College of Business and Economics

Department of Accounting and Finance

The Effect of Internal Control on Financial Performance: The Case of Selected Privately Owned Manufacturing Share companies in Addis Ababa

By:

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A Thesis submitted to Department of Accounting and Finance in partial fulfillment of the requirement for the award of the Degree of Master of Science (MSC) in Accounting and Finance

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DECLARATION

I, WorkinehTesfaye Beyene, hereby declare that the thesis entitled ***The Effect of Internal Control on Financial Performance: The case of selected privately owned manufacturing share companies*** is the result of my own original work and that no part of it has been presented for another degree in this university or elsewhere.

Declared by:

Name: Workineh Tesfaye Beyene

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Date:……..

Statement of Certification

This is to certify that WorkinehTesfaye Beyene has carried out his research work on the topic entitled '***The Effect of Internal Control on Financial Performance: The case of Selected privately owned manufacturing Share companies in Addis Ababa.*** The work is original in nature and is suitable for submission for the reward of M.Sc. Degree in Accounting and Finance.

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ADDIS ABABA UNIVERSITY

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BY:

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External Examiner	**Signature**

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Abbreviation and ACRONYMS

CA:	Control Activity
CE:	Control Environment
COSO:	Committee of Sponsoring Organizations of the Tread way Commission
ETB:	Ethiopian Currency Birr
FDRE:	Federal Democratic Republic of Ethiopia
IC:	Information& Communication
ICS:	Internal Control System
M:	Mean
MA:	Monitoring Activity
MOTI:	Ministry of Trade and Industry
POMSC:	Privately owned manufacturing share companies
RA:	Risk Assessment
ROA:	Return on Asset
ROE:	Return on Equity
S.D.:	Standard Deviation
SPSS:	Statistical Package for the Social Science

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ABSTRACT

The existence of an organization in a turbulent and dynamic business environment, among other factors, depends largely upon the internal control system in place. The main objective of the study was to seek the effect of internal control system on the financial performance privately owned manufacturing share companies. To achieve the objective of this study, the research employed a quantitative research approach. A total of 46 employees in the department of finance and internal audit departments in four privately owned manufacturing firms were involved by the survey where the response rate was 89%. Exploratory research design was used and the survey data were collected using structured questionnaires and the recent five years audited financial statement of the sample firms. To test the relationship between internal control elements namely control environment, control activity risk assessment, information & communication and monitoring activity that were used as independents variables (predictors) with financial performance of privately owned manufacturing firms, correlation analysis were adopted. The findings of the study were that internal control systems had positive relationship with financial performance of privately owned manufacturing share companies but the study revealed that some components of internal control systems had insignificant contribution to the financial performance of a manufacturing firm. Recommendations were made to privately own manufacturing firms to strength their monitoring activity and to pay attention to maintain strong control environment to improve the financial performance of their firms.

Key Words*:* Internal Control, Financial Performance, privately owned manufacturing firms, Control Environment, Control Activities, Risk Assessments, Information & Communications and Monitoring Activities

Chapter One

1. INTRODUCTION

This chapter represents the background of the study which focuses on the importance internal control systems for an organization in general and for manufacturing firm in particular. In addition to that the chapter includes statement of the problem, objective of the study, significance of the study as well as research questions and research hypotheses**.**

1.1. Background of the Study

A firm's ability to meet its objective with respect to remaining competitive and relevant rests largely on the policy and strategies as well as effectiveness of procedure established to safeguards its operation (Kaplan, 2007).

A sound internal control helps a firm to prevent frauds, error and minimize wastage. As organization today face, increasingly complex, dynamic and treating environments, attentions has been focused on both the running of day-to-day business affairs and the adaption of the organizations to changing environments condition (Amudo and Inanga, 2009).

An effective system of internal control system can give managers the means to provide accountability for their program as well as the means to obtain reasonably assurance that the program they manage to meet goals and objective (Reid &Smith, 2000).

In order to assure shareholders' and to manage risks, companies increased interest in internal control. If a proper internal control system is implemented, all of the operation, physical resources, and data will be monitored and under control, objective will be achieved, risks will be minimized and information will be reliable (Sultan and Hague, 2011).

Effective internal control system contribute to the effective of the operation by mitigating and preventing risk such as misuse resources , wastage and preparation of unreliable financial reporting (Mergi, 2013).

Internal control is important for all form of business and is a highly pertinent issue within the domain of risks management since the beginning of the 21st century. This has been propelled by a series of a large corporate scandals and failure (Cruoch, 2012). The most well-known

accounting scandals over the past decades have probably been the cases of Enron and WorldCom. In the aftermath of the Enron debacle, it turned out it had long neglected several internal control deficiencies, which contributed significantly to the downfall of many companies (Mariri, 2010).

Internal control is recognized as a key corporate governance mechanism and disclosure of information about internal control systems is viewed as a significant component in the process of restoring public trust in corporate probity in the wake of financial scandal (Spira& Gowthorpe, 2008).

In the modern business world, corporate objective and the environment in which companies operate are constantly evolving. As a result, the risk facing companies are continually changing too. A successful system of internal control system must therefore be responsive to such changes (Treba, 2003).

As Seyoum (2017) noted that in Ethiopia, manufacturing enterprises management control practice is not well developed. Since, the manufacturing sector is a nascent industry; no sophisticated system may be expected. Yet, in this global world of trade and industry, where customers have several choices, competitive products and services only are destined to succeed.

In the recent few years in Ethiopia, we have seen an unprecedented growth of the number of share companies under formations through initial public offer of shares (Fikadu, 2010). The writer further stated that the separation of ownership and control could practically become complete where no shareholder has any more than a fraction of one percent of the capital. Kaldor (1976) suggested that the growth of any given nation in GDP was positively related to growth in the nation's manufacturing sector. Productivity in the manufacturing industries was also positively related to growth in this sector. He also commented that the productivity of the non-manufacturing sector was associated with growth in manufacturing.

Hence, for the very reason whether the importance of a sound internal control system is crucial in the operation of privately owned firms in general and privately owned manufacturing share companies in particular makes an interesting research topic.

1.1.1. Over view of Ethiopian Private Manufacturing Sector

Getu (2014) private manufacturing sector is strongly associated with the socio-economic situation of a country such as job opportunity, income generations, and market stability. This notation has been justified by Addis Ababa Chamber of Commerce and Sectorial that has done a survey in 2014 stated that Ethiopia's manufacturing sector is among the key productive sectors of the economy that can spur economic growth and development because of its immense potential for wealth creation, employment generation and poverty alleviation. The survey further explains that the manufacturing sector makes an important contribution to the Ethiopian economy. On the other hand, Arkebe (2018) argued that although Ethiopia has emerged as one of Africa's fastest-growing economies, its manufacturing sector is still far from being an engine of growth and economic transformation. It currently plays a marginal role in employment creation, exports, and output, and falls short on stimulating domestic linkages

1.2. Statement of the problem

Control in a manufacturing firm should evolve overtime and all the department and units of firms should undergo positive transformation. Most firms try to establish internal control to achieve positive performance in their operation (Chenhall, 2003). Chenhall (2003) argued that despite firms' efforts to maintain internal control system, most firms still struggle with liquidity problems, untimely financial report, fraud and misuse of their resources.

Despite the growing number of manufacturing share companies in Ethiopia particularly for private ownership, poor performance remains a major challenge. One root cause of this problem is the absence of adequate and effective internal control system to prevent and mitigate a various risks in which they are operating (Seyoum, 2017).

The stagnate growth of manufacturing sector particularly privately owned shares companies in Ethiopia, besides other factors, weak internal control system have had great impact upon the nation's economy. Therefore, nowadays it demands a sound internal control system in the manufacturing sector because the operation of manufacturing is more complex than the other sectors.

Government bodies in Ethiopia such as the National Bank of Ethiopia regulate the internal control system of Share Company's operation, but limited to only public and privately owned financial institutes. However, the other sectors especially privately owned manufacturing share companies that operate in a complex business environment are not enforced directly by any regulatory body to safeguard investors against weak internal control system in the manufacturing sector. As Yared (2012) stated in the absence of a strong legal framework and regulatory body, and in the absence of risks and opportunities sharing between the principals, the investors, and agent, the board and management, these problems may remain as big operational challenges of the industry.

Many researches have been conducted at national level on the topics of the impact of internal control system on the performance of an organization particularly financial performance (Rahel, 2017) , (Fikru, 2018) , (Selam, 2016), (Ngozi, 1992) , (Kamau, 2013) , (Ashenafi, 2017). The majority of them had showed that non-compliance to the internal controls is one of the major hindrances to the achievement of positive financial performance. However, most of the studies were carried out either on the service sector or on the manufacturing sector of public enterprises that were fully or partially owned by the government. This raises the issue regarding the applicability of their findings to the privately owned manufacturing share companies even though there are a growing number of privately owned manufacturing share companies that engaged in different manufacturing sectors.

Accordingly, there is a need to establish the relationship between the internal control systems and financial performance of privately owned manufacturing share companies.

1.3. Objectives of the Study

1.3.1. General Objective

The general objective of this study was to establish the relationship between the role of internal control and the financial performances of privately owned manufacturing share companies.

1.3.2. Specific Objectives

1. To measure the privately owned manufacturing share companies' internal control system that was in place as per COSOs' internal control, integrated framework.

2. To examine the effectiveness of internal control system on the financial performance of privately owned manufacturing share companies.
3. To analyses, the relationship between internal control variables and financial performance of privately owned manufacturing share companies.

1.4. Research Questions

The study has assessed the effectiveness of internal controls and its impact in the financial performance of privately owned manufacturing share companies. Therefore, the following research questions were addressed.

1.4.1. General Research Questions

How effective are the internal control system components in privately owned manufacturing share companies to achieve high financial performance?

1.4.2. Specific Research questions

The study has developed the following specifics questions

1. What type (s) of internal control system widely adopted in POMSC
2. What is the practice of internal control activity look like at POMSC in Ethiopia
3. How strong are the five COSOS internal control components employed in POMSC
4. Where is/are areas of deficiencies in Internal Control System of POMSC?

1.5. Research Hypotheses

Based on different empirical arguments, the following hypotheses were developed:

H_1: There is significant and positive relationship between control environment and financial performance of privately owned manufacturing share companies.

H_2: There is significant and positive relationship between control activity and financial performance of privately owned manufacturing share companies.

H_3: There is significant and positive relationship between risk assessment and financial performance of privately owned manufacturing share companies.

H_4: There is significant and positive relationship between information communications and financial performance of privately owned manufacturing share companies.

H_5: There is significant and positive relationship between monitoring activity and financial performance of privately owned manufacturing share companies.

1.6. Importance of the Study

This study is important for those researchers who will be interested in undertaking other researches related to this. This is because it increases their knowledge on internal control system on privately owned manufacturing share companies and provides the necessary information to be incorporated in their work. The study will help them to come up with better proposal on internal control and its effect on performance of privately owned manufacturing share companies. The study will also provide the basis of recommendation to the management of the best approach to designing, installing and promoting operational efficiency and eliminating wastage.

It is hoped that this research sheds light on the topic of the impact of internal control system in the financial performance of privately owned manufacturing share companies and will provoke future research on the subject.

1.7. Scope and Limitation of the Research

This study was limited to only selected privately owned manufacturing share companies (POMSC) which are found in Addis Ababa, although the impact of internal control is important for any firm. Therefore, the study was not discussed whether the implementation and results of internal control at privately owned manufacturing share companies are comparable to those used by other companies.

For the purpose of the study, internal control systems comprised the five elements of the integrated framework of internal control systems designed by COSO. The effect on other organization aspects is not covered. Furthermore, the study was limited to return on asset (ROA) only as measurement of firm's performance, though there are other types of firm's performance measurement.

1.8. Structure of the Study

This research paper is organized in to five chapters. The first chapter shows the general introduction. The second chapter presents the literature review and the third chapter explains about the research design and methodology in brief. The fourth chapter presents and discussions of the results of the study. The final chapter, chapter five, shows the conclusions and recommendation of the study.

Chapter Two

2. Literature Review

2.1. Definitions

2.1.1. Internal Control

COSO's definition of Internal control is a process, affected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives (COSO, 2007). Another definition of Internal control system is the integration of the activities, plans attitudes, policies and efforts of the people of an organization working together to provide reasonable assurance that the organization will achieve its objective and mission (Jokipi A, 2006).

2.1.2. Firm's performance

Performance measurement refers to the process of measuring the actions efficiency and effectiveness (Neely et al,.1995). On the hand, McDevitt (1997) described performance measurement as a process wherein the organization manages its performance to match its corporate and functional strategies and objectives.

2.1.3. Performance Measurement

Effective performance measurement is essential in ensuring that an organization's strategy is successfully implemented. The purpose of performance assessment is not only to know how well a business is performing but also to ensure that the business perform better so as to help it to serve to its customers , employees, owners and stakeholders (Mariri, 2012).

2.1.3.1. Return on Asset (ROA)

Return on Assets (ROA) is an indicator of how profitable a company is relative to its total assets. ROA gives an idea as to how efficient management is at using its assets to generate earnings (John, 2010).

On a related idea, Hagel and Brown (2013) elaborated further that ROA provides a more balanced view of profitability compared to traditional metrics. Metrics like ROE disregard risk that financial leverage creates. The Researcher further noted that another advantage of ROA is its ability to measure business operations.

John et al. (2010) commented that using ROA as a key performance metric quickly focuses management attention on the assets required to run the business

2.2. Evolution of Internal control system

The repercussion of stock market crash in 1929 led to the enactment of the Security Acts, 1933 and the Security Exchange Acts 1934 in the USA (Wegman 2008). Later a committee known as the Committee of Sponsoring Organization (COSO) was formed to develop a framework for evaluating the effectiveness of internal control systems (Moeller, 2011). In 1992 the committee was issued the integrated frame work for internal control system. In the same year the name called the Cadbury report was issued in the UK that was the first corporate governance code which emphasis how company ought to be directed and controlled with particular attention on the financial aspects of corporate governance and has become the foundation of corporate governance systems worldwide (Kaplan, 2012).

In 2002 the Sarbanes –Oxley Acts also known as Public company Accounting Reform and Investor Protection Act was passed in the USA in response to the global corporate and accounting scandals, which affected major US Business Corporation such as Enron Corporation, Tyco, WorldCom etc. (Coalson, 2014).

2.3. The Objective of Internal Control System

According to the International Organization of Supreme Audit Institutes the specific purposes of internal control are to safeguard resources against loss due to waste, abuse, mismanagement, error and fraud and also to ensure adherence to law, regulation, contract and management policies and procedure as well as directives. Another purposes of internal control in a firm the Institutes further says that to develop and maintain reliable financial report and management data as well as to promote orderly, economical, efficient and effective operations and produce quality products and services and consistent with the organization's mission.

Similarly the 2013 COSO Framework lists three categories of internal control system objectives. They are:

1. Operations Objectives – related to the effectiveness and efficiency of the entity's operations, including operational and financial performance goals, and safeguarding assets against loss.
2. Reporting Objectives – related to internal and external financial and non-financial reporting to stakeholders, which would encompass reliability, timeliness, transparency, or other terms as established by regulators, standard setters, or the entity's policies reliable financial statements.
3. Compliance Objectives - related to adhering to laws and regulations that the entity must follow.

2.4. Theories of Internal Control

2.4.1. Agency theory

As stated by Sharma (1997), the agency theory is based on the assumption on separation of ownership and control wherein managers are autonomous and are likely to increase their personal gains at the expense of owners. As a result, the agency theory stresses that in order to keep manager's interest with those of organization, firm implement management control system.

The agency theory addresses the best way to organize relationships wherein one party, the shareholder or the principal defines the work whereas another party, the manager or the agent performs the work (Eisenhardt, 1989). Sarens et al (2011) also stated that the principal employs an agent to perform a task, or to do the work that the principal is unwilling or unable to do. For example, in an organization the principals are the shareholders of the firm, entrusting the agent - board of directors to carry out tasks on their behalf. This implies that the assumptions of the agency theory are based on preferences and motives behind human behavior.

The agency theory, according to Miller (2005), also assumes that problem of information asymmetry may exist between the agent and the principal due to the separation of ownership from control. Information asymmetry arises when one faction to a transaction has superior information compared to the other. Generally, the agents are better informed about the day to day management of the firm than the principals (Eilifsen et at., 2006). Therefore, the theory argues that as a result of information asymmetry and self- interest of agents, principals lack reasons to

trust that agents will act in their best interest (Bonazzi, & Islam, 2007). The two problems that agency theory described are: the problems that are when the desire or goal of the principal and agents are in conflicts and the principal unable to verify what the agent is actually doing and the problems that arise when the principal and agents have different attitude towards risk. Because of different risks tolerance the principal and the agents may each be inclined to take different actions (Davis et al., 1997).

2.4.2. Contingency theory

The assumption underlying contingency theory is that there is no single type of organization's structure is equally applicable to all organizations. Rather organizations effectiveness is dependent on a fit or match between the type of technology, culture, the size of the organization, the feature of the organization structure and environmental volatility (Woods 2009).

The contingency theory asserts its theory is based on two assumptions. First, it assumes that no strategy which is universally superior and there is no one best way in which a company could be organized (Donaldson, 2001). Of the second assumption, the theory argument that the choice of approach, structure or control system depends on the contingency circumstances such as the environment, risk profile, strategy, size, the organizational structure and best activities at hand (Donaldson, 2006).

According to Walker (1999) internal control activities occur at all level and functions of an entities. He point out that some control activities such as top level review of actual performance, review by management at the functional level, management of human capital, control over information processing, physical control over vulnerable asset, segregation of duties, accurate and timely recording of transaction and events.

2.5. Components of Integrated Internal Control System

The COSO framework of internal control segregates the internal control system into five components: control environment, control activities, risk assessment, information and communication, and monitoring activities (COSO, 2013). The framework of internal control system developed by COSO argues that every sound system of internal control must have five components namely: control environment, risk assessment, control activities, information & communication and monitoring of internal control (COSO, 1994). Accordingly Pickett (2010),

these components interact among each other's, forming an integrated system that react dynamically to changing conditions. In theory, the positive correlation between the variables of internal control system and performance is highly advocated in the agency theory.

2.5.1. Control Environment

Control environments refer to that an aspect of internal control that offers the structure and discipline for the realization of the main objectives of internal control systems in addition to the climate, which affects the entire quality of the systems of internal control (Whittington et al 2006). Similarly, as stated by Jokipii (2006), control environment is the style, philosophy, and supportive attitude, in addition to the ethical values, competence, morale and integrity of those involved with the organization. Therefore, for an organization to achieve its goals, management, board of directors and other key personnel ought to uphold good ethical values and integrity (Kaplan, 2013).

2.5.2. Risk Assessment

Risk assessment is the process of discovery and evaluating risks to the realization of organization's objectives. Risk assessment process forms part of the internal control components (Giovanis, 2011). As stated by Kaplan (2013), risk assessment has to be systematic and embedded in the procedures and operations of an entity.

According to Sayior (2010) the consequence of an effective risk assessment process on performance is clear because risk assessment forms the basis for determining where internal control activities are needed. The risk assessment enables an organization to focus on those risks that will affect the overall success of the firm.

2.5.3. Control Activities

Kaplan (2008) indicates that control activities consist of procedure, policies, and system, which ensure that management directives and controls over financial reporting are carried out. In addition to that, COSO (2013) further explained that control activities are performed at all levels of the entity, at various stages within business processes, and over the technology environment. Control activities include a range of activities as diverse as approvals, authorizations,

verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

2.5.4. Communication and Information

Noel (2010) stated that surrounding the activities of control environment are systems of information and communication that allow the people of the organization to pick up and interchange the information required to control, manage and conduct its operations.

Information and communication are necessary for achieving the organization's objectives since they support the functioning of the other components of Internal Control System. However, weaknesses in the information and communication may render the other components ineffective and may cause wastes of resources and clients' dissatisfaction (COSO, 2011).

2.5.5. Monitoring Activities

A crucial aspect of any complete system of internal controls is regularly monitoring how effective the internal controls are, in order to find out whether or not they are properly designed and functioning (Treba, 2003). This means that organizations regularly need to evaluate the design and operation of the controls to ascertain whether the internal control components are effective to mitigate relevant risk to an acceptable level.

Di Napoli (2007) submits that in order to ensure effective monitoring of internal control and achieve performance targets, personnel are expected to know and understand the objectives, mission, and the level of risk tolerance of the organization, as well as their individual responsibilities.

Monitoring controls, according to DiNapoli (2007), is the review of an organization's activities and transactions to assess the quality of performance over time and to determine whether controls are effective. Saiyor (2010) also argues that monitoring involves the process that evaluates the quality of internal control system's performance with time.

COSO (2013) identifies 17 principles that help to map with the five components of COSO's integrated internal control system.

Table 2.1: Components of Internal Control systems

1.Control Environment	3.**Control Activities**
1.1.Demonstrates commitment to integrity and ethical values 1.2.Exercises oversight responsibility 1.3.Establishes structure, authority, and responsibility 1.4.Demonstrates commitment to competence 1.5.Enforces accountability	3.1. Selects and develops control activities 3.2.Selects and develops general controls over technology 3.3.Deploys through policies and procedures
2.Risk Assessment	**4.Information & Communication**
2.1.Specifies suitable objectives 2.2.Identifies and analyzes risk 2.3.Assesses fraud risk 2.4.Identifies and analyzes significant change	4.1.Uses relevant information 4.2.Communicates internally 4.3.Communicates externally
5.Monitoring activities	
5.1.Conducts ongoing and/or separate evaluations 5.2.Evaluates and communicates deficiencies	

2.6. Empirical Studies

A study was conducted by Rahel (2017) to determine the role of internal control systems on financial performance on Ethiopian Shipping and Logistics Services Enterprises (ESLSE) as a case study. Rahel(2017) conducted the existing internal control system in the organization and investigating the relationship between the five internal control elements of COSO and financial performance. The author used explanatory research design by using both descriptive and quantitative methods with Likert-scale self-administrative questionnaires and interviews made

with employees in the finance department of the case company. She also gathered secondary data from the company's financial statements and publications.

The target population of the study was 40 employees in the finance department of the case company and census design was also adopted. Rahel (2017) had done multiple regression analysis to determine the relationship and the significance level of elements of internal control system towards financial performance. Unlike the other similar studies in the area, the result revealed that internal control system contributed only 31% variation on financial performance. Paradoxically, the researcher recommended that if the company to achieve better performance, more commitment would be needed on the part of the management in monitoring internal control system for the effectiveness of the internal control system.

Another study conducted by Fikru,(2018) who examined how the internal control systems in the Ethiopian banks have aided in combating or preventing fraud in the banking industry by using primary data and a survey method. He found that internal control techniques employed by banks in checking fraud had been effective but put marks on some improvements and the final conclusion of his study was that there is significant relationships between internal control system components namely control environment, risk assessment, control activity, information and communication and monitoring and fraud. As a result, the researcher had given some recommendations to provide input for areas of control such as management should ensure that proper internal control system is in place and ensure their full implementation to reduce chances of fraud.

The study that was done by Kamau (2014) in Kenya was sought to determine the effect of internal control system on financial performance of manufacturing firms in Kenya. To achieve the objective of the study, the researcher used hypothesis testing research design. The author chosen 65 manufacturing firms registered by ministry of industrialization in Kenya. Kamau (2014) selected a sample of 20 manufacturing firms from a target population of 65 manufacturing firm. The author drawn sample using stratified random sampling technique.

Kamau(2016) from her findings revealed that most manufacturing firms had a control environment as one of the functionality of internal controls of the organization that greatly impacts on the financial performance of the firms. Kamau(2016) concluded that manufacturing

firms that had invested on effective internal control systems had more improved financial performance as compared to those manufacturing firms that had a weak internal control system.

Sabina et al (2013) tried to study to what extent internal control systems influence on the performance of the Sri Lankan Telecom limited. The researchers though used both primary data and secondary data for their study, their study solely depends on primary data collection technique such as questionnaire, interview & observation. Sabina et al (2013) selected sixty employees from staff of the Sri Lanka Telecom limited. The authors employed percentage, correlation and SWOT analysis as the main tools of data analysis. Sabina et al (2013) findings showed that there was a strong relationship between internal control system and organizational performance of the Sri Lanka Tele com limited.

A study by Ashenafi (2017) focused on assessment of the internal control system in the micro finance institution in Ethiopia to identify the possible areas of deficiencies in the system. The author selected three micro finance institutes out of the total population of 19 using a purposive sampling techniques based on the year of establishment and the number of branch they have had in Addis Ababa. Ashenafi (2017) used survey method of data collection through questionnaires to employees of the selected institutions and semi-structured interview with the institution management. The researcher's result indicated that internal control in the micro finance institutes in Addis Ababa is satisfactory. Therefore, his study concludes that effective internal control leads to high financial performance.

2.7. Lessons Learnt and Knowledge Gap

The agency theory has revealed that internal control mechanism plays a major role in mitigating agency cost and thereby improves firm performance. The theoretical review has again pointed out that the need for internal controls varies according to a firms' characteristic, which corresponds with the contingency theory's stipulation that each organization has to choose the most suitable control system by taking into account contingency characteristics.

Most of the studies carried out in the topic of Internal Control System in Ethiopia were either on the services sector or on manufacturing sector of private limited companies as well as public enterprises. This raises issues regarding applicability of their findings to the privately owned manufacturing share companies. Therefore the objective of this study was to fill the gap by

evaluating the effect of internal control elements on the financial performance of a manufacturing firm.

2.8. Limitations of Internal Control System

The 2013 COSO Framework acknowledges that there are limitations related to a system of internal control. For example, certain events or conditions are beyond organization. As controls are performed by people and are subject to human error. An effective system of internal control recognizes their inherent limitations and address way to minimize these risks by the design, implementation and conduct the system of internal control. No matter how well internal controls are designed, they can only provide reasonable assurance that objectives have been achieved (Mercer University, USA).

2.9. Conceptual Framework

This study believes that to evaluate the impact of internal control system in a firms' performance the five components of internal control must be adopted as essential tools. As a result, the researcher identify financial performance as a dependent variable and effective of internal control system through the five components of internal control elements namely control environment, risk assessment, information and communication system, control activities and monitoring as independent variables.

Internal control components

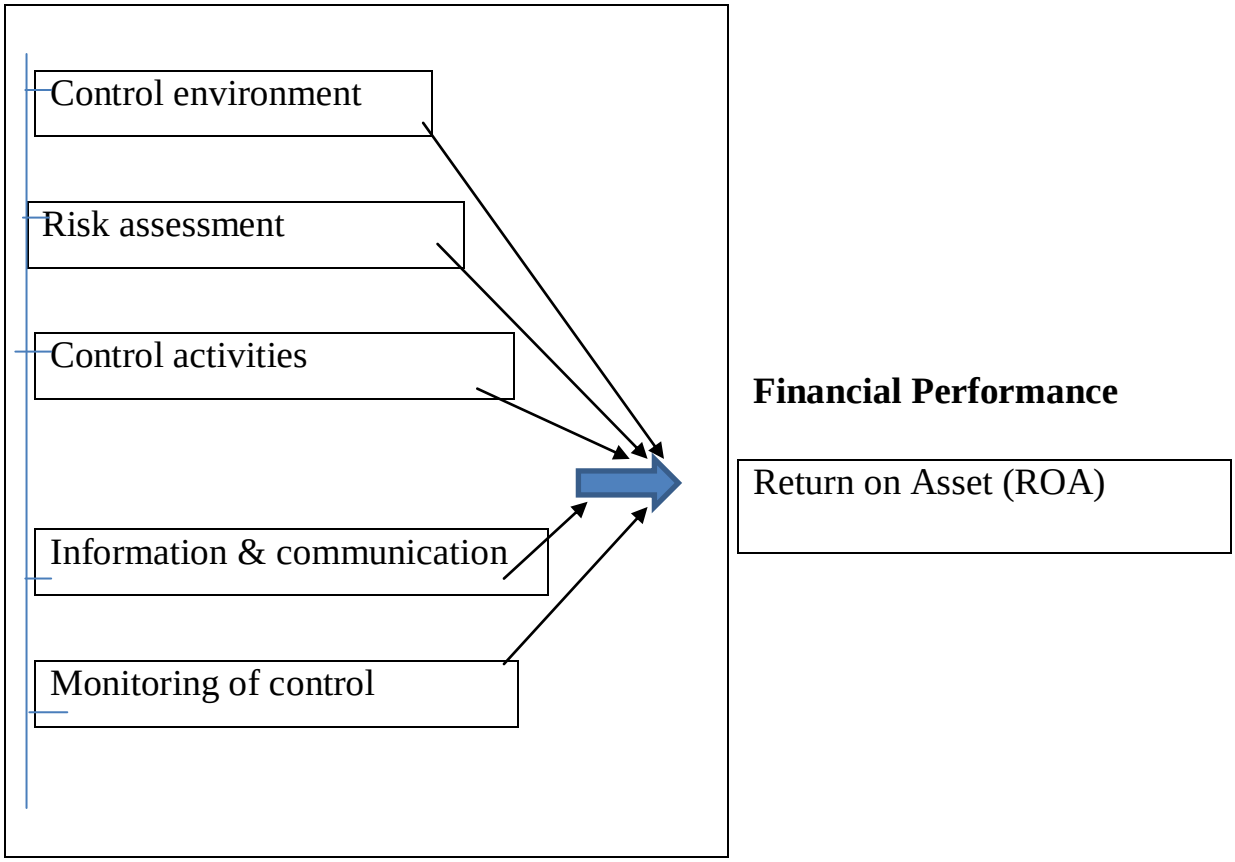


Figure 2.1: Conceptual Framework of internal control components vs financial performance

Source: Various researchers from the empirical review

Chapter Three

3. Research Methodology

3.1. Introduction

A research methodology is the procedural plan that is adopted by the researcher to validly, objectively, and accurately answer the research questions. It is a detailed explanation of the procedures and techniques that were used while collecting, processing and analyzing data. This section of the study therefore described the research design, target population, sample and sampling technique, data collection instruments, procedures, and data analysis methods.

3.2. Research Approaches

According to Creswell (2003), quantitative approach is a means for testing objectives and theories by examining the relationship among variables. These variables, in turn, can be measured, so that numerical data can be analyzed using statistical procedures.

Quantitative approach presents ease and speed in conducting research and can cover a wide range of situations as well as help to analysis data with statistical methods since it is easier to generalize the findings (Amaratunga et al., 2002). Furthermore, Maree (2007) argues that the results from a quantitative approach are based on numerical values and logical conclusions other than interpretations, which may enable future replication and comparisons with other studies.

Therefore, the researcher in this study was adopted quantitative method based on the objective of this study, the nature and relationship between the variables to be studied under considerations.

3.3. Research Design

Exploratory research design was used which is aimed at investigating/evaluating the effect of internal control in privately owned manufacturing share companies based on the research questions.

3.4. Target population of the study

A population of a study is the aggregation of all possible individuals, objects or measurement of interest (Cohen et al., 2007). The target population of this study was privately owned

manufacturing share companies in Addis Ababa, Ethiopia. According to the data that were obtained from the Ministry of Trade and Industry of FDRE, currently (2019) there were 14 private owned manufacturing share companies whose registered capital were ETB 250 Million and above.

3.5. Research Sample and Sampling Procedures

According to Faber et al. (2014), sample should not be neither too large to be economical nor too small to keep validity of findings. Therefore, in this study two sampling stages were used. The first one was to sample out the privately held manufacturing share companies and secondly the number of respondents within the firms. From the current14 manufacturing share companies under private ownership in Addis Ababa, Ethiopia, four private manufacturing firms were selected under this study. The main reason the selection of these four manufacturing firms are because of their number of shareholders who owned the firm, establishment date , the sector in which the firms engaged in as well as the capital to which registered at Ministry of Trade and Industry. It is recommended that a sample of 10% to 30% of the target population is a sufficient representation of the population (Yates, 2004).

In this research, the researcher targeted employees of finance and internal audit departments in each sampling firm. The reasons of choosing only employees of finance and internal auditing departments are those employees have more information & knowledge about internal control in firm than other employees.

Table 3.1: Target Population

Name of firms	**Number of internal auditor and finance employees**
1. Tsehay Industry S.C. (The Former Kaliti Metal Product Factory)	14
2. Ethiopian Pharmaceutical Manufacturing S.C.	12
3. Faffa Food Factory S.C.	8
4. Addis Ababa Bottle and Glass Factory S.C.	12
Total	**46**

3.6. Sources of Data and Data Collection Method

3.6.1. Sources of Data

Data were collected using both the primary and secondary data collection technique. The primary data collection technique was used in the research i,e, structured close ended questionnaires whereas the secondary data were collected from the sample companies' audited financial statements of the last five years (from 2013-2017).

3.6.2. Data Collection Methods

A questionnaire is a research instrument that consists of a series of questions related to the area of study which the respondents fill. The main reason that the researcher employed questionnaires was to draw the feeling, experience, beliefs or activities of the responders that were used to test the hypothesis.

The questionnaire developed in two parts. The first part was the general aspect of the respondents while the second part was sought information on the role of internal control system in privately owned share companies through COSO's components of integrated internal control. In order to evaluate effectiveness of internal control the respondents were asked to indicate their agreement or disagreement with each question on a five point Likert response scales that ranges from ' strongly agree (score as 5) agree (score as 4) , neutral (score as 3), disagree (score as 2) and strongly disagree (score as 1). The expected mean for effective internal control components will be 5 or closer to 5. The reason why the researcher selected rating scales is that because it is more convenient and easier to respondent than other methods.

3.7. Data Analysis Technique

Data that were obtained from the respondents were analyzed using the Statistically Packaged for the Social Science (SPSS) software program version 21 and MS-Excel as this software enable to analysis data easily to get the desired output. Then the result presented using statically tools such as frequencies tables, mean and standard deviation. Based on the answers collected from the

respondents, the data were grouped in summary. Furthermore, to measure the consistence and reliability of the data, a reliability of test has been done using Cronbach's alpha.

3.8. Description of Variables and Model specifications

3.8.1. Description of Variables

Regression analysis was used to come up with the model expressing the hypothesized relationship between the independent variables i.e. *Control environment, Risk Assessment, Control Activities, Information and Communication and Monitoring* and the dependent variable, which is the *Performance* of the sample firms.

Table 3.2: Measurement of Variables

Variables	**Description**	**Measurement**
Financial performance	Ability to operate efficiently, profitably, survives, grow and react to environmental opportunities and threats.	This was measured using Return on Assets (ROA) ROA= Net Income/Total Asset
Control Environment	Presence of integrity and ethical values, commitment to competence, human resource practices and organization structure.	This was measured by the level of integrity, ethical values, and competence of personnel tasked with creating, administering, and monitoring the controls
Control Activities	These are the policies, procedures and mechanisms put in place to ensure management directives are properly carried out.	This was measured by the number of effective policies, procedures and mechanisms put in place to ensure directives of the management are properly carried out
Risk Assessment	Entails risk identification, risk evaluation and risk response.	This was measured by level of risk carefully to be accepted and maintained determined levels.

Information and communication	This involves good identification of and proper capturing of pertinent information. Also entails proper flow of information across and within all the sections of the organization.	This was measured in terms of how information is identified, captured, and communicated in the appropriate form and within stipulated time frame
Monitoring Activities	This is the process of assessing the quality of the internal control structure over time.	This was measured by how frequent the quality and effectiveness of internal controls are assessed and reviewed over time.

3.8.2. Model Specification

To test hypothesized relationships, which are set in this research the researcher assessed several previous studies, which adopted multiple regression models. Therefore, in this study multiple regression models were employed as shown the equation hereunder.

$$P = \beta 0 + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + \beta 5X5 + \epsilon$$

Where,

P – Performance of the Case Company

β0 - Constant

X1 – Control Environment

X2 – Risk Assessment

X3 – Control Activities

X4 – Information and Communication

X5 –Monitoring

β1 up to β5= Measure of sensitivity of variable X to changes in P

Є= Error term

CHAPTER FOUR

4. DATA ANALYSIS AND RESULTS

4.1. Introduction

This chapter presents analysis and findings of the study as set out in the research objective and methodology. The study findings are presented on internal controls on financial performance of privately owned manufacturing share companies. To achieve the objective of this study the respondents were encouraged to respond to the questionnaires objectively to ensure validity and reliability of the data.

4.2. Response Rate

The study sought to collect data from 46 respondents of which 41 respondents were responded that constitutes 89% of the respondent's rates. The study was carried out to establish the relationship between internal controls and financial performance of privately owned manufacturing share companies.

4.3. Descriptive Statistics

Descriptive statistics are used to describe the main features of a collection of data quantitatively. The findings of the study are shown hereunder:

4.3.1. Age of the Respondents

For the age distribution as shown, hereunder 12% of the respondents fall within the age of 18-27 where as 39% of the respondents' ages were in the category of between 28-37 which is the higher age distribution of the respondents. On the other hand, 17.1% of the respondents were within the age of 38- 47 and the remaining i.e. 14.6% of respondents' age were above 47 years. However the survey instrument was not inclined to some age groups rather it represented all age categories as shown in the table here under.

Table 4.1: SPSS (2019) Output for Age of the Respondents

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	18 - 27 years	12	29.3	29.3	29.3
	28-37 years	16	39.0	39.0	68.3
	38-47 years	7	17.1	17.1	85.4
	above 47 years	6	14.6	14.6	100.0
	Total	41	100.0	100.0	

4.3.2. Gender of the Respondents

Out of 41 respondents, 56.1% were male and 43.9% are female. These distributions showed that both male and female represented in the study as shown below. This indicate that there was no biased in the data collection in connection with gender of respondents.

Table 4.2: SPSS (2019) Output for Gender of Respondents

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Male	23	56.1	56.1	56.1
	female	18	43.9	43.9	100.0
	Total	41	100.0	100.0	

4.3.3. The highest Level of Education Attained by the Respondents

The respondents were asked about their highest level of education in order to determine whether they understood the internal control systems and its effect on financial performance of their respective firm.

From the findings as shown, here above that most of the employees were first-degree holders which represents 78%, whereas 14.6% and 7.4% of the respondents had attained postgraduate

level and diploma level respectively. This clearly shows that most of the employees in manufacturing firms were at least diploma holders at internal audit and finance departments. The implication of this result is that respondents with higher academic qualification will have better understanding of ICS than others.

Table 4.3: SPSS (2019) Output for Highest Educational Level of Respondents

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Diploma	3	7.3	7.3	7.3
	1st Degree	32	78.0	78.0	85.4
	2nd Degree	6	14.6	14.6	100.0
	Total	41	100.0	100.0	

4.3.4. Academic Field of the respondents

As far as the respondents' field of study concerned 90.2% of the respondents are graduates of Accounting. The remaining 9.8% respondents are qualified either in the field of economics or other disciplines. Respondents with knowledge of accounting have a better understanding concept of internal control systems than other fields (Rahel, 2017).

Table 4.4: SPSS (2019) Output for Field of Study of Respondents

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Accounting& Finance	37	90.2	90.2	90.2
	Other field	4	9.8	9.8	100.0
	Total	41	100.0	100.0	

4.3.5. Year of Experience of the Respondents

According to the survey result, almost half of the respondents working experiences were ranged from the past five years up to fifteen years, which accounts for 51.2% of the respondents while 29.3% and 19.5% of the respondents had above twenty years and less than five years working experiences respectively as shown the table below. The implication of this survey result is that

the more the employees have experience in their respective professions the more they will have understanding of the practice of ICS in a firm.

Table 4.5: SPSS (2019) Output for Work Experience of the Respondents

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	below 5	8	19.5	19.5	19.5
	5 - 10 Years	13	31.7	31.7	51.2
	11- 15 years	8	19.5	19.5	70.7
	above 15 years	12	29.3	29.3	100.0
	Total	41	100.0	100.0	

4.4. Functionality of Internal Controls in privately owned manufacturing share companies

The respondents were requested to determine the degree of functionality of internal controls in the following aspects of financial performance in a five point Likert scale. The range was 'strongly agree' (5), 'strongly disagree' (1). The scores of "strongly disagree" and to 'disagree' were taken to present a variable, which had an effect to a less agree (equivalent to mean score of 0 to 2.5 on the continuous Likert scale. The scores of 'to neutral' was taken to represent a variable that had an effect to a moderate degree (equivalent to a mean score of 2.5 to 3.4 on the continuous Likert scale. The score of 'agree' and 'strongly agree' were taken to represent a variable that had an effect to a large degree (equivalent to a mean score of 3.5 to 5.0 on a continuous Likert scale. A standard deviation of >1.5 implies a significant difference on the effect of the variable among respondents.

4.4.1. Control Environment

The study sought to determine the degree to which the functionality of the internal controls of the organization that affects the financial performance of privately owned manufacturing share companies. The findings shows that all elements of control environments mean scores were between 3.59 and 3.93 which show that there were effective control environment practice across

the majority privately owned manufacturing share companies. Below are the findings in table 4.6.

Table 4.6:SPSS output (2019) Descriptive statistics for Control Environment

	N	Minimum	Maximum	Mean	Std. Deviation
1. There is clear separation of roles and responsibilities in your firm	41	1.00	5.00	3.9268	.98464
2. Your company holds periodic training to ensure employees are aware of their duties pertaining to internal control.	41	2.00	5.00	3.8537	.82344
3. Management closely monitors implementation of Internal control systems in your firm	41	1.00	5.00	3.8780	.97967
4. The management and/ or board of directors of your company understands the importance of internal controls, including the division of responsibility	41	1.00	5.00	3.7805	1.08426
5. Your organizational structure is appropriate for the size and complexity of the company	41	1.00	5.00	3.6585	.99020
6. Standards of conduct are communicated and reinforced to all levels of your firm	41	1.00	5.00	3.5854	1.07181
Valid N (listwise)	41				

Source: SPSS (2019) and Survey Result

From the above results, it is clear that majority of the privately held manufacturing firms had internal controls. The result shows, the manufacturing firms had relatively a clear separation of roles and responsibilities (M=3.92, S.D= 0.98). On the hand, the employees of the firms were given periodic training to aware in connection with internal control of their respective firms' resources though they are slight deviation among the respondents as shown by the standard deviation of the survey result (M=3.85, S.D= 0.82). The finding is in support of with Arwing's (2013) who elaborated that offering training on internal control system equips employees with the requisite skills needed to perform their internal control system roles. The meaning of the

result is that employees knew their obligations regarding the controls systems. This was to help achieve internal control system (COSO, 2013).

A survey result shows that the management gave due attention implementation of internal control system (M=3.88, S.D. =0.98) even though there are a clear variations in responses among the respondents. In a similar result the management and the board of directors of private owned manufacturing firms were well understood the importance of internal controls, including the division of responsibility but the finding show there were a great degree of variations among the respondents(M= 3.78 S.D.= 1.08).

Privately owned manufacturing share companies as per the survey results had appropriate organizational structures which were fit for their size and complexity of the firms (M= 3.66 S.D.=0.99). This was enhancing organizational performance. The result supported the argument of Donaldson (2006) that organizations that perform well when their structure matched with their setting. The least result recorded in control environment element was regarding the communication and reinforcement level of the standards of conduct to all employees in private owned manufacturing share companies the findings were not revealed disagreement scale but there were high deviation among the respondents' response(M=3.59,S.D.=1.07).

4.4.2. Control Activities

Table 4.7: SPSS output (2019) Descriptive statistics for Control Activities

	N	Minimum	Maximum	Mean	Std. Deviation
1. Corrective action is taken to address internal control weaknesses	41	1.00	5.00	4.0244	1.10652
2. Staffs are trained to implement the accounting and financial management system	41	1.00	5.00	3.7805	1.10707
3. Your company has policies and procedures addressing proper segregation of duties between the authorization, custody, and recordkeeping	41	2.00	5.00	3.9512	.80471

4. The company has a process that requires regular back up of computer files and testing of the back-up files to ensure proper functionality.	41	1.00	5.00	3.4146	.92129
5. The entity maintains policies and procedures to facilitate the recording and accounting of transactions in compliance with law and regulations.	41	1.00	5.00	3.3659	1.39205
6. Management determines which relevant business processes require control activities.	41	1.00	5.00	3.5854	.94804
Valid N (listwise)	41				

Source: SPSS (2019) and Survey Result

Regarding the control activity of privately held manufacturing share companies there were almost all firms had taken proper and timely correction action to address whenever internal control weaknesses appear however, the deviation in response among the respondents were vary greatly as shown the survey results(M=4.02 ,S.D.= 1.11).

The private manufacturing firms implemented relatively accounting and management system by giving training the concerned staffs but the result does not show uniform as the respondents response were not similar (M=3.78,S.D=4.11). On the hand, a better result was recorded as far as the policies and procedures that were in place in private owned manufacturing share companies to address segregation of duties between the authorization, custody& recordkeeping and in a relative terms the respondents responses were closely related as stated in the survey result (M= 3.95, S.D. = 0.81).

The firms under survey had processed back up of computer files and testing of the back-up files to ensure proper functionality of the files but not as regular as it was required that were confirmed by the respondents response (M=3.34, S.D.=0.92).Similarly, the policies and procedures that maintained under privately owned manufacturing firms to facilitate the recording

and accounting of transactions in compliance with law and regulations were not satisfactory as the findings average result was below 3.50 and also there were high deviations among the respondents' responses (M= 3.37 S.D.= 1.39). The survey result that shows the commitment of the management to determine which relevant business processes require control activities in private owned manufacturing firms were satisfactory (M=3.59 S.D.= 0.95).

4.4.3. Risk Assessment

The study examined the impact of risk assessment as functionality internal controls of manufacturing firms, which were under private ownership, and its impact on the financial performance of manufacturing firms. Below are the results of the findings:

Table 4.8:SPSS output (2019) Descriptive statistics for Risk Assessment

	N	Minimum	Maximum	Mean	Std. Devi
1. The company has clear objectives and these have been communicated so as to provide effective direction to employees on risk assessment and control issues	41	1.00	5.00	3.3902	1.22225
2. Management ensures that risk identification considers both internal and external factors and their impact on the achievement of objectives	41	1.00	5.00	3.0000	1.34164
3. Management appropriately evaluates risk when planning for new product or activity	41	1.00	5.00	3.4878	1.22723
4. The organization has mechanisms in place to identify and react to risks presented by changes in government, regulatory, economic, operating, or other conditions that could affect the achievement of the goals and objectives of the firm	41	1.00	5.00	3.0732	1.43858
Valid N (listwise)	41				

Source: SPSS (2019) and Survey Result

From the above findings, it can be said that most of privately owned manufacturing firms had clear objectives and also objectives had been communicated so as to provide effective direction to employees on risk assessment and control issues (M= 3.39 S.D.=1.22). But there were some respondents responses were either neutral or disagreed which reflected that there were some firms whose objectives were neither set clearly as it required nor communicated effectively their employees.

In a similar way, according to the survey result here above, the risk identification activity by the management of private owned manufacturing firms were not said satisfactory to achieve the objective of their respective firms (M=3.00 S.D.= 1.34) as the mean result indicated that the majority responses were neutral in this particular risk activity case. However, the management of privately owned manufacturing share companies evaluated risk when planning for new product or activity but needs further improvement as the result revealed a little less than the average score with great variation response among the respondents(M=3.49, S.D.=1.23).

The above result shown that the mechanisms that were in place by privately owned manufacturing firms' to identify and react to risks presented as a result of changes in government, regulatory, economic, operating, or other conditions were not properly implemented as the majority respondents' responses were neutral in this case (M= 3.07 S.D.=1.44).

4.4.4. Information and Communication

The study sought to establish the effect of information and communication on financial performance of privately owned manufacturing firms. The results of this analysis are as provided below in table 4.9.

Table 4.9:SPSS output (2019) Descriptive statistics for Information Communication

	N	Minimum	Maximum	Mean	Std. Deviation
1. Management has identified individuals who are responsible for coordinating the various activities within the entity	41	1.00	5.00	3.2683	1.36060

2. All employees understand the concept and importance of internal controls including the division of responsibility	41	1.00	5.00	3.4390	1.09656
3. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control	41	1.00	5.00	3.2195	1.03712
4. Communication helps to evaluate how well guidelines and policies of the organization are working and being implemented	41	1.00	5.00	3.4634	1.09767
5. There are established channels of communication for individuals to report suspected breaches of laws or regulation or other improprieties	41	2.00	5.00	3.5854	.80547
6. The organization has processes in place to communicate relevant and timely information to external parties.	41	1.00	5.00	3.4146	1.30337
Valid N (listwise)	41				

Source: SPSS (2019) and Survey Result

According to the above result, the management of the privately owned manufacturing share companies had identified individuals who were responsible for coordinating the various activities within the entity, however since the response from the respondents were highly deviated it cannot be concluded that there were proper practice of such activity uniformly across all firms (M=3.27, S.D. = 1.36).

Though the survey result regarding employees' understanding of the concept and importance of internal controls including the division of responsibility in privately owned manufacturing share companies were below the average standard, there were some firms whose employees' understood the importance of internal control as the findings revealed there were variance in the response(M= 3.44, S.D = 1.10).

As per the survey result in the table above, privately owned manufacturing share companies had communicated information which is necessary to support the functioning of internal control (M=3.22, 1.04).On the other hand, privately owned manufacturing share companies had understood the importance of communication that help to evaluate well guidelines and policies of their firms (M= 3.41, S.D = 1.30).

4.4.5. Monitoring Activity

The study sought to establish the effect of information and communication on financial performance in relation to the length of operation of the organization. The results of this analysis are as provided below in table 4.10

Table 4.10: SPSS output (2019) Descriptive statistics for Monitoring Activity

	N	Min	Max	Mean	Std. Dev.
1. There are independent process checks and evaluations of controls activities on ongoing basis	41	1.00	5.00	3.4634	1.02707
2. The company periodically evaluates internal controls, and communicates the results to company's board of directors.	41	1.00	5.00	3.3171	1.33115
3. Monitoring has helped in assessing the quality of performance of the organization over time	41	1.00	5.00	3.1463	1.19501
4. The organization selects, develops, and performs ongoing and/or separate evaluations on business process to ascertain whether the internal control system is effective and functioning	41	1.00	5.00	3.2195	1.03712
5. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including management and the board of directors, as appropriate	41	1.00	5.00	3.1220	1.22872

Source: SPSS (2019) and Survey Result

It is observed that from the findings of here above, there were independent process to checks and evaluate of controls activities on ongoing basis in the majority firms which were under study but the result show that it needs further improvement as the mean score is slightly lower than 3.50(M= 3.46, S.D= 1.03).The above table show that most firms had occasionally, not periodically, evaluated internal controls, subsequently communicated the results to the firms' board of directors (M=3.33 S.D= 1.32).

In the table above, they were lower mean of monitoring assessment with regard to the quality of performance of the privately owned manufacturing share companies and also there were greatly variance in the response of the respondents (M=3.15, S.D. =1.20).There were also similar result had been recorded regarding privately owned manufacturing firms' selection and separate evaluations of business process to ascertain whether the internal control system was effective and functioning in their respective firms (M=3.22 S.D= 1.04).

As per the findings the majority of the firms under study had evaluated and communicated internal control deficiencies to those parties responsible for taking corrective action, including the management and the board of directors, however the result asserted that such practice had not done in a timely manner (M=3.21 S.D= 1.23).

4.5. Reliability test

One of the most widely used methods to test the reliability and validity of data collected through questionnaire is use of Cronbach's alpha coefficient. Lee Cronbach (1951) defines reliability as an attribute of an instrument used to measure consistency. Consistency indicates that an instrument that has constructive value it used to measure. A commonly accepted rule of thumb for describing internal consistency using Cronbach's alpha is as follows

Cronbach's Alpha	**Internal Consistency**
$0.90 \leq \alpha$	Excellent
$0.80 \leq \alpha < 0.90$	Good
$0.70 \leq \alpha < 0.80$	Acceptable
$0.60 \leq \alpha < 0.70$	Questionable
$0.50 \leq \alpha < 0.60$	Poor
$\alpha < 0.50$	Unacceptable

Table 4.11:Reliability Statistics

Cronbach's Alpha	N of Items
.891	5

Source: SPSS output (2019) and Survey Result

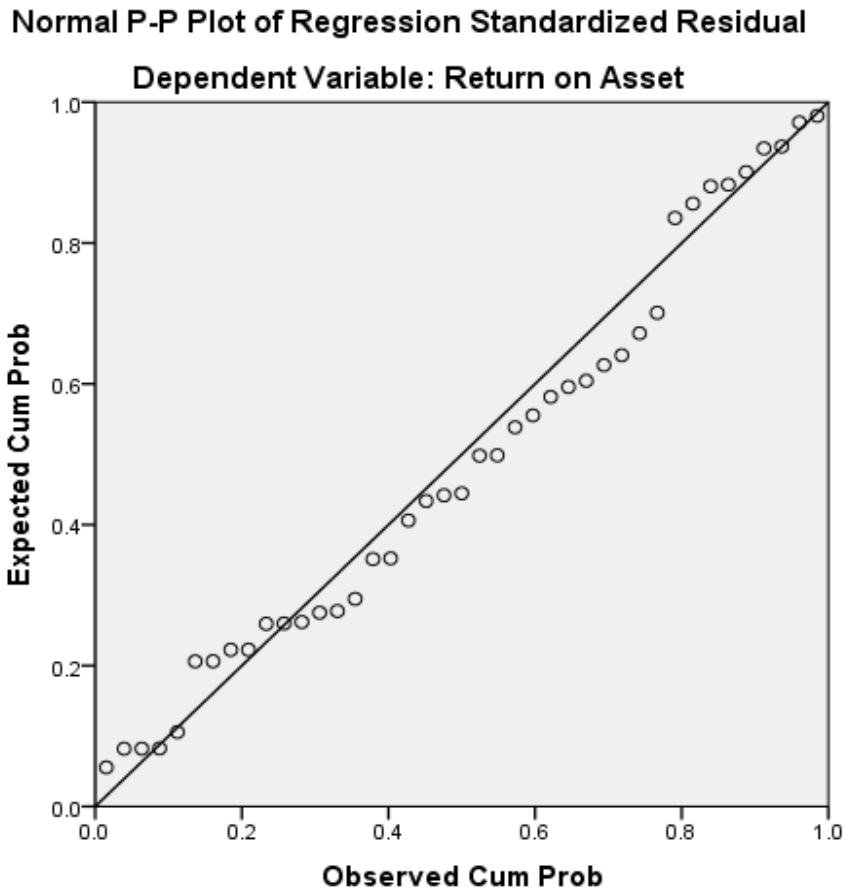
Cronbach alpha for data collected 41 constructs of Internal Control System is 0.891, which is acceptable as far as the reliability of the data. In other words, the responses generated for all of the variables used in this study was reliable enough for data analysis.

4.6. Assessment of Ordinary Least Square (OLS) Assumptions

4.6.1. Linearity Test

Linearity refers to the degree to which the change in the dependent variables is related to the change in the independent variables. To determine whether the relationship between the dependent variable (Financial performance) and the independent variables (control environment, control activities, risk assessment, information & communication and monitoring activities) is linear, plots of the regression residuals using SPSS computer software had been employed.

The scatter plot of residuals show no significance difference in the spreads of the residuals as it is shown in the figure here below. Therefore, the results suggest that the relationship between the dependent and the independents variables predict is linear

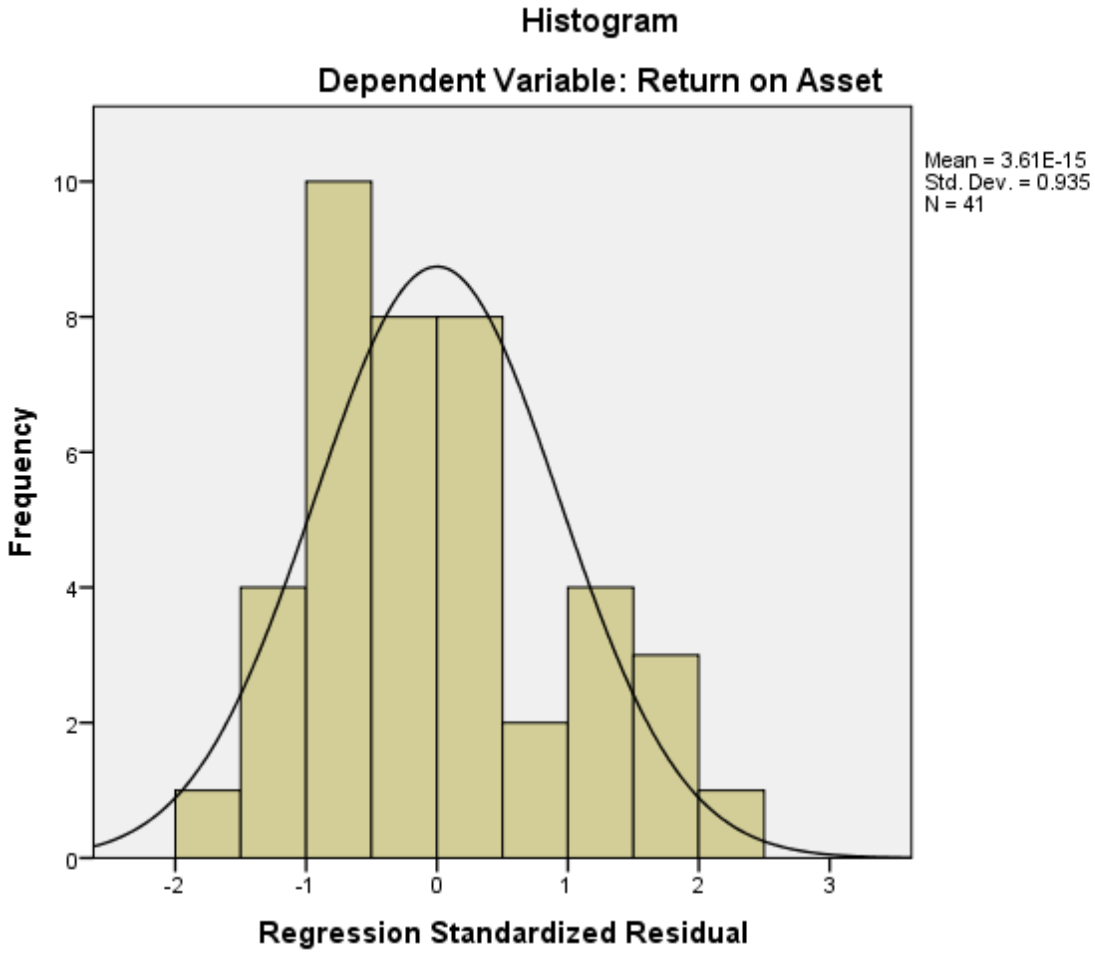


Graph 4.1: Normal Plot of Standardized Residual

Source: SPSS (2019) and Survey Result

4.6.2. Normality Test

As indicated the figure below the frequency distribution of the standardized residuals are fairly closed. Furthermore, the histogram is bell shaped which show the residual are normally distributed. Therefore, there is no violation of the assumption normally distributed error term.



Graph 4.2: Normality Test
Source: SPSS (2019) output and Survey Result

4.6.3. Multi-collinearity Test

Multi-collinearity refers to the degree to which independent variables are correlated. Multi-collinearity exists when either one independent variable is correlated with another independent variable or one independent variable is correlated with a linear combination of two or more independent variables (Gujarati, 2004). As a rule of thumb, multi-collinearity is a potential problem when the result of the correlation coefficient is 0.08 or above. The findings the correlation matrix table hereunder indicates that the highest correlation is 0.745, which is between information& communication and risk assessment as there is no correlation equal or

more than 0.80in this findings it can be concluded that the problems of multi-collinearity did not exist between variables in the model.

Table 4.12: **Pearson Correlation**

	ROA	CE	CA	RA	IC	MA
ROA	1					
CE	.745**	1				
CA	.625**	.741**	1			
RA	.540**	.502**	.571**	1		
IC	.681**	.677**	.726**	.747**	1	
MA	.659**	.518**	.460**	.588**	.724**	1

Source :SPSS(2019) out put

4.6.4. Test of Correlations

Correlation is a way to index the degree to which two or more variables are related to each other. The main objective of correlation is to measure the degree of linear relationship between two variables. Correlation coefficient between two variables ranges from 1.00 to -1.00.

As indicated in the table below the correlation coefficient between the independent and dependent variables were not high. The highest correlation coefficient of 0.745 was recorded between return on asset and control environment at 0.00 level of significant. On the other hand, the least correlation coefficient of 0.540 was shown between return on asset and risk assessment

at 0.00 level of significant. Therefore, the result shows that financial performance and internal control system in manufacturing firms have significant relationship with the level of control environment.

Table 4.13:Correlations Matrix

		ROA	CE	CA	RA	IC	MA
ROA	Pearson Correlation	1					
	Sig. (2-tailed)						
	N	41					
CE	Pearson Correlation	.745**	1				
	Sig. (2-tailed)	.000					
	N	41	41				
CA	Pearson Correlation	.625**	.741**	1			
	Sig. (2-tailed)	.000	.000				
	N	41	41	41			
RA	Pearson Correlation	.540**	.502**	.571**	1		
	Sig. (2-tailed)	.000	.001	.000			
	N	41	41	41	41		
IC	Pearson Correlation	.681**	.677**	.726**	.747**	1	
	Sig. (2-tailed)	.000	.000	.000	.000		
	N	41	41	41	41	41	
MA	Pearson Correlation	.659**	.518**	.460**	.588**	.724**	1
	Sig. (2-tailed)	.000	.001	.003	.000	.000	
	N	41	41	41	41	41	41

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

Source: SPSS (2019) output

4.7. Regression Analysis

A study was done to establish the relationship between internal control and financial performance of privately owned share companies. The analysis applied SPSS computer software to compute the measurements of the regressions analysis for the study.

4.7.1. Model Summary

The model summary indicates that the summary of the regression analysis as shown in the regression model. Below are the findings of model summary in the table 4.14.

Table 4.14: Model Summary

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.815[a]	.664	.616	.02486	.903

a. Predictors: (Constant), MA, CA, RA, CA, IF

b. Dependent Variable: ROA

In order to explain the percentage of variation in the dependent variable (financial performance) as explained by the independent variables (element of internal control system). The study used coefficient of determination (which was used to explain whether the model is a good predictor or not) that was obtained from the model summary in the table 4.12above.

From the findings of the analysis, the result show that the independent variables (Control Environment, Risk Assessment, Control Activities, Information and Communication and monitoring) contributed to 61.6% of the variation in financial performance as explained by adjusted R2 of 0.616. The remaining 38.4% of the variations are explained by other variables that are not included in the model. The R-square according to Hair et al.(2009) is an indication of goodness of fit of data. Therefore, the model indicates that it is a good prediction.

4.7.2. Analysis of Variance (ANOVA)

The study conducted an Analysis of Variance (AOV), in order to test the relationship between components of internal controls and financial performance of privately owned manufacturing share companies. The results were as shown below:

Table 4.15: Analysis of Variance (ANOVA)

ANOVA[a]

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.043	5	.009	13.813	.000[b]
	Residual	.022	35	.001		
	Total	.064	40			

a. Dependent Variable: ROA

b. Predictors: (Constant), MA, CA, RA, CA, IC

Source: *SPSS (2019) output and survey result*

The p-value (0.000) of the coefficient R of the regression model is statistically significant at 5% level of significance. Therefore, the findings of the results show that the level of significance was less than .000(b) this implies that the regression model is significant in predicting the relationship between internal control components and financial performance. However, it cannot be concluded that all elements of internal control components had equally significant correlations with financial performance.

This result confirms the conceptual framework of the study and the results of Muraletheran (2011) who investigated the effect of internal controls on financial performance of organizations in Sri Lanka. The study found that internal control is statistically significant in predicting financial performance of a firm.

4.7.3. Test for Coefficients

The table below shows that the level of significance on the variables. Test of coefficient helps to test about the effect of each independent variable in the model on the dependent variable. In another words, the standardized beta coefficient indicates the individual contribution of each predictor to the model, if other independent are held constant. The value of standardized beta coefficient can identify the most and the least factor of internal control system that affects the organizations' performance (Anthony 2017).

Table 4.16: **Test for Coefficients**

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.	95.0% Confidence Interval for B	
		B	Std. Error	Beta			Lower Bound	Upper Bound
1	(Constant)	-.139	.028		-4.879	.000	-.196	-.081
	Control Environments	.032	.011	.476	3.071	.004	.011	.054
	Control Activities	.005	.011	.071	.422	.676	-.018	.028
	Risk Assessment	.002	.008	.035	.235	.815	-.015	.019
	Information& Communication	.002	.012	.043	.205	.839	-.022	.027
	Monitoring Activity	.019	.008	.329	2.250	.031	.002	.036

a. Dependent Variable: ROA

Source: SPSS (2019) output and Survey Result

From the above table 4.16, the researcher sought to establish the degree to which the role of internal controls on financial performance of privately owned share companies. The following regression equation was obtained:

ROA= -0.139+0.48CE+0.071CA+0.035RA-+0.043IC+0.329MA…….

The constant has a negative coefficient of value of -0.139, which means holding all other variables constant the financial performance of private owned shares companies will decrease by 13.9%.

From the above regression model holding all the other factors constant, financial performance is measured by the efficiency and effective implementation of internal controls. The results of the multiple regression model shows that there is a positive relationship between internal control and financial performance of privately owned manufacturing share companies. This implies that a single unit increase in any of the independent variables results into a corresponding increase in financial performance of private manufacturing firms.

The statistics in the above table shows that control environment and monitoring activity had the largest standardized beta with significant level of (0.001) which is less than 0.05 while the other three variables of internal control had the smallest standardized beta. It indicates that control environment and monitoring activity make the strongest contribution to explain the financial performance of privately owned manufacturing share companies when the variance explained by all other variables in the model is controlled. The result obtained for control environment corroborates with the conceptual framework and the result of Noel (2010), who found out that the control environment, is among one of the internal control variables that significantly explain firms' performance**.**

4.8. Hypotheses Testing

The main goal in many research studies is to check whether the data collected support certain statements or predictions. In this study, the hypotheses determined to test for a significance difference of the independents variables (components of internal control system) and dependent variable (financial performance of the firms). A test was done to analysis the relationship between internal control elements and financial performance of as set out in chapter one of this study. The findings of the study were analyzed hereunder:

H_1: *There is significant and positive relationship between control environment and financial performance of privately owned manufacturing share companies.*

The effect of control environment on financial performance remains significance given a p-value .05 (p-value=0.004) with positive beta value of 0.476. Thus, we accepted the hypotheses that there is positive and significant relationship between control environment and financial

performance of in the privately owned manufacturing share companies. Therefore, the study accepted this hypothesis.

H_2: *There is significant and positive relationship between control activity and financial performance of privately owned manufacturing share companies.*

The impact of control activity on the financial performance of privately held manufacturing share companies are insignificant given a p-value higher than 0.05 (p-value=0.676). However, control activity has positive relationship with financial performance of POMSC as the findings show positive beta value of .071. As a result, the hypothesis is rejected concerned with the significant of the two variables relationship.

H_3: *There is significant and positive relationship between risk assessment and financial performance of privately owned manufacturing share companies.*

As far as the relationship between the above two variables concerned the findings show there is insignificant relationship between them as opposed to the hypothesis due to the fact that the p-value of risk assessment (0.815) is higher than the alpha value of (0.01). Therefore, we rejected the hypotheses even though the two variables had positive relationship.

H_4: *There is significant and positive relationship between information communications and financial performance of privately owned manufacturing share companies*.

This hypothesis has again rejected, as the p-value of the independent variable (0.839) is higher than the alpha value of (0.01) though there was observed positive relationship between the two variables

H_5: *There is significant and positive relationship between monitoring activity and financial performance of privately owned manufacturing share companies*.

From the table 4.12 the coefficient result show that there is significant and positive relationship between monitoring activity and financial performance of privately owned manufacturing share companies as the p value of monitoring activity (0.031) is less than the alpha value of (0.031) which is statically significant and there was positive beta coefficient (0.329) as indicated in the table 4.12.

4.9. Interpretations of the Results

4.9.1. Control Environments

As it can be seen from the table 4.16 the control environment variable coefficient suggests a positive effect on the financial performance of a firm. Hence, a one-point increase the control environment variable, the probability of the privately owned manufacturing firm being in financial performance would increase by 47.6% while the other independent variables in the model are held constant. The effect of control environment on financial performance remains significance given a p-value .05 (p-value=0.004). Thus, we accepted the hypotheses that there is positive significant relationship between control environment and financial performance of in the privately owned manufacturing share companies. This finding supports Mawanda's (2008) assertion that there is positive relationship between control environment and financial performance of an organization.

4.9.2. Control Activity

The findings indicate that there is a positive relationship between control activity and financial performance. That is if a one percent increase of control activity, results in a 7.1% increase of financial performance holding all the other variables are held constant. However, the impact of control activity on the financial performance of privately held manufacturing share companies are insignificant given a p-value higher than 0.05 (p-value=0.676). Hence, the study found that control activities have no significant effect on the performance of privately owned manufacturing share companies. As a result, we rejected the hypothesis that was stated that there is positive significant relationship between control activities and financial performance of privately owned manufacturing share companies. The result is consistent with the conceptual framework and supports the findings of Ndugu (2013), who found that control activities have statistically insignificant effect on the performance of an organization.

4.9.3. Risk Assessment

With respect to risk assessment, the variable had a positive standard beta coefficient of 0.035 but it was statistically insignificant at 5% level of significance. The reason is that the p-value of risk assessment (0.815) is higher than the alpha value of (0 .001).Therefore, we rejected the

hypothesis that stated there is significant positive relationship between risk assessment and financial performance of privately owned share companies. The results contradict with the finding of Njeri (2014) who stated that risk assessment explains variations in the performance of manufacturing firms in Kenya.

4.9.4. Information and Communications

From the findings, information communication had a positive standardized coefficient however; it was statistically insignificant at 0.001 alpha levels. The reason is that the p-value of information communication (0.839) is higher than the alpha value of (0.01). Therefore, the research had found out that information and communication has insignificant effect on the financial performance of privately owned manufacturing share companies. Thus, we obliged to reject the hypothesis that stated that there is positive relationship between information and communications and financial performance of POMSC. The result obtained for information communication is consistent with the findings of Muraleetheran (2011) who evaluated the impact of internal control on financial performance of organization in Jafnna District, in Sirlaka.

4.9.5. Monitoring Activities

From the result of the coefficient test here above, monitoring activities had a positive standardized coefficient and it was statistically significant at 5% level of significance. This is because the p-value of monitoring activity (0.031) is less than the alpha value of (0.05). As a result, the study found that monitoring activities significantly affects the financial performance of manufacturing firms. Therefore, we accepted the hypothesis that stated that there is significant positive relationship between monitoring activities and performance of privately owned manufacturing share companies. The result obtained from monitoring activity correlated with Rahel (2017) who confirmed that monitoring activity had significant impact on the performance of Ethiopian Shipping and Logistics Enterprise.

4.10. Summary of the findings

According to the respondents' demographics information, it was shown that almost all of the employees of finance and internal audit department in private manufacturing firms were at least diploma holders. The respondents were asked to comment on the length of working experience

that they had served in the firm to find out whether they were in a position to provide accurate and reliable information in connection with internal controls and financial performance in the privately held manufacturing firms. The findings explained that most of the employees had adequate experience in relation to the internal controls and financial performance of private owned manufacturing firms.

Whether the functionality of the internal controls of the firm had a role the financial performance of privately owned manufacturing firms, the findings revealed that most manufacturing firms had a control environment as one of the functionality of internal controls of the firm that greatly influence the financial performance of the firms.

The study also evaluated the impact of risk assessment as functionality internal controls of the firm affect the financial performance of the privately owned manufacturing firms. It was also established that the management had put in place mechanisms for mitigation of critical risks that may result from fraud. These results are clear indication that most manufacturing firms observed risk assessment procedures as functionality of internal control of the manufacturing firms.

The regression results revealed that there is a positive relationship between internal controls and financial performance of privately owned manufacturing share companies. However, there are only two elements of internal control components namely control environment and monitoring activities have significant impact on the financial performance of manufacturing firms whereas control activity, risk assessment and information& communication have insignificant effect on the financial performance of privately owned manufacturing share companies.

CHAPTER FIVE

5. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1. Introduction

The final chapter of this study presents the summary of study, conclusions, and recommendation. The study was sought to determine the effect of internal controls on financial performance of privately owned manufacturing share companies.

5.2. Summary of the Study

The main objective of this study was to establish the relationship between internal control systems and the financial performance of privately owned share manufacturing.

Descriptive research design was adopted for this study. They used a sample of four privately owned manufacturing firms from a targeted population of 14 large privately owned manufacturing share companies in Addis Ababa.

The study used primary data collected from structured close-ended questionnaires and secondary data collected from the sample firms audited financial statements. Quantitative data was analyzed using descriptive statistics. Quantitative data was coded and entered into Statistical Packages for Social Science (SPSS Version 21.0). The data was analyzed based on descriptive statistics. Multiple regression analysis was used to establish the relationship between internal controls and financial performance of privately owned manufacturing firms.

From the research findings, concerning their level of education, the study findings showed that most of the respondents were graduates of Accounting and Finance. On the length of service, most respondents have worked between 5-10 years.

The results of the regression model show that there is a positive relationship between internal controls and financial performance of privately owned manufacturing share companies. Holding all the other factors constant, financial performance is measured by the efficiency and effective implementation of internal controls. The results of the multiple regression model shows that there is a positive relationship between internal control and financial performance of privately owned manufacturing share companies. This implies that a single unit increase in any of the

independent variables results into a corresponding increase in financial performance of manufacturing firms. On the other hand, when we observed the significance of all independents variables of internal control only two variables are significantly contributed whereas the remaining three predictors are insignificant.

The study further established that the majority of private owned manufacturing firms had given relatively attention regarding control environment activity to maintain internal control with compared to the other internal control activities.

5.3. Conclusions

From the results of the study, it could be concluded that private manufacturing firms that had applied strong internal control systems had more improved financial performance as compared to those private manufacturing firms that had a weak internal control system. From the research results, it was shown that privately owned manufacturing firms that maintained particularly control environment and monitoring activity achieved high financial performance.

The study with regard to the objective that set out in the first chapter concludes that control environment, control activity, risk assessment, information& communication and monitoring activity positively affected the performance of privately owned manufacturing share companies even though some of them were not significantly affected on the financial performance of the firm.

To sum up, internal control system positively affected the performance of privately owned manufacturing share companies in Addis Ababa. The indication is that an improved internal control systems guide to high level of financial performance in privately owned manufacturing share companies.

5.4. Recommendation

According to the key finding and the conclusions of this study privately owned manufacturing share companies are advised to strength their monitoring activity through mechanism of periodically evaluating the effectiveness and functioning of internal control system as well as timely communicates internal control deficiency to take corrective action immediately in order to achieve a better financial performance result.

Moreover, it is recommended to privately owned manufacturing shares companies to pay attention to maintain strong control environment, which can be achieved, by adopting better standards of conduct for their employees and appropriate organizational structure.

Finally, the concerned organ of the government such as the Ministry of Trade and Industry should supervise and regulate privately owned manufacturing share companies to ensure that their operations comply with the rule and regulation of a firm as well as the nation.

5.5. Suggestion for further Research

It is suggested that further research can be conducted to evaluate the impact of financial performance of privately owned manufacturing share companies using other predictors in addition to components of internal control system.

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Appendixes

Addis Ababa University
College of Business and Economics
Department of Accounting & Finance

Questionnaires'' for **Effect of Internal Control System on Financial Performance: The Case of Selected privately owned manufacturing share companies in Addis Ababa.**

The objective of this study is to assess ***the effect of Internal Control System on financial performance: The case of Selected privately owned manufacturing share companies in Addis Ababa.*** To supplement the data obtained from different sources, the researcher looks to gather relevant information from a sample of your firms using self-developed questions.

Participation in this study is completely voluntary, the questionnaire results will be recorded anonymously and strict confidentiality will be maintained and individual responses will not be identified in the paper.

N.B. Please do not write your name or any other your personal information except that your demographic information, which is, stated under Part One.

If you have any query or further information you can contact me at the address shown here under:

Workineh Tesfaye email address: ***workineh.beyene@yahoo.com***

Part one: Demographic Information (Please tick the appropriate box)

1. **Sex**: Male ☐ Female ☐

2. **Age**: 18 – 27 yrs ☐ 28 – 37 yrs . ☐ 38 – 47yrs ☐ Above 47 ☐

3. **Education**: Diploma ☐ B.A/BSC ☐ M.A/M.S.C ☐ PHD ☐

4. **Academic Qualification**: Accounting ☐ Management ☐ Economics ☐ Others_____

5. **Year of service in the firm**: Less than or equal to 5 yrs. ☐ 6 – 10 yrs. ☐ 11 – 15 yrs. ☐ Above 15yrs. ☐

Part Two: Effect of internal Control in your firm based on Internal Control Components

S.N.	1. Control Environment	Strongly agree	Agree	Neutral	Disagree	Strongly Disagree
1.1.	There is clear separation of roles and responsibilities in your firm					
1.2	Your company holds periodic training to ensure employees are aware of their duties pertaining to internal control.					
1.3	Management closely monitors implementation of Internal control systems in your firm					
1.4.	The management and/board of directors of your company understands the importance of internal controls, including the division of responsibility					
1.5	Your organizational structure is appropriate for the size and complexity of the company					
1.6.	Standards of conduct are communicated and reinforced to all levels of your entity					

S.N.	2. Control Activities	Strongly agree	Agree	Neutral	Disagree	Strongly Disagree
2.1	Corrective action is taken to address internal control weaknesses					
2.2.	Staffs are trained to implement the accounting and financial management system					
2.3	Your company has policies and procedures addressing proper segregation of duties between the authorization, custody, and recordkeeping					
2.4	The company has a process that requires regular back up of computer files and testing of the back-up files to ensure proper functionality.					
2.5	The entity maintains policies and procedures to facilitate the recording and accounting of transactions in compliance with law and regulations.					
2.6	Management determines which relevant business processes require control activities.					

S.N.	3. Risk Assessment	Strongly agree	Agree	Neutral	Disagree	Strongly Disagree
3.1	The company has clear objectives and these have been communicated so as to provide effective direction to employees on risk assessment and control issues					
3.2.	Management ensures that risk identification considers both internal and external factors and their impact on the achievement of objectives					
3.3.	Management appropriately evaluates risk when planning for new product or activity					
3.4.	The organization has mechanisms in place to identify and react to risks presented by changes in government, regulatory, economic, operating, or other conditions that could affect the achievement of the goals and objectives of the firm					

S.N.	4. Information and Communication	Strongly agree	Agree	Neutral	Disagree	Strongly Disagree
4.1	Management has identified individuals who are responsible for coordinating the various activities within the entity					
4.2	All employees understand the concept and importance of internal controls including the division of responsibility					
4.3	The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control					
4.4	Communication helps to evaluate how well guidelines and policies of the organization are working and being implemented					
4.5	There are established channels of communication for individuals to report suspected breaches of laws or regulation or other improprieties					
4.6	The organization has processes in place to communicate relevant and timely information to external parties.					

S.N.	5. Monitoring Activities	Strongly agree	Agree	Neutral	Disagree	Strongly Disagree
5.1.	There are independent process checks and evaluations of controls activities on ongoing basis					
5.2	Internal reviews of implementation of internal controls in units are conducted periodically					
5.3	Monitoring has helped in assessing the quality of performance of the organization over time					
5.4	The organization selects, develops, and performs ongoing and/or separate evaluations on business process to ascertain whether the components of internal control are present and functioning					
5.5	The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including management and the board of directors, as appropriate					

Thank You for your Cooperation