INTERNAL CONTROLS AND FINANCIAL REPORTING QUALITY OF NIGERIAN DEPOSIT MONEY BANKS: AN EMPIRICAL ANALYSIS

MUHAMMAD, Rabi'u Ya'u
Department of Accounting
Al-Qalam University Katsina
rabiuyau@auk.edu.ng

MADAWAKI, Abdulkadir
Department of Accounting
Al-Qalam University Katsina
abdulkadirmadawaki@yahoo.com

JIBRIL, Jamilu
Department of Accounting
Al-Qalam University Katsina
jamiljibril943@gmail.com

ABSTRACT

This study examined effects of internal control systems on financial reporting quality of Deposit Money Banks in Nigeria. The study specifically examined impact of control environment (CE), risk assessment (RS), control activities (CA), information communication (IC), and monitoring (MON) on financial reporting quality (FRQ). The population of the study consists listed deposit money banks in Nigeria. A sample size of 384 was drawn from the population using Cochran formula. Survey method was used to obtain data from respondents using structured questionnaire. The study employed second-generation statistical analysis tools of Smart Partial Least Square (Smart PLS) and SPSS. Five hypotheses were formulated and tested. The study found that risk assessment, information communication, monitoring have positive significant effect on financial reporting quality while control activities have negative significant effect on financial reporting quality. However, control environment was found to have positive but insignificant effect on financial reporting quality. The results of this study offer valuable insight to deposit money banks, regulators, and researchers to further understand effect of internal controls on financial reporting quality. Thus, the study recommends that regulators should encourage all banks to maintain and improve on the implementation of internal controls COSO framework in order to ensure effectiveness and efficiency of operation, reliability of financial reporting and compliance with rules and regulations. It is also recommended that banks should establish a robust information management system for comprehensive risk analysis and reporting.

Keyword: Control activities, control environment, financial reporting quality, information communication, monitoring, risk assessment

INTRODUCTION

Users of financial statements need accurate and reliable information to enable them make informed economic decisions. The primary objective of financial reporting is to provide sufficient financial information concerning the economic wellbeing of an entity, with a view to facilitating decision-making. The quality of users' economic decision largely depend on the accuracy and reliability of earnings information at their disposal (Hacinamiento & El, 2014). High quality information devoid of fraud or misstatements certainly assists in making better economic decisions. However, the reports may be manipulated by managers in various ways which could consequently reduce the quality of information contained in the reports.

Financial reporting quality is an issue that attracts interest of regulatory bodies, shareholders, researchers and accounting professionals (Chu et al., 2018). This is due to the fact that financial reporting has been the primary means through which information is disseminated to outsiders, about the financial strength and performance of an entity. Quality financial reporting is important because it help capital providers and other stakeholders to make sound decision with regards to investment, credit, and similar resource allocation decisions with a view of improving overall market efficiency (Owolabi & Amosun, 2020).

Conversely, misrepresented financial reports mislead users and negatively impact capital markets, erode investors' confidence and hurts company reputation (Enofe et al., 2016). Thus, financial reporting quality has implication on market efficiency and economic performance of a country (Zhang, 2019; PWC, 2013).

Despite the importance of quality reporting and the adverse effects of manipulated report, management may engage in opportunistic behaviour to achieve personal interest at the expense of other stakeholders. In line with Agency theory, management as agent always pursue their personal interests at the detriment of principals' interests. The incentives for managing earnings may include the need to meet internal or external earnings expectations, conceal company's deteriorating financial condition, increase stock price or increase management compensation based on financial results.

Extant literature shows that banks involved in fraud and accounting scandals for a long period of time without taking any serious measure to hold back their occurrence are liable to failure and collapse (Aduwo, 2016; Ben Pam, 2013). Here in Nigeria, the rate at which fraud and other accounting scandals are increasing, especially in the banking sector, is alarming. The outcome of forensic examination conducted by Central Bank of Nigeria (CBN) on five indicted banks in 2009 revealed how fraudulent activities and manipulation of financial reports concealed huge funds as non-performing loans (Olatunji & Adekola, 2017; Lucy et al., 2016). All these happened in an environment with internal controls in place and a number of measures intended deter fraud and ensure accuracy and reliability of financial reports.

However, installing the control mechanisms and fraud prevention measures is one thing while their functioning, and getting desired results is another thing. Hence, there is the need to investigate impact of internal controls on financial reporting quality, the effect of forensic accounting on financial reporting quality and the moderating role of forensic accounting techniques on the relationship between internal controls and financial reporting quality.

LITERATURE REVIEW

Concept of internal controls

Internal control system is also defined as the whole system of control, financial or otherwise, established in an organisation in order to provide reasonable assurance with regard to effectiveness and efficiency of operation, reliability of financial statement and compliance with management policies. Internal control has long been advocated as a mechanism for building quality financial reporting and has been used voluntarily by firms. It is a process affected by an entity's board of directors, management and other personnel, designed to provide assurance regarding the achievement of objectives relating to the operations, reporting and compliance (COSO, 2013).

Control environment

The effectiveness of any internal control system depends on its control environment which is considered as the root that sets the tone at the top and the control consciousness of all staff of an organization. Control environment is the foundation of all other components of internal control (COSO, 1992, 2013) which provides discipline, principles and structure for the organization. Hence, this study defines control environment as the tone at the top consisting of discipline, principles and organizational structure that influences the control consciousness of the people in the organization.

Risk Assessment

Risk assessment is an essential component of internal control. It involves identifying and analysing risk related to achievement of objectives (Hwang et al., n.d.). Risk assessment enables the detection and assessment of risks that are pertinent to goal achievement (Muhunyo, 2018). At every level in an organization, there is a tendency of both internal and external risk that threatens the achievement of objectives. Therefore, COSO (1992) suggests that assessment of risk level is compulsory for organization because all organizations face risk from both internal and external sources regardless of its size or status. However, management is responsible for assessing all threats regarding financial reporting integrity, reliability and accuracy within the organization's control environment (Salameh, 2019).

Control activities

Control activities are policies and procedures that help in carrying out management directives. These policies and procedures cut across all organisational and functional levels with various objectives and can be manual or automated (Owolabi & Amosun, 2020). Control activities ensure necessary actions are taken to address risks. This implies strong control activities in business processes provides reasonable assurance with regards to efficiency and effectiveness of operation, reliability of financial reporting and compliance with policies.

Information and communication

The major aspects of information and communication include information systems, communication of control responsibilities, organizational communication and external communication. Communication systems represent procedures and channels employed by organizations to disseminate vital information, directives and policies (Nguyen, 2020). Therefore, open channels of communication are necessary to allow information to flow throughout the entity and into the financial statements and therefore management should discuss the identification, capture, and flow of financial information in its report.

Monitoring

Monitoring control is the on-going process to ensure that internal control controls are functioning as intended. It is the last component of internal control which ensures that an internal control system is well designed and is functioning effectively. Monitoring is defined as the review of an organization's activities and transactions to assess the efficiency and effectiveness of internal control system over time. Amissah, (2017) opines that monitoring involves the process of assessing the quality of internal control system.

Concept of financial reporting quality

Financial reports are formal documents containing information about the financial performance and position of an entity. It is the channel of communication between companies and stakeholders about the economic wellness of an entity to help them make informed decisions. Financial reporting is a products of accounting system that provide information needed to make economic decisions. A complete annual reports contain: a statement of financial position as at the end of the period; a statement of comprehensive income for the period; a statement of changes in equity for the period; a statement of cash flows for the period; notes, comprising a summary of significant accounting policies and other explanatory information. Hassan (2013) views financial reporting as a means through which information is dispersed to present and potential equity investors, lenders, and other stakeholder in order to help them make useful economic decisions.

Internal controls and financial reporting quality

Doyle et al. (2007) examined the relationship between accruals quality and internal controls. The study used discretionary accruals, average accruals quality, historical restatement and earnings persistence as proxies for accruals quality while internal control material weakness disclosure was used as proxy for internal control. The study found that internal control weaknesses are associated with poorly estimated accruals. Bimo et al., (2019) in their study, examined effect of internal over financial reporting (ICOFR) and organizational complexity on financial reporting quality. The study reveals that internal control over financial reporting has a positive influence on financial reporting quality. Using an agency theory to underpin their study, Ujan and Mukhlasin (2019) examined impact of internal control disclosure and ethics disclosure on earnings quality. Their results reveal that internal control and ethical disclosure signal the quality of earnings information for investors and reduce information asymmetry.

However, Salehi and Bahrami (2017) investigated effect of internal control and risk management on earnings quality of companies listed on the Tehran Stock Exchange in Iran. The study employed ex post facto research design on a sample of 560 listed companies from 2009-2014 and used panel data regression. The study found no significant relation between internal control and earnings quality. Also, Chen et al. (2018) explored impact of internal control quality on earnings management. The results show that there is a significant negative correlation between internal control levels and earnings management levels and the higher quality internal control reduces earnings management by both accounting choices and real activities.

The studies mentioned above were all conducted in rule-based countries where internal control information disclosure is mandatory. And they relied on reported internal control weaknesses as proxy for internal controls. However, this study was conducted in Nigeria where internal control weaknesses are reported in the financial statement. Also the study used internal control components as proxy for internal control.

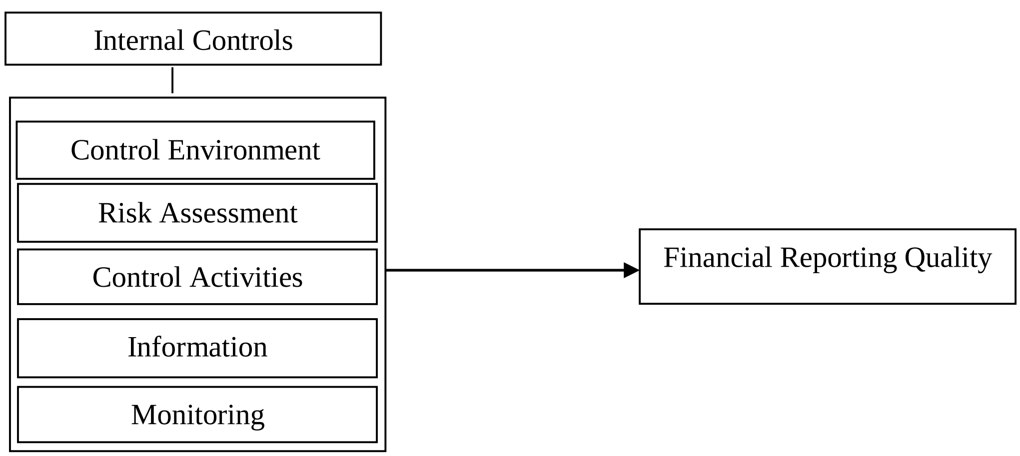

Fig. 1: Research Framework

METHODOLOGY

Based on the research model developed, the present study focuses on theory testing and verification, drawing on the philosophical assumptions of the positivist paradigm. This study adopts the positivist ontology, empirical epistemology and quantitative methodology. A cross-sectional design is also used in this study as data were collected at a single point in time by deploying survey method through the administration of a well-structured questionnaire to 384 respondents drawn from an infinite population of forensic accountants, accountants, internal auditors and risk managers via Cochran Formula (Cochran, 1977). The study used Partial Least Square Structural Equation Modelling (PLS-SEM) as techniques of data analysis after conducting preliminary analysis to ensure the data is fit for multivariate analysis.

RESULTS AND DISCUSSION

According to Hair et al. (2017), the estimation of the outer model (i.e. measurement model) is first examined by checking the internal consistency reliability (i.e. Cronbach alpha and composite reliability), convergent validity, and discriminant validity. After establishing the reliability and the validity of the constructs, the structural model estimates were evaluated.

Assessment of Measurement Model

To evaluate the measurement model of this study, the researcher is tasked to assess the reliability of individual items measuring each latent construct, the internal consistency reliability (i.e., construct reliability), discriminant validity, as well as convergent validity for each of reflective constructs (Hair et al., 2017).

Table 1: Item Loadings, Internal Consistency, and Average Variance Extracted

Constructs	Indicators	Outer Loadings	Cronbach's Alpha	Composite Reliability	Average Variance Extracted (AVE)
Control Environment	CE1	0.67	0.63	0.73	0.51
	CE2	0.69			
	CE5	0.57			
	CE8	0.62			
Risk Assessment	RA2	0.90	0.78	0.83	0.56
	RA4	0.51			
	RA5	0.62			
	RA8	0.88			
Control Activities	CA2	0.74	0.83	0.88	0.60
	CA3	0.78			
	CA5	0.68			
	CA9	0.85			
	CA11	0.82			
Information Communication	IC3	0.87	0.82	0.88	0.66
	IC5	0.85			
	IC8	0.87			
	IC11	0.63			
Monitoring	MON3	0.92	0.93	0.95	0.83
	MON6	0.92			
	MON7	0.88			
	MON10	0.91			
Financial Reporting Quality	FRQ2	0.67	0.76	0.84	0.51
	FRQ5	0.76			
	FRQ6	0.76			
	FRQ7	0.87			
	FRQ8	0.71			

As can be seen in Table 1, apart from the items that were removed from the analysis due to some measurement issues, all other indicators have loadings of above 0.50 indicating item's reliability in measuring their respective reflective latent constructs. Table 1 shows that the composite reliability of the reflective constructs in this study ranges between 0.61 to 0.93 while Cronbach's alpha ranges between 0.73 and 0.95. Going by the rule that 0.60 and above are acceptable values of CR, it was concluded that all the constructs are reliable as all their respective CR values are above the threshold of 0.60 and not beyond the problematic value of 0.95. It can also be concluded that the Cronbach's alpha of all the constructs are reliable given that the values are above threshold of 0.70.

Consequently, following the threshold level of 0.50 value for the AVE, all constructs have convergent validity as each construct has an AVE level above 0.50. Thus, these values indicate that all of the aforementioned constructs of this study have convergent validity, and thus they all explained more than 50 percent of the variance of their respective indicators.

The discriminant validity is established when a latent construct is unique and captures phenomena not represented by other constructs (Hair et al., 2017).

Table 2: Discriminant Validity (Heterotrait-Monotrait Ratio (HTMT)

Constructs	CA	CE	FRQ	IC	MON	RA
CA						
CE	**0.78**					
FRQ	0.29	**0.75**				
IC	0.51	0.61	**0.66**			
MON	0.53	0.78	0.74	**0.77**		
RA	0.72	0.63	0.73	0.72	**0.71**	

As can be seen from Table 2, the HTMT statistics is presented based on correlations among items of their reflective constructs. All the reflective latent constructs of this study have discriminant validity as the HTMT value is lower than the thresholds of 0.85 proposed by (Kline, 2011). Therefore, discriminant validity was confirmed using the HTMT criterion. Consequently, it is enough to say that all the latent constructs of this study have discriminant validity using all the approaches.

Table 3: Hypothesis test

Relationship	Beta Values	Standard Deviation	T Stat.	P Values
Control Environment -> Financial Reporting Quality	0.01	0.04	0.22	0.83
Risk Assessment -> Financial Reporting Quality	0.20	0.09	2.40	0.02
Control Activities -> Financial Reporting Quality	-0.24	0.04	6.49	0.00
Information & Communication -> Financial Reporting Quality	0.52	0.07	7.61	0.00
Monitoring -> Financial Reporting Quality	0.16	0.07	2.30	0.02

Note: CE=Control Environment, RK=Risk Assessment, CA=Control Activities, IC=Information and Communication, MON=Monitoring, FRQ = Financial Reporting Quality

Table 3 shows that the statistical analysis for Ho_1 indicates that control environment is insignificantly and positively related to financial reporting quality ($\beta = 0.01$, $p>0.05$). This means that the financial reporting quality is not significantly improved by the control environment. In other words, the effect control environment has on quality of financial report is positive but not significant.

Also, Ho_2 showed that risk assessment has significant and positive impact on financial reporting quality ($\beta = 0.20$, $p<0.05$). This indicates the higher the risk assessment, the higher the financial reporting quality. In other words, at 5% significance level, when risk assessment increases, financial reporting quality increases significantly. Hence, we can argue that when deposit money banks engage in higher assessment of risk, it will significantly help a Bank improve the quality of its financial reporting.

The analysis for Ho_3 indicates that control activities is significantly and negatively related to financial reporting quality ($\beta = -0.24$, $p<0.05$). This means that the financial reporting quality is not significantly reduced by the control activities. In other words, the effect control activities has on financial reporting quality is significantly negative.

The result for Ho_4 shows that information and communication is positively and significantly related to financial reporting quality ($\beta = 0.52$, $p<0.05$). This implies that the higher the information and communication, the higher the financial reporting quality. In other words, a unit change in information and communication will lead to significant positive increase in financial reporting quality of listed deposit money banks in Nigeria. Hence, we can argue that financial reporting quality is significantly improved by an increase in information and communication.

The analysis for H_{05} indicates monitoring is positive and significantly related to financial reporting quality (β=0.16, p<0.05). That is, the higher the monitoring, the higher the financial reporting quality. Hence, when the monitoring is high, it is expected that the financial reporting quality will be increased significantly.

CONCLUSION

The following are the conclusion drawn based on the findings of the study: The banks' Control environment is not strong enough to influence financial reporting quality. The inference is that banks do not have effective and efficient control avenues that will provide reasonable assurance with regard to the presentation of reliable and quality financial reports.

The study also concludes that there is frequent and continuous risk assessment in the Banks which brings about improvement in financial reporting quality. In other words, to advance financial reporting quality among deposit money banks, Banks must engage in the evaluation of risk in order to mitigate uncertainties.

The study concludes that too much control activities without appropriate techniques of implementation, would not increase the quality of financial reports but rather it decreases its quality. The study concludes that, information and communication is a very good predictor of financial reporting quality. In other words, in order to promote and advance financial reporting quality among deposit money banks, Banks need to invest on information and communication systems. Finally, the study concludes that, deposit money banks engage in higher monitoring activities with a view to drive higher the financial reporting quality.

RECOMMENDATIONS

In line with the findings and conclusion of the study, the following recommendations were made: The study recommends that management of deposit money banks should ensure that all rules and policies are strictly followed through rigorous monitoring and evaluation and also deployment of employees with forensic accounting knowledge in the internal control cycle. The study also recommends that banks and regulatory agencies should promote sound ethical culture with a view to increase awareness and discourage involvement in any fraudulent activities.It is also recommended that the bank management should provide and ensure the periodic assessment of operational risk in order to mitigate uncertainty, deter fraud and promote financial reporting quality among Nigerian Banks.

REFERENCES

Aduwo, O. O. (2016). The role forensic accounting in combating the menace of corporate failure. *International Journal of Economics, Commerce and Management*, *4*(1), 640–649.

Akindele R.I. (2011). Fraud as a negative catalyst in the Nigerian banking industry. *Journal of Emerging Trends in Economics and Management Sciences*, *2*(5), 357–363.

Amissah, A. (2017). *Effect of internal control systems on performance of companies in the insurance in Ghana*. 204.

Ben Pam, W. (2013). Discriminant analysis and the prediction of corporate bankruptcy in the banking sector of Nigeria. *International Journal of Finance and Accounting*, *6*, 319–325.

Bimo, I. D., Siregar, S. V., Hermawan, A. A., & Wardhani, R. (2019). Internal control over financial reporting, organizational complexity, and financial reporting quality. *International Journal of Economics and Management*, *13*(2), 331–342.

Chen, Y., Li, J., & Wang, Y. (2018). *An Empirical study on internal control and earnings management of chinars listed companies based on the modified Jones model*.Retrieved from https://doi.org/10.2991/meess-18.2018.44

Chu, L., Dai, J., & Zhang, P. (2018). Auditor tenure and quality of financial reporting. *Journal of Accounting, Auditing and Finance*. Retrieved from https://doi.org/10.1177/0148558X16665701

Doyle, J. T., Ge, W., & Mcvay, S. (2007). over Financial Reporting. *The Accounting Review*, *82*(5), 1141–1170. http://www.sciencedirect.com/science/article/pii/S0165410106000905

Enofe, A. O., Olorunnuho, M. S., & Okporua, A. D. (2016). Forensic Accounting and Fraudulent Financial Reporting in Nigeria. *Journal of Accounting and Financial Management*, *2*(1), 21–34.

Hassan, shehu usman. (2013). Financial Reporting quality. *The Business & Management Review*.

Hwang, S., Shin, T., & Han, I. (n.d.). *2004- CRAS-CBR Internal control risk assessment system using case-based reasoning.pdf*.

Muhunyo, M. B. (2018). Effect of Internal control systems on financial performance of public institutions of higher learning in Nairobi City County, Kenya. *International Academic Journal of Human Resource and Business Administration*, *3*(2), 273–287.

Nguyen, T. M. (2020). The effect of internal control on the performance of pharmaceutical firms in vietnam. *Accounting*, *7*(2), 395–400. https://doi.org/10.5267/j.ac.2020.11.012

Olatunji, O. C., & Adekola, D. R. (2017). The Roles of auditors in fraud detection and prevention in Nigeria Deposit money banks: Evidence from Southwest. *European Scientific Journal*, *13*(31), 290. https://doi.org/10.19044/esj.2017.v13n31p290

Owolabi, S. (2010). Fraud and fraudulent practices in Nigeria banking industry. *African Research Review*, *4*(3), 240–256. https://doi.org/10.4314/afrrev.v4i3.60263

PWC. (2013). Inter n al Co n t ro l: I n te g rate d f ra mewo rk e xe cu tive s u mmar y. *Coso*, *May*, 1–20.

Salameh, R. S. (2019). What is the impact of internal control system on the quality of banks' financial statements in Jordan? *Academy of Accounting and Financial Studies Journal*, *23*(5), 1–10.

Salehi, M., & Bahrami, M. (2017). The effect of internal control on earnings quality in Iran. *International Journal of Law and Management*, *59*(4), 534–546.

Sunday A., O., & Olayemi, O. A. (2020). Internal control systems and quality of financial reporting in insurance industry in Nigeria. *Journal of Finance and Accounting*, *8*(5), 218-228.

Ujan, A. A., & Mukhlasin. (2019). The effect of internal control and ethics disclosure on earnings quality: Investor perception-based analysis. *Academy of Accounting and Financial Studies Journal*, *23*(6), 1–8.

Zhang, D. (2019). Top Management Team Characteristics and Financial Reporting Quality. *The Accounting Review*. https://doi.org/10.2308/accr-52360