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Effect of Internal Control Environment on the Financial Performance of Companies Quoted in the Nairobi Securities Exchange

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ABSTRACT
Internal Controls are processes designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of the financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Internal Control Systems play an important role in every organization as it assist in realization of their financial performance goals. The study sought to determine the effect of internal control systems on financial performance of companies quoted in the Nairobi Securities Exchange (NSE). To achieve the objective of this study, the research specifically looked at the following objectives, control environment, internal audit, risk management, internal control activities and role of corporate governance controls on the financial performance of quoted companies in Kenya. The study adopted survey research design. The population chosen for this study was all 62 companies quoted in NSE. The study used a sample of 38 companies from a target population of 62 companies quoted in NSE. The sample was drawn using stratified random sampling technique. The study relied on both primary and secondary data. Primary data was collected using structured questionnaires while the Secondary data was extracted from audited annual reports, publications and document analysis. Data analysis used both descriptive and inferential statistics. Frequency tables were prepared, averages determined and tests of hypothesis like ANOVA, chi-square, correlation analysis were done. The data was analyzed using statistical package for social scientists (SPSS) computer software version 21.0. The results and findings concluded that there was significant association between internal control environment and financial performance recommends that internal control environment should be enhanced to further improve the financial performance of companies quoted in Nairobi Securities Exchange.
Key Words: Internal Controls, Control Environment, Information and Communication, Monitoring Activities, Profitability, Efficiency

INTRODUCTION
The chapter focuses on the background to the study in which the concept of internal control system is put into perspective. It also clearly brings out the general perception that; institution of internal control systems will always lead to improved financial performance. The chapter handles the purpose of the study which is to determine the effect of internal control systems on the financial performance of quoted companies in Nairobi Securities Exchange. The chapter also brings into focus the scope of the study as covering companies quoted in Nairobi Securities Exchange

The companies listed at the NSE are classified into the following segments: Agricultural seven companies, Automobiles and Accessories three companies, Banking eleven companies, Commercial and Services nine companies, Construction and Allied five companies, Energy and Petroleum five companies, Growth Enterprise Market Segment two companies, Insurance six companies, Investment four companies, Manufacturing and Allied nine companies, Telecommunication and Technology one company. Suspended companies were excluded from the study, as their current trading performance is nonexistent. The sampling method used was stratified sampling technique as the companies are heterogeneous and falls into different segments. This sampling method ensured that the sample obtained was representative of the population. The findings were then projected to the whole segments represented at NSE.

Internal Controls are processes designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of the financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations (Mwindi, 2008). Tunji (2013) and Dhillon (2001) argue 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) framework look 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.

The COSO framework (2013) identifies five main elements of internal control systems against which the review should take place. These include Control environment, Risk assessment, control activities, information and communication and monitoring. There is a general expectation that institution and enforcement of proper internal control systems will always lead to improved financial performance. The COSO framework also found out that properly instituted systems of internal control improve the reporting process and also give rise to reliable reports which enhances the accountability function of management of an entity. Internal controls are put in place to ensure safe custody of all companies’ assets; to avoid misuse or misappropriation of assets and to detect and safeguard company’s resources against probable frauds.

Recently a number of financial scandals have been witnessed in quoted companies both in local and international scene. For example in America, investors lost $180 billion in World Com Scandal of 2002, $150 million in Tyco Scandal of 2002, $1.4 billion in Heath South Scandal of 2003 (the largest publicly traded company) and $3.9 billion in America international Group (AIG) scandal of 2005, among several financial fraudulent activities affecting publicly quoted companies. In the early 2000s, a number of high-profile corporate accounting scandals resulted in some investors, company personnel and other stakeholders suffering significant losses. These scandals resulted in demands for a greater emphasis on corporate governance. In July 2002, the United States Congress passed the Sarbanes-Oxley Act (SOX) in an effort to reduce public concern over a number of high profile corporate failures in the US. Ashbaugh-Skaife et al., (2008) documented that firms reporting internal control weaknesses have more complex operations; have experienced recent changes in organizational structure; are at increased exposure to accounting risks; and have fewer resources to invest in internal control. Furthermore, Doyle et al., (2005) indicated that firms with material weaknesses have a lower earnings quality than those that do not report material weaknesses. Additionally, Hamersley et al., (2007) showed a negative market reaction to firms that had reported material weaknesses in internal control per the requirement of Sarbanes-Oxley Act Section 302.

In South Africa, cases of accounting scandals have been recorded in Randgold and Exploration companies. In Nigeria, the managing director and chief financial officer of Cadbury Nigeria were dismissed in 2006 for inflating the profits of the company for some years before the company’s foreign partner acquired controlling interest. These scandals emphasize the need to evaluate, scrutinize, and formulate systems of checks and balances to guide corporate executives in decision-making. These executives are legally and morally obliged to produce honest, reliable, accurate and informative corporate financial reports periodically (Hayes et al., 2009).

In Kenya, Statistics available from CMA 2014 have shown most firms especially quoted companies have registered declining financial performance in the recent years. Examples include Kenya Airways which reported a loss Ksh 10 billion, Mumias Sugar company Ksh 3.4 billion loss, Uchumi super markets Ksh 226million loss, Eveready East Africa limited Ksh 248million loss, CMC holding suspended from NSE and so on. Rezaee (2012) revealed that financial reporting is ineffective due to corruption, frauds, and ineffective regulations that have led to poor financial performance in publicly quoted companies. According to World Economic Forum (WEF), Kenya was ranked position 106 out of 144 due to mega corporation scandals. Some of the companies cited by the report for poor corporate governance were CMC and centum Ltd.

Companies listed in Nairobi stock exchange are expected to have effective and efficient internal controls to provide reasonable assurance about the achievement of the entity's objective with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. According to Capital Market Authority Act (cap.485, gazette Notice no. 3362), the board of public listed company is required to maintain a sound system of internal controls to safe guard the shareholders investments and assets. Despite existence of elaborate system of internal controls in quoted companies, a number of quoted companies continue to experience financial distress which has threatened their survival in the business.

Internal Control Systems

The 2013 COSO Framework defines Internal Control system as "a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance'. The control environment sets the tone of an organization, influencing the control consciousness of its employees. The Committee of Sponsoring Organizations (COSO), a voluntary organization offering guidance on monitoring internal controls, report indicates that this component is the foundation for all other components of internal control, providing both discipline and structure to the organization. The COSO framework identifies five main elements of a control system against which the review should take place. These include Control environment, Risk assessment, control activities, information and communication and monitoring. Internal control systems operate at different levels of effectiveness. Determining whether a particular internal control system is effective is a judgment resulting from an assessment of whether the five components - Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring - are present and functioning. Effective controls provide reasonable assurance regarding the accomplishment of established objectives.

According to Feng, Li and McKay (2009), the quality of an organization internal control system has significant impact on the accuracy of management guidance, likewise firms that disclose ineffective internal controls system have larger tendency of experiencing management errors in their operation than those firms that report effective internal controls system. Schneider and Church (2008) in their study stated that 'effective internal controls systems are fundamental drivers toward earnings quality. In the same vein, effective internal control system has an essential role to play in a firm's success (Jokipii, 2010).

Other scholars have defined Internal control as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of a firm's objectives in the effectiveness and efficiency of operations, reliability of financial and management reporting, compliance with applicable laws and regulations and protect the organization's reputation. Effective internal control system operates when some specific procedures are adopted by the management. International Accounting Standards (IAS) categorizes internal control types as a plan of organization, segregation of duties, control of documents, safeguarding of assets, competence of staff, arithmetic and accounting controls, recording and record keeping , supervision, authorization and approvals, vocation and rotation of duties, cost feasibility , routine and automatic checks (Kaplan, 2008). The above studies greatly support that effective internal controls significantly contribute to financial performance of companies.

Financial Performance

Financial performance is a measure of company's policies and operations in monetary terms. It is a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. There are many different ways to Measure Company's financial performance. This may be reflected in the firm's return on investment (ROI), return on assets (ROA), value added, among others and is a subjective measure of how a firm can use assets from its primary mode of business and generate revenues (Mishkin, 2007) .

Positive financial performance in a firm can be achieved by eradicating waste in benefits services processes and systems. The "critical success factor" for a firm is the degree to which it fulfils its set objectives and mission in terms of being efficient, effective and economical. The information obtained from a sound internal control system as reflected from financial statements will provide a report on a firm's financial performance and position that is useful to a wide range of users for assessing the stewardship and making economic decisions (Doyle et al., 2007).

Internal Control Systems are very instrumental in achieving the firm's set mission and objectives; hence Value for Money. The main approach to VFM is the firm's control over the use of resources in order to achieve its set objectives. Heads of departments should establish sound arrangements for planning, appraising, authorizing and controlling operations in order to achieve positive Financial Performance. Financial Performance and Value for Money are used to assess whether or not a firm has obtained the maximum benefit from the goods and services it acquires and / or provides, within the resources available to it (COSO, 2013).

Value for Money is not paying more for a good or service than its quality or availability, justifies. A well public spending implies a concern with economy (cost minimization), efficiency (output maximization) and effectiveness (full attainment of the intended results). The most effective way to improve Financial Performance is by reducing the level of irregularity and fraud through improvements in the firm's systems of internal financial control. Shareholders need to be assured that their resources are being used efficiently and effectively in providing the right service at the least cost. Financial Performance analysis needs to pay attention to total risks and is related to concepts of efficiency and effectiveness (CPA Australia, 2008).

Internal Controls and Financial Performance

Internal control systems including internal audits are intended primarily to enhance the reliability of financial performance, either directly or indirectly by increasing accountability among information providers in an organization (Jensen, 2003). Internal control therefore has a much broader purpose such that the organization level of control problems associated with lower revenues, which explore links between disclosure of material weakness and fraud, earnings management or restatements internal controls provide an independent appraisal of the quality of managerial performance in carrying out assigned responsibilities for better revenue generation (Beeler et al., 1999). Fadzil et al., (2005) said that an effective internal control system unequivocally correlates with organizational success in meeting its revenue target level. Effective internal control for revenue generation involves; regular review of the reliability and integrity of financial and operating information, a review of the controls employed to safeguard assets, an assessment of employees' compliance with management policies, procedures and applicable laws and regulations, an evaluation of the efficiency and effectiveness with which management achieves its organizational objectives (Ittner, 2003).

There are three major classifications of internal controls; preventive, detective, and corrective. Preventive controls predict potential problems before they occur, make adjustments, and prevent an error, omission or malicious act from occurring. The detective controls are used to detect and report the occurrence of an omission, an error or a malicious act. Finally, the corrective controls help in ensuring that the impact of a threat is minimized, identify the cause of a problem as well as the correct errors arising from the problem. Corrective controls correct problems discovered by detective controls and modify the processing system to minimize future occurrence of the problem (Singleton et al., 2006).

According to CPA Australia (2008) each internal control procedure is designed to fulfil at least one of these eight criteria discussed below.

Completeness: that all records and transactions are included in the reports of business. Accuracy: the right amounts are recorded in the correct accounts. Authorization; the correct levels of authorization are in place to cover such things as approval, payments, data entry and computer access. Validity; that the invoice is for work performed or products received and the business has incurred the liability properly.

Existence of assets and liabilities: Has a purchase been recorded for goods or services that have not yet been received? Do all assets on the books actually exist? Is there correct documentation to support the item? Handling errors; that errors in the system have been identified and processed. Segregation of duties; to ensure certain functions are kept separate. For example, the person taking cash receipts does not also do the banking. Presentation and disclosure; timely preparation of financial reports in conformity with generally accepted accounting principles. All internal controls, whether administrative or accounting, are linked to a financial consequence. For example, keeping records for long service leave entitlements is an administrative control but it does ultimately have a financial consequence.

Nairobi Securities Exchange

The Nairobi Securities Exchange (NSE), was formed in 1954 as a voluntary organization of brokers, is now one of the most active markets in Africa. The NSE has played a role in increasing investor confidence by modernizing its infrastructure. At the dawn of independence, stock market activity slumped due to uncertainty about the future of independence in Kenya. However, after three years of calm and economic growth, confidence in the market was rekindled and the exchange handled a number of highly over-subscribed public issues (Moyes et.,2006).

In 1980s the Kenyan government realized the need to design and implement policy reforms to foster sustainable economic development with an efficient and stable financial system. In particular, it set out to enhance the role of the private sector in the economy, reduce the demands of public enterprise on the exchequer, rationalize the operations of the public enterprise sector to broaden the base of ownership and enhance capital markets in the formation of a regulatory body "the capital markets authority" in 1989, to assist in the creation of an environment conclusive to the growth and development of the country's capital markets as detailed in the Statistical Abstract of 1990. The NSE is poised to play an increasing role in the Kenyan economy, especially in the privatization of state owned enterprises. In 2006 the NSE installed the automated trading system (ATS), which has resulted in high trading volumes with the daily market turnovers exceeding Ksh110 billion in some days. The implementation of the ATS provided for longer trading hours, increased trading efficiency and price discovery Economic Survey of 2007.

The boom experienced at the NSE in the recent past has resulted to an increase in the volume traded, with the stock market registering increased activity especially with initial public offers. The rapid growth of the NSE has been subject to debate among scholars, Politicians and the general public. Statements have been reported in the media questioning the phenomenal growth of the NSE in the past three years and more specifically the appreciation of stock prices of quoted companies. The growth has been attributed to the high growth rate registered by the Kenyan economy in the last three years and the changing international perception of Kenya as a secure investment destination as reported in the Statistical Abstract of 2008.

NSE introduced the NSE All-share Index (NASI), which is complementary to NSE 20 share index in an effort to provide investors with a comprehensive measure of the performance of the stock market. The Nairobi Stock Exchange is one of the leading developing markets in the world and investing in stocks has been hyped so much that the mention of the IPO reflexively elicits a pat on the pocket. Starting with KenGen offer in May 2006, the NSE has seen tremendous growth in the number of retail investors. However, the majority of investing public is still in the dark on the operations of the stock market. Many still do not bother to follow up on their investments, preferring to once in a while to keep the tab through media reports.

The Nairobi Securities Exchange facilitates good management of companies by asking them to give periodic reports of their performance. Providing a daily market reports and price list to ensure that investors know the worth of their assets at all times. In July 2011, the Nairobi Stock Exchange Limited changed its name to the Nairobi Securities Exchange Limited. The change of name reflected the strategic plan to evolve into a full service securities exchange which supports trading, clearing and settlement of equities, debt, derivatives and other associated instruments.

Corporate Governance guidelines of 2002 issued by the NSE actually recognizes the important role played by the Internal Audit function and actually gives the various best practices companies can adopt in regards to setting up an audit function. In Kenya, the internal audit function is becoming increasingly important and it's very crucial in the public sector. All listed companies are required to have an internal audit department. According to the Capital Markets Authority Act Chapter 485A, the board should establish an internal audit function which should be independent of the activities they audit and should be carried out with impartiality.

Most of the companies quoted at the Nairobi Stock Exchange (NSE) have not adopted corporate governance guidelines and those who have, do not enforce them. The confused application of the state corporations Act, Companies act, capital market regulatory Authority Act and various circulars and directives from government authorities often create conflict structures and procedures, (Macharia, 2012).

Statement Of The Problem

Globally, financial scandals have been witnessed triggering reaction for tighter regulation and enhanced standards for accounting and corporate governance (Sarbanes and Oxley, 2002). In America, scandals such World.com and Enron in year 2002 where investors lost over $180 billion led to enactment of Corporate and Auditing Accountability and Responsibility Act (Sarbanes and Oxley, 2002). These major financial scandals were caused by poor internal control systems including weak corporate governance which the Sarbanes Oxley Act of 2002, tried to address.

In Kenya, Statistics available from CMA report of 2014 have shown most firms especially quoted companies have registered declining financial performance in the recent years. Examples include Kenya Airways which reported a loss ksh 10 billion, Mumias Sugar company Ksh 3.4 billion loss, Uchumi super markets ksh226million loss, Eveready East Africa limited Ksh 248million loss, CMC holding suspended from NSE.

Data available from a World Bank report of 2014 show that declining financial performance of quoted companies adversely affects the economic growth of the Kenyan economy. Most quoted companies have functional internal audit departments charged with responsibility of providing management with re-assurance that internal control systems are adequate and quality of services is in place. 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 put companies at risk of financial inadequacy, employee dissatisfaction and poor financial performance (Kaplan, 2008).

In the aftermath of corporate scandals and the global financial crisis, corporate governance has received significant attention from regulators and the public. Regulatory responses have focused on increasing disclosure requirements relating to corporate governance and this has, in turn, driven increased awareness and demand for internal assurance on corporate governance processes, including internal control and risk management. Thornton (2004) observes that in recent years, stakeholder's expectations from internal audit functions have changed significantly. The focus has now moved from a compliance and financial control function to facilitating organizations to proactively identify, assess and control risks. Previous studies have focused on the contribution of internal control systems on financial performance of small and medium scale business enterprises (Nyakundi, Nyamita and Tinega, 2014). Mawanda (2008) researched on effects of internal control systems on financial performance in an institution of higher learning. Khamis (2013) researched on contribution of internal control systems to financial performance of financial institution. Majority of the studies involving internal controls have focused on investigating the characteristics of firms that disclose material weaknesses in internal control. Al-Matari et al., (2012) noted that there was lack of research in developed as well developing nations regarding the direct association of internal control systems and firm performance.

In the Kenyan, researches done relating to internal control systems and financial performance do not show directly the effect of corporate governance and government policy on financial performance of companies. For example case study researches done by Wanjara (2014) and Kamau, (2013).

This study therefore focused on wider scope of companies quoted in the Nairobi securities exchange and sought to fill existing research gaps in determining the effect of internal control systems on financial performance of the companies quoted at NSE.

Research Objective and Hypothesis

The objective of the study was to establish the effect of internal control environment on financial performance of companies quoted in Nairobi Securities Exchange. The research hypothesis of the study was: There is no relationship between internal control environment and the financial performance of companies quoted in the Nairobi Securities Exchange.

LITERATURE REVIEW

Measurement of Financial Performance of Companies

Dixon et al., (1990) said that appropriate performance measures are those which enable organizations to direct their actions towards achieving their strategic objectives. Reid and Ashelby (2002) contends that performance is measured by either subjective or objective criteria, arguments for subjective measures include difficulties with collecting qualitative performance data from small firms and with reliability of such data arising from differences in accounting methods used by firms.

In order to survive and succeed in a competitive market, firms must focus on maximizing profit or they will eventually be driven out of business (Dutta and Radner, 1999). John (2011) supports this claim by saying that only efficient firms stay in the market, and that less productive firms will eventually exit many markets. Performance measures provide a mechanism for the organization to manage its financial and non-financial performance. Accountability is increased and enhanced, ensuring that projects support the organizational strategy and that better services and greater satisfaction are provided to a customer.

Wilks and imblelman (2004) found out that objective performance measures include indicators such as profit growth, revenue growth, return on capital employed. Financial consultants Stern Stewart and Co. created Market Value Added (MVA), a measure of the excess value a company has provided to its shareholders over the total amount of their investments (John, 2011). This ranking is based on some traditional aspects of financial performance including: total returns, sales growth, profit growth, net margin, and return on equity.

Dwivedi (2002) argues that other financial measures should include value of long-term investment, financial soundness, and use of corporate assets. John (2011) discussed accounting based performance using three indicators: return on assets (ROA), return on equity (ROE), and return on sales (ROS). Each measure is calculated by dividing net income by total assets, total common equity, and total net sales, respectively. The current study proposes to assess company financial performance using the following indicators as used by the various scholars discussed in previous studies above, Profitability, Return on asset and earnings per share.

Control Environment and Financial Performance

According to COSO, the control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.

The control environment, as established by the organization's administration, sets the tone of an Institution and effects the control consciousness of its people. Management attitude should be committed to ethical business practices and to following the established control procedures. This is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include: Integrity and ethical values; the commitment to competence; leadership philosophy and operating style; and the way management assigns authority and responsibility, and organizes and develops its people (Thornton, 2004).

A study by Khamis (2013) found out that there is a significant positive relationship between internal control system (control environment) and financial performance of financial institution. In his research Mawanda (2008) established that there is a positive relationship between control environment and financial performance of institutions of higher learning in Uganda as portray by his case study of Uganda Martyrs University.

RESEARCH METHODOLOGY

This study adopted a survey research design. The population of this study focused on the state-owned corporations in Kenya. Stratified random sampling technique was used to determine the sample size. The number of respondents involved in this study was 144. Data was collected using questionnaires. Data was analysed through the use of descriptive statistics and multiple linear regression analysis. The multiple linear regression models will be used to estimate the causal relationship between ROA and the independent variables.

Data Analysis, Results and Discussion

The study adopted different statistical approaches to examine the effect of internal control systems on financial performance of companies quoted in the Nairobi Securities Exchange. All constructs were adopted from pre-existing scales found in the literatures. In addition to descriptive statistics, the reliability among the multiple measures of the variables that comprise this study was measured using Cronbach's alpha coefficient generated by statistical packages for social sciences (SPSS). Cronbach's alpha is a measure of consistency and checks if the questions of the questionnaire were understood and if the data are minimally reliable (Babbie, 2002);

Response Rate

The data was collected from the companies listed in Nairobi securities Exchange which are registered and regulated by Capital Market Authority. The sample of the study consisted of 38 companies out of 62 listed companies.The target population was 144 Senior Managers out of which 115 responses were received,translating into 79.8% response rate. The response was considered appropriate since Sekaran (2008) argues that any response above 75% is classified as best.

RESULTS AND DISCUSSION

Gender Distribution

The gender of the respondents was sought. Majority (59.5%) of the respondents were male while the rest (40.5%) of the respondents were female as shown in Table 1.The statistics show that majority of employees incharged of internal control systems in companies quoted in Nairobi Securities Exchange are Male. The distribution however represents a fair gender balancing , an indication of successful efforts of various gender mainstreaming compaigns.

Table 1: Distribution of Respondents by Gender

Gender	**Percentage**
Male	59.5
Female	40.5
Total	**100.0**

Sector Distribution of the Respondents

The distribution of respondent per sector as shown in the Table 2 below shows that there is proper representation of all the sectors represented by various companies quoted in Nairobi securities Exchange, an indication that proper stratification of the sector was done.

Table 2: Distribution of Respondents by Sector

Sector	**Target**	**Response**	**%**
Automobiles	8	5	4.34
Banking	26	22	19.13
Commercial/Services	23	19	16.52
Construction And Allied	11	9	7.83
Energy/Petroleum	11	10	8.69
Growth Enterprises	4	2	1.74
Insurance	11	10	8.69
Investment	8	4	3.49
Manufacturing	23	18	15.65
Telecommunication	4	4	3.49
Total	**144**	**115**	**100**

Job Position of Respondents

Although the unit of observation for this study was the Senior Managers in the quoted companies as already indicated in the methodology, this question sought to establish the job position of the respondents in the organization. An overwhelming 94% of the respondents were Senior executive management with 6% indicating Middle level managers as indicated in Table 3.This was very important profile distribution for this study since the respondents were the right people with adequate information relevant to this study hence best placed.

Table 3: Job position of Respondents

Designation	**Percentage**
Senior Executive Managers	96%
Middle Level Manager	4%
Total	**100**

Level of Education of Respondents

Respondent's level of education was sought and majority (57%) of the respondents indicated that they have at least a degree level of education while sizeable (43%) possess a higher degree at postgraduate level (Table 4). This is highly expected since the respondents are at a senior management level where the skills knowledge and Competencies is supposed to be high. This depicts that the respondents were well educated and informed and therefore furnished this study with better information which added value.

Table 4: Level of Education of Respondents

Education Level	**Percentage**
Bachelors Degree	57
Post graduate	43
Total	**100**

Working Experience of Respondents

This question sought to investigate the number of years each respondent have worked with the company. Majority (39.1%) of the respondents have a working experience between 6 to 10 years, 25.2% have 11 to 15 years, 25.2% have 11 to 15 years 17.4% have below 5years, 11.3% have 16 to 20years and 7% have over 20 years of experience as shown in Table 5. This means that the respondents have adequate working experience with the companies and therefore possess the necessary knowledge and information which was considered useful for this study.

Table 5: Working Experience of Respondents

Experience in years	**Percentage**
Less than 5 years	17.4
6 to 10 years	39.1
11 to 15 years	25.2
16 to 20 years	11.3
Over 20 years	7.0
Total	**100.0**

Test for Normality

The test for normality of financial performance (dependent variable) was done by use of Kolmogorov-Smirnov test. Given that H0 and H1, set α=0.05, the rule is that reject H0 if P-value is less than α else fail to reject H0, where:

H0: The data is normal
H1: The data is not normal

Table 6 indicates that using the Kolmogorov-Smirnov Test of normality, employee engagement data is normal since the P-value, 0.240 is above 0.05 and thus we fail to reject the null hypothesis (H0).The study therefore concluded that financial performance variable is normal in distribution and hence subsequent analysis could be carried out.

Table 6 further shows that financial performance is approximately normally distributed with a mean of 17.9347, standard deviation of 5.69643and the number of respondent were 115 represented by N=115. The dependent variable should be normally distributed because the study was using multiple linear regression model, where the condition of normality must be satisfied.

Table 6: Test for Normality

One-Sample Kolmogorov-Smirnov Test

		Financial Performance
N		115
Normal Parameters[a]	Mean	17.9347
	Std. Deviation	5.69643
Most Extreme Differences	Absolute	.096
	Positive	.061
	Negative	-.096
Kolmogorov-Smirnov Z		1.030
Asymp. Sig. (2-tailed)		.240

One way to make it very likely to have normal residuals is to have a dependent variable that is normally distributed (Cooper and Schindler, 2011). Figure 1 shows the normal QQ plot which indicates that the condition of normality for employee engagement is satisfied. The quantile-quantile (QQ) plot is an excellent way to see whether the data deviate from other distributions but only interested in the normal distribution. The the scatter plot shows the relationship between the actual observed values and what those values would be expected when the data is normally distributed.

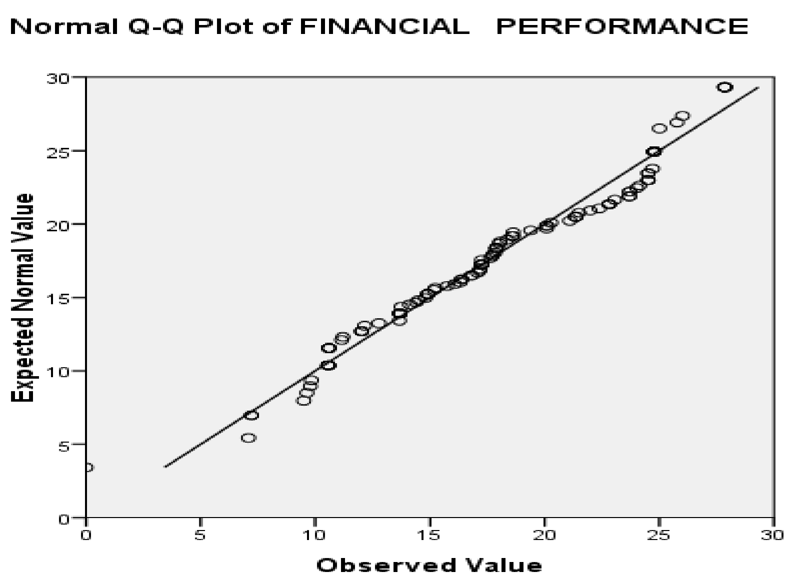

Figure 1: Normal QQ Plot of Financial performance

According to Cooper and Schindler (2011), for a variable to be normally distributed most of the points should lie on the theoretical quantile line. The theoretical quantile line of the data is fitted and from the normal QQ plot it indicates that the observed values versus the expected normal values are randomly distributed along the line of best fit indicating that the dependent variable is normally distributed.

Descriptive Analysis on Internal Control Environment and Financial Performance

Integrity and Ethical Values

The variables considered for integrity and ethical values in this study were entity policies (on business practices, conflict of interest and code conduct), tone at the top and fairness of management dealings with stakeholders (employees, suppliers, shareholders and citizens).The study sought to investigate if the companies have appropriate entity policies regarding such matters as acceptable business practices, conflict of interest and code of conduct and if they were adequately communicated. The questions required the respondents to choose the following: strongly disagree, disagree, neutral, agree and strongly agree. The result indicated that majority (56.6%) of the respondents strongly agreed that their companies have appropriate entity policies regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct and that they were adequately communicated, while 39.1% agreed and 4.4% were neutral. Further the study sought opinion on whether management demonstrate the appropriate "tone at the top", including explicit moral guidance about what is right and wrong and the same communicated in both words and deeds. Majority 57.4% of the respondents agreed, 30.4% strongly agreed while 11.3% were neutral and 0.9% disagreed. As to whether management dealings with stakeholders are based on honesty and fairness, most of the respondent 47% agreed, 29.6% strongly agreed while 22.6% were neutral and a few (0.9%) disagreed. The respondents' opinion summary are shown in table 4.9 below.

The result agree with the finding by (Whittington and Pany, 2001) that Control environment factors include: Integrity and ethical values; the commitment to competence; leadership philosophy and operating style; and the way management assigns authority and responsibility, and organizes and develops its people.

In view of the above results it can be concluded that most companies quoted in Nairobi securities exchange have appropriate entity policies on business practices, conflict of interest and code of conduct and that they are adequately communicated. The study also confirms that management of those companies demonstrates appropriate tone at the top and that management dealing with stakeholders are based on honesty and fairness. This confirms that most companies quoted in Nairobi securities exchange have entrenched in their systems integrity and ethical values which is a clear indication of good internal control environment.

Commitment to competence

The commitment to competence variables considered in this study were existence of employee job description, management determination of the employee level of knowledge and skills required to perform a job, adequacy of employee compensation and evaluation of employee performance. The result of the of the finding indicated that majority (51.3%) of the respondents agreed that employees in their companies have job descriptions, including specific duties, reporting responsibilities, and that constraints are clearly established and effectively communicated to employees while 33% strongly agreed and 14.8 % were neutral. The rest 0.9% disagreed with the opinion. As to the opinion whether Management determines the level of knowledge and skills needed to perform a particular job and if this information is used in the hiring process, most (48.7%) of the respondents agreed, 30.4% strong agreed while 19.1% were neutral and a few 1.7% disagreed. Further opinion on whether the company adequately compensates employees in order to attract qualified individuals, most (42.6%) of the respondents agreed while 16.5% strongly agreed, 34.8% were neutral, 5.2% disagreed while a few (0.9%) strongly disagreed. On the opinion about if employee performance evaluation techniques are implemented to identify incompetent or ineffective employees, majority of the respondent (47%) agreed while 20.9% strongly agreed. Only a few 5.2% disagreed while 27% remained neutral.

The result agree with the finding by (Whittington and Pany, 2001) that Control environment factors include: Integrity and ethical values; the commitment to competence; leadership philosophy and operating style; and the way management assigns authority and responsibility, and organizes and develops its people.

The findings tend to confirm that employees in companies listed in Nairobi securities exchange have clear job descriptions and that management determines the level of knowledge and skill needed to perform a particular job. The company adequately compensates their employees and have performance evaluation mechanism in place. This confirms that management of most companies quoted in Nairobi securities exchange is committed to competence, a clear indication of existence of good internal control environment. This is expected to have positive impact on financial performance.

Management Philosophy and Operating Style

On management philosophy and operating style, the study sought to investigate whether management and operating decisions were dominated by a few individual, if management did analysis of risks before making a decision and if the management had a mechanism to identify and react to events and activities that affect achievement of the company objective. The results as indicated in table 4.9 below, were majority (35.7%) of the respondents agreed that management and operating decisions are not dominated by a few individuals with 16.5% strongly agreeing while a few 5.2% disagreed and 39.1% remaining neutral. As to whether Management analyses the risks and potential benefits of a venture before making a decision most (48.7%) of the respondents agreed that Management analyses the risks and potential benefits of a venture before a decision is made while 21.7% strongly agreed and 26.1% remained neutral. A few (2.6%) and (0.9%) disagreed and strongly disagreed respectively. Further on the opinion about whether management has mechanism to anticipate, identify and react to events or activities that affect achieving company objectives, majority (56.5%) of the respondent agreed that the management had mechanism to anticipate and identify events while 12.2% strongly agreed and 28.7% were neutral. A few (2.6%) disagreed.

The result concur with the finding by (Whittington and Pany, 2001) that Control environment factors include: Integrity and ethical values; the commitment to competence; leadership philosophy and operating style; and the way management assigns authority and responsibility, and organizes and develops its people.

The findings confirm that management decisions in companies listed in Nairobi securities exchange are not dominated by a few individuals and that analysis of risk and potential benefits of a venture is done before making a decision. The study also confirms that management in listed companies have mechanism to anticipate, identify and react to events that may affect company objectives. This attest to presence of a positive management philosophy and style in companies quoted in Nairobi securities exchange, indication of existence of good internal control environment.

Organizational Structure

In regard to the organizational structure, the study sought to investigate if the organization of the company was clearly defined in terms of line of authority and responsibility, if there was adequate supervision and monitoring of decentralized operations and if the organizational structure was appropriate for the size and complexity of the entity. The findings were as follows. Most (51.3%) of the respondents agreed that organization of the company is clearly defined in terms of lines of authority and responsibility, whereas 35.7% strongly agreed and 13% disagreed. Opinion on whether there was adequate supervision and monitoring of decentralized operations, most (57.4%) of the respondents agreed there was adequate supervision and monitoring of decentralized operations while 18.3% strongly agreed and 22.6% remained neutral. Only a few (1.7%) disagreed. As to whether the organizational structure was appropriate for the size and complexity of the entity, most (43.5%) of the respondents agreed that organizational structure was appropriate for the size and complexity of the entity while 17.4% strongly agreed. Only 2.6% disagreed while 36.5% of the respondents were neutral.

The result collaborate the findings by Daft (2004) that organizational structure defines how job tasks are formally divided, grouped and coordinated. There are six elements that managers of agencies need to address when they design their organization’s structure. These are: work specialization, departmentalization, and chain of command, span of control, centralization, decentralization and formalization. An organization’s structure is a means to help management of companies achieve its objectives (Daft, 2004).

The findings confirm that organization structure of companies listed in Nairobi securities is clearly defined in terms of lines of authority and responsibility and there is adequate supervision and monitoring of decentralized operations. The findings also confirm that the organization structure for most of quoted companies is appropriate for the size and complexity. This is a clear indication of existence of good internal control environment.

Assignment of authority and responsibility

Regarding assignment of authority and responsibility, the study sought to investigate if the companies had clear assignment of responsibilities and delegation of authorities and if employees had had job responsibilities including specific duties, reporting relationship clearly established and communicated. From the findings 53.9% of the respondents agreed that there was clear assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements, whereas 28.7% strongly agreed while 3.5% disagreed and 13.9% were neutral. Further opinion was sought on whether all employees have job responsibilities, including specific duties, reporting relationships clearly established and communicated, the results indicated majority (53%) of the respondents agreed that employees have job responsibilities, including specific duties, reporting relationships clearly established and communicated,25% strongly agreed while 18.3% were neutral and 3.5% disagreed.

The result collaborate the findings by Draft (2004) that organizational structure defines how job tasks are formally divided, grouped and coordinated. There are six elements that managers of agencies need to address when they design their organization's structure. These are: work specialization, departmentalization, and chain of command, span of control, centralization, decentralization and formalization. An organization's structure is a means to help Management of companies achieve its objectives (Daft, 2004).

The findings confirm that employees of companies listed in Nairobi securities have clear assignment of responsibility and delegation of authority, an indication of existence of good internal control environment.

Human Resource Policy and Practices

On human resource policy and practices, the study sought to investigate if all personnel including key managers possess adequate knowledge and experience to discharge their responsibilities, if turnover of key personnel is low and if there is management commitment to competence to ensure that personnel receive adequate training to perform their duties. In relation to opinion on whether all personnel including key managers, possess adequate knowledge and experience to discharge their responsibilities, majority (47%) of the respondents agreed that personnel including key managers, possess adequate knowledge and experience to discharge their responsibilities , 22.6% strongly agreeing while 27.8% were neutral. Only a few (2.6%) disagreed. As to whether turnover of key personnel is relatively low, 33% of the respondents agreed that turnover of key personnel in their company is relatively low while 21.7% strongly agreed and 27% were neutral. 15% of the respondent disagreed and 2.6% strongly disagreed. Finally on whether management has shown commitment to competence and ensured that personnel receive adequate training to perform their duties, most (42.6%) of the respondents agreed that management has shown commitment to competence and ensured that personnel receive adequate training to perform their duties while 22.6% strongly agreed. 27.8% of the respondents disagreed while a few (7%) strongly disagreed. The results are summarized in Table 7.

The study concurs with the findings by (Boxall and Purcell, 2003) that human resource advantage can be traced to better people employed in an organization. It also corroborates the finding by (Becker et al., 1997) that performance can be achieved with the help of high performance work system which takes into account the factors affecting, individual performance such as recruitment procedures, motivation, training and management development .People are able to perform tasks if they have the right skills required for the job.

The results confirm that most companies quoted in Nairobi securities exchange have good human resource policies and practices which attest existence of good internal control environment.

Table 7: Respondents' Opinion on Internal Control Environment

Respondents Opinion	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Entity policies	.0%	.0%	4.3%	39.1%	56.5%
Management "tone at the top"	.0%	.9%	11.3%	57.4%	30.4%
Honesty and fair dealings	.0%	.9%	22.6%	47.0%	29.6%
Job descriptions Effectively communicated	.0%	.9%	14.8%	51.3%	33.0%
Level of knowledge and skills	.0%	1.7%	19.1%	48.7%	30.4%
Employee compensation	.9%	5.2%	34.8%	42.6%	16.5%
Employee performance evaluation techniques	.0%	5.2%	27.0%	47.0%	20.9%
Management and operating decisions	3.5%	5.2%	39.1%	35.7%	16.5%
Analysis of Risks and potential benefits	.9%	2.6%	26.1%	48.7%	21.7%
Mechanisms to anticipate, identify and react	.0%	2.6%	28.7%	56.5%	12.2%
Lines of authority and responsibility	.0%	.0%	13.0%	51.3%	35.7%
Monitoring of decentralized operations	.0%	1.7%	22.6%	57.4%	18.3%
Structure appropriate for size and complexity	.0%	2.6%	36.5%	43.5%	17.4%
Responsibility and delegation of authority	.0%	3.5%	13.9%	53.9%	28.7%
Job responsibilities established and communicated	.0%	3.5%	18.3%	53.0%	25.2%
Personnel possess knowledge and experience	.0%	2.6%	27.8%	47.0%	22.6%
Turnover of key personnel relatively low	2.6%	15.7%	27.0%	33.0%	21.7%
Management commitment to competence	.0%	7.0%	27.8%	42.6%	22.6%

Regression Analysis

The study carried out regression analysis to establish the statistical significance relationship between the independent variables notably, internal control environment , internal audit funtion, risk management, control activities and corporate governance on the dependent variable which was financial performance. According to Marshall and Rossman (2006) regression analysis is a statistics process of estimating the relationship between variables. Regression analysis helps in generating equation that describes the statistics relationship between one or more predictor variables and the response variable. The regression analysis results were presented using a scatter plot diagram, regression model summary tables, Analysis of Variance (ANOVA) table and beta coefficients tables.

Regression Analysis on internal control environment versus Financial performance

H_0: There is no significant relationship between internal control environment and financial performance.

Regression analysis was conducted to determine the significance relationship of internal control environment against Financial performance. Figure 2 illustrates scatter plot diagram of regression analysis results of significance of internal control environment versus financial performance. The Figure 4.2 presents that all the plots appear in the first quadrate and the line of best of fit indicates an estimate line that is increasingly positively upwards. This implies that there is a positive linear relationship between internal control environment and financial performance.

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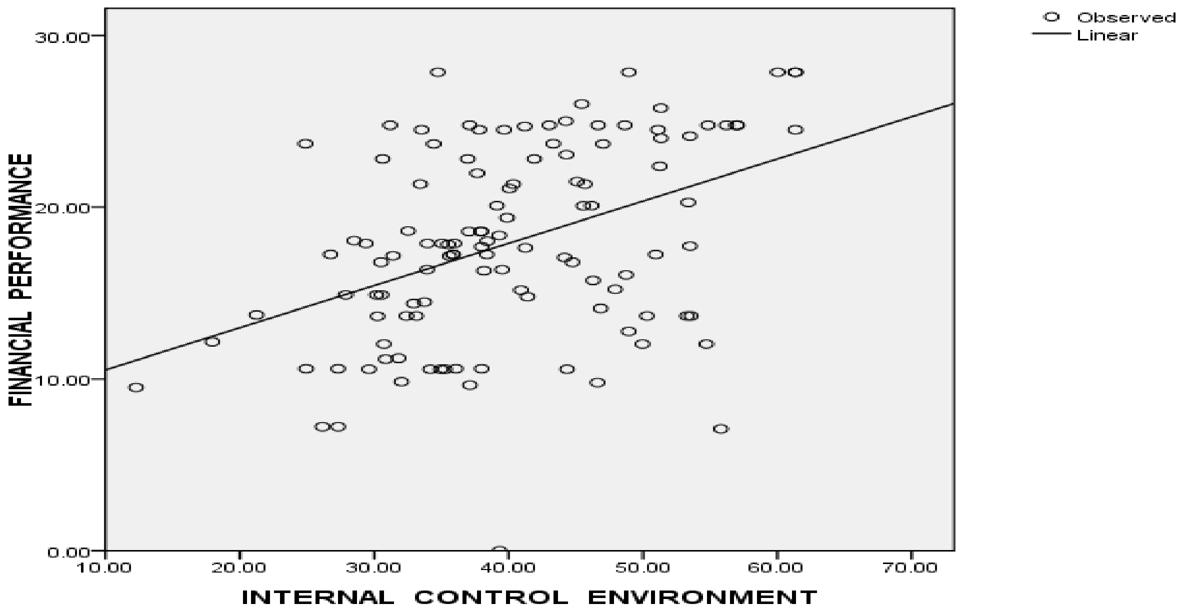

Figure 2: Regression Model on internal control environment versus financial performance

Table 8 presents the regression model on internal control environment versus financial performance. As presented in the table, the coefficient of determination R^2 is 0.176 and R is 0.420 at 0.05 significance level. The coefficient of determination indicates that 16.9% of the variation on financial performance is influenced by internal control environment. This implies that there exists a positive significant relationship between internal control environment and financial performance.

Table 8: Correlations of internal control environment and financial performance

		FINANCIAL PERFORMANCE	INTERNAL CONTROL ENVIRONMENT
FINANCIAL PERFORMANCE	Pearson Correlation	1	.420**
	Sig. (2-tailed)		.000
	N	115	115
INTERNAL CONTROL ENVIRONMENT	Pearson Correlation	.420**	1
	Sig. (2-tailed)	.000	
	N	115	115

R	.420[a]
R Square	.176
Adjusted R Square	.169
Std. Error of the Estimate	5.19227

The Analysis of variance (ANOVA) results as shown in Table 9 further confirms that the model fit is appropriate for this data since p-value of 0.000 which is less than 0.05. This implies that there is a significant linear relationship between internal control environment and financial performance.

Table 9: Analysis Of Variance (ANOVA) for Internal Control Environment

ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	652.788	1	652.788	24.214	.000[a]
	Residual	3046.439	113	26.960		
	Total	3699.228	114			

The results further indicate that internal control environment have positive and significant effects on financial performance (Table 10). The fitted model FP = 8.07+0.246*X1. This implies that a unit change in internal control environment will increase financial performance by the rate of 0.246. Even when internal control environment is non-existence, financial performance is still positive at 8.07 indicating that there are other drivers of financial performance including internal audit, risk management, control activities and corporate governance.

Table 10: Internal Control Environment and Financial Performance

Coefficient

	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	t	Sig.
(Constant)	8.077	2.061		3.919	.000
INTERNAL CONTROL ENVIRONMENT	.246	.050	.420	4.921	.000

SUMMARY AND CONCLUSIONS

Factor analysis was done in order to reduce internal control items to manageable and meaningful size, where all the 18 items met the threshold of 0.4 and above. Descriptive statistics were used to analyze this research objective and other subsequent analysis was done. The results indicated that internal control environment exist in companies quoted in Nairobi securities exchange where, 73% of respondents indicated that there is adequate internal control environment. However, 23% were indifferent and 4% indicated that internal control environment is not adequate.

The correlation analysis also indicated that there is a positive significant relationship between internal control environment and financial performance. The positive relationship was represented by 0.42, and the number of respondents was 115. The results corroborates with the findings of Mawanda (2008), states that institution which have enforcement of proper internal control systems will always lead to improved financial performance. Regression analysis was done where the results indicated that internal control environment had a goodness of fit of 16.9% indicating that internal control environment explained 16.9% of the variation in the financial performance of companies quoted in Nairobi securities Exchange in Kenya. The results and findings therefore conclude that there was significant association between internal control environment and financial performance. The study, therefore, recommends that internal control environment should be enhanced to further improve the financial performance of companies quoted in Nairobi securities exchange.

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