Effect of Internal Control Systems on Financial Reporting of Corporate Organizations in Nigeria

MUFUTAU, Adewale M.

Department of Accounting
Bingham University,
Karu, Nasarawa State.
E – Mail: mufadem@yahoo.com, Phone No: +234 7030124655

Abstract

The purpose of this study is to establish the relationship that exists between internal control activities and the financial reporting of corporate organizations in Nigeria. The literature review is based on agency theory and stakeholder theory. An exploratory research design was carried out. The study used the secondary method of data collection basically sourced from journals, the internet, and other relevant publication. The study had the following research questions: is there any relationship between internal control and quality report? does board size have any significant impact on financial reporting, and if there is a significant difference between internal control and financial reporting? The study shows that there is a significant relationship between internal control and quality financial reporting. The study recommends that more studies of internal control be undertaken as this will have an impact on financial reporting. The investigation recommends proper checks and balances in all financial transactions. There should be an effective and efficient security network to reduce frequent theft, a threat to life and property. The study also recommends that the management of every corporate organization should organize regular training for staff on the control mechanism.

Keywords: Internal control, control activities, financial reporting, corporate organization

INTRODUCTION

Internal control is the system or mechanism rules, and procedures implemented by a company to ensure the integrity of financial and accounting information, promote accountability and prevent fraud by which companies are directed and controlled. The quality and the way the internal contol is either effective or ineffective have significant effect in the financial reporting of the organizations. The management should ensure that control put in place is strictly adhered to by staff and ensure, this can be effect through proper training and stiff penalty for deviants. Corporate governance involves a set of association amongst a company's board, its shareholder and other stakeholders. Corporate governance also provides the arrangement through which the objectives of the company are set, and the way of attaining those objectives (Cadbury, 1992). Good corporate governance is a product of high financial reporting quality that would reduce the fraudulent disclosures of report from the annual financial statements (Norwani et al. 2011). Corporate governance cannot be separated from financial reporting quality Cohen et al. [2004]. Financial reporting quality is defined as the financial disclosure statements that will disclose the financial status in the annual report and strengthen the investors' confidence in making credible decisions about their organizations. The chief objectives of financial reporting is to portray the position and performance of the entity in question so that investors in equity and debt, among other stakeholders, can make credible and economic decisions based on accurate information regarding potential risks and returns (Deloitte, 2012; FRCN, 2015). Board of directors' responsibility is to render service on how the economic resources of the shareholders were used. The shareholders thereafter, used an external auditor to provide assurance service to confirm that the financial reports put together by Management show a true and fair view of financial dealings of the organization for the indicated duration. One of the major responsibilities of auditors is that, they assure confidence to financial statements users about the reported information. Audit services have been crucial to the quality of financial reporting since industrial revolution. To be noted that information provided to the auditor is a function of internal control, if the control activities of the organization is poor , this will definitely affect the outcome of the auditor report.

Internal control as defined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a process, affected by an entity's board of directors (trustees), management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: Effectiveness and efficiency of operations,reliability of financial reporting compliance with applicable laws and regulations.They include a wide range of activities that occur throughout the organization, by supervisory and front-line personnel. Typically, management is responsible for developing an appropriate system of internal controls, but every employee is responsible for following and applying those practices. Key Internal Control Activities in the workplace. All employees fit into the organizational picture of internal control, whether or not their job responsibilities are directly related to these example activities.Segregation of Duties, Authorization and Approval, Reconciliation and Review, Physical Security.Turnbull (2020) explanation focuses on the positive role that internal control has to play in an organization. Facilitating efficient operations implies improvement, and, properly applied, internal control processes add value to an organization by considering outcomes against original plans and then proposing ways in which they might be addressed.At the same time, Turnbull also conceded that there is no such thing as a perfect internal control system, as all organizations operate in a dynamic environment: just as some risks recede into insignificance, new risks will emerge, some of which will be difficult or impossible to anticipate. The purpose of any control system should therefore be to provide reasonable assurance that the organization can meet its objectives. The main objectives of internal control are:Efficient conduct of business,Safeguarding assets,preventing and detecting fraud and other unlawful acts,completeness and accuracy of financial records,timely preparation of financial statements (ACCA, 2014).

Internal control failures are what happens with the internal controls a company has are flawed, so flawed "that a material misstatement in a company's financial statements will not be prevented or corrected.", Financial reporting is considered as being of high quality if it possesses three attributes which include transparency, full disclosure, and comparability. Transparency is referred to as therevealing of information about events, transactions, judgment, and estimates which allows users to see the result and implication of decisions, judgment and estimates of preparers. Full disclosure is related to the provision of all information necessary for decision-making while comparability means that similar transactions are accounted for in the same manner both cross- sectional arising among companies as well as over time (Barton&Waymire,2004). Several factors could influence the quality of financial reporting among which are the the control system that produces the report. The effectiveness of the control in the financial reporting process could depend on its effectiveness and efficiency. (Klein, 2002). The management opportunist conduct which could influence the quality of reporting may likely be moderated or reduced by an effective internal control (Chandar, Chang, & Zheng, 2012; Liao & Hsu, 2013). The existence of control in an organization is beneficial to management, external and internal auditors since it enhances the quality of the internal control system (Musa & Oloruntoba, 2014). Internal control tends to provide a positive signal about financial disclosure and help enhance shareholders' confidence in financial reporting quality (Islam et al. 2010). Recent research documents that effective controlsystem could be fundamental to high financial reporting quality (Fodio et al. 2013; Hassan, 2012). The aim of this study is to ascertain whether effective internal control system could lead to high financial reporting quality. The significance of the study of internal control system is that they help in monitoring and overseeing the financial statements. Also,it assists the firm in maintaining the goal and objectives of meeting the shareholders wealth and increasing the investor confidence in the financial reporting quality. The theoretical and contextual contribution of the study is that there is a positive relationship between internal control and financial reporting quality in the annual report and this agrees with the agency and stakeholder theory viewpoint. This can be attributed to the fact that large firms demand and use better corporate governance mechanisms in disclosing information to the advantage of the stakeholders (Barbu et al., 2014)

LITERATURE REVIEW

Conceptual Framework

Internal Control

An internal control is a procedure or policy put in place by management to safeguard assets, promote accountability, increase efficiency, and stop fraudulent behavior. In other words, internal control is a process put in place to prevent employees from stealing assets or committing fraud.Since the accounting scandals in the early 2000s, there has been an increasing importance placed on internal controls in every level of an organization. In fact, the Sarbanes Oxley Act requires management to design, implement, and personally evaluate the effectiveness of internal controls within the business. Executives found guilty of not properly managing the internal control structure of their companies can face fines and even prison time now.Needless to say, internal controls are a big deal. They protect the company assets and even help streamline the operations.

According to Adedoyin (2012),The seeming obscurity of the internal audit is reinforced by the fact that the form its reports should take, is not expressly provided for in the Companies and Allied Matters Act 1990. Even Sections 63-65 of the Investment and Securities Act (ISA) 2007 which require external auditors to provide assurance on the internal control system of corporate entities did not also specify the format of reporting. Yet these pieces of legislation strictly confer on the Board of Directors the responsibility for evolving internal control measures that will guarantee the security of corporate assets, which is one of the main duties of the internal audit department. In spite of these legal inadequacies, the role of internal audit in value creation deserves to be acknowledged. Thus, efforts by an organization to seek and adopt best practices in internal control and audit efficiency, is most commendable. Internal Control System (ICS) is a process affected by an organization's board of directors and all the levels of management designed to provide reasonable assurance regarding the effectiveness and efficiency of operations, reliability of financial reporting and compliance with management policies (COSO, 2009; 2013). The board of directors retains oversight responsibility for management's design, implementation, and conduct of internal control. Studies have examined the effectiveness or quality of ICS from different perspectives Kinney and McDaniel, 1989; DeFond and Jiambalvo (1991); Krishnan; Bryan and Lilien (2005) used characteristics such as firm size and beta, Frankel, Johnson & Nelson, 2002;Chan, Farrell, & Lee, (2005) employed firms reporting material weaknesses, earnings management and lower return-earnings associations, Doyle, Ge, & McVay (2006) took accruals quality of material weakness firms.

Quality Financial Reporting

Whittington & Pany (2001), talk about the comprehensiveness of internal controls in addressing the achievement of objectives in the areas of financial reporting, operations and compliance with laws and regulations. They further note that “Internal control also includes the program for preparing, verifying and distributing to the various levels of management those current reports and analyses that enable executives to maintain control over the variety of activities and functions that are performed in a large organization” They mention internal control devices to include; use of budgetary techniques, production standards, inspection laboratories, employee training and time & motion studies among others. According Bakibinga 2001, corporate law requires a divorce between ownership and management of an entity. Owners normally entrust their resources in the hands of managers. Managers are required to use the resources entrusted to them in the furtherance of the entity’s objectives. Managers normally report to the owners on the results of their stewardship for the resources entrusted to them through a medium called financial statements. It is these financial statements that reveal the financial performance of an entity. John J. Morris (2011) believes that Enterprise Resource Planning systems provide a mechanism to deliver fast, accurate financial reporting with built-in controls that are designed to ensure the accuracy and reliability of the financial information being reported to shareholders.

Empirical Review

Mansur and Muhammad (2020) carried out a study on the Emperical investigation of Financial Reporting Quality And Internal Control System Of Nigerian Stock Exchange Lotus Islamic Index. This research study is based on Ex-post factor research design, is a non-experimental research technique, and secondary source of data collection was used and financial reporting and the internal control system of the 15 companies that made the Lotus Islamic Index for period of 2012-2016 were obtained. Data was anayzed using the Regression and Correlation Results. The primary objective of the study is to examine the financial reporting quality and the internal control system of the 15 companies that made the Lotus Islamic Index for period of 2012-2016.The aim of analysis used is to determine the relationship that exist between variables for the same time frame.The major finding of the study was that the Control Environment Control Activities & Monitoring aspect of Internal Control System significantly relates to Financial Reporting Quality. Ejoh and Patrick (2014), in their study,The Impact of Internal Control Activities on Financial Performance of Tertiary Institutions in Nigeria.Thier study provides evidence of a link beetween internal control and quality financial reporting disclosure.The study establishes the relationship between internal control activities and financial performance in Tertiary Institutions in Nigeria. The study area is Cross River State College of Education, Akamkpa. Data was collected using questionnaires and interview guide as well as review of documents and articles. The method of analysis employed was survey design while the stratified sampling procedure wasadopted in administering the questionnaires. The data were analyzed using simple percentages, tables,correlation coefficient and z-scores. The study revealed that all activities of the College are initiated by the top management. Regarding control activities, the study found that there is clear separation of role in the institutions' finance and account department and that superior officer in the College supervised regularly work done by their subordinate. Also, the study found that the institution financial statements are audited annually by external auditors. However, there is a possibility for a single staff to have access to all valuable financial information without the consent of other staff. On the budgetary control, the study revealed that the institution adhere strictly to the provisions of annual departmental budget and that control are in place to exclude incurring expenditure in excess of allocated fund. Also, there is poor security network in the College. The study result further showed that there is no significant relationship between internal control activities and financial performance of Cross River State College of Education. The investigation recommends proper checks and balances in all financial transactions. There should be effective and efficient security network to reduce frequent theft, threat to life and property. The study also recommends that management of the institution should organize regular training for staff on control mechanism.

Theoretical Framework

Agency Theory

Agency theory discusses the separation of ownership from control in the modern enterprise, the agent-principal relationship and the consequential conflict of interest that has emerged. Ideally, managers as agents are expected to monitor corporate affairs in a most profitable manner so as to maximize the value of the owners as principals and protect the interest of other stakeholders. Under the theory, managers are responsible for managing the business profitably and are also responsible for preparing the financial statement of the organization at the end of the period. While the control and the running of the day-to-day affairs of corporate entities is with the managers, there are two major factors that usually give rise to agency problems; self-serving interest and incentives/managerial discretions. For instance, the interest of management usually conflicts with the interest of the owners, in which the managers try to meet their goals at the expense of the firm, and this can affect the performance in many ways. On the other hand, managers are usually given incentives to meet or to beat earnings target and hence receive bonuses that are tied to the firm's earnings (i.e. performance related). Considering the influence of managers and possibilities of information asymmetry between managers and owners, the managers are likely to use the discretion they have on accruals and manipulate firm performance through accounting earnings.

Stakeholder Theory

The word "stakeholder", the way we now use it, first appeared in an internal memorandum at the Stanford Research Institute (now SRI International, Inc.), in 1963. The term was meant to challenge the notion that stockholders are the only group to whom management need be responsive3. By the late 1970's and early 1980's scholars and practitioners were working to develop management theories to help explain management problems that involved high levels of uncertainty and change. Much of the management vocabulary that had previously developed under the influence of Weberian bureaucratic theory assumed that organizations were in relatively stable environments. In addition, little attention, since Barnard (1938), had been paid to the ethical aspects of business or management, and management education was embedded in a search for theories that allowed more certainty, prediction and behavioral control. It was in this environment that Freeman (1984) suggested that managers apply a vocabulary based on the "stakeholder" concept. Throughout the 1980's and 1990's Freeman and other scholars shaped this vocabulary to address these three interconnected problems relating to business.

METHODOLOGY

This study adopted the exploratory assessment method by reviewing research work done by other researchers in related work. The data for this research study were adequately sourced using the secondary method of data collection basically sourced from the internet, articles by researchers and other relevant publications.

RESULT AND DISCUSSION

Samuel, Mudzamir and Mohammad (2017) carried out a study on; Empirical Analysis on the Financial Reporting Quality of the Quoted Firms in Nigeria: Does Audit Committee Size Matter? This paper examined the relationship of audit committee size and financial reporting quality in Nigeria. The empirical study has performed using a sample of 189 companies and 664 year observation from the period of 2011-2015. One of the desirable features of corporate governance is to enhance financial reporting quality for facilitating efficient and effective resources allocation of economic decision making by corporate managers. Panel data regression was adopted and audit committee size was found positive and significant with financial reporting quality .Our results underscore the importance of the corporate governance recommendation as a mean of strengthening the monitoring and oversight role of audit committee plays in the financial reporting process. Finally the study offered recommendations to enhance financial reporting quality disclosure. Owolabi, Babarinde, Thomas (2020), the study examined theEffect of Corporate Governance on Audit Quality in Nigerian Banks. This paper examined the effect of corporate governance on audit quality in deposit money banks (DMBs) in Nigeria. This research also examined and determined the impact that the gender diversity, size of the board, Non-Executive in the Board, foreign directorship and board composition have on the audit quality in Nigeria IDMBs. Secondary data were gathered from fifteen (15) listed banks covered the duration of twelve years (2007 - 2018). The data were processed using panel data estimator which was based on pooled regression model, fixed effect model and random effect model while the hausman test were used to choose the better model. The result showed that gender diversity ethnic diversity, board composition and board size are significant variables that can explicate on audit quality of the deposit money banks in Nigeria, but foreign diversity cannot significantly explicate on audit quality. Surge in ethnic representation on the board of directors will have substantial effect on the audit assurance of the Banks in the country.

Enekwe, Chike and Udeh conducted a study on the effect of audit quality on financial performance of listed manufacturing firms in Nigeria from 2006-2016. The study specifically investigated the effects of auditor's independence, audit committee and audit fee on return on assets of listed manufacturing firms. Ex- post facto research design was adopted for the study. Stratified purposive sampling technique was used to select 24 firms from the 80 listed manufacturing firms in Nigeria. Secondary data were gathered from the published annual financial statements of the companies. Ordinary Least Square method of regression was employed in the analysis of data. The study revealed that auditor's independence has a positive and significant effect on financial performance of listed manufacturing firms, among others. It was concluded that attributes of audit quality influence financial performance of manufacturing firms in Nigeria.The study recommended, among other things, that auditor's independence should be increased through improved internal control, integrity tests and adequate utilization of auditor's experience in order to enhance financial performance of manufacturing firms. Several researchers have reached the conclusion that there is a significant relationship between internal control and quality financial reports. Management's attitude towards internal control has a very wide impact on staff compliance,they are expected to be a perfect role model to the staff in compliance to the internal control system.

CONCLUSION AND RECOMMENDATION

Based on the findings of the study, it is concluded that the quality of internalcontrol determines the quality of financial report in Nigeria.There is a strong link between internalcontrol and financial report, the effectiveness of internal control and financial report is highly correlated and the quality of information provided by internal control system is fundamental for the report. Based on the findings and conclusion from the study, the following recommendations are made;

i. Future research should be conducted on how internal control system affects financial reporting.
ii. A study should be conducted on the measurement of transparency ,accountabilty and quality financial reporting.

References

Adelopo, I., (2011). Voluntary disclosure practices amongst listed companies in Nigeria. Advances in Accounting, 27(2), 338-345.

Ahmed, A.S. & Duellman, S., (2007). Accounting conservatism and board of director characteristics: An empirical analysis. Journal of accounting and economics, 43(2), 411-437.

Enekwe C.,Chike N. & Sergius N. Udeh (2020) Effect Of Audit Quality On Financial Performance of Listed Manufacturing Firms In Nigeria (2006-2016). Institute of Advance Scholars (IAS) Publication, Advance Journal of Management, Accounting and Finance, Volume: 5, Issue: 01, 2020.

Ghafran, C. & O'Sullivan, N.,(2013). The governance role of audit committees: reviewing a decade of evidence. International Journal of Management Reviews, 15(4)381-407.

Haniffa, R.M. & Cooke, T.E., (2005). The impact of culture and governance on corporate social reporting. Journal of accounting and public policy, 24(5) 391-430.

Mansur L.K & Muhammad T. (2020). Financial ReportingQuality And Internal Control System Of Nigerian Stock Exchange Lotus Islamic Index.

Musa, F.I. & Oloruntoba, F.O., (2014). Examination of the relationship between audit committee characteristics and financial reporting quality of Nigerian Deposit banks. EuroEconomica, 33(1).

Ndifon E. & Patrick E. (2014).The Impact of Internal Control Activities on Financial Performance of Tertiary Institutions in Nigeria. Journal of Economics and Sustainable DevelopmentVol.5, No.16, 2014.

Norwani, N.M., Zam, Z.M. & Chek, I.T., (2011). Corporate governance failure and its impact on financial reporting within chosen companies. International Journal of Business and Social Science, 2(21).

Nyor, T., (2013). Financial reporting quality of nigeria firms: Users' perception. International journal of Business and Social sciences, 4(13).

Omar, B. & Simon, J., (2011). Corporate aggregate disclosure practices in Jordan. Advances in Accounting, 27(1), 166-186.

Owolabi S.A., Babarinde,&Thomas A. Effect of Corporate Governance on Audit Quality in Nigerian Banks (2020).International Journal of Multidisciplinary and Current Educational Research (IJMCER) Vol.2, Issue 5,pp 290-2962020.

Popova, T.T., Georgakopoulos, G., Sotiropoulos, I. & Vasileiou, K.Z., (2013). Mandatory disclosure and its impact on the company value. International business research, 6(5).1.

Samuel A. E., Mudzamir M. and Mohammad A .(2017)An Empirical Analysis on the Financial Reporting Quality of the Quoted Firms in Nigeria: Does Audit Committee Size Matter?. International Journal of Academic Research in Business and Social Sciences2017, Vol. 7, No. 9.