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"EFFECT OF INHERENT RISK ASSESSMENT ON SACCOS' GOVERNANCE PERFORMANCE OF DEPOSIT TAKING SACCOS IN KAKAMEGA COUNTY, KENYA"

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Abstract

The study determined the effect of inherent risk assessment on Saccos' governance in Kakamega County. Descriptive survey was used. Simple random and purposive sampling was used to select 46 respondents. Data was collected through open and closed ended questionnaires for Sacco members and interview schedules for the heads of the identified departments, CEOs and board members. Data analysis was done using descriptive statistics. Inherent risk assessment had a significant effect on the corporate governance of an organization. The study recommended that Saccos establish and maintain management information systems for effective risk assessment within their institutions so as to maximize on good governance impact on sacco performance. The study recommends further research on the influence of ICT Audit, complexity, transparency and standards on the effectiveness of internal audit systems in Saccos and deposit taking microfinance organizations.

Key Words: Inherent Risk Assessment, Sacco Governance, Performance

1. Introduction

The internal audit (IA) function is one of the fundamental units that enables organizations achieve sound corporate governance. An objective internal audit function, with the skills to identify risk control problems and the authority to pursue its concerns, is essential to the proper discharge of directors' responsibilities.

The IA function as an in-house monitoring mechanism of organizational risks and internal controls would thus be in a favorable position to help the external auditors to undertake their audit assessments (Felix, Gramling & Maletta, 2005). External auditors are potentially able to utilize assistance from internal auditors work as assistants under the direct supervision of the external auditors. Relevant work completed by the IA function on its own throughout the financial audit year is also another assessment tool. External auditors may rely on the procedures that internal auditors performed related to testing internal controls, as well as on the substantive testing procedures they have performed. Such assistance, in turn, is likely to save external auditors' time and effort in their audit engagement.

Corporate governance has been under a strong and critical public spotlight in recent years, in the wake of a succession of blows to market confidence and integrity, particularly in the United States but echoed in Australia and other countries as well. The community's expectations of boards and senior management, and of those charged with providing an independent review of a company's operations and financial accounts, have been raised. To meet those expectations, governments and regulatory authorities around the globe have mounted a concerted campaign to improve standards of corporate behavior and transparency through the international harmonization of accounting standards, strengthening the principles of corporate governance, lifting the bar on the "fitness and propriety" of directors and managers and introducing improved market disclosure standards.

The global regulatory environment is in an arena of constant change. Stipulations and guidelines are regularly reviewed and refined to retain their effectiveness. Very often, different countries may have distinct recommendations or legal expectations that can complicate the role and consistency of internal audit process across a geographically spread enterprise. Whether it is ISO, SEC or SOX guidelines, companies are now expected to proactively initiate internal, IT-enabled enterprise-wide audit solutions that ensure compliance.

In Kenya, the Sacco Societies Regulatory Authority (SASRA) is established under the Sacco Societies Act of 2008 with the mandate to license Sacco Societies to carry out deposit taking business; Regulate and supervise deposit taking Sacco Societies; Manage the Deposit Guarantee Fund under the trustees appointed under the Act and Advise the Minister on national policy on deposit taking Sacco Societies in Kenya.

The overall Mandate of the Sacco is, to receive funds by the issue of shares and acceptance of deposits from members, encourage savings at a reasonable rate of interest, avail loans to members for productive and provident purposes, educate members in management, control of money and also promote understanding of the economic framework within which Co-operatives operate, develop a sense of self-reliance in its members, offer to the members' complementary savings and credit in form of Front Office Services and diversify other financial products as may be required by the members from time to time and ensure safety and soundness of the member funds through appropriate insurance coverage.

Co-operatives have for a long time provided the institutional infrastructure upon which both the poor and middle class have organized themselves socially, culturally, economically and politically. The need for closer oversight is that accepting withdrawable deposits is particularly considered a high-risk activity as depositors risk losing their money. Although registration of Saccos still remains under the Commissioner for Co-operative Development in accordance with the Co-operative Societies Act, Saccos are also required to apply to SASRA for an annual renewable license to continue operating the Fosas.

The approach concerned with the effectiveness of inherent risk (IR) assessments is typified by Griffiths, (2006). Each of these studies considered the role of risk assessment in the detection of errors. It was also suggested that auditors who have a good understanding of their auditee's business can accomplish such an assessment with relative ease. Contrary to the presumption in International Accounting Standard (IAS) 39 that inherent risk is difficult and costly to assess, these studies suggest that some IR factors can and should be assessed.

Attempts to understand IR assessment processes include O'Regan, (2002), who described the development of a conceptual model of how auditors assess inherent risk in a normal audit environment and its implementation as a knowledge-based (expert) system. Peters et al (2002) asserted that "the auditor begins the inherent risk evaluation process by generating expectations of accounts balances. The auditor identifies changes that have occurred in the firm or its environment and determines how those changes should interact with historic trends to produce an expected balance in the account" (Sarens & De Beelde, 2006). Consistent with Walker, Shenkir, and Barton (2003) conceptual model included both historical firm data and the historic evaluation of management and control as essential factors contributing to the auditor's assessment of inherent risk. This study demonstrated that particular inherent risk factors are explicitly assessed by practitioners. However, Choo,(1988) concluded that auditors do not consider it appropriate to generate numerical estimates of risk on an account by account basis, but reason about a client's financial statements using knowledge about changes in the industry and/or the client, management's motivations, and prior track record. Practitioners' preferences for qualitative risk assessment have also been evidenced in Daniel, (1988).

Research has shown that the link between timeliness and corporate governance are scarce. The intuition is that the timeliness in financial reporting for Private UK firms are less conservative in their earnings reporting than public firms (Ball & Shivakumar, 2004). In this way private firms face a lower demand for timely financial reporting. They resolve the asymmetric information problem to a larger extent through an insider mode. Hence, it is less likely that public financial information is used for contracting purposes between the claim holders of the firm. Furthermore, a higher proportion of outside board directors in UK is positively associated with timely recognition of economic losses in the earnings reporting (Beekes, Pope, and Young, 2004).

The intuition is that outside board directors have a greater incentive to act as monitors than inside directors since their wealth is less tied to the specific firm's performance. Bushman, Chen, Engel, and Smith (2003) argue that timeliness has a direct effect on governance choices that is distinct from effect of other firm characteristics and capture meaningful differences across large public firms. With more timely loss recognition, the financial report can support a larger set of contracts among insiders and outsiders, less additional monitoring will be needed by the outside investor in order to protect his claim, that is, timely recognition of economic losses improves upon the contractual effectiveness embedded into financial reporting.

Recent scandals and bankruptcy in large corporations revealed huge gaps between boards of directors, executive management, internal control and organizational performance. The importance of internal control and audit is aggravated even more after accounting firms are being sued by shareholders for their inability to detect fraud (Schnatterly, 2001) since then there are changes involved in strengthening internal control in organizations (for instance SOX, 2002). At the same time, several authors proposed that quality and corporate governance (CG) should be dealt as inseparable areas. For instance, the CSR/CG framework published by British Standards Institution (Castka et al., 2004a) makes a significant contribution to this trend. This work offers organizations a framework for establishing, maintaining, improving and documenting their CSR/CG management system. The authors assert that these concepts cannot be mutually exclusive but merge together, each offering a different yet complementary perspective on the activities of an organization, to form a robust strategic business management tool.

Liebesman (2004) strongly advocates that ISO 9000 and ISO 14000 can be used to reduce risks with compliance with the Sarbanes-Oxley Act (SOX, 2002): Because of SOX, the CEOs and CFOs of public companies must certify their financial statements, and each year they must certify the effectiveness of their systems of internal controls mandated by the law. Top management needs to obtain better information about the effectiveness of their organizations. Quality and environmental people should be at the table when the internal financial auditors develop their reports to top management and the board of directors.

In the later work Liebesman (2005) asserts that ISO 9000 and ISO 14000 can be substituted by other quality framework, such as Malcolm Baldrige National Quality Award. Importantly, Liebesman (2005) further demonstrates one important outcome of the integration of CSR and CG with quality management: that this can be used as a vehicle to bring quality at the board level and rejuvenate quality programs in organizations.

Research into white-collar crime (which is understood as any crime committed by business people or professionals in the course of occupation) reveals that the most effective mechanisms used to discover frauds are internal audits. Schnatterly (2001) reports that: 36 percent of frauds are uncovered in organizations by internal controls (including internal auditor reviews); 28 percent are uncovered through letters from customers; 12 percent from anonymous sources; 21 percent by accident; and only 3 percent are discovered by external auditor reviews.

However, internal auditing practices are often criticized – as mechanisms that lead to compliance mentality (Karapetrovic, 1999) or adding little value to the running of organizations (Seddon, 2000). Similar arguments can be drawn in relation to third-party certification. Third-party certification is under increased attack and looking at the findings from the discovery of frauds, only 3 percent attributed to external auditors (Schnatterly, 2001), this should be of little surprise. Problems can be summarized in three areas. First, the critiques point at the commercial nature of the relationship between the certifier and the audited organization (Lal, 2004). This relationship can cause laxity and malpractice in ISO certification. Second, the competence of auditors is often questioned and they are seen as adding little value to organizations. Third, the accountability of the certification body to final customer and end user is marginal.

Clearly, a profound change in third party verification practices is necessary. The efforts so far suggest that there is willingness for change and in fact some changes are in progress (Wade, 2002; Lal, 2004). The International Accreditation Forum (IAF) and ISO has attempted to address the criticism by revision of requirements for accreditation bodies that accredit conformity and for auditor competences yet IAF asserts that the profound changes will need more time (Feary, 2005). In the meanwhile, some accreditation bodies (UL, The HPA) have already challenged the management systems paradigm and offer new approaches to ISO management systems certification (HPO, 2006).

1.2 Statement of the Problem

Internal auditors need to be out in front, leading the business units with regards to the internal control system and also focusing on strategic business objectives. In the company environment, management is the most important auditee of the internal audit department since effectiveness of the internal auditing practices can be described through the expectations of management with regard to the internal auditing practices. However, growing regulatory guidelines and compliance with SASRA regulations and Sacco Act (2008) in relation to internal audit has continued to receive criticisms in relation to good cooperate governance. Instances of laxity have been identified in the way cooperate management executes its functions. For example, inherent risk assessment is not fully utilized in the detection of management errors. The internal audit function has been labelled as a mechanism that adds little value to running of organizations compounded by the level of competence of the auditors. There is great need to strengthen the IA function in order to realize good governance. The role of internal audit in enhancing good corporate governance has not been exhaustively explored in Saccos in Kenya. This is the reason why this study was carried out.

1.3 Purpose of the Study

The purpose of this study was to determine the effect of inherent risk assessment on Saccos' governance performance in deposit taking Saccos in Kakamega County.

1.4 Research Questions

What is the effectiveness of inherent risk assessment in Saccos?

1.5 Significance of the Study

The policy makers may be sensitized on the importance and effectiveness of corporate governance and the internal audit which creates an insight into the extent of their laws-making process to take in enhancing internal auditing among Saccos.

Investors and general public may be informed on their rights as shareholders through the findings. Members will be made aware of the importance of corporate governance and the internal monitoring machinery through the internal audit and the audit committees. This may help to ensure that international standards of corporate governance within the Saccos are adhered to at the local levels.

Findings may also be helpful to the regulators, especially SASRA, to ensure that the management systems within every Sacco, are equipped with the adequate internal controls to promote accountability and transparency and adherence to the statutory provisions governing the sector.

1.6. Scope of the study

The study was confined to the effectiveness of inherent risk assessment in deposit-taking saccos, focusing on five such Saccos in Kakamega County namely, Kakamega Teachers Sacco (Kateco), Mumias Outgrowers Sacco (Mosaco), Mudete Factory Tea Sacco (Mufate), Wevarsity Sacco, and Sukari Sacco. The study was limited to exploring the internal audit function and corporate governance in registered deposit taking Saccos.

1.7. Conceptual Framework

The independent variable in this study is the IA function which includes costs and cost efficiency, impacts of productivity, profitability, focus on core competencies, strategic flexibility and access to information and knowledge. The dependent variable of this study is governance. The relationship between these variables is shown in Figure 1.1 below.

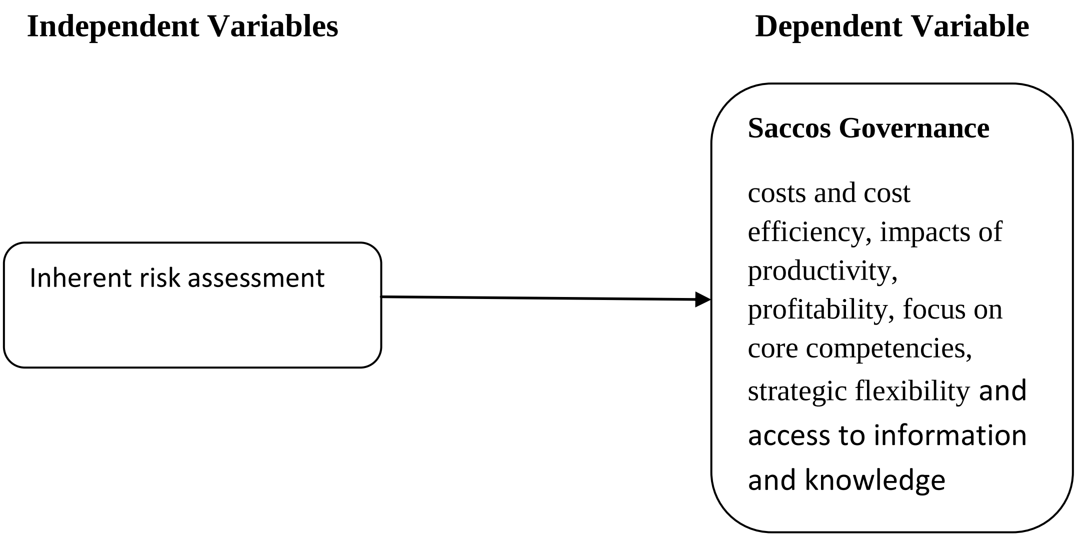

Figure 1.1 Conceptual Framework showing the effect of Inherent risk assessment on corporate governance

2. Literature Review

2.1. Corporate Governance

According to Mayer (1997), corporate governance is concerned with ways of bringing the interests of (investors and managers) into line and ensuring that firms are run for the benefit of investors. Corporate governance is concerned with the relationship between the internal governance mechanisms of corporations and society's conception of the scope of corporate accountability.

Keasey, Thompson and Wright (1997) have also defined corporate governance to include the structures, processes, cultures and systems that engender the successful operation of the organizations. This implies that corporate governance is seen as the whole set of measures taken within the social entity that is an enterprise to favour the economic agents to take part in the productive process, in order to generate some organizational surplus, and to set up a fair distribution between the partners, taking into consideration what they have brought to the organization.

Generally, the different systems of corporate governance embody what are considered to be legitimate lines of accountability by defining the nature of the relationship between the company and key corporate constituencies. Corporate governance systems may be therefore thought of as mechanisms for establishing the nature of ownership and control of organizations within an economy. In this context, corporate governance mechanisms are economic and legal institutions that can be altered through the political process sometimes for the better.

Corporate governance therefore describes how companies ought to be run, directed and controlled. It is about supervising and holding to account those who direct and control the management. For a Small and Medium Enterprise (SME), it concerns the respective roles of the shareholders as owners and the managers (the directors and other officers). It is about setting rules and procedures as to how the company is run. It is also about putting checks and balances in place to prevent abuses of authority and ensure the integrity of financial results. As a result, the role and independence of the auditor has been under scrutiny.

2.2 Empirical review

Since one of the primary responsibilities of the audit committee is to review and monitor the audit process, active and independent audit committees can influence the extent of the audit (Dezoort, 1997). Independent directors on audit committees have incentives to protect their reputation and avoid potential litigation. These incentives can be explained by the demand-based perspective in the context of regulatory oversight of Saccos and the scrutiny of the role of independent directors. The demand-based perspective suggests that independent directors seek differentially higher audit quality.

Higher management ownership reduces managers' incentives to issue misleading information to shareholders and motivates them to increase firm value (Jensen and Meckling, 1976). A negative association commonly observed between management ownership and audit fees reflects a reduction in Internal audit arising from a greater alignment between management's and company shareholders' interests. Consistent with this proposition, O'Sullivan (2000) found a negative association between management share ownership and audit fees. However, beyond a certain level of management ownership, management may entrench themselves and indulge in non-value creating activities and misreport the results of operations. Agency theory predicts the need for a more extensive audit in such circumstances. Thus, the relationship between management ownership and audit fees might be non-linear. Consistent with prior studies (O'Sullivan, 2000), we use non-independent director ownership as a proxy for management ownership.

Independent directors and auditors share the same objective of identifying and rectifying reporting errors deliberately or otherwise made by managers. Given their impartiality, such directors are more likely to question and challenge management (Carey et al, 2000). As the interests of independent directors holding significant equity shares are aligned with that of shareholders, they are more likely to demand more extensive auditing to protect their interests and reputation.

3. Methodology

This study adopted a descriptive research design which was meant to determine the effect of internal auditing on governance of deposit taking Saccos in Kakamega County.

It targeted heads of departments of the Saccos, selected from six departments including Credit, Finance, Information Communication Technology (ICT), Front Office Service Activity (Fosa), Marketing and Audit, CEOs from each of the six Saccos, members of the Board of Directors from each of the six saccos and general members from each of the selected Saccos.

It used purposive sampling technique to select a total of 36 heads of department, 6 CEOs and 12 members of the board drawn from the 6 deposit-taking Saccos in Kakamega County.

Simple random sampling was used to select 10 members from each of the six Saccos used in the study. A total of 114 respondents were used in the study. It utilized questionnaires to collect data from the members. The questionnaire designed in this study comprised of two sections ; demographic and operational characteristics designed to determine fundamental issues including the demographic characteristics of the respondent, while the second part was devoted to the identification of the influence of internal auditing on governance of deposit taking Saccos in Kakamega County. The study considered content validity. According to Kothari (1985), content validity is the extent to which a measuring instrument provides adequate coverage of the topic under study. To achieve this, the research instruments were designed with regard to the objectives and research questions.

Validity of the instruments was determined by research specialists from Mount Kenya University to ascertain that there was adequate coverage of the content from the topic under study. Reliability was determined using the Split-Half method after a pilot study. First, the instrument was divided into two halves after assigning odd numbers to one half of the sample and even numbers to the other half. The two halves were coded and scored. The degree of correlation between the scores on the two halves was calculated using Cronbach's Alpha Correlation Coefficient which varies between 0 – 1. A value of 0.7 and above implies an acceptable level of reliability of the instrument. The research instruments had a value of 0.76.

Authority to conduct research was obtained from Ministry of Higher Education Science and Technology. The researcher reported to the County Commissioner for clearance to conduct the research in the County. Each Sacco in the sample was visited to make appointment for the administration of the research instruments. The questionnaires were personally administered on the agreed date while the interviews were conducted on the agreed dates and time. Data collected was both quantitative and qualitative. Qualitative data was analyzed using content analysis while quantitative data was analyzed by descriptive analysis.

4. Findings, Interpretations and Discussion

4.1 Inherent risk assessments effect on SACCOs governance

This variable was meant to establish to what extent inherent risk assessment affect Sacco's governance in the region. Findings show that inherent risk assessment effects on Sacco's governance is moderate. The table below shows the findings;

Table 1: The extent of inherent risk assessment on Sacco's governance

Effect of inherent risk assessment on Sacco's governance					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	No extent at all	11	11.45	11.45	11.45
	Little extent	22	22.91	22.91	34.36
	Moderate extent	42	43.75	43.75	78.11
	Great extent	18	18.75	18.75	96.86
	Very great extent	7	3.12	3.12	100
	Total	96	100.0	100.0	

The above findings demonstrate that inherent risk assessments have a significant effect on Sacco's governance. This supports the analysis by O' Reagan (2002) who concluded that inherent risk assessment is one of the fundamental aspects of auditing with a significant effect on governance.

The analysis below gives the assessments of the various components of risk assessments on Sacco's governance. Inherent risk assessment on Sacco's governance was measured using a likert scale and measured the level of agreement or disagreement with how various variables as listed below;

- The Sacco's consider the role of risk assessment in detection of errors (consideration of the role of Risk Assessment)
- Auditors in the Sacco's have a good understanding of their auditee's business (auditors understand their business)
- Non systemic transactions and Sacco characteristics are associated with incidence of errors (non systemic transactions)
- Inherent risk at the Sacco is difficult and costly to assess (inherent risk is costly)
- Auditors at the Sacco begin inherent risk evaluation process by generating expectations of accounts balances (expectations of accounts)
- The auditor identifies changes that have occurred in the firm or its environment and determines how they should interact to produce an expected balance in the account (change identification)
- There is a preference for qualitative risk assessment at the Sacco.(preference for qualitative risk assessment)

The researcher used SPSS to generate a descriptive analysis of the variable on the effects of inherent risk assessments on Sacco's governance. Statistics used were the minimum and maximum range, mean of the responses, the standard deviation from the mean and the variance. Very low mean figures indicate strong agreement with the statements while higher figures indicate very high disagreements. High figures for standard deviation (those greater than one) indicate a wide range is responses showing wide disparities.

The table summarizes the finding from the analysis;

Table 2: Mean and standard deviation of inherent risk assessment measures

Inherent risk assessment measures	N	Min	Max	Mean	Std. Deviation
Consideration of the role of risk assessment	96	0	4	2.00	1.20
Auditors understand their business of auditing	96	0	4	2.56	1.491
Non systemic transactions are associated with incidence of errors	96	0	4	2.27	1.159
Inherent risk at the Sacco is difficult and costly to assess	96	0	4	2.86	1.085
Auditors begin evaluation of risks at the Sacco by generating expectations of accounts balances	96	0	4	2.53	0.677
Auditors identify changes that have occurred in the firm or environment to determine how they should interact	96	0	4	3.07	.878
There is preference for qualitative risk assessment at the Sacco	96	0	4	2.00	.977
Valid N (listwise)	95				

The table above shows that there is moderate consideration on the role of risk assessment as the mean is 2.00. On whether auditors understand their roles and business of auditing the table shows that the respondents are slightly varied in their opinions (sd=1.491) but overall the respondents are not sure with the auditors competence in accomplishing risk assessment. This shows that the auditors have not been fully trusted to implement inherent risk assessment within their organizations.

Majority of the respondents think that inherent risk assessment at their Sacco's is difficult and costly to assess. The low standard deviation (very close to zero) indicate that majority of the respondents agree with that statement.

Most respondents were not sure whether the auditors in the Sacco's begin the inherent risk evaluation process by generating expectations of accounts balances. Peters et al (2002) asserted that "the auditor begins the inherent risk evaluation process by generating expectations of accounts balances; that the auditor identifies changes that have occurred in the firm or its environment and determines how those changes should interact with historic trends to produce an expected balance in the account. This findings show that majority of the respondents are not aware of basic audit procedures that relate inherent risk analysis. This is exhibited by the low standard variation which shows that respondents' answers varied little from each other.

Responses in relation to auditor's role in identifying changes within the organization also show that majority of the findings are not aware of such process. Auditing standards call for auditors identifying changes that have occurred in the environment and determining how those changes to accounts should interact with historic trends.

Most respondents were not sure whether there was a preference for qualitative risk assessment at their Sacco's. The low standard deviation also points to uniformity in their answers.

4.2 Judgments of Inherent Risk at the Sacco

The researcher sought to examine the significance of various factors in influencing judgments of inherent risk at the Sacco. This was done by getting their mean and standard deviation to ascertain their level of significance. The measurement scale used here was inversely proportional to the value of the figure i.e. the higher the mean figure the more insignificant (less significant) the factor.

Table 3: Mean and standard deviation of factors influencing judgments of inherent risks at the Sacco

Factors influencing judgments of inherent risks at the Sacco	**N**	**Min**	**Max**	**Mean**	**Std. Deviation**
Turnover of controllers	96	0	4	2.00	1.20
Financing pressure	96	0	4	1.56	1.491
The complexity of overhead in inventory	96	0	4	2.27	1.159

The quality of personnel responsible for inventory calculation	96	0	4	1.26	0.785
Valid N (listwise)	95				

As per the above table the most significant factor influencing judgments of inherent risk at the Sacco was the quality of the personnel responsible for inventory calculation (1.26). This is followed by financing pressures (1.56). However, most respondents were not sure if the turnover of controllers had a significant influence on the judgment of inherent risk at the Sacco. Sarens (2006) also concurs that despite the financing pressure of in an organization or any other environmental factors like complexity of overhead and turnover of controllers; the quality of personnel in terms of professional competence supersedes any other factor in influencing their judgments. The study therefore affirms Houghton and Fogarty, (1991) experimental study which found that the four factors (turnover of controllers, financing pressure, the complexity of overhead in inventory and the quality of personnel responsible for inventory calculation) were significant in influencing judgments of IR.

5. Summary Findings, Conclusion and Recommendation

5.1 Inherent Risk Assessments

The research shows that inherent risk assessment is crucial in the detection of errors within the Sacco's; and that it plays a significant role in corporate governance i.e. 44% of respondents thought that the effect was moderate, while 19% and 3% thought the effect was great and very great respectively. However the findings also show that inherent risk assessment within the Sacco's is difficult and costly to implement. Findings suggest that most of the Sacco's management were not aware of the intrinsic aspects of inherent risk assessments. Furthermore the study reveals that the most significant factors influencing inherent risk assessment within the Sacco's was the quality of the personnel involved in inventory calculation; financial pressures; turnover of controllers and lastly the complexity of overhead in inventory.

5.2 Conclusions

Sacco's understand the significance of the process but are reluctant to implement due to imagined difficulties and high costs. Management is also not aware of the intrinsic processes that define and involve inherent risk assessments within their Sacco's.

5.3 Recommendations

The study also recommends that the Sacco's establish and manage knowledge or Management Information System within their institutions so as to enable all parties within the institution to freely access and utilize the official information.

The study further recommends that the management including the CEOs and members of BODs be given induction courses on good governance especially to support the risk assessment function.

5.4 Suggestion for further research

1. The influence of ICT on the effectiveness of internal audit systems in deposit taking organizations
2. The influence of internal control systems on the corporate governance of organizations, Audit complexity and Sacco governance, Audit transparency and Sacco governance ,Auditing standards and Sacco governance
3. Further recommendation was that there should be a deliberate attempt to conduct a study which establishes the relationship of management's commitment based on factors that are external to the Sacco such as governmental policies, information technology, shareholder influence and other financial and operational constraints outside the mandate of the Sacco's.

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