Internal Control System and Financial Performance of Manufacturing Firms in Nigeria

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Abstract
Lack of internal control system or the weakness of the controls is the direct cause of cases of fraudulence of firm financial reporting. A lot have been debated by various researches about the importance and influence of internal controls particularly as the control affects the financial performance of firms. The study investigates the major effect of internal controls on financial performance of organizations such as production firms through a review of related literature comprising of conceptual, theoretical and empirical studies. The study is conceptual. From the review of recognized scholars in this field of study, it was found that there is good relationship between financial performance of production firms and the system of internal control. The study concluded that the success of any organization depends to a large extent on the measures an organization put in a place to support performance operations and facilitate the attainment of the objectives of the organization. Some of the recommendations of the study are as follows: Management must establish and maintain sound internal control system. Management must also prepare to combat any circumstances that may post threat to the organization's ability to achieve its target goals. The controls should be reviewed regularly for effectiveness.

Background to the Study

Every organization has its desired goals to achieve. The desire of the non- making profit organization may be to satisfy the social demands of the citizens (David, 2012). On the other hand, the target of the profit making organization may be to create wealth and maximize shareholders value (Arruanda, 2004). The basic factors of organizational governance are risk management and financial performance (Melanco, 2002). The success of any organization is to a large extent depend on the series of controls put in place to support its activities and facilitate the achievement of its goals (Mark, 2002). Some of the measures may include, recruitment of qualified and competent employees, establishment of security measures to assure assets protection, establishing process and procedures to execute operations, constituting policies that guides the attitude of organizational members, initiating procedures for authorization of transactions and the limits of employees as well as management supervision, providing proper procedure for record keeping, establishing cordial relationship among members of the organization and formulating methods of performance reporting within the organization (Abdolmohammadi, Read, and Scarbrough, 2013). The above measures together with others such as internal auditing that a firm may implement in order to attain its line up objectives necessitated an internal control system of an organization (David, 2013). The size, nature and range of a particular organization that may make it impossible for the management to carry out personal and first hand supervision of activities also constitute a system of internal controls (Mark, 2002).

Business failure around the world today, have been attributed to the failure of internal control system (Boulescu, 2003). The winding up of many organizations across the world today, such as Okiti-Pupa Palm Oil, Ifon Ceramic Industry, Akure Coca-Cola, Igbokoda Oluwa Glass, Ajaokuta Power and Steel, NITEL, Ekiti Block Industry, Lagos Leventis Store, John Holt, United African Company, Dunlop and Menchelline tyres UTC Motors and UAC (in Nigeria): Sports Authority and WorldCom (in Europe): Maxwell Communication Corporation and Tyco (in England) were due to failure of internal control system. Internal controls help organizations to achieve their desired goals. However, the collapse of the above mentioned organizations have raised concerns about the importance and influence of system of internal controls, particularly as it affects financial performance of organizations.

There have been a lot of researches on internal control system of firms. It appears to be no empirical studies on the effects of internal controls system on the financial performance of firms. Also, there was no empirical study on the financial performance of firm like micro finance institutions. The federal government of Nigeria approved over eight hundred (800) of the micro finance institutions to alleviate poverty in the country. But due to the failure of internal control system, over five hundred (500) of the financial institutions collapsed in the country. Arising from the above, there is need to carry out a research to determine the effects of internal controls on the financial performance towards identifying the gap that could be of interest to future research studies on financial performance of firms in Nigeria.

Statement of the Problem

Internal control and its effects on the quality of financial reporting should be regarded as very important in all firms just because the task of the controls is to preclude and prevent fraud in firms. Internal controls are established to forestall misappropriation of firm's properties, to detect and safeguard the assets against likely frauds and to ensure safe custody of all assets. Every organization should recruit qualified, skillful, competent and dedicated employees. Honesty and sincerity of management is very important for the success of an organization. Nonetheless, firms still battle with liquidity problems, untimely financial reports, deficient accountability for the organization's financial resources, fraud and abuse of the organizational resources and unwise decisions that lead to the failure of achieving the firm's expected results. Also, business activities are not carried out according to the rules and regulations guiding the activities of the firms such as accounting standards and Generally Accepted Accounting Principles (GAAPs). This results to the misuse of the firm's properties, incomplete financial records and inadequate information which leads to misleading financial statements that cannot be relied on by the users of financial statements (stakeholders) of the organizations. Accel (2014) opined that inadequate controls has resulted to large business loss due to fraud and misappropriation of the assets while organizations and stakeholders have suffered huge losses.

Objectives of the Study

The broad objective of the study is to examine the impacts of internal control system on financial performance of production firms in Nigeria. The specific objectives are to:

- **i.** Examine the extent to which Internal Control System affects financial performance of production firms in Nigeria, and
- **ii.** To determine the association between internal control system and financial perfor mance of production firms in Nigeria.

Literature Review

The section discussed conceptual issues, relevant theories and empirical evidences from prior studies relating to the effects of internal control systems and financial performance of production firms in Nigeria.

Conceptual Framework

Conceptual issues reviewed include: Internal Control Systems and Financial Performance of Manufacturing Firms.

Internal Control System (ICS)

Internal control system is categorized into accounting and administrative controls (Sawyer, 2003). Accounting control connotes with the plan of the organization, logics and process which are executed with a view of securing assets and promoting dependability of financial records (Pandy, 2007). Administrative control consist the plan of an organization, logics and process which are executed with a view of securing assets and assuring dependability of operational efficiency and adherence to management policies and directives. This is also referred to as operational controls (David, 2009, Iman, Novita, and Tarmizi, 2017).When control is weak, operational efficiency can be subverted notwithstanding the nature of the organization (McKinely, Pany, and Reckers, 1985). If there is no control in place, the financial management of an organization will end in lawlessness, which can be amounted into a free for all between the management and employees (Tsedal, 2015).

Organizational control is the plan of activities that define and apportion obligations to an individual that is referred to as scheduled officer (Knowledge Management Team, 2009). There is always a line of reporting activities of the organization through the appropriate channel (Lakis & Girinjnas, 2012). Segregation of duty is one of the most premier controls in an organization. It brings down the risk of internal manipulation and inadvertent error and gain the component of checking irregularities (Lawrence, 2002). Physical control deals with the physical custody of properties. It involves the process and technics put in place to bound admittance to unauthorized areas in an organization ((Lawrence, 2010). Arithmetical and accounting controls are controls that check and confirm that transactions to be processed are accurate and correct (Tsedal, 2015). The success of any organization depends on the competency, ability, skills, qualification and integrity of the operators. Personnel control deals with the recruitment of suitable candidates and necessary training of employees (Lord, & DeZoort, 2011). Supervision control: This control deals with the day-to-day activities of an organization. It involves the supervision of the activities of one person by another. This is usually the relationship between a superior and subordinate. The later reports performance activities to the former (Mahmoud, 2016). Management control. This is a control exercised by the management of an organization within and outside the entity for the success of operations. This type of control is the overall control of the organization. It reviews other controls to ensure adherence compliance to organization's policies (Mautz and Sharaf, 1980). Authorization and approval control. This control requires an ideal situation. It takes bureaucratic form. Before any action is taken place at all, there must be request of action to be considered for approval by the authority (Mu'azu and Siti, 2014).

Internal control is the combination of inter-related autonomous controls that put in place by management to accomplish a number of objectives in an organization. When management fails to establish a proper internal audit system in an organization, the internal control will be ineffective. A good internal audit aids the effectiveness of internal control (Pandy, 2007). Other factors responsible for the defect of internal control include dishonesty, fraudulent act, and unstable environment. A deliberate and misrepresentation of financial information by one or more individuals among the management or employees makes the control not to be functional. Also, manipulation and falsification of records or documents renders the control useless. An unstable environment could also lead to defect in internal control system (Knapp, 2003).

It is obvious that internal controls are indispensable characteristics of any organization. However, no matter how good internal control system is, it cannot guarantee its effectiveness. In most cases, the system is override by the authority (Mu'azu and Siti, 2014).

Ewa and Udoayang (2012) opines that the absence of internal control system in a production organization amounts to urge fraud. This study is of the opinion that as far as production companies are concern, the foremost issue that the control prevents is abuse of organizational fund and assets, while fraud is the least issue that the control prevents. Okoli (2012) submitted that an organization will only thrive if it has internal control system. Okoli (2012) stressed further that preparation of financial statements in line with regulatory requirement enhances financial status. This study argues that it is not enough to say that the present of internal control system in an organization will make it successful. The most important aspect of any control is protection. If there is control in an establishment, and the control is not adequately protected, such control becomes useless.

Financial Performance

Performance relates to the attainment of a given task measured against predetermined standards of fact, completeness, cost, and velocity (Chuke, 2001. Iman, Novita and Tarmiri, 2017. Amanj and Akram, 2016). Performance is the level at which achievement has been attained in an organization (Moyer, McGulgan and Kretlow, 2005. National Treasury Publication (NTP), 2003, and Fairfax County Publication (FCP), 2008). Performance implies the behaviour of the activities of an organization over a specified period of time (Veronica, Tarno and Voros, 2014., Angus, 2014., Artsberg, 2005., Auditing Standards, 2014 and Barlett, 1991, 1993). Financial performance is the deed of performing financial activities. In a broad term, financial performance refers to the level to which financial objectives has been attained. It is the process of measuring the performance of an organization's policies and operations in pecuniary terms. It is used to measure organization's overall financial status over a period of time and can also be used to compare similar industries or sectors in the same economy.

The purpose of measuring financial performance is to compare performance with the predetermined plans of organizations. The variables to be measured are explained below: Growth: Growth refers to the enlargement of an organization over a time. Artsberg (2005) measured 50 companies in four categories, such as liquidity, owner earnings, management profit performance and purchase. He concluded that the growth variable did not have any important influence on financial performance. Profitability: Out of accounting measures, profit exhibits how effective the management of an organization is in terms of investment and financing decisions. Profitability ratios measure how effectual the management of an organization realizes profits on sales, total assets, and stockholders' investment (Artsberg, 2005). Capital structure: Capital structure is another essential factor that determines the performance of an organization. Capital structure refers to the ratio of debt and equity financing (Elliot, 1972). Liquidity: Beyond securing an organization survival, liquidity aids companies to reach higher profitability by reducing their input needs. It also grants strategic benefit in the economically difficult period (Veronika, Tarnóczi, and Vörös, 2014). Long-term and short-term creditors are concerned with the amount of leverage a company employs because it indicates the company's risk exposure in meeting debt service charges i.e. interest and principal repayment (Watts and Zimmerman, 1978., Cengage 2006., Clark and Flanagan, 2015., Crane 2004 and Dejan 2011). A company that is heavily financed by debt gives creditors less protection in the event of bankruptcy (Moyer, McGulgan, and Kretlow, 2005). Liquidity ratios depicts the association of an organization's current assets to its current liabilities, and its ability to meet due debts. Two commonly used ratios are the current ratio and the quick ratio (Brigham and Micheal, 2008).

Financial performance analysis can be classified into material and routine use (Numzilar, Norhagah, and Sarmah, 2012). Under the basis of material used, financial performance can be analyzed into internal and external analysis (Exchange Commission, 2007). Internal analysis is the undertaken by the employers and employees of the organization who have access to the books of account and other information related to the business (Foreign Corrupt Practice Art (FCPA), 1997). External analysis is the undertaken by the outsiders of the business such as investors, creditors and government who are deny access to the internal records of the organization (George, 2009). The system of **f**inancial performance can be analyzed into horizontal and vertical. Horizontal analysis reviews financial statements for a number of years and analyzed it. The current year's figures are measured with the standard and changes are shown. This analysis aids management to have an insight into levels and areas of strength and weaknesses (Knapp, 2003). Vertical analysis studies the quantitative relationship of the various items of financial statements on a particular date. It is useful in comparing the performance of several companies in the same group (Knapp, 2003). In most cases, financial analysts assess organization's production and productivity performances on profitability, liquidity, working capital, fixed assets, fund flow, social, financial structure activity and profitability (George, 2009).

Analysis of financial performance assists various groups in an organization. Interest of various groups in the organization is determined by the financial performance of the establishment. Creditors are interested in the liquidity of the organization. Bond holders are interested in the cash-flow ability of the organization. Investors are interested in present and expected future earnings as well as stability of the organization. Management is interested in internal control, good financial condition and better performance of the organization (George, 2009, and Melancon, 2002).

Review of Empirical Studies

Dejan carried out a research work on the internal audit position of companies in Europe, United State in 2011. He adopted interview to obtain data. Ordered logistic regression model was used to analyze the data collected. In his findings, it was revealed that there is connection between the legal form of companies and internal control system. The result of the scholar is in line with our findings. Our findings reported that there is good relationship between internal control system and financial performance of manufacturing firms.

Nurmzilah, Norhagah and Saramah (2012) analyzed the role and authority of internal auditors in ensuring financial performance of manufacturing firms through internal control systems in Malaysia. Unstructured questionnaire was applied for data collection. The data collected was analyzed with correlation method of analysis. Their research work depicts that internal auditors enjoy authority and autonomous over the management in the organizations in the country. The result of the researchers is at variance with our findings.

Hongming and Yanan studied the correlation between internal control system and enterprise value based on the information system in China in 2012. They used questionnaire and interview to obtain data. They analyzed their data with regression analyzes and percentages. They found that there is no cohesion between internal control system, internal information and communication. This study did not state the effects of not having cohesion between internal control system, internal information and communication, as it was clearly demonstrated in our findings. When there is no coherence between the above phenomenon, the value of enterprise could not be enhanced.

Mu'azu and Siti (2014) reviewed the effectiveness of internal auditing in some of the organizations in Nigeria. They adopted structured questionnaire to obtain data. The data obtained analyzed with quantitative technics analysis. They found that internal control was able to achieve its targets based on good internal audits in the organizations in the country. Their results agreed with our findings. There is no doubt good internal auditing enhances the performances of internal controls.

Tsedal (2015) analyzed the quality of internal auditing in Ethiopian public Universities in Addis Ababa. He applied unstructured questionnaire to obtain data. He used ordinary least square regression to analyze data. The results of his findings revealed that there is no clear line of responsibility in the universities. The result of this researcher is not explicit. The result did not indicated whether the none clear line of responsibility in the Universities was caused due to lack of internal control system or weak of the controls as clearly stated in our findings.

Ironkwe and Promise (2015) carried out a research study on the impact of internal controls on financial performance in production companies in Nigeria. They applied questionnaire and interview to collect data. The data collected was analyzed with panel regression. Their findings revealed that there is no significant association between internal control system and the usage of organizations funds and assets. In addition, their result revealed that there is no relationship between the inadequacy of the controls and fraud perpetration in organizations in the country. Their results are not in line with our findings. Our findings indicated that internal control system prevent and detect frauds.

Amanj and Akram reviewed the effects of internal control system on the financial performance in telecommunication companies in Australia in 2016. They adopted survey questionnaire for data collection. They analyzed their data with percentages. In their result, they revealed that the control served the purpose it was designed for in the companies. Their result further revealed that not all the companies in the country valued internal control system. The first result of their study agreed with our findings that internal control system enhanced the success of financial performance in manufacturing firms. The worry about these results is that the researchers did not tell readers the danger in not valuing internal controls in an organization.

The association of internal control system and public sector revenue generation was analyzed by Mahmoud in Nigeria in 2016. Coded questionnaire was used to gather data, while correlation analysis was used by him for the analysis of the data. He found that there was frequent auditing of public sectors in the country. He further found that the good internal auditing in the sectors aid the control's effectiveness. The results of the study corroborate our findings that when there is good internal auditing in an organization, it strengthens internal controls.

Toma, Sahabi, Gordon, and Mohammed (2007) conducted a research work on impact of auditing and internal control system on health institutions in Ghana**.** They adopted structured questionnaire as a tool for the collection of data. They analyzed their data with quantitative technics. They found that internal control system achieves significantly the desired results in the financial performances of some of the health sectors. Also, they discovered that auditing and internal control system of the institution was effective. The results of the researchers justified our findings that there is cordial relationship between financial performance of manufacturing companies and internal control systems that resulted to the achievements of the firms.

David (2009), Iman, Novita and Tarmizi (2017) examined the value of internal auditing and internal control system on the accountability in Indonesia. The study applied survey research for its data collection, while correlation method of analysis was adopted to analyze their data. Their findings revealed that the application of internal auditing and internal control system really improve the quality of accountability in the country. Their results are in consonance with our findings that the application of sound system of internal controls aids the success of organizations.

Methodology

The study is a conceptual paper. As a result, no quantitative tool was applied. The study was carried out on the basis of library desk research and survey of extant literature. In addition, Journal and textbooks were consulted in the writing of the paper.

Discussion

Financial performance is an important aspect of a firm. No organization can grow without good financial performance. The going concern of a particular firm depends to a large extent on its financial performance. The financial performance is used to measure the achievement of a given firm at a particular point in time. It shows the condition of the firm for a specified period. The reason for measuring the success of firms is to get required information related to fund flow, usage of fund, effectiveness, and efficiency. The information can also motivate managers to make the necessary decisions. (David, 2009; Iman; Novita, and Tarmizi, 2017). Profitability is most essential among accounting measures. It presents how good management is doing in investment and financing decisions. Profitability ratios quantify how effectual the management of a firm is generating profits on sales, assets, and stakeholders' investment. As regards corporate performance, we concentrate on the successes of an entity. Researchers regard corporate performances as components of management performances with reference to financial and non-financial performances. Strategic performance is an alternative approach to corporate performance. It is considered as a serial of steps with the intention of ensuring implementation of strategic, tactical and operational plans in line with the objectives of the firm (Dejan, 2011). Performance of an entity depends on the conduct of the personnel charged with governance within and outside of the firm. International standards recognize that task provided by qualified managers is a very good factor in constituting a positive control environment, contributing to the execution of effective internal controls. Administration with sets clear objectives prevents risk activities, and demonstrates personal interest in monitoring and developing effective system of internal control (Bouloscu, 2011). According to Chita & Promise (2006),"Management accounting may be regarded as performance factors aiding the firm to attain its desired goals. Financial statements are the process of communicating financial performance of organizations (US, 2003). The statements provide users such as shareholders, competitors, employees with useful insights about the financial verve and value of a firm. Administrators and management accountants required to study, analyze and interpret financial statements for further decision making (Dejan, 2011).

Internal control comprises the plan of an organization and all the coordinate methods and measures adopted within a business to safeguard its assets check the accuracy and reliability of its accounting data prorate operational efficiency and adherence to prescribed managerial policies." The definition of internal control is divided into financial internal control and non-financial (administrative) internal control. Financial internal control pertains to financial activities and may be exemplified by controls over company's cash receipts and payments financing operations and company's management of receipts and payments. Financial internal control on the other hand deals with activities that are indirectly financial in nature i.e. controls over company's personnel section and its operations, fixed assets controls and even controls over laid down procedures. (David, 2011), A sound internal control system helps an organization to prevent frauds, errors and minimize wastage .Custody of assets is strengthened; it provides assurance to the management on the dependability of accounting data eliminates unnecessary suspicion and helps in maintenance of adequate and reliable accounting records.is correct (Arruada, 2004). Despite the fact that good internal control systems are expensive to install and maintain, it is important that every firm must establish the controls forth purpose successful operations (Woods, 2009).

Researches have attempted to explain the construct of rural development in the past. David (2009); Iman; Novita, & Tarmizi (2017) delimit rural development as a betterment of the living standards of the less income group living in the far distance areas on a self-keep up basis through transmuting socio-special structure of their productive (Dejan, 2011).
It is well asserted that empowerment is closely colligated to development as it implies an increase in economic strength of people. Rural development and empowerment are therefore vital elements for alleviating poverty and assuring society's economic growth and transformation (Okoli, 2012). Economic development is about people's welfare. It was contented that rural habitants require empowerment to alive and enhance their enterprise and thus make them commercially workable and sustainable (Lord, & DeZoortd, 2011). Cultivators require farm tools, seeds, fertilizer and pesticides. Empowerment is demanded to cater for the micro nature of their enterprises. Economic growth in the agricultural sector had long been identified as stipulation to overall economic growth and poverty reduction. (Pandy, 2007).World Bank categorized microfinance institutions as financial institutions that "consists agents and organizations engaged in relatively small financial transactions using specialized methodologies to serve low income households (George, 2009). Judging from all indications, it is clear that the focus and key objective of microfinance is poverty alleviation. Unfortunately, due to the failure of internal control system most of the micro finance institutions in Nigeria collapsed and failed to realize their purposes. As a result, many Nigerians suffered the required empowerment. .

Summary of Findings

The study analyzed the effects of system of internal control on financial performance of manufacturing firms in Nigeria, through adequate review of related literatures comprising of conceptual, theoretical and empirical. The paper searched to determine the extent to which internal control system influence financial performance of manufacturing firms in Nigeria. The results of the study depict that internal control system to a substantial extent influence financial performance of manufacturing firms in the country. The study revealed that positive relationship exists between internal controls and financial performance.

Recommendations

The following recommendations are based on the findings of the study:
Management should always cultivate the attitude of establishing and maintaining enable control environment as the success of their businesses lying on the strength of the control environment. This is achieve able by ensuring that: authorities and audit committee meet on regularly to review performance of the organization, qualified and experience employees are recruited in the services of the organizations, training on the jobs to acquire more experience as well as constituting the necessary human resources policies to motivate employees and ensure that integrity and ethical behaviour are the priorities of the organization, The management of manufacturing firms supported by the audit committee should make sure that the system of internal control is regularly monitored and review, Management should establish internal control systems in such a way that it will build the confidence of investors in the manufacturing firms, Those charged with the supervision of the manufacturing firms should

prepare to combat all possible circumstances (manufacturing risk) that may threaten the company's ability to achieve its line up objectives. This is done through regular appraisement of the controlling environment of the organization to detect threats that may arise from technical challenges, legislation and competitions. Well established internal auditing is good for this assignment. Internal control system should be made a priority in firms like micro finance institutions to put an end to the unwarranted collapse of the institutions. This will to a great extent reduce the hardship of the people in the remote area.

Conclusion

Arising from the findings of the study, it is important to conclude as follows:
Many business failure across the world, have been associated to the failure of internal controls, There is fundamental relationship between system of internal controls and financial performance of manufacturing firms in Nigeria, The achievements of manufacturing firms that are successful in Nigeria is as result of well constituting of internal controls within the organizations, In adequate internal control systems resulted to business failure in the country, Lack of internal controls or the presence of weak internal controls is the major cause of business collapse in Nigeria

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