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THE EFFECT OF PREVENTIVE INTERNAL CONTROLS ON THE MARKET PERFORMANCE OF NON- FINANCE PUBLIC COMPANIES LISTED BY THE NAIROBI SECURITIES EXCHANGE

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Abstract: *Internal Controls are developed processes enforced by those charged with administration, management and other personnel, for instance, managers and supervisors. They provide appropriate assurance for an entity to achieve its objectives through ensuring the reliability of the financial reporting, smooth operations, proper accountability, and compliance with applicable set guidelines. Preventive controls are accounting controls that are established as a check against the possible happening of errors and frauds. Preventive measures are usually regular and incorporated as part of a firm's internal control system. The market performance of non-finance public companies listed by NSE has been showing unstable performance. The NSE 20 Share index, which is one of the market performance measures, indicated a declining trend towards the end of the year 2018 and 2019. Despite this concern with market performance, it is still unclear how much market performance is affected by companies' preventive internal controls. The study therefore sought to establish the effect of preventive internal controls on market performance of Non Finance Public companies listed by NSE. The study's objective was to establish the effect of preventive internal controls on the market performance of non-finance public companies listed by NSE. The study was reviewed theoretically using the agency theory. This study used a descriptive research design approach and utilize a target population of 45 non-finance public companies listed by NSE. The census method was used to enable the researcher to gather enough evidence on the problem statement. The study used the questionnaire as the primary data collection tool. Correlation and regression analysis was conducted to establish the relationship between preventive internal controls and market performance. The study established that preventive internal controls had a direct and significant effect on the market performance of non-finance public companies listed by NSE. (p= 0.000, β= 0.247). The study concluded that preventive internal controls collectively had a significant effect on the market performance of non-finance public companies listed by NSE. The study recommended that management of companies and the NSE should emphasize on strong preventive internal controls which keep managers on toes on their agency role, this in return leads to good organizational performance which in turn n lead to good market performance shown by the market returns.*

Keywords: *preventive controls, internal controls and market performance*

1. INTRODUCTION

Every entity that comes to being is always concerned with its market performance since it is one the measures of a firm's overall performance. Shareholders are always concerned with how a firm is performing in the

market. For instance, the market capitalization and share price of the companies in the NSE platform. For this to be achieved firms employ guidelines and procedures which ought to be followed in order to restrict the self-centered interest of managers and stewards and capitalize on profits (Jokipii, 2010). This is achieved through reducing chances of fraud and material misstatements by engaging strong internal controls.

Market performance of non-finance companies listed at the NSE has kept on fluctuating over the last several years. For instance, over the years 2016 and 2017, the market capitalization changed by +22.53% but fell to -10.13% between 2017 and 2018 only for it to raise back to +16.23% over the period 2018 to 2019.

In Kenya, the non-finance public companies listed have been performing poorly, researches have been done in that regard. Majority of them focused on the correlation between internal controls and organizations financial performance. For instance, Kamau (2013) examined the consequence of internal controls on financial performance of manufacturing firms and revealed a significant positive liaison. Majority of the researches done in Kenya revealed affirmative relationship on internal controls and performance of the different firms discussed.

The majority of this research that have been carried out have greatly focused on the financial performance of an entity and the connection between internal controls and reporting ignoring the larger part of market performance, which entails market returns, share capitalization, and the number of shares traded. The researchers have also concentrated on individual firms, and therefore generalizing the results be difficult. The majority also focused on narrow areas, for instance, internal audits and control environments, not considering the broader controls, for instance, preventive as a whole.

Concept of Preventive Internal Controls

These are accounting controls that are established as a check against the possible happening of errors and frauds. Preventive measures are usually regular and incorporated as part of a firm's internal control system. They form a critical component of the internal control and check system and are therefore expected to profoundly affect business performance (Whittington & Pany, 2015).

Under this class of controls, it includes review and approvals- This entails regular review of processes to ensure they are done as set. It also includes approvals by specific designated individuals of every transaction and end of a process. This is to ensure authenticity of every transaction and ensure that they adhere to the set guidelines of the organization. Review and approvals are mostly done by firm’s supervisors, head of departments, line managers and general managers.

Secondly we have segregation of duties, which entails every individual doing a specific task which is distinct form the other. For instance, if one person receives a cheque then a different person banks the cheque. This ensures accountability and minimizes chances of fraud. Under segregation, duties are classified into authorization, custody record keeping and reconciliation. The four stages should be handled by four different people. This is because if you give one person control over whole assets of the company it exposes the company to risk.

Thirdly, we have staff rotation, this entails moving the staff from one task to another in the same organization. This helps to ensure that everyone is experienced in any department in the organization and also reduces chances of fraud since a person know that they are not in that department forever. Being changed overtime will expose any fraud or misstatements to the new occupant of the role.

Lastly access controls and physical controls, they entail putting measure in place which prevent or deter access by individuals to unauthorized materials or places. This could include fitting of CCTV cameras, installation of passwords to sensitive processes, password coded doors and physical guards at the doors. Physical controls will aid reducing chances of access to unauthorized materials and places and paste responsibility to those allowed in there in case of anything.

Concept of Market Performance

Market performance is how well a firms shares are performing in the stock market as shown by market returns. For instance the change in share prices with reference to the initial price (Modi & Mishra 2010).

It is basically the performance of a certain firm. It entails a measure of the number of shares traded, market capitalization, profitability, and share price changes. It greatly reflects how the business is performing. Every firm needs to be in business in the long run. To achieve this, it must set in place the precise procedures to guarantee that the entity is profitable. It should also ensure that all customers are satisfied and remain loyal to the brand. And should also ensure that it is not kicked out of business by other competing firms.

Market performance reflects the value of a company in the stock market. The greater the performance the higher the premium investors are placing in the company. It is expected that companies with tighter controls should portray high profitability which in turn would help increase share price in the market. In reality however these expectations may vary and that’s why this study is concerned with how internal controls affect share price and therefore market return and therefore market performance (Jokipii, 2010).

The common measure of market performance is Holding Period Returns (HPR). This return involves calculating the change in price as a fraction of the beginning price. For instance months HPR will be taken as the ratio of the difference between the ending price and the beginning price of the shares to share price at the beginning of the month. Therefore an entity should ensure that efficiency is maintained in business operations so as to foster a good performance in the market by having good market returns.

Statement of problem

Market performance of firms indicate the desirability of the stocks of those firms in the market as per the demand and supply of the securities which is based on investor sentiments about the concerned firms. It is therefore a good barometer of measuring the performance of the business in general and the managers’ stewardship role in particular. Companies are always concerned with market performance since it greatly impacts shareholders' wealth maximization, which is mostly one of the corporate organizations' main objectives.

Market performance of non-finance companies listed at the NSE has been fluctuating over the last several years. For instance, over the years 2016 and 2017, the market capitalization changed by +22.53% but fell to -10.13% between 2017 and 2018 only for it to raise back to +16.23% over the period 2018 to 2019. The same applies to share price performance. The NSE 20 Share index, which is one of the market performance measures, indicated a declining trend towards the end of the year 2018 and 2019 (NSE Report, 2020).

Despite this concern with market performance, it is not clear how firm internal controls used impact such market performance. In essence, it is still unclear how much performance is affected by companies' internal controls. Most of the studies regarding internal controls have focused on the relationships of internal controls and the financial performance leaving the broader scope of market performance, which is key for any entity to survive in the long-run.

Muio (2012) and Kakucha (2009) evaluated how internal controls affect financial performance of Nairobi private hospitals. They proved that there was a positive relationship between internal controls and financial performance, but it was varying from one organization to another. The study by Muio & Kakucha majored on the relationship of internal controls and financial performance. It did not address the aspect of market performance which is key area considered by investors. The study also majored on the private sector and therefore results could not be generalized to the public sector. Kamau (2013) sought to investigate the impact of internal controls on manufacturing firms' financial performance in Kenya. He established a positive correlation between internal control and the financial performance of manufacturing companies. The study by Kamau also majored on one segment of the economy and also a narrow spectrum of financial performance hence informing a need for further research

The majority of this research that has been carried out has greatly focused on the financial performance of an entity and the relationship between internal controls and performance ignoring the larger part of market performance, which entails market returns, share capitalization, and the number of shares traded. The researchers have also concentrated on individual firms, and therefore generalizing the results be difficult. The majority also focused on narrow areas, for instance, internal audits and control environments, not considering the broader controls, for instance, detective, preventive and corrective controls as a whole.

This study sought to address some of those issues by evaluating the effect of preventive internal controls comprehensively on the market performance of non-finance public companies listed by the NSE.

Objective

The objective of the study was to establish the effect of preventive internal controls on the market performance of Non-Finance public companies listed by NSE.

2. LITERATURE REVIEW

Theoretical Review

A theory is a set of interconnected propositions and thoughts that show a structured opinion of occurrence's by highlighting the link between variables. Theories help to project situations Nalukenge, Nkundabanyanga, & Ntayi, (2018). This study was guided by the Agency theory.

Agency Theory

The theory was introduced by Jensen and Meckling (1976). It elaborates and resolves issues on agency relationships. The Agency theory is a principle that explains the relationship between agents and the principal while resolving arising issues. An agent is a person who undertakes to be responsible of an undertaking on behalf of his boss, the principal. The agent has the mandate to undertake duties on behalf of the principal as well as decision making. The significance of this theory to this study is that internal controls forms part of the mechanisms used by businesses to prevent negative agency effects on the achievement of organizational goals. The stronger the controls, the better the performance that will be expected. It helps in addressing the agency muddle by mitigating costs that negatively influence the performance of the agent-principal relationship (Cruz & Haugan, 2019).

Empirical review

Cheng, Goh, and Kim (2018) set to evaluate the impact of internal controls on financial reporting on entities operational efficiency. The study uses the audit analytics method from a sample of 24,462 through the period

2004- 2014. They used a panel regression model of operational efficiency and internal controls. The findings indicate that operational efficiency is better in organizations with strong internal controls compared to those with weak internal controls. However, this research in relation to the current study had a few issues not addressed. First, it is in a foreign country and therefore cannot be generalized in Kenya. Second, it only evaluated financial performance leaving the broader market performance, which this research seeks to focus on.

In China, Ge, Li, Liu, and McVay (2018) sought to explore the agency theory aspects with respect to managers in the context of financial controls. They studied the impact of the strength of internal control on financial reporting. The research was geared towards evaluating how controls curb resource extraction among companies listed with the Chine Equities Market. The study used the two-stage linear regression approach on a sample of 8,497 firms. They collected secondary data from the Chinese Stock Market and Accounting Research (CSMAR) database. They found out that there is a positive relationship between installing controls and deterrence of resource extraction. They also noted that many firms were not implementing the controls put in place. It, however, fails on two fronts in the context of the current study. First, it is done in a different country other than Kenya, and the country context can affect research outcomes.

Eniola and Akinselure (2016) investigated the effect of internal controls on Nigerians manufacturing firm's financial performance. They adopted a descriptive survey design. It was based on a non-probabilistic sampling approach of 150 firms. The data collected was based on a structured questionnaire. Data analysis was done using multiple regression on a statistical tool, SPSS. They found out that internal controls have a noteworthy positive relationship with the fraud perpetrated in organizations and that strong controls serve to improve financial performance. However, the study concentrated on financial performance. It only focused on one sector of non-finance public companies, unlike the current, which focuses on the market performance of all the listed non-finance companies.

Njui (2012) sought out to determine the efficiency of internal control and audit in improving good ascendency in Kenya's public sector. The findings show that internal control has a significant influence on corporate governance in government ministries. Risk management, compliance, and consulting had the least effect. The study used questionnaires to collect data and used a descriptive research design. Data analysis was completed through a multiple regression model using SPSS tools. It, however, focuses only on the public sector and financial performance, yet the current study is geared towards market performance.

3. RESEARCH METHODOLOGY

The study adopted a descriptive research design. This scientific method involved data collection and analysis. The descriptive research design aimed at drawing concise predictions about the features of the phenomena under investigation. This design enabled the researcher to effectively survey the effect of internal control on the market performance of non-finance public companies listed by NSE. The preference for this design is due to its ability to save time and easiness of the researcher to acquire current truthful information from employees of the enterprise Mugenda (2003).

The study took into consideration the entire 45 non-finance public companies listed by NSE as the population size (NSE, 2021). All the 45 non-finance public firms listed at the NSE therefore participated in this study. For an effective gathering of information, the census survey approach was employed by the researcher since there is no need for sampling because the non-finance public firms are not many.

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This study used both primary and secondary data. It used a questionnaire as the main tool of primary data collection. The questionnaire combined both open and closed-ended type questions which were self-administered to the audit departments of the non-finance public companies listed by NSE. Secondary data was obtained from the NSE website. Data regarding the price of shares at the beginning of the year and the price at the end of the year was obtained. The data was purchased from the company's website and the companies whose information were missing was physically obtained from the NSE premises.

A pilot test on five questionnaires was used to test for both validity and reliability. Validity signifies the capability of an instrument to give accurate and meaningful data on the phenomenon being measured. The designed questionnaire was pre-tested in five of the non-financial public firms in Kenya. Data analysis was done based on descriptive statistics using Statistical Package for Social Sciences (SPSS). Model 22.0 was used to aid the analysis, and multiple regression used to show the correlation between preventive internal controls and market performance of non-finance public companies listed by NSE.

The study employed the multiple regression model below. The model was used to show the relationship between the study independent and dependent variables as indicated below;

Market performance = f (preventive controls)

$MP = \beta 01 + \beta 1\ X1 + \varepsilon 1$

Where MP is Market Performance

$\beta 01$, $\beta 1$ are coefficients

X1 is aggregate mean of preventive controls

$\varepsilon 1$ is error term

A 2 tailed t-test was carried out to establish the effect and the significance of preventive internal controls and market performance. Hypothesis was also tested at 95% confidence level (5% significance level. The research took into consideration all ethical issues. The researcher obtained all authorization from the institution and the National Commission for Science, Technology, and Innovation (NACOSTI)

4. RESULTS

Effect of Preventive Internal Controls on the market performance of non-finance public companies listed by NSE.

This section presents measures of central tendency and measures of dispersion in the data relating to the independent variables (preventive internal controls) and the dependent variable (market performance as measured by market returns). The findings are presented in table 1 next page.

With respect to the measures of central tendency, the mean of the data was used. In this respect, market performance had a mean return of 24.19%. This implies that on average, investors in the stock exchange obtained a return higher than the Treasury bill rate. Based on capital asset pricing model of Sharpe (1964), this is expected because the risky investments in the market must have a return higher than the TB rate which over the study period averaged 8.21%.

All the mean values are divided by 5 since the Likert scale was derived on a 5-point scale with 1 being very weak controls and 5 reflecting very strong controls. Accordingly, the percentages are the scaled values of the mean values in table 1 next page.

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Preventive controls had a mean 66.17% which is above 50% indicating preventive controls have a major influence on the market performance. With respect to measures of dispersion, standard deviation was utilized in the study. Preventive controls had 0.8462. This indicates a wide cross sectional variation in the levels of preventive controls instituted by the various companies at the Nairobi Securities Exchange with respect to preventive controls. Taken on a relative level where coefficient of variation was used. This involved comparing the mean with the standard deviation to show the level of volatility. The findings are indicated in table 1 below.

The CV specifies the relative level of volatility with respect to the mean. The higher the volatility, the higher the risk of the variable and vice versa. With this measure, market performance showed the highest level of volatility with a value of 1.2979. This is consistent with the random walk theory of Burton (1973) which indicates that information arrives in the market at a random fashion and therefore returns are expected to be random therefore having a very volatile value as indicated by the coefficient of variation. In line with the size anomalous effect of Banz (1981), small companies are expected to outperform their large counterparts, which led to this wide variability in market.

Preventive internal controls registered a CV of 0.2553. The most differences in the internal controls instituted by NSE companies is therefore the preventive internal controls. This may be largely due to the fact that most companies have computerized their operations such that there is a high need for preventive measures to avoid cybercrime that may affect their operations.

Table 1: Descriptive Statistics

	Mean	**% Mean**	**Std. Deviation**	**CV**	**N**
Market performance	**0.241940**	**0.24194**	**0.3140120**	**1.2979**	**35**
Preventive Controls	**3.308571**	**0.66171**	**0.8462274**	**0.2553**	**35**

The constants in the subsequent regression output model are usually influenced by the variable correlations (Gujarati & Porter, 2009). For this study, the correlation findings are indicated in table 2 below. In a nutshell, the preventive controls have a positive correlation with market performance. This indicates that an increase in the level of preventive controls corresponds with increase in market performance and vice versa.

Table 2: Correlation Analysis

		Market performance	**Sign (1-tailed)**	**N**
Pearson Correlation	**Market performance**	**1.000**	**0.000**	**35**
	Preventive Controls	**.700**	**0.063**	**35**

From the findings in table 2 above the coefficients of correlation between market performance and internal controls are 0.700 for preventive controls. This indicates that for the preventive controls, the level of

association is highly positive and that firms can improve their performance in the stock market by institution of very stringent internal preventive controls. In line with Al-Thuneibat, Al-Rehaily and Basodan, (2015), preventive controls are instrumental in preventing errors and frauds and thereby preventing misappropriation of financial and other resources from the organization. The implication is that all the value addition efforts will be deployed in improving financial performance and therefore shareholder wealth maximization. These findings are also in line with Agency theory of Jensen and Meckling (1976) which indicate that the level of agency conflicts reduces with the amount of corporate controls instituted and therefore this should be expected to improve financial performance in general and market return in particular as this finding is revealing.

For a model to be suitable for analysis it must explain the changes in the dependent variable following variations in the independent variables as measured by the coefficient of determination (R-square). In addition, it must have statistical significant at the chosen confidence interval such that the explained changes must be significantly different from zero. This evaluation as per Sekaran (2013), is examined using ANOVA F-test where the model F value must be different for the significant F-value. Table 3 below and Table 4 next page show the model parameters as well as the ANOVA results respectively.

Table 3 Model Suitability

R	.712[a]
R Square	0.507
Adjusted R Square	0.459
Std. Error	0.23102
F Change	10.606
df1	3
df2	31
Sig. F Change	0

From the table 3, R represents the multiple coefficient of correlation. It shows how preventive are jointly related with the market returns of the company under evaluation. The findings in table 3 have an R value of 0.712. This shows a strong positive correction between these controls and the market performance. Just like the conclusion arrived at for the individual correlations, the findings fall perfectly in line with the expectation of the efficient market hypothesis of Fama (1970) which indicates that internal information is usually priced by the stock market. The findings also falls in line with Agency theory of Jensen and Meckling (1976) which expects a reduction in agency problems as propagated by strong systems of internal controls to help boost not only financial performance, but also the resultant market returns hence market performance

Table 4 ANOVA[a]

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	**Regression**	**1.698**	**3**	**.566**	**10.606**	**.000[b]**
	Residual	**1.654**	**31**	**.053**		
	Total	**3.353**	**34**			

a. Dependent Variable: Market performance
b. Predictors: (Constant), Corrective controls, Detective controls, Preventive Controls

With respect to model prediction significance, the ANOVA F values were established from the data as indicated in table 4 the model is expected to be viable if the F from the model is greater than the F of the model at the significance level of analysis (Sekaran, 2013). From Table 4 above, the F value is 10.606 while the significance F is 0.000. Accordingly, the study rejects the null hypothesis that the model is unsuitable for multiple linear regression with the conclusion that it suits that data and therefore viable conclusions can be drawn from carrying out the multiple linear regression of internal controls on market performance.

Table 5: Multiple Linear Regression Output

		Unstandardized Coefficients		Standardized Coefficients		
Model		**β**	**Std. Error**	**β**	**t**	**Sig.**
1	**(Constant)**	**1.618**	**0.561**		**2.886**	**0.007**
	Preventive Controls	**0.247**	**0.049**	**0.666**	**5.066**	**0.000**

From table 5 the β1 is established to be 0.247. This was done at 95% confidence interval and measured by the t statistic at 32 degrees of freedom. At this level, the critical value of t for a two tailed test is 2.037. This is a significantly lower value than the t for the PIC coefficient, β1 of 5.066. Given that the t value is greater than the critical t, the study rejects the null hypothesis that preventive internal controls barely influence market performance and concludes that these controls have a significant effect on the market returns of the companies listed at the Nairobi Securities Exchange. This finding is corroborated by the P-value of 0.000 which is less than the critical significance value of 0.05. Again based on the p-value the null hypothesis is rejected and it is concluded that preventive internal controls positively affect the market performance of public companies in Kenya.

5. CONCLUSION AND RECOMMENDATION

Conclusion

Preventive internal controls were represented by a preventive internal controls index based on conditions set within the internal control systems as deterrent measures against fraud and errors. The findings from a mean percentage perspective showed that the controls were generally very strong and way above average at 66.17%. This however suggests that there is room for improvement and that public companies can come up with even stronger preventive controls to enhance their internal control systems.

Preventive internal controls are those measures that are set in place to deter occurrences of errors and deceptions in the operations of business and other organizations. The findings of the study were that these were very strong among the listed companies at the NSE. The research rejected the null hypothesis that preventive internal controls have no significant effect on market performance of companies listed at the Nairobi Securities Exchange. It is therefore concluded that the strength of the preventive internal controls have a significant influence on the market performance of public companies in Kenya.

The implication of this is that the strength of preventive internal controls is a market priced information risk factor and that the stronger the preventive internal controls, the better the market performance of the companies and vice versa. It is therefore concluded that preventive internal controls have a positive influence on the market performance of companies listed at the Nairobi Securities Exchange.

Recommendation

It emerged from the study that preventive internal controls are priced by the market through positively affecting market performance of the shares trading at the stock market. It is therefore recommended that companies put in place measures to strengthen the preventive and that companies find a way of reporting about the same to investors and financial analysis's in the stock market. Such communication can be through financial statements or public pronouncements by the public companies. This will help investors capture this information and use it in the making of their investment decisions with respect to buying, holding or selling their investment in shares of listed companies.

From a descriptive analytical point of view, it was observed that the market returns from the cross section of companies listed at the Nairobi Securities Exchange was wide and varied. They may be due to the wide variety of businesses and sizes. It is however recommended that the Capital Market Authority must undertake measures to reduce the volatility of returns among public companies so as to reduce the investment risk. This is likely to make the stock market a more attractive investment avenue for a majority of investors in Kenya and the diaspora who are largely risk averse.

Areas of Further Research

Firstly the study focused on companies listed at the Nairobi Securities Exchange. This means the non-listed firms were not considered yet they still have internal controls that can be priced indirectly by markets. It is therefore recommended that a study be undertaken to evaluate the influence of preventive controls on the value of non-public companies in Kenya and possibly across the East African area.

Secondly, the study was fashioned as a cross sectional study. This is because the methodology and data collection made use of a questionnaire for data gathering and therefore a time series study could not be possible under the timelines of the study. It is therefore suggested that a similar study be undertaken to take into account both time series and cross sectional effects. The panel analysis would help bring out the cross sectional and time series implications on values of firms be they listed on unlisted.

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