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INTERNAL AUDIT SYSTEM ON FINANCIAL PERFORMANCE IN PUBLIC HEALTH SECTOR IN KENYA

A CASE OF MATUNGU HOSPITAL (KENYA)

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Abstract

Most researches in public health service delivery reveal that Public hospitals in Kenya are characterized with poor service delivery, this therefore result in most insured patients preferring private hospitals than public ones. The problem has been blamed on financial related issues. However, the national government and the county government spend a lot on health budget with little impact at the hospitals, in the financial year 2013/2014 the national government allocated the ministry of health approximate Kshs 94 billion towards the health sector. Internal controls for financial management in hospitals are yet to be analyzed on their effect to the problem. The purpose of this study was to analyze internal control systems (ICS) on financial performance in public health sector. The study also examined the relationship between internal audits on financial performance. The study was guided by agency theory and the study adopted a case study of Matungu Hospital and targeted a population of 120 respondents with a sample size of 40 respondents which will be 30% of the total target population. A structured questionnaire was used as data collection instrument. Reliability of data collection instruments was ascertained by the use of test-retest method while validity was established through the use of piloting and expert opinion. The study data was analyzed using both descriptive and *inferential statistics with the help of the Statistical Package for the Social Sciences. Descriptive statistics and inferential statistics used included measures of dispersion, Pearson Product Moment Correlation Coefficient, Chi-Square and Multinomial Regression. Study findings established that there was a statistically significant positive relationship between internal audit and financial performance at Matungu hospital. Further still, study findings revealed that delay in government supplies, poor government policy and weak internal control systems account for the challenges experienced in financial performance at Matungu hospital.*

Keywords: Internal control, Performance, System, Public policy, Public health

INTRODUCTION

Every organization both profit or non-profit organization has its objectives and goals in mind to achieve. For the non-profit making organization, their goal is to satisfy the social need of the citizens and in the effort to achieve these purposes supervision more often than not play a vital role. Management use internal control as a tool to check it staff due to the fact that managers are not able to monitor all the activities of the organization. It therefore adopts the internal control in such a way that the system checks itself and any irregularity within the system is been detected and corrected. To ensure that the system checks itself, management could use devices such as internal audit, effective communication and control activities. The effective arrangement and implementation of this control system would ensure proper management

According to financial report by Institute of Certified Public Accountant of Kenya ICPAK (2007), many organizations have implemented advanced technological platforms, yet Internal control which is an institution system, defined and implemented under its responsibility, which aim to ensure that laws and regulations are complied with, the instructions and directional guidelines fixed by Executive Management or the Board of Management of the institutional internal processes are functioning correctly, particularly those implicating the security of its assets, financial information is reliable, and generally, contributes to the control over its activities, to the efficiency of its operations and to the efficient utilization of its resources. By helping to anticipate and control the risks involved in meeting the objectives the institution has set for itself, internal control system plays a key role in conducting and monitoring various activities. However, internal control cannot provide an absolute guarantee that the institution objectives are met, this because managers fail to implement this strategies which however lead to many organization been caught in cut-throat problem that creates huge problem in service delivery.

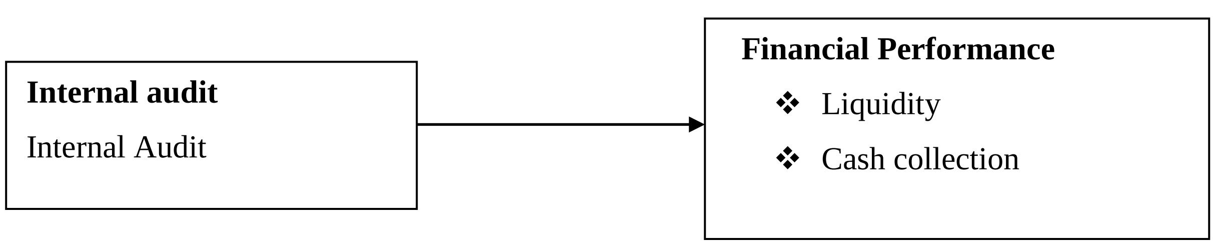
According to the Internal Audit Report (2012) by the GOK, on Matungu Hospital the report recommended that the hospital should institute a proper ICS which would lead to improved financial performance. A properly instituted system of internal control would improve liquidity, cash collection, enhance surplus and creditors' satisfaction. Even though significant efforts have be made to enhance financial performance, there was still need to do more. Although the hospital had automated its cash collection process and established the internal control activity which had resulted in increased cash collection, the procurement process still remains a great challenge in the hospital as stipulated in the audit report.

THEORETICAL FRAMEWORK

The study was guided by The Agency Theory as put across by Jensen and Meckling (2009) and expounded later by Gerrit Sarens and Mohammad J. A. M., (2010). According to the agency theory, a firm consists of contracts between the owners who provide the resources (the principal) and managers (the agent) who are charge with using and controlling those resources (Jensen and Meckling, 2009). The theory posits that agent have more information than principal and that this information asymmetry adversely affects the principal ability to monitor whether or not their interests are being properly served by agent. The assumption of agency theory is that principal and agent act rationally and use contracting to maximize their wealth.

The Theory was chosen for this study because Internal control is one of many mechanisms used in business to address the agency problem (Jensen and Meckling, 2009) and studies had shown that internal control reduces agency costs. In the study, ICS was construed to mean a process enacted or developed by the entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the categories, reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Financial performance were considered in terms of measures like service delivery (using absolute and relative measures), liquidity (using liquidity ratios such as current ratio, acid test ratios) and Accountability (in terms of financial accountability) (ACCA- Managerial Finance Paper 8; 2009/2010; and Pandey;2011)

Figure 1. Conceptual Framework



EMPIRICAL LITERATURE

Internal Controls Systems and Financial Performance

According to Hayes *et al*. (2009) internal control comprises several components, the control environment, the entity's risk assessment process, the information and communication systems, control activities and monitoring of controls. However, this research will consider three components of the internal control system. These are internal audit, information and communication and control activities. The other components of the internal control systems will be held constant. Verschoor (2007) drawing from Statements of Standard Auditing Practices No. 6 (SAP 6) which defines Internal control as "the plan of organization and all the methods and procedures adopted by the management of an entity to assist in achieving management objectives of ensuring as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of fraud and error, the accuracy and completeness of accounting records and the timely preparation of reliable financial information".

It is therefore worth noting from the above that, properly instituted systems of internal control will ensure, completeness of all transactions undertaken by an entity, that the entity's assets are safeguarded from theft and misuse, transactions in the financial statements are stated at the appropriate amounts, all assets in the company's financial statements do exist, all assets presented in the company's financial statements are recoverable and that entity's transactions are presented in the appropriate manner according to the applicable reporting framework (ACCA Audit and Assurance Services).

Internal control is the term generally used to describe how management assures that an Institution does meet its financial and other objectives. ICS not only contribute to managerial effectiveness but are also important duties of corporate boards of directors (Verschoor 2007). Anderson (2008) argued that there are two types of major internal controls associated with the management of large firms, particularly diversified firms, which have an important effect on firm innovation, these are; strategic controls and financial controls. Strategic controls entail the use of long term and strategically relevant criteria for the evaluation of business level managers' actions and performance. Strategic controls emphasize largely subjective and sometimes intuitive criteria for evaluation (Pandey, 2011).

The use of strategic controls requires corporate managers to have a deep understanding of business level operations and markets. Such controls require a rich information exchange between corporate and divisional managers (Hoskisson & Moesel, 2009). On the other hand, financial controls entail objective criteria such as return on investment (ROI) in the evaluation of business level managers' performance.

They are similar to what Ouchi (2007) and Eisenhardt (2009) referred to as outcome controls. Thus, top level managers establish financial targets for each business and measure the business level managers' performance against those targets. Such an approach can be problematic when the degree of interdependence among business units is high. Thus, emphasis on financial controls requires each division's performance to be largely independent. As a firm grows especially through acquisition, it also grows in complexity and the number of units that corporate executives must oversee and manage thereby increasing their spans of control. Clearly each acquisition increases corporate managers' need for information processing sometimes dramatically so. These changes make it difficult for corporate managers to use strategic controls. To reduce information processing demands, they may change their emphasis from strategic to financial controls.

The three major categories of management objectives comprise effective operations, financial reporting and compliance (Hayes et al, 2005). Effective operations are about safeguarding the assets of the organization. The physical assets like cash, non physical assets like receivables, important documents and records of the company can be stolen, misused or accidentally destroyed unless they are protected by adequate controls. The goal of financial control requires accurate information for internal decision because management has a legal and professional responsibility to ensure that information is prepared fairly in accordance with applicable accounting standards. Organizations are equally required to comply with many laws and regulations including company laws, tax laws and environment protection laws. The authoritative (2004) Principles of Corporate Governance of the American Law Institute recommends that every large publicly held corporation should have an audit committee that would review on a periodic basis the corporation's internal controls.

According to Verschoor, (2009), approximately three-quarters of the 500 largest publicly held U.S. corporations voluntarily make a public assertion of management's responsibilities for properly reporting financial results and also maintaining an effective system of internal control. These management statements on internal control are contained in the company's annual report to shareholders. He asserts that; virtually all of these companies report using the same strategies to execute management's internal control responsibilities. These include references to segregation of functions, programs of selection and training of personnel, the results of an internal auditing function, oversight from the audit committee of the board of directors, and the work of the company's external auditors. Verschoor (2009) believes that management declarations about internal controls represent a management commitment and are not just a promotional statement.

METHODOLOGY

Correlation research design was employed to examine the relationship between internal audit systems and financial performance. A Case study approach was adopted.

To determine the sample size, the researcher used 30% of the population as the sample size. Thus the sample size was 40 employees of the hospital which consisted of 4 Medical office 100%, 4 departmental heads 30% and 32 general employees 30% drawn from different sections of the hospital (Kothari 2008). Study relied on primary data and questionnaires were used as the instrument for the purpose of the study to collect the primary data.

The data was analyzed using both statistical and narrative methods. Pearson's product moment Correlation, chi-square and simple regression were used as a way of assessing the relationship between internal audit and financial performance.

EMPIRICAL RESULTS AND DISCUSSION

Relationships between internal audit and financial performance in Matungu hospital

The study sought to determine the relationship between internal audit and financial performance at Matungu hospital. To effectively investigate this objective, the following research question was formulated:

What is the relationship between internal audit and financial performance in Matungu Hospital?

Study variables relating to internal audit and those relating to financial performance were analyzed using Pearson Product Moment Correlation Coefficient (Table 1).

Table 1: Relationship between Internal Audit and Financial Performance

		Financial Performance
Internal Audit	Pearson Correlation	.679**
	Sig. (2-tailed)	.032
	N	40

**Correlation is significant at 0.05 level (2- tailed)

*Correlation significant at 0.01 level (2 - tailed)

Findings in table 1 reveal a statistically significant positive relationship between internal audit and financial performance at Matungu hospital (r=0.679; P<0.05). This means that an improvement in the internal audit function results in improved financial performance at Matungu Hospital.The work of the internal auditor should appear to be properly planned, controlled, recorded and reviewed. Examples of the due professional care by the internal auditor are the existence of an adequate audit manual, general internal audit plans, procedures for controlling individual assignments and satisfactory arrangements for reporting and following up.Internal auditing is performed as part of the monitoring activity of an organization. It involves investigating and appraising internal controls and the efficiency with which the various units of the organization are performing their assigned functions. An Internal Auditor is normally interested in determining whether a department has a clear understanding of its assignment, is adequately staffed, maintains good records, properly safeguarding cash, inventory & other assets and cooperates harmoniously with other departments. The internal auditor normally reports to the top management. Findings of this study are discussed in line with findings in empirical studies relating internal audit and financial performance.

The quality and effectiveness of internal audit procedures in practice are necessary since internal auditors cover a wide variety of assignments, not all of which will relate to accounting areas in which the external auditor is interested. For example, it's common these days for internal audit to undertake the extensive and continuous task of setting management goals and monitoring its performance (Woolf, 2008). Emasu (2010) notes that "The effectiveness of internal audit function partly depends on; legal and regulatory framework, placement of the function and its independence, existence of audit committees, resources allocated to the function and professionalism of internal audit staff". It is however a bitter reality that internal audit departments are rarely adequately facilitated. Regarding the size and facilitation of the Internal Audit Function. Gerrit and Mohammad (2010), found evidence in support of the monitoring role of the Internal Audit Function. They specifically, found evidence that management ownership is positively related to the relative size of the Internal Audit Function, which is inconsistent with traditional agency theory arguments that predict a negative relationship, but more in line with recent studies on earnings management. This finding suggests that increased management ownership may influence the board of directors to support larger Internal Audit Functions to allow them to closely monitor managers' performance. It is also plausible that management with higher share ownership is motivated to invest in larger Internal Audit Function for better monitoring of earnings and for signaling to the board of directors that, despite their high stake in earnings, they are convinced that appropriate use of resources has to be assessed on a regular basis.

According to Bhatia (2008), Internal Auditing is the review of operations and records sometimes undertaken within the business by especially assigned staff. It's also an independent appraisal function established within an organization to examine and evaluate the effectiveness, efficiency and economy of managements control system (Subramaniam, 2006). Its objective is to provide management with re-assurance that their internal control systems are adequate for the need of the organization and are operating satisfactorily (Reid &Ashelby, 2002). It is a component of the internal control system set-up by management of an enterprise to examine, evaluate and report operations of accounting and other controls.

Gerrit and Mohammad (2010) believe that the proportion of independent board members will have a negative effect on the size of Internal Audit Function. This finding may indicate a substitution effect, which means that independent board members may be considered as an alternative monitoring mechanism to the Internal Audit Function. The authors further assert that the control environment has a significant effect on the relative size of the Internal Audit Function.

More recently, a study by Goodwin-Stewart & Kent (2006), using a sample of Australian listed companies, shows that the existence of an Internal Audit function is positively associated with firm size and commitment to risk management. Subramaniam (2006) also show that the risk and control awareness have an influence on the scope of the Internal Audit function. These results suggest that when management is aware of risks and control activities, they are more likely to understand the role of the Internal Audit function in monitoring risk and control activities, thus it is more likely that they will support a relatively larger Internal Audit function (Subramaniam 2006) holds that there must be a strong internal control system and the internal auditor must verify the operations of the system in the same way as the external auditor. It involves the investigation, recording, identification and review of compliance tests of control, they also argued that effective internal audit procedures provide sufficient relevant and reliable evidence in order to detect and prevent fraud. Kochan (2008), considers auditing procedures in one company and describes steps taken in implementing a quality assurance system, she discusses the use of internal audits as an essential part of ISO 9000 certification process.

CONCLUSIONS

The objective of the study sought to determine the relationship between internal audit and financial performance at Matungu hospital. Study variables relating to internal audit and those relating to financial performance were analyzed using Pearson Product Moment Correlation Coefficient.

Findings revealed a statistically significant positive relationship between internal audit and financial performance at Matungu hospital ($r=0.679$; $P<0.05$). This meant that an improvement in the internal audit function results in improved financial performance at Matungu Hospital. Findings revealed a statistically significant positive relationship between internal audit and financial performance at Matungu hospital. Based on the findings, it is concluded that internal audit significantly influences financial performance at Matungu hospital.

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