Internal Control and Impact of Financial Performance of The Organizations  
(Special Reference Public and Private Organizations in Jaffna District)  

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Abstract  
Internal Control System is a vital role in every organization to achieve their management objectives. Nowadays public sector organizations have been privatized because of shortcomings of the internal control system adopted is not satisfactory. This study focuses in Jaffna district organizations. This study examined whether the internal control system leads to increase financial performance of the organizations. In this study, internal control is measured by control environment, risk assessment and control activities and financial performance are measured by profit, efficiency and liquidity respectively. To test this hypothesis data were collected through questionnaire, observation and personal interviews and 181 samples were selected from employees who were employed in the offices. Chi square and regression statistical analysis were used to measure the variables. The study finds internal control and financial performance are statistically significant in determining performance. Perhaps most importantly, the study finds positive relationship between internal control and financial performance, even though they are not statistically significant relationship with control environment and information and communication and financial performance. The study further points out that keen attention should be paid on to adopt efficient management information system and training of the staff.  

Key Words: Control activities, Control environment, Financial Performance  
Internal control, risk assessment
**Introduction**

Internal control is a dynamic integral process that is continuously adapting to the changes an organization is facing. Management and personnel at all levels have to be involved in this process to address risks and to provide reasonable assurance of the achievement of the entity’s mission and general objectives.

Internal control must be evaluated in order to provide management with some assurance regarding its effectiveness. Internal control evaluation involves everything management does to control the organization to achieve its objectives. Internal control would be judged as effective if its components are present and function effectively for operations, financial reporting, and compliance. The board of directors and its audit committee have responsibility to make sure that the internal control system within the organization is adequate. This responsibility includes determining the extent to which internal controls are evaluated. Two parties that are involved in the evaluation of internal control are the organization's internal auditors and their external auditors.

**Literature Review**

Internal control is a dynamic integral process that is continuously adapting to the changes an organization is facing. Management and personnel at all levels have to be involved in this process to address risks and to provide reasonable assurance of the achievement of the entity’s mission and general objectives.

Today, organizations are less able to perform many internal accounting controls (e.g., multiple layers of authorization, cross-checking, supervision, and segregation) because, as previously argued, they employ less people due to technological advancement and changing management techniques. However, the revised professional guidance highlights opportunities to strengthen overall control. The audit is acknowledging the importance of the revised control criteria in achieving effective internal control (Armour 2001; Kinney 2000). Effective control requires a range of control elements and to this end COSO (1994) identifies five basic control components: control environment, control activities, risk assessment, information and communication, and monitoring.

Armour (2001) and Kinney (2000) are acknowledging the importance of the revised control criteria in achieving effective internal control. According to the Chartered Institute of Public Finance and Accountancy (CIPFA), financial reporting comprises (CIPFA 2002): Financial statements. These comprise external reports of a general nature that relate to the organization’s financial position. Annual accounts are the most obvious example, but other
examples might include the organization’s budget and periodic reports on financial performance. Special-purpose is financial performance. These include financial performances that are required by regulators, tax authorities and others, where the requisite information and format are specified by an external authorized body. These are formal reports which are produced for decision-makers within the organization.

However, internal and external control mechanisms are fundamentally different by definition. Jensen (2003) found External control mechanisms such as external audits are intended primarily to enhance the reliability of financial performance, either directly or indirectly by increasing accountability among information providers. On the contrary, as defined before, internal control has a much broader purpose and cannot be superseded by external control processes.

Rittenberg et.al (2005) found Subjects having an interest in the effectiveness of a company’s internal control system include managers, board of directors, the audit committee, internal and external auditors, regulators, suppliers and customers, investors and lenders. Internal control information provides the users better assurance on (a) the likelihood that the company has addressed significant risks and can address them in the future and (b) the likelihood that interim financial data for decision making will be accurate.

Doyle et al. (2005) found that the company level of control problems, which cannot be audited as easily, are associated with lower earnings quality, which explore links between disclosure of material weakness and fraud, earnings management or restatements.

LIU Xinmin (2007) examined out relationship between a firm’s internal control mechanisms and the choice of innovation mode. Using a sample of 585 Chinese firms, this study tests the proposed model. Results show that strategic control has a positive relationship with radical innovation, but a negative relationship with incremental innovation, while financial control has a negative relationship with radical innovation, but a positive relationship with incremental innovation.

Cohen, (2002) reiterated the importance of the control environment with the findings from a survey of auditors that “tone at the top” and its implication for the behavior of employees, is the most important ingredient for effective control.

Rittenberg et al. (2005) said that the control environment starts with the board of directors and management, who set the tone of an organization through policies, behaviors and effective governance. If the tone set by management is lax, then fraudulent financial reporting is more likely to occur.
Hooks et al. (1994) and Simons (1995) found out flatter organizational structures and technological innovation have resulted in fewer middle managers, the traditional “gatekeepers” of control, who were previously responsible for the assembly and distribution of information, checking and authorizing transactions, and the supervision of employees. Sia et al. (1997) found this interpretation is consistent with research findings that after the implementation of re-engineering, traditional internal accounting controls were found to be less important.

Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to inform business decision-making and external reporting Sawyer (2003). Financial information can also be used for operating decisions (e.g. monitoring performance and allocating resources) and some operating information can be essential for developing financial statements (e.g. routine purchases procedures, information on competitors’ product releases).

A growing body of evidence suggests that these changes are likely to influence the effectiveness of monitoring mechanisms and therefore CEO replacement decisions (e.g., Weisbach (1988), Shivdasani (1993), and Yermack (1996). This section describes the changes in monitoring mechanisms that occurred during the period we examine and discusses the potential implications of these changes for CEO replacement decisions.

Cohen et al. (2002) found less likely to undergo separate evaluations of their internal control system, and the need for separate evaluations may be offset by highly effective ongoing monitoring activities. Central is the requirement that those performing the monitoring function be independent of those being monitored.

**Problem Statement of the Study**

Effectiveness of internal control on financial performance should be considered most important in every organization, because the task of internal control is to prevent and detect fraud in the organization. For this purpose organizations give much important to the internal audit which is generally a feature of large companies. It is a function provided either by employees of the entity of sourced from an external organization to assist management in achieving corporate objectives. The code of corporate governance highlights the need for business to maintain good system of internal control, to manage the risk the organizations faces. Internal audit can play a key role in assessing and monitoring internal control policies.
and procedures. Therefore internal control is needed to achieve efficiency and effectiveness of operations in meeting business objectives, the preparation of reliable published financial accounts and the compliance with applicable laws and regulations. Even though the organizations operate its activities in order to achieve the profit for its income generations and or survival it can be attained through the internal control. Which have different components of control such as control environment, risk assessment, control activities, information and communication and monitoring (COSO1994).

Jensen (1993) argues that the corporate governance structures of Leveraged Buyout (LBO) Substantial changes in internal control mechanisms have the impact on monitoring quality and financial performance. That’s why the present study is initiated to find out that to what extent perception of internal control and perception of financial performance of public and private sector organizations in Jaffna district.

1.3 Research Questions

- Is there any relationship between the internal control (components) and financial performance?

1.4 Objectives of the study

This study has three main objectives.

1. To find out the relationship between internal control and financial performance.
2. To find out the major determinants of internal control system.
3. To find out the financial performance factors.

Hypotheses of the Study

The study attempts to test the following hypotheses.

\( H_1 \): Internal control and financial performance is positively correlated.

\( H_2 \): Internal control has a significant impact on financial performance

Limitations of the Study

The limitations on internal control effectiveness need to be stressed to avoid exaggerated expectations due to a misunderstanding of its effective scope. Internal control cannot by itself ensure the achievement of the general objectives defined earlier.

This research has the following limitations.
The study is delineated only to the private and public sector organizations located in Jaffna district.

The analysis is made only with the data gathered from the perception of the management of the organization.

Consider only COSO Frame work.

Data collection and sampling Design

Primary and secondary data were used for the survey. Primary data were collected through questionnaire and interviews, secondary data were collected from books, journals, magazine, etc.

Sampling Design

The study is limited to randomly selected public and private organizations in Jaffna district. The researcher attempted to cover different type of organizations to identify internal control that could be found in practice. In this study, 35 organizations from public and private sectors were selected from Jaffna district.

The process of sample selection

Stratified random sampling method was used to select the sampling organizations. There are 65 public and 18 private organizations in Jaffna district. First, we make a sampling frame of 65 public organizations. From this sampling frame, we have selected 35 organizations randomly. This technique is known as random sampling techniques. Thus, we could select 35 sampling units from public organizations and 12 sampling units from private organizations. The sampling units were identified and list was prepared. It has been decided to collect data from employees who are related to accounting and auditing, from each of the selected sampling unit entailing two levels of employees. i.e middle level and high level. Lower level employees were not selected, because they are not aware with the fact.

Methodology

Questionnaire was used to collect the data. The questionnaire was divided into three sections; first section consists of personal details of the employees. In the second section 20 statements
were given to measure the internal control and third section consists of 12 statements to measure the financial performance of the organizations.

Financial performance depending upon internal control, internal control which consists of 5 components such as Control environment, Risk assessment, Control activities, Information and communications and Monitoring. Based on the information the following model is formulated.

$$FP = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \beta_5X_5 \ldots$$ (1)

Where,\n\n$\beta_0, \beta_1, \beta_2, \beta_3, \beta_4$ and $\beta_5$ are the regression co-efficient

FP – Financial performance
X1 – Control environment
X2 – Risk assessment
X3 – Control activities
X4 – Information and communications
X5 – Monitoring

Regression analyses are carried out to find out the significant effect of independent variables ($X_1, X_2, X_3, X_4$ and $X_5$) on dependent variables (FP).

Conceptual model

**Internal control** \(\rightarrow\) **Financial performance** (Profit, Efficiency, Liquidity)

Statistical tools used in the study

The following statistical tools or techniques were used in the study:

i. Multiple regressions ($r^2$) – to find out the impact of internal control on financial performance. Data analysis is done by the help of software package SPSS version 13.

ii. Chi-Square – was used to find out whether personal variables are dependent or independent.

Reliability analysis

Reliability test was used to test the reliability of the variables. The result of Cronbach’s alpha of internal control and financial performance are 0.936 and 0.919 respectively. According to this result, it shows that the questions issued to the respondent, are more reliable for this measurement of effective internal control and financial performance of the organizations.
Reliability analysis on item scale was performed using SPSS. Cronbach’s alpha as suggested by many experts (Page & Meyer .2000) for each variable with item-scales. Results have been presented below.

Table 1 Scale reliability of independent variables

<table>
<thead>
<tr>
<th>Concept/Independent Variables</th>
<th>Cronbach’s alpha</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control Environment</td>
<td>.76</td>
</tr>
<tr>
<td>Risk Assessment</td>
<td>.84</td>
</tr>
<tr>
<td>Control Activities</td>
<td>.88</td>
</tr>
<tr>
<td>Accounting. Information</td>
<td>.84</td>
</tr>
<tr>
<td>Monitoring</td>
<td>.86</td>
</tr>
</tbody>
</table>

As further table 1 Cronbach’s alpha value for each components of internal control is more than 0.7 which is highly reliable and then an attempt was made to compute Cronbach’s alpha value for each component of financial performance such as profitability, efficiency and liquidity. This result is tabulated in table 2.

Table 2 Scale reliability of Dependent variables

<table>
<thead>
<tr>
<th>Concept/Dependent Variables</th>
<th>Cronbach’s alpha</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit</td>
<td>.86</td>
</tr>
<tr>
<td>Efficiency</td>
<td>.84</td>
</tr>
<tr>
<td>Liquidity</td>
<td>.85</td>
</tr>
</tbody>
</table>

As further table 2 Cronbach’s alpha value for each components of financial performance is more than 0.7 which is highly reliable. The researcher decided to continue the study.

Validity

Researcher identified the variables which are related to internal control through the extensive literature survey, control environment, risk assessment, information and communication, control activities, and monitoring are the more suitable factors to measure the internal control, because the researchers used these variables for the purpose of same study. (Faudziah Hanim, 2005). These are purely suited for our SriLankan context.
Similarly, profit, efficiency and liquidity are the most commonly used variable for the measurement of financial performance (Mark A. Huselid, 1995, Richard B. Robinson, 1983). So we satisfied with the content validity.

**Descriptive statistics - internal Control**

Descriptive statistics were used to identify the importance of the factors are control environment, risk assessment, control activities, accounting information and communication and monitoring. A normality assumption was validated through Kolmogorov-Smirnov Test. So researcher was used to this test. In order to rank them, the ranking of the factors were made on the basis of mean and std. deviation. The table 3 presents these details.

<table>
<thead>
<tr>
<th>Independent Variable</th>
<th>Mean</th>
<th>Rank (Mean)</th>
<th>Std. Deviation</th>
<th>Rank (Std. Deviation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control Environment</td>
<td>12.57</td>
<td>1</td>
<td>3.341</td>
<td>1</td>
</tr>
<tr>
<td>Risk Assessment</td>
<td>12.32</td>
<td>3</td>
<td>3.357</td>
<td>3</td>
</tr>
<tr>
<td>Control Activities</td>
<td>12.23</td>
<td>5</td>
<td>3.346</td>
<td>2</td>
</tr>
<tr>
<td>Accounting Information</td>
<td>12.55</td>
<td>2</td>
<td>3.616</td>
<td>5</td>
</tr>
<tr>
<td>Monitoring</td>
<td>12.27</td>
<td>4</td>
<td>3.391</td>
<td>4</td>
</tr>
</tbody>
</table>

Table 3 shows the means and standard deviation of the components of the internal control system. From the results, the control environment component of internal control system is a highly rated item with a mean value of 12.57 while control activities is the least rated item with a mean value of 12.23. The control environment component of internal control system is a highly rated item with std. deviation value of 3.341 while accounting and information is the least rated item with standard deviation value of 3.616.

**Descriptive statistics - financial performance**

Descriptive statistics were used to identify the importance of the factors are profit, efficiency and liquidity in order to rank them. A normality assumption was validated through Kolmogorov-Smirnov Test. So researcher was used this test. The ranking of the factors were made on the basis of mean and standard deviation. The table 4 presents these details.
Table 4 Descriptive statistics for financial performance

<table>
<thead>
<tr>
<th>Dependent Variable</th>
<th>Mean (Mean)</th>
<th>Std. Deviation (Std. Deviation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit</td>
<td>12.04</td>
<td>3.67</td>
</tr>
<tr>
<td>Efficiency</td>
<td>12.27</td>
<td>3.13</td>
</tr>
<tr>
<td>Liquidity</td>
<td>11.77</td>
<td>3.60</td>
</tr>
</tbody>
</table>

Table 4 shows the means of the dependent variable of financial performance. From the results, the efficiency is highly rated item with a mean value of 12.27 while liquidity is the least rated item with a mean value of 11.77. The efficiency is highly rated item with standard deviation of 3.13 while profit is the least rated item of std. deviation 3.67.

The Relationship between Internal control and financial performance

The aim of the present study is to identify the relationship between internal control and financial performance. For this purpose Chi- squared analysis was used. To find out the association between internal control and level of financial performance chi-square test has been carried out.

Table 5 Internal control and level of financial performance

<table>
<thead>
<tr>
<th>Level of Internal control</th>
<th>Level of financial performance</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Low Level</td>
<td>Average Level</td>
</tr>
<tr>
<td>Low Level</td>
<td>23</td>
<td>4</td>
</tr>
<tr>
<td>Average Level</td>
<td>14</td>
<td>96</td>
</tr>
<tr>
<td>High Level</td>
<td>0</td>
<td>13</td>
</tr>
<tr>
<td>Total</td>
<td>37</td>
<td>113</td>
</tr>
</tbody>
</table>

Chi-square value between internal control and financial performance p value is 0.000 which is statistically significant at 0.05 significance levels. It revealed that there is association between internal control and financial performance.

This prediction equation is in the following graph, along with a plot of the data points.
Now let us check the usefulness of the hypotheses model- that is whether X (internal control) really contributes information for the prediction of Y (financial performance) using the straight line model.

**Impact of internal control on financial performance**

In this analysis we tried to find out the impact of internal control system on financial performance for this purpose multiple regression analysis was used and the results are tabulated by table 6.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Un standardized Coefficient - b</th>
<th>t - value</th>
<th>P –value Significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>1.856</td>
<td>1.425</td>
<td>.156</td>
</tr>
<tr>
<td>Control environment</td>
<td>-.305</td>
<td>-1.976</td>
<td>.051</td>
</tr>
<tr>
<td>Risk assessment</td>
<td>.810</td>
<td>4.719</td>
<td>.000</td>
</tr>
<tr>
<td>Control Activities</td>
<td>1.091</td>
<td>6.183</td>
<td>.000</td>
</tr>
<tr>
<td>Information and communication</td>
<td>.287</td>
<td>1.797</td>
<td>.074</td>
</tr>
<tr>
<td>Monitoring.</td>
<td>.909</td>
<td>5.342</td>
<td>.000</td>
</tr>
</tbody>
</table>

Table 6 Predictors of Financial Performance – Model 1 Summary
Coefficient of determination – $R^2$ is the measure of proportion of the variance of dependent variables about its mean that is explained by the independents or predictor variables (Hair et.al.1998). The adjusted R square value “indicates how well the independent variables influence the dependent one (Benjamin 1999).

The specification of the five independent variables in the above model reveals that the ability to predict financial performance. Adj $R^2$ value of 0.818 which is in the model denotes that 81.8 % of observed variability in financial performance can be explained by the differences in the independent variables. Remaining 18.2 % variance in the financial performance sufficiency is related to other variables. In the above model t values are significant (Sig 0.05) for the all variables $X_2$, $X_4$ and $X_5$ with the exception of $X_1$ and $X_4$. Coefficients for the all variables are in the expected direction.

**Hypotheses Testing**

Several methods of analyses were utilized to test hypotheses. The analyses used to test the hypotheses include correlation, regression and chi-square test. The hypotheses sought to test for a significance difference of five variables of internal control and three variables of financial performance.

An attempt was made to find out the relationship between the internal control and financial performance with the following hypothesis.

**H$_1$: Internal control and financial performance is positively correlated**

To test the above hypothesis, Chi square test was used and value of 161.1($p = 0$) at 0.05 significant level indicates that there is relationship between internal control and financial performance.

Hence the hypothesis is accepted.

Multiple regression analysis was carried out to find out the impact of independent variable on dependent variables with the following hypothesis.
**H2: Internal control has a significant impact on financial performance**

As per the table 6 $R^2$ value of 0.818 revealed that internal control system has an impact on financial performance, i.e. internal control system in the samples organizations is contributing to determine the financial performance by 81.8%. Thus the hypothesis two ($H_2$) is accepted.

**Conclusion**

The study was carried out to find out the impact of internal control and performance of the private and public organizations in Jaffna District. Further this study is mainly tested by using Chi square test and regression analysis. Through this present study’s hypotheses are tested. From obtained from the study, it is apparent that the perceived internal control has a significant impact on financial performance. Control environment and information and communication negatively influences the financial performance. However, the risk assessment, control activities, accounting and communication and monitoring positively influences the financial performance. Since the work performed by the organizations have been implemented in the past and the work schedules take into consideration the goals of internal control, therefore, this will lead to lower control environment of the financial performance. This is because; the necessary proper procedures are already applied in managing the internal control. However, the better the performance of risk assessment, control activities and monitoring of the internal control lead to better financial performance.

**Reference**


Consideration of Internal Control in a Financial Statement Audit. SAS 55. American institute of certified public accountants (ACIPA) 2006


