RELATIONSHIP BETWEEN INTERNAL CONTROL SYSTEMS AND FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN HOMA BAY TOWN, KENYA

BY

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DEPARTMENT OF ACCOUNTING AND FINANCE

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DECLARATION

Declaration

I declare that this research project is my own work and has never been presented for any award.

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(MBA/BE/06007/2015) Signature Date

Approval

This research project has been submitted for examination with my approval as the university supervisor.

Dr. Robert B. K. Mule, PhD ___________________ __________________
(Department of Accounting and Finance) Signature Date

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I take this opportunity to thank the almighty God for enabling me reach this far. I also thank all people who made a contribution in my academic life so far.

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I am greatly indebted to my colleagues and classmates; the lecturers in the School of Business and Administration of Maseno University.

Lastly, my warm regards and blessings go to all of those who have made a positive contribution in my life. May the good Lord bless you all.

DEDICATION

This project is dedicated to my spouse, Mary Achieng and my daughters Whitney Natasha and Chemy Ivy for their patience, understanding and encouragement during this study and the entire course.

ABSTRACT

Small and Medium enterprises (SMEs) is one of the biggest contributors to the economy. Economic survey 2009 statistics indicate a tremendous growth of small and medium scale Enterprises in Kenya over the last ten years; constituting about 98 per cent of all business enterprises in the country; yet 90 per cent of the business start-ups do not operate beyond their third anniversary. Specific studies focused on the relationship between the internal control systems and financial performance of SMEs in Homa Bay town. The main objective of this study was therefore to establish the relationship between the ICS and financial performance of SMEs in Homa Bay town, Kenya; Specifically establishing the effect of risk assessment on the financial performance of SMEs in Homa Bay town; Determining the relationship between internal control activities and the financial performance of SMEs in Homa Bay town; and establishing the relationship between audit communication and the Financial performance of SMEs in Homa Bay town. The research was based on the theory of inspired confidence and the agency theory. The research was conducted using both quantitative and qualitative approaches. The study employed correlation research design. The study used primary datawhich was collected by the use of structured questionnaires. The data was collected from both the managers and the owners and computed mean was used. The population of the study was 152 SMEs of which 20 SMEs were used during pilot study and a sample size of 132 SMEs used during the main data collection. Content Valid Index was used to test the instrument which was used for data collection, this did not form part of the final sample size. The CVI was 0.75 and for a research instrument to be valid, the CVI should be more than 0.7, below which the instrument is invalid hence the instrument was valid.Multiple regression analysis was used to analyze data.The results were presented using tables and graphs. The findings of this study are of benefit to SMEs managers and owners in employing ICS, the Government too can use this research in formulation of policies on SMEs and finally the research may stimulate academics and encourage further studies in the area of ICS and SMEs.From the results of the analysis, the findings show that the independent variables (risk assessment, control activities, audit communication) display a strong relationship for the study. There was a positive strong connection between the variables of the study as shown by 74.3%.The regression results also show that 55.2% of performance of small and medium enterprises in Homa Bay town, Kenya can be explained by internal control systems. This means that internal control systems help increase performance of small and medium enterprises in Homa Bay town, Kenya by 55.2 percent. The study concluded that there is a positive relationship between internal control systems and financial performance.

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ABBREVIATIONS AND ACRONYMS

AICPA - American Institute of Certified Public Accountant

ANOVA -Analysis of variance

CAE - Chief Auditor Executive

CDF - Constituency Development Fund

CEO - Chief Executive Officer

COSO - Committee of Sponsoring Organization

CVI - Content Valid Index

IAS - Internal auditing standards

ICS - Internal Control Systems

IFAC - International Federation of Accountants

MFI - Micro Finance Institutions

MRA - Multiple Regression Analysis

NSE - Nairobi Stock Exchange

ROA - Return on Assets

ROCI - Return on Capital Invested

ROE - Return On Equity

S.D - Standard Deviation

SMEs -Small and Medium-Sized Enterprises

SPSS - Statistical Package of Social Science

U.S.A - United State of America

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CHAPTER ONE

INTRODUCTION

The chapterpresented an overview of the concepts under study, the research problem, the objectives of the study, the research hypotheses, value of the study and the conceptual framework that was adopted by the research.

1.1 Background to the study

In this chapter we handle the purpose of the study which is establishing the relationship between the ICS and financial performance of SMEs. It also concerns the specific objectives of the study that were determined as; establishing the effect of risk assessment on the financial performance of SMEs in Homa Bay town; Determining the relationship between internal control activities and the financial performance of SMEs in Homa Bay town; and establishing the relationship between audit communication and the financial performance of SMEs in Homa Bay town.With ROA as the main determinant of ICS among SMEs. This chapter also looks at the scope of the study as covering Homa Bay town, Kenya. It tackles the justification of the research and brings out a diagrammatical representation linking Internal Control Systems and the Financial Performance of SMEs.

Internal Control Systems refer to measures instituted by an organization by an organization so as to ensure attainment of the entity's objective, goals and missions. According to Committee of Sponsoring Organization (COSO), (2012) Internal control systems is a process effected by entity's board of managers, management and other personnel within all the levels of the organization designed to provide reasonable assurance regarding the achievements of objectives in three particular areas which are, efficiency in operations, reliability of financial reporting, accountability and also compliance with applicable laws and regulations. It also refers to policies and procedures put in place to ensure that the objectives of the organization are achieved and these procedures and policies provide the detailed controls implemented within the organization. The internal control systems allows the financial institution to foresee potential problems which may cause financial losses through fraud, thereby preventing or reduces future losses (Hayali, Dinc, Sarili, Secil, &Aysel (2013). The Small and Medium enterprise (SMEs) is one of the biggest contributors to the economy. It is estimated that today, Kenya's SMEs constitutes 98 percent of all businesses in the country, absorbs annually up to 50 per cent of new non-farm employment seekers, has an employment growth rate of 12-14 percent, contributes 30 percent of total employment and 3 percent of GDP.

According to Tunji (2013) internal control systems should be frequently monitored and evaluated so that the management would know how effective they are. Most of the financial problems that are experienced by the Firms are due to internal control systems and risk management which were insufficient and most of the firms did not understand the risks that they were exposed to. Ali (2013) established that many organizations mainly focused on financial reporting controls until such a time when the financial crisis arises. It showed that many risk came from other factors other than financial reporting control alone that is some came from internal and external variables with some external variables beyond the control of the organization.

Nyakundi, Nyamita&Tinega(2014), in their study on the Effect of internal control systems on financial performance of small and medium scale business enterprises in Kisumu City, admitted controversy as to why there is a declining business survival trend among Small and Medium scale Enterprises despite government's commitment to availability of funds. Stratified and simple random sampling techniques were employed and both quantitative and qualitative approaches; cross sectional survey research design were applied. The study specifically revealed that a significant change in financial performance is linked to internal controls systems.

Amudo and Inanga (2009) carried out a study in Uganda to evaluate the internal control systems and its application in audit planning for the regional member countries of the African Development Bank Group institute for the management of the Public Sector Projects that the Bank finances. The study identified the following six essential components of an effective internal control systems: control environment, risk assessment, control activities, information and communications, monitoring and information technology. The outcome of the evaluation process was that some control components of effective internal control systems were lacking in those projects. These rendered the control structures ineffective and therefore audit planning was found to have no significant relationship with the functioning of the internal control systems.

Kamau(2013) on her study titled ‘The Effect of Internal Controls on The Financial Performance of Manufacturing Firms In Kenya’ established a positive correlation between internal controls effectiveness in manufacturing firms, that is, manufacturing firms that had invested on effective internal control systems had more improved financial performance as compared to those manufacturing firms that had a weak internal control systems. The study considered all the components of internal control. The population chosen for this study was 65 manufacturing firms registered by ministry of industrialization in Kenya. The study selected a sample of 20 manufacturing firms from a target population of 65 manufacturing firm.

Wanjara (2014) carried out a research on influence of internal control systems on the financial performance of Kenya Power and Lighting Company. The objective was to determine the influence of internal control systems on the profitability of Kenya Power and Lighting Company. He adopted descriptive research design and 362 were sampled purposively. Data was collected using questionnaires which were self-administered to the respondents.The analysis was done using descriptive statistics such as frequency distribution, measure of central tendency and regression analysis to show the relationship. Data was presented in form of charts, figures and tables. The study established that cash inventory and systems controls influence the financial performance of the company.

Mawanda (2008) conducted a research on effects of internal control systems on financial performance in institution of higher learning in Uganda. In his study he investigated and sought to establish the relationship between internal control systems and financial performance in an Institution of higher learning in Uganda. Internal controls were looked at from the perspective of Audit Planning, Control Environment, Internal Audit and Internal control activities whereas Financial performance focused on Liquidity, Accountability and Reporting as the measures of Financial performance. The study established a negativeinsignificant relationship between internal control systems and financial performance. The study recommended competence profiling and prior planning in the Internal Audit department which should be based on what the University expects the internal audit to do and what appropriate number staff would be required to do this job. The study therefore acknowledged role of internal audit department to establish internal controls which have an effect on the financial performance of organizations.

Reviewed studies investigating the relationship between internal control systems and the performance of SMES show mixed results. Kamau (2012) studied manufacturing firms, however the study did not conduct a relationship between the internal control systems and the performance of small and medium enterprises in Homa Bay town. This study also took a sample of 20 manufacturing firms out of the maximum 65 manufacturing firms while this study looked at all the 152 SMEs. The study used a descriptive research design while the study at hand used a correlation research design and the business environment in which this study was made is different as manufacturing firms have got an internal control systems in place as opposed to some SMEs which do not have it totally. Nyakundi, Nyamita and Tinega did a research on the effect of internal control systems on financial performance of small and medium scale business enterprises in Kisumu City. The research deign was descriptive, stratified and simple sampling techniques was used however this study was a correlational research and all the 152 SMEs was looked at. Moreover this study specifically looked at the relationship between the internal control systems and the performance of small and medium enterprises in Homa Bay town. Wanjara (2014) did a research on the influence of internal control systems on the financial performance of KPLC. He adopted a descriptive research design and only sampled 362 firms. However the research was not done on the relationship between the internal control systems and the performance of small and medium enterprises, the research did not adopt a correlation research design and did not look at the entire population. Moreover KPLC are parastatals managed by the Government as opposed to SMEs which are privately managed. Mawanda (2008) conducted a research on the effects of the internal control systems on financial performance in institutions of higher learning in Uganda. The study used a descriptive research design. The ICS of higher learning institutions are more organized as compared to SMEs in Homa Bay, the research was not on the performance of SMES in Homa Bay town. Moreover The study was on public institutions as opposed to SMEs which are private in nature. It's from these points why the research determined the relationship between the internal control systems and the performance of small and medium enterprises in Homa Bay town. The review of literature above indicates that the relationship between the internal control systems and the performance of small medium enterprises is still contentious since scholars have not agreed upon the relationship with some indicating a positive relationship (wanjara (2014) and others indicating negative relationship (Mawanda (2008). Of the reviewed studies, none has attempted to establish the relationship between the internal control systems and the performance of small and medium enterprises in Homa Bay town.

1.2 Statement of the problem

Kenya has about 1.6 million registered Small and Medium Enterprises constituting about 98 percent of all business enterprises in the country(Economic Survey, 2009). SMEs represent the largest sector in the economy employing up to 75 percent Kenya's workforce and contributing up to 18.4 percent of the country's GDP. Internal control systems are widely believed to be crucial to the success of a business as it acts as a powerful brake on the possible deviations from the predetermined objectives and policies. This means that a business that puts in place appropriate and adequate internal control systems is likely to perform better than those that do not. In instances where there have been lack of or inadequate internal control systems, the business concerned may be prone to fraud and other forms of financial misappropriation, factual and true financial positions of the business may not be reflected which is misleading to the owners who may think that their business are doing well. Many organizations in the whole world including the small businesses which embrace the internal control systems are actually doing well in terms of their financial performance, efficiency and growth. However, financial performance of the SMEs in Homa Bay town has shown mixed results with some thriving and others collapsing within months of establishment. While a number of studies have been carried on the possible causes of these failures, studies on the relationship between internal control systems and the financial performance of SMEs are missing. Studies on the relationship between internal control systems and the financial performance of SMEs have demonstrated that there is no agreement on the relationship between the variables with some studies finding a significant positive relationship between internal control systems and the financial performance of SMEs and others finding no significant relationship between internal control systems and the financial performance of SMEs. No study has attempted to establish the relationship between internal control systems and financial performance of SMEs in Homa Bay town. This research established the relationship between internal control systems and financial performance of SMEs in Homa Bay town.

1.3 Objective of the study

The main objective of the study was to establish the relationship between internal control systems and the financial performance of SMEs in Homa Bay town.

The specific objectives were, to:

(i) Establish the effect of risk assessment on the financial performance of SMEs in Homa Bay town,

(ii) Determine the relationship between internal control activities and the financial performance of SMEs in Homa Bay town, and

(iii) Establish the relationship between audit communication and the financial performance of SMEs in Homa Bay town.

1.4 Research Hypothesis

This research was guided by the following research hypothesis:

H_{01}: There is a relationship between risk assessment and financial performance of SMEs in Homa Bay town.

H_{02}: There is a relationship between internal control activities and financial performance of SMEs in Homa Bay town.

H_{03}: There is a relationship between audit communication andfinancial performance of SMEs in Homa Bay town.

1.5. Scope of the study

The study was done among the small and medium enterprises in Homa Bay town. The town was chosen since the small and medium enterprises in it face the same problems that other small and medium enterprises in other parts of the country face in internal control systems. It was also chosen because of the researcher's knowledge of the town which made the researcher to be more comprehensive since data collection was easily done. The research was conducted in the year 2017.

1.6 Justification of the Study

It was expected that the findings of this study would be of benefit to the SMEs especially in understanding the relationship betweeninternal control systems and the financial performance of SMEs in Homa bay town. The findingsare also useful to SME since it will enable them to evaluate effectiveness of the audit communication. The research findings also provided valuable information to the relevant government agencies that are useful in policy formulations on risk assessment on the performance of SMEs. The information obtained and analyzed may serve to inform policy makers to improve on practices that are typically associated with the performance of SMEs for better decision making and planning. Moreover, future researchers might find the findings and recommendations of the study useful in that they might offer a basis for further studies on the relationship between internal control systems and the financial performance of SMEs in Homa Bay town.

1.7 Conceptual framework

The conceptual framework used in the study was adapted from a study by Ewa and Udoayang (2012) who conducted a study to establish the impact of internal control design on banks' ability to investigate staff fraud among listed Banks in Nigeria. However, some modifications were made; the bank's ability to investigate staff was replaced by financial performance of SMEs. In regard to the conceptual framework, the independent variable of internal control systemswas measured by respondents' knowledge on risk assessment, internal control activities and Audit communication. The dependent variable in the study was the financial performance of the SMEs. Financial performance of the SMEswas measured using Return on Assets (ROA) which was evaluated by dividing Net Income by the Total Assets. ROA gives an idea as to how efficient management is at using its assets to generate earnings.

$$\text{Return on Asset} = \frac{\text{Net Income}}{\text{Total Assets}}$$

The conceptual framework is shown below

INDEPENDENT VARIABLES

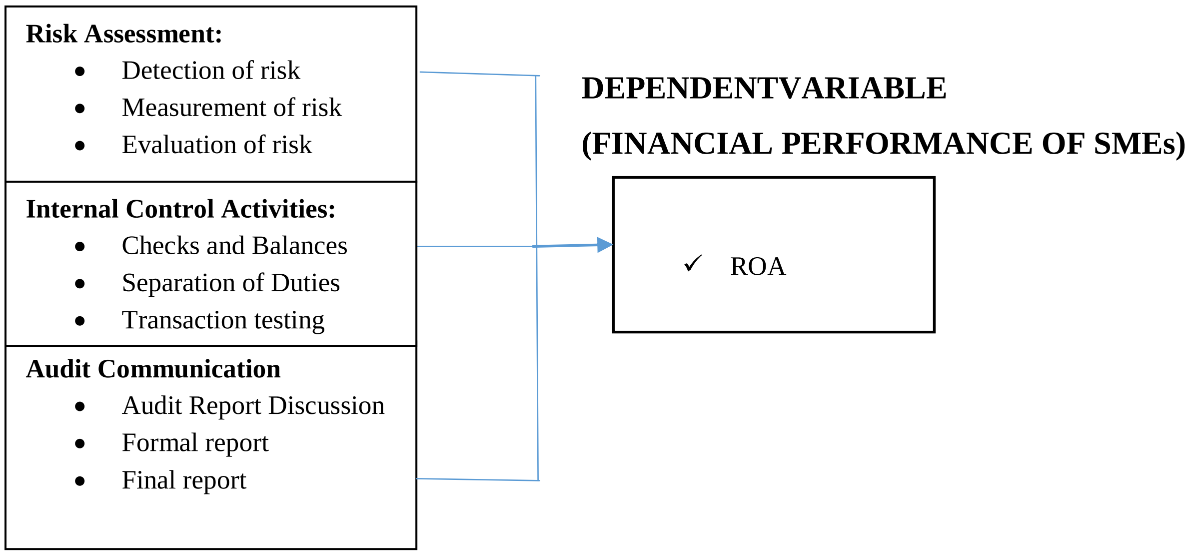


Figure 1.1: Relationship between Internal Controls and Financial performance of SMEs

Source: Ewa and Udoayang (2012)

CHAPTER TWO

LITERATURE REVIEW

This chapter reviewed literature on internal control systems in order to show the research gaps for the study. The section specifically reviewed theoretical underpinnings on internal control systems and empirical literature.

2.1 Theoretical Review

A theory is a reasoned statement or groups of statements which are supported by evidence meant to explain phenomenon (Kombo and Tromp, 2006). Previous studies on audit practices were underpinned either on the Theory of Inspired Confidence or the Agency Theory. These two theories are explained in the sub-sections below.

2.1.1 The Theory of Inspired Confidence

The theory addresses both the demand and the supply for audit services. According to Ewa and Udoayang (2012), the demand for audit services are the direct consequence of the participation of third parties (interested parties of a company) in the company. These parties demand accountability from the management, in return for their investments in the company. Accountability is realized through the issuance of periodic financial reports. However, since this information provided by the management may be biased, and outside parties have no direct means of monitoring, an audit is required to assure the reliability of this information. With regard to the supply of audit assurance, the theory suggests that the auditor should always strive to meet the public expectations. The theory requires auditors to perform their task in such a way that they do not betray expectations of a rational outsider while on the other hand they should not arouse greater expectations than their audit justifies. The demand for audit service is the direct consequence of the participation of third parties in the company or institution. These parties demand accountability from the management in return for their investments. Accountability is realized through the issuance of periodic financial reports. However this information provided by the management may be biased and outside parties have no direct means of monitoring, an audit is required to assure the reliability of this information according to Charmichael (2004). The theory connects the social needs for reliable financial statements with the technical possibilities of auditing to meet those needs and also takes into account the changes in need over time .This theory was relevant because internal auditors are bestowed with confidence that they will not betray the stakeholders of the SMEs and will therefore provide information that will inspire their confidence.

2.1.2 Agency Theory

Jensen and Meckling (1976) defines agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves some decision making authority to the agent". In agency theory the principal delegates decision making responsibility to an agent. The theory implies entrusting resources to the agent and in turn this agent must produce a report regarding the use of the resources both quantitatively and qualitatively. Audit serves a fundamental purpose in promoting confidence and reinforcing trust in financial information.

Agency theory is a useful economic theory of accountability that helps to explain the development of internal audit (Adeyemi, 2011). It is assumed that both the agent and principal are utility maximizers and that principals and agents act rationally and use completed contracting to maximize their wealth. A consequence of the latter assumption may be the "moral hazard" problem as the agents may face the dilemma of acting against the interests of their principals. Since principals do not have access to all available information at the time a decision is being made by an agent, the principals are unable to determine whether the agent's actions are in the best interest of the firm. To reduce the likelihood of this problem and limit the possible divergence from their interests by the agent, the principals can limit these divergences by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In most agency relationships the principal and agent incur positive monitoring and economic bonding costs. As agents the management of SMEs may use window dressing to commit a misappropriation of finances because the owners are not involved in day-to-day financial transactions activities. This theory was relevant to this study because it involves the financial management in SMEs.

2.2 Review of Empirical Studies

2.2.1Relationship between Risk Assessment and Financial Performance of SMEs.

A number of studies have been conducted to investigate the relationship between risk assessment and financial performance of organizations. Most of these studies however show inconsistent results leading to theory stagnation. A study on the impact of risk-based audit on financial performance in Kenya's insurance companies conducted by Kasiva (2012) among 44 respondents that included finance officers, internal auditors, credit officers, relationship officers, and accountants found out that risk-based auditing through risk management should be enhanced to enable the organization concerned to detect risks on time. Kasiva (2012) further argues that fraud risk assessment is one area that deserves significant reliance on internal audit work. In this light, it is reasoned that due to the fact that internal auditors are more privy with the operations of the firm they work for than external auditors, are particularly suited to carry out fraud risk assessment.

In a survey of internal auditors' risk management practices in the Kenya's banking sector, Kibaara (2007) investigated bank internal auditors' risk assessment practices and established that, most banks in Kenya were in the process of drafting the risk management processes and strategies in line with risk assessment.

Abiola(2013) conducted a study on effects of risk assessment on fraud prevention among Nigerian Commercial Banks. Data were sourced from the respondents through structured and well-designed questionnaires and multiple regression analysis (MRA) was used to analyze data. The result revealed that there is significant positive relationship between risk assessment and fraud detection in Nigeria Commercial Banks. Similarly, Ayagare, Apich&Nartey(2014) conducted out a research on the effectiveness of internal control systems of Ghanaian Banks. The study evaluated the control environment, and monitoring activities as components of internal control systems. Using a five point Likert scale to measure respondents' knowledge and perception of internal control systems the study reported a negative significant relationship between monitoring activities and financial performance of the banks.

Murithi (2009) set out to survey the role of internal control activities in enterprise risk management for quoted companies under the industrial and allied sector listed at the NSE. The sample comprised of all 18 listed companies under the Industrial and Allied Sectors with the

NSE as at 31st December 2008. The data was collected through a questionnaire to the internal audit department and where the function was outsourced it was distributed to the outsourced consultant. Data analysis was through descriptive statistics. The conclusion was that the internal auditors were well aware of their core roles in risk management but it was further discovered that internal audit functions were spending a lot of time in risk management beyond their mandate due to lack of a specialized risk department in the organization. Audit reports were also found to have appositive relationship with enterprise risk management.

Kakucha (2009) evaluated the level of effectiveness of internal controls of enterprises operating in Nairobi. The study also sought to establish the extent to which risk assessment aids in audit planning. The study was quantitative and was conducted between September 2007 and June 2009 using a sample of 30 small businesses as listed in the Narobi Stock Exchange (NSE) Register of Kenya. Primary data was collected from the managers of the small business using interviews and examination of documents pertaining to internal controls. The study established that there are deficiencies in the systems of internal controls, with the degree of deficiencies varying from one enterprise to another. The components of internal control that were missing in most businesses surveyed were: firstly, risk analysis, and secondly lack of proper flow of information. In addition, the study established that the sample population had limited awareness of what constituted an effective systems of internal control. The study also found that there is a negative relationship between the age of an enterprise and the effectiveness of its systems of internal control while a negative correlation between the resources held by an enterprise and its internal control systems weaknesses exists. Audit planning was therefore positively correlated with the age and size of the firm. The recommended that these was need to enlighten the operators of small business of what constitutes an efficient and effective systems of internal control through forums and seminars.

Reviewed studies investigating the relationship between risk assessment and financial performance (Kibaara,2007;Murithi, 2009;Kakucha, 2009; Kasiva, 2012; Abiola, 2013; Ayagare, Apich&Nartey 2014;) show mixed result leading to theory stagnation.Abiola (2013), Ayagare, Apich&Nartey (2014); Kibaara (2007) studied banks, Kasiva, (2012)studied insurance companies, as most SMEs are private. A study on the impact of risk-based audit on financial performance in Kenya’s insurance companies. He sampled 44 insurance companies and the research design adopted was a descriptive. However insurance companies are more organized than SMEs and operate in different business environment. This research was also a correlational research as opposed to the descriptive research by Kasiva (212). Kibaara (2007) in a survey of internal auditors' risk management practices in the Kenya's banking sector used descriptive research and sampled banks. However the banks sampled are big with all the infrastructures put in place as opposed to SMEs which are privately owned, the study did not use correlational research design and the study did not look at the entire population. Moreover, the study surveyed banking sector not SMEs. Abiola (2013) conducted a study on the effects of risk assessment on fraud prevention among Nigerian Commercial Banks and Ayagare, Apich&Nartey(2014) conducted out a research on the effectiveness of internal control systems of Ghanaian Banks in the two cases a study was made on banks which are more organized with good structures on the place. Moreover the banks studied are listed in the stock exchange of various countries as opposed to the SMEs in Homa Bay town which are never. Murithi (2009) researched on the role of internal control activities in enterprise risk management for quoted companies under the industrial and allied sector listed at the NSE. He sampled 18 companies, data analysis was descriptive statistics. However this research looked at the entire population, data analysis was done by multiple regression analysis. Moreover listed companies big, organized and more stable as compared to SMEs in Homa Bay town. In all the studies none studied the relationship between risk assessment and the financial performance of SMEs in Homa Bay town.

2.2.2 Relationship between Internal control activities and Financial Performance of SMEs.

Studies conducted to investigate the relationship between internal control activities and financial performance of firms also show inconsistencies in their results. Matendera (2013) in a study on challenges facing public audit institutions indicated that internal control activities have no significant relationship with financial performance of the institutions because of inadequate resources, lack of adequate training and development, inadequate knowledge on issues such as corporate governance, professionalism, integrity issues pose a challenge to a greater extent to the overall performance of the audit institutions. The study further found that top management commitment to the overall strategy was found to be average while poor communication of the strategy was ranked among the factors affecting performance. The study revealed that auditors face serious problems ranging from factors such as low staff motivation, lack of adequate training and capacity building, resistance to change problems, political interference, environmental, communication and leadership problems in their line of duty. The research recommended more resource allocation from the government to the organization, the staffs to be sponsored for short courses in order to improve their skills, more incentives should be offered to the entire team so as to improve their commitment to the strategy implementation and drive the strategy holistically.

Rono (2006) conducted a study on the effectiveness of the internal control activities in the management of finances in public universities in Kenya. The study sought to determine whether there was a significant difference in the evaluation of the effectiveness of theinternal control systems in the financial management between the academic and nonacademic departments in Egerton University. It concluded that the evaluation of the effectiveness of the internal control systems in the university depended on the category of the departments. The research revealed that the internal control systems in EgertonUniversity were effective due to the well-established departments charged with the responsibility of implementing the internal controls as they carry out the financial processes for example, finance, supplies and personnel departments with their various sections like cash office, salaries, computer, debtors and creditors. Audit conduct was therefore found to have a positive relationship with management of finances.

Using the analytical approach and focusing on audit planning, internal control activities and monitoring, Barra (2010) investigated the effect of penalties and other internal controls on employees' propensity to be fraudulent among Nigerian listed firms. Data was collected from both managerial and non-managerial employees. The results showed that the presence of the control activities, separation of duties, increases the cost of committing fraud. Thus, the benefit from committing fraud has to outweigh the cost in an environment of segregated duties for an employee to commit fraud. Further, it was established that segregation of duties is a “least-cost” fraud deterrent for non-managerial employees, but for managerial employees, maximum penalties are the “least-cost” fraud disincentives. The results suggest the effectiveness of preventive controls internal control activities such as segregation of duties is dependent on detective controls. The research also found that planned audits were likely to give employees more time to conceal frauds.

Olumbe (2012) conducted a study to establish the relationship between internal controls and corporate governance in commercial banks in Kenya. The researcher conducted a survey of all the 45 commercial banks in Kenya. It was concluded that most of the banks had incorporated the various parameters which are used for gauging internal controls and corporate governance. This was indicated by the means which were obtained enquiring on the same and this showed that the respondents agreed that their banks had instituted good corporate governance with a strong systems of internal controls and that there is a positive relationship between internal control and corporate governance.

Njeru (2013) conducted a study on internal audit control activities and corporate governance among commercial banks in Kenya found that audit control activities were still poor in the banks. Data was collected using a structured questionnaire distributed to all the 43 commercial banks in Kenya as at December 2012. It was further analyzed by the use of descriptive statistics aided by SPSS data analysis tool and for each of the commercial bank a level of internal audit independence and a level of corporate governance was determined. A regression model was then used to analyze the relationship between internal audit independence and corporate governance within a test of significance of 95% confidence level. The study found out that there was indeed a threat to internal audit independence since the Chief Executive Officer (CEO) had powers in most banks to approve the internal audit budget, determine the compensation of the Chief Audit Executive (CAE) as well as hire and fire the CAE. The study further found out that there was a strong linear relationship between internal audit independence and corporate governance among commercial banks in Kenya. This implies that in policy and practice there are gaps in relation to internal audit independence that needs to be addressed by management.

According to Ejoh andEjom, (2014) on their study on The Impact of Internal Control Activities on Financial Performance of Tertiary Institutions in Cross River State College of Education, Nigeria. Data was collected using questionnaires and interview guide as well as review of documents and articles. The method of analysis employed was survey design while the stratified sampling procedure was adopted in administering the questionnaires. The data were analyzed using simple percentages, tables, correlation coefficient and z-scores. The study revealed that there is no significant relationship between internal control activities and financial performance of Cross River State College of Education. The investigation recommends proper checks and balances in all financial transactions. There should be effective and efficient security network to reduce frequent theft, threat to life and property. The study also recommends that management of the institution should organize regular training for staff on control mechanism.

Ewa and Udoayang (2012) carried out a study to establish the impact of internal control design on banks' ability to investigate staff fraud and staff life style and fraud detection in Nigeria. Data were collected from 13 Nigerian banks using a four point Likert Scale questionnaire and analyzed using percentages and ratios. The study found that Internal control design influences staff attitude towards fraud such that a strong internal control mechanism is deterrence to staff fraud while a weak one exposes the systems to fraud and creates opportunity for staff to commit fraud. Audit planning were also found to have a positive significant relationship with deterrence of frauds.

Empirical evidence (Matendera, 2013;Rono, 2006; Njeru, 2013; Ejoh and Ejom, 2014;Barra, 2010; Ewa and Udoayang', 2012; Olumbe, 2012;) shows inconclusive results on the relationship between audit control activities and financial performance of SMEs. However, Matendera (2013) only studies public institutions using a descriptive research design. The effect of internal control activities, this research went further to look at financial performance of SMEs.Ewa and Udoayang' (2012) used samples of 13 banks with a 4 point likert scale, this research looked at all the SMEs in Homa Bay town on a 5 point likert scale, here SMEs in Homa Bay town are not considered. Barra (2010) used samples of banks, he used only separation of duties which the research confirmed that the presence of control activities increases the cost of committing fraud. This research went further to look at checks and controls and transaction testing together with separation of duties. Here indicates that SMEs were not included.Rono (2006) uses a sample of public universities while Njeru (2013) only studies commercial banks using descriptive research design, this research was a correletional research design and the data was taken for SMEs in Homa Bay town. Ejoh and Ejom (2014) did a research on a college of education, analyzed the data using Z-score which is used to assess the level of bankruptcy, this research used MRA to analyse the data, moreover the research was done on SMEs in Homa Bay town. Olumbe (2012) studied commercial banks which are more stable as far as their internal control activities are concerned, this is unlike the SMEs in Homa Bay town. Moreover, the review of literature showed that little was known on the relationship between internal control activities and the financial performance of SMEs in Homa Bay town.

2.2.3 Relationship between Audit Communication and Financial Performance of SMEs.

Sigowo (2009) explored the role of internal audit communication in promoting good corporate governance in SACCOs. The sample comprised of 20 SACCOs operating within Nairobi selected randomly. The study found out that audit communication functions was guaranteed since there were audit committee at the Board level; the internal audit function spent around 36% of their time in doing corporate governance test, assessing internal controls, risk management and ensuring compliance and finally it was noted that internal audit function was being involved in pre-auditing tasks and reporting hence limiting their effectiveness. Audit reporting was however found to have no significant relationship with corporate governance.

Achuora, Arasa&Ochriri (2010) examined the factors that affect effectiveness of public procurement audits for constituency development funds in Kenya. Specifically the study sought to investigate the effect of the legal framework, auditor's specific professional qualities, technical audit factors and audit communication on effectiveness of public procurement audits. A descriptive research design was employed, using a stratified random sampling to ensure representativeness. Both quantitative and qualitative methods of data analysis were used. Descriptive statistics as well as regression analysis were used to facilitate examination of the relationship between the variables of interest. The study findings indicate that technical audit factors such as audit reporting have greatest influence on effectiveness of public procurement audit, followed by regulatory framework, client related factors and auditor's professional qualities respectively. The study recommends that a summarized regulatory framework for CDF procurement management be prepared by policy makers, more public auditors be trained on public procurement audit and the CDF managers be exposed to audit as a positive management tool.

Mutua (2012) researched on impact of risk based audit on financial performance of commercial banks in Kenya. Although her study concentrated on risk based audit, she acknowledged that communication of audit information requires appropriate effective and efficient internal audit. From the findings, the study concluded that risk based auditing through internal auditing standards and internal auditing staffing should be enhanced to enable firms to be able to detect risks on time and concentrate on high risk areas leading to increased transparency and accountability, hence enhancing financial performance. She acknowledged that communication of audit information requires appropriate effective and efficient internal audit.

Ndege (2012) researched on the role of audit communication on the performance and financial ratios of commercial banks in Kenya. The objective of his study was to identify factors, in a ratio form that shape bank performance as measured through return on assets (ROA) and return on equity (ROE).In his study he concluded that ROA and ROE can be used to measure financial performance of banks in Kenya. Internal audit operations especially audit follow-ups and recommendations do not only have short-term effect on the running of an organization but is the backbone of an organization and it dictates the prosperity or the down fall of the particular organization. Its effectiveness and acceptability should be stressed at all levels and especially the management to enhance its viability. However it seems that laxity has crept in and it is in light of this view that we seek to analyze the factors affecting implementation of internal audit reports in Kenyan banks.

Ndimitu (2011) conducted a study aimed at establishing the relationship between internal audit and effective financial management in Embuwater and Sanitation Company. Primary data was collected from staffs in the different levels as per the organization structure using a questionnaire and secondary data included cost of internal audit from the payment cash book and salaries journals. The research found out that internal auditing provides value to governing bodies and senior management as an objective source of independent advice when the audit reports are given in time a fact that ensures proper processes are followed in generating and safeguarding the organization's wealth.

The review of literature on the role of audit communication and financial performance of firms has received much attention. Sigowo (2009) explored the role of internal audit communication in promoting good corporate governance in SACCOs. The study did not explore this role on SMEs. Achuora, Arasa&Ochriri (2010) examined the factors that affect effectiveness of public procurement audits for constituency development funds in Kenya using audit communication as one of the constructs. Mutua (2012) researched on impact of risk based audit on financial performance of commercial banks in Kenya. Although her study concentrated on risk based audit, she acknowledged that communication of audit information requires appropriate effective and efficient internal audit. He did a research on banks which are more organized with good audit communication standards as compared to SMEs in Homa Bay town. Ndege(2012) also did a research on banks which have good audit communication systems in place as compared to SMEs in Homa Bay town. None of the studies explored the relationship between audit communication and the performance of SMEs in Homa Bay town. This research addressed this research problem.

CHAPTER THREE

MATERIAL AND METHODOLOGY

This chapter describes methodology which was adopted by the study. It includes the research design, study area, validity and reliability of data collection instruments, data sources and data collection methods, sampling procedures, ethical procedures, data processing, analysis and presentation.

3.1 Research Design

Research design refers to the way the study is designed, that is, the method used to carry out the research (Mugenda and Mugenda (2003). Correlation research design was adopted in the investigation in which quantitative data was collected and analyzed in order to describe the specific phenomenon in its current trends, current events and linkages between different factors at the current time. Correlated research design was chosen because it enabled the researcher to establish the relationship between internal control systems and the financial performance of SMEs in Homa Bay town Kenya.

3.2 Study Area

The research was conducted in Homa Bay town, which is situated along the shores of Lake Victoria in the western part of Kenya, approximately 34^0 E and O^0, 15’S. The population of the town is approximately 1 million according to the 2009 population census (Oyier, 2012) and an area of 154.7 km². According to statistics available in the offices of Trade Ministry of Homa Bay County Government, there are 152 small and medium enterprises in Homa Bay town.

3.3 Target Population

Mugenda and Mugenda (2003) define population as an entire group of individuals, events or objects having common observable characteristics. The target population in this study was 152 SMEs registered in Homa Bay town at the County Government’s Ministry of Trade offices. 20 SMEs were looked at during the pilot study and the remaining 132 were looked at afterwards.

3.4 Data Collection

3.4.1 Sources of Data

The researcher used self-administered questionnaires as research tools to collect primary data from the respondents who are the owners and the managers and a mean was looked at since they provided the same data. This approach was considered to be the most appropriate for this research because it enabled the researcher to collect as more data as possible (Fisher, 2004).

The following scale was used in the questionnaire;

Figure 3.1: Likert Scale

Scale	Interpretation
5	Strongly Agree
4	Agree
3	Not Sure
2	Disagree
1	Strongly Disagree

3.4.2 Data Collection Procedure

The main method of data collection was self-administered questionnaire. The researcher first acquired an introduction letter from the Dean School of Business and Economics before going to the area of study where permission was sought and then appointments made for the day of data collection according to the convenience of the respondents. The secondary data was collected from the financial statements and interviews with the managers and owners..

3.4.3 Instrument for Data Collection

One type of questionnaire was used to collect primary data from the respondents. The questionnaire consisted of both structured and non-structured questions. The structured questions were on a five-point Likert scale for ease of analysis. Secondary data was also collected from financial documents available at the SMEs offices.

3.5 Reliability and Validity of Data Collection Instrument

According to Mugenda and Mugenda (2003), reliability ensures the degree of consistency or stability is high and hence it involved examining the research instrument several times for reliability in relevance, clarity and ambiguity of items. In achieving this, a pilot study was carried out from 20 SMEs located in Homa Bay town, where a total number of 2 respondents from each SMEs were interviewed who did not form part of the final sample size, this was too used in pretesting the data instrument using a test – retest reliability. The pilot test ensured that the items in the questioner were clearly stated, had the same meaning to all the respondents and also gave the researcher an idea of approximately how long it would take to complete the questioner.

The researcher used the Content Valid Index (CVI) which is a scale developed by computing or rating the relevant items in the instrument or questionnaire by checking their clarity, their meaningfulness in line with all objectives stated dividing by the total number of items. The validity was described as follows:

$$\text{CVI} = \frac{\text{Relevant Items}}{\text{Total Number of Items}}$$

Fisher (2004) indicates that for a research instrument to be valid, the CVI should be more than 0.7, below which the instrument is invalid.

The overall reliability was established at 0.75 which is greater than 0.70 hence the instrument was treated as reliable

3.6 Data Analysis

After data collection, the data was cleaned and coded. While the objectives were analyzed descriptively, multiple regression analysis was used to establish the relationship between the dependent variable offinancial performance of SMEs and the independent variable of Internal controls. This study was based on the regression model below to establish the relationship between variables:

$Y = a_0 + a_1X_1 + a_2X_2 + a_3X_3 + \varepsilon$

Where:

Y =SMEs Performance (measured in terms of ROA to the SMEs.)

$X_1 =$ *risk assessment*

X_2= InternalControl activities

X_3 = auditcommunication

a_0= the constant term and a_1, a_2 and a_3 are the regression coefficients.

ε = is the error term assumed to be normally distributed.

3.7 Data Presentation

The research findings were presented using tables and figures.

CHAPTER FOUR

RESULTS

This chapter provides a summary of the data analysis, results of the study and the discussion of the results of the study. The results were presented on the relationship between internal control systems and financial performance of small and medium enterprises in Homa Bay town, Kenya.

The study was based on the following specific objectives; to establish the effect of risk assessment on the financial performance, to determine the relationship between internal control activities and the financial performance and to establish the relationship between audit communication and the financial performance of SMEs in Homa Bay town.

4.1 Response Rate

The Sample size of 152 respondents was targeted by the study from which 132 filled in and submitted the questionnaires leading to a response rate of 86.8%. In making conclusions for the study this response rate was satisfactory as per Mugenda and Mugenda (1999). The response rate was representative, a 50%response rate is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent. The response rate was considered to be excellent, based on the assertion. The results were presented in table 4.1 below

Table 4.1: Response return rate

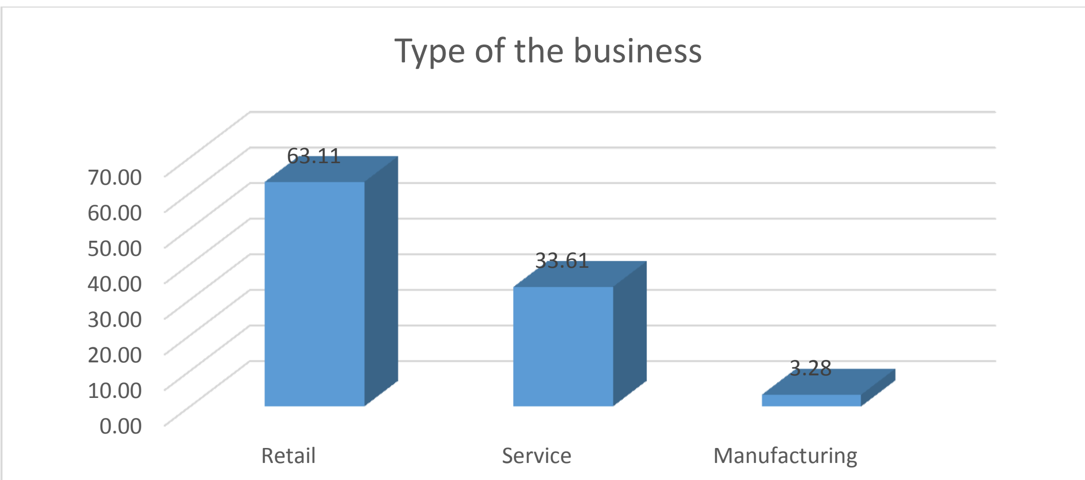
	Frequency	**percentage**
Returned	132	86.8
Not returned	20	13.2

Source: Research data, (2017)

4.2 General information

The study sought to establish the information on the type of business, level of education, position of the employee, number of employees in the business and number of years the business has been operation. These bio data points at the respondents' appropriateness in answering the questions. When asked the type business, majority 77(63.11%) of the respondents indicated the business is retail and the rest of the respondents 41(33.61%) and 4(3.28%) indicated the type of business is service and manufacturing respectively. The results were presented in figure 4.1 below.

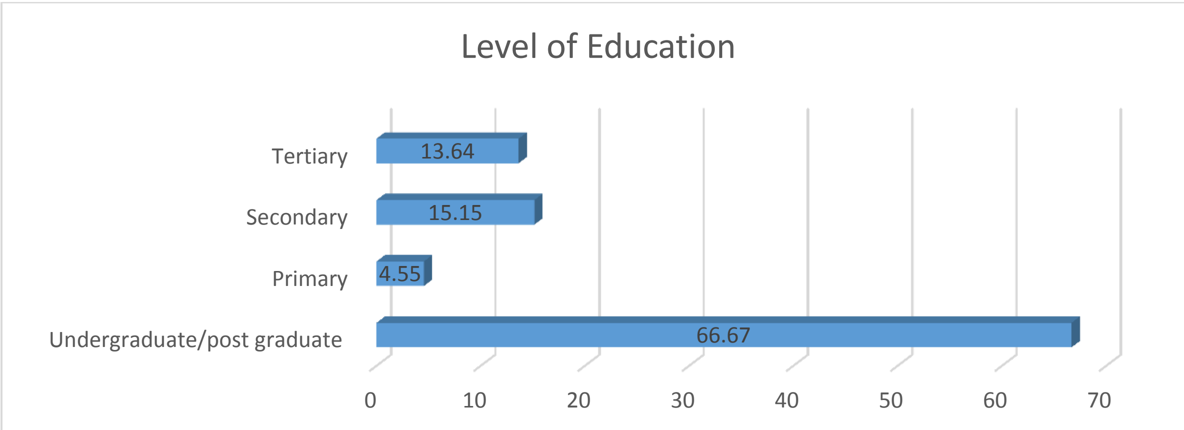
Figure 4.1: Type of business



Source: Research data, (2017)

As pertaining to their highest level of education attained, 66.67% of the respondents had undergraduate/post graduate degree education, 13.64% had tertiary level education while 15.15% and 4.55% had reached up to secondary and primary level in education respectively in various fields indicating clearly their level of articulation of the subject matter and their ability to contribute to the internal control systems as was evidence in the research findings. This is also the reflection of the SME culture change philosophy of continuous training for best results. The results were presented in figure 4.2 below

Figure 4.2: Level of Education



Source: Research data, (2017)

The respondents were required to indicate their current positions in the business. 20.45% of the respondents indicated they were owners of the business, 50.76% indicated they were managers of the business and the rest 28.79% 0f the respondents indicated they were senior employees of the business. The results were presented in table 4.2 below

Table 4.2: The current position of the employee

	frequency	percentage
Owner	27	20.45
Manager	67	50.76
Senior employee	38	28.79
Total	132	100.00

Source: Research data, (2017)

The respondents were also requested to indicate the total number of employees in the organization they work with. The majority 78.03% of the respondents indicated their organization had less than 10 employees, 19.7% of the respondents indicated that their business had 11 to 20 employees, 1.52% of the respondents that their business had 21 to 30 employees and the rest 0.76% of the respondents had 41 and above employee. The results were as shown in table 4.3 below.

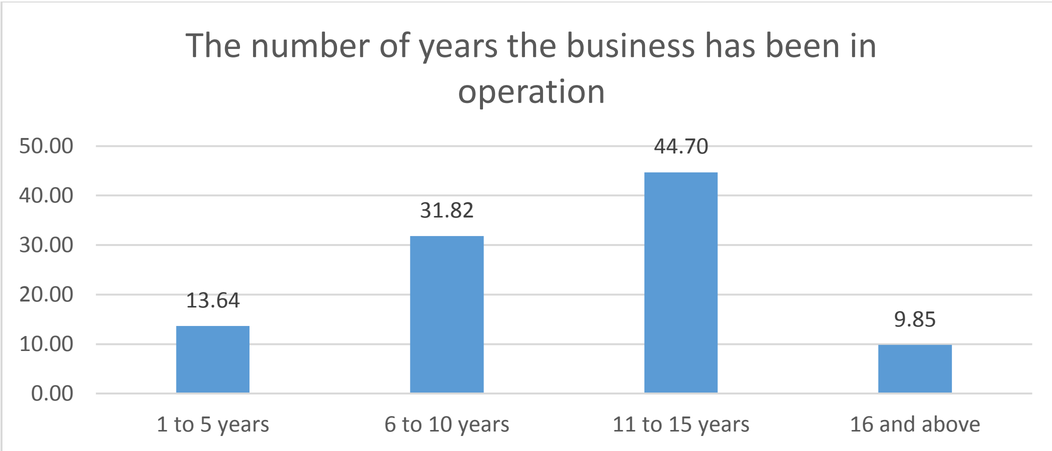
Table 4.3:The number of employees in the business

Less than 10	103	78.03
11 to 20	26	19.70
21 to 30	2	1.52
41 and above	1	.76
Total	132	100.00

Source: Research data, (2017)

The study also requested the respondents to indicate the number of years the business has been in operation. 13.64% of the respondents indicated their business has been operation for 1 to 5 years, 31.82% of the respondents indicated their business has been in operation for 6 to 10 years, 44.7% indicated 11 to 15 years and 9.85% indicated their business has been in operation for more than 16 years. The results are shown in figure 4.3 below

Figure 4.3: The number of years the business has been in operation



Source: Research data, (2017)

The respondents were asked to indicate the sources of finance for the business. 89.39% of the respondents indicated the source of funds for the business through contribution from friends and families, 98.48% of the respondents indicated that the source of funds for the business is retained earnings, 37.88% of the respondents indicated the source of funds for their business through borrowing of bank loans. Other sources of finance are through MFI (6.82%), mobile money (8.33%) and Sacco's (19.70%) as indicated by respondents. The results were presented in table 4.4 below

Table 4.4: Sources of finance for the business

	Frequency	percentage
Family/Friends	118	89.39
Retained Earnings	130	98.48
Banks	50	37.88
MFI	9	6.82
Mobile money	11	8.33
SACCOs	26	19.70

Source: Research data, (2017)

The study requested the respondents to indicate the net income for last year. The respondent 23.48% indicated that the net income for their business was ksh.200,000 and below, 26.52% of the respondents indicated their business had a net income of ksh.200,001 to ksh.400,000, 28.79% of the respondents indicated their business had a net income of ksh.400,001 to ksh.600,000, 14.39% of the respondents indicated their business had net income of ksh.600,001 to ksh.800,000, 4.55% of the respondents indicated ksh.800,001 to ksh.1,000,000 and 2.27% of the respondents indicated their business had net income of ksh.1,000,000 and above. The results were presented in table 4.5 below

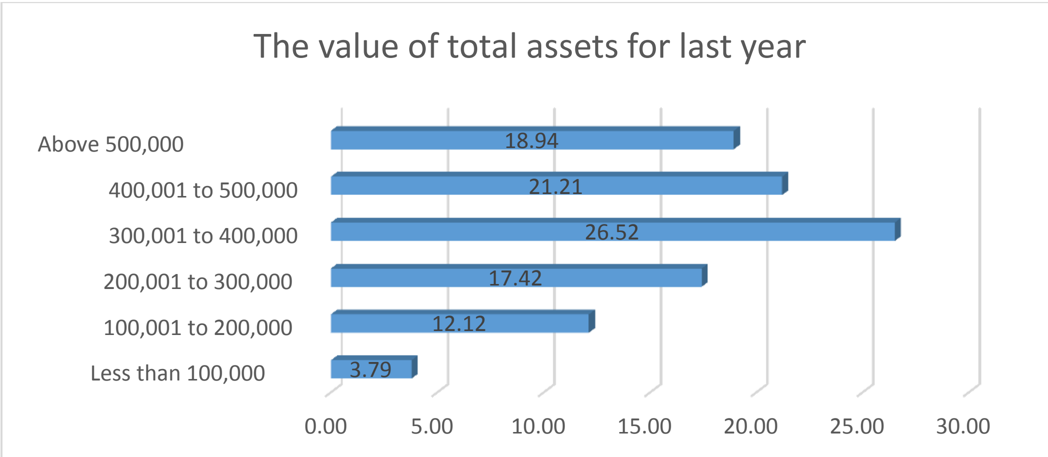
Table 4.5: Net Income for the last year

	Frequency	**percentage**
Less than 200,000	31	23.48
200,001 to 400,000	35	26.52
400,001 to 600,000	38	28.79
600,001 to 800,000	19	14.39
800,001 to 1,000,000	6	4.55
Above 1,000,000	3	2.27

Source: Research data, (2017)

The respondents were asked to indicate value of total assets for last year. 3.79% of the respondents indicated the last year's total value of the assets was less than ksh.200,000, 12.12% of the respondents indicated that the value of the assets was ksh.200,001 to ksh.400,000, 17.42% of the respondents indicated the total value of the assets was ksh.400,001 to ksh.600,000, 26.52% of the respondents indicated ksh.600,001 to ksh.800,000, 21.21% of the respondents indicated ksh.800,001 to ksh.1,000,000 and 18.94% of the respondents indicated that the total value of the assets for last was above ksh.1,000,000.

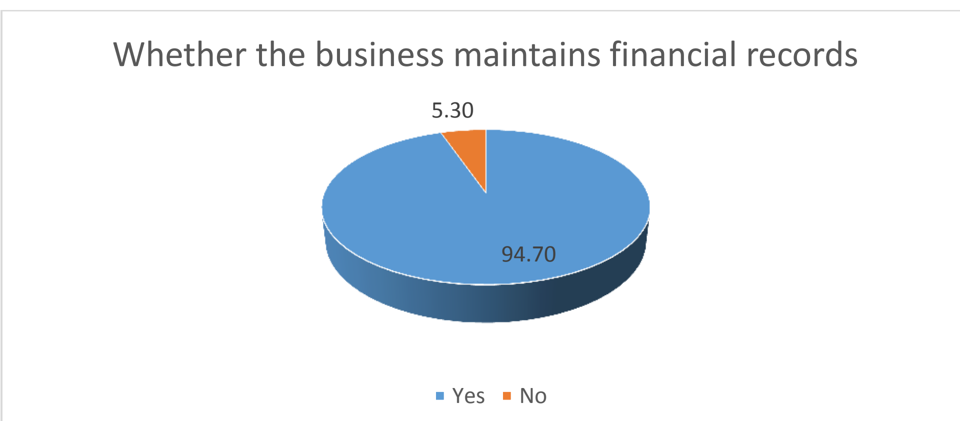
Figure 4.4: The value of total assets for last year



Source: Research data, (2017)

The respondents were asked whether they maintain financial records for their business.The majority 94.70% of the respondents indicated they maintain financial records for their business and the rest 5.30% of the respondent said they don't maintain financial records for their business.

Figure 4.5: Whether the business maintains financial records



Source: Research data, (2017)

56% of the respondents said the owner of the business maintains financial records, 41.6% of the respondents said the financial records are maintained by the manager and the rest 2.4% said the internal accountant maintains the records.

Table 4.6: Types of financial records the business maintains

	Frequency	Percentage
Statement of Comprehensive Income	84	38.36
Statement of Changes in Equity	5	2.28
Statement of Cash flow	5	2.28
Statement of Financial Position	84	38.36
Ruled Exercise Book	41	18.72

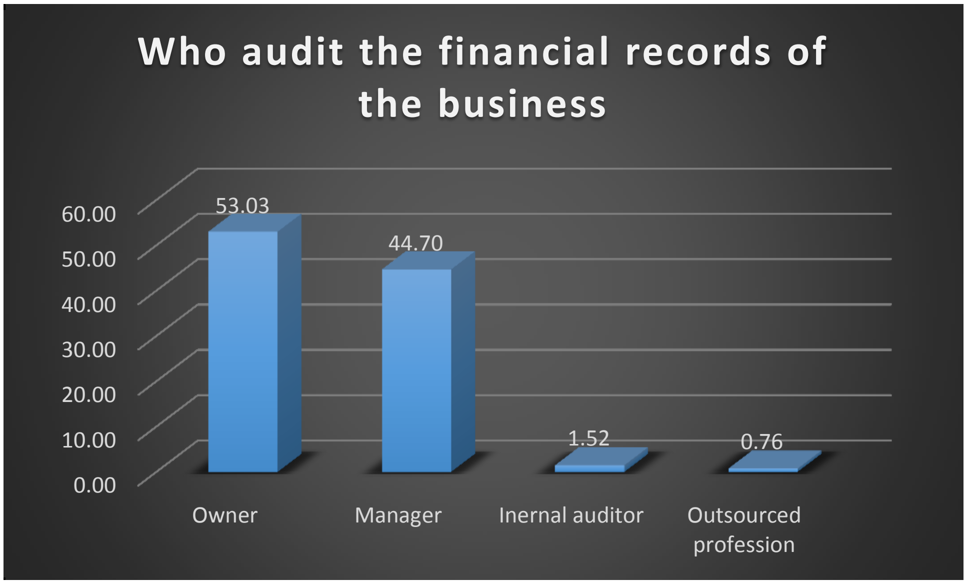
Source: Research data, (2017)

The respondents were requested to indicate the type of financial records theirbusiness maintain.

38.36% was equally shared between the respondents who indicated their business maintain statement of comprehensive income and statement of financial position, 18.72% of the respondents indicated their business maintains the records in ruled exercise book and the rest 2.28% was shared equally between the respondents who indicated their business maintains statement of changes in equity and statement of cash flow. The table 4.6 above presents the results.

The respondents were asked to indicate who audits the financial records. The 53.03% of the respondents indicated it is the owner who audits the financial records of their business. 44.07% of the respondents indicated it is the manager who audits the financial records of their business and the rest of the respondents 1.52% and 0.76% indicated it is the internal auditor and the outsourced profession who audits the financial records of their business. The results were as shown in figure 4.6 below

Figure 4.6: Who audit the financial records of the business



Source: Research data, (2017)

The majority of the respondents 93.6% of the respondents indicated they receive audit reports and the rest 6.4% indicated they don't receive audit reports. Also 93.16% of the respondents indicated they involve stakeholders when reading the report and 6.84% of the respondents disagreed with the statement.

4.3 Risk assessment

The study sought to ascertain the extent to which different indicators of risk assessment influenced financial performance in small and medium enterprises in Homa Bay town, Kenya. The respondents were asked to respond to selected indicators based on the extent to which they felt the indicators had effects on financial performance. The levels of measurements were Strongly Disagree (1), Disagree (2), Not sure (3), Agree (4) and Strongly Agree (5). The findings obtained are presented in table 4.7 below

Table 4.7: Findings on risk assessment

Risk Assessment	Mean	Stddev
The business has accounting and financial management systems to detect risks.	3.81	1.02
Detected risks are evaluated to check the extent of damage.	3.81	1.11
There is risk measurement when detected.	3.73	.93
Some business risks go undetected.	3.85	.96
Actions are immediately taken on the detected risks.	3.82	1.00
Overall mean and standard deviation	**3.80**	**1.00**

Source: Research data, (2017)

Results in table 4.7 shows that consideration of risk assessment in error/risk detection, the auditors understanding of the evaluation and the ease with which to assess risk, risk measurement when detected, actions are immediately taken on the detected risks and some business risks go undetected had higher influence on financial performance in small and medium enterprises in Homa Bay town, Kenyaas indicated by a mean of 3.81, 3.81, 3.73, 3.85 and 3.82 with a standard deviation of 1.02, 1.11, .93, .96 and 1.00 respectively. This clearly indicates that risk assessment affected the financial performance in small and medium enterprises in Homa Bay town, Kenya.

4.4Internal Control Activities

The study sought to ascertain the extent to which different indicators of internal control activitiesinfluenced financial performance in small and medium enterprises in Homa Bay town, Kenya. The respondents were asked to respond to selected indicators based on the extent to which they felt the indicators had effects on financial performance. The levels of measurements were Strongly Disagree (1), Disagree (2), Not sure (3), Agree (4) and Strongly Agree (5). The findings obtained are presented in table 4.8 below

Table 4.8: Findings on internal Control Activities

Internal Control Activities	Mean	Stddev
The business has clear separation of roles.	3.73	.78
There is appropriate supervision by senior staff on the work of junior staff.	3.59	.85
Corrective actions are taken to address weaknesses identified.	3.52	.99
The business security systems identify and safeguard business assets.	3.89	.87
Payments are approved by senior persons before they are actually made.	4.26	1.00
Overall mean and standard deviation	**3.80**	**1.04**

Source: Research data, (2017)

Findings in table 4.8 shows that consideration of appropriate supervision by senior staff on the work of junior staff, and corrective actions are taken to address weaknesses identified had higher influence on financial performance in small and medium enterprises in Homa Bay town, Kenya as indicated by a mean of 3.59, and 3.52 with a standard deviation of 0.85 and 0.99 respectively. This clearly indicates that internal control activities affect the financial performance in small and medium enterprises in Homa Bay town, Kenya.

The results also show that the clear separation of roles, business security systems identify and safeguard business assets and approval of payments by senior persons before they are actually made affected financial performance in small and medium enterprises in Homa Bay town, Kenyaas indicted by a mean of 3.73, 3.89 and 4.26 with a standard deviation of 0.78, 0.87 and 1.00 respectively. This clearly indicates that internal control activitiesaffected the financial performance in small and medium enterprises in Homa Bay town, Kenya.

This is in line with Ray and Pany (2001)'s "suggestion of segregation of duties" such that no one person should handle all aspects of a transaction from the beginning to the end. The lack of supervision by senior staff is an indication of deficiencies in strategic controls as advocated for by Hitt, Hoskisson, Johnson, and Moesel (1996) which if not addressed may lead to material internal control weaknesses. Action being taken to address weaknesses in the systems is an indication of the commitment to systems. This is the commitment referred to by Whittington and Pany (2001)

4.5 Audit Communication

The study sought to ascertain the extent to which different indicators of audit communicationinfluenced financial performance in small and medium enterprises in Homa Bay town, Kenya. The respondents were asked to respond to selected indicators based on the extent to which they felt the indicators had effects on financial performance. The levels of measurements were Strongly Disagree (1), Disagree (2), Not sure (3), Agree (4) and Strongly Agree (5). The findings obtained are presented in table 4.9 below

Table 4.9: Findings on audit Communication

Audit Communication	Mean	Stdd ev
The business is periodically audited	3.85	.89
An audit report is presented after the audit	4.27	.75
An audit report is discussed after the presentation	3.73	.99
Audit recommendations are implemented	3.74	1.01
Overall mean and standard deviation	**3.90**	**.97**

Source: Research data, (2017)

Findings in table 4.9 shows that consideration of audit recommendations and implementation, auditing of business periodically, discussion of audit report after the presentation andpresentation of audit report after the audit had higher influence on financial performance in small and medium enterprises in Homa Bay town, Kenya as indicated by a mean of 3.74, 3.85, 3.73 and 4.27 with a standard deviation of 1.01, 0.89, 0.99 and 0.75 respectively. This clearly indicates that audit communicationaffected the financial performance in small and medium enterprises in Homa Bay town, Kenya.

4.6 Financial performance

The respondents were asked to indicate the extent to which they disagree or agree with various aspects of financial performance in their respective small and medium enterprises in Homa Bay town, Kenya. The five-point Likert scale with Strongly Disagree (1), Disagree (2), Not sure (3), Agree (4) and Strongly Agree (5) was used and their responses recorded in Table 4.10.

Table 4.10: Findings on financial performance

Financial performance indicators	Mean	Stdd ev
The business has enough cash to meet its obligations effectively	3.35	1.01
The business has a well-developed Chart of Account	3.94	.95
The business assets have increased over time	3.52	1.00
The business minimizes costs, expenditures and all company receipts are dully corrected	3.49	1.12
Actions are immediately taken on the detected risks.	3.90	.91
Overall mean and standard deviation	**3.64**	**1.00**

Source: Research data, (2017)

From table 4.10, it is clearly evident that, respondent were indifferent as to whether the respective small and medium enterprises in Homa Bay town, Kenyaaccounting systems adequately identifies receipts and expenditures and costs are minimized. This is revealed by a mean value of 3.49 which is the “not sure” position according to the Likert scale. However, the standard deviation of 1.12 reveals that, respondents varied in their responses to the test. The results in table 4.10 reveal that respondents were not sure as to whether the SMEs' has enough cash to meet its obligations effectively. This is shown by a mean value of 3.35. However, a significant standard deviation of 1.01 reveals that in as much are respondents were not sure in their responses, they varied greatly in their responses to test statement. This casts doubt on the financial soundness referred to by Verschoor (1999).

The results in table 4.10 above reveal that respondents agree that corrective action is normally taken to address weaknesses as shown by a mean value of 3.90 and SME has well-developed chart of account with a mean value of 3.94. However, a significant standard deviation of 0.91and 0.95 shows that there are very varied responses as far as responses to this financial tests was concerned. Action being taken to address weaknesses in the systems is an indication of the commitment to systems. This is the commitment referred to by Whittington and Pany (2001).

4.7Regression Analysis

A study was conducted on the relationship between internal control and financial performance of small and medium enterprises in Homa Bay town, Kenya. The analysis applied the statistical package for social sciences (SPSS) to compute the measurements of the multiple regression for the study. The study evaluated the independent variables and the dependent using questionnaires.

In order to assess the influence of internal control systems on financial performance, the study had set the following null hypothesis; H01: Internal control systems does not have significant effect on financial performance of small and medium enterprises in Homa Bay town, Kenya.In order to test the above hypothesis, the researcher used regression coefficient (beta β) with the test criteria set that the study should reject the null hypothesis $H_0 1$ if $\beta \neq 0$ and p-value < α, otherwise fail to reject H_0 and F tests were conducted to determine the indication and overall significance of the relationships respectively.

4.7.1 Model Summary

The model summary shows the summary of the regression analysis as shown in the regression model. Below are the findings in the table 4.8

Table 4.8: Model Summary

In order to explain the percentage of variation in the dependent variable financial performance as explained by the independent variables. The researcher used coefficient of determination that was obtained from the model summary in the table 4.11.Coffecient of determination was used to explain whether the model is a good predictor.

Table 4.11: Goodness of fit analysis of internal control systems on performance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.743	.552	.542	.114

Source: Research data, (2017)

From the results of the analysis, the findings show that the independent variables (risk assessment, control activities, audit communication) contributed to 54.2% of the variation in financial performance as explained by adjusted R^2 of 54.2% which shows that the model is a good prediction.R is the correlation coefficient which displays the relationship between variables of the study, from the result shown in the table above there was a positive strong connection between the variables of the study as shown by 74.3%.The regression results also shows that 55.2% of performance of small and medium enterprises in Homa Bay town, Kenyacan be explained by internal control systems (R squared =.552). This means that internal control systems help increase performance of small and medium enterprises in Homa Bay town, Kenyaby 55.2 percent.

4.7.2 Analysis of Variance

The study conducted an Analysis of Variance, in order to test the impact of the relationship between internal control systems and financial performance of small and medium enterprises in Homa Bay town, Kenya. The findings were as shown below:

Table 4.12: Overall significance: ANOVA (F-test) of Internal control systems on performance

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2.018	3	.673	51.769	.003[a]
	Residual	1.640	128	.013		
	Total	3.658	131			

a. *Predictors: (Constant), risk assessment, internal control activities, audit communication*

b. Dependent Variable: Financial performance

From the study results, the regression results reveal that internal control systems had overall positive significance impact on financial performance (p-value = 0.03)

The regression result also shows that at individual level, there was a statistically significant positive linear relationship between internal control systems and performance (β= 0.743) Table 4.12in that the p-value is less than 0.05 (0.003< 0.05) Table 4.12. The hypothesis criteria was that the null hypothesis H0 should be rejected if β≠0 and p-value < α otherwise fail to reject H_0. From the above regression results β=0.743≠0 and 0.003< 0.05, the study therefore rejects the null hypothesis and conclude that internal control systems had significant effect on financial performance of small and medium enterprises in Homa Bay town, Kenya.

4.7.3 Test for Coefficients

This table shows the level of significance on the variables, it also provides the standardized and unstandardized coefficients as shown below:

Table 4.13 Individual significance (T-test) of Internal control systems on performance

	Un-standardized Coefficients		Standardized Coefficients		
Model	B	Std. Error	Beta	t	Sig.
1(Constant)	.973	1.012		2.341	.001
Risk assesment	.211	.331	.621	4.29	.004
Control activities	.463	.204	.502	2.857	.025
Audit communication	.308	.129	.491	2.779	.003

Source: Research data, (2017)

From the above table 4.13, the researcher sought to establish the extent to which internal control systems impact on financial performance of SME. The following regression equation was obtained:

$Y = 0.973 + 0.211_{X1} + 0.463_{X2} + 0.308_{X3}$

β_0 = 0.973, shows that if the level of independent variables are held at constant zero, financial performance would be 0.973.

β_1= 0.211, shows that one unit change in risk assesment would results in 0.211units increase in financial performance

β_2= 0.463, shows that one unit change in control activities would results in 0.463units increase in financial performance

β_3= 0.308, shows that one unit change in audit communication would results in 0.308units increase in financial performance

From the above regression model holding all the other factors constant, financial performance is measured by the efficiency and effective implementation of internal control systems. The results of the multiple regression model shows that there is a positive relationship between internal control systems and financial performance of SME in Kenya. This implies that a single unit increase in any of the independent variables results into a corresponding increase in financial performance of SMEs.

CHAPTER FIVE

DISCUSSION CONCLUSIONS AND RECOMENDATIONS

Examining internal control systemsas defined by AICPA; internal Control comprise the plan of the organization and all the coordinate methods and means adopted within the business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. This chapter provides a summary of findings, conclusion, recommendations, implications of the study on policy, theory and practice, limitation of the study, and further suggestion for research.

5.1 Summary of Findings

The study sought to examine the relationship between internal control systems and financial performance of small and medium enterprises in Homa Bay town, Kenya. Primary data was collected and used in the analysis.

The study conducted a regression analysis to establish the relationship between internal control systems and financial performance of small and medium enterprises in Homa bay town, Kenya. From the research findings, the study established that there existed a strong positive relationship between risk assessment, internal control activities and audit communication and the performance of small and medium enterprises in Homa Bay town, Kenya.

5.2 Conclusions

Based on the findings of the study it is concluded that risk assessment exists in small and medium enterprises in Homa Bay town, Kenya. Risk assessment can help detect risks and enhance financial performance in SME. Risk assessment helps to minimize risk, increases transparency and accountability hence enhancing financial performance in small and medium enterprises in Homa Bay town, Kenya. Internal auditors' understanding of the SME's risk, consideration of risk assessment in the detection of errors, auditor`s recognition of work environment in risk assessment and management, auditor's involvement of management in risk evaluation process and auditors identification of changes that influence SMEs are the indicators of risk assessment which influences financial performance in small and medium enterprises in Homa Bay town, Kenya. Finally the study concluded that there exists a positive relationship between risk assessment and financial performance in small and medium enterprises in Homa Bay town, Kenya.

Based on the findings of the study, it is concluded that the SME has an effective internal control systems as supported by the study findings and responses to questionnaire on clear separation of roles, supervision and management commitment to control activities.

5.3 Recommendations and implications of the study on policy, theory and practice

The study recommended that there is a positive relationship between internal control systemsand financial performance which may suggest that high levels of internal control systems could be of importance. Therefore it is important for the county government to examine what value internal control systems may add to SMEs.

The study also recommends that management should establish and implement periodic review of internal audit performance to ensure that its performance and value to the institution is maximized and to ensure compliance with appropriate standards and guidance. The study further recommends that the head of Internal Audit department should be a professional accountant and registered with any of the professional accountancy body in Kenya to ensure ethical righteousness.

5.4 Limitation of the Study

The main limitation of study was inability to include more organizations as this study concentrated only on SME due to resource constraints. The study would have covered more institutions across all sectors of the financial institutions so as to provide a more broad based analysis. However, the researcher recommended further studies in other financial institutions in Homa Bay town, Kenya.

The study also faced limitation of non-corporation from the respondents especially where the management was unwilling to reveal information about the internal control systems and financial performance of the SME and this sometimes delayed in filling of the questionnaire. The researcher made follow ups to ensure data was collected without further delays.

The study also faced a limitation, whereby the respondents were found to be uncooperative because of the sensitivity of the information required for the study. The researcher explained to the respondents that the information they provided was to be held confidential and was going to be used for academic purpose only.

5.5 Recommendations for Further Studies.

The study determined the relationshipbetweeninternal control systemsand the financial performance ofsmall and medium enterprises in Homa Bay town, Kenya. The study recommends that a further study should be carried out to investigate the challenges facinginternal control systems in small and medium enterprises in Homa Bay town, Kenya.

The study also suggests that a further study be undertaken to establish the relationship between internal control systems and financial performance in other towns in Kenya as a way of enhancing generalizability of the results. Finally the study recommends a further research to determine the effects of internal control systems in other financial institutions particularly on Saving Credit cooperative societies registered in Kenya. This would lead to revealing the effects of internal control systemspractices on financial performance in such institutions in Kenya

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Appendices

Appendix I :**Letter of Consent**

Maseno University
Private Bag
Maseno

Dear……………

I am a postgraduate student registered in the School of Business and Economics, Maseno University. I am currently carrying out a research on **"Relationship Between Internal Control Systems and Financial Performance of Small and Medium Enterprises in Homa Bay Town"**

The questionnaire attached herewith is meant to gather information for this study from you. All responses will be **treated confidentially**. The results will be reported only in terms of the entire population. Therefore **do not write your name in this questionnaire.** You are kindly requested to respond to all items in the questionnaire.

Your positive response will be highly appreciated.

Yours Faithfully,

Fredrick OkinyihKondiek
MBA student
Department of Accounting and Finance
Maseno University.

Appendix 2**: Budget for the Study**

S/N	**Item**	**Quantity**	**Unit price**	**Total cost**
1	Photocopying papers	5 Reams	500/=	2,500/=
2	Notebooks	15	60/=	900/=
3	Pencils	10	25/=	250/=
4	Typing Services			6,000/=
5	Binding			1,000/=
6	Internet			5,000/=
7	Flash disk	1	1,800/=	1,800/=
8	Photocopying			4,000/=
9	Data collection			6,000/=
10	Pre test visits			5,000/=
11	Field trips			15,000/=
12	Data collection Assistants	8	2,500/=	20,000/=
13	Subsistence during field work			10,000/=
14	Data analysis			10,000/=
GRAND TOTAL				**87,450/=**

Appendix 3: **Time Frame for the Study**

Year	**Month**	**Activity**
2017	January - April	Drafting Research proposal
2017	May	Review of Research proposal
2017	June/July	Research proposal Defense
2017	July/August	Correction of Research proposal
2017	August/September	Data collection /Data analysis
2017	September	Submission of Final Research Project
2017	September	Correction of Final Research project
2017	October	Submission of Final Research Project
2017	December	2017 Graduation

Appendix 4: **Research Questionnaire**

Dear respondent,

I'm a student at MasenoUniversity currently pursuing Masters in Business Administration and *as part of the course, I'm carrying out a research with the aim of writing a report at the end. This questionnaire is designed to assist in collecting data to determine the relationship between internal control systems and financial performance of small and medium enterprises in Homa Bay town. Since you have been identified as one of them, I humbly request you to answer the questions in this questionnaire as honestly as possible.*

Please note that the findings of this research are solely meant for academic purposes and all the responses will be treated with utmost confidentiality.

SECTION A: BACKGROUND INFORMATION

1. What is the name of the SME? ………………………………(Optional)
2. What is the type of the business?
   a) Retail [1]
   b) Service [2]
   c) Manufacturing [3]
3. What is your highest level of education?
   i. Primary [1]
   ii. Secondary [2]
   iii. Tertiary [3]
   iv. Degree/Post graduate [4]
4. What is your current position in the business?
   a. Owner [1]
   b. Manager [2]
   c. Senior Employee[3]
   d. Any other(Specify)…………………………………………
5. Please indicate the number of employees in the business.
   a. Less than 10 [1]
   b. 11-20 [2]

c. 21-30 [3]

d. 31-40[4]

e. 41 and above [5]

6. Kindly indicate the number of years the business has been in operation.

i. 1-5yrs [1]

ii. 6-10 yrs [2]

iii. 11-15yrs [3]

iv. 16 and Above [4]

7. What are the sources of finance for the business?

a. Family/Friends [1]

b. Retained Earnings [2]

c. Banks [3]

d. MFI [4]

e. Mobile money [5]

f. SACCOs [6]

g. Any other sources (Specify)………………………………….

8. What was the Net Income for last year?

a. Less than 200,000 [1]

b. Between 200,001 – 400,000 [2]

c. Between 400,001 – 600,000 [3]

d. Between 600,001 – 800,000[4]

e. Between 800,001 – 1,000,000 [5]

f. Above 1,000,000 [6]

9. What was the value of Total Assets for last year?

a. Less than 100,000 [1]

b. Between 100,001 – 200,000 [2]

c. Between 200,001 – 300,000 [3]

d. Between 300,001 – 400,000 [4]

e. Between 400,001 – 500,000 [5]

f. Above 500,000 [6]

10. Do you maintain financial records?

Yes [1]

No [2]

If yes, who maintains the records?

a. Owner [1]
b. Manager [2]
c. Internal Accountant [3]
d. Outsourced professional [4]
e. Others (Specify)……………………………………..

11. Which types of financial records does the business maintain? (Multiple Response)

a. Statement of Comprehensive Income [1]
b. Statement of Changes in Equity [2]
c. Statement of Cash flow [3]
d. Statement of Financial Position [4]
e. Ruled Exercise Book[5]

Others (Specify)……………………………………..

12. . Who audits the financial records?

a. Owner [1]
b. Manager [2]
c. Internal Auditor [3]
d. Outsourced professional [5]

13. After the audit, do you normally receive audit reports?

Yes [1]

No [2]

If yes, do you involve the stake all holders in discussing the report?

Yes [1]

No [2]

SECTION B: MAIN ISSUES: INTERNAL CONTROL SYSTEMS AND FINANCIAL PERFORMANCE OF SMALL BUSINESS

14. Please rank the following statements on likert scale of 1 – 5 ranging from strongly disagree to strongly agree where:

    1 = strongly disagree

    2 = disagree

    3 = not sure

    4 = agree and

    5 = strongly agree (Please choose one response)

Statements	**Responses**				
Risk Assessment	1	2	3	4	5
The business has accounting and financial management systems to detect risks.					
Detected risks are evaluated to check the extent of damage.					
There is risk measurement when detected.					
Some business risks go undetected.					
Actions are immediately taken on the detected risks.					
Internal Control Activities	1	2	3	4	5
The business has clear separation of roles.					
There is appropriate supervision by senior staff on the work of junior staff.					
Corrective actions are taken to address weaknesses identified.					
The business security systems identify and safeguard business assets.					
Payments are approved by senior persons before they are actually made.					

Audit Communication	1	2	3	4	5
The business is periodically audited.					
An audit report is presented after the audit.					
An audit report is discussed after the presentation.					
Audit recommendations are implemented.					
There is an audit exit conference immediately after the audit					
Financial performance					
Financial performance indicators	1	2	3	4	5
The business has enough cash to meet its obligations effectively					
The business has a well-developed Chart of Account and all company receipts are dully corrected					
The business assets have increased over time					
The business minimizes costs and expenditures					
Actions are immediately taken on the detected risks.					

Thanks for your precious time!