

Corporate governance and internal controls over financial reporting in Ugandan MFIs

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Abstract

Purpose – The purpose of this paper is to investigate the relationship between corporate governance and internal controls over financial reporting (ICFR) of microfinance institutions (MFIs) in Uganda.

Design/methodology/approach – This study was cross-sectional and correlational. In all, 70 Ugandan MFIs were surveyed and the data were analyzed using SPSS Version 20 to test the nine hypotheses which were put forward. The hypothesized relationships were tested using the ordinary least squares regression.

Findings – The findings based on multiple regression analysis suggest that board role performance, expertise and Association of Microfinance Institutions in Uganda (AMFIU) membership are significant predictors of the ICFR. However, board independence and separation of CEO and chairman roles are not significant predictors. The results also show that the firm-specific control variables (auditor type, size, accounting qualification and age) are also not significant.

Research limitations/implications – This study has limitations in that it is cross-sectional, thus limiting monitoring changes in behavior over time and also because the effectiveness of the ICFR was assessed using perceptions.

Practical implications – Efforts by regulators and other stakeholders to improve the ICFR must focus on the corporate governance aspects such as board expertise and ensure that the board performs its roles.

Originality/value – The paper adds to the existing literature on the corporate governance and ICFR by documenting the relationship between the corporate governance and ICFR. The study complements the previous studies on the ICFR by demonstrating that board expertise and board role performance improve the ICFR. Such evidence does not currently exist. The findings also indicate that an MFI which is a member of AMFIU was found to have better ICFR supporting self-regulation.

Keywords Corporate governance, Microfinance, Internal controls over financial reporting

Paper type Research paper

Introduction

The demand for an improvement in the quality of financial reporting has led regulators to look for mechanisms that will improve financial reporting (Onumah *et al.*, 2012). The emphasis at the moment is being placed on improving the internal controls over financial reporting (ICFR) as a method of achieving quality reporting. ICFR are controls designed to address risks that are related to financial reporting. They consist of all the controls that are designed to provide reasonable assurance that the entity's financial statements are reliable and prepared according to the generally accepted accounting practices. Examples of ICFR include employment of qualified staff in the accounting department, supervision of accounting personnel, reconciliations segregation of duties and others (Doyle *et al.*, 2007). The reliability of financial reporting is a function of effective internal controls (Public Companies Accounting Oversight Board (PCAOB), 2004). Ashbaugh-Skaife *et al.* (2007) argue that if a firm has weak internal controls, managers are not able to make reliable accrual estimates necessary to produce high-quality earnings and other financial information. Doyle *et al.* (2007) assert that weak internal controls lead to



low-quality accounting accruals from intentional mis-statements and unintentional accounting errors. Weak ICFR undermine management's ability to make well informed decisions as well as damaging management's credibility with shareholders, regulators and the public. On the whole, weak internal controls give managers an opportunity to manipulate earnings which leads to distorted financial information.

The study of ICFR in the micro finance sector in Uganda is very important. With the transformation of microfinance institution (MFIs) from NGO status to regulated MFIs (Ledgerwood and White, 2006), there is need for increased external funding which puts pressure on the internal control system and places new demands on the quality of management and corporate governance. Further, with the decrease in external funding opportunities available, funds will only be available to MFIs that demonstrate good governance. As noted by Ashbaugh-Skaife *et al.* (2009), firms with effective internal controls are rewarded by a lower cost of capital. Moreover, many MFIs in Uganda accept savings/deposits from members even if they are not regulated by any government agency/Central Bank which increases the vulnerability of savers and other stakeholders. In such an environment where the regulatory mechanisms are weak (World Bank, 2014), strong corporate governance mechanisms and ICFR become the only credible mechanisms of protecting the investors (Kosgei *et al.*, 2014).

The MFIs in Uganda have been found to have poor ICFR. Research by the Department for International Development (DFID, 2007) indicates that many savings and credit cooperatives (which are examples of MFIs) have weak internal controls allowing errors and omissions to go on for long before they are detected. This is exacerbated by the low-staffing levels making segregation of duties very difficult. As a result, it is common to find one person initiating a transaction, approving it and also making a payment. DFID (2007) further indicates that the management board is expected to supervise the work of staff, but lack the technical capacity to do so.

Literature indicates that corporate governance practices might explain the existence of weak internal controls in the MFIs (Zhang *et al.*, 2007; Mitra and Hossain, 2011; Hoitash *et al.*, 2009). Goh (2009) suggests that corporate governance characteristics such as audit board quality are associated with timeliness in remediation of internal control weaknesses. Krishnan and Visvanathan (2007) add that the quality of governance and external auditors play important roles in maintaining good internal controls that are critical to the integrity of financial reporting. The same position is presented by Hoitash *et al.* (2009) that board and audit board characteristics are associated with internal control quality. Despite a number of prior researches on corporate governance and ICFR, the findings are mixed. For instance, Doyle *et al.* (2007) finds no significant impact of eight corporate governance attributes on internal control disclosures. Moreover, the findings of Krishnan and Visvanathan (2007) also indicate that board independence, proportion of ownership of CEO, CEO duality, auditor type were not significant predictors of internal control disclosures. On the other hand, the findings Beasley (1996) suggest that the inclusion of outside members on the board increases effectiveness of monitoring management for the prevention of financial statement fraud. Empirically, this demonstrates mixed findings and majority of these studies have been carried out in listed firms. As a result, it is not clear whether corporate governance attributes studied in the listed firms would equally yield the same results in non-listed firms like the MFIs in Uganda.

This paper makes the following contributions to the accounting literature. First, we broaden the literature on corporate governance and the ICFR by focusing on Uganda. Prior studies on corporate governance and ICFR have focused on the disclosures of weaknesses in the internal control system in the developed countries where the regulatory mechanisms are strong. While in the developed countries, e.g. USA, reporting on the ICFR is a requirement for public companies, in Uganda there are no regulatory requirements to

make such disclosures even for listed firms on the stock exchange. This presents an opportunity to study internal controls and corporate governance in an environment with a different regulatory regime, specifically where the regulatory environment is weak. Moreover, to the best of our knowledge, no published study has examined the impact of corporate governance on the ICFR in the micro finance sector in Uganda. Our study therefore adds to the dearth of the literature on the efficacy of corporate governance in improving the ICFR in Uganda.

Prior studies by Bryan and Lilien (2005), Zhang *et al.* (2007), Mitra and Hossain (2011), Doyle *et al.* (2007) and Hoitash *et al.* (2009) have assessed the effectiveness of ICFR using the disclosures made by management. In view of the fact that there is no regulation requiring disclosures of the ICFR required in Uganda, the measurements are expected to differ. We assessed the quality of the ICFR using the five dimensions as required by the Board of Sponsoring Organizations of the Treadway Commission (COSO) framework (internal control environment, control activities, information and communication, monitoring and risk assessment) and questions relating to each dimension were anchored on a six-point Likert scale.

The regulatory framework of MFIs in Uganda

The regulatory and supervisory framework for micro finance industry in Uganda is formulated under the tiered approach. The tiered approach reflects the concept of microfinance as a line of business. Microfinance intuitions are found under Tiers 3 and 4, as categorized by the Bank of Uganda. MFIs in Tier 3 are deposits taking institutions, regulated by the Central Bank of Uganda under Micro Deposit Taking Institutions Act (MDI) of 2003. Under the MDI Act the board is responsible for good corporate governance. The board is also tasked to reporting to shareholders at the AGM that the internal controls provide reasonable assurance as to the integrity and reliability of the financial statements. Further, the MDI Act mandates the external auditor to warn the board in case there are no adequate internal controls.

MFIs in Tier 4 which include SACCOs, NGOs, limited companies and others are not regulated by the Central Bank of Uganda although the regulation is underway. It is important to note that these different MFIs in Tier 4 have the respective legislations under which they are formed, for instance SACCOs are regulated under the Cooperative Act of 1991. The duty of the board/board members under the Cooperative Act in relation to the ICFR is not explicit as it is in the MDI Act. For MFIs that are registered as companies, they are regulated by the Companies Act of 2012. The Act is also silent on the role of the board on the ICFR. However, it indicates that the balance sheet has to be signed by two directors on behalf of the board. We therefore expect that MFIs in Tier 4 will have poor governance and weak ICFR.

Corporate governance guidelines for MFIs in Uganda

As stated above, MFIs operating in Uganda can operate as NGOs, companies and SACCOs. The Companies Act as revised in 2012 provides for the corporate governance practices under Section 14 and Table F. The code of corporate governance supplements the substantive provisions of the Act on the composition and responsibility of the board directors. The code also requires the division of responsibility of the chairperson and CEO. The code is however only enforceable against a public company while private companies have the option to adopt the code or not. With the exception of Equity Bank, MFIs that are registered as companies are private thus the enforceability of the code is limited.

For MFIs that are registered as SACCOs, the Cooperative Act of 1991 provides for the committee in proxy which is the board. In general little guidance is given by this Act regarding current corporate governance practices, for instance the Act does not indicate any information relating to audit committees, internal audit, qualification of directors, etc.

However, the Act specifies the roles of the board and usually the chairman of the board is not the CEO. However, there are cases where both roles are combined especially in societies which are small and probably due to lack of enforcement. This is not a surprise as Lynham *et al.* (2006) noted that improvements in corporate governance in Africa are very difficult to achieve in the absence of stringent regulatory structures. Similarly, the findings by Wanyama *et al.* (2009) indicated that the level of implementation of the corporate governance guidelines is poor due to lack of appropriate framework to support implementation and enforce compliance.

Literature review

Theory and prior studies

The majority of studies linking corporate governance structures and internal controls have been founded on the agency theory (Mitra and Hossain, 2011). The agency theory primarily deals with the principal-agent relationship (also referred to as the agency relationship) existing in the separation of ownership and management, or in the separation of risk-bearing, decision-making and management functions (Jensen and Meckling, 1976; Morris, 1987). Corporate governance and quality ICFR are intended to resolve problems and issues that arise from the principal-agent relations of self-interest. Shareholders and other stakeholders may employ a range of corporate governance mechanisms to help reduce the agency costs such as appointing independent directors on the board, CEO different than chairman, and reporting on the internal control system. Indeed, the PCAOB (2004) notes that an effective internal control imposed by an active governance mechanism can mitigate the adverse effect of agency problems on reported accounting numbers because internal controls are designed to provide reasonable assurance about the reliability of reported financial information in accordance with GAAP. The “model of man” underlying the agency theory is that of self-interested actor rationally maximizing personal economic gain. According to Donaldson and Davis, there are other “models of man” who originate in organizational psychology and organizational sociology. This introduces the stewardship theory as an alternative theory that can be used to explain governance. The stewardship theory advocates the CEO being the chairman and the organization will enjoy the benefits of unity of direction. The role of the board according to the stewardship theory is to guide management to achieve the corporate mission and objectives. The stewardship theory dismisses the need for control mechanisms as they are seen as counterproductive (Hernandez, 2012) because stewards are acting in the best interests of the principals.

Hypotheses development

Board independence. The board of directors receives its authority over internal controls and other decisions from the shareholders of the corporation. As representatives of owners, the board is responsible for supervising the financial reporting function which extends to the ICFR (Hoitash *et al.*, 2009). The responsibilities of the owners are delegated to the board because shareholders generally diversify their risks by owning securities in different firms and this creates a challenge of monitoring (Fama, 1980). As stated by Beasley (1996), although the board delegates its decision management functions to top management, the board retains the ultimate control over top management. Such control includes board’s right to ratify and monitor important decisions. Consequently, the board assumes responsibility for establishing appropriate internal control system within the firm and monitoring top management’s compliance with the system. Krishnan (2005) argues that an entity’s internal control is a function of the quality of its control environment and that includes the board of directors and the audit committee.

Board independence refers to the extent to which the board is comprised of the non-executive directors who have no relationship with the firm beyond the role of the director (Davidson *et al.*, 2005). The existence of independent directors on the board acts as a monitoring and control mechanism to the executive directors due to their opportunistic behavior (Jensen and Meckling, 1976). Outside directors are considered as decision experts, independent and not intimidated by the CEO and able to act as a positive influence over director's deliberations and decisions.

The findings of Beasley (1996) indicate that "no fraud" firms had a higher proportion of outside directors suggesting that board independence is associated with fraud prevention. Other studies relating board independence and financial reporting quality indicate that independent directors are associated with reduction in income smoothing and improve the quality of financial reporting (Lai and Tam, 2007; Shen and Chih, 2007). The findings of Dechow *et al.* (1996) indicate that companies committing fraud tended to have weaker corporate governance and a lower percentage of outside directors. Indeed, Mitra and Hossain (2011) asserts that a board comprising of more independent members and diligent members is likely to monitor management actions in corporate affairs. A board that lacks independence will find it difficult to respond to the failures of top management, including failures in the internal control system:

H1. Board independence is positively associated with the sound ICFR.

Board role performance. The corporate governance literature recognizes different roles of the board in decision making. The resource dependence theory and stakeholder theory emphasize resource allocation and boundary spanning roles of the boards. On the other hand, the agency theory focuses on board roles to mitigate agency problems and to monitor management. The involvement of directors in the strategic course of the entity is mainly explained by stewardship theory. Maassen (1999), Zahra and Pearce (1989) and Babić *et al.* (2011) suggest three roles of the board, which are the strategic, service and control roles. The service roles of the board include co-opting external influencers, establishing of contacts, enhancing the organization's reputation and giving advice to the organization (Mintzberg, 1983). In the service role, the board is expected to secure linkages to various stakeholders with the purpose of diffusing power of external influencers and securing critical resources of the corporation. Indeed, Nkundabanyanga and Ahiauzu (2012) confirm that the board of Ugandan service firms should act as a source of knowledge reinforced by the number of contacts they access and requisite experience and expertise on particular issues relevant to the challenges organizations face. The control role involves selecting a chief executive officer, exercising control during a crisis and reviewing managerial decisions and performance. However, the findings of Nkundabanyanga and Ahiauzu (2012) for Uganda's setting favored the stewardship theory which argues that interests of managers and members of the board are not in conflict as the control role seems to suggest.

The board's responsibility toward internal controls extends to assessing the risks facing the entity; the probability of such risks materializing; the entity's ability to reduce the impact of the risks; and the costs and benefits that are related to operating controls (Zaman, 2001). Further, in its monitoring role, the board is expected to encourage high-quality financial information in order to avoid expropriation by one party (management) and to align management interests with those of shareholders. An effective board that encourages high-financial reporting is expected to monitor the financial discretion and ensures that accounting choices made by management are valid (New York Stock Exchange, 2002). Dichev and Skinner (2002) further argue that the board influences the integrity of financial accounting process by providing an independent oversight over management performance

and to hold management accountable to shareholders. Epps and Ismail (2009) articulate that the board is supposed to monitor management actions and limit manager's opportunistic behavior. This opportunistic behavior especially relating to earnings management is restrained by instituting and monitoring the ICFR. It is thus expected that firms, where the board performs its roles, will choose less opportunistic and more conservative approaches as evidenced by prior research (Ahmed and Duellman, 2007; García *et al.*, 2007) as result of the strong ICFR.

It is therefore hypothesized that:

H2. Board role performance positively influences the soundness of ICFR.

CEO duality. The position of chairperson is thought to be important in improving board effectiveness (Haniffa and Cooke, 2002). The corporate governance guidelines assume that the board's ability to perform its monitoring role is weakened when the CEO is also the chairperson of the board (Davidson *et al.*, 2005). The appointment of the CEO to the position of the chair can lead to concentration of power (Beasley, 1996) and possible conflicts of interest, resulting in a reduction in the level of monitoring. Finkelstein and Daveni (1994) argue that when the CEO obtains so much power, he/she is able to use the firm for their own interests rather than those shareholders rendering the board ineffective. A CEO who is also the chairperson of the board can dominate the agenda, content of the board meetings, control the process of nominating directors, facilitating consideration of individuals who are loyal to the CEO. Since the CEO in this case will in fact be monitoring his own decisions and activities, CEO domination will reduce the board effectiveness to provide oversight over managerial decisions and activities. Also, CEO dominated boards are more likely to be associated with lower levels of monitoring management performance and a weak internal control environment. Yang and Zhao (2014) investigated CEO duality and firm performance; the results indicate that separating these roles is very beneficial to firm performance especially when competition intensifies. Jensen (1993) points out that the internal controls of a firm would fail where there is role duality, as the board cannot effectively perform its key functions including those of evaluating and firing the CEO. Kyereboah-Coleman and Biekpe (2006) indicate that when the CEO doubles as the board chairman, it leads to conflict of interest and monitoring of top management reduces having a negative impact on profitability. Likewise, Kantudu and Samaila (2015) argue that when both roles are combined, it gives the CEO ability to override the firm's internal control structure. This is too confirmed by the findings of Abbott *et al.* (2000) and Beasley (1996) who indicate that role duality is associated with financial statement fraud. This may perhaps be as a result of being able to override the existing internal controls due to the concentration of power. We thus argue that the separation of power of CEO and chairman will greatly assist in having the sound ICFR which will in turn improve the quality of financial reporting:

H3. CEO duality negatively influences the ICFR.

Financial expertise of the board. The financial reporting scandals that occurred revealed that board members either did not exercise their responsibilities or did not have expertise to understand the complexities of the businesses and financial reporting in general (Duff, 2009). Thus, it is critical that board members, especially the audit board members, have expertise in financial reporting and auditing issues (Cohen *et al.*, 2004). It is presumed that specialized experience and expertise should assist identifying key audit bottlenecks to improve the ICFR. Recent findings of Nkundabanyanga *et al.*, (2015) indicate that financial expertise was significantly associated with performance. Similarly, Michelin *et al.* (2015) argue that accounting expertise is relevant for board members not only in evaluation of management performance

(through internal and external reporting) but also in appreciating the impact of accounting procedures and information systems on the reliability of financial reporting. Moreover, accounting experts on the board promote the improvement of the ICS devoted to the quality assurance of financial reporting (Krishnan, 2005; Zhang *et al.*, 2007). Thus, it is expected that where the board has some members with accounting and financial expertise, they are likely to promote quality ICFR:

H4. Board expertise positively influences the ICFR.

Control variables

The works of Bartov *et al.* (2000) suggest that failure to control for confounding variables could lead to falsely rejecting the hypothesis when in fact it should be accepted. For this reason, we control for size, age, auditor type and accounting qualification. It has been consistently discovered that, for instance, size is associated with the quality of the ICFR. The findings of Doyle *et al.* (2007) indicate that firms disclosing internal control material weaknesses tend to be smaller, financially weaker, more complex, growing rapidly or undergoing restructurings. This position is supported by the works of Bryan and Lilien (2005) who suggest that larger firms on average have resources to dedicate to effective internal controls compared to smaller firms. Resource constraints are likely to hinder the ability of such firms to adequately staff their operations with competent personnel. We therefore expect to find better ICFR in larger firms than the small firms.

Another factor that is likely to determine the processes and procedures in place is the age of the firm. According to Doyle *et al.* (2007) older firms are more likely to have ironed out the kinks in their internal control procedures. We therefore expect to find fewer control weaknesses in older firms.

We also control for auditor type. For MFIs in Uganda, registered under the Cooperative Act of 1991, the auditor can either be a certified accountant licensed by the ICPAU or the registrar of cooperatives. These cooperative officers are not necessarily professional accountants/auditors since they are recruited as commercial officers. We thus expect strong ICFR in firms that are audited by the certified public accountants because of their expertise compared with the firms that are audited by the registrar of cooperatives.

Accounting qualification/ expertise has been associated with disclosure of internal control weaknesses in studies such as Krishnan (2005) and Goh (2009). In addition to the financial expertise of the directors, the academic background of the preparers is equally important. However, the majority of the studies have focused on the expertise of the audit board rather than the expertise of the preparers of financial statements. In this study given the fact that the audit board is not a legal requirement, we shall consider the expertise of the preparers.

In this study, we also controlled for regulatory oversight. It is expected that MFIs that are members of the Association of Microfinance Institutions in Uganda (AMFIU) have better internal controls than those who are non-members. AMFIU is the national apex of MDIs and MFIs and the voice of the micro finance industry in Uganda and its membership covers microfinance providers from all the four tiers. Superior ICFRs are expected from the AMFIU members as a result of membership eligibility requirements such as willingness to be externally audited and financial education trainings conducted by the AMFIU to members. Katto *et al.* (2014) argue that in the absence of a strong regulatory framework for MFIs especially in Tier 4, these apex bodies, such as the AMFIU, through self-regulation play a critical role in fostering corporate governance standards through the membership criteria, codes of conduct and training.

We therefore hypothesize that:

H5. Size is positively associated with the quality of the ICFR.

H6. Auditor type is positively associated with the quality of the ICFR.

- H7. The MFIs age is positively associated with the quality of the ICFR.
- H8. Accounting qualification of the preparer is positively associated with the quality of the ICFR.
- H9. An MFI belonging to AMFIU is expected to have better internal controls than a non-member MFI.

Research methodology

The population of the study was made up of 125 MFIs which are registered with the AMFIU and non-AMFIU members. A sample of 95 was generated using Yamane's formula of 1973 that guides sample selection. According to Yamane, sample size is given by $n = N/(1+N(e)^2)$ where n is a sample size, N is the total population and e is tolerable error. On the basis of Yamane's approach with a total population (N) 125 and tolerable error (e) 0.5 percent, a sample size of 95 was obtained. We used simple random sampling to select the MFI from the list. The study targeted two respondents per MFI who were the finance manager and a board member in order to limit response bias from a single individual. These two respondents were considered knowledgeable. This approach of having more than one respondent per institution has been used in previous research works of Baer and Frese (2003) and Kamukama *et al.* (2011). The board member being targeted was the manager responsible for the overall running of the MFI. Since the unit of analysis is an MFI, all responses were aggregated to an MFI during data analysis. Further, as indicated in Table II, there were no significant differences in their perceptions regarding the corporate governance and the ICFR.

Before aggregation, data were checked for completeness. Simple frequency runs were performed to screen the data so as to identify missing values. The identified missing values were replaced using linear interpolation. Data were analyzed using SPSS Version 20; Pearson correlation coefficient used to establish the hypothesized relationships and regression analysis carried out to establish the prediction potential of the independent variables (Tables I and II).

| Symbol | Variable description | Acronym |
|-----------|---|------------|
| β_1 | Average score of questions on board independence | BODIND |
| β_2 | Average score of questions on board role performance | BODPERF |
| β_3 | Average score of questions on board expertise | BODEXP |
| β_4 | A dummy variable coded as 0 if CEO is not chairman of the board and 1 if CEO is the chairman of the board | CEODUALITY |
| β_5 | A dummy variable coded as 1 if the firm is medium sized; 0 or otherwise | SIZE |
| β_6 | A dummy variable coded as 1 if the auditor is certified by ICPAU, or otherwise | AUD |
| β_7 | A dummy variable coded as 1 if the firm has been trading for ten years or over, or otherwise | AGE |
| β_8 | A dummy variable coded as 1 if the finance manager had an accounting qualification, or otherwise | ACCQ |
| β_9 | A dummy variable coded as 1 if non-AMFIU member; or otherwise | REG |
| | Internal control environment | ICFRENV |
| | Risk assessment | ICFRISK |
| | Control procedures | ICFRAC |
| | Monitoring | ICFRMON |
| | Information and communication | ICFRINFO |
| | Control role | PERFCON |
| | Service role | PERFSER |
| | Strategic role | PERSTR |

Table I.
Description of
variables in the study

| | Sum of squares | df | Mean square | F | Sig. |
|-----------------|----------------|-----|-------------|-------|-------|
| <i>ICFRENV</i> | | | | | |
| Between groups | 0.784 | 1 | 0.784 | 3.789 | 0.054 |
| Within groups | 22.331 | 108 | 0.207 | | |
| Total | 23.115 | 109 | | | |
| <i>ICFRISK</i> | | | | | |
| Between groups | 1.384 | 1 | 1.384 | 2.933 | 0.090 |
| Within groups | 50.954 | 108 | 0.472 | | |
| Total | 52.338 | 109 | | | |
| <i>ICFRAC</i> | | | | | |
| Between groups | 0.294 | 1 | 0.294 | 0.655 | 0.420 |
| Within groups | 48.516 | 108 | 0.449 | | |
| Total | 48.810 | 109 | | | |
| <i>ICFRINFO</i> | | | | | |
| Between groups | 0.354 | 1 | 0.354 | 0.837 | 0.362 |
| Within groups | 45.615 | 108 | 0.422 | | |
| Total | 45.969 | 109 | | | |
| <i>ICFRMON</i> | | | | | |
| Between groups | 1.396 | 1 | 1.396 | 3.141 | 0.079 |
| Within groups | 48.013 | 108 | 0.445 | | |
| Total | 49.409 | 109 | | | |
| <i>BODIND</i> | | | | | |
| Between groups | 0.016 | 1 | 0.016 | 0.043 | 0.837 |
| Within groups | 40.371 | 108 | 0.374 | | |
| Total | 40.387 | 109 | | | |
| <i>BODEXP</i> | | | | | |
| Between groups | 1.252 | 1 | 1.252 | 1.720 | 0.192 |
| Within groups | 78.597 | 108 | 0.728 | | |
| Total | 79.850 | 109 | | | |
| <i>BODPERF</i> | | | | | |
| Between groups | 0.625 | 1 | 0.625 | 1.774 | 0.186 |
| Within groups | 38.075 | 108 | 0.353 | | |
| Total | 38.700 | 109 | | | |

Table II.
Analysis of variance

Questionnaire

The questionnaire used constituted sections relating to background information, corporate governance and the internal controls. The background information required the respondents to indicate their education level, to indicate how long they had been in business, the number of employees, the type of auditor, etc. A six-point Likert scale was used for board expertise, board independence, board role performance and the ICFR which required respondents to indicate the extent of their agreement. To assess validity of the instrument, it was given to five experts (two academicians and three practitioners) to assess the relevancy of the questions. The practitioners included one external auditor of MFIs, a board member and an accountant. Their contribution was taken into consideration in designing the final questionnaire that we used for data collection. To ensure reliability of the instrument, the Cronbach's α test was performed. The coefficients were above 0.7 and therefore the questions were reliable (Table III).

Measures

As already highlighted, this study utilized perceptions in studying the corporate governance and the ICFR. By using perceptions to study the effectiveness of internal controls and

Table III.
Reliability of the
instrument

| Variable | No. of items | Cronbach's α |
|----------|--------------|---------------------|
| BODEXP | 5 | 0.900 |
| BODIND | 11 | 0.701 |
| PERFCON | 6 | 0.830 |
| PERFSER | 4 | 0.796 |
| PERSTR | 5 | 0.905 |
| ICFR | | |
| ICFRENV | 8 | 0.810 |
| ICFRISK | 7 | 0.867 |
| ICFRAC | 5 | 0.855 |
| ICFRINFO | 4 | 0.895 |
| ICFRMON | 6 | 0.911 |

corporate governance, our study differs from all the previous studies of Hoitash *et al.* (2009), Bryan and Lilien (2005) and Doyle *et al.* (2007). Further, some studies, for instance Hoitash *et al.* (2009), have studied corporate governance, but specifically the audit committee characteristics. In this study, we examined characteristics of the whole board since some MFIs do not have active audit committees in place.

Corporate governance was operationalized in terms of board independence, board expertise, CEO duality and board role performance. Board independence was looked at in terms of the constitution of board, whether the board had both executive and non-executive members (Beasley 1996); whether the majority of the board members were non-executive, etc. The perception-based measure was adopted because African economies are very much transitional economies (Okeahalam, 2004), thus there are instances when the board members are financially dependent on the entity where there are board members who limit independence. For instance, a report by USAID (2007) on Uganda indicated that sitting fees per board member over the course of the year was equivalent to full time professional salary. Further, this report highlights that once a board member is monetarily interested in attending the board meetings their independence is compromised. This report further highlighted the issue of loans to board members as compromising independence. According to Katto *et al.* (2014), they noted political interference in the operations of MFIs in Tier 4 since some MFIs in tier have received government support. This therefore implies that independence of board members in an African setting, specifically Uganda, may not be measured by the ratio of executive and non-executive directors alone. This therefore led to questions such as: "board members have no conflict of interest"; "our managers reward board members through unconditional loans approvals"; and "the national politics interferes with the appointment and operations of the board."

Board role performance was studied in terms of the three roles (strategic, control and service role) by Maassen (1999).

CEO duality was studied in terms of whether the roles of the CEO and chairman were performed by the same person. Board expertise was assessed in terms of whether the some board members had accounting expertise and experienced in the nature financial services.

The soundness of ICFR was assessed on the basis of five components of COSO framework, which are control environment, control activities, monitoring, information and communication and risk assessment (Amudo and Inanga, 2009; Onumah *et al.*, 2012), although the COSO framework broadly defines internal control in terms of achieving the effectiveness and efficiency of operations, the reliability of financial reporting and compliance with applicable laws and regulations. In this research, we were majorly interested in controls related to financial reporting, hence, the items in the questionnaire were biased to financial reporting.

Some items on the ICFR were derived from the COSO model requirements, for instance under information and communication; the COSO model requires that accurate information is captured, therefore two items bringing out this requirement are “the accounting system in place is able to capture all the transactions,” and “the system in place produces accurate data.”

Age of the MFI was operationalized in terms of young and old. We assumed that MFIs of ten years and above were old, while MFIs less than ten years are young. The same reasoning was used for size, as MFIs with employees below five were considered small while those above five employees were considered medium (Tables IV and V).

The model

Regression analysis was used to determine the predictive strength of the relationship between the independent variables and the dependent variable. In particular, the following regression model was tested:

$$ICFR = \beta_0 + \beta_1BODIND + \beta_2BODPERF + \beta_3BODEXP + \beta_4CEODUALITY + \beta_5SIZE + \beta_6AUD + \beta_7AGE + \beta_8ACCQ + \beta_9REG + \epsilon_j$$

where the dependent variable, ICFR, is the average score of questions on the internal controls measured on a six-point Likert scale. The variables are defined in Table I.

Results and discussion

Descriptive statistics

We generated means and standard deviations to summarize the observed data. These are presented in Table II. The statistics show that the mean rating for dependent variable (ICFR) is 5.3606 with a maximum of 6.00 and minimum of 4.05. The rest of the independent variables (AGE, AUD, ACCQ, and SIZE) are all measured dichotomously, hence the minimum is 0 and maximum is 1. In all, 70 percent of the MFIs employed more than five employees, 70 percent had their financial statements audited by a certified auditor by ICPAU and 40 percent of the MFIs had been existing for over a period of ten years while 50 percent had been existing for a period of six to ten years (Table VI).

| | 1 | 2 | 3 |
|--|--------|--------|--------|
| Our board is balanced in terms of skills | 0.894 | | |
| Some of our board members have accounting experience | 0.867 | | |
| Our board chairman does not hold substantial shares in this institution | 0.860 | | |
| We have a board with individuals who are experienced in the nature of our business | 0.858 | | |
| The board appoints the managing director/manager and can also dismiss | | 0.810 | |
| The board presides over important functions such as the annual general meeting, press meetings, etc. | | 0.795 | |
| Our board ratifies major decisions | | 0.792 | |
| The board contributes to strategy development through careful refinement of strategic plans | | 0.754 | |
| The board secures linkages with various stakeholders in the business environment | | 0.611 | |
| The majority of our board members are non-executive members | | | 0.848 |
| Board members have no conflict of interest | | | 0.747 |
| Eigenvalues | 4.601 | 1.975 | 1.234 |
| % variance explained | 31.004 | 27.736 | 12.259 |
| Cumulative variance explained | 31.004 | 58.740 | 70.999 |

Table IV.
Factor analysis for
corporate governance

Notes: 1. Board expertise; 2. Board role; 3. Independence

| | 1 | 2 | 3 | 4 | 5 |
|---|--------|--------|--------|--------|--------|
| Proper financial records and accounts are maintained in relation to the entity's operations | 0.802 | | | | |
| Transactions go through a series of checks to facilitate authorization before completion | 0.735 | | | | |
| Management has put in place mechanisms for mitigation of financial reporting risks | 0.715 | | | | |
| There are measures put in place to report unusual transactions | 0.692 | | | | |
| No employee can process a transaction alone from the start to the end | 0.691 | | | | |
| Write off of bad debts is authorized by a senior member of staff or the board | 0.645 | | | | |
| The potential for material mis-statements due to fraud is explicitly considered in assessing risks to the achievement of financial reporting objectives | | 0.850 | | | |
| The risky areas identified that affect financial reporting are ranked | | 0.848 | | | |
| Management has identified all risky areas that can result into fraudulent financial reporting | | 0.726 | | | |
| Management has identified those accounting standards where compliance is not easily achieved | | 0.718 | | | |
| The board periodically reviews policies and procedures to ensure that proper risk assessment and control processes have been instituted | | 0.629 | | | |
| The accounting system in place produces accurate financial data to enhance decision making | | | 0.840 | | |
| There is room for discussion in case there are transactions that an accountant is not sure how they should be treated | | | 0.774 | | |
| The accounting system in place is able to record and report all the transactions that take place in the institution | | | 0.772 | | |
| Financial accounting information is used at all levels of the organization | | | 0.732 | | |
| Management always provides the board complete access to bank records | | | | 0.832 | |
| Our top management is willing to report the true financial position of this institution to stakeholders | | | | 0.697 | |
| The board exercises its oversight responsibility of financial reporting | | | | 0.682 | |
| Management implements internal control recommendations made by the external auditor | | | | | 0.636 |
| The board reviews the independence of the external auditors | | | | | 0.567 |
| Eigenvalues | 11.145 | 2.221 | 1.822 | 1.423 | 1.192 |
| % variance explained | 23.125 | 17.215 | 14.991 | 9.401 | 6.483 |
| Cumulative variance explained | 23.125 | 40.340 | 55.337 | 64.732 | 71.215 |

Notes: 1. Control activities; 2. Risk assessment; 3. Info and comm; 4. Environment; 5. Monitoring

Table V.
Factor analysis for
internal controls over
financial reporting

Correlation analysis. Pearson's correlation coefficient analysis was used to establish the relationships between the study variables. The correlation analysis results are shown in Table III. The findings reveal a weak positive association between board independence and sound ICFRs ($r = 0.263$, $P < 0.05$). The results also indicate a strong significant positive relationship between board role performance and quality ICFR ($r = 0.713$). Similarly, the relationship between board expertise and quality ICFR is strong, positive and significant ($r = 0.703$, $p < 0.05$). AMFIU membership has a significant positive relationship with ICFR ($r = 0.375$, $P < 0.05$). However, findings too indicate that size, firm's age, accounting qualification are not associated with quality ICFR (Table VII).

The multiple regression results of the relationship between quality ICFR and the independent variables (board independence, board role performance, board expertise, CEO duality and control variables; size, firm age, accounting qualification and auditor type)

Table VI.
Descriptive statistics
for the independent
and dependent
variables

| Variable | Obs | Mean | Std | Min | Max |
|------------|-----|--------|---------|------|------|
| BODINDEP | 70 | 4.7302 | 6.2442 | 3.00 | 5.89 |
| BODEXP | 70 | 5.0938 | 0.8929 | 1.50 | 6.00 |
| BODPERF | 70 | 5.1560 | 0.52748 | 3.70 | 5.95 |
| ICFR | 70 | 5.3606 | 0.45869 | 4.05 | 6.00 |
| ICFRENV | 70 | 5.4473 | 0.41395 | 4.44 | 6.00 |
| ICFRISK | 70 | 5.2551 | 0.64390 | 3.29 | 6.00 |
| ICFRAC | 70 | 5.4721 | 0.56758 | 3.80 | 6.00 |
| ICFRMON | 70 | 5.3423 | 0.64888 | 3.50 | 6.00 |
| ICFRINFO | 70 | 5.0536 | 0.69794 | 3.13 | 6.00 |
| CEODUALITY | 70 | 0.585 | 0.49615 | 0.00 | 1.00 |
| AGE | 70 | 0.3429 | 0.47809 | 0.00 | 1.00 |
| AUD | 70 | 0.7000 | 0.46157 | 0.00 | 1.00 |
| ACCQ | 70 | 0.2394 | 0.42978 | 0.00 | 1.00 |
| SIZE | 70 | 0.6857 | 0.46758 | 0.00 | 1.00 |

are shown using two models. In the first model board role performance is aggregated, while in the second model the roles of the board are split (strategic, control and service role). The results in this original model indicate that the total variation in ICFR explained by the independent variables is 63.5 percent. Specifically, the results indicate that corporate governance variables (board role performance, board expertise) and AMFIU membership are significant explanatory variables of the ICFR. This means that *H2*, *H4* and *H9* are supported. The results, however, show that board independence and CEO duality are not significant explanatory variables and therefore *H1* and *H3* are not confirmed.

In respect of control variables, the results indicate that all firm-specific control variables (size, auditor type, firm age and accounting qualification) are not significant predictors of quality ICFR. This means that *H3*, *H5*, *H6*, *H7* and *H8* are not confirmed.

In Model 2, we present the three roles of the board separately; the model explains 66.1 percent of the variation in the ICFR. The model shows that the control role, board expertise and AMFIU membership are significant predictors of ICFR (Tables VIII and IX).

Discussion of findings

The significant findings in respect of board role performance suggest that when the board performs its role, we have quality ICFR. Our findings are consistent with Nkundabanyanga *et al.*, (2015) as their findings indicated that the more the board performed its role of resource provision, service, monitoring and control, the better the performance of the schools. One of the roles of the board is assessment which involves monitoring the intrinsic ability of top management. The monitoring of managerial actions is a part of the board's obligations against managerial malfeasance. We, as a result, expect the monitoring by the board to extend to the well-functioning of the ICFR, as the self-serving behavior of management is reduced. Our results in Table IX, when the three board roles are not aggregated, the control is the only role that significantly influences the ICFR. This implies that the control role contributes more to the better functioning of internal controls than the service and strategic role.

One of the control roles of the board is ensuring that management is acting in the best interests of the owners. The board is able to carry out this role through its choice of the external auditor. Through its choice of the auditor, the board exercises its oversight over financial reporting requirements and controls all the accounting practices. Cohen *et al.* (2008) argues that the external auditor plays a significant role in monitoring financial reporting quality, and hence can be viewed as an important participant in the governance process. According to Kaawaase (2013), the board carries out its monitoring role by inquiring about

| | BODINDEP | BODEXP | BODPERF | CEODUALITY | ACCQ | AGE | SIZE | AUD | REG | ICFR |
|------------|----------|---------|---------|------------|---------|-------|-------|-------|---------|------|
| BODINDEP | 1 | | | | | | | | | |
| BODEXP | 0.449** | 1 | | | | | | | | |
| BODPERF | 0.099 | 0.647** | 1 | | | | | | | |
| CEODUALITY | -0.317** | 0.148 | 0.353** | 1 | | | | | | |
| ACCQ | 0.014 | 0.022 | 0.208 | -0.065 | 1 | | | | | |
| AGE | -0.206 | 0.378** | 0.129 | 0.058 | 0.047 | 1 | | | | |
| SIZE | 0.025 | 0.108 | 0.123 | -0.007 | 0.153 | 0.100 | 1 | | | |
| AUD | 0.346** | -0.060 | 0.095 | 0.335** | 0.433** | 0.144 | 0.027 | 1 | | |
| REG | 0.096 | 0.121 | 0.270** | -0.309** | 0.169 | 0.112 | 0.035 | 0.210 | 1 | |
| ICFR | 0.263* | 0.703** | 0.713** | 0.346** | 0.169 | 0.183 | 0.132 | 0.036 | 0.375** | 1 |

Notes: **Correlation is significant at the 0.05, 0.01 level respectively (2-tailed)

Table VII.
Correlation results

Table VIII.
Results of multiple regression analysis

| Source | SS | df | MS | | | | | |
|------------|--------|-------|---------|-------|-------------|-------------|-------|--|
| Model | 9.908 | 9 | 1.101 | | | | | |
| Residual | 4.610 | 60 | 0.077 | | | | | |
| Total | 14.517 | 69 | | | | | | |
| | Coef. | SE | t-value | Sig. | Lower bound | Upper bound | VIF | |
| (Constant) | 2.251 | 0.456 | 4.934 | 0.000 | 1.338 | 3.163 | | |
| BODIND | 0.110 | 0.070 | 1.574 | 0.121 | -0.030 | 0.250 | 1.716 | |
| BODEXP | 0.202 | 0.063 | 3.222 | 0.002 | 0.077 | 0.327 | 2.812 | |
| BODPERF | 0.286 | 0.095 | 3.007 | 0.004 | 0.096 | 0.476 | 2.256 | |
| CEODUALITY | 0.106 | 0.084 | 1.257 | 0.214 | -0.063 | 0.275 | 1.577 | |
| ACCQ | 0.011 | 0.090 | 0.119 | 0.906 | -0.190 | 0.169 | 1.350 | |
| AGE | 0.040 | 0.078 | 0.506 | 0.615 | -0.117 | 0.197 | 1.264 | |
| SIZE | 0.047 | 0.073 | 0.637 | 0.527 | -0.100 | 0.193 | 1.048 | |
| AUD | 0.085 | 0.086 | 0.989 | 0.327 | -0.087 | 0.258 | 1.427 | |
| REG | 0.228 | 0.088 | 2.594 | 0.012 | -0.404 | 0.520 | 1.586 | |

Notes: Number of obs = 70; $F = 14.328$; Prob > 0.000; $R^2 = 0.682$; Adj. $R^2 = 0.635$; Durbin Watson = 1.506; MSE = 0.27718

Table IX.
Results of multiple regression analysis (board roles are split)

| Source | SS | df | MS | | | | | |
|------------|--------|-------|---------|-------|--------------------|-------------|-------|--|
| Model | 10.375 | 11 | 0.943 | | | | | |
| Residual | 4.142 | 58 | 0.071 | | | | | |
| Total | 14.517 | 69 | | | | | | |
| ICFR | Coef. | SE | t-value | Sig. | 95% conf. interval | | VIF | |
| | | | | | Lower bound | Upper bound | | |
| (constant) | 2.391 | 0.441 | 5.419 | 0.000 | 1.1508 | 3.275 | | |
| BODINDEP | 0.019 | 0.073 | 0.259 | 0.797 | -1.127 | 0.165 | 2.104 | |
| BODEXP | 0.245 | 0.064 | 3.804 | 0.000 | 0.116 | 0.374 | 3.191 | |
| PERFCON | 0.424 | 0.114 | 3.718 | 0.000 | 0.196 | 0.653 | 3.223 | |
| PERFSER | 0.170 | 0.103 | 1.659 | 0.103 | 0.376 | 0.035 | 3.570 | |
| PERFSTR | 0.047 | 0.075 | 0.619 | 0.539 | 0.104 | 0.197 | 3.237 | |
| CEODUALITY | 0.122 | 0.082 | 1.476 | 0.145 | 0.043 | 0.287 | 1.616 | |
| ACCQ | 0.086 | 0.092 | 0.932 | 0.355 | 0.270 | 0.704 | 1.526 | |
| AGE | 0.109 | 0.078 | 1.391 | 0.170 | -0.048 | 0.265 | 1.345 | |
| SIZE | 0.011 | 0.073 | 0.155 | 0.877 | -0.134 | 0.157 | 1.113 | |
| AUD | 0.043 | 0.085 | 0.507 | 0.614 | -0.127 | 0.213 | 1.483 | |
| REG | 0.182 | 0.086 | 2.108 | 0.039 | -0.354 | 0.009 | 1.641 | |

Notes: Number of obs = 70; $F = 13.206$; Prob > 0.000; $R^2 = 0.715$; Adj. $R^2 = 0.661$; Durbin Watson = 1.523

the quality procedures, assessing the skills and experience of the proposed audit teams. Further, Hay *et al.* (2006) and Carcello *et al.* (2002) argue that quality boards insist on an expanded audit scope and vigorously monitor the audit process. Other control roles of the board include the board evaluating the performance of management and communicating the successes and failures. Through the evaluation of management performance, management will be under pressure to put in place proper systems such as the ICFR.

Further, our results also indicated that an MFI that is a member of AMFIU has better ICFR than an MFI which is not a member. This implies that the self-regulatory functions of AMFIU, such as settings standards through eligibility requirements and capacity building, have a positive impact on the ICFR in MFIs. MFIs that are members of AMFIU are able to share information on the best practices in the industry which improves the ICFR of members.

The results relating to board expertise suggest that when board members have expertise (are experienced in the nature services provided by the MFI, have accounting expertise, are also directors in other entities), they are able to institute proper ICFR. Boards with

financial expertise have been linked to market advantages and consistent financial reporting as they are able to deal with the complexities of financial reporting. When the board members are experienced, they are able to provide the right strategic direction and bring ideas on how to improve performance. Certainly, directors with expertise are able to interpret the recommendations of auditors (internal and external) in relation to improving the ICFR. Moreover, such boards are more likely to understand auditor judgments and support the auditor in auditor-management disputes than members without such knowledge. Further, board members with financial expertise are likely to be aware of the regulatory requirements governing financial reporting. For example, the Accountants Act of 2013 requires the head of accounts, finance and internal audit, to be members of Institute of Certified Public Accountants of Uganda for public and private institutions with public interest, which when implemented enhances the ICFR. Second, board members with financial expertise are also likely to be aware of their role of monitoring the effectiveness of ICFR.

Our findings agree with the findings of Nkundabanyanga *et al.*, (2015) which suggest that school boards should have the requisite knowledge on how schools are managed. Similarly, the findings of Agrawal and Chadha (2005) and Kaawaase (2013) suggest that financial expertise on boards is associated with lower incidence of restated earnings and audit quality, respectively. These restatements generally result from fraud or various types of errors discovered after the financial statements have been issued (Kalbers, 2009), which could be an indication of weak ICFR (Bryan and Lilien, 2005). Further, this finding supports the requirement of Institute of Corporate Governance of Uganda (2008) which recommends a board to be composed of qualified individuals who reflect a diversity of training, experience and background. It is therefore concluded that the experience of the board can lead to greater assurance as far as the effectiveness of the ICFR is concerned, as these experienced directors will demand better financial reporting systems in place.

The findings show that board independence was an insignificant explanatory variable for the ICFR. In our study, audit was a multidimensional construct operationalized in terms of board tenure characteristics, constitution of the board in terms of the executive and non-executive directors, and clear separation of roles of management and the board. Our findings have contradicted previous studies, such as He *et al.* (2009); Beasley (1996); Beasley *et al.* (2000), which indicate board independence increases the board's ability to monitor management, reduction in financial statement fraud and enhanced disclosure. However, the findings of Krishnan (2005) and Zhang *et al.* (2007) also indicated that the independence of the audit committee was not associated with the disclosure of material weaknesses regarding the ICFR. Our results should be interpreted with caution as our measurements differed. Majority of the studies operationalize board independence as a proportion of non-executive directors to the total number of directors. In this study, board independence was multidimensional as indicated above.

In respect of control variables, our results which suggest that size is positively associated with the ICFR contradict those reported in prior studies such as Mitra and Hossain (2011), Bryan and Lilien (2005) and Doyle *et al.* (2007). Our results may be varying from previous studies due to the differences in the way size was measured. In the majority of the studies above, size was measured in terms of total assets, sales turnover and market value of equity. In this study, we used number of employees to measure size. Another control variable considered in this study is firm age. From literature, it was expected that this control variable would predict the ICFR as older firms have experience, therefore better the ICFR. In this research, firm age does not significantly predict the ICFR. This could be due to the fact that even young MFIs are trying to improve their ICFR to enhance legitimacy to access critical resource for investment (Appiah *et al.*, 2016). The accounting qualification of the preparers never had a significant association with the ICFR. Parry and Groves (1990) in their assessment of whether the employment of qualified accountants had any impact on the quality of financial reporting had no significant association. Abayo and Roberts (1993)

believe that the qualification alone may not be the only solution to problems facing developing countries with respect to inadequate accounting systems. In this regard, even when the finance director is qualified, the environment within the MFI may hinder the proper functioning of the control procedures. However, our findings contradict previous studies that have been carried out, which indicate the importance of accounting qualifications on accounting information quality (Lin *et al.*, 2006; Mangena and Pike, 2005; Taurigana *et al.*, 2008). Another probable reason for the insignificance of control variables could be that once the board has expertise and it is performing its roles, then factors like age and size of the MFI are not critical in attaining proper ICFR.

Summary and conclusion

The aim of this study was to investigate the relationship between the corporate governance and the ICFR. We surveyed 95 MFIs, both AMFIU and non-AMFIU members. Our findings suggest that corporate governance characteristics (board role performance, expertise and CEO duality) are significantly associated with the ICFR. However, board independence and all our firm-specific characteristics control variables (auditor type, size, accounting qualification and age) are not associated with the ICFR. Overall, these results have important implications for stakeholders such as shareholders, Government of Uganda and the different regulators of MFIs. For the regulators such as the Ministry of Trade, registrar of companies, our findings suggest that great attention has to be paid to the composition of the board of the MFIs in terms of its expertise. As the Central Bank approves newly appointed board members, the same should be done with these other regulators of MFIs if better ICFR are to be realized. Second, as new legislation for MFIs is underway (Katto *et al.*, 2014), these findings imply that in the new legislation the board roles should be explicitly stated plus laying expertise requirements for board members. Third, the issue of a regulating body for MFIs in Tier 4 can no longer be ignored. AMFIU is self-regulating, but our results have shown that membership improves the ICFR, implying that an external regulating authority established by government responsible for licensing and supervising these MFIs would provide tremendous results in the MFI industry.

Like any study, there are a number of limitations with the present study and the findings should be interpreted in the light of these limitations. First, the data are cross-sectional thus limiting monitoring changes in behavior over time. We utilized perceptions in measuring board independence, board expertise, board role performance and ICFR. The operationalization of variables, like board independence, is unique compared to existing literature, hence when comparing our findings with previous studies this should be taken into consideration. Second, all our control variables, except AMFIU membership, were found not to be associated with the ICFR. This is especially surprising given that size has been found to be consistently found to be associated with the ICFR. More research is therefore needed to better refine the measurements used in the study.

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Appendix. Research questionnaire

Dear respondent,

I am undertaking a research study on Corporate Governance and Internal Controls over Financial Reporting in Micro Finance Institutions in Uganda. This is entirely for academic purposes. I kindly request you to complete this questionnaire and all responses will be treated with a high level of confidentiality. Your kind cooperation is highly appreciated.

Thank you.

Background information of the respondent

1. Name of Institution
2. Branch.....
3. Highest academic qualification attained of the respondent

| UACE | Certificate | Diploma | 1 st Degree | Masters | PhD |
|----------|-------------|----------|------------------------|----------|----------|
| 1 | 2 | 3 | 4 | 5 | 6 |

4. Professional qualification possessed by the finance director
 a) ACCA b) ATC/CAT c) CPA d) None d) Others

5. Age of the respondent

| 25 years and below | 26-35 years | 36-45 years | 46-55 years | Above 55 years |
|--------------------|-------------|-------------|-------------|----------------|
| 1 | 2 | 3 | 4 | 5 |

6. Gender of the respondent a) Male b) Female

7. Designation of the respondent
 a) Finance Manager b) Board member

8. How long have you worked with this organization
 a) Less than 1 year to 5 years b) 6-10years c) 11-15 years
 d) Above 15 years

9. Number of years the Financial Institution has been operating in Uganda
 a) Less than 1 year to -5 years b) 6-10 years c) 11-15 years
 d) Above 15 years

10. Indicate the number of employees in the Financial Institution
 a) 4 and below employees b) 5-50 employees c) Above 50 employees

11. Name of the external auditors for the financial year 2013/2014.....

12. Size of the audit firm
 a) Big four member b) Small firm (1-2 partners) c) Medium sized firm (3+ partners)
 d) Cooperative registered auditors

This section has statements about ethical culture, corporate Governance, expected utility, deterrence measures and compliance with accounting standards. You are provided with a scale of six options. Kindly tick (√) once the choice suits the statement in the space provided.

| INTERNAL CONTROLS OVER FINANCIAL REPORTING | | Strongly Disagree | Disagree | Somewhat Disagree | Somewhat Agree | Agree | Strongly Agree |
|--|---|-------------------|----------|-------------------|----------------|-------|----------------|
| Internal control environment | | | | | | | |
| IC1 | Our top management is willing to report the true financial position of this Institution to stakeholders. | | | | | | |
| IC2 | The board exercises its oversight responsibility of financial reporting. | | | | | | |
| IC3 | Our top management is enthusiastic about presenting the true financial position of the entity. | | | | | | |
| IC4 | The board periodically reviews policies and procedures to ensure that proper risk assessment and control processes have been instituted. | | | | | | |
| IC5 | There is always collective board decision making. | | | | | | |
| IC6 | Management always provides the board complete access to bank records. | | | | | | |
| IC7 | The board reviews the independence of the external auditors. | | | | | | |
| IC8 | The company's organizational structure supports effective internal controls over financial reporting. | | | | | | |
| Risk assessment | | | | | | | |
| IC9 | Management has identified all risky areas that can result into fraudulent financial reporting. | | | | | | |
| IC10 | The potential for material misstatements due to fraud is explicitly considered in assessing risks to the achievement of financial reporting objectives. | | | | | | |
| IC11 | Management has identified those accounting standards where compliance is not easily achieved. | | | | | | |
| IC12 | The risky areas identified that affect financial reporting are ranked. | | | | | | |
| IC13 | Management has put in place mechanisms for mitigation of financial reporting risks. | | | | | | |
| IC14 | Management is aware of the objective of financial reporting. | | | | | | |
| IC15 | There are measures put in place to report unusual transactions. | | | | | | |
| Control activities | | | | | | | |
| IC16 | No employee can process a transaction alone from the start to the end | | | | | | |
| IC17 | Transactions go through a series of checks to facilitate authorization before completion. | | | | | | |
| IC18 | Write off of bad debts is authorized by a senior member of staff or the board. | | | | | | |
| | | Strongly Disagree | Disagree | Somewhat Disagree | Somewhat Agree | Agree | Strongly Agree |
| IC19 | Staffs that handle finances are regularly rotated. | | | | | | |
| IC20 | There is adequate supervision of finance staff while carrying out their duties. | | | | | | |
| Information and communication | | | | | | | |
| IC21 | Financial Accounting information is used at all levels of the organization. | | | | | | |
| IC22 | An accountant is free to consult in case there are transactions an accountant is not sure how they should be treated | | | | | | |
| IC23 | The accounting system in place is able to capture all transactions | | | | | | |
| IC24 | The system in place produces accurate data | | | | | | |
| Monitoring | | | | | | | |
| IC22 | Internal controls relating to financial reporting are evaluated often with the changing environment. | | | | | | |
| IC23 | Management implements internal control recommendations made by the external auditor. | | | | | | |
| IC24 | This Institution has a designated board to deal with weaknesses raised by the external auditor. | | | | | | |
| IC25 | Management gives appropriate and timely attention to material control weaknesses once identified. | | | | | | |
| IC26 | There are regular checks to ensure compliance with the internal controls. | | | | | | |
| IC27 | Ineffective or unnecessary controls have been identified and eliminated. | | | | | | |

| CORPORATE GOVERNANCE | | | | | | | |
|----------------------------------|---|-------------------|----------|-------------------|----------------|-------|----------------|
| Board Independence | | | | | | | |
| CG1 | Our board is constituted of both executive and non executive members. | | | | | | |
| CG2 | The majority of our board members are non executive members. | | | | | | |
| CG3 | Board members have no conflict of interest. | | | | | | |
| CG4 | The national politics interferes with the appointment and operations of the institution's Board | | | | | | |
| CG5 | The Managers of this institution influence Board members to take decisions in their favor. | | | | | | |
| CG6 | Our managers reward board members through unconditional loan approvals. | | | | | | |
| CG7 | We have a dominating board chairman. | | | | | | |
| CG8 | We have clear separation of roles between the board and management. | | | | | | |
| CG9 | Our board chairman does not hold substantial shares in this Institution. | | | | | | |
| CG10 | The tenure of our board members is well defined | | | | | | |
| CG11 | All the board members are appointed on contract basis. | | | | | | |
| Board financial expertise | | | | | | | |
| CG12 | We have a board with individuals who are experienced in the nature of our business. | | | | | | |
| CG13 | Some of our board members have accounting experience. | | | | | | |
| CG14 | Some of board members have expertise in financial services activities. | | | | | | |
| CG15 | Most of our board members are also board members in other entities | | | | | | |
| CG16 | Our board is balanced in terms of skills. | | | | | | |
| | | Strongly Disagree | Disagree | Somewhat Disagree | Somewhat Agree | Agree | Strongly Agree |
| Board role Performance | | | | | | | |
| Control role | | | | | | | |
| CG17 | Our board of members delegates authority to management and monitors its implementation. | | | | | | |
| CG18 | The board monitors managers' activities to ensure that they are acting in the interest of owners. | | | | | | |
| CG19 | The board appoints the managing director/manager and can also dismiss. | | | | | | |
| CG20 | Our board monitors management performance. | | | | | | |
| CG21 | Our board ratifies major decisions. | | | | | | |
| CG22 | Our board members ensure that senior management's successes and failures are communicated | | | | | | |
| Service role | | | | | | | |
| CG23 | The board secures linkages with various stakeholders in the business environment. | | | | | | |
| CG24 | The board represents the Institution's interests in the community. | | | | | | |
| CG25 | The board presides over important functions such as the Annual General Meeting, press meetings etc. | | | | | | |
| CG26 | The board contributes to strategy development through careful refinement of strategic plans. | | | | | | |
| Strategic role | | | | | | | |
| CG27 | The board requires management to have a unique corporate strategy. | | | | | | |
| CG28 | The board reviews the corporate strategy quite often. | | | | | | |
| CG29 | The board ensures that corporate strategy is well thought and executed. | | | | | | |
| CG30 | The Board sets resources aside to achieve the mission of Financial Institution. | | | | | | |
| CG31 | The Board regularly identifies the strength of, opportunities available, the weaknesses and threats to the Institution and maps a strategic direction to take | | | | | | |

Corporate Governance (CEO Duality)

CG 27 The CEO is the chairman of the board

a) Yes

b) No

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