

The Effect of Internal Audit Function on Financial Performance in Lamu County, Kenya

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Abstract: Internal Control Systems play assist in the realization of financial performance goals. The main objective of this study was to determine the effect of internal control systems on financial performance of Lamu County. The specific objectives of the study were: on To establish the effect of internal audit function financial performance in Lamu County; To determine the effect of risk management on financial performance in Lamu County. The study adopted a survey research design. Given the small number of employees in the finance department in Lamu County, census was used; hence the total 97 employees participated in the study. The study collected both primary and secondary data. The researcher used structured questionnaires to collect primary data. Data was analysed using descriptive statistical methods, frequencies and percentage with the aid of Microsoft Excel. It was presented using APA tables. The study concludes that Lamu County has an effective internal audit function that plays the role of monitoring and evaluating organization activities; It has an effective and efficient internal audit function which is able to detect fraud, but it is not able to prevent and control it; an indication of good internal control systems. The study recommends that: The internal audit function in Lamu county should be empowered to not only detect fraud, but also be able to prevent and control it; Internal audit department should play a major role in fraud detection and prevention. The audit recommendations should be taken seriously in the county. The control environment and control activities should on a regular basis be evaluated by internal audit department to provide management with the assurance on the adequacy and effectiveness of mitigation controls that management has put in place.

Keywords: Internal Audit, Monitoring Activities, Efficiency, Financial Performance.

1. INTRODUCTION

Internal controls refer to the measures instituted by an organization so as to ensure attainment of the entity's objectives, goals and missions (Brennan & Soloman, 2008). They are systems of policies and procedures that protect the assets of an organization, create reliable financial reporting, promote compliance with laws and regulations and achieve effective and efficient operations. These systems are not only related to accounting and reporting but also relate to the organizations communication processes, internally and externally, and include procedures for: - handling funds received and expended by the organization, preparing appropriate and timely financial reporting to board members and officers, conducting the annual audit of the organization's financial statements, maintaining inventory records of real and other properties and their whereabouts. Tunji (2013) argues that internal controls encompass a set of rules, policies, and procedures an organization implements to provide reasonable assurance that: (a) its financial reports are reliable, (b) its operations are effective and efficient, and (c) its activities comply with applicable laws and regulations. The Committee of Sponsoring Organizations of the Treadway Commission (COSO, 2013) framework looks at internal control as a process, affected by an entity's board of directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of objectives in the following categories: Effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations.

2. STATEMENT OF THE PROBLEM

Data from World Bank (2014) shows that there was decline in service in all sectors of the economy including tourism. Poor financial performance of quoted companies adversely affects the economic growth of the Kenyan economy. There is however, continued poor financial performance, where budgets are not followed, rules and regulations on the use of finances are not adhered to and there is massive unaccounted for funds. This has led to the risk of financial inadequacy, employee dissatisfaction and poor financial performance (Mikes & Kaplan, 2014).

County Governments have several internal control systems, but they are weak and poorly utilized. According to the findings of the Auditor general (2014), the use of technology is low and there is poor book-keeping. This is evident that the financial management in the counties is not up to the expected standards locally and internationally, and this may create room for financial impropriety or unfair view of the financial reporting. Studies done relating to internal control systems and financial performance do not show directly the effect of government policy on financial performance. For example, case study researches done by Wanjara, (2014) and Kamau, (2013). Furthermore, the aspect of financial management is not captured in many researches and this forms the gap to be filled by this study on the the effect of internal audit function financial performance in Lamu county in Kenya.

3. LITERATURE REVIEW

Agency theory has been widely used in literature to investigate the information asymmetry between principals (shareholders) and agent (management). This study used the agency theory to determine the effect of internal control systems on the financial Performance. Sarens and Abdolmohammadi (2011) state that according to the agency theory, a company consists of a set of linked contracts between the owners of economic resources (the principals) and managers (the agents) who are charged with using and controlling these resources. A significant body of work has been undertaken in this area within the context of the principal-agent framework.

The agency relationship can have a number of disadvantages relating to the opportunism or self-interest of the agent: For example, the agent may not act in the best interests of the principal, or the agent may act only partially in the best interests of the principal. There can be a number of dimensions to this including for example, the agent misusing their power for pecuniary or other advantage, or the agent not taking appropriate risks in pursuance of the principal's interests because the agent views those risks as not being appropriate while on the other hand the principal may have different attitudes to risks.

There is also the problem of information asymmetry whereby the principal and the agent have access to different levels of information; in practice this means that the principal is at a disadvantage because the agent has more information. The theory was therefore very relevant in this study as shareholders who are the owners of the quoted companies have delegated the responsibilities of daily running of the companies to the management who acts as their agents and hence great need for strong internal control systems to ensure shareholders and other stakeholder's interests are adequately safeguarded. The theory therefore supports existence of control environment, internal audit and risk management.

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (institute of internal Auditor). Gupta (2001) asserts that "Internal audit is an independent appraisal function established within an Organization to examine and evaluate its activities as a service to the organization".

The objective of internal audit is to assist members of the organization in the effective discharge of their responsibilities. It's also an independent appraisal function established within an organization to examine and evaluate the effectiveness, efficiency and economy of managements control system (Subramaniam, 2006). Its objective is to provide management with re-assurance that their internal control systems are adequate for the need of the organization and are operating satisfactorily (Reid & Ashelby, 2002). It is a component of the internal control system set-up by management of an enterprise to examine, evaluate and report operations of accounting and other controls. The quality and effectiveness of internal audit procedures in practice are necessary since internal auditors cover a wide variety of assignments, not all of which will relate to accounting areas in which the external auditor is interested.

Emasu (2007) notes that "The effectiveness of internal audit function partly depends on; legal and regulatory framework, placement of the function and its independence, existence of audit\committees, resources allocated to the function and professionalism of internal audit staff". It is however a bitter reality that internal audit departments are rarely adequately

facilitated. Regarding the size and facilitation of the internal audit function, Gerrit and Mohammad (2010) found evidence in support of the monitoring role of the internal audit function. They specifically found evidence that management ownership is positively related to the relative size of the Internal Audit Function, which is inconsistent with traditional agency theory arguments that predict a negative relationship, but more in line with recent studies on earnings management.

4. RESEARCH METHODOLOGY

This study adopted a survey research design. The design will enable the acquisition of relevant information on the effects of internal control systems on financial management in Lamu County. The study was conducted in Lamu County Headquarters. It targeted employees in financial and accounting positions at the County headquarters. The study collected both primary and secondary data. The researcher used structured questionnaires to collect primary data. The researcher used both open ended and structured questionnaires. Content validity will be determined by making logical links between questions and the objectives of the study. Quantitative data was analysed using descriptive statistical methods, frequencies and percentage with the aid Microsoft Excel. Hypothesis will be tested using regression model. Qualitative data from open ended questions was analysed using content analysis. The data analysed was presented using frequency tables which enabled the researcher to easily interpret the findings of the research. Interpretation of the data was done within the frame of reference of the research problem.

5. FINDINGS

Table 1: Internal Audit Function

Scale: (Strongly Disagree=5, Disagree=4, Neutral=3, Agree=2, Strongly Agree=1)

Respondents opinion	5	4	3	2	1
The county has a functional internal audit unit/department	.0%	.9%	.9%	19.1%	79.1%
The timing of the audit is appropriate.	.9%	9.6%	18.3%	43.5%	27.7%
The internal audit unit has developed an internal audit manual that guides audit operations such as planning, implementation, monitoring, and evaluation.	.0%	2.6%	13.9%	45.2%	38.3%
The audit is always completed on a timely basis.	3.5%	22.6%	25.2%	29.6%	19.1%
Internal audit findings are reported directly to top management	.9%	1.7%	2.6%	51.3%	43.5%
The internal audit unit plays a major role in fraud detection	.9%	4.3%	15.7%	57.4%	21.7%
Recommendations of the internal audit unit are taken very seriously	26.1%	53.9%	16.5%	2.6%	9%
The internal auditor(s) demonstrate professionalism and an objective approach.	18.2%	68.7%	11.3%	.9%	9%
The audit department provides management with assurance that there are no major weaknesses and/or major internal control weaknesses are reported.	17.4%	66.1%	13.9%	1.7%	9%

In relation to monitoring and evaluation, the study sought to investigate if the companies have a functional internal audit, if the timing/completion of audit is appropriate and if the internal audit department has developed manual that guide on planning monitoring and evaluation. The result in table 1, indicated that 98.2% of the respondents said that the county has a functional internal audit department. On the other hand, 71.2 of the respondent said that that the timing of audit was appropriate. As to whether the internal audit unit in the county has developed an internal audit manual that guides audit operations such as planning, implementation, monitoring, and evaluation. Moreover, 83.5% of the respondents agreed that internal audit unit in the company has developed an internal audit manual that guides audit operations such as planning, implementation, monitoring, and evaluation. Furthermore, 48.7% of the respondent said that the audit is always completed on a timely basis. The results indicate that Lamu County has an effective internal audit function that plays the role of monitoring and evaluating organization activities, an indication of presence of good internal control systems.

The results also indicate that 94.8% of the respondents said that internal audit findings are reported directly to top management. Also, 79.1 of the respondents said that internal audit department in the county does not play a major role in fraud detection and prevention. From the findings, 80% of the respondents said that the audit recommendations are not taken seriously in the county. Moreover, 86.9% of the respondents said that the internal auditor does not demonstrate professionalism and objective approach in executing their duties. Finally, 83.5% of the respondents said that there are no major weaknesses and/or major internal control weakness which are reported. Therefore, the findings show that although Lamu County has an effective and efficient internal audit function which is able to detect fraud, it is not able to prevent and control it. The results confirm that Lamu County Government has entrenched corporate governance an indicator of presence of good internal control systems.

6. CONCLUSION AND RECOMMENDATION

The study revealed that 75.4% of the respondents said that Lamu County has an effective internal audit function that plays the role of monitoring and evaluating organization activities, an indication of presence of good internal control systems. Whereas only 40.62% of the respondents said that Lamu County has an effective and efficient internal audit function which is able to detect fraud and prevent and control it. The study concludes that Lamu County has an effective internal audit function that plays the role of monitoring and evaluating organization activities. It has an effective and efficient internal audit function which is able to detect fraud, but it is not able to prevent and control it. All these indicate that Lamu County government has good internal control systems. The internal audit function in Lamu county should be empowered to not only detect fraud, but also be able to prevent and control it. Internal audit department should play a major role in fraud detection and prevention. The audit recommendations should be taken seriously in the county. The internal audit should demonstrate professionalism and objective approach in executing their duties.

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