ISSN: 2617-4138
DOI: 10.32898/ibmj.01/7.1article21
www.ijarke.com

INTERNATIONAL JOURNALS OF ACADEMICS & RESEARCH
(IJARKE Business & Management Journal)

Internal Control Systems and Financial Performance of Microfinance Institutions in Laikipia County – Kenya

Peter Ondieki Ogaro, Kenyatta University, Kenya
John Mungai, Kenyatta University, Kenya

Abstract

Most microfinance institutions have pulled out of the industry altogether because of how much money has been lost in Kenya's microfinance sector. Return on equity has grown negatively due to low profitability and losses. From the 2015–2016 fiscal years to the 2022–2023 fiscal years, client deposits declined. After rising in December 2016, the capital base was hit hard by the growth of nonperforming loans. As a result, liquidity levels will fall in 2019, 2020, 2021, and 2022. This research set out to address that question by analyzing microfinance institutions in Laikipia County, Kenya, with an eye on their internal control mechanisms and their impact on their efficiency. The goals of the research were to analyze the financial performance of microfinance institutions in Laikipia County, Kenya, and how the control environment affected that performance. The research was based on systems theory. Questionnaires and a descriptive research approach were used to collect primary data. Five MFIs operating in Laikipia County were the focus of the research: KWFT, Faulu Ltd., Asa Ltd., SMEP, and PAWDEP Ltd. A total of 289 individuals were surveyed, with 168 chosen at random from the pool of potential respondents. Both descriptive and inferential statistics were used to examine the quantitative data. Data was shown quantitatively using graphs, tables, and frequency tables. Based on the findings, MFIs' control chains are ineffective because of their lack of progress in corporate structure. On the other hand, all of the company's core functions are regulated by established policies and procedures. The results showed that the staff performed well in carrying out the financial management tasks, with the periodic accounts reconciliation being the only stumbling block. To aid in the assessment, reduction, and tracking of risks, the MFIs have devised individualized approaches to risk management. The research found that MFIs' financial performance in Laikipia County, Kenya, was positively and significantly impacted by control environment. The study suggested that microfinance institutions (MFIs) broaden the scope of their control measures to include both the degree of compliance and the control activities involved in authorizing transactions.

Key words: *Control Environment, Financial Institutions, Financial Performance, Risk Assessment*

1. Introduction

The expansion of microfinance institutions (MFIs) accelerated after decolonization in less developed countries, the ancestral homelands of several states. This is because these nations did not provide enough aid to their most vulnerable citizens (Srnec, 2019). As microfinance institutions (MFIs) developed long-term strategies to lend to low-income communities, new types of organizations began to crop up to meet the demand: village banks, non-governmental organizations (NGOs), rural banks of banking institutions, and NBFIs (Elgar, 2008).

Several shifts have occurred within microfinance organizations, and one of them is a heightened focus on long-term fiscal viability and efficiency. According to Christen et al. (2015), microfinance has been commercialized due to the need for more product diversity and better access to funding from commercial sources. Because of the shift, microfinance institutions may now provide a wider range of banking products and services, such as savings accounts and insurance. Problems with capital, inefficient internal controls, liquidity, and regulations are just a few of the obstacles that microfinance institutions (MFIs) have faced on their path to achieving some of these goals and the required levels of profitability.

Internal control systems are dynamic, integrated mechanisms that adapt to changes in an organization (Lightle, Castellano, & Cutting, 2017). This process is time-consuming and requires input from management and workers at all levels of the company. To provide management some reassurance about the efficacy of an internal control system, the author suggests testing it. One of the most popular resources for developing, deploying, and evaluating internal controls is the COSO Integrated System for Internal Controls. Microfinance institutions (MFIs) are required to show that they have implemented and are using the five components of internal control and the system's internal control concepts. Environment for control, evaluation of risks, dissemination of information and communication, activities for monitoring, and continuous control measures are all part of this (Amaka, 2012).

An important part of running a company is establishing a control environment. This is due to the fact that it mirrors the perspective and standards of management on the significance of internal audit inside the business unit (Kinyua, 2016). The other

ISSN: 2617-4138
DOI: 10.32898/ibmj.01/7.1article21

parts of the internal control system rely on it for structure and as a base (Fadzil, Haron & Jantan, 2017). Internal controls help to decrease the possibility of fraud in organizational operations; how effective these controls are depends on the function and quality of a company's control environment (Eniola & Akinselure, 2016). This means that an appropriate control environment is crucial to the efficient operation of any government institution. Indicators of control activities in this report will include property physical controls, task separation, and purchase approval.

1.1 Results in the Bank

A company's financial success may be defined as the degree to which its policies, operations, and activities have achieved its stated objectives within a certain time frame. Financial institutions' handling of their responsibilities to finish loans within the prescribed period is reflected in the character of MFIs' financial performance (Mihret, James, & Joseph, 2010). When many perspectives on financial performance are considered together, a complete picture of an MFI entity's achievements in relation to its numerous accountability obligations is painted. Market financial performance measurements that researchers often employ include earnings per share (EPS), market price share (MPS), dividend price share (DPS), and price-to-earnings ratio (P/E ratio) (Mwakimasinde, Odhiambo, and Byaruhanga, 2014). Coverage, activity, liquidity, profitability, and leverage are other financial performance metrics (Ondieki, 2012). These monetary performance indicators are sometimes used in conjunction by researchers (Ray & Kurt, 2011).

The five components that make up an MFI's health status are capital adequacy, asset quality, management, earnings, and liquidity, or "CAMEL" for short. This method of tracking financial performance is quite successful. Gilbert, Meyer, and Vaughan (2000) state that the acronym CAMELS was changed in 1997 to reflect the inclusion of the sixth component, an MFI's Sensitivity to Market Risk. One benefit that MFIs obtain from using the products and services of credit market information systems is the capacity to execute more transactions swiftly and easily. This will undoubtedly have a large beneficial impact on their overall financial performance.

Profitability as a percentage of sales and liquidity levels are financial performance indicators in this study. Profitability as a percentage of sales is an indicator of a company's sales growth potential. It shows how a business makes do with its money and employees to achieve its goals (Robins, 2015). How well a company utilizes its primary business resources and its ability to pay off its debts when they come due are two indicators of its liquidity (Waweru, 2007 & Alloyo, 2010).

The retail loan and deposit-taking industry is quite competitive, thus MFIs have adapted by developing innovative strategies to stay afloat. Equity, donor funds, concessional and commercial borrowings, members' savings, wholesale deposits from institutional investors, and retail savings from the general public are the primary sources of funding for MFIs, which are highlighted by the liability structure. Liabilities, rather than asset classifications, are the primary area in which MFIs vary. Because of this liability structure, microfinance institutions (MFIs) in Kenya are now more informed about the MFI Act of 2006, which provides a model for how MFIs should function. Not only does the Act provide guidelines for MFI operations, but the Association of Microfinance Institutions (AMFI) does the same.

According to the Microfinance Rating Annual Report (2017), the microfinance industry in Kenya saw a precipitous decline in financial performance in 2016. The sector's OSS was 107%, ROA was 1%, and ROE was 8%. Despite an increase in the number of DTM licenses granted in 2018, Ali (2019) states that microfinance institutions (MFIs) reported a decline. But 58.9% of all assets came from publicly produced deposits, which was the sector's main source of funding. Furthermore, borrowings were 16.6% of the whole equity, which amounted to 18.2% of total assets. The efficiency of financial lenders' processes for transferring funds determines how long they can stay in business. Due to their size and other revenue streams, commercial banks continue to enjoy the highest return on equity (ROE) and return on assets (ROA) rates, at 26% and 5.4%, respectively. The average return on equity for microfinance institutions (MFIs) fell to 3.9% between 2013 and 2017. In 2013, credit-only microfinance institutions (MFIs) outperformed all other microfinance organizations in terms of sustainability and profitability.

As of December 2014, four out of nine DTMIs—two approved in 2010 and two in 2012—had failed to reach financial break-even. No DTMI may lend more than 2% of their equity to any one borrower in Kenya, under the law. Microloans are once again the focus of DTMIs' mobilized deposits; for instance, FSD Kenya estimates that 70% of the total mobilized deposit should go toward microloans (2012). It is possible that regulators, DTMIs (also known as MFBs), and credit-only MFIs will determine Kenya's depth-of-outreach.

1.2 Microfinance Institutions in Laikipia County

Ten banks, ten microfinance organizations, and six insurance firms operating out of the townships of Nanyuki and Nyahururu provided services to Laikipia in 2017. There are several of these, including Equity, KCB, Standard Chartered, KRep, Fina, Bank of Africa, Barclays, CFC, Family Bank, and Co-operative Bank. Additionally, the hamlet has two banks. Within the major urban centers, agency banking has also been created by Equity, KCB, and Co-operative banks. Up to the county's village banks, the major mobile phone providers provide mobile banking services. Many MFIs have shut down as a result of declining profitability, poor investment returns, and insufficient liquidity levels. By the close of business 2018, 5 MFIs remained in operations; KWFT -

ISSN: 2617-4138
DOI: 10.32898/ibmj.01/7.1article21
www.ijarke.com

Nanyuki and Nyahururu branch, Faulu – Nanyuki branch, Asa Ltd - Nanyuki and Nyahururu branch, SMEP - Nanyuki and Nyahururu branch and PAWDEP – Nyahururu branch. However, in 2019, SMEP closed its branch in Nanyuki town (CBK, 2019).

2. Statement of the Problem

Credit risk, which has led to more nonperforming loans (NPLs), less dependence on deposits, and more reliance on costly borrowed funds, is one of the difficulties that microfinance institutions (MFIs) confront due to factors such as interest rate caps, inadequate internal control systems, and shifting market dynamics (CBK, 2017). The vast majority of research has shown that effective internal control systems significantly and positively affect financial performance. Yet, the vast bulk of research on internal control systems has come from the public sector, and the vast majority of those studies have come from Western nations. What's more, many of these studies have shown contradictory outcomes. These empirical researches have led to gaps in methodology, concepts, and context.

Research by Yao, Yusheng, and Bah (2017) examines the effectiveness of internal control systems in the public sector as a means to reduce financial irregularities in Ghana. The research confirmed the existence of substantial connections between government financial management and internal control systems. Research by Ibrahim, Diibuzie, and Abubakari (2017) examined how health institutions in the upper west area of Ghana's financial performance were affected by internal control systems. Financial success was positively correlated with the internal control system, according to the research. We will fill the conceptual and contextual gaps. Public sector financial management in Ghana was the subject of the research conducted by Yao, Yusheng, and Bah. Financial performance of Ghanaian health institutions was the focus of the research by Ibrahim, Diibuzie, and Abubakari. Financial performance of microfinance institutions in Kenya is the focus of this research.

3. Objective of the Study

The main objective of the study was to analyze the financial performance of microfinance institutions in Laikipia County, Kenya.

4. Literature Review

4.1 Systems Theory

System theory was first put out in the 1940s by the biologist Ludwig von Bertalanffy. In 1956, Ross Ashby expanded on it in his work "Introduction to Cybernetics." Bertalanffy (1968) emphasized that real systems responded and interacted with their surroundings, and that they might grow continuously by adding new, improved features. Bertalanffy argues that systems theory avoids reducing institutions and organizations to their individual elements by instead concentrating on its overall layout and the ways in which their parts interact to create it. A company like this would have devised a system that has nothing to do with the parts (like the several divisions of a company like accounting, finance, human resources, and R&D). Because they share common organizational ideas and principles, the several fields may eventually become one.

According to Hartman (2010), systems theory provides a framework for examining organizational dynamics, but it does not provide a specific theory on how a company should be run. Following the widespread adoption of systems theory, Hartman made the astute observation that any organization can be broken down into its constituent parts—its internal and external subsystems—that work together to handle inputs and outputs. The definition of a system, as stated by Smit and Cronje in 2002, is a collection of parts that cooperate to accomplish a goal.

4.2 Financial Performance and the Control Environment

Kisanyanya and Omagwa (2018) investigated the relationship between the financial performance and internal control methods of public higher education institutions. The purpose of this study was to investigate internal control elements in the financial performance of higher education institutions in Vihiga County, Kenya. The data gathering sample size was 96 people drawn from four different public universities. According to the results, internal control mechanisms improved financial results. The control environment variable had a favorable and statistically significant effect on the financial performance. Other study aspects that greatly enhanced financial performance were risk assessment, management methods, and monitoring. There was a stronger effect of control activities on financial performance. In place of the actual control environment, we used things like organizational structure, human resource policy, and procedure. Surplus (income-expenses), cost control, and accountability were the metrics used to evaluate financial success. Institutions dealing with money will be the subject of this investigation.

Musya (2017) looked at how the county governments of Kenya use internal control systems to collect money. Control environment, risk assessment, control activities, information and communication, and monitoring were used as stand-ins for the five components of internal control. The study made use of both quantitative and qualitative methodologies. Forty-seven people were picked at random to fill out semi-structured questions. For this data analysis, we turned to SPSS Version 20.0, a program developed by the Social Sciences Statistical Software Institute. The research states that the likelihood of fraud, revenue loss, and

ISSN: 2617-4138
DOI: 10.32898/ibmj.01/7.1article21
www.ijarke.com

abuse of collected cash has increased due to weak internal controls, poor information and communication systems, and other similar issues. Regression and correlation were the statistical tools used. The results show that the control environment has a major impact on the tax collection capabilities of Kenyan county administrations. Control environment proxies included operating style, designated personnel' devotion and competency, and control management and monitoring. Governmental agencies will not be the focus of this research.

5. Research Methodology

A descriptive research strategy was used in this investigation. The study only focused on Laikipia County and looked at five microfinance institutions (MFIs) in Laikipia County: KWFT, Faulu Ltd, Asa Ltd, SMEP, and PAWDEP Ltd. The researcher used a simple sampling approach to identify the study's sample size. Questionnaires served as the main means of gathering information.

6. Research Findings and Discussion

6.1 Descriptive Statistics on Control Environment

The objective was to determine the effect of control environment on financial performance. The results were summarized in Table 1.

Table 1: Control Environment

Statements	Mean	Std. Dev.
The accounting and financial system of the MFI is top-notch.	3.012	.881
An advanced organizational structure adequately depicts the control chain.	2.765	.799
All of the firm's core activities are governed by formal policies and procedures.	3.996	1.122
A number of authorities and responsibilities have been established to ensure the following protocols are followed.	4.122	.888
Their internal control objectives and processes have the backing of the company's ethos, behavioral code, HR policy, and incentive programs.	3.337	1.304
Results of all tasks are assigned responsibilities and follow-up measures. feedback	3.991	1.111
There is adequate communication between the audit committee's internal and external auditors.	3.765	.915
In the interest of the organization, all parties involved are forthright and equitable.	2.998	1.222
Aggregate	**3.4983**	**1.030**

Source: Survey Data (2024)

The findings showed that MFIs' accounting and financial systems were modest (M=3.012, Std Dev=0.881), and that there has been little progress in the area of business structure that adequately reflects the control chain (M=2.765, Std Dev=0.799). According to the results, all of the company's core activities are governed by formal rules and procedures (M=3.996, Std dev=1.122). The majority of respondents (M=4.122, Std Dev=0.888) said that there are authorities and responsibilities to ensure that protocols are followed. The majority of respondents (M=3.337, Std Dev=1.304) also felt that their internal control objectives and processes were fairly supported by the company's code of conduct, HR policies, and incentive programs. Based on the results of all tasks, the respondents agreed that duties and follow-up measures are assigned (M=3.991, Std dev=1.111). Additionally, they reached a consensus that the audit committee adequately maintained the direct link between the internal and external auditors (M=3.765, Std dev=0.915). But most people who took the survey think that stakeholders aren't looking out for the company's best interests when making decisions (M=2.998, Std dev=1.222). Human resource policies, stakeholder interests, and processes did not adequately manage the control environment, as shown by the aggregate mean of 3.4983.

6.2 Inferential Analysis

The independent variables underwent a regression analysis to ascertain their influence on the dependent variable. Table 2 presents a summary of coefficients.

Table 2: Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.213	.301		.558	.045
	Control Environment	.144	.159	.031	.215	.001

a. Dependent Variable: Financial Performance

The model that was adopted was;

ISSN: 2617-4138
DOI: 10.32898/ibmj.01/7.1article21
www.ijarke.com

$$Y=0.213X+0.144X_1+ e$$

Results in Table 2 shows that control environment had a positive and substantial effect on financial performance of Laikipia County, Kenya ($\beta = 0.144$, $p< 0.05$). This implies that a unit increase in control environment will lead to a 0.144 unit increase in financial performance of Laikipia County, Kenya.

7. Conclusions and Recommendations

The research found that microfinance institutions' (MFIs') financial performance in Laikipia County, Kenya, was significantly improved by the control environment. Financial variables like profit and liquidity levels were significantly affected by the degree of competence, ethical standards, and compliance shown by management.

In order to strengthen the connection between internal controls and financial performance, the researcher offered several suggestions based on the study's results. It is recommended that MFIs broaden their control measures in two areas: compliance level and control activities, which pertain to the authorization of transactions. These might be accomplished by delegating tasks to individuals according to their skill sets and education. Customer service strategies that work might potentially boost performance by revealing which customers are "at risk" and which ones are worth the most to the company.

References

1. Ali Abdi Abdirashid, Ambrose O Jagongo, (2019). Group Lending and Loans Performance in Micro-Finance Institutions in Nairobi City County, Kenya: Case of Kenya Women Microfinance Bank Limited *International Journal of Current Aspects*: Vol 3 No III.
2. Amaka, C. P. (2012). *The Impact of Internal Control System on the Financial Management of an Organization (A Case Study of the Nigeria Bottling Company Plc., Enugu).*Master's Thesis. Faculty of Management and Social Sciences Caritas University.
3. COSO. (2013). Internal Control-Integrated Framework.
4. Eniola, O, J., Akinselure, O, P., (2016). Effect of internal control on financial performance of firms in Nigeria. A study of selected manufacturing firms. *IOSR Journal of Business and Management (IOSR-JBM)*:18-10. PP 80-85.
5. *Fadzil,* F. H., Haron, H., & Jantan, M. (2017). Internal auditing practices and internal control system. *Managerial Auditing Journal, 20*(8), 844-866.
6. Gilbert, R. A., Meyer, A. P., & Vaughan, M. D. (2000). The role of a CAMEL downgrade model in bank surveillance. *Federal Reserve Bank of St. Louis Working Paper Series*, (2000-021).
7. Hartman, S. W. (2010). Management Theory. New York: New York Institute of Technology.
8. Ibrahim, S., Diibuzie, G & Abubakari., M (2017). The Impact of Internal Control Systems on Financial Performance: The Case of Health Institutions in Upper West Region of Ghana. *International Journal of Academic Research in Business and Social Sciences*.7, 4: 2222-6990.
9. Kisanyanya and Omagwa (2018) relationship between public universities' financial performance and their internal control systems. *The International Journal of Business & Management* ISSN 2321–8916.
10. Kinyua, J., K (2016). The relationship between monitoring and evaluation activities and financial performance of companies quoted in the Nairobi Securities Exchange. *Accounting, Auditing and Accountability Journal*, *22*(2), 20-38.
11. Lightle, S. S., Castellano, J. F., & Cutting, B. T. (2017). Assessing the control environment: to determine whether management has created a culture in which ethical behavior is encouraged, internal auditors must survey the people.
12. Meyer, J. W., & Rowan, B. (1977). Institutionalized organizations: Formal structure as myth and ceremony. *American journal of sociology*, 340-363.
13. Mihret, D. G., James, K. & Joseph, M. M. (2010). Antecedents and organizational performance implications of internal audit effectiveness: some propositions and research agenda. *Pacific Accounting Review,* 22(3), 224 – 252.
14. Mwakimasinde, M. O., Odhiambo, A. & Byaruhanga, J. (2014). Effects of Internal Control Systems on Financial Performance of Sugarcane out grower companies In Kenya. *Journal of Business and Management,* 16(12), 62-73.
15. Musya, F., M. (2014). The impact of inward controls on income assortment by province governments in Kenya. *Global diary of the executives*, 5(3), 76 -85.
16. Ondieki, N. M. (2012). *Effect of Internal Audit on Financial Performance of Commercial Banks In Kenya*. Master's Thesis, University of Nairobi.
17. *Peter Lartey Yao, Kong Yusheng, Fatoumata Binta Maci Bah A Critical Examination of Internal Control Systems in the Public Sector, A Tool for Alleviating Financial Irregularities: Evidence from Ghana.* International Knowledge Sharing Platform Vol 8, No 22 (2017).
18. Ray W.O & Kurt P. (2011). *Principles of Auditing and Other Assurance Services.* Irwin/McGraw-Hill. NY.