EFFECT OF INTERNAL CONTROL ON THE FINANCIAL PERFORMANCE OF SMALL AND MEDIUM SCALE ENTERPRISES IN EKITI STATE, NIGERIA.

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Abstract

This study evaluates the effect of internal control on financial performance of small and medium scale enterprises in Ekiti State. Using a questionnaire survey of 75 selected small and medium scale enterprises in Ado Ekiti metropolis, the study sourced primary data through the use questionnaire. The study specifically sought to investigate the effect of risk assessment (RASS), information and communication (ICOM) and monitoring (MONIT) on the return on assets (ROA) of the selected SMEs. Findings in the study shows that there is a positive and significant correlation between risk assessment and the Return on Assets at 5%. (P=0.018<0.05), it also shows that there is a positive and significant correlation between information and communication and the Return on Assets at 5%. (P=0.016<0.05). The study also shows a positive and significant correlation between monitoring and the Return on Assets at 5%. (P=0.035<0.05). In particular, this study shows that the risk assessment, information and communication, and monitoring components of internal control are key drivers of SMEs financial performance. These findings have important implications for business owners who aim and aspires to enhance the effectiveness of internal control in boosting their return on assets and total profitability. The study concludes that financial performance of small and medium scale enterprises in Ekiti State is impacted by effective internal control, and the basic components of internal control are essential to it. The study recommends that owners of small and medium scale enterprises should upgrade and ensure that internal controls are in place in their businesses to improve the financial performance and overall profitability in their operation.

Keywords: Internal Control, Financial Performance, Return on Assets, Risk Assessment Information and Communication, Monitoring.

1.0. Introduction

Most organizations now acknowledge that one of the most important components required for the survival of government agencies and commercial enterprises is internal control. Organizations face several risks, including fraud, mistakes, misappropriation of cash, and inefficient and ineffective operations, in addition to the issue of limited resources. So, measures must be taken to create an internal control system in order to reduce, if not totally eliminate, these risks. 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 Tredway 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."

internal controls are defined by Ahmed and Nganga (2019) as a planned structural method of financial performance and other methods used by the administration to carry out activities in an orderly and efficient manner. Internal controls must be in place for all internal operations within a company. Ensuring that structural activities are stable and free from risk is the responsibility of internal controls (Njeri, 2013). To assist them accomplish their objectives, organizations put internal control systems in place, which improves firm compliance and reduces the loss of corporate resources. Kinsanyanya and Omagwa (2018) assert that these controls provide total certainty over the accomplishment of the firm's goals. Ramukama (2014) asserts that task segregation, internal audits, training programs, and corrective internal controls are necessary to achieve the desired outcomes.

Internal controls are the procedures that an organization does to guarantee that its missions, aims, and objectives are met. They are a collection of rules and guidelines that an organization has adopted to make sure that its transactions are handled properly to prevent wastage, theft, and improper use of its resources. Internal controls refer to procedures that are created and implemented by personnel responsible for management, governance, and other areas to offer a reasonable level of assurance regarding the accomplishment of an organization's goals concerning the accuracy of its financial reporting, the efficacy and efficiency of its operations, and adherence to relevant legal and regulatory requirements (Mwindi, 2008). It is important to remember that internal controls only give an entity's management and board of directors a reasonable, if not 100%, certainty that the organization's goals will be met. "All systems of internal control have inherent limitations that affect the likelihood of achievement" (Hayes et al., 2005). Internal control systems are put in place by organizations to assist them meet performance and organizational goals, avoid resource loss, facilitate the creation of trustworthy reports, and guarantee legal and regulatory compliance.

There is a widespread belief that establishing and upholding sound internal control mechanisms would inevitably result in enhanced financial outcomes. Additionally, there is a widespread perception that effectively implemented internal control systems strengthen the accountability function of an entity's management by streamlining the reporting process and producing credible reports. However, existing literature continues to hint at or highlight the fact that most organizations' financial performance has been illusive despite complex control systems.

The financial performance of small and medium-sized enterprises (SMEs) in Nigeria has been hindered by weak internal controls, leading to a rise in capital insufficiency and insolvency. Every organization without an internal control system is known to be susceptible to several threats that have the potential to quickly destabilize the organization. Among the most common hazards include theft and improper handling of organizationally vital records, which an employee may conduct to obtain an unfair advantage. Inaccurate and untrustworthy financial records are another problem that can compromise an organization's integrity. Other issues include not adhering to annual budgets and planning policies, not following applicable laws regarding accounting practices and the presentation of financial statements, and so on. Hence, this study aims to investigate the effect of internal control on financial performance of small and medium enterprises.

The specific objectives of this study are to;

- **i.** Examine the effect of risk assessment on Return on Assets of small and medium scale enterprises in Ekiti State.
- **ii.** Analyse the effect of information and communication on Return on Assets of small and medium scale enterprises in Ekiti State.
- **iii.** Examine the effect of monitoring on Return on Assets of small and medium scale enterprises in Ekiti State.

Hypotheses

The following null hypotheses were formulated in this study;

- **i.** There is no significant relationship between risk assessment and return on assets of small and medium scale enterprises in Ekiti State.
- **ii.** There is no significant relationship between information and communication and return on assets of small and medium scale enterprises in Ekiti State.
- iii. There is no significant relationship between monitoring and return on assets of

small and medium scale enterprises in Ekiti State.

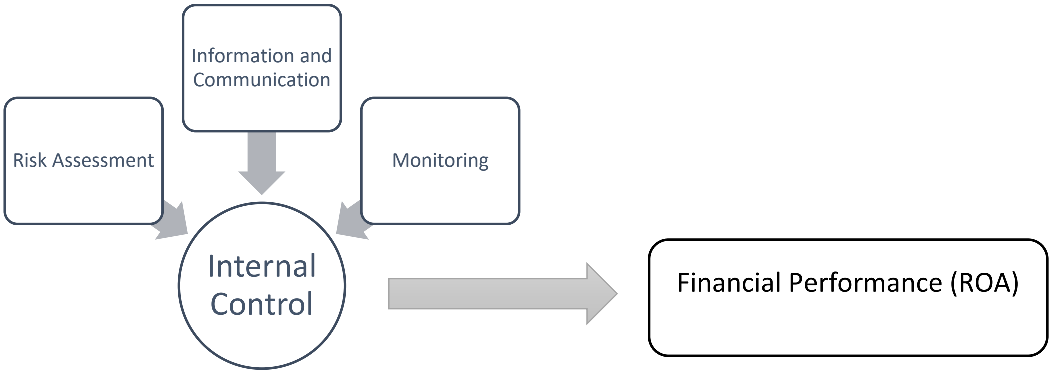
2.0. Literature Review

2.1. Conceptual Review

2.1.1 Internal control

Adagye (2015) asserts that internal control is created and carried out by an organization's management in order to ensure the organization's expansion and survival. Ndungu (2013) defines internal control systems as a collection of policies and guidelines that guarantee transaction processing in a way that thwarts theft, waste, and improper use of an organization's resources. According to Salihu (2015), an internal control system is a crucial instrument that aids all educational establishments in offering high-quality instruction as well as a positive and supportive environment for research, teaching, and learning. According to Adagye (2015), ensuring the accuracy of financial reporting, the efficacy and efficiency of operations, and compliance with rules and regulations are the main goals of an internal control system.

Conceptual Framework.



Source: Author's Compilation.

2.1.2 Control Activities

According to Uwadiae (2013), control activities are described as acts that assist in ensuring that management's instructions to mitigate risks in the pursuit of stated objectives are followed out. These actions are defined by policies and procedures. As per the report, control operations are executed across the technology environment, at different stages within business processes, and at all levels of the organization. These operations can be either proactive or reactive, and they can involve a range of manual and automated processes, including business performance assessments, authorizations and approvals, verifications, and reconciliations.

2.1.3 Risk Assessment

The process of identifying risks to attaining organizational objectives, evaluating potential events for their influence on accomplishing organizational objectives and likelihood of occurrence, and choosing a course of action in response to the risks is known as risk assessment. Frazer (2012) asserts that risk assessment helps a company identify and evaluate risks associated with achieving set objectives. It is imperative to do a thorough examination of all internal and external hazards that affect any company, as stated by COSO (1992). Numerous times, the threats would call for prompt action. That was the consensus reached by Hayali, Dinc, Sarl, Dizman, and Gundogdu (2012). Prior to conducting a risk assessment, Uwadiae (2013) suggests that objectives be established and linked at different levels of the organization. In order to properly define operational, reporting, and compliance objectives, management must engage in a dynamic and iterative risk assessment process.

2.1.4 Monitoring Activities

Monitoring is the process of determining how consistently the internal control system performs over time. In order to provide a reasonable assurance regarding the achievement of the company's objectives, Coffin (2003) suggested that an evaluation mechanism be carried out to appraise and examine internal control systems in order to guarantee that procedures are upheld consistently over a prolonged period of time. Additionally, he asserts that the oversight of the internal control system includes the internal audit. In order to determine the necessary actions in response to audit and evaluation findings and recommendations, managers will promptly evaluate the results of the audit and other reports, including those that point out flaws or recommendations made by auditors and others examining the department's operations.

2.1.5 Control Environment

An organization's control environment establishes the tone for the organization and affects how well its internal controls work. One intangible component is the control environment. Nonetheless, it serves as the cornerstone for all other internal control elements, offering structure and discipline and incorporating both technical proficiency and ethical commitment. According to Kababo (2013), a management system is a collection of procedures and guidelines that must be followed when conducting internal controls inside a company. The internal control process of the organization will operate at all levels, according to COSO (2013), because a successful control environment fosters a certain mind-set. Additionally, a number of papers attempted to emphasize the management system's impact on financial performance. Kinyua, Gakure, Gekara, and Orwa (2015), Muraleetharan (2013), Mawanda (2008), and Ali (2013) are a few of the research that are included in the lists.

2.1.6 Financial Performance

A company's financial performance is a monetary indicator of its actions and policies. It's a comprehensive measure of a business's overall financial health over time and can be used to compare businesses that are similar within the same industry or to group industries and sectors together. There are numerous ways to assess a company's financial performance. This is a subjective indicator of how well a corporation can use resources from its primary line of business to generate revenue and can be observed in the firm's return on investment (ROI), return on assets (ROA), and value added, among other indicators (Mishkin, 2007). A company's financial performance can be enhanced by the elimination of waste in benefit services, processes, and systems.

2.2 Theoretical Framework

This study will be guided by "The Agency Theory" as initially put across by Jensen & Meckling, (1976) and later expounded on by Gerrit Sarens & Mohammad J. Abdolmohammadi, (2010). Gerrit & Mohammad theory also has connotations with the Theory of firm articulated by Nicolai J. Foss *et al*. According to the agency theory a company consists of a nexus of contracts between the owners of economic resources (the principals) and managers (the agents) who are charged with using and controlling those resources (Jensen & Meckling, 1976). Agency theory posits that agents have more information than principals and that this information asymmetry adversely affects the principals' ability to monitor whether or not their interests are being properly served by agents. Furthermore, an assumption of agency theory is that principals and agents act rationally and use contracting to maximize their wealth. A consequence of this assumption may be the 'moral hazard' problem (Jensen & Meckling, 1976), indicating that in an effort to maximize their own wealth, agents may face the dilemma of acting against the interests of their principals. This Theory was chosen for this study simply because internal control is one of many mechanisms used in business to address the agency problem. and again "studies have shown that internal control reduces agency costs" (Abdel-khalik 1993; Barefield et al. 1993).

2.3 Empirical Literature

Olufunmilayo and Olubodun (2018), in their scholarly research, aimed to examine the influence of the internal control system on employee performance of small processing enterprises in Ondo state, Nigeria. A total of 4,500 enterprises registered with the Nigerian Association of Small Scale Industrialists in Ondo State, out of which 195 randomly selected processing enterprises formed the sample of the study. The study indicated that monitoring and control environment have considerable ($p<0.05$) effect on personnel performance. The study concluded that the internal control system considerably ($p<0.05$) influences the personnel performance of small-scale manufacturing enterprises in Ondo State, Nigeria. It was suggested that small-scale processing enterprises should give priority to the implementation of internal control system components since they influence personnel performance and, at the end of the day, organizational performance.

Yahya (2018) investigated the relationship between internal control practices and the financial performance of commercial state corporations in Kenya using a descriptive research design, targeting 33 commercial state corporations and using questionnaires. The research found that risk assessment, control environment, and information communication have a considerable ($p<0.05$) effect on financial performance.

Hoang, Duc, and Thug (2021), in their study of the impact of internal control on the quality of accounting information in Vietnamese paper-processing enterprises, using a correlational research design, analyzed the impact of internal control on the quality of accounting information. The scholars used questionnaires to conduct a survey within the paper processing firms. Out of 321 questionnaires distributed, only 296 were valid and were used in the research. Research results indicated that the accounting information system, control environment, and internal control procedures in Vietnamese paper processing enterprises have a considerable ($p<0.05$) influence on the quality of accounting systems.

Makamache and Chikwature, 2020 in their research, examined the effectiveness of internal control on operations performance using a case of uni-handling international limited, where the sample included clients (55), management (10), and Operational staff (30) having used the census method. The scholars managed to conclude a considerable ($p<0.05$) relationship between internal controls and operational and financial performance. Nevertheless, they also established that internal financial control is not a substitute for the individual performance of the entire personnel. Apparently, it has some imperfections, although those may be marginal Internal control effectiveness - a clustering approach, as studied by Länsiluoto et al. (2016), discovered that the concept of an effective internal control system, due to its multidimensional approach, cannot be viewed from a single perspective. Internal control components were evaluated based on their effectiveness in meeting the objectives of internal control, which were labelled in clusters 1, 2, and 3 respectively. Cluster 3 scored the lowest in the ranking, indicating that there is a relationship between the variables and that it is non-linear and complex. Firms with the most effective system received high marks. In a study conducted in Vietnam on the impact of internal control on pharmaceutical firm performance (Nguyen, 2021). The quantitative research found that monitoring, information, and communication had the greatest influence on performance when it came to internal control.

Channar et al. (2015) investigated the effectiveness of internal controls and their relationship to financial performance. It revealed the components' functionality as well as their relationship to financial performance. It used profitability ratios to measure financial performance and discovered that, when compared to a public bank, internal control is more effective in private banks but less effective in Islamic banks. The statistical significance of this discovery, however, was low, as was its financial operation, reiterating that the internal control system's efficiency and the banks' financial operation were both favorable.

3.0. Methodology

The research employed a descriptive survey together with a quantitative approach to primary source data collection and analysis. One hundred (100) small and medium scale enterprises made up the study's sample size. The respondents were chosen using simple random sampling technique. A set of questionnaires with 45 items was distributed to respondents based on all the study's factors. As a result, only those having proficiency and familiarity with adequate book keeping and accounting were selected. Consequently, one hundred (100) business owners were chosen. These one hundred (100) individuals received a questionnaire, of which seventy-five (75) were fully completed and returned, representing 75% of the respondents used for analysis. With the aid of the Statistical Package for Social Sciences (SPSS) version 20.00, the ordinary least squares method was used to analyse the data.

3.1 Model Specification

The study employed a multiple regression model, which has been proven to be appropriate for conducting multivariate data analysis. Researchers that backed the approach included Amissa (2017), Channar et al. (2015), and Kinyua et al. (2015). The models for regression are shown below:

$ROA_{it} = \beta_{0it} + \beta_1 \text{ RASS}_{it} + \beta_2 \text{ ICOM}_{it} + \beta_3 \text{ MONIT}_{it} + \mathcal{E}_{it}$ ………………………(3.1)

Where:

ROA = Return on Assets

RASS = Risk Assessment

ICOM = Information and Communication

MONIT = Monitoring

β_0 = Constant Terms

β_1, β_2, β_3 = Coefficients of the Predictable Variables

$\mathcal{E}$ = Error Term

4.0 Results and Discussion

Table 4.1: Descriptive Statistics

Variable	*N*	*Min*	*Max*	*Mean*	*Std. Dev*
RASS	75	2.00	4.51	3.383	.5805
ICOM	75	2.25	4.73	3.686	.6332
MONIT	75	2.40	4.43	3.358	.5082
ROA	75	2.25	5.00	3.381	.6360
Valid (leastwise)	N				

Source: **SPSS Output Results (Author's Computation) 2024**

Table 3.1 displayed the details of the descriptive statistics for the outcome and predictive variables. ROA = Return on Assets, RASS = Risk Assessment, ICOM = Information and Communication, MONIT = Monitoring. The most prominent among the results in the descriptive statistics is the higher standard deviations of ROA (0.6360) and lower standard deviation of MONIT (0.5082) relative to the standard deviations of other predictable variables used in the model, which range from 0.6 to 5.1. The higher standard deviation of ROA is an indication that the financial performance of the selected Small and medium scale enterprises are relatively influenced by effective internal system. Similarly, the mean value of Return on Assets (ROA), which is the metric that was used to measure the financial performance of Small and medium scale enterprises is 3.381 with a standard deviation of 0.6360. That suggests a high dispersion from the mean value of ROA recorded within the period of study. The outcome displays a minimum value of 0.225, and a maximum value of 0.500. The average value of 338.1% suggests that internal control, when employed efficiently, will help in boosting the Return on Assets, hence improving the financial performance of Small and medium scale enterprises in Ekiti State.

The result of the descriptive analysis in respect to Risk Assessment (RASS) further reflects a mean of 3.383, a standard deviation of 0.5805, a minimum of 0.200, and a maximum of 0.451. The mean value of 338.3% and a standard deviation of 58.05% indicate that there is a high dispersion from the mean value of RASS recorded because the standard deviation is lower than the mean value within the period of study. The high average value indicates that proper assessment of risk would help in improving the return on assets of small and medium scale enterprises in Ekiti. Information and Communication (ICOM) reveals a mean of 3.686 (368.6%) with a standard deviation of 0.6332 (63.32%), a minimum value of 0.225 and a maximum value of 0.475, This shows that there is a high dispersion from the mean value of ICOM recorded within the period of study. This result implies that small and medium scale enterprises are using an appreciable level of information and communication as medium of control in order to improve its ROA during the period under study. Also, the result reveals a mean of 3.358 in respect to Monitoring (MONIT) with a standard deviation of 0.5082. According to the standard deviation, there is little variation from the mean MONIT value observed over the study period. This suggests that sole proprietors of small and medium scale enterprises devote time to identify and correct the control weaknesses so as to materially improve their return on assets

Table 3.2: Correlation Matrix

VAR		*RASS*	*ICOM*	*MONIT*	*ROA*
RASS	Pearson Corr	1	.042	.152	.233
	Sig. (2-tailed)		.814	.367	.018
ICOM	Pearson Corr	.042	1	.093	.242
	Sig. (2-tailed)	.814		.584	.016
MONIT	Pearson Corr	.152	.093	1	.247
	Sig. (2-tailed)	.367	.584		.035
ROA	Pearson Corr	.233	.242	.047	1
	Sig. (2-tailed)	.018	.016	.035	

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

*. Correlation is significant at the 0.05 level (2-tailed).

***Source:* SPSS Output Results (Author's Computation) 2024**

The link between explanatory and outcome factors as well as between predictable variables themselves is determined using the correlation matrix in Table 3.2, The Pearson's coefficient of correlation was used because the goal was to describe the strength of the relationship between the variables. The correlation analysis was carried out by obtaining the average replies for each of the variables employed in this study. The table demonstrates a positive association between each independent variable (RASS, ICOM, MONIT) and the dependent variable (ROA).

Risk assessment (RASS) and Return on Assets in small and medium scale enterprises in Nigeria have a favourable and significant relationship. The correlation coefficient between risk assessment and the Return on Assets is 0.233, which is significant at 5%. (p-value of 0.018).

As a result, there is has a significance relationship between risk assessment and return of assets. Additionally, Information and Communication (ICOM) and Return on Assets (ROA) of small and medium scale enterprises were found to be positively and significantly correlated. The coefficient of 0.242, which is significant at 5%, served as proof of this (p-value of 0.016). This suggests that effective information and communication may boost the financial performance of small and medium scale enterprises. In a similar vein, Monitoring (MONIT) and Return on Assets (ROA) of small and medium scale enterprises were found to be positively and significantly correlated. The correlation coefficient between monitoring and the Return on Assets is 0.247, which is significant at 5%. (P=0.035<0.05). This suggests that sole proprietors of small and medium scale enterprises devote time to identify and correct the control weaknesses so as to materially improve their return on assets. The results of the Pearson regression demonstrate a substantial positive link between effective internal control system and the Return on Assets in small and medium scale enterprises in Nigeria.

4.1 Test of Hypotheses

Hypothesis One: There is no significant relationship between risk assessment and return on assets of small and medium scale enterprises in Ekiti State.

The correlation coefficient between risk assessment and the Return on Assets is 0.233, which is significant at 5%. (P=0.018<0.05). This shows a positive and significance relationship between risk assessment and return of assets. Therefore, the null hypothesis is rejected.

Hypothesis Two: There is no significant relationship between information and Communication and return on assets of small and medium scale enterprises in Ekiti State.

The correlation coefficient between information and communication and the Return on Assets is 0.242, which is significant at 5%. (P=0.016<0.05). This shows a positive and significance relationship between information and communication and return of assets. Therefore, the null hypothesis is rejected.

Hypothesis Three: There is no significant relationship between monitoring and return on assets of small and medium scale enterprises in Ekiti State.

The correlation coefficient between monitoring and the Return on Assets is 0.247, which is significant at 5%. (P=0.035<0.05). This shows a positive and significance relationship between information and communication and return of assets. Therefore, the null hypothesis is rejected.

5.0. Conclusion and Recommendation.

In line with the findings of the study on the analysis carried out on the effect of internal control on financial performance of small and medium scale enterprises, the study draws the following conclusions;

Risk assessment has a positive relationship on financial performance of small and medium scale enterprises in Ekiti State, and the relationship was statistically significant. This simply implies that risk assessment will result in an improved return on assets (ROA) of small and medium scale enterprises in Ekiti State. Also, information and communication has a positive relationship on financial performance of small and medium scale enterprises in Ekiti State, and the relationship was statistically significant. This simply implies that effective information and communication as a component of internal control will boost the return on assets (ROA) of small and medium scale enterprises in Ekiti State. Lastly, monitoring has a positive relationship on financial performance of small and medium scale enterprises in Ekiti State, and the relationship was statistically significant. This implies that owners of small and medium scale enterprises devote time to identify and correct the control weaknesses so as to materially improve their return on assets return on assets (ROA) of small and medium scale enterprises in Ekiti State. In summary, financial performance of small and medium scale enterprises in Ekiti State is impacted by internal control, and the basic components of internal control are essential to it. The study recommends that owners of small and medium scale enterprises should upgrade and ensure that internal controls are in place in their businesses to improve the financial performance and overall profitability in their operation.

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