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ABSTRACT

Internal control practices have been established to influence financial performance of County Government, though County Government has been facing a myriad of challenges in terms of financial performance. The drive of this study was to establish Internal Control Practices that Influence County Government of Lamu to streamline their operations and perform efficiently and effectively for the benefit of the general interest. Therefore the general objective of the study was to determine the internal control practices and financial performance of County Government of Lamu. Specifically, the study endeavored to establish the effect of audit function, risk management, financial reporting and cash management on financial performance of County Governments of Lamu. The study was based on the following theories: The Agency theory, Attribution theory and procedural justice theory. The researcher adopted a descriptive research design. The target populations of the study were 30 employees drawn from 5 departments in the Ministry of Finance, Budget and planning in the County Governments of Lamu. A modified Likert scale questionnaire was used to collect data. A pilot study was carried out to refine the instruments. The pilot and consistency of the questionnaire were further assessed using Crobach's alpha. Data collected was analyzed using SPSS version 23 for Windows. Frequency counts, percentages, means, standard deviation and the information generated was presented in form of tables. Multiple linear regression analysis was conducted in order to establish the relationship between dependent variable (financial performance), and the independent variables (audit function, risk management financial reporting and cash management) on financial performance of County Governments of Lamu. The study found out that County Government of Lamu had a functional internal audit unit or department which carried out audit on a timely basis and whose findings were reported directly to top management. The study established that the County Government of Lamu did not have a well-documented policy on risk management and that management did not encourage reporting of events in order to identify risks. It also established that the capacity to perform risk assessment was not adequate. The study established that employees from top management level in Finance Planning Ministry of County Government of Lamu did not assist in making cash flow projections and executing finance and accounting functions and that they were not in a position to ensure budgetary controls. Based on the findings of the study, it was concluded that there is a positive relationship between internal audit function, Risk management, financial reporting and Cash management have a positive relationship with the Performance of County Governments of Lamu. The study recommended that the internal audit unit needs to play a major role in fraud detection and prevention by strengthening the internal control system. County Government of Lamu should promulgate *well documented policies on risk management. They also need to encourage reporting of events in order to identify risks. They should also increase their capacity to perform risk assessment. County Government of Lamu should involve employees from top management level in Finance Planning Ministry to assist in making cash flow projections and executing finance and accounting functions and budgetary controls.*

Key Words: *Internal Audit Function, Financial, Performance, County Governments, Lamu Kenya*

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INTRODUCTION

Internal controls in accounting and auditing, refers to the assurance of the attainment of a firm's objectives in its efficiency and the compliance to laws, regulations and policies (Lumen, 2014).

Internal controls are laws that safeguard the assets of an organization, provide dependable financial reporting, enhance compliance with regulations and laws and achieve efficiency in operations. These systems also adhere to the organizations communication processes, internally and externally, and include procedures for: - handling funds received and spend by the organization and reporting to county executive committee.

They also conduct the organization's annual audit by auditor general and maintain inventory records of real and other properties. Brennan & Soloman, (2008) and Treba (2003) explained that weaknesses in the systems (control over the payroll, over expenditure commitments and over procurement) results in the inability to guarantee that resources are taken to defined priorities and to guarantee that there is value for money will be attained in public spending.

The absence the internal controls is the main cause of fraudulent financial reporting. Global corporate financial scandals of WorldCom and Enron in USA, Chuo Aoyama from Asia and Parmalat from Europe are examples of this (Treadway, 1987). In South Africa, cases of scandals include Randgold, JCI and Expedition companies. In Nigeria, Cadbury dismissed its leaders for inflating profits in 2006.

These scandals emphasize a need to evaluate and formulate monitoring systems of to guide executives in decision making. These executives are lawfully and morally obligated to trustworthy and honest corporate financial reports periodically (Hayes, 2005).

Objectives of the Study

This study sought to determine how internal controls affect financial performance in County Government of Lamu and specifically to determine the effect of internal audit function on financial performance in County Governments of Lamu, Kenya

Statement of the Problem

Data from World Bank (2014) shows a decline in services in the economy especially the county government. Poor performance financially in county governments adversely affects the economic growth of Kenyan economy. Poor financial performance resulting from incompetent budgeting, and regulations in using finances are not adhered to and there is massive unaccounted of funds, incomplete records and book keeping management. This has led to risk of financial inadequacy, employee dissatisfaction and poor financial performance (Mikes & Kaplan, 2014).

Studies done relating to controls internally in relation to financial performance do not show directly the influence of governments' internal controls on financial performance. Some of the challenges experienced in the Counties include; financial reporting not being done on time, struggles with liquidity problems, fraud and misuse of County resources. Accountability for the financial resources is still wanting. Some of the decisions made did not yield expected results.

(GOK, 2013) A study carried out by Aikins (2008) in USA on investigation of government's internal auditors' role to improve financial performance established that in general local government, auditors performed audits in areas dealing with fiscal receipts and payment. The auditors' work significantly influenced local government's financial performance as seen through improvements in the internal controls. In addition, the findings were very general and failed to focus specifically on internal control influence on performance in County Governments. Majority of the researchers measured performance in their County Governments based on; Success for effective use of County revenue on development projects including infrastructure, health, education, trade and corporate social responsibility, (GOK, 2013).

The second measurement included the client satisfaction with the services offered in the County Government. It includes issues about effectiveness in service delivery. The third perspective included the internal business process that covers the communication among key stakeholders, timely reporting, and risk management in departments at the county and controls for the benefit of the citizen.

Fourth perspective was the ability in the County to come up with new opportunities for the unemployed population, promote SMEs through funding, marketing the agricultural produce in new markets and creating tourist attraction opportunities. Finally, transparency and direct accountability of leaders was another element of performance according to Transparency International Report, (GOK, 2013).

There is a notable lack of research among developed as well in developing nations regarding the direct association of controls and financial performance. Studies conducted by Simiyu (2011) on effective use of internal controls in parastatals in Kenya, Hanau (2014) on assessment of Internal controls on revenue collection in Zanzibar, Webola (2009) on the correlation of internal controls and resource management of NGO's in Tanzania & Abikoye (2010) influence of internal controls in Nigeria public sector. .However, the studies that were conducted did not focus on the efficiency of the internal controls on the performance of the Counties.

Consequently, this study sought to close the knowledge gap that exists by determining the effect of internal control drivers and the financial performance in the county government.

Scope of the Study

This study was confined only to the top management, middle level management and lower level management. Ministry of Finance, Budget and Planning in the County Government of Lamu which was the main focus for this study.

LITERATURE REVIEW

The following theories were used:

Agency Theory

Sarens & Abdolmohammadi (2011) state that for the agency theory, a company consists of a set of linked contracts between the owners of economic resources (the principals) and managers that are responsible for controlling these resources. Adams (1994) in his article stated that the agency theory provides for richer, more meaningful research in exploring internal audit. Agency theory also helps explain the characteristics of internal audit, for example, size, and scope of activities, like financial versus operational auditing. The theory can test empirically if cross-sectional variations within internal audit practices show different contracting relationships emanating from differences within the organizational form.

Attribution Theory

Research using attribution theory examines the role of information in social environment to explain events and behaviors (Schroth & Shah, 2000).

According to Reffett (2007), "when evaluators believe comparable persons would have acted differently in a given circumstance, evaluators tends to attribute responsibility for an outcome to the person.

Conversely, when evaluators believe comparable persons would have acted similarly, evaluators tends to attribute responsibility for the outcome to the situation." The former refers to internal or dispositional attributions, while the latter refers to external or situational attributions (Wilks & Zimbelman, 2004).

Bonner, (1998) found that auditors were may sued when they fail to detect common frauds, and the evaluators believed that the fraud would have been detected by other auditors. Hence influence the internal controls practices in the organization's financial performance especially in risk management.

Procedural Justice Theory

Procedural justice deals with fairness in resolving disputes and allocating resources. Procedural justice theory is a social psychology theory concerned with decision making process and the effect of the process on social relationship. The theory deals with what constitutes fair decision procedures, and is the basis for the practice of decision-makers to use and apply laws or criteria that they believe are fair, just, and necessary in the decision making process (Patterson & Smith, 2007). External attribution occurs, if an auditor perceives the procedures as being unfair, and their litigation as negative (Carter, 1991).

Procedural justice theory purports that there is there is need for fairness and communication in the workplace which is consistent with moral and ethical values. This establishes internal control systems and financial performance (Steven 2003).

Internal Audit Function and Financial Performance

Internal auditing ensures that an organization accomplishes its objectives since it brings a systematic, approach in order to evaluate and then improve on effectiveness of risk management, control, and governance. It is a component of internal controls set-up by management of an enterprise to examine, evaluate and report operations of accounting and other controls. The quality of audit procedures are necessary for internal auditors covering a wide range of assignments, not all of which will relate to accounting areas in which the external auditor is interested.

Emasu (2007) notes that the efficiency of internal audit function depends on legal framework, placement of the function, existence of audit\committees, resources allocated and professionalism of the internal audit staff. However internal audit departments are never adequately facilitated.

Gerrit & Mohammad (2010) found evidence in support of the monitoring role of the internal audit function. Specifically they found evidence about management ownership being positively related to size of Internal Audit Function, which is inconsistent with traditional agency theory s which predicts a negative relationship.

METHODOLOGY

The researcher used a research design which is descriptive. The target population was all the 30 employees from top management level in Finance Planning Ministry of County Governments of Lamu from five departments. The questionnaires were used since they required less time, were less expensive, permitted collection of data derived from a wide population and respondents' anonymity ensured that they gave honest answers (Orodho and Njeru, 2003). To enhance validity and reliability, pilot study was done through administering the instruments to 10 randomly selected respondents from all the 5 departments. Each department was presented by two respondents in the pilot who did not take part in the actual study. Quantitative data was analyzed by use of descriptive statistical methods, frequencies and percentage with the help of (SPSS).

FINDINGS

Internal Audit Function

Respondents were asked to indicate the extent to which their County Governments applied internal audit practices. The findings were summarized as shown in Table 1:

Table 1: Internal Audit Function

SD = Strongly Agree, A = Agree, N = Neutral, D = Disagree, SD = Strongly Disagree

Internal Audit Function	N	SA	A	N	D	SD	MS	Total	S.E
There is a functional internal audit unit/department in the County.	30	**51.2**	2.4	17.1	26.8	**2.4**	4.22	100	.154
The timing of the audit is appropriate.	30	0.00	**41.5**	29.3	0.00	29.3	4.00	100	.121
The internal audit unit has developed an internal audit manual that guides audit operations.	30	22.2	**39.0**		2.4	34.1	4.00	100	.148
Audit is completed on timely basis.	30	**39.0**	2.2	34.4	0.00	24.4	3.45	100	.129
Internal audit findings are reported directly to top management	30	0.00	**39.0**	34.2	0.00	24.4	3.41	100	.110
The internal audit unit plays a major role in fraud detection and prevention	30	4.9	4.8	22.0	24.4	**43.9**	3.36	100	.162
Recommendations of the internal audit unit are taken very seriously	30	**43.9**	4.7	22.0	24.4	4.9	3.34	100	.162
Internal audit report address weaknesses in our internal control system	30	24.3	**43.9**	22.0	4.9	4.9	3.28	100	.162
The audit department provides management with assurance that there are no major weaknesses and/or major internal control weakness is reported.	30	**56.1**	22.3	0.00	22.0	0.00	3.26	100	.109

As shown in Table 1, majority (51%) of the respondents indicated that there is a functional internal audit unit/department in the County with a mean of 1. Forty two percent of the respondents indicated that the timing of the audit is appropriate with a mean of 4.00. Thirty nine percent indicated that the internal audit unit has developed an internal audit manual that guides audit operations with a mean of 4.00. Thirty nine percent indicated that the audit is always completed on a timely basis with a mean of 3.45. Thirty nine percent of the respondents agreed that internal audit findings are reported directly to top management with a mean of 3.41. Forty four percent indicated that the internal audit unit does not play a major role in fraud detection and prevention with a mean of 3.36. Forty four percent of the respondents indicated that Recommendations of the internal audit unit are taken very seriously with a mean of 3.34. Forty four percent of the respondents said that internal audit report address weaknesses in our internal control system with a mean of 3.28. Fifty six percent of the respondents indicated that the audit department provides management with assurance that there are no major weaknesses and/or major internal control weakness is reported with a mean of 3.26.

CONCLUSION AND RECOMMENDATION

Internal Audit Function

The study found out that County Government of Lamu had a functional internal audit unit or department which carried out audit on a timely basis and whose findings are reported directly to top management. However, the study established that the internal audit unit did not play a major role

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in fraud detection and prevention. It also established that internal audit report addressesed weaknesses in the internal control system. These findings were in agreement with the study conducted by Musya (2014) who established that weak internal controls activities and lack of proper information and communication systems have encouraged collusion to fraud, loss of revenue and embezzlement of collected revenue. Based on its findings, the study recommended the following: The internal audit unit need to play a major role in fraud detection and prevention by strengthening the internal control system.

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