

A Study Evaluating Internal Control Environment and Its Effect on Banks Performance in the Banking Sector of Ghana

Eleazer Fianko Ofei^{1, *}, Henry Kofi Mensah²

¹Department of Business Administration, Accra Institute of Technology, Accra, Ghana

²Department of Human Resource and Organizational Development, Kwame Nkrumah University of Science and Technology, Kumasi, Ghana

Abstract

Banks play a major role in accepting deposits and making available credit facilities to clients, the performance of banks is considered very key to its profitability and the is the need to ensure that necessary measures are adopted to promote this objective. In this study, the purpose was to analyse the internal control environment set up by management and assess its effect on the financial performance of banks operating in Ghana. In view of this, the research objective was to determine the effect of the internal control environment on the financial performance of Ghanaian banks. A questionnaire was developed and used to solicit the views of 676. Data collected was analysed with the help of hierarchical linear regression. The results from the analysis indicated that the banks had an internal control environment setup within the banks, it further established that the results were significant and the effect was positive. This implied that as control environmental activities improved or increased financial performance of the banks similarly improved. These results imply that banks have internal control environments that have been well developed and functioning. The study, therefore, recommends that the bank should continuously review the control environment and ensure all policies and procedures are functioning as they should and if possible, review section that seems to have issues. The study finally provided empirical evidence on the effect of internal control environment more specifically relating to the entire banking sector of Ghana.

Keywords

Internal Audit, Internal Control Environment, Bank of Ghana, Financial Performance

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1. Introduction

Internal audit has risen in relevance in organisations over the years. This is because an internal audit is viewed as a collection of actions that help the firm by reviewing controls and measures implemented by companies to guarantee outcomes are accomplished. Companies have found it nearly hard to fulfil their financial objectives due to unstable macroeconomic conditions, a complicated business climate, fraud and accounting disputes, and poor corporate governance processes [26]. This has prompted the establishment of an adequate internal audit department to

comprehensively analyse potential business risks and recommend immediate remedial steps. Internal audit, according to Ofei, Andoh-Owusu, & Asante [32], is a significant support tool for management, the audit committee, and all other stakeholders in the sector. In the study, Ngunyi [29] found that internal audit successfully contributes to giving an objective examination of a firm's operating efficiency. The internal auditor has a specific position inside the organisation. Management hires him or her, but he or she is frequently obliged to examine management's activities [35]. If management is working on financial improvements, the auditor must report immediately to the board committee to

* Corresponding author

E-mail address: eleazerfianko.ofei@gmail.com (E. F. Ofei)

address management's disrespect for company policy [2]. The internal auditors' duties are managed by an officer who usually is a manager or with the management team, the member of the audit committee mostly under the Corporate Governance Directive, normally published in the Ghanaian context by the Bank of Ghana, which sets out the audit framework in the audit charter [19]. Internal auditors should have unfettered and free use of effective testing methodologies if needed, access to records and employees. Bett [4] said that a significant internal audit role is necessary if public trust in financial and corporate governance is to be strengthened. To follow and assure the financial performance of the entire company, financial institutions have created an internal audit process. Senior management is rewarded by financial outcomes, which are important performance measures audits in its divisions [24]. Internal audits are a business branch conducting an unbiased assessment of the management structure of the company as a whole. The major role of the office responsible for the conduct of internal audit plays an important role by assisting the Board of Directors and senior management in ensuring the financial integrity, long-term profitability and sustainability of the company, according to the [18].

1.1. Research Problem

Banks' financial performance has been of great concern, including for Ghana, to all parties. This is because of the acknowledgement of Ghanaian banking from all fields as a development tool Boateng & Agyei [6] and because it has also become part of Ghana's financial system. The early phases of the banking industry were concerned with liberalising the banking sector so that more local and foreign organisations could be included to attain financial inclusion. This led to the fast spread of banks across the country. There are already 23 universal banks in Ghana [5]. Now, the question is how these banks can sustain their operations and keep the trust of their stakeholders. It highlighted several concerns concerning banks' corporate governance procedures and, more specifically, the control environment developed management and how it affects the performance of banks.

Studies done previously has not adequately addressed the research gaps existing concerning internal control environments and financial performance. For instance, studies were done by Ahmed & Ng'anga [1] and BoG [7] focused their studies on other sectors other than the banking sector, similarly, their studies were contextually done in other countries than Ghana, as Ghana has unique banking laws and a study in this context would be useful to policymakers in addressing the challenges in the banking sector as stressed on earlier. Other studies that were done in the Ghanaian context also failed to consider the banking sector such as studies

done [32]. It is against this notion that this study examined the effect of the internal control environment on the performance of banks using the Ghanaian banking sector as the focal point of this study.

1.2. Research Objective

This study is guided by an objective, which seeks to assess the effect of the internal control environment on the financial performance of banks operating in Ghana.

2. Literature Review

Internal audit plays an important part in carrying out the tasks that companies need to ensure the company's longevity and continued existence as an enterprise in the immediate future. The actions taken by the corporations are intended to aid in the protection of these organizations' corporate interests and services. According to Ofori [33], the key features of failed internal control systems are inadequate control systems, which contribute to low organizational efficiency. As a result, companies are supposed to have strong, proactive, and reliable internal control mechanisms in place to maintain the necessary stability and security. Internal audit function should be done with utmost impartiality and objectivity and internal auditors and to function freely without been influence by members of the board or management team. By extensively conducting internal audits, organisations may improve their performance by utilising a comprehensive and organised objective method to guarantee risk management, control systems and corporate management procedures are efficient. This is true of all organisations, including financial institutions The function of an Internal Auditor should be to advise top management on evaluating internal controls or on the ability to strengthen internal controls as successfully and effectively as possible while lowering or reducing costs, this assertion is as per the Institute of Internal Auditors.

2.1. Theoretical Review

2.1.1. Agency Theory

This notion is built on the principles of modern business operations of companies. It is founded on the notion that an organization's members must be split into 2 groups: the directors, the managers, who control the firm [20, 13]. A principal-agent organisation, as per business theory, increases uncertainty, which can result in higher costs associated with resolving disagreements between principals and agents [20, 13]. Other scholars claim that agency theory is the most important issue in corporate governance, and the main agent theory is often utilised as the reference premise for this discussion. In large businesses where shares ownership is common, managerial technologies vary from those necessary

to optimise shareholder earnings, as per agency theory [25]. The philosophy's central principle is that the management works in his or her self-interest. The notion is that contracts that lay out both the agents and the directors' essential rights are required to solve disputes in the relationship between principal and agent [20]. Internal policies can control how relationships, rights, obligations and means of assessing and enhancing management develop within an organisation [15]. According to Shleifer & Vishny [36], residual rights are granted to the agent for him or her to make discretionary judgments in distributing money owing to market instability, implying that on-the-spot decisions may be required due to dependent conditions. Residual rights are included as a result of the concept that a contract is not an effort. This proved, however, to be the principal cause of dispute with the owners and agents because of the latter's regular violation [36].

Agency theory also acknowledges that in a big business with widely spread or dispersed ownership, certain shareholders who only own a small number of shares do not have the luxury of devoting time to tracking managers' actions (agents). Among other authors, Eisenhardt [13] has discussed several scenarios in which agency conflicts might arise. Eisenhardt identifies two major causes of agency problems: "(a) the interests or aims of the principal and agent conflict, and (b) it is impossible or costly for the principal to monitor what the agent is doing." In the notion of agency theory, though, the Board is very clearly obliged to supervise agents with the resources of a shareholder to enhance the performance of the company. The use of financial benefits by the board of directors is supported by the theory of agency, and the delegation and consolidation of power to subordinate. To balance the agent's obligations with the principal, it has been necessary, according to Fama & Jensen [14], to incorporate contracts between principal agents on the board of directors and executive compensation schemes. Finally, the theory of agencies recognises the possibility for disguised bias from the Board. To overcome these differences, the concept advises that the committee be made up mostly of external directors who might be preferably neutral and willing to deal honestly with directors and agents. This is to assist in monitoring and controlling the activities of the agent and ensuring that their activities are following the board's requirements. This necessitates the use of control mechanisms, particularly the incorporation of monitoring and control activities in the contract governing the agent-principal relationship. According to the agency's philosophy, non-leaders and independent managers contribute to effective corporate management by monitoring and supervising the decisions of senior management and are considered as a control and check process or procedures to enhance the performance of the board.

2.1.2. Stewardship Theory

Based on the current theory of stewardship, it is reasonable to build governance structures that enable companies to react quickly and effectively to market opportunities, since people can be trusted to be acting on the collective good and to benefit their shareholders, by providing central command and by supporting self-sustaining decision making. As part of this strategy, the CEO and Chairman of the board are integrated and either non-existent or restricted audit committees. Managers are honest, driven by intrinsic rather than extrinsic incentives, and self-motivated to promote shared interests, according to stewardship theory [30, 8].

As an option to the theory of agency, stewardship theory asserts that when leaders and agents exchange ideas or businesses develop altruistic ideals, responsible conduct is governed internally [9]. Because it maximizes the steward's utility function, a steward maintains and maximizes shareholder value via business success [8]. A key feature of this theory is that it addresses an absence of faith in the agency theory's authority and ethical behaviour [10]. Directors and managers, according to stewardship theory, are seen as stewards of a business whose primary purpose is to advance the interests of its owners [11]. Furthermore, the theory says that success and recognition, the inherent delight of outstanding results, and the manager's respect for authority and work ethic all have an impact on management decisions in ways other than money [23, 3, 28].

2.2. Empirical Review

Ofei, Andoh-Owusu, & Asante [32] examined the effect of the internal control environment on Ghanaian banks' financial performance in the research entitled Effect of Internal Auditing function on Ghanaian banks' financial performance. A sample of 154 participants was used by the researcher. The data for the study was obtained employing questionnaires, and the data was analysed through multiple regression. The results of this study suggested the financial performance of Ghanaian banks was affected by the internal control environment; nevertheless, the effect was not considered significant. The study recommends that bank management enhance the control environment by strengthening the policies and processes that banks utilize to protect assets and properties. It also recommends that current policies, processes, and activities be evaluated regularly to ensure that they are still relevant in the face of changing competition and developments. Even though it only looked at five institutions, this study was unable to determine the influence of the internal control environment on the larger banking sector. The study did not take into consideration the influence of demographic characteristics such as gender, age, education, experience, and job tenure. Other studies, such as

Nwobodo, Adegbe & Banmore [31], looked at how a bank's internal control system affected the non-financial performance of a sample of quoted depositors. In the research, the Coso [7] framework was used. The survey study design was employed, with a population of 568 employees and a sample size of 292 determined using the Cochran sample size method. Data for this study were gathered by delivering a structured questionnaire to 292 top and middle-level management teams from the various selected head offices of Nigerian listed deposit money banks. The study's findings suggest that the internal control system has a favourable and substantial impact on the operational performance of selected Nigerian quoted deposit money institutions. The study failed to demonstrate the value of monitoring activities in the Ghanaian environment, as well as the value of monitoring efforts to the banking industry. The study also failed to account for demographic factors such as gender, age, education, experience, and job tenure.

The influence of the internal control environment on the financial performance of local governments in the coastal areas of Kenya was studied [1]. The survey was initiated using a descriptive design. The target group was 30 persons

from the Ministries of Finance, Budget and Planning of the Coastal Region County governments. Four coastal counties in Kenya were included in the research: Mombasa, Kilifi, Kwale, and Taita, and 40 financial managers from each county's Finance Planning Departments were asked to participate. A 40-person survey was carried out. The findings of the study show a positive and significant effect on the financial performance of the control environment. The county governments have to be honest and committed to ethical ideals. At all county levels, specific behavioural standards must be understood and methods to assess performance and immediately remedy deviations from expectations must be in place. County governments need to effectively communicate with their investors to strengthen their relationships.

2.3. Conceptual Framework

This study's conceptual framework is consistent with earlier research that identified internal control environment as independent factors such as; [32, 31, 1] and financial performance as a dependent variable such as; [12, 22].

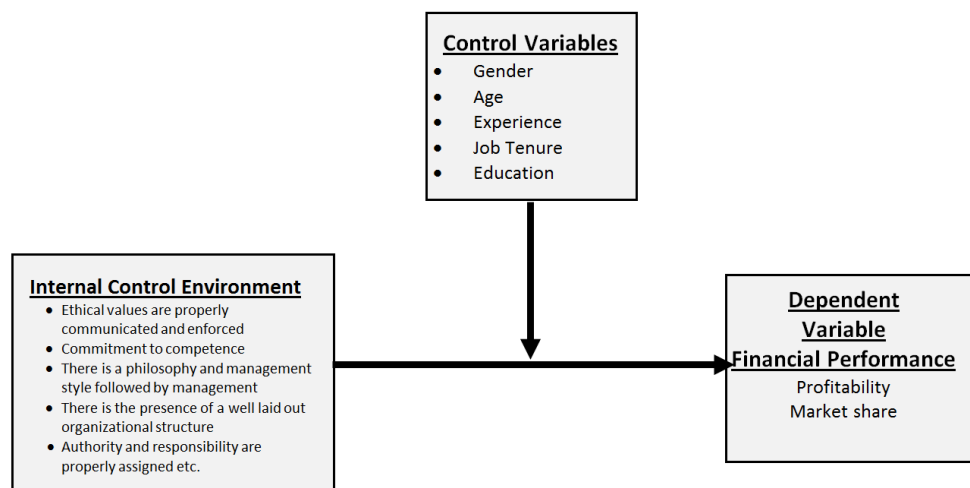


Figure 1. Researcher's Conceptual Framework.

3. Methods and Materials

3.1. Research Design

The researcher made use of explanatory research in this study to discuss the study's results. Explanatory research investigates the association between variables [34]. In this study, an exploratory research design was adopted, this is used when there is a problem or condition that leads to the understanding of the relationship between exploratory or research factors under study. The data was analysed using quantitative approaches such as correlation and regression to further evaluate the relationships given in-depth utilising

qualitative data.

3.2. Sample and Sampling Procedure

This research was based on the non – probability sampling techniques, a sample of 760 respondents were selected from 20 banks with 38 respondents drawn as follows, 5 respondents from the board of directors, 8 respondents from the internal audit committee, 5 members from the risk management committee, 15 members from the operations department and 5 respondents from the managers.

3.3. Data Collection and Instrumentations

The study relied on primary data, which was collected from

respondents via a questionnaire. This was done since a questionnaire, as a tool, is one of the most effective methods for allowing respondents to offer their perspective on a phenomenon while simultaneously allowing access to replies from a large sample size. An efficient method of collecting responses from a large sample helps the researcher to ensure that the researcher's notions are translated into quantifiable elements for quantitative analysis [34].

3.4. Model Specification

To measure the effects of the internal control environment on the financial performance of Ghanaian banks, the researchers employed a hierarchical linear regression. The study used the following model:

$$FP = \beta_0 + \beta_1 ICE + (\beta_1 Gen + \beta_2 Age + \beta_3 Exp + \beta_4 Ten + \beta_5 Edu)$$

Where:

FP= *Financial Performance*

ICE= *Internal Control environment at time t*

Age= *Age of respondents at time t*

Gen= *Gender at time t*

Exp= *Experience of employees at time t*

Ten= *Tenure of office at time t*

Edu= *Educational background of employees at time t*

4. Results and Discussion

4.1. Descriptive Statistics

Table 1. Test of Normality.

Variable	Statistics	Statistic	SE	Shapiro-Wilk's	p
Financial Performance	Skewness	-1.31	0.09	0.96	0.211
	Kurtosis	2.52	0.19		
	Mean	53.11	0.28		
Internal Control environment	Skewness	-0.75	0.09	0.93	0.000
	Kurtosis	0.69	0.19		
	Mean	19.21	0.09		

According to Garson [17], the absence of outliers in the data and normality is met if skewness and kurtosis fall between the range -3 and 3. This recommendation suggests that the estimated kurtosis or skewness should be less than 3 or greater than -3. This criterion is met for all the variables in the above. Thus, the variables' data were normally distributed. The use of kurtosis and skewness can, however, be misleading. As such, the Shapiro-Wilk's test, which confirms data normality at $p > 0.05$ was conducted [17]. It can be seen that financial performance met the criteria whilst the internal control environment did not meet the above criterion. Garson [17] noted that deviation from normality is not problematic if

the sample size is large (i.e. sample size ≥ 400) or the skewness and kurtosis assumptions were met. With this information, a basis is established for proceeding with the proposed parametric test.

4.2. Assessment of Data Reliability and Validity for Multidimensional Constructs

This section assesses the reliability and validity of the multi-dimensional construct, the results of the assessment are presented in the table below.

Table 2. Psychometric properties of multi-dimensional constructs.

Construct	Domain	Item	CR	CA	AVE	MSV
Financial Performance	F1	Sales volume	0.567	0.788	0.597	0.245
		Profit levels	0.832			
		Return on investment (ROI)	0.499			
		Return on sales (ROS)	0.567			
		Market share	0.821			
	F2	Growth in sales	0.543			
		Growth in profitability	0.661			
		Growth in ROI	0.801			
		Growth in ROS	0.722			
		Growth in market share	0.555			
All scale	---	---	---	0.822	---	---
ICE	F1	Ethical values are properly communicated and enforced	0.498	0.743	0.563	0.231
		Commitment to competence	0.545			
		There is a philosophy and management style followed by management	0.614			

Construct	Domain	Item	CR	CA	AVE	MSV
	F2	There is the presence of a well laid out organizational structure	0.580			
		Authority and responsibility are properly assigned	0.560			
		There is the presence of human resource policies and procedure	0.684			
		The head of the Internal Audit function is a member of the senior management team in the company and reports to the CEO	0.726			
		The internal audit department reports functionally to the audit committee of the Boards	0.738	0.743	0.563	0.231
		The company has a functional internal audit unit/department	0.587			
		Internal audit findings are reported directly to top management and the audit and risk sub-committee of the board.	0.670			
		The internal audit unit in the company has developed an internal audit manual that guides audit operations such as planning, implementation, monitoring, and evaluation.	0.466			
		Management creates internal auditor's independence and allows the internal audit department to conduct its work independent of the management	0.610			
		There are policies and procedures available for the functioning of audit staff	0.555			
		The head of the Internal Audit function is a member of the senior management team in the company and reports to the CEO	0.548			
		All scale	---	---	---	0.775

† CR – composite reliability; CA – Cronbach's alpha; AVE – average variance extracted; ASV – maximum shared variance; ICE – internal Control Environment

In the above Table, the first construct is financial performance, which produced two factors. Factor loadings for each factor met the condition *composite reliability* ≥ 0.5 as recommended [11]. This condition is also met for each factor of the internal control environment. Factors of the two constructs also met the condition *Cronbach's alpha* ≥ 0.7 . This condition is also met for the whole construct. That is, the internal consistency of the factors and constructs was met. According to Kelava [21], Convergent validity and discriminant validity, which are indicators of construct validity, are assessed with the average variance extracted

(AVE) and maximum shared variance (MSV). Convergent validity is met with the criterion $CR < AVE$ whereas discriminant validity is met with the condition $MSV < AVE$ [21]. In the table, both conditions are met by the two constructs. Hence, construct validity was confirmed for the two scales.

4.3. Model Fit Indices

This section presents the model fit indices for the measurement models, the results of the assessment are presented in the table below.

Table 3. Model fit indices for the measurement models.

Variables	Chi-square(χ^2)	p	RMSEA	TLI	GFI	AGFI
Financial performance	1.271	0.132	0.021	0.984	0.971	0.991
ICE	2.32	0.104	0.048	0.972	0.966	0.989
Recommended	≤ 3	≥ 0.05	≤ 0.08	≥ 0.95	≥ 0.9	≥ 0.9

† RMSEA – random mean square error of approximation; TLI – Tucker-Lewis Index; GFI – goodness-of-fit indices; AGFI – adjusted goodness-of-fit indices; ICE- Internal Control Environment

the above table shows the model fit statistics for the two measurement models used to compute statistics in subsequent Tables. The table also shows the recommended baselines or criteria. It can be seen that all the statistics met the

recommended criteria, suggesting that both models were of satisfactory fit. Results in the above exploratory analysis, therefore, set a satisfactory foundation for analysis data with a parametric statistical tool such as HLR analysis.

4.4. Descriptive Statistics Showing Ratings on the Main Variables

Table 4. Summary of descriptive statistics.

Variable	Maximum	Mean	Mean (% of Maximum)	SE	SD
Financial Performance	50	38.75	77%	0.20	5.24
Internal Control Environment	70	53.11	76%	0.28	7.38

The role of the table above is to estimate the perceived level of the key variables. Since the 5-point scale was associated with a continuum of descriptive anchors, the level of a variable (i.e. whether a variable is high or low) depends on the size of the mean score corresponding to that variable. Similarly, a variable increase as its average score gets closer to its maximum value.

The standard error (SE) and SD are indicators of the precision of the estimate [17]. The precision of the variable increases as the SE and SD decrease. It can be said that all the variables in the table are high because they account for more than 70% of the maximum score. Financial performance accounted for the largest relative mean score (Mean = 38.75; SD = 5.24), which is

77% of the maximum score. This result suggests that financial performance was rated to be at the highest level of practice. The internal control environment produced the smallest relative mean scores representing 76% of the maximum score. These findings suggest that financial performance was high, likewise the other variable.

4.5. Correlation Results

Table 5. Correlation Results.

Variable	#	1	2
Financial Performance	1	1	.645**
Internal Control Environment	2		1

**p<0.001; *p<0.05.

The table above shows the correlation matrix of relevant variables including covariates. In the table, financial performance is positively correlated with internal Control environment ($r = 0.645$; $p = 0.000$; two-tailed. This result suggests that the financial performance of the bank's increases as the internal control environment increase.

4.6. Regression Results

This section presents findings on the specific objective and hypotheses as recalled as follows:

H_1 – *Internal Control environment has a significant effect on financial performance among the banks.*

Table 6. Coefficients.

Model	Predictor	Coefficients			Collinearity Statistics		
		B	SE	$\beta(t)$	Tolerance	VIF	Dubin Watson
1 ^a	(Constant)	12.408	1.469	(8.45)			
	Internal Control Environment	.372	.025	0.52 (14.8)**	0.63	1.59	1.67
	(Constant)	10.443	1.800	(5.80)**			
	Internal Control Environment	.360	.025	0.51(14.15)**	0.59	1.69	
2 ^b	Covariate	1.384	.323				
	Gender (reference – male)	.069	.225	0.13(4.28)**	0.88	1.13	
	Age	1.376	.443	0.01(0.31)	0.84	1.20	
	Experience	-1.397	.426	0.33(3.10)**	0.17	4.64	
	Job tenure	.157	.218	-0.35(-3.28)**	0.17	4.72	
	Education	12.408	1.469	0.02(0.72)	0.87	1.15	

**p<0.001; *p<0.05; ^abaseline model without covariates; ^bultimate model with covariates; SE – standard error; VIF – variance inflation factor

The results of the hypotheses are captured in the table above. With this table, the researcher examined the direct effects of the internal control environment on financial performance. These effects are tested in two regression models. The first model did not adjust for covariates whereas the second adjusted for covariates. Though the source of the final results is the second (ultimate) model, a comparison of the two models is necessary to understand the influence of the confounding variables in the second model. In the ultimate model, the internal control environment ($\beta = 0.51$; $t = 14.15$; $p = 0.000$) have a positive effect on financial performance after controlling for the covariates, which confirms that the financial performance of the bank's increases as the internal control environment improve. The Durbin-Watson statistic of the model is also about 1.7, which falls within the range of 1.5-2.4 recommended by [17]. The Durbin-Watson statistic, therefore, connotes the absence of autocorrelation in the data. Moreover, each predictor accounts for a variance inflation factor (VIF) value \leq of 5, indicating that the multi-Collinearity assumption is met for the model [17].

The objective of the study was to determine the effect of the internal control environment on the financial performance of banks in Ghana. In line with this objective, the study sought to answer the questions "to what extent does internal control environment affect the financial performance of banks in

Ghana?". The results indicate that the internal control environment had a significant positive effect on the financial performance of banks in Ghana after controlling for demographic variables such as gender, age, educational background etc. The results collaborate with the study results of [32, 1, 12, 16] who found a positive significant effect of internal control environment on financial performance. The results further showed that the confounders such as gender, age, the educational background had some effect on the internal control environment, hence there was the need for those effects to be controlled to determine the actual effect of the internal control environment on financial performance.

These results are in line with the findings of Nwobodo, Adegbe & Banmore [31] who also found that confounding variables have some effect internal control environment, although the effects may not be very significant. The most probable explanation for the results is that the bank internal control environment may be very effective and emphasis is placed on the internal audit department and committee as directed by the bank of Ghana. From the results, it is observed that although the study results showed a positive result, this implies that the internal control environment of the banks is carried out in line with the provisions of the corporate Governance directives as published by the banks of Ghana in 2018. The results are also consistent with the

requirements of the Bank of Ghana, as stated in the corporate Governance directive 2018, which suggest that all banks should have a board and the board should be responsible for the establishment on internal audit committee to protect shareholders and stakeholders, this collaborates with the [7] which provides that as part of the first line of control elements, there is the need for the establishment of the internal audit committee. From the foregoing discussions, it is evident that the banks in Ghana have a structure in place that oversees the audit of the bank's activities and processes.

5. Findings and Recommendations

The study aimed to examine the role of internal audit on the financial performance of banks, the first objective sought to determine the effect of the internal control environment on the financial performance of banks in Ghana. In line with this objective, the study sought to answer the questions "to what extent does internal control environment affect the financial performance of banks in Ghana?" The results indicate that there was a strong positive relationship between the internal control environment and financial performance, which indicates that performance improves as the internal control environment are improved, the study further finds that the internal control environment had a significant positive effect on the financial performance of banks in Ghana after controlling demographic variables such as gender, age, educational background etc. The findings indicate that financial performance improves as internal control environment activities and processes are increased by the banks. The study recommends that banks should continue to enhance the performance of banks through enforcing the control environment policies and processes of the banks. It is further recommended that future studies be replicated in other sectors of the banking sector such as rural banks to determine the contribution of the internal control environment on the performance of rural banks.

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