

EFFECT OF INTERNAL CONTROL SYSTEMS ON PUBLIC EXPENDITURE MANAGEMENT IN KERICHO EAST NATIONAL TREASURY, KENYA

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Abstract

Non-compliance in internal control systems has mounted pressure on financial regulators and professional bodies such as the Institute of Certified Public Accountants of Kenya, the Institute of Internal Auditors, Kenya Chapter, the National Treasury along with other similar organizations to come up with rules and regulations to strengthen management of public resources to ensure compliance with internal control systems and best practices for good corporate governance and prosperity. The study sought to determine the effect of control environment and risk assessment on public expenditure management. A random sampling of 288 staff in various ministries and departments returned 277 (96.18%) valid responses. Data was collected using a structured questionnaire. It was found that internal control systems had a positive significant relationship with control environment (0.296) but a negative significant relationship with risk assessment (0.053). The findings suggested that internal control systems especially control environment need great attention in order to improve public expenditure management of government ministries and departments.

Keywords: *Control environment, Risk assessment, Public expenditure management, Kenya*

INTRODUCTION

According to the Committee of Sponsoring Organization of Treading Commission (COSO) (2013), ICS is a processes designed and put in place by an organization's top management to provide attainable goals and targets on the achievement of corporate goals by timely and accurate management of operations, reliability on financial reporting, and compliance with laid down rules and regulations. According to Millichamp and Taylor (2012), five components/elements of ICS include; control environment, risk assessment, control activities, information and communication, and finally monitoring.

In Kenya, implementation of internal control systems in the public sector which is the responsibility of the National Treasury in conjunction with ICPAK, that is, the accountant's professional body has not been very effective (Odhiambo, 2017). The National Treasury comes up with guidelines detailing how public resources should be managed; it thus prepares and submits national budgets to National Assembly for approval and thereafter disburses funds to the various public entities based on their needs. The National Treasury under whose docket the internal audit department employs and posts qualified internal audit personnel to government MDAs to review and report on the effectiveness of ICS to the Principal Secretaries in various ministries for necessary action.

Statement of the Problem

An internal control system is considered to be a significant factor in public expenditure management. An effective ICS is therefore supposed to ensure that public expenditure is properly budgeted for, directed towards projects identified through public participation by the civil society to help improve their livelihood, and that payments must be properly supported. ICS in the public sector in Kenya has been wanting for so long. Based on the Auditor General's report (2014/2015), government MDAs incurred an estimated expenditure of Kshs.67 billion which did not have support documents to justify payment. In Kericho East National Treasury a total of Kshs. 88,884,148.30 incurred by MDAs on various projects was not properly supported consequently, there is some doubt as to whether the funds were applied on the intended projects hence the need to determine the effect of ICS on public expenditure management in Kericho East National Treasury.

Objective of the Study

The general objective of this study was to examine the effect of internal control systems on public expenditure management in Kericho East National Treasury. Specifically the study

sought to; determine the effect of control environment on public expenditure management and the effects of risk assessment on public expenditure management.

REVIEW OF RELATED LITERATURE

The definition of control environment in this study as adapted from Millichamp and Taylor (2012) refers to the ethical values, awareness, staff competence and actions of the top management as well as that of the junior personnel of an entity. Basically, it is the culture of an entity and it is concerned with internal control systems and contains part of the corporate governance structure. ICS characterizes control condition as a segment of inside control framework that composes the tone at the top administration of an element affecting the control cognizance of its staff. It is consequently the column or benchmark for the various components of inner control frameworks. A deficiency in internal control systems arises when the top management's interests are not aligned with those of the owners of an entity. It is thus important to determine the functionality of control environment and its relationship on public expenditure management (Dallu, 2016). The components of inward control condition incorporate; uprightness, moral qualities and ability of the element's representatives, top administration's initiative style and additionally the way the administration distributes specialist and obligation and the corporate vision given by the vital chiefs of the association.

Risk assessment is the determination of actions/inactions that may affect an organization's operations. It refers to the processes and approaches used by managers of an entity to determine the chances of happenings of possible risks in whichever industry they operate in and then the devising of ways to minimize/mitigate those risks (Millichamp & Taylor, 2012). Risks have got a serious bearing on public expenditure management, if not contained; it will affect the intended outcome (Mullins, 2010). Risk assessment has two components; first, risk identification that require a firm to conduct systematic internal evaluation, industry analysis using Michael Porter's approach. Internal risks such as strategic risk, operational risk, governance and financial risks; these are easy to mitigate since the management has a hand in their control as opposed to external risks which are beyond the control of the management. The external risks which are beyond management control include events like political risk, economic risk, legislative risk, compliance and technological risk. Risk evaluation refers to process of analyzing the likelihood of the occurrence of the threat by categorizing them into high, medium and low chance of happening. Once risks are identified and evaluated, the management can transfer the risk by means of insurance, subcontracting or outsourcing, reduce the risk through raising staff awareness, putting security measures in place, diversification, strengthening of internal controls, good staff recruitment and training; conducting research and development and

developing quality control measures over production of goods and services, accept the risk by doing nothing hope for the best, and lastly to avoid the risk by not allowing the organization to engage in high-risk ventures (Millichamp & Taylor, 2012).

Theoretical Review

The theoretical foundation of this study is anchored on the agency theories, system theory and institutional theory. According to Orina (2011), agency theory is the relationship which exists whenever one party known as the principal appoints another party known as agent and delegates decision making authority to it. The writer asserts that agency problem arises when the interests of the parties involved start to conflict; that is, the operator surrenders to self-intrigue, pioneering conduct and missing the mark regarding objective consistency between the expectations of the essential and the specialist's interests. This study used agency theory to establish the effect of Internal Control Systems on public expenditure management.

All organizations are classified as open systems as opposed to closed systems, the reason being they interface with their environment for the exchange of information to help them receive inputs and process the same into outputs that will transform the lives of the citizens. Review of systems theory is important to this study since ICSs on management of public expenditure revolve around the smaller units/sub-systems/departments within the larger system. In the case of our study, Kericho East National Treasury consists of sub-systems like the examination section, vote book section, bank reconciliation section, procurement section, cash office section, internal audit unit amongst others all of which work towards organizational objective/goal congruence.

Institutional theory entails an approach directed towards understanding organizations and management practices as the product of social needs rather than economic driven forces. This has become a popular perspective within the precincts of management theory due to its ability to explain organizational behaviours which defy economic rationality (Shuddaby, 2013). National Treasury as an organization, whose responsibility is to ensure that public resources are channeled to the intended use, prepares guidelines and policies such as financial management regulations, manual on standardization of codes for funding and allocations, internal audit Manual and the Procurement guidelines. Every one of these records is the premise of assessing the proficient and adequacy of ICSs for the administration of open use. This theory is important in our study because it advances arguments in favour of enhanced corporate governance and creation of audit committees all involved in managing public expenditure.

Conceptual Framework

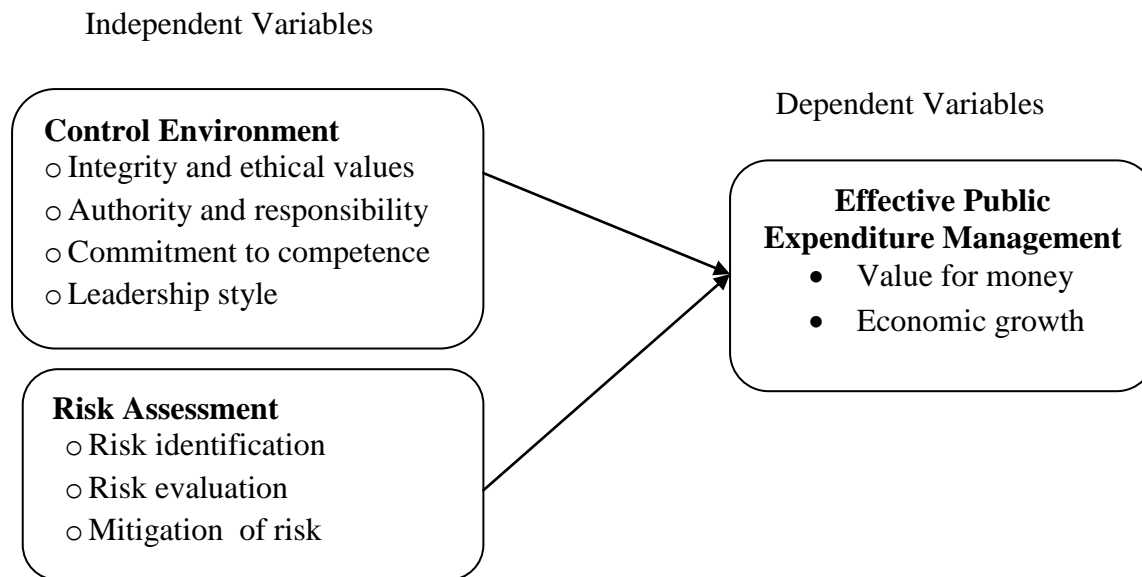


Figure 1: Conceptual Framework

Sources: Modified and Conceptualized Millichamp and Taylor (2012), Dallu (2016).

RESEARCH METHODOLOGY

This study was conducted through a correlation research design. Stratified random sampling technique was utilized in selecting the sample size of 288 respondents working in Kericho East National Treasury. The study mainly relied on primary data collected through use of structured questionnaires with both open and close-ended questions. A total of 277 (96.18%) valid responses were received. A Cronbach Alpha coefficients of 0.844 was actualized, thus indicated that research instrument was good and reliable (Pallant, 2005). Karl Pearson's Product Moment Correlation Coefficient (r) was applied to test the multi co-linearity.

ANALYSIS AND FINDINGS

Inferential Statistics

Table 1 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.835 ^a	.698	.682	.88797

a. Predictors: (Constant), Control Environment, Risk Assessment, Control Activities, Information Communication, Monitoring

The model summary for the regression analysis showed that $R^2 = 0.698$ which indicated that 69.8 percent of the study variable explains the internal control systems on public expenditure management, while 30.2 % variation in the dependent variable is explained by other factors that are not included in the study denoted by (ϵ) in the model.

Table 2 ANOVA^a

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	451.571	13	34.736	44.054	.000 ^b
	Residual	195.547	248	.788		
	Total	647.118	261			

a. Dependent Variable: internal control

b. Predictors: (Constant), Risk Assessment, Control environment

According to the Anova results, the mean square of the residuals is very small (0.788) compared to mean square of the regression (34.736). The F-statistics of the regression ($F_{(13, 248)} = 44.054$) which was statistically significant ($p < 0.05$) revealed that the model significantly predict the change of the dependent variable as result of the two predictor variables included in the model. This implies that the coefficients of the model are not equal to zero, suggesting that the model fits the data significantly.

Table 3 Coefficients^a

Model		Unstandardized		Standardized	T	Sig.
		Coefficients		Coefficients		
		B	Std. Error	Beta		
1	(Constant)	-.155	.145		-1.072	.285
	Internal Control Environment	.296	.070	.248	4.240	.000
	Risk Assessment	-.053	.075	-.039	-.707	.480

The regression model equation then becomes:

$$PEM = -0.155 + 0.296ICE - 0.053RA + \epsilon$$

Where: PEM= public expenditure management, ICE= Internal Control Environment, RA= Risk Assessment, ϵ = Error term denoting those variables affecting performance.

As in table 3, it was established that there exist a statistically significant positive relationship between internal control environment and internal control system ($\beta = 0.296$, $p < 0.05$). The relationship between risk assessment and internal control system on public

expenditure management in Kericho East national treasury was negative and statistically insignificant ($\beta = -0.053$ $p < 0.05$).

These results agrees with the finding by Whittington and Pany, (2001) who noted that control environment factors such as integrity and ethical values; the commitment to competence; leadership philosophy and operating style; and the way management assigns authority and responsibility, and organizes and develops its people constitute a strong internal control system which government ministries and departments need to incorporate into their day to day operations. The study also agree with COSO (2013) who outlines that control environment factors which includes integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors are key in ensuring effective internal control systems in an organization.

The risk assessment and internal control system on public expenditure management was negative and statistically insignificant. This meant that the ministries and departments had not fully embraced the risk assessments which according to Ray and Pany (2001) risk assessment are policies and procedures that help ensure that management directives are carried out. The results of Tunji (2013) and Dhillon (2001) who noted that organizations need to set rules, policies, and procedures and implements them to provide reasonable assurance that: (a) its financial reports are reliable, (b) its operations are effective and efficient, and (c) its activities comply with applicable laws and regulations. There is need for the ministries and departments to ensures that risk assessment which entails coming up with policy establishing what should be done and procedures to effect the policy and that all developed policies must be implemented thoughtfully, conscientiously and consistently to achieve the desired objectives results (Anduuru 2005).

SUMMARY AND CONCLUSION

Based on the regression model there existed a statistically significant positive relationship between control environment and public expenditure management ($\beta = 0.296$, $p < 0.05$), risk assessment and public expenditure management was negative and statistically insignificant ($\beta = -0.053$ $p < 0.05$). The findings of the study suggested that internal control systems especially control environment is a significant area which head of ministries and departments in Kericho East National Treasury should give great attention to in order to improve public expenditure management and stimulate economic growth.

Confirming the argument of the findings, this study suggests that control environment was a significant area government ministries and departments should give attention to in order to enhance their public expenditure management. Further it can be concluded that effective internal control systems must incorporate the effects of corporate governance and government policy to enhance public expenditure management. From the above conclusion, strong internal control systems must be entrenched in all levels of the national government by the managers to enhance public expenditure management. The management should ensure that their ministries and departments have strong internal control measures where control activities in form of policies and procedures are adequate. The control environment and control activities should be evaluated by internal audit department on regular basis to provide management with the assurance on the adequacy and effectiveness of mitigation controls that management has put in place.

AREAS FOR FURTHER RESEARCH

In spite of the contributions made by this study, future research may consider replicating this study in the private sector in Kenya in order to establish the influence of internal control systems on their performance. Secondly, future research may be replicated in different sectors of the economy to confirm the role of internal control systems on financial performances in the public sector.

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