Internal Control System and Performance of State Departments in the Upper Eastern Region of Kenya

Abstract: State departments are required to adhere to the stipulated guidelines, be accountable to the state on the funding, safeguard resources and use them economically and effectively against stated objectives while ensuring risks are appropriately identified, analyzed and managed. To ensure compliance and accountability, the national treasury has instituted an internal control system to ensure compliance by all Authority to Incur Expenditure (AIE) holders with all requirements as provided for in the Public Financial Management Act. This study therefore intended to evaluate how effective the internal control system has been in enhancing performance of the state departments. The study was guided by various theories, namely, the agency theory, contingent theory and the stewardship theory. The study adopted a survey design targeting all the state departments in all sub counties in the upper Eastern region of Kenya (Meru, Tharaka Nithi, Emba, Isiolo and Marsabit counties). All the 276 departmental heads, otherwise called Authority to Incur Expenditure (AIE) holders were included in the study. However, a representative sample of 110 respondents was obtained using stratified random sampling. Data was collected using a self-administered questionnaire. A pilot study was conducted by issuing 10 questionnaires to the members of the population who were not in the sample. The instrument was validated by seeking expert opinion. Data was analysed using descriptive analysis and correlation analysis. The analysed data was presented using tables and pie charts. The study established a strong positive relationship correlation between internal control system and the departmental performance. There was a general trend of improvement in performance of the various departments over the three years period. It was concluded that the independent variable had positive influence on the dependent variable. It was recommended that the departmental managers should ensure internal control system is functional all the time.

Keywords: Internal control system, Internal Audit, Performance, State Departments.

BACKGROUND OF THE STUDY

Internal audit has been defined differently by various authors. The Institute of Internal Audit (2009) defined it as an independent, objective assurance and consulting activity designed to add value and improve organization’s operations. Internal audit is meant to improve the effectiveness of a firm’s risk management, control and even governance processes. The internal audit function achieves this by giving insight and recommendations based on assessment of business operations. Chiggai (2016) in a study carried out in South Africa, views internal auditing as a self-overseeing, objective and a consulting function that is intended to add value and develop operations in organizations. The national government has instituted the office of internal audit general to head the internal audit function in national government. The internal audit department is the custodian of the internal control system (GoK, 2018).

These audit units support the National Government operating at the regional and sub county levels. The Internal Audit Unit at the sub county and regional level is expected to support the sub county accounting officers and AIE holders in the departments in the effective discharge of their responsibilities by measuring, evaluating, and reporting on the effectiveness of the internal control systems implemented by them. The internal audit unit should ensure that, first, the AIE holders have appropriately assessed the risk and adopted strategies to manage the risks within acceptable levels, secondly, comply with the applicable policies, procedures, laws and regulations, next, that there is accountability and reliability of internal and external reporting as well as compliance with the relevant code of conduct and ethical guidelines (GoK, 2018). The state departments have an office in each and every sub-county. They represent their respective ministries at local level in discharging the ministerial functions.
These departments have a budget allocation that is financed by the central government through the treasury. Each department is required to offer service to the public, while upholding accountability and professionalism. The departmental heads, otherwise known as Authority to Incur Expenditure (A.I.E) holders or rather the accounting officer should channel the provided funds in strict adherence to not only the approved vote heads but also stick to the vote head amount and only after following the necessary procedures. Consequently, each departments is required to adhere to the stipulated guidelines, be accountable to the state on the funding, safeguard resources and use them economically and effectively against stated objectives while ensuring risks are appropriately identified, analyzed and managed. Should the state departments achieve the aforementioned, their performance would be jubilated. To this end, internal control systems has been put in place to ensure compliance by all AIE holders with all requirements as provided for in the PFM Act.

**Statement of the Problem**

Internal auditing exists in corporates, public corporations, national governments and even county governments. Several studies (kibet, 2008; Kibara, 2007; Radu & Ramona, 2013; Chepkorir, 2010; Otieno, 2012; Davidson et al, 2005) have linked internal control systems to firm’s performance. An effective internal auditing function is expected to oversee the internal control systems in state departments and by so doing enhance their performance in terms of accountability, compliance and service delivery. Although it’s not the primary duty of the internal auditor to institute and maintain an internal control system, it is expected that the internal auditor should oversight the aforementioned. The Internal Auditor General expects the internal auditors at county and sub county level to perform sufficient audit work over and above gathering other available information during the year that would be useful in forming an opinion about the effectiveness and adequacy of the internal control system.

All state departments have internal auditors who are supposed to play the oversight role. However, the Auditor General’s report of the years 2015/2016 to 2017/2018 have persistently cited several fundamental issues in several state departments namely irregular procurement, unsupported payments, budget under-utilization, authorized payments among many others. Such issues should be unearthed by an effective internal control system under the watch of the internal auditor who is expected to appraise its effectiveness. How much has the oversighting role of the internal control system influenced the performance of state departments in the Upper Eastern region of Kenya? This study therefore seeks to establish how the internal control system influences the performance of state departments in the Upper Eastern region of Kenya.

**Theoretical Literature Review**

**Agency Theory**

According to Fama (2006), agency theory is about agency relationship. Agency relationship exists between a principal (citizens) and the agent (the government). Agency theory has been defined as a contract where a principal delegates his responsibility to another party called the agent to undertake the delegated responsibilities on his behalf. There are two main problems that agency theory attempts to address. First, a problem that arise when the objectives of the agent and the principal are in conflict and the principal is not able to verify the actions of the government (agents). Secondly, the problem arising as a result of principal and agent having different risk appetite. When the two have different risk tolerances, they may each be declined to take different actions. Cohen (2010) contend that internal audit function, coupled with other interventions such as financial reporting, external audit etc. go a long way in maintaining cost efficient contracting between owners and managers. Agency theory doesn’t only aid an understanding of why internal auditing exists, but also help explain the size and scope of internal auditing department, for instance, financial versus operational auditing.

**Stewardship Theory**

The above theory stems from psychology and sociology. Davis, Schourman and Donakdson (1997) observed that stewardship theory protects the steward and seeks to maximize the shareholders wealth through organizational performance. The stewards are the executives and firms management that is spending their time, energy and resourcefulness to work, protect and make earnings for the firm owners. In contrast to the agency theory, whose focus is on the perspective of individualism (Davis, 1991), this theory weighs on the top executives as the stewards should be persuaded and fulfilled when hierarchical accomplishments are achieved.

Contrasting Agyris (1973) whose focus on agency theory identified the management as material things, (Donakdson and Davis, 1991) argued that stewardship theory recognizes the value of structures in empowering the stewards and gives them full autonomy built on trust. This approach therefore focus on the staff ranks or the management being more independent so as to maximize shareholders wealth. This view was also supported by (Fama, 1980) by contending that executives endeavor to manage their careers in such a manner that portrays them as organisational active stewards. In the same breath, shleifer and Vishny (1997) observed that the executives return finance to the firms’ owners in order to earn good performance score.

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that will enhance their re-election. In addition, it also builds good reputation in the financial markets should the firm intend to seek further financing. Tosi (2003) and Davis (1997) similarly observe that participative management which entails involvement oriented philosophy as proposed by this theory is beneficial to a firm. This philosophy leads to reduced need for costly internal control methods to curb agency costs and governance challenges, a task that involves internal audit work in a firm. This study borrows the stewards’ theory assumptions that the executives mind their best interest at the expense of the owners. This aspect brings some risks that call for need of auditing practice in organizations. The stewardship theory major presumption is that the practice of executives are adjusted to the interests of the principals.

Contingency Theory

Auditing aims at testing the reliability of a firm’s information, practices, policies and procedures. Regulations by government require that specific financial institutions be subject to independent financial audits. However, industry standards may suggest audits in other areas such as environmental, safety and technological audits. Despite the subject of the audit there are various factors that have an effect on a firm’s final results and hence the contingency theory. This is an organizational theory that postulates that there is no one best way to manage a firm. Instead, the best course of action is dependent (contingent) upon the internal and external situation. A contingent leader therefore applies their own style efficiently to the right situation.

This theory involves the relationship between leadership style and the favorableness of the situation. Fiedler (1986) described situational favorableness as comprising of three empirically derived perspectives namely, first, the leader-member relationship which is high when the leader is generally respected and followed by followers. Secondly, the extent of task structure which is high when the task is very structured. Finally, the power from the leaders’ position which is deemed high when there is a great deal of power and authority that are formally attributed to the leaders’ position. According to Fiedler (1986) the situations are favourable to a given leader when the three perspectives are high. This theory concludes that there is no one best approach in management and therefore different situations call for different ways to handle, manage and resolve any arising issue of concern. Given the above, audit function should therefore oversee the dynamics of leaders as they apply their discretion in decision making.

Conceptual Framework

A conceptual framework is a diagrammatic representation of the interrelationship between the hypothesized variables (independent and dependent variables) of the study. This relationship is as shown in the diagram below:

<table>
<thead>
<tr>
<th>Internal Control System</th>
<th>State Departments Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existence of ICS</td>
<td>Internal Auditors report on</td>
</tr>
<tr>
<td>Operational effectiveness of ICS</td>
<td>- (Full) Disclosure</td>
</tr>
<tr>
<td>Identification of ICS gaps</td>
<td>- (Complete) Accountability</td>
</tr>
<tr>
<td>Suggest remedial actions</td>
<td>- (Minimum) Risk exposure</td>
</tr>
</tbody>
</table>

As shown in the diagram above, internal controls helps a department to promote orderly, economical, efficient and effective operations, safeguarding resources and promoting adherence to laws, regulations and contracts as well as developing and maintaining reliable financial data that is accurate, reliable and timely. The departmental performance is dependent on how much departments adhere to the public financial management Act of 2012, PFM regulations and other directives by the national treasury. With effective and efficient oversighting of departments by the internal audit unit, it is expected that the departments will be accountable, have adequate disclosure and have reduced risk exposure.

Methodology

The study adopted a survey design targeting all the state departments in all sub counties in the upper Eastern region of Kenya (Meru, Tharaka Nithi, Embu, Isiolo and Marsabit counties). All the 276 departmental heads, otherwise called Authority to Incur Expenditure (AIE) holders were included in the study. However, a representative sample of 110 respondents were obtained using stratified random sampling. Data was collected using a self-administered questionnaire. A pilot study was conducted by issuing 10 questionnaires to the members of the population who were not in the sample. The instrument was validated by seeking expert opinion. Data was analysed using descriptive analysis and correlation analysis. The analysed data was presented using tables and pie charts.

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**FINDINGS**

This section presents the findings on the relationship between the oversight role of the internal auditors and the departmental performance.

**Influence of Internal Audit Activities on Effectiveness of Internal Control System**

Table 1: Effectiveness of Internal Control System

<table>
<thead>
<tr>
<th>The Internal Audit Unit regularly:</th>
<th>Agree</th>
<th>Not Sure</th>
<th>Disagree</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>i Checks the key ICS that provide assurance of the departmental operations</td>
<td>63 f</td>
<td>17 f</td>
<td>11 f</td>
<td>91 f</td>
</tr>
<tr>
<td>ii Evaluates the operational-effectiveness of the controls to identify any gaps</td>
<td>54 f</td>
<td>21 f</td>
<td>16 f</td>
<td>91 f</td>
</tr>
<tr>
<td>iii The Internal Audit Unit Checks the systems’ strength and weakness</td>
<td>42 f</td>
<td>26 f</td>
<td>23 f</td>
<td>91 f</td>
</tr>
<tr>
<td>iv Recommends improvements in procedures where gaps are identified</td>
<td>51 f</td>
<td>29 f</td>
<td>12 f</td>
<td>91 f</td>
</tr>
<tr>
<td>v Checks whether the prescribed system of controls are properly implemented</td>
<td>77 f</td>
<td>5 f</td>
<td>10 f</td>
<td>91 f</td>
</tr>
<tr>
<td>vi Ascertains that the control system is operating in practice</td>
<td>67 f</td>
<td>13 f</td>
<td>12 f</td>
<td>91 f</td>
</tr>
<tr>
<td>vii Reports on opportunities for improving operational performance</td>
<td>79 f</td>
<td>12 f</td>
<td>0 f</td>
<td>91 f</td>
</tr>
</tbody>
</table>

Whereas installation of a system of internal controls is the management’s duty, the internal auditor should satisfy himself/herself that the management has taken actions to manage risk and increase the likelihood that set organizational goals and objectives are achieved. This study therefore sought to find out how effective the internal audit function is. First, the respondents were asked to state checks the key ICS that provide assurance of the departmental operations.

**Oversighting of ICS by Internal Audit Unit on Performance**

The respondents stated their agreement to the extent to which they believed internal audit unit has influence on performance. The findings were as shown on the table below.

Table 2: Oversight Role of Internal Audit Unit on Performance

<table>
<thead>
<tr>
<th>Measure of Performance</th>
<th>Agree</th>
<th>Not Sure</th>
<th>Disagree</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disclosure</td>
<td>58 f</td>
<td>13 f</td>
<td>20 f</td>
<td>91 f</td>
</tr>
<tr>
<td>Accountability</td>
<td>61 f</td>
<td>19 f</td>
<td>11 f</td>
<td>91 f</td>
</tr>
<tr>
<td>Risk Exposure</td>
<td>78 f</td>
<td>4 f</td>
<td>9 f</td>
<td>91 f</td>
</tr>
</tbody>
</table>

As shown in the above table, when departmental heads were asked to pronounce whether the internal audit function has influenced departmental performance, majority were on the affirmative whereby 63% said it influenced disclosure, 67% said it influenced accountability and 86% felt if has influence on risk exposure to the departments.

**Trend of the Performance over the last three years**

The study focused on the performance of the state departments for the years 2016/17, 2017/18 and 2018/19. This study sought to establish the trend of performance of the state departments over this period. The respondents were therefore asked whether performance improved, declined or remained constant and the respondents had the following views.

Table 3: Trend of Performance

<table>
<thead>
<tr>
<th>Response</th>
<th>Decreased</th>
<th>Constant</th>
<th>Improved</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meeting work plans targets</td>
<td>39 f</td>
<td>24 f</td>
<td>28 f</td>
<td>91 f</td>
</tr>
<tr>
<td>Disclosure</td>
<td>42 f</td>
<td>24 f</td>
<td>47 f</td>
<td>91 f</td>
</tr>
<tr>
<td>Accountability</td>
<td>23 f</td>
<td>11 f</td>
<td>57 f</td>
<td>91 f</td>
</tr>
<tr>
<td>Risk Exposure</td>
<td>16 f</td>
<td>21 f</td>
<td>54 f</td>
<td>91 f</td>
</tr>
</tbody>
</table>

As shown in the above table, it was the general opinion of the respondents that the performance improved over the last three years. Specifically, the majority of the respondents (43%) felt that the work plans by the department were met, 63% of the respondents mentioned that accountability improved and 59% felt that risk management also improved over the same period. At the same time, 52% said disclosure improved. Thus, of the three measures, improvement in
accountability was chosen by the most respondents and improvement in disclosure by the least number of respondents. More respondents (46%) cited decrease in disclosure as compared to only 18% who mentioned that risk management declined over the period in question. 63% of the respondents mentioned that accountability improved and 59% felt that risk management also improved over the same period. At the same time, 52% said disclosure improved. Thus, of the three measures, improvement in accountability was chosen by the most respondents and improvement in disclosure by the least number of respondents. More respondents (46%) cited decrease in disclosure as compared to only 18% who mentioned that risk management declined over the period in question.

<table>
<thead>
<tr>
<th>Internal Control System</th>
<th>Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Pearson correlation</td>
</tr>
<tr>
<td></td>
<td>Sig. (2 tailed)</td>
</tr>
<tr>
<td></td>
<td>N</td>
</tr>
</tbody>
</table>

The findings indicate that the relationship between ICS and Performance of state departments in the upper Eastern region of Kenya is positive, strong and significant ($r = 0.821, p<0.01 (0.00)$). It’s therefore imperative that the internal controls are functional all the time since this has a positive yet significant relationship with performance. These findings are similar to the study by Mawanda (2008) that found there existed a significant relationship between internal control system and financial performance.

**Conclusion**

Internal control system has positive influence on performance of state departments. To this end, the internal audit should endeavor to remain independent and proactively play their oversight role while upholding professionalism and unquestionable integrity. It should also be noted that the performance of the various departments improved over the three years period. Of the various measures of performance, accountability was shown to have been the most improved, and unquestionable integrity. It should also be noted that the performance of the various departments improved over the three years period. Of the various measures of performance, accountability was shown to have been the most improved, followed closely by risk management and finally disclosure. From the aforementioned, the internal control system seemed to be a necessary function in pursuit of performance.

**Recommendations**

The strength and hence effectiveness of the internal control system should be constantly checked and prompt feedback given to the departmental heads all the time.

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