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INFLUENCE OF INTERNAL CONTROLS ON FINANCIAL DISTRESS OF SASRA REGULATED SACCOS

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ABSTRACT

Financial distress in SACCOs can be attributed to internal controls instituted by the board by the board of directors. While SACCOs are deemed to be stable and well governed by a board of directors who are accountable to SASRA for all internal controls of a firm, at times the controls put in place have not detected and or prevented fraudulent activities from taking place hence causing financial distress in SACCOs. This study was designed to evaluate internal controls instituted by the SACCOs and the relationship between internal controls and financial distress of SACCOs in Kenya. Descriptive research design as employed on sample size of 46 SACCOs based in Nairobi as a cluster sample within a population of 176 SACCOs registered by sasra. Purposive sampling was used within the cluster to select the chief executive officer, the accountant and the internal auditor of each SACCO. Questionnaires were employed to collect primary data which was analyzed by descriptive statistics to establish means and standard deviations in variables. A regression model was used to establish the relationship between variables and to provide description of the data and to explain the achievement of the study. The study established a mutual effect of internal controls and financial distress of SACCOs in Kenya. The study thereby recommends that the government through SASRA should ensure that committee reports are properly implemented; there should be a follow up to check on the extent of implementation of the audit subcommittee reports as this will help to safeguard members' funds.

Keyword: Financial Distress, Board of Directors, Internal Controls, SASRA

INTRODUCTION

A co-operative has been defined by the International Cooperative Alliance describes as an independent conglomeration of individuals voluntarily united to fulfill common social, cultural and economic objectives through a jointly-owned and democratically-controlled business. Co-operatives generally exist in two classifications: Non-financial cooperatives that majorly deal with promotional activities, housing, farm produce, investment and transport and financial co-operatives such as SACCOs (Kiaritha, 2016).

Sacco's are very instrumental in developing the economy of any country since they help to mobilize money assets from low income earners, foster liquidity and proper functioning of the Sacco's financial system (Kiaritha, 2016). Sacco's sector faces several challenges among them being financial distress (Kariuki, 2013). If a Sacco is faced with financial distress, working environment of the SACCO deteriorates, inability to meet financial obligations is common and wages are renegotiated downwards. If the situation continues, bankruptcy may become a reality (Kariuki, 2017). However, if appropriate management steps are taken and financial distress factors are used effectively, it can recover and experience resurgence (Gathigia, 2016).

Internal control systems are regarded as mechanisms put in place by an organization to monitor the progress of events during implementation of projects to ensure that organizations achieve short term and long term objectives more efficiently and effectively (Sarens & De Beelde, 2006). Internal controls can be regarded as systems that enable firms to mitigate financial risks and enhance internal efficiency and effectiveness. The quality of information provided by firms should be based on market facts (Smith, 2011). It is therefore required that a SACCO's board duly establishes an Audit Committee to monitor financial reporting, particularly relating to annual fiscal statements, business risks and the redress mechanisms and the external and internal audits.

The Audit subcommittee's primary function is to undertake analysis and assessment of a SACCO's fiscal state or position, performance, adopted in-house checks and results of the internal audit function and make suggestions on corrective actions regularly and at least once every three months. The authority of this subcommittee may in some circumstances be diversified to cover SACCO's risk management oversight. Additionally, it is necessary that the subcommittee is comprised of at least three members assigned from the board and it is also required that one of them must be knowledgeable on financial and accounting matters. However, regulations restrict the Board chairperson from sitting in this sub- committee.
According to a report by SASRA, (2015a) the audit committee's main responsibility comprises guaranteeing that in-house checks are put in place and effectively upheld for ultimate realization of a Sacco's financial reporting aims and goals. According to OECD (2015) the subcommittee manages the firm's in-house checks mechanisms on fiscal reporting and its disclosure rules and processes, including availing the certification and achieves this by analyzing internal controls which entails the depth and extent of the internal audit strategy. This responsibility is also expanded to carrying out an assessment on results of the internal audit and provision of suggestions on measures that should be implemented by management, re-examining of statements of internal audit and their comprehensive success, including the depth and extent of audit coverage. It manages the firm's in-house audit docket ensuring that the functioned is adequately staffed and resourced for efficacy.

It also assesses the latitude of the in-house audit strategy, reports by the audit team and board reaction, and the employment and replacement of high-ranking internal auditing executive and evaluates the performance and efficacy of the function yearly. The committee periodically reviews with both the internal and outside auditors, as well as with management, the procedures for maintaining and evaluating the effectiveness of these systems (Ibid). It must be promptly informed of any material insufficiencies or flaws in internal controls and kept abreast about the corrective measures. Further, this predominant responsibility extends to communication on internal controls as well as any counsel or suggestions and reaffirm that suitable action has been implemented, making certain that accounting records and financial communications are done in good time to factually exhibit operations and result (SASRA, 2015).

This sub-committee is also mandated with assessing cooperation and synchronization between the in-house and outsourced audit duties and also the supervision of the external auditors factoring pertinent professional and regulatory obligations. It also proposes names of external auditors derived from the commissioner of Co-operatives' gazetted list for designation which takes place at the Annual General Meeting in order to analyze with external auditors the depth and extent of the year's audit plan, carry out an assessment on systems of internal audit reported and provide critique on assistance extended by management to the auditors (SASRA, 2015).

It is essential for organizations to have a good understanding of their risks and how well they are managed. Discrepancy between reported risk responses and the actual status could mislead those who rely on the information to ensure that an organization does not experience financial distress.

Financial distress has been defined to encompass circumstances whereby a business organization experiences impediments in paying off its financial contracts, and in particular, those of its creditors (Kariuki, 2013). It means there is a tight cash situation and if prolonged may occasion bankruptcy or liquidation. Corporate financial distress can also be taken to mean a situation where a corporate organization experiences extreme lack of liquidity that cannot be rectified without serious restructuring of business operations and capital structure (Hafizah, 2015). Outecheva (2007), further explains that financial distress occurs in the following phases: decline in performance, collapse, bankruptcy, as well as failure to meet financial obligations. Inasmuch as decline and collapse are shown by performance in terms of how profitable the business organization is, bankruptcy and inability to meet business obligations are ingrained in its liquidity. Muriithi (2016) asserts that financial distress is a situation where a business organization finds impediments in paying its debts. It is a state that is experienced by firms due to internal and external challenges thus leading to bankruptcy and even liquidation (Gathigia, 2016). Outecheva (2007) argues that indicators of financial distress among firms can be; declining profits, declining market share, poor service delivery, demotivated employees and inability to adapt to changes. Outecheva further argues that a business entity can experience financial distress even without failing to meet its financial obligations due to internal issues of management and policies of operation.

STATEMENT OF THE PROBLEM

Previous studies (Ooko et al., 2013; Olando, 2012 and Kabaiya, 2012); have shown the presence of financial distress in SACCOs in Kenya. This has threatened their sustainability such that they have not been able to absorb their operational losses. This has led to the losses being absorbed by members‟ savings and share capital which leads to their impairment. Due to this difficult situation faced by SACCOs, some of them have been shut by the regulator with some receiving instructions to operate conditionally. It is against this backdrop that this study seeks to establish the influence of corporate governance on financial distress of SACCOs regulated by SASRA. In particular, the study therefore sought to establish the influence of and investment decisions' on financial distress of SACCOs in Kenya.

SPECIFIC OBJECTIVE

The specific objective of this study was to determine the relationship between internal controls and financial distress of SACCOs in Kenya.

RESEARCH HYPOTHESIS

There is no significant relationship between internal controls and financial distress of SACCOs in Kenya

LITERATURE REVIEW

The United States' Committee of Sponsoring Organizations of the Tread way Commission (COSO) released an Internal Control – Integrated Frameworking1992, which defines internal control as a process, intended to reinforce the potential of attainment of objectives and effected by an firm's board of directors, management and other personnel, in efficacy of operations, credibility of fiscal reporting and compliance as also acknowledged in the Rutteman Report of 1994.

An analysis of the internal control concepts reveals that its usage is fairly extensive as it is supposedly involves the performance of both the public and private sectors and albeit being defined in diverse ways highlighting its various characteristics, the essential term still remains the same in most: that it connotes inspecting, observing, maintaining and regulating the activities of an entity (Barnabas, 2011).

Internal controls may be contextualized differently based on circumstance. Yeh and Yeh (2007) note that much as values such as honesty, conviction, reverence, sincerity, abilities, bravery, tact, self-drive are seldom mentioned, they nevertheless can affect the understanding of the concept and its definition since different epochs of time and circumstances can invoke different colours of meaning. The nexus between people and control make it essential for internal control to be aligned to the entity's vision, mission and principles and the definition focused to identifying its functions and evaluation (Buck and Breuker, 2008).

It is often focused on mechanisms and processes employed to achieve goals (Cobit, 2007). Buck and Breuker (2008) define it as error detecting and rectifying system; while Mackevičius (2001) defines it as a summation of certain rules, norms and means. From the definitions one can conclude that internal control must be relate to safety, rationality in property use and the credibility of fiscal accounting. The theory is thus pertinent to this study as it outlines the internal control policies, procedures and rules to be adopted within the SACCOs.

STAKEHOLDER THEORY

Kujala and Freeman (2019), argue that the foundation and development of this theory can be drawn from the Scandinavian literature on management dating back to the 1960's; the Swedish researcher, Eric Rhenman came up with the perceptions and conceptions of stakeholder thinking. Subsequent to R. E. Freeman's contribution in 1984, the approach to the stakeholder steadily improved its relevance in organizational studies worldwide and has been recognized important in conceptualizing the correlation between business and society. The understanding in stakeholder theory that, eventually, an organization must operate in such that each shareholder is contented with what they invest and the returns which interests must be balanced over time (Freeman et al., 2007).

The stakeholder's approach argues that in a business organization, it is important to extend the organizational goals beyond the maximization of the organization's profit including the interests of non-shareholding groups (Mitchell et al., 1997) and premised on the assumption that growth and sustenance of favourable and beneficial shareholder relationships is vital for creating value. Given the societal dynamics, the stakeholder approach can be helpful to business organizations and their leaders in identifying the problems to deal with so as to bring about innovations and value (Kujala & Freeman, 2019).

A stakeholder can be defined as any individual or group capable of affecting or being affected by the realization of the organization's operations of an organization (Freeman 1984) while the underlying principle within this concept is a redefinition of the organization and how it should be. Friedman (2006) argues that in itself, the organization should be regarded on the basis of the group of stakeholders and purposed to manage the interests, needs and viewpoints of these stakeholders or shareholders. It is expected that the stakeholder management is implemented by the board who should manage the organization to the benefits of the stakeholders ensuring that their rights and decision making are not violated and that the board on the other hand acts as an agent of the stakeholders to safeguard the stake of each group, which groups Freeman views as absolutely necessary to the existence and growth of every organization. He further reiterates that the outlook of stakeholders is crucial and as such should be considered by the management of organizations. Under the stakeholder theory, stakeholder recourse principle may allow institution of action against the board for breach of duty of care (Freeman 2004).

In literature the principles and views discoursed in the stakeholder concept are referred to as normative stakeholder theory which according to Friedman (2006), explains theories of how stakeholders and managers should operate and envision the objectives of the business entity ethically. Another approach to this concept is the descriptive stakeholder concept which focuses the conduct of the managers and stakeholders and how actions and roles should be viewed. Where managers want to flavor and work for their own interest, their actions is dealt with by the instrumental stakeholder theory. Freeman (2004), further explains that conceived self-interest are viewed as those interests accruing to the organization that help maximize profits and shareholder value. From the foregoing, it can be inferred in the long run, an entity will be successful if the board employs the stakeholder concept in its relationship and dealings with the stakeholders.

According to Fontaine, Haarman and Schmid (2006) stakeholder theory argues that organizational management is founded on principles of business ethics that address issues of various stakeholders in the changing business environment. A Stakeholder Approach identifies models which should guide the behaviour of employees to work towards organizational goals. Business, codes of ethics are developed by firms to guide and give employees the expected code of conduct at the work place (Delves & Patrick, 2006). The stakeholder expectation is that agents of the firm should have moral integrity to make decisions that will enable the firm to maximize profits with minimal harm to the society (Freeman, 2017).

Gathigia (2016) views an organization as an integral part of the society that should work towards attainment of stakeholder goals in the long-run. (Fontaine et al., 2006) assert that open systems

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are likely to achieve goals through recognition of stakeholder's interests and needs in the competitive business environment. Managers should always formulate decisions that do not conflict with stakeholder expectations. Competitive firms should make decisions that represent all stakeholders because of the social responsibility of enterprises in the changing business environment.

This theory underpins this study by explaining that SACCOs will probably continue being competitive if stakeholder information is enhanced by the presence of decentralized structures. Stakeholders, both internal and external will feel more recognized if firms implement open systems of communication. Organization productivity is usually enhanced by implementation of bottom-up and top-down organizational communication models. This structure also enhances teamwork and employee dedication which are essential for organizational growth and in turn reduces financial distress. Decision making by managers will be in such a way as to maximize shareholders wealth and not for the managers only to benefit. In this way shareholders will not risk their most valued investments and even the benefits such as dividends. The returns on these investments will also be improved and sustainable and therefore SACCOs will not close down or operate under restricted conditions. Investors will have faith with organizations that maximize stakeholders' worth.

RESEARCH METHODOLOGY

The target population for this study comprised of all licensed SACCOs regulated by SASRA in Kenya as per the 2017 records. This population was sufficiently large enough and incorporated the various elements and characteristics of corporate governance that the study sought to establish. The sample for this study was obtained from a sampling frame which included all SACCOs regulated by SASRA in Kenya. Cluster sampling was used to study SACCOs in Nairobi County which according to SASRA (2015) has the highest concentration of Deposit-Taking SACCOs and accounts for a total of 46 DT-SACCO head offices.

The researcher collected primary data from the targeted respondents using self-administered questionnaires.

RESULTS AND DISCUSSIONS

The results on the relationship between internal controls and financial distress of SACCOs in Kenya was as discussed in table 4.18

	Mean	Std. Deviation	N
An Internal audit department is put in place in the SACCO	3.92	.943	127
An Audit subcommittee is already instituted in the SACCO	3.39	1.295	127
The internal Auditor freely interacts with the audit sub-committee	3.65	1.135	127
The internal auditor clearly answers to the audit sub-committee	3.69	1.057	127
The Audit subcommittee is involved in the appointment of the external auditor	4.02	1.158	127
The sub-committee has instituted other risk handling measures like loan insurance in the Sacco	4.08	1.049	127

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Management always implements the recommendations of internal audit department to satisfaction	3.85	1.081	127
The management implements the recommendations of external auditors to satisfaction	2.26	.708	127
Mean	3.607		

Source: Research Data, 2019

Table 4.18 indicates the mean, standard deviation and the total number of respondents for the 8 items that were used to measure internal controls. The highest mean was recorded for item 6: The sub-committee has instituted other risk handling measures like loan insurance in the SACCO (4.08) followed by item 5: The audit sub-committee is involved in the appointment of the external auditor (4.02), item 1: An Internal audit department is put in place in the SACCO, item 7: Management always implements the recommendations of internal audit department to satisfaction (3.85), item 4: The internal auditor clearly answers to the audit sub-committee (3.69), item 3: The internal auditor freely interacts with the audit sub-committee (3.65), item 2: audit sub-committee is already instituted in the SACCO (3.39) and finally item 8: The management implements the recommendations of external auditors to satisfaction (2.26).

The average of means for the eight items that were used to measure internal controls was found to be 3.61. Considering that this mean was greater than 3, the result indicates a strong relationship between the items that were used to measure internal controls and financial distress.

Correlation Analysis

Variable		
Internal-Controls	Pearson Correlation	-0.895
	Sig.	0.003

Source: Research Data, 2019

The correlation results indicate a strong negative and significant ($P<0.05$) relationship between internal controls and financial distress of SACCOs in Kenya. This means that improving any of the items under consideration under this variable will reduce financial distress by -0.895

SUMMARY, RECOMMENDATIONS AND CONCLUSIONS

The objective of this study was to establish the influence of internal controls instituted by SACCO boards on financial distress of SACCOs in Kenya. The study therefore established that internal controls instituted by SACCO boards negatively influenced financial distress of SACCOS in Kenya.

The study recommends that the regulatory authority should establish a mechanism which will ensure that SACCO's internal controls are strengthened as per SASRA recommendations. The independence of members should be enhanced and the internal control department allowed recommending the external auditors to the AGM. An external auditor who is sourced by the internal audit department will work more independently with the department to establish loopholes and failures of management. The regulator should ensure that the recommendations of the committees are implemented to the letter which means weak controls will be strengthened to help safeguard the members' stake in the SACCOs.

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