

## EFFECT OF INTERNAL CONTROL SYSTEM ON FINANCIAL PERFORMANCE OF LISTED DEPOSIT MONEY BANKS IN NIGERIA.

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### ABSTRACT

*This study examined the effect of internal control on financial performance of listed deposit money banks in Nigeria. The triangulated research design was employed for the study. The population of the study consist of two hundred and twenty (220) respondents drawn from the thirteen (13) listed deposit money bank. Multiple regression analysis was used to test the formulated hypothesis computed with the aid of Stata12 statistical software. The study revealed a negative and insignificant effect of control environment on net profit margin of listed deposit money banks in Nigeria and the existence of a positive but insignificant effect of risk assessment on net profit margin of listed deposit money banks in Nigeria. The study recommended that banks should create and maintain a strong internal control environment since the organization's financial success is influenced by the strength of the control environment. Finally, banks should also practice adequate controls in custody and disposal of assets including cash and to reduce the risk of material misstatements in financial reporting in relation to recognition and measurement of assets, liabilities, revenue and cost or insufficient disclosure.*

**Keywords: Internal Control, Control Environment, Risk Assessment, Financial Performance, Net Profit Margin.**

### INTRODUCTION

The firm's level of goal achievement in terms of shareholder's wealth maximization is well articulated by the information presented in the financial statements (Chimaleni et al., 2015). A high level of performance signifies that all its factors of production are optimally utilized efficiently and effectively. Corporate performance of companies can be ascertained financially or in terms of production capacity. Corporate financial performance was the area of concern for this study can be viewed in terms of profit maximization, maximizing return on assets and maximizing shareholder return which is built on the company's efficiency. Multiple ratios can be used to analyze the financial performance of the company like return on asset, return on equity, and net profit margin. The financial performance can be assured with a sound and effective internal control system in place in the reporting organization.

Internal control has been recognized in most organizations as one of the most essential ingredients, necessary for the survival of the business enterprise and government agencies. Apart from the problem of scarce resources, organizations run a high risk of fraud, errors, miss appropriation of funds and inefficient and ineffective operations. Steps are required therefore to minimize, if not eliminate completely, these risks, by establishing internal control system. For every organization, there are risks that the organizational goals and objectives are not achieved. All efforts aimed at preventing such risks or identifying and correcting such risks are viewed as internal control. Internal control as defined by Committee of Sponsoring Organizations of the Treadway Commission (COSO, 2013) is "a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance." To achieve internal control objective of which the reliability of financial statements is among, management must apply the components of internal control in every operating activity. The components are; (1) Control environment, (2) risk assessment, (3) control activities, (4) information and communication systems, and (5) monitoring (COSO, 2013).

Many recent business failures around the world have been ascribed in part to internal control problems. It is well known that the failure of some companies around the world, including Enron Energy Corporation, WorldCom, Tyco (in the United States), Maxwell Communications Corporation, the Mirror Group Newspaper (in the United Kingdom), NITEL and NAFCON (in Nigeria), and some new generation banks in Nigeria, was caused by internal control failure and, by extension, corporate governance failure (Abdulrashid & Aliyu, 2019).

The rate of banks financial distress and eventual collapse has raised concern and questions on the effectiveness of its internal control system that is meant as watchdog on the activities of the organization. Weak internal control system gives room for fraudulent activities and practices within the bank. Internal control ineffectiveness is among the problems of the banking industry, and that allowed rogue traders to cause huge financial losses to these banks. The Nigerian financial sector has its crisis traceable to a number of factors chiefly among which were huge non-performing loans, lack of transparency, capital inadequacy, and in addition to this weak internal controls and ineffective or compromised external audit also played a very significant role in the crisis that enveloped the sector, especially from early 1990's up till mid-2004. Despite the 2005 Nigerian banking sector reforms, a breakdown has occurred in the banks' systems of internal control, resulting in regulatory failures and poor corporate governance. Thus, this study intends to examine the effect of internal control system on financial performance of listed deposit money banks in Nigeria.

### Research Hypotheses

The following research hypotheses were formulated and tested in this study.

**Ho<sub>1</sub>:** Control environment does not have any significant effect on net profit margin of listed deposit money banks on the Nigerian Exchange Group.

**Ho<sub>2</sub>:** Risk assessment does not have any significant effect on net profit margin of listed deposit money banks on the Nigerian Exchange Group.

### Literature Review

#### Internal Control System

Internal control is a broad concept that covers the entire range of procedures, methods and controls established by an organization to increase the probability to achieve its business goals (Institute of Internal Auditors (IIA), 2012). Also, internal control can be seen as a group of policies and procedure that are embedded to form control on firm's activities to ensure the entity followed objectives set by management and board of directors (Yousef, 2017). Internal control comprises internal checks, internal audits, and other control devices. Even though internal control and internal audit are connected, they are not the same. Internal control refers to the systems, rules, procedures, and processes put in place by the board of directors, management, and other people to protect the company's assets, restrict or control risks, and fulfill the firm's goals. Effective internal controls are the backbone of a safe and sound organization. A well-designed and consistently implemented a system of operational and financial internal control assists the board of directors and management in protecting the company's resources, producing credible financial reports, and adhering to laws and regulations. It enables the organization to achieve its objectives more effectively.

#### Control Environment

The control environment includes the attitudes, awareness, and actions of management and directors, management and those charged with governance concerning the entity's internal control and their importance in the entity (Gamage et al., 2014; Mary, Albert, & Byaruhanga, 2014). Control environment also refers to all factors which are effective in determining, increasing or decreasing the effectiveness of policies, procedures, and methods specific to a process. The element of control environment includes communication, enforcement of integrity, and ethical

values. According to Gamage et al. (2014), five factors are identified that affect control environment; integrity and ethical values, human resource policies and practices, assignment of authority and responsibility, a commitment to the competence, organizational structure, and management's philosophy and operating style, and board of directors or audit committee.

### **Risk Assessment**

An entity's risk assessment process is the process of identifying and responding to business risks and the results thereof (Mary et al., 2014). Risk Assessment is defined as identification of potential errors and implements procedures, policies, and control to detect those errors and prevent them. Risk assessment can also be the identification and analysis of risks relevant to the achievement of objectives (Frazer, 2012). In order word risk assessment is the process of detecting, assessing and determining how to succeed these things. Both external and internal risks could prevent the achievement of established objectives at every level in an organization.

### **Financial Performance**

In the view of Rong et al. (2019) a performing company is a company that creates value for its shareholders and this is realized when the return on equity is higher than the funding cost. A firm's performance indicates whether the company is worth investing in or not. Also, firms measure performance to ascertain if they are efficient and effective in their operations. Financial performance therefore refers to the process of measuring the results of a firm's policies and operations in monetary terms. Financial performance predominantly shows the sector of a business outcome as well as results, showing the overall financial health condition of the business sector over a particular time period (Naz et al., 2016).

### **Theoretical framework**

This study is anchored on the agency theory. This theory involves the principal (shareholder) and the agent (management). Agency theory describes economic exchange relation between principal and agent. Principal-agent relation in which principal delegates work to the agent, is described using the metaphor of a contract (Jensen & Meckling, 1976). The relationship between principal and agent based on the contract is a focal point of agency theory. Principal wants to maximize his/her benefits while minimizing reward to the agent at the same time. On the other hand, the agent wants to maximize his/her benefits. This goes to say that this theory is based on what each party stands to get. Therefore, there is need for a sound internal control system in place to actualize the goal of this theory.

### **Empirical Review**

Abdulrashid and Aliyu (2019) examined the impact of the internal control system on the financial accountability of NGOs in Nigeria. The study's findings demonstrated how internal control systems are proven to have considerable potencies of increasing or derailing the quality of services supplied by NGOs, as well as having the combined impact of predicting proper accountability in NGOs when all parameters are held constant. The study also showed that NGOs must prioritize employee welfare and development because they are change agents.

Eke (2018) investigated the internal control and financial performance of hospitality organizations in Rivers State. The analysis discovered that internal controls have a substantial impact on the financial performance of hospitality organizations and that there is a positive association between internal controls and the financial performance of HOs in Rivers State. According to the study, the control environment determines total revenue and thus the financial performance of hospitality organizations; its absence or inadequacy may spell disaster for an organization.

Ndiaye et al. (2019) examined the impact of internal control on the profitability of microfinance institutions in Senegal. The study utilized a survey design to sample 118 MFI's study utilized multiple regression analysis to analyses quantitative data collected from the MFI's and the

hypothesis was tested at 95% confidence interval. The study found out that all dimensions of internal control were positively and significantly associated to the four indices of profitability of MFI's in Senegal.

Umar and Dikko (2018) examined the effect of internal control on performance of commercial banks in Nigeria. A survey method was employed and the study used stratified random sampling, in which a total of 382 questionnaires were administered to either staff of operations, marketing, or security department in the Nigerian commercial banks. The study revealed that there is a positive and significant relationship between the four components of internal control (control environment, control activities, monitoring and risk assessment) and bank performance.

Ibrahim et al. (2017) examined the impact of internal control systems on financial performance: the case of health institutions in upper west region of Ghana using an ordered logistic regression model for a sample of fifty (50) respondents. The study revealed a positive relationship between internal controls and financial performance.

Olumbe (2012) conducted a study to establish the relationship between internal controls and corporate governance in commercial banks in Kenya. The researcher conducted a survey of all the 45 commercial banks in Kenya. It was presumed that the majority of the banks had joined the different parameters which are utilized for gaging internal controls and corporate governance. The results demonstrated that banks had established great corporate governance with a strong system of internal controls and that there is a connection between internal control and corporate governance.

Ahmed and Muhammed (2018) investigated internal control systems and its relationships with the financial performance in telecommunication companies. The study used both primary and secondary techniques to collect the data. The findings of the study showed that there is a significant relationship between internal controls and financial performance.

Odek and Okoth (2019) analyzed the effects of internal control systems on financial performance of small and medium distribution companies in Kenya. The results of the study revealed that control activities have a negative and significant effect on financial performance of Moonbluz enterprise. The study also revealed that risk assessment has a positive and insignificant effect on financial performance of Moonbluz enterprise.

Nyakundi et al. (2014) studied the effect of internal control systems on financial performance among SMEs in Kisumu city, Kenya. The research was conducted using both quantitative and qualitative approaches; adapting cross-sectional survey research design. The study used both primary and secondary data. The study concluded that internal control systems as significantly influence the financial performance of Small and Medium scale Enterprises.

Rosman et al. (2016) examined the relationships between internal control including control environment, control activities, risk assessment, monitoring and budgetary participation, and performance effectiveness of NPOs. A total of 96 questionnaires out of 150 distributed questionnaires were returned. Based on the result of the multiple regression analysis, there are significant relationship between control environment, control activities, risk assessment, monitoring and financial performance. In addition, the result also showed significant relationship between control environment, risk assessment, budgetary participation and non-financial performance.

## **METHODOLOGY**

This study adopts the triangulated research design in determining the effect of internal control system (Control environment and Risk assessment) and financial performance (net profit margin). The population of this study consist of two hundred and twenty (220) respondents drawn from the thirteen (13) listed deposit money bank the top management staff and middle management staff of listed deposit money bank in Nigeria. Multiple regression analysis was used to test the formulated hypothesis computed with the aid of Stata12 statistical software.

**RESULTS/FINDINGS****Table 4.1: Multiple regression results with NPM as dependent variable**

Linear regression	Number of obs =	110
	F( 3, 106) =	12.53
	Prob > F =	0.0000
	R-squared =	0.1192
	Root MSE =	.41144

npm	Robust		t	P> t	[95% Conf. Interval]	
	Coef.	Std. Err.				
cen	-.0862739	.0772333	-1.12	0.266	-.2393963	.0668486
ras	.0303973	.0163633	1.86	0.066	-.0020446	.0628392
fmsze	.2906343	.0487328	5.96	0.000	.1940167	.3872519
_cons	2.787947	.4556127	6.12	0.000	1.88465	3.691243

Source: Output from STATA version 12

Table 4.1 above present the model which regress net profit margin (fnpm) against control environment (cen), and risk assessment (ras) alongside the moderator variable firm size (fmsze). The standard robust error in the regression addresses heteroskedasticity. The F statistics in Table 4.6 shows that the model exhibit excellent fit at  $Prob > F = 0.0000$  and that the independent variables statistically and significantly predict the dependent variable. The independent variables in the model explain 12% of the variation in net profit margin.

**Test of Hypotheses****Test of Hypothesis 1**

**Ho<sub>1</sub>:** Control environment does not have any significant effect on net profit margin of listed deposit money banks on the Nigerian Exchange Group.

**Table 4.2:** Regression on the effect of control environment on net profit margin.

Number of obs =	110
R-squared =	0.1192
Root MSE =	.41144

npm Interval]	Coef.	Robust Std. Err.	t	P> t	[95% Conf.
cen	-.0862739	.0772333	-1.12	0.266	-.2393963
.0668486					
cons	2.787947	.4556127	6.12	0.000	1.88465
3.691243					

Source: Output from STATA version 12

From table 4.2 above, the result of the data regress on the effect of control environment on net profit margin shows a negative and insignificant effect of control environment on net profit margin of listed deposit money banks in Nigeria ( $p$ -value= 0.266). It means that a 1% increase in control environment will bring about a 0.086% decrease in net profit margin all other variables are held constant. From the result, we accept the null hypothesis that "Control environment does not have

any significant effect on net profit margin of listed deposit money banks on the Nigerian Exchange Group.”

### Test of Hypothesis 2

**Ho<sub>2</sub>:** Risk assessment does not have any significant effect on net profit margin of listed deposit money banks on the Nigerian Exchange Group.

**Table 4.3:** Regression on the effect of risk assessment on net profit margin.

Number of obs = 110  
R-squared = 0.1192  
Root MSE = .41144

npm Interval]	Coef.	Robust Std. Err.	t	P> t	[95% Conf.
ras	.0303973	.0163633	1.86	0.066	-.0020446 .0628392
cons	2.787947	.4556127	6.12	0.000	1.88465

Source: Output from STATA version 12

From table 4.3 above, the result of the data regress on the effect of risk assessment on net profit margin shows a positive but insignificant effect of risk assessment on net profit margin of listed deposit money banks in Nigeria (p-value= 0.066). It means that a 1% increase in risk assessment will bring about a 0.030% increase in net profit margin all other variables are held constant. From the result, we accept the null hypothesis that "Risk assessment does not have any significant effect on net profit margin of listed deposit money banks on the Nigerian Exchange Group."

### Discussion of Findings

Hypothesis one revealed the existence of a negative and insignificant effect of control environment on net profit margin of listed deposit money banks in Nigeria (p-value= 0.266). This finding is supported by the finding of Ejoh and Ejom (2014) that revealed no significant relationship between internal control activities and financial performance of Cross River State College of Education. This finding contradicts the finding of Nyakundi et al. (2014) that concluded that that internal control systems as supported by the study findings significantly influence the financial performance of Small and Medium scale Enterprises. Also, it contradicts the finding of Magu and Kibati (2016) that revealed a positive relationship between internal control systems and financial performance of KFA Ltd.

Hypothesis two revealed the existence of a positive but insignificant effect of risk assessment on net profit margin of listed deposit money banks in Nigeria (p-value= 0.066). This finding is in line with finding of Odek and Okoth (2019) that revealed that risk assessment has a positive and insignificant effect on financial performance of Moonbluz enterprise. This finding contradicts the finding of Umar and Dikko (2018) that concluded that there is a positive and significant relationship between the four components of internal control (control environment, control activities, monitoring and risk assessment) and bank performance. also, it disagrees with the finding of Ndiaye et al. (2019) that revealed that all dimensions of internal control were positively and significantly associated to the four indices of profitability.

## RECOMMENDATIONS

The following recommendations are made for the study;

- i. Banks should create and maintain a strong internal control environment since the organization's financial success is influenced by the strength of the control environment.
- ii. Banks should also practice adequate controls in custody and disposal of assets including cash and to reduce the risk of material misstatements in financial reporting in relation to recognition and measurement of assets, liabilities, revenue and cost or insufficient disclosure.

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