources. Internal control activities have r-value of 0.513 indicating a strong positive significant relationship between internal control activities and utilization of financial resources. The p-values (<0.001) are below 0.01 thus led to rejection that internal control activities does not influence the utilization of financial resources, at 1% level of significance Therefore, internal control activities are positively correlated to utilization of financial resources. Control environment has r-value of 0.506 indicating a strong positive relationship between internal control environment and utilization of financial resources. The p-values (<0.001) are below 0.01 thus led to rejection of that internal control environment does not influence the utilization of financial resources, at 1% level of significance. Therefore, internal control environment is positively correlated to the utilization of financial resources by State Corporations in Nakuru County.

4.3 Regression Analysis

Table 4.3: Regression Model

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-1.290	.439		-2.938	.005
Internal Audit Function	.532	.128	.372	4.157	.000
Internal Control Activities	.475	.124	.385	3.844	.000
Internal Control Environment	.250	.077	.291	3.265	.002

a. Dependent Variable: Utilization of Financial Resources

Source: Researcher (2018)

From the regression model in Table 4.3, the regression equation was obtained. Using the unstandardized beta coefficients, the following regression equation was developed.

$$Y = -1.290 + 0.532X_1 + 0.475X_2 + 0.250X_3 + \mathcal{E}$$

From the full regression model, the beta values were obtained which explain the regression equation. The standardized beta coefficients give a measure of influence of each variable to the model. Regarding the influence of utilization of financial resources, the study revealed that the internal audit function had the greatest significant influence on utilization of financial resources (β=0.532, p<0.001) i.e. for every unit increase in internal audit function, a 0.532 unit increase in utilization of financial resources is predicted, holding all other variables constant, followed by internal control activities (β=0.475, p<0.001) which is also statistically significant, and finally the least influence on utilization of financial resources was internal control environment which was also significant (β=0.250, p=0.002).

5. SUMMARY, CONCLUSION AND RECOMMENDATIONS

From the study findings it was clear that there is a positive relationship between internal controls and utilisation of financial resources by State Corporations that have operations in Nakuru County, Kenya. This is demonstrated by the level of significance attained by each of the independent variables. Data analysed using regression model exhibited a positive relationship between internal controls and utilisation of financial resources. Internal control system is one important area State Corporations should give attention to in order to enhance utilization of financial resources as suggested by the study findings. The findings of this study support the findings of previous researchers. Therefore, State Corporations have to invest in establishing strong internal control systems to realize better utilisation of financial resources.

The management of State Corporations should exert collective efforts in identifying the ideal mix of effective and efficient internal control systems that matches their operation needs and invest in them. The researcher suggests further research on the determinants of internal control systems and their implications on financial performance; this will shed more light on the appropriate model to choose when implementing better internal control systems that enhance financial performance of firms. Subsequent studies should consider replicating this study in other public sectors and private sectors to confirm the role of internal control systems and corporate governance on utilisation of financial resources by public companies

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