

Contribution of Internal Control System towards Financial Performance: An Empirical Configuration for Future Strategies

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Abstract

Internal control system in an organization preventing the dishonest financial reporting is the need of present scenario especially in Nepalese financial institutions. Therefore, this study intends to present the contribution of internal control system towards financial performance in Nepalese commercial banks. To know the contribution of internal control system descriptive research design has been applied to assess the current practice of internal control system and its effect on financial performance in Nepalese commercial banks. In this 280 employees from top 7 commercial banks were selected based on their paid up capital as the sample for this study. The result depicts that internal control has significant relation with financial performance in commercial banks of Nepal. Therefore, this study concludes that internal control system mainly control environment and internal audit have the significant contribution to the financial performance while considering liquidity and profitability in Nepalese context. Hence, the result of the study will have significant contribution for the concern authorities to make their future strategies for their responsible financial reporting.

Keywords: Internal Control, Contribution, Strategies, Reporting, Financial Performance.

Introduction

The past studies have focused on the need of the internal control system for pursuing the organizational objectives by insuring the financial reporting with efficient and effective operation in a reliable way. Internal control system reduces the financial fraudulent and discrepancy in financial reporting of an organization and Nepal is not far from this effects as a least developed country where the many companies are in in-between. Thus, the area of internal control system in Nepalese context is worthwhile for study to present the real picture. Internal control is an arrangement of internal managerial efficacy leading to layout a system that will develop the financial check and stability to support the corrective actions anticipated by the organization for ensuring the achievement of organizational objectives. It is a set of tool arranged to encourage the employee or the group of

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employees for the attainment of organizational objectives (Odunko, 2022). Internal controls are the measures established by the organization for ensuring the accomplishment of the organizational objectives. It constitutes a bunch of procedures designed and implemented by the concerned authorities to deliver realistic reassurance about the attainment of organizational goals with regard to the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations (Ogneva et al., 2007; Ejoh and Ejom, 2014).

Internal control including; control activities, risk assessment, control environment, communication and monitoring have remained the effective mechanism facilitating organization to achieve their financial goals and existence (Cohen et al., 2000; Rittenberge et al., 2005). The profitability and growth of the organizations can be supported by the effective implementation of internal control system through protecting the assets and other resources thus minimizing the chances of losses (Bett and Memba, 2017). Internal audit as a part of internal control system directly or indirectly improve the consistency of financial performance through increasing accountability amongst the data users and data providers in the organization (Odek and Okoth, 2019). Unnecessary expenses, wastage and ineffectiveness can be congested with implementation of effective internal control system (Quasim, 2021). The procurement process of organization can be made efficient with support of internal control system leading to the cost control and boosting the profitability by controlling the wastage (Kinyua et al., 2015; Jacob and Philip, 2016).

Internal control system is overall system of control consisting of financial control which aimed to take over organizational activities in effective and efficient way to prevent its assets and safeguard form the potential losses of assets and information (Omar and Yussuf, 2021). The continuity of effective internal control system is important due to its positive impact on the financial performance of organization through controlling and preventing the dishonest activities in the organization. The internal control system supports confident financial reporting and improves the working efficacy at the mean time also assure the compliance of laws and regulation (Bongani, 2013; Nanzala and Ingabo, 2021).

To achieve the predetermined goal of the organization it need to be ensure the effective and efficient processes, dependable information (both financial and non-financial) and compliance of rules and regulations (Ibrahim, Diibuzie and Abubakari, 2017). When the management practice is weak, fake financial reporting inclines to be frequent as the controlling mechanism is started with management their role of effective implementation is key for the good and efficient governance. Internal control system has need to be established for pursuing the institutional objectives to ensure the reliable financial reporting, effective and efficient operation (Crawford, 2011) Internal control system is a newsworthy matter of worldwide falsified financial reporting and accounting scandals in both developed and developing countries (Muhunyo and Jagongo, 2018; Omar and Yussuf, 2021).

Many studies and literatures have argued about the relationship between internal control and financial performance of organizations. Nepalese banking sector is also one of the

contributing service industry of Nepalese economy and their financial performance is always a key area of concern for their all the stakeholders. Despite this reality a comprehensive study related to internal control system has been inadequately available in Nepal. Therefore, this study is intending to present the contribution of internal control system on the financial performance in Nepalese commercial banks, which is need of present scenario in Nepalese financial institutions.

Methodology

This paper has applied descriptive research design to assess the practice of internal control system in Nepalese commercial banks of Kathmandu valley. All the employees of 27 commercial banks of Nepal operated in Kathmandu valley are considered as the population of the study. Whereas, 280 employees of top 7 seven commercial banks based on their paid-up capital were taken as the sample for this study. The respondents consist from different department as well as different levels that have the understanding of internal control system. This study has used control activities and internal auditing of studied banks as to indicate the internal control system while profitability and liquidity as to indicate the financial performance of concerned banks. To fulfill the study objectives, primary data are collected through structured questionnaire based on 5-point Likert scale. All the collected data are process through MS-Excel and SPSS. For assessing the practice of internal control system, descriptive statistics has been used. Similarly, to explore the role of internal control system towards banking performance regression analysis has been implemented.

Result and Analysis

Table 1: Respondents Profile:

Variables	Frequency	Percentage
<i>Gender:</i>		
Male	163	58.2
Female	117	41.8
<i>Age:</i>		
Below 20	28	10.0
20-30	84	30.0
30-40	77	27.5
40-50	53	18.9
Above 50	38	13.6
<i>Education:</i>		
Below Bachelor	28	10.0
Bachelor	92	32.9
Master	128	45.7
Above Master	32	11.4
<i>Position:</i>		
Assistant	45	16.1
Senior Assistant	58	20.7
Junior Officer	82	29.3
Officer	53	18.9
Senior Officer and Above	42	15.0

Source: Survey, 2022

Table 1 shows the demographic characteristics of the respondents for this study. It displays that majority of the respondents for this study is the male staffs of different commercial banks of Nepal. The respondents comprise from the different age groups of banking employees however many (about 57%) of staffs lies in age group 20 to 40. Though, 13.6% respondents are beyond the age of 50 years. The table demonstrated that nearly 46% banking staffs taking part in this research are master degree holders and about 33% respondents with bachelor's degree. The study includes banking employees from all the positions. However, the in numbers the junior officers form different commercial banks of Nepal are more than other position holders banking staffs. The table indicated that this study includes diversified banking employees as respondents for the research.

Table 2: Control Activities

Statements	N	Mean	Std. Deviation	Min	Max
My bank has clearly assigned duties and responsibilities	280	3.88	0.87	2	5
We are properly instructed about the procedures and guidelines of bank	280	4.12	0.68	2	5
We are motivated to accomplish our duties thoroughly	280	3.76	1.10	2	5
Bank has adequate control over the access of its resources	280	3.93	0.75	2	5
Any changes over employee's data are approved by authentic body of bank	280	4.08	0.72	3	5
Timely monitoring and feedback are provided by the bank's authority	280	3.84	0.85	3	5

Source: Survey, 2022

The table 2 shows the control activities practiced by the Nepalese commercial banks. It shows that majority (M=3.88) of banking staffs believe that their bank has assigning duties and responsibilities clearly. It also expresses that respondent of this study agreed (M=4.12) on they are properly instructed about the procedures and guidelines of bank. Similarly, table demonstrated that majority (M=3.76) of respondents feel motivated to accomplish their duties however, some deviating opinion cab be also seen on this aspect. The banking staffs under this study believe (M=3.93) that their banks have adequate control over the access of its resources. It is seen that respondents agreed (M=4.08) that any kinds of changes on employee's data are approved by authentic body of bank. Likewise, respondents believe (M=3.84) that the bank's authority regularly and timely monitor the activities and provided the feedbacks.

Table 3: Internal Auditing

Statements	N	Mean	Std. Deviation	Min	Max
My bank has regularity in its internal auditing	280	4.18	0.55	3	5
External auditor regularly checks the financial reports of our bank	280	3.64	0.87	2	5
Internal auditing in our bank complies with Nepalese standard of audit	280	3.52	0.98	2	5
Practice of internal audit in our bank helps to detect financial errors and frauds.	280	4.15	0.58	3	5
Internal audit in our banks checks the implementation of legal compliances and accounting policies.	280	3.82	0.95	2	5
We are confident on independence of internal auditor after review of documents	280	3.57	1.18	2	5

Source: Survey, 2022

Table 3 shows the position of internal audit in sampled commercial banks. This express that majority of respondents are agreed (M=4.18) that their respective banks conducted the internal audit. Table also demonstrated that many of respondents have felt that external auditor of banks regularly checks the financial statements of banks. The banking staffs taking part on this study experience that their banks internal audit complies with the Nepalese standard of audit however, some respondents have found the different opinion on this. The majority of banker responding for this study agreed (M=4.15) that the practice of internal audit on their banks helps to detect the financial errors and frauds. They also believe (M=3.82) that internal audit in their banks help to check the implementation of legal compliances and accounting policies. The respondents have shown the mix opinion on the independence of internal auditor after reviewing the documents.

Table 4: Financial Performance

Statements	N	Mean	Std. Deviation	Min	Max
Our bank has increasing trend of profit	280	3.98	0.78	3	5
Return on equity of our bank has increased over the years	280	3.85	0.69	2	5
The volume of lending and deposit of our bank is increasing	280	4.20	0.66	3	5
Each year the cash flow of our bank is increasing than previous years	280	4.05	0.72	3	5
Return on assets of our bank is increasing over the years	280	3.76	0.87	2	5
Earnings per share of our bank is increasing over the years	280	3.89	0.84	2	5

Source: Survey, 2022

Table 4 shows the respondents agreements about the financial performance of their respective banks under this study. The table demonstrates that majority of respondents are agreed (M= 3.98) that their bank has increasing trend of profit. It also displays that the banking staffs taking part on this study were express that their bank has increasing return on equity over the years. They also believe (M=4.20) that the total volume of lending and deposit of their banks is increasing. Most of the respondents are agreed (M=4.05) that the cash flows of their respective banks are increasing than of previous year. Likewise, the respondents are also showing the agreement that their banks' return on assets are increasing over the years. The respondents were express (M=3.89) that their banks have increasing earnings per share over the year.

Table 5: Correlation between Internal Control System and Financial Performance

Variables	Control Activities	Internal Auditing	Financial Performance
Control Activities	1		
Internal Auditing	0.18	1	
Financial Performance	0.56**	0.62**	1

Source: SPSS Output

Note: **Correlation is significant at the 0.01 level (2-tailed)

The table 5 shows the relationship between dependent and independent variables under this study. It shows that both the independent variables have the positive association (r=0.56 & 0.68) with the dependent variable. It indicates that as the control activities and internal audits of the banks under this study increases it leads to the positive changes in their financial performance.

Table 6: Summary of Regression model

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	
	0.72	.524	0.512	1.121	
	Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	196.24	1	196.24	0.000
	Residual	64.32	43	1.49	
	Total	260.56	44		

a. Dependent variable: Financial Performance

b. Predictors: Constant, Control Activities and Internal Auditing

The table 6 shows the overall summary of the regression analysis. The F-statistics on the table is used to analyze suitability of the regression model under this study. The value of f-statistics and the p-value indicated that the used regression model has 0.001 probability of having incorrect prediction. The value of R² i.e., 0.52 indicated that the internal control system of the banks under this study contributed 52.4% of the variation on the financial performance of studied banks.

Table 7: Regression Coefficient

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	24.65	1.38		6.54	0.000
	Control Activities	0.41	0.30	0.52	12.36	0.014
	Internal Auditing	0.38	0.16	0.43	0.14	0.017

a. Dependent Variable: Financial Performance

Table 7 shows the positive impact of control activities and internal auditing on the financial performance of the banks under this study. The value of beta coefficient indicated how the change in independent variables would change in dependent variable. It displays that one-unit positive variation in control activities would increase the financial performance by 0.41 units. Likewise, one-unit positive variation in internal audit would make positive change in financial performance by 0.38 units. Table signed that, internal control (control activities & internal auditing) have positive effect on financial performance of banking institutions of Nepal under this study. The study model can be, $Y = 24.65 + 0.41X1 + 0.38X2 + Et$, ($p < 0.05$)

Discussion and Conclusion

This study has aimed to explore the contribution of internal control system on the financial performance of Nepalese commercial banks. The results of the study are showing that the banks have an effective internal control system as supported by the study findings of clear separation of duties; there is adequate control over access to resources belonging to the bank. Likewise, there are adequate controls over information systems. There is also compliance with bank guidelines that can lead to reliable financial reporting. There is a good operation of controls especially considering that the audit function is well extended to which clearly has affected their efficiency as discovered by this study. The respondents under this study agree that there is effective internal control system in Nepalese commercial banks. The finding of the study has shown that there exists positive relationship between internal control system and financial performance in Nepalese commercial banks which is similar with the findings of Nyakundi et al. (2014); Ibrahim, Diibuzie and Abubakari (2017); Taun (2020); Madhushani and Jayasiri (2021). In line with this, Jacob and Philip (2016) shows that internal control has significant relation with commitment of fraud in organization and recommended that strong and effective internal control system to diminish the execution of frauds for smooth financial reporting. In the same way Channar, Khan and Shakri (2015) concludes that the effective internal control system has positive relation with financial performance of the banks. Sahabi et al. (2017) also showed the positive relation of effective internal control system with financial performance even though it failed to illustrate the assessment of risk and how it affects to financial performance. Likewise, study of Ejoh and Ejom (2014) expressed that there is no significant relation of internal control activities and financial performance. Moreover, this study found that the control activities and internal auditing as indicator of internal control system has significant positive effect on the financial performance of Nepalese

commercial banks and the result is consistent with study of Odunko (2022) expressing that cash control, risk assessment and internal control has positive significant impact on the firm performance in Nigeria. Similarly, Muhunyo and Jagongo (2018) admit that control environment, control activities, risk assessment, information and communication as indicator of internal control system having a significant influence on the financial performance of the higher learning institutions in Kenya. The finding is similar with Boakye (2016); Hailemarin (2014); Quasim (2021); Anthony, Mukaila and Oluwafemi (2021) conveying the positive role of internal control system on the performance of organization. This study concludes that internal control system (control activities and internal audit) have the significant contribution on the financial performance (liquidity and profitability) of the commercial banks of Nepal. This study will contribute to the stakeholders of the banking industry to understand the importance of internal control system that need to be consider while planning their future policies. The academics can be benefited with it as source of literature on the concerned area of research. This study has focuses on the effect and contribution of internal control system on the banking performance. However, many aspects of the internal control systems can be incorporated by the further researcher. The methodology used under this study was based on the survey with questionnaire, the future scholars have wide area to consider this on their future studies.

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