

# Evaluation of Effectiveness of Internal Control System in Small Business Organisations in Ekiti State of Nigeria

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## Abstract

The study evaluates the effectiveness of internal control system in selected small business organizations in Ekiti States in Nigeria. The study identified types of Internal Control and assesses the impact of internal control on these organizations. This was with a view to develop appropriate framework to improve the effectiveness of internal control in a system. The study covered purposefully selected small business organizations in Ekiti states of Nigeria. Questionnaires were administered and were supplemented with oral interview to elicit information from staff of these organizations. The data collected included the level of the adequacy of internal control, the level of staff involvement in internal control and the impact of internal control on the smooth operations of organisations. The data collected were analyzed using appropriate statistics. The result showed that there was grossly inadequacy of internal control in the organizational aspect having a rating index of 2.50, arithmetic and accounting control with a rating index of 2.88, personnel has rating index of 2.96 and segregation of duties with an index of 2.80. The study concluded that the compliance with the internal control in small organizations in Ekiti State is very poor. Suggestions were made on different ways of improving the effectiveness of internal control system in order to achieve the organizational objectives.

**Keywords:** Internal Control, asset, management, compliance, financial

## 1.0 Introduction

Internal control is the process established by management, it also includes the management information system which is designed to help the organization in accomplishing specific goals or objectives. It is a means by which an organization's resources are directed, monitored, and measured. At the organizational level, internal control objectives relates to the reliability of financial reporting, prompt feedback on the achievement of operational or strategic goals, and compliance with laws and regulations. At the specific transaction level, internal control refers to the actions taken to achieve a specific objective and this reduces variation process which leads to more predictable outcomes.

A reliable internal control system should be put in place in any organization so as to achieve the best result in their activities

## 1.1 Statement of Problem

Millichamp (2002) said that a system of accounting and record keeping will not succeed completely and accurately processing all transactions unless controls, known as internal control, are built into the system, most organization has internal control system in place but despite the existence of this internal control system, there are many challenges that affect the smooth running of small business organization. Most of these small business organizations have internal control in place but the effectiveness of the internal control is very poor.

## 1.2 Objective of the study

The objective of this study is to assess the effectiveness of internal control in small business organizations, specifically, the objectives are: to assess the effect of the existence of internal control system in small business organizations and to establish the adequacy of such internal control

## Discussion

Awe (2005) defined Internal Control as 'the measures taken by an organization for the purpose of protecting its resources against wasters, ensuring efficiency, accuracy and reliability in accounting and operating data; securing compliance with organization policies and evaluating the level of performance in all divisions of the organization'. Millichamp (2002) defined Internal Control as 'the whole system of controls, financial or otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the completeness and accuracy of the records'.

Robertson and Louwers (2000) defined Internal Control as: a process, effected by the entity's Board of Directors, Management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following three categories:

- Reliability of financial reporting
- Effectiveness and efficiency of operations

- Compliance with applicable laws and regulations'

Conclusively, Internal Control System is prescribed practices which the management of enterprises develops and adopted in order to facilitate the smooth and efficient running of an enterprises' operation and for security of its assets.

The objectives of Internal control are viewed by Alan and John (2012) are:

- To carry on the business in an orderly and efficient manner,
- To ensure adherence to management policies,
- Safeguard its assets; and
- Secure the accuracy and reliability of the records

If organizations fail to implement and comply with Internal Control, then the future of such organizations would be in shamble. Therefore there is a need to give a serious attention to the design of internal control measures that would help organization in achieving its goals.

According to Tiggos (2002) There are mainly two types of controls which are preventive and detective.. Preventive controls are the most utilized type of control, and are usually done on a transaction-by-transaction or event-by-event basis. This type of control is often expensive in terms of workflow disruption and implementation costs. Examples of defensive controls include: Matching and comparing documents from different sources to ensure integrity (Van (2004).

Detective controls, on the other hand, help management identify when preventive controls have broken down and corrective action is needed.

### **Functions of Internal Control System**

Internal control system directs, controls and monitors the accomplishment of organisational goals in an efficient and economic manner. According to Burr, Gandara and Robinson (2002) Internal Control minimizes the occurrence of variances, which may impede the attainment of organisation's specific goal enhances free flow of work and it defines clearly the line of responsibility and accountability in an organisation. It provides basic analytical tools such as financial summary, internal authorization of assets, acquisition and investment in inventories for sound management decision. It is the very foundation upon which the statutory audit is based. It enhances considerably, the conduct of the audit.

All business organizations, regardless of form, size or nature face internal and external risks and these risks must be managed. The evaluation and monitoring of these risks should be an ongoing process. The system of internal control as stated by David and Steinbart (2000) is designed to provide reasonable assurance that assets are safeguarded, accounting records are reliable and there is compliance with laws and regulations. The small business organization's owner/manager may experience difficulty in implementing many of the recommended principles of internal control because of limited numbers of employees or because of related high expenses. The owner/manager can prevent or detect inconsistencies through constant and careful supervision and monitoring of operations. He can identify breakdowns in internal control through inquires, inspection, review and observation. Internal control effectiveness depends on the trustworthiness, competence and integrity of employees and their understanding of prescribed policies and procedures.

### **Types of Internal Control**

The types of internal control according to Leslie (1987) can be categorized into: Organisation, segregation of duties' physical, authorization and approval, arithmetic and Accounting, Personnel, supervision and management

According to Alleyne and Howard (1987) physical control involves physical custody of assets and involves procedures and security measures that are designed to ensure that access to assets is limited to authorized personnel while Olatunji, Dada and Bankole ( 2002) stated that arithmetic and accounting controls is to ensure that no valid transaction have been omitted from the accounting records and to ensure that all valid transactions are accurate and consistent with originating documents and also that record is done at the appropriate time without unnecessary delay.

Adeniyi (2012) states "Arithemetical and accounting are controls within the recording function which check that the transactions to be recorded and processed have been authorized.

Robertson (2002) states that 'internal control consists of five interrelated components – management control environment, management's risk assessment management's control activities, management's monitoring and the management's information and communication system that link all the components

## Interpretation and Discussion of Findings

**Table 1: Compliance with Internal Control System**

5	4	3	2	1	Total score	weighted score	Rx
Very Often	Often	Less Often	Seldom	Rarely	56	122	2.17
5(25)	5(20)	6(18)	19(38)	21(21)			

Source: Field Survey 2013

NOTE: RATING 1 - Rarely  
 2 - Seldom  
 3 - Less Often  
 4 - Often  
 5 -Very Often

Mean Score = 3+1.5811  
 High = 4.581  
 Average =3.0000  
 Low = 1.4189

Rx = Rating Index (weighted Average)

Table 1 shows the rating index of compliance with Internal Control in small business organization in Ekiti State. The rating index of 2.17 which indicates that compliance with internal control is rarely exercised.

**Table 2: Impact of internal control on organization**

	5 High Positive Impact	4 Positive Impact	3 No Impact	2 Negative Impact	1 High Negative Impact	Total Response	Weighted Score	Rx
Production Time	21(108)	24(96)	7(21)	2(4)	2(2)	56	2.2	4.07
Admini. Time	25(125)	22(88)	7(21)	1(2)	2(2)	56	238	4.25
Labour Cost	25(125)	22(88)	7(21)	1(2)	2(2)	56	238	4.25
Material Cost	18(90)	19(76)	10(30)	4(8)	5(5)	56	209	3.73
Quality Control	15(75)	20(80)	11(33)	8(16)	2(2)	56	206	3.68
Information Management	16(80)	27(108)	5(15)	6(12)	2(2)	56	217	3.88

Source: Field Survey 2013

NOTE: RATING 1 – High Negative Impact  
 2 - Negative Impact  
 3 -No Impact  
 4 - Positive Impact  
 5 -High Positive Impact

Mean Score = 3+1.5811  
 High = 4.581  
 Average =3.0000  
 Low = 1.4189

Rx = Rating Index (weighted Average)

As shown in table 2, Internal Control has positive impact on the control of labour cost and material cost with rating indices of 4.4 and 4.07 respectively. These indices indicate that effective internal control can reduce labour and material costs in an organization. However, Internal Control was found to have no impact on production time, administrative time, quality control and information management with rating indices of 3.30, 3.71, 3.68 and 3.88 respectively.

**Table 3 : Adequacy of internal control**

	5 Very Adequate	4 Adequate	3 Fairly Adequate	2 Inadequate	1 Grossly inadequate	Total response	weighted score	Rx
Organization Control	4(20)	6(24)	10(30)	30(60)	6(6)	56	140	2.50
Physical Control	16(80)	18(72)	9(27)	11(22)	2(2)	56	203	3.63
Segregation of duties	7(35)	8(32)	12(36)	25(50)	4(4)	56	157	2.80
Authorization & Approval	21(105)	15(60)	9(27)	3(6)	8(8)	56	206	3.68
Personnel	8(40)	18(40)	13(39)	22(44)	3(3)	56	165	2.96
Arithmetic & Accounting	13(65)	5(20)	9 (27)	20(40)	9(9)	56	161	2.88
Supervision	14(70)	20(80)	11(33)	6 (12)	5(5)	56	200	3.57
Management	11(55)	12(48)	14(42)	10(20)	9(9)	56	174	3.10

Source: Field Survey 2013

NOTE: RATING 1 – Grossly Inadequate Mean Score = 3+1.5811  
 2 - Inadequate High = 4.581  
 3 - Fairly Adequate Average =3.0000  
 4 - Adequate Low = 1.4189  
 5 - Very Adequate

Rx = Rating Index (weighted Average)

The adequacy of internal control is shown in table 3. The rating indices reveals that organization control, segregation of duties, personnel and arithmetic and accounting were inadequate with rating indices of 2.50, 2.80, 2.96, 2.16 and 2.88 respectively. However, physical control, authorization and approval, supervision were adequate indices of 3.63, 3.68 and 3.57.

Explanations received from the oral interview conducted in some of the organization selected for the study indicates that the reason for the adequacy of internal control in respect of physical control, authorizations and approval and supervision is due to the involvement of owners of the business in these areas of internal control. The management control is adequate with an index of 3.10. Findings from oral interviews conducted also revealed that management of most of the small business organizations were in some cases comprises of relatives of the proprietors and in many cases, formal management set up were not in place.

**Table 4: Level of involvement in internal control**

	Very High	High	Moderate	low	Very Low	Total response	weighted Score	Rx
Board	15(75)	17(68)	10(30)	12(24)	2(2)	56	199	3.55
Top Mgt.	25(125)	17(76)	9(27)	2(4)	1(1)	56	233	4.16
Middle Mgt.	22(110)	16(64)	14(42)	2(4)	2(2)	56	222	3.96
Lower Mgt.	12(60)	6(24)	8(24)	19(38)	11(11)	56	157	2.80
Other Staff	9(45)	11(44)	6(18)	3(6)	27(27)	56	140	2.5

Source: Field Survey 2013

NOTE: RATING 1 – Very Low  
 2 - Low  
 3 - Moderate  
 4 - High  
 5 -Very High

Mean Score = 3+1.5811  
 High = 4.581  
 Average =3.0000  
 Low = 1.4189

Rx = Rating Index (weighted Average)

Involvement of staff and management is a key to the success of any effective internal control system. The study sought to know the level of involvement of Board of Directors, Top management, middle management, lower management and other staff in the internal control of the organization. Table 4 shows that the involvement of Board of Director in the internal control of the organization is fairly moderate while that of the top management is high with a rating index of 4.16. The involvement of middle management is also fairly moderate with an index of 3.96 and that of lower management and other staff were very low with indices of 2.80 and 2.50 respectively. For effective internal control system in an organization, all staff needs to be involved at least moderately.

### Hypothesis 1

H<sub>0</sub>: Internal Control in Private Business Sector Organization in Ekiti State is not weak

H<sub>1</sub>: Internal Control in Private Business Sector Organization in Ekiti State is weak in small business

Contingency table showing whether Internal Control is weak in small business

Response	Observed frequency (O <sub>i</sub> )	Expected frequency (e <sub>i</sub> )	$\frac{(O-e)^2}{e}$	Result
Yes	13	28	$\frac{(13-28)^2}{28}$	8.04
No	43	28	$\frac{(43-28)^2}{28}$	8.04
Total	56	56		16.08

$$X^2_o = 16.08$$

X<sup>2</sup><sub>e</sub> given that the degree of freedom (d.f)

$$= 2-1 = 1$$

and that if significance = 5%

X<sup>2</sup><sub>e</sub> = (0.05, d f = 1) from the table is 3.84

**Decision:** since X<sup>2</sup><sub>o</sub> is greater than X<sup>2</sup><sub>e</sub> the H<sub>0</sub> is rejected and H<sub>1</sub> accepted i.e. Internal Control in is weak.

### Hypothesis 2

H<sub>0</sub>: There is compliance with Internal Control system in Private Business Sector

H<sub>1</sub>: There is no compliance with Internal Control system in Private Business Sector

Contingency table showing whether there is existence of internal control in Small Organisation

Response	Observed frequency (O <sub>i</sub> )	Expected frequency (e <sub>i</sub> )	$\frac{(O-e)}{e}$	Result
Yes	11	28	$\frac{(11-28)^2}{28}$	10.32
No	45	28	$\frac{(45-28)^2}{28}$	10.32
Total	56	56		20.64

$$X^2_o = 20.64$$

$$X^2_e \text{ given that the degree of freedom (df)} \\ = 2-1 = 1$$

and that if significance = 5%

$X^2_e = (0.05, df = 1)$  from the table is 3.84

Decision: since  $X^2_o$  is greater than  $X^2_e$   $H_0$  is rejected and  $H_1$  accepted i.e. Existence of Internal

The result of tested hypotheses show that there is weak internal control in small organisations in Ekiti State and where there is internal control there is no compliance with such internal control.

### Conclusion

Good internal control system is very necessary in any organization for the smooth running of the activities in the organization. It has been discovered that there is close relationship between the adequacy of internal control system and reduction of cost and wastes.

Involvement of all staff in the internal control in an organization is very important for the effectiveness of the control. The involvement of the lower cadre of staff in small business is very low, most organization does not involve the junior officers in their internal control system.

### Recommendations

Based on the findings of this study in respect of the problems identified, the following suggestions and recommendations will be necessary in order to have effective internal control system put in place and also to improve the effectiveness of internal control system. All staff in the organization should be involved in the internal control system. This will make it easy for the control to be very effective if all the staff is involved in the process of these controls.

In view of the identified problems of poor personnel control, small business owners should not base their employment of staff on who you know, but it should be based on merit performance during selection process. They should ensure round peg in a round hole. The right caliber of staff should be employed for the right job and there should be proper segregation of duties between staff and good monitoring of lower level of staff by the higher level of staff.

It is expected that the implementation of these recommendations would provide the requisite policy framework for effective internal control system in business organisations in this country and it will also improve cost effectiveness in these organizations

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