

THE IMPACT OF INTERNAL CONTROL SYSTEM ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM-SCALE MANUFACTURING ENTERPRISES IN KEGALLE DISTRICT OF SRI LANKA

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Abstract

The main objective of this study is to find the impact of internal control systems on small and financial performance in Kegalle District. Nearly all small and medium-sized manufacturing enterprises now need to maintain an internal control system due to current business trends. A few empirical research on the connection between the Internal Control System and Financial Performance have been carried out in the setting of Sri Lanka. Therefore, there is a gap in empirical evidence regarding financial performance and the internal control system. Therefore, the goal of this work is to close this information gap. The study used primary data to extract information. Two hundred (200) owners of small and medium-sized manufacturing businesses provided the data, which was then examined using descriptive statistics, regression analysis, correlation analysis, and hypothesis testing. With the aid of the Software Statistical Package of Social Science, version 22.0, they were shown as graphs, tables, and charts. The analysis's conclusions demonstrated that small and medium-sized manufacturing enterprises' internal control systems and financial performance are both at a high level. Furthermore, there is a substantial positive correlation between financial performance and the internal control system. The study's findings support the conclusion that internal control systems have a major impact on the financial performance of small and medium-sized manufacturing enterprises in the Kegalle District.

Keywords: Small and Medium Scale Enterprises, Internal Control, Financial Performance

Introduction

Different authors, in most cases, have given different definitions to these Small and medium-sized manufacturing enterprises. Various countries are using many parameters to introduce the SMEs such as the number of persons employed, amount of capital employed, amount of capital invested, and amount of turnover and nature of business. However, in Sri Lanka, government agencies use different criteria than the non-government agencies' criteria (Gamage, 2013). The Small and medium-scale manufacturing enterprises in Sri Lanka are one of the major contributors to the economic development and success of the country. SME manufacturers must increase their productivity. The manufacturing sector is very broad that includes wood floors, and industrial and consumer products. Studies have shown that the sector has the necessary ability to alleviate poverty through the creation of employment opportunities and the generation of income.

Most of the Small and Medium scaled manufacturing enterprises among all businesses' use an internal control system to improve their performance. Internal control plays an integral role in a company's success. It is a policy and procedure to ensure the continued reliability of the accounting system of the company. The system of internal control system helps a company to prevent fraud, and errors and minimize wastage. Internal control refers to the

techniques and procedures implemented by an organization to protect its resources, ensure the integrity and dependability of its financial information, enhance operational effectiveness, and promote adherence to established management guidelines. Under the COSO Internal Control-Integrated Framework, the internal control system is broadly defined as a process, effected by an entity's board of directors, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance (COSO, 1992) .

Small-scale enterprises are mostly managed by family members and close relatives who show less interest in following internal control systems than they have in the latter (Frederick D.S.Choi, Gray K.Meek, 2009). It is important to note that internal controls just give reasonable, not total confirmation to an entity's management and board of directors that the organization's goals are accomplished. Aruna (2003) Points out that a firm's performance depends heavily on a sound internal audit function.

All the companies in the world use the internal control system for measuring their performance and attempts to establish the effectiveness of the internal control system. Internal control keeps an organization from achieving its objectives and its mission. According to studies, they lower the risk of asset loss, increase operational effectiveness and efficiency, and support legal and regulatory compliance (Nijiru, 2016). Internal control can be financial or non-financial. Financial internal control relates to financial activities and may be revealed by controls over the company's cash receipts and payments financing operations and the company's management of receipts and payments.

Effective internal control in SMEs has led to the success of the business and it is also a fundamental and important step in reducing employee theft (Oseifuah & Gyekye, 2013). The research on internal control of small and medium manufacturing enterprises is not so many; most of them are concentrated on how to improve internal control. Implementation of internal controls is deep into all aspects of manufacturing operations, strengthening internal control means creating benefits for the manufacturing operations. Enterprises improve their business through effective internal control which is how the resources of these SMEs are directed, monitored and measured. Effective internal control in SMEs leads to the success of the business and it is also a fundamental and important step in reducing employee theft (Nyakundi , Nyamitha, & Tinega, 2014). The effectiveness of an Internal Control System can be measured by the factors of Control Environment, Risk Assessment, Control Activities, Information and Communication and Monitoring (Amaka, 2012).

The proper internal control system always leads to improved financial performance. Financial performance is an act of performing a financial activity. Normally it is a process of measuring the results firm's policies and operations in monetary terms. Effective internal control ensures the reporting process and gives highly reliable reports to enhance the accountability of the management of the entity. Internal controls primarily try to enhance the reliability of financial performance, either directly or indirectly by increasing accountability among information providers in an organization (Jenson, 2003). Internal control systems including internal audits are intended primarily to enhance the reliability of financial performance, either directly or indirectly by increasing accountability among information providers in an organization (Jensen, 2003). COSO framework (2005) tried to discover the relation between the two variables of internal control and financial performance. That shows a small relationship between internal control and financial performance and it mentions, that internal control system plays an important role in preventing and detecting fraudulence, decreasing illegal conduct and enhancing compliance with laws and regulations in the industry, improving the competitiveness of the entity, improving the quality of data and information and protecting the organization's resources. SMEs have concentrated on the availability, accessibility and cost efficiency in the utilization of finances (Nyakundi , Nyamitha, & Tinega, 2014). Within the business population, small and medium-sized businesses take up a large space of business organization, a factor that has contributed to the urgent need for ICSs.

The financial performance of this study includes two dimensions (business Growth and business volume) under that dimension to find out the level of financial performance of SMEs. The research on the internal control system of small and medium manufacturing enterprises seems to be less and most of them are regarding how to improve internal control. The establishment of the internal control system in the SMEs in the Kegalle district indicates variations in having an internal control system. According to this variation in financial performance is influenced by variation in the internal control system. By using this variation, in this study, the researcher attempts to identify the impact of the internal control system on the financial performance of only small and medium manufacturing enterprises.

Research Problem

Small and Medium-scale Enterprises contribute a large part of Sri Lanka's economy and it accounts for 80% of the total number of enterprises. The agri-business sector is engaged in growing spices, fruits and vegetables and the manufacturing, sector is engaged in numerous industrial activities accounting for about 20% of industrial establishments. SMEs are an essential source of employment opportunities and provide 35% of employment (Ministry of Industry and Commerce). In our best awareness, the effect of the internal control system on the financial performance of SMEs is not clear in Sri Lanka. However, in recent years, the impact of internal control systems has achieved much importance (Njeri, 2014).

The impact of internal control systems on financial performance is considered more important in every Small and Medium Manufacturing Enterprise for preventing and detecting fraud and errors and reducing wastage. As well as for ensuring the reliability of accounting. SMEs always have an internal audit department to help in compliance with the laws, policies, procedures and regulations. Most enterprises attempt to achieve the effectiveness of financial performance from the internal control system. However, there are some challenges or efforts found regarding the internal controls to achieve positive performance. However, while implementing the internal control system in SMEs, firms can be identified whether these controls are effective or not. The absence of adequate internal control measures discloses the financial performance of the enterprises that might be faced with certain threats. Some of them struggle with liquidity problems, financial reports are not made timely, accountability for financial resources is wanting, fraud and misuse of institutional resources have been unearthed and several decisions made have not yielded the expected results (Raymond & St-Pierre, 2004). The corrective or effective internal controls help ensure that the impact of the threat is minimized, identify the cause of the problem and rectify the errors. Corrective controls discover correct problems through detective controls and modify the processing system to minimize the future occurrence of the problem (Ibrahim, Diibuzie, & Abubakari, 2017). While implementing effective controls, the next problem is the effectiveness of internal control affecting SMEs' financial performance. According to that, previous research studies' findings do not apply to Sri Lankan SME manufacturing enterprises. Therefore, this study considers selecting SME manufacturing enterprises in Kegalle district in Sri Lanka There are 1925 Small and Medium Scaled manufacturing enterprises in Kegalle district. (Ministry of National and Economic Affairs). It is very important to examine the impact of the internal control system on financial performance because more SMEs follow the internal control system. This research study will be analyzed in this area. Therefore, extremely hope that this study tries to fill the research gap.

So this study has investigated **“What is the impact of internal control system on the financial performance of Small and Medium scale manufacturing enterprises in Kegalle District?”**

Research Objectives

1. To examine the impact of the control environment on the financial performance of small and medium-scale manufacturing enterprises in Kegalle District

2. To examine the impact of risk assessment on financial performance of small and medium-scale manufacturing enterprises in Kegalle District
3. To examine the impact of control activities on financial performance of small and medium-scale manufacturing enterprises in Kegalle District
4. To examine the impact of information and communication on financial performance of small and medium-scale manufacturing enterprises in Kegalle District
5. To examine the impact of monitoring on the financial performance of small and medium-scale manufacturing enterprises in Kegalle District
6. To assess the impact of the internal control system on financial performance of small and medium-scale manufacturing enterprises in Kegalle District

Literature Review

Small and Medium-sized Enterprises (SMEs) are identified as one of the leading groups of economic activities globally and support a substantial part of the economic activities in the Asia Pacific region (Weerasiri & Zhengang, 2012). In Sri Lanka, SMEs consist of both manufacturing and service sector enterprises in a wide spectrum of industry disciplines. In addition to the standalone enterprise nature, these SMEs play an important role in supply chain links to the large industry or service sector too. Small and medium enterprises (SMEs) have been the backbone of the economic growth of an economy in driving industrial development (Normah, 2006). At present, the vibrant SME sector is identified as an engine of growth playing a significant role in economic growth, innovation, employment generation and poverty reduction (Prasad, 2004). SMEs play a big role in national economies by providing job opportunities and supporting big industries.

The fact that there are no unique criteria or a unique definition for small and medium enterprises in Sri Lanka like in other countries and there is no universally accepted definition of SMEs. Apart from the different criteria various types of definitions were adopted by different official agencies for administrative and statistical purposes (Aruna, 2003). Small and medium-scale enterprises (SMEs) make up a large part of Sri Lanka's economy, accounting for 80 per cent of all businesses and SMEs play an important role in promoting inclusive growth (National Human Resources and Employment Policy). Like in other developing nations, SMEs play a crucial strategic role in Sri Lanka and make up a sizable portion of all industrial and commercial firms. It promotes growth by import substitution as well as through direct exports and they mostly supply goods and services to large directly exporting ventures and thereby contribute towards moderating balance of payments difficulties (Hewaliyanag, 2001).

With the globalization trend, the SME sector is not merely seen as a sector for “protection and promotion” but, more importantly as a driving force for “growth and development” Therefore, the Government of Sri Lanka recognizes that enhancing national and international competitiveness is fundamentally important for this sector to face the emerging challenges and develop SMEs as a thriving sector (Ministry of Industry and Commerce). The SME Policy Framework will support new SME businesses, bolster established ones, and expand nursing programs for potentially viable sick SMEs. Its goal is to support high-potential, promising SMEs and enhance the business environment so they can realize their full potential in today's globalized economy.

Hypothesis Formulation

Based on the previous research arguments, the researcher developed the following hypotheses within this research:

H1: There is a significant impact of Control Environment on Financial Performance in Small and Medium Scale Manufacturing Enterprises

H2: There is a significant impact of Risk Assessment on Financial Performance in Small and Medium Scale Manufacturing Enterprises

H3: There is a significant impact of Control Activities on Financial Performance in Small and Medium Scale Manufacturing Enterprises

H4: There is a significant impact of Information and Communication on Financial Performance in Small and Medium Scale Manufacturing Enterprises

H5: There is a significant impact of Monitoring on Financial Performance in Small and Medium Scale Manufacturing Enterprises

H6: There is a significant impact of Internal Control Systems on Financial Performance in Small and Medium Scale Manufacturing Enterprises

Conceptual Framework

Independen Variables

Dependen Variable

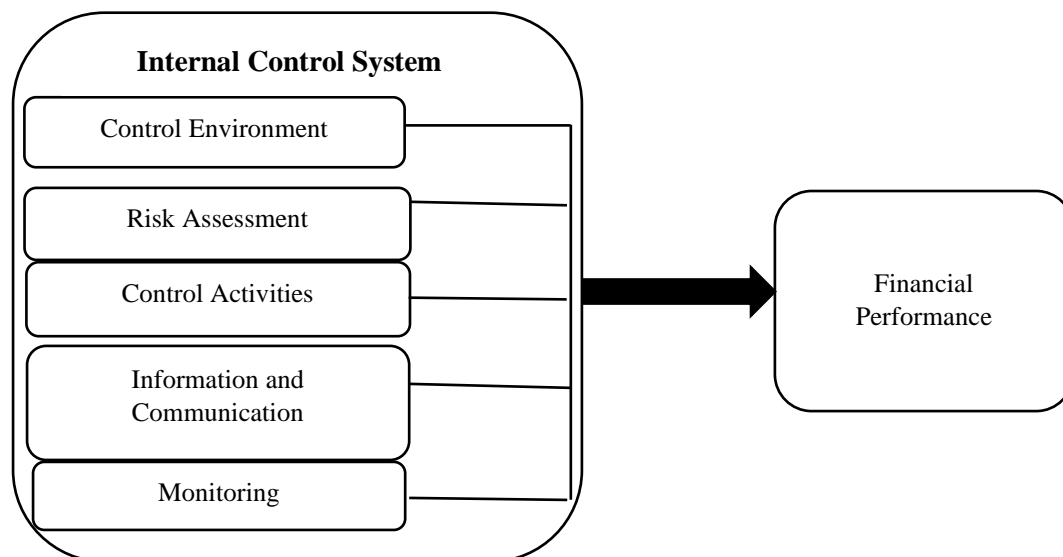


Figure 1. Conceptual Framework

Source: (COSO, 1992)

Methodology

According to the Sri Lanka Standards Institution (SLSI), SME owners are considered to be made up of enterprises which employ less than 249 employees. There are 1925 Small and Medium manufacturing enterprises in Kegalle district (Local Government Authorities – 2019). In this study, the size of the sample is selected as 200 entities from the total population of the small and medium manufacturing enterprises in Kegalle district. Data for this investigation was collected via the use of a survey. The survey approach was appropriate for this study because of the nature of the constructs presented in the theoretical model. These data have collected the individual, problems and phenomena. In this research, the desired data is gathered through primary and secondary sources of data.

The data relating to the selected sample is collected using the questionnaire method. Questionnaires used in this research were originally developed by the researcher and are related to independent and dependent variables to

achieve research objectives. Secondary data can provide a useful source from which to answer, or partially answer the research question. Literature surveys are based on various published and unpublished research, journals, books, and newspaper articles. This research was conducted by applying a survey approach to measuring the impact of internal control systems on the financial performance of SME manufacturing enterprises through primary data.

Univariate Analysis – Mean, Standard Deviation

Univariate analysis was done by using descriptive statistics. This study covered all response variables as well as the demographic characteristics of the respondents. According to Frederick, Choi, Gray & Meek (2009), descriptive statistics provide the basic features of the data collected on the variables and provide the impetuses for conducting further analyses. Every variable in the research model was analyzed using the Descriptive Statistical method (Mean and Standard deviation).

Table 1: Decision Rule

Range	Decision attributes to the Internal Control System	Decision Attributes to Financial Performance
If $1.0 \leq X_d \leq 2.5$	Low Level	Low Level
If $2.5 < X_d \leq 3.5$	Moderate Level	Moderate Level
If $3.5 < X_d \leq 5$	High Level	High Level

Table 2: Cronbach's Alpha Test

Variables	No. of statements	Cronbach's Alpha
Internal Control	29	0.947
Control environment	07	0.754
Risk Assessment	05	0.818
Control Activities	08	0.880
Information and Communication	05	0.844
Monitoring	04	0.737
Financial performance	04	0.797

Source: Survey Data

Bivariate Analysis – Correlation Analysis

Correlation is a statistical measure that indicates the extent to which two or more variables fluctuate together. A positive correlation indicates the extent to which those variables increase or decrease parallel; a negative correlation indicates the extent to which one variable increases as the other decreases.

Bivariate Analysis – Simple Regression Analysis and Multiple Regression Analysis

The Simple Regression Analysis was used in this research to determine the functional relationship between a Dependent Variable and an Independent Variable (a predictor) for prediction and making other inferences. Multiple regression analysis is a statistical tool that allows examining how multiple independent variables (predictors) are related to a dependent variable.

Data Analysis and Findings

The reliability of the instrument was measured using alpha analysis. It measured the internal consistency of the instrument, based on the average inter-item correlation. Cronbach's Alpha Coefficient (CAC) is calculated for statements of each of the dimensions and the full set of data collected.

According to the table, Mean values of Control Environment, Risk Assessment, Control Activities, Information and Communication, Monitoring, Internal Control, Business Volume, Business Growth, and Financial performance are at high levels. Business Growth has a higher mean value compared to other dimensions. When taking the Internal control system is high level. Because the mean value of internal control is 4.0219. The Standard Deviation of all variables is the smallest that shows the smallest dispersion with a close relationship.

Table 3: Mean and Standard Deviation for Variables

Indicator	Mean	Std. Deviation
Internal Control System	4.0219	0.61299
Control Environment	4.0114	0.57987
Risk Assessment	4.1180	0.66019
Control Activities	3.9613	0.68309
Information and Communication	4.1050	0.61299
Monitoring	3.9138	0.71488
Financial Performance	4.1250	0.62757
Business Volume	4.0500	0.69817
Business Growth	4.2000	0.68546

Source: Survey Data

According to the results of the Pearson correlation, the coefficient of correlation (r) value is 0.886 and the significant level is 0.000. The correlation is significant at 0.01 (2 – 2-tailed), and as the Coefficient (r) is more than 0.5, it is found as a positive correlation and it is t strong. This shows a strong positive and statistically significant relationship between Internal Control Systems and Financial Performance. As shown in the figures the scatter plots between Internal Control variables and Financial Performance indicate a positive correlation with scattered points around a straight line.

Table 4: Correlation between Internal Control System and Financial Performance

	Control Environment	Risk Assessment	Control Activities	Information and Communication	Monitoring	Internal Control
Pearson Correlation (r)	0.839	0.857	0.814	0.755	0.782	0.886
Significant Level (p)	0.000	0.000	0.000	0.000	0.000	0.000

Source: Survey Data

Simple regression analysis is used to determine the impact of the independent variable on the dependent variable. In this study, simple regression analysis is used to provide a pattern of relationship between the set of predictors and the outcome factor (Financial Performance). All results show p values are less than 0.05 ($p < 0.05$) and it indicates the alternative hypotheses are not rejected.

Table 5: Statistics of Regression between Internal Control and Financial Performance

Method	Linear					
	Control Environment	Risk Assessment	Control Activities	Information and Communication	Monitoring	Internal Control
R	0.839	0.857	0.814	0.755	0.782	0.886
R square	0.705	0.735	0.662	0.570	0.612	0.785
Adjusted R square	0.703	0.734	0.660	0.568	0.610	0.784
Std.Error	0.34197	0.32369	0.36582	0.41271	0.39189	0.29196
Sig t	0.005	0.000	0.000	0.000	0.000	0.001
b-constant	0.481	0.768	1.164	1.442	1.437	0.478
b-value	0.908	0.815	0.747	0.653	0.687	0.907
Beta	0.839	0.857	0.814	0.755	0.782	0.886

Source: Survey Data

Table 6: Model Summary

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.896	0.803	0.798	0.28235

Source: Survey Data

Table 7: ANOVA Test

ANOVA b						
Model		Sum of squares	Df	Mean square	F	Sig
1	Regression	62.909	5	12.582	157.817	0.000
	Residual	15.466	194	0.080		
	Total	78.375	199			

Source: Survey Data

According to the Multiple Regression analysis, the coefficient (R) is 0.896 is indicates a Strong positive relationship between Internal Control and Financial Performance. The determination of the coefficient (R^2) is 0.803. According to the ANOVA table, the significance is 0.000 and it is lower than 0.05 ($P < 0.05$). Thus, it can be concluded that 80.3% of variations in Financial Performance are significantly explained by Internal Control. Thus,

Internal Control is a good and significant predictor of Financial Performance. According to regression analysis results, the qualities of the Control Environment, Risk Assessment, and Control Activities variables have been significant ($p < 0.05$) except for Information and Communication, Monitoring.

Table 8: Coefficient Test

Model	Unstandardized Coefficients		Standardized Coefficient	t	Sig
	B	Sd.Error	Beta		
1					
(Constant)	0.327	0.142		2.305	0.022
Control environment	0.316	0.072	0.292	4.404	0.000
Risk Assessment	0.328	0.070	0.345	4.713	0.000
Control Activities	0.139	0.069	0.151	2.007	0.046
Information and Communication	0.075	0.049	0.086	1.533	0.127
Monitoring	0.083	0.060	0.95	1.387	0.167

Source: Survey Data

Discussion

These discussions on the level of Internal Control system and Financial Performance among owners of Small and Medium Manufacturing Enterprises in Kegalle District. According to the Internal Control System have a high level. The reason that SMEs owner has good awareness of Internal Control Systems. Internal Control System decision is measured through five indicators namely Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring. It indicates the Internal Control, which has fallen within the range of $3.5 < X \leq 5.0$, the mean value is 4.0219 with a high level of Internal Control with a standard deviation of 0.61299.

According to the dependent variable, Financial Performance has a high level. Financial Performance is measured through four dimensions namely Sales Earnings, Net worth, Sales Value, and Asset value. Based on the findings of the research a strong positive relationship was found between Internal Control and financial performance. According to Njeri (2014), there is a positive relationship between Internal Control and financial performance. Similarly, Olumbe (2012), established the relationship between internal controls and corporate governance in commercial banks in Kenya and concluded that strong internal control systems led to improved corporate governance. The study found that internal control has a significant relationship with financial performance and concluded that the internal control system is a positive significant predictor of financial performance (Eke, 2018).

A strong positive relationship was found between Control Environment and financial performance. According to Eke (2018), this indicates a positive linear relationship and a high degree of correlation between the control environment and total revenue. A strong positive relationship was found between Risk Assessment and financial performance. A strong positive relationship was found between Control Activities and financial performance. According to Lagat, Okelo, & Terer (2016), there is a positive relationship between Control activities and Financial Performance. A strong positive relationship was found between Information and Communication and financial performance. A strong positive relationship was found between Monitoring and financial performance.

When considering the simple regression analysis between these two variables, Control Environment is found to have a significant positive impact on Financial Performance. According to Njeri (2014), the findings revealed that

most manufacturing firms had a controlled environment as one of the functionalities of internal controls of the organization that greatly impacted the financial performance of the firms.

As per the results of simple regression analysis between these two variables, Risk Assessment is found to have a significant positive impact on Financial Performance. Under the Njeri (2014) results are a clear indication that most manufacturing firms observed risk assessment procedures as the functionality of internal control of the manufacturing firms. However, the author acknowledges the need for a wider approach to the risk assessment component and holds an opinion that in the future the assessment of the internal control system should be even more closely related to risk management (Muraleetharan , 2010).

As per the results of simple regression analysis between these two variables, Control Activities are found to have a significant positive impact on Financial Performance. According to Ibrahim, Diibuzie, & Abubakari (2017), variables with positive significant coefficients are positive correlates of financial performance among the sampled health institutions. For a one-point increase in control activities score among health institutions for this sample, the probability of being in a higher financial performance category would increase. The study of Njeri (2014), examined the significant impact of control activities on the financial performance of manufacturing firms in Kenya.

As per the results of simple regression analysis between these two variables, Information and Communication are found to have a significant positive impact on Financial Performance. Under Eke (2018) and Muraleetharan (2010) study control activities and performance of organizations established a positive relationship between control activities and performance.

As per the results of simple regression analysis between these two variables, Monitoring is found to have a significant positive impact on Financial Performance. Hsu, Hsiao, and Li (2009) examined the effect of board monitoring on corporate investment and firm performance and admitted that strong board monitoring for firms with few financial constraints is significantly related to the promotion of corporate investment and the improvement of firm performance in Taiwan. This result is consistent and is within expectations of the findings from the prior studies describing their significant relationship between Monitoring and Financial Performance (Njeri, 2014).

The results of this finding and looking at each independent variable are Control Environment with 0.000, Risk Assessment with 0.000, Control Activities with 0.046, Information and Communication with 0.127 Monitoring with 0.167 are positive impact on the Financial Performance in Small and Medium Manufacturing Enterprises According to that Control Environment, Risk Assessment and Control Activities are significant which are less than 0.05. Further Information and Communication, Monitoring are insignificant which are greater than 0.05

Multiple regressions determine the overall fit (variance explained) of the model and the relative contribution of each of the predictors to the total variance explained, therefore removing the insignificant variables to determine the overall fitness of the model.

Conclusion

Conclusions have been derived from the findings to address the research questions. The study covered the interaction between financial performance and predictor variables (Control environment, risk assessment, control activities, information and communication, and monitoring). The main objective of the study was to assess the impact of the internal control system on the financial performance of small and medium-scale manufacturing enterprises in the Kegalle District. The overall objective is to examine the impact of the Internal Control System and Financial Performance. However, research finally concludes that there is a significant and positive

relationship between Internal Control Systems on Financial Performance in Small and Medium Manufacturing Enterprises in Kegalle District.

Recommendations

Introducing benefits of the internal control system to the firm's every person. It was recommended that to encourage the adoption of sound accounting systems in small and medium-scale manufacturing enterprises. The study further recommends expanding the new methods of the internal control system to identify frauds and errors by periodically monitoring and evaluating. Guide employees to set objectives take calculated risks and identify risks that are affecting business and it should be evaluated well. Manufacturing firms should develop and organize constant seminars and workshops to train and educate managers and employees on matters about the proper implementation of accounting policies and procedures to enhance their skills and expertise in their practice as professionals. The owners of the SME manufacturing firms should prepare the responsibility chart and target dates and relevant works. Create a working culture that values listening to others, seeking mutual understanding, and welcoming sharing of information. All employees in the firm should meet regularly by Establishing a good employee network within the organization to appraise the performance of the organization, competent personnel are engaged and their competence is continually improved to make them perform better as well as designing appropriate human resource policies to motivate employees. Management of the business must consider accounting information in making their decision that leads to effective decision-making for the firm

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