EFFECT OF INTERNAL CONTROL ENVIRONMENT ON FINANCIAL PERFORMANCE OF BANKS IN GHANA

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ABSTRACT

Internal control environment is a key internal audit activity necessary for promoting the health of business activities. In this study, the researchers examine the effect of internal control environment on the performance of banks in Ghana. The study made use of a sample of 154 respondents selected from 5 banks, the study adopted the quantitative research approach, data collected was analyzed using inferential statistical methods such as correlations and regression analysis. The study found that there was a weak significant correlation between internal control environment and financial performance of banks in Ghana. It was further observed that there was no significant effect of internal control environment on the financial performance of banks in Ghana, whereas there was no significant effect of control environment and control activities on the financial performance of banks in Ghana. The study recommends that the management of banks should strengthen the control environment, by enhancing the policies and procedures adopted by the banks in safeguarding assets and properties, and the need to continuously review the existing control policies, procedures and activities performed to ensure that they have not outlived their usefulness in the wake of changing competitions and advancement in technology and management orientation

KEYWORDS: *Internal control systems, Internal control, Internal control Environment, Internal Audit & Financial Performance*

Received: Sep 19 2020; **Accepted:** Oct 09, 2020; **Published:** Nov 02, 2020; **Paper Id.:** IJAFMRDEC20201

1. INTRODUCTION

The internal control environment, as many organizations point out, determines the tone of the institution and affects the control consciousness of its people. The management approach should be based on ethical business practices and established control procedures. It is the basis of all other components of internal control that ensure order and structure. Factors in the control environment include: honesty and ethical values; commitment to competence; leadership philosophy and work style; and the way management assigns authority and responsibility, and organizes and develops its people (Thornton, 2004).

The environment forms an internal control system (ICS) that can operate on every level of the institution. The control environment is one of the five components of the COSO framework and consists of the following five principles: integrity and ethical values, independence of management and internal control of the board of directors, organizational structure, quality involvement, development and retention of employees, management control philosophy and risk-based

COSO (2013) indicated that the environment forms an internal control system (ICS) that can operate on every level of the institution. The control environment is one of the five components of the COSO framework and consists of the following five principles: integrity and ethical values, independence of management and internal

control of the board of directors, organizational structure, quality involvement, development and retention of employees, management control philosophy and risk-based assessment COSO (2013).

According to Ahmed & Ng'anga (2019), internal control environment sets the tone for or basis for carrying out internal control activities across all organizations. Therefore organizations need to develop their internal controls with complete emphasis on the internal control environment ensuring that the right activities are adopted to make sure that assets are protected and enhanced of the profit potential of these organizations. Similarly, Ahmed & Ng'anga, (2019) stated that monitoring in organizations is an essential activity that needs close attention if organizations would like to see an increase in the financial performance of their organizations. This implies that weak monitoring activities and processes have the potential of opening up the system for financial malfeasance that are likely to affect the financial stability of the organization. In the study by Ahmed & Ng'anga, (2019) they pointed out that one key aspect of risk assessment in organizations is the ability for management to be able to identify risk and control risk, this is essential as a weak risk control system set the avenue for misappropriation and misuse of funds which affects the performance in relation to its financial standing for these institutions. In managing the financial performance of organizations, these organizations need to adopt effective and efficient information communication systems to ensure that timely information is generated and reported for necessary action to be taken (Ahmed & Ng'anga, 2019). Organizations need to communicate or report to shareholders of the institution on the nature of activities and performance to create trust and confidence (Ahmed & Ng'anga, 2019).

Financial performance in relation to global macro-financial vulnerabilities remained broadly subdued in spite of a slowdown in global economic growth. In 2019, heightened uncertainties emerging from geopolitical factors including the US-China trade tensions and prolonged Brexit negotiations slowed down economic activities and dampened global economic growth. Improvement in global financing conditions induced by an accommodative monetary policy stance, in most advanced economies, moderated downside risks to global growth and financial stability (BoG, 2019)

Favourable macro-financial developments reduced vulnerabilities stemming from the domestic economy. Domestic output remained strong at 6.5 percent in 2019, while headline inflation continued to decline. In the review period, a balance of payments surplus was also observed as a result of a narrowing of the current account deficit. This is expected to support stability of the local currency the Cedi and lead to improvements in the Gross International Reserves. On credit developments, the Credit-to-GDP gap was below its potential level, indicating that the economy has the capacity to absorb more credit without a significant build-up of risks. The banking sector remained sound and robust to severe stress test scenarios, featuring significant increases in credit impairments, extreme movement in interest and exchange rates, and liquidity pressures. Also risk emanating from cross-border exposures remained contained. The broad level of risk containment in the banking sector was underpinned by strong capital and liquidity positions, placement of offshore funds with stable institutions and improvement in asset quality, earnings and efficiency. Going forward, favourable economic prospects in the near term and the gradual phase in of Basel II/III are expected to firm up gains achieved through the banking sector reforms (BoG, 2019)

The performance of the insurance sector broadly improved in 2019, with the outlook for premium growth, risk retention and insurance penetration remaining positive. Policy reforms and a favourable operational environment improved premium income, assets and capital positions. Despite these improvements, persistent underwriting losses and declining investment yields continued to affect profitability. In the near to medium term, the introduction of the new minimum

capital regime is expected to improve efficiencies through consolidation. In addition, insurance penetration is expected to improve on the back of a broad-based introduction of innovative insurance products and comprehensive policy reforms aimed at strengthening the insurance industry. Driven by strong growth in private pension funds, the pensions sector continued to expand in spite of emerging vulnerabilities from weak investment outturns, weakened contribution growth and rising benefit payout. Notwithstanding these vulnerabilities, the pensions sector exhibits a strong potential for growth in the medium to long term as policy measures are targeted at increasing contributions flows and inclusion (BoG, 2019)

In the capital market, the performance of the stock exchange declined in the period under review posing a risk to large equity holders such as the public pension fund. The declining performance reflects the reductions in the size, access, and efficiency dimensions of the stock market. Despite these developments, capital flight remained low as foreign investors increased their presence on the domestic capital market, partly due to restored banking sector stability and favourable macroeconomic prospects. The financial sector also continued to witness policy reforms aimed at safeguarding financial and macroeconomic stability. The reforms included the resolution of insolvent institutions, increase in minimum capital requirements, enhancement of supervisory regimes, establishment of a regulatory forum and measures for curbing Money Laundering and Combatting the funding terrorist activities, establishment of a Financial Stability Advisory Council, and operationalization of the Ghana Deposit Protection Corporation, among others (BoG, 2019)

2. PROBLEM STATEMENT

Internal control environment has significant activities that ensure that the right procedures and practices are done in an organization leading to protection of assets and resources, enhancing the financial performance of institutions. Organizations having weak internal control environment have experienced dwindling financial performance.

The Banking sector of Ghana is a key sector that controls the financial sector by providing needed support for individuals and businesses and providing financial inclusion. The sector has in recent years gone through a lot of challenges, with banks unable to meet up with the minimum capital requirements, leading to the consolidation of some banks and others absorbed by the Ghana commercial banks with others downgraded to savings and loans etc. Aside this, the bank of Ghana had to come to the support of the banks with 10.98billion Cedis which is equivalent to 2.1billion dollars, (Bank of Ghana, 2018). This raises concerns on the effectiveness of the internal audit of these banks and also the sustainability of the operations of these banks and calls for stringent measures to be taken to ensure that such drain on the national purse does not pressure. This study examines the association between the internal Control Environment of these banks and the performance of these banks and seeks to provide a recommendation on the way forward.

Previous studies conducted on internal audit with emphasis on internal control environment such as the study by Ahmed & Ng'anga, (2019) was conducted in the local government which is in a different context other than the banking sector. The study is further limited as it only focused on county government agencies and did not consider all other institutions in Kenya. Also, the study was conducted in Kenya which is an African country but does not fit into the Ghanaian context as the control environments are different in terms of rules, regulations and banking laws.

In other interrelated studies, Kinyua, Gakure, Gekara, & Orwa, (2015) examined the Effect of Internal Control Environment on the Financial Performance of Companies Quoted in the Nairobi Securities Exchange. The research was conducted on companies registered on the Kenyan stock exchange without specifically considering the banking sector or the Ghanaian context. The study also used stratified random sampling which is a procedure that allows for some level of

bias.

Mbilla, Nyeadi, Gbegble, & Ayimpoya, (2020) assessed the Impact of Monitoring, Information and Communication on Banks Performance in Ghana. Although the study was done considering banks in Ghana, the study failed to consider all five internal control dimensions, this study only considered two of the dimensions which are information and communication and monitoring, the research failed to consider all banks in the Ghanaian banking sector, the study did not further consider internal control environment.

From the knowledge and contextual gaps identified in the previous studies, there is a need for further studies in the area of internal control environment in the Ghanaian context focusing on all five internal control environments.

1. Objectives of the study

The objective of the study is to determine the effect of control environment on the financial performance of banks in Ghana.

2. Research Questions

The research is guided by the research question, which is, what extent does control environment affect the financial performance of banks in Ghana?

The study is guided by the hypothesis; there is no significant effect of internal control environment on the financial performance of banks.

3. THEORETICAL REVIEW

The control environment, as recognized by an organization, sets the tone of the Department and influences the management of its people. Management practices should engage with the business model and follow a management strategy. This is the recognized as the stepping stone or blue print for all the other activities that assist in the control of organizations, making available the needed training and procedures for effective functioning of the organization. Environmental management includes: Integrity and ethics; promises of eligibility; life style and type of work; and a project management approach that allocates power and responsibility, and organizes and develops its people (Thornton, 2004).

COSO (2013) demonstrated that the control system creates a sense of what the control systems can do at all levels in the industry. The control system is one of the five components of the COSO system and consists of the following five components; Integrity and ethics, Board of Chief Independent from management and oversight of internal management, Organization Structure, Attracting, nurturing, and retaining good employees, management skills content management and risk management COSO (2013).

Agency Theory

This philosophy takes its source from the values of the Modern Corporation. It is worth noting that the firm's players can be divided into two groups: directors who are the owners and agents of the company that manages the firm (Jansen & Merckling, 1976; Eisenhardt, 1998). Agency theory states that the agent-agent relationship leads to conflict, which can then lead to additional costs, including settling disputes between directors and agents (Jensen & Meckling, 1976; Essie Hardt, 1998). Agency theory was discussed as the most important issue of corporate governance, and the theory of important agents is the starting point for that discussion. The theory of the agency is that in a modern corporation, where shareholder

ownership is widespread, management actions differ from requirements required to increase shareholder income (Malin, 2007). Because this theory is accepted by the agency's perspective, non-executive directors and independent directors can be part of effective corporate governance by overseeing senior managers' decisions. Finally, they are viewed as a checking and balancing mechanism that increases the performance of the board.

Stewardship Theory

Stewardship theory allows people to work in the public interest and the interests of their stakeholders; it makes sense to build structures of management and power, because they provide a single command and convenience. The theory is based on Autonomous decision making that allows companies to respond quickly and decisively to market opportunities. This approach, for example, is easy to integrate with or audit the roles of CEO and chairman of the board of directors and audit committees. Management theory assumes that managers are honest, more than internal rewards rather than external rewards, and self-motivated to promote collective interests (Nicholson and Kiel, 2003, Davis-et al., 2003). The stewardship theory is adopted for this study because it strongly argues that managers and boards of directors are good stewards of a firm and they should be given utmost trust.

Institutional Theory

Institutional theory is one of the priority perspectives in the theory of organization and management (Greenwood et al., 2008); It has been widely used to assess the practical impact of corporate governance codes (Solomon, 2013). Biasley et al. (2009) explain institutional theory through its insights into specific environmental management and management structures that contribute to researchers' knowledge of corporate governance (CG). For example, Biasley and et al. (2009) confirms that institutional theory that governance structures are often symbolic / solemn; Their legitimacy is paramount, but formal processes are freely compatible with genuine control. This theory was accepted because there is a general consensus among researchers that institutional theory is useful for studying the role and function of internal audit, especially when used in conjunction with agency theory.

Empirical Studies

Ahmed & Ng'anga, (2019) studied the effect of Internal Control Practices and Financial Performance of County Governments in the Coastal Region of Kenya. The study adopted a descriptive study design. The study population was 115 respondents, which included internal audit staff of the district administration, the study was conducted using primary data, the data were collected through questionnaires. Data analysis was descriptive and concluding analysis. The study found a positive and significant impact on financial results between risk assessment, monitoring, control environment, information and communication. According to the study, risk identification and mitigation play the most important role in influencing the financial performance of county governments. The study recommended that countries take timely measures to identify risks and take effective measures to reduce risks so as not to adversely affect their financial results. The study by Ahmed & Ng'anga, (2019) was conducted in local governments in areas other than the banking sector; the study did not include oversight, but only four of the five internal oversight activities, and therefore is a key component of the oversight function, which limits the assessment of oversight activities. The study adopted three theories, such as Agency Theory, Attribution Theory, and Procedural Justice Theory, but failed to study management theory, stakeholder theory, and institutional theory, suggesting the need for a different theoretical approach to research. The study is further limited because it focuses only on district government agencies and does not cover all other institutions in Kenya. Similarly, the study was conducted in

Kenya, an African country that does not fit the context of Ghana, as the environment is different in terms of rules, regulations and banking laws.

Kinyua, Gakure, Gekara, & Orwa, (2015) examined the Effect of Internal Control Environment on the Financial Performance of Companies Quoted in the Nairobi Securities Exchange (NSE). All 62 companies listed on the Nairobi stock exchange was used for the study. A sample of 38 companies from the target population of 62 companies quoted in NSE was used in the study. The sample was drawn using a stratified random sampling technique. The study relied on both primary and secondary data. Primary data was used and this was collected with the help of a structured questionnaire. Data collected by the researchers was analysed using both descriptive and inferential statistics. Their study observed a significant association between internal control environment and financial performance, the study recommended that internal control environment should be enhanced to further improve the financial performance of companies quoted in Nairobi Securities Exchange. The study focused on companies listed on the Kenyan stock exchange without specifically considering the banking sector. The study also used stratified random sampling which is a procedure that allows for some level of bias.

Mbilla, Nyeadi, Gbegble, & Ayimpoya, (2020) evaluated the impacts of monitoring, information communication on banking activities in Ghana. The survey was conducted by the researchers, with a sample size of twelve banks representing 300 representatives. A descriptive study was performed and the regression on the field data was analyzed. The results of the study showed that information and communication does not significantly affect financial results or performance of banks. There was also no significant effect between monitoring and financial results or performance of banks. Therefore, the managers of the banks were advised to invest more in information and communication to improve performance. Although the study focused on banking in Ghana, the study did not address all five criteria of internal control, including two from the ICT and the monitoring standard.

Collins, (2014) examined the impact of internal controls on the financial performance of microfinance institutions in the Kisumu Central Constituency in Kenya. The study adopted a descriptive and correlation design. The convenience sampling method was used and 7 institutions and 35 respondents (five respondents per institution; 2 mid-level managers and 3 employees) were selected from a total of 18 microfinance institutions specifically selected for this study. Questionnaires were used to collect data analyzed using source data and correlations and presented in tables. The results showed a positive relationship between internal control. The study suggests that institutions should strengthen control over the process of 100% debt collection. The study shows that further attention should be paid to the adoption of effective information systems.

Mire, (2016) assessed the Effects of Internal Control System on the Organizational Performance of Remittance Companies in Mogadishu-Somalia. In the study, quantitative research methods were adopted, characterizing the specific research design. The study focused on remittance companies located in the Baqara market, 15 remittance companies in the Baqara market was used, and 402 employees worked in 15 remittance companies. The primary data were collected using questionnaires. Data screening was performed to identify any missing data and was further tested for reliability and normality. The study suggested that there was a need to increase the control environment for remittance companies in Mogadishu; risk assessment and control services, as these variables have been found to have a positive impact on the organizational performance of remittance companies in Mogadishu. The study did not consider all five variables of internal control, nor did the study use customer satisfaction and employee satisfaction as dependent variables without taking into

account asset yield, and the study also did not focus on the bakery sector.

1. Conceptual Framework

The study is grounded on the Committee of Sponsoring Organizations of Tread Way Commission (COSO) Model introduced by COSO committee in 1992 and modified in 2013. Through a comprehensive review of literature: Mire, (2016); Collins, (2014); Mbilla, Nyeadi, Gbegble, & Ayimpoya, (2020); Kinyua, Gakure, Gekara, & Orwa, (2015); Ahmed & Ng'anga, (2019) the study identified five major independent variables; Control Environment (CE), Control Activities (CA), Risk Assessment (RA), Information & communication (IAC) and Monitoring (MO) that may affect Bank's Financial Performance. To guide this study the researchers focus on internal control environment. Conceptual framework of the study is as follows;

5. METHODOLOGY

In this study, researchers use a descriptive study design to illustrate the relationship between internal control environment and financial performance of banks in Ghana, a quantitative research approach was adopted in this study. This design is also considered appropriate because it allows the researcher to obtain the standardized and unobservable tools of the structured research tool and to rely on standardized research methods on the standard combination method. 154 samples were used in the study. This sample size is considered appropriate because it is consistent with the findings by Hair, Sarstedt, Ringle, & Mena, (2011) When conducting a survey, 100 characters are considered sufficient to form the statistical power of the study. Again, the sample selected is based on recognized selection criteria required for a given population. In the study, the method of targeted selection was used in the selection of banks for the study. Respondents included managers, accounting officers, auditors, and top executives of the respective banks. The analysis was performed using inertial analysis in the form of correlation and regression analysis.

8. ANALYSIS OF DATA

This section discusses the analysis from the data collected, as follows;

8.1 Test of the relationship between variables

A correlation analysis was performed to verify the significant relationship between the independent variables. The results of the analysis are recorded in the table below;

Table 1: Correlations

		Internal Control Environment	Performance
Internal Control Environment	Pearson Correlation	1	.109
	Sig. (2-tailed)		.177
	N	154	154
Performance	Pearson Correlation	.109	1
	Sig. (2-tailed)	.177	
	N	154	154

The Pearson's r for the correlation between Control environment and performance variable is (0.109, P -value > 0.05) which is close to 0 with a less significant value of 0.177 which is greater than 0.05. This shows a weak insignificant relationship between internal control environment and financial performance, meaning that changes in one variable are Weakly correlated with changes in these cond variable. The findings are in contrast with Kinyua, Gakure, Gekara, & Orwa, (2015) who examined the Effect of Internal Control Environment on the Financial Performance of Companies Quoted in the Nairobi Securities Exchange The results and findings concluded that there was a significant association between internal control environment and financial performance.

1.2 Effect of internal control environment on the financial performance of banks in Ghana.

In other to test the effect internal control environment on financial performance, regression was done to ascertain the effect. The regression results from the regression analysis done on the effect of internal control environment is captured below;

Table 2: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.109 ^a	.012	.005	2.71931
a. Predictors: (Constant), Internal Control Environment				

From the model summary, it is observed that the five independent variables explain 0.012% of the changes or variations in the dependent variable which is performance. by this, it means there are other variables other than the independent variables that account for 1.2% of variations or changes in the financial performance of the banks.

Table 3: ANOVA^a

	Model	Sum of Squares	df	Mean Square	F	Sig.
1	Regression	13.624	1	13.624	1.842	.177 ^b
	Residual	1123.986	152	7.395		
	Total	1137.610	153			
a. Dependent Variable: Performance						
b. Predictors: (Constant), Internal Control Environment						

From the ANOVA results, the significance value of 0.177^b which is greater than 0.05, indicates that the model is statistically not significant in predicting how the independent variable studied influenced the financial performance of banks in Ghana.

Table 7: Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	17.572	1.992		8.820	.000
	Internal Control Environment	.094	.070	.109	1.357	.177
a. Dependent Variable: Performance						

From the above regression model, holding internal control environment constant, the beta coefficient would 17.572. The established regression equation by the study was $Y = 17.572 + 0.094X_1$. Where Y = Financial Performance; X_1 = Internal Control Environment.

As shown in the table above, it is observed that internal control environment has an insignificant effect on financial performance with ($t=0.094$, $p\text{-value} > 0.05$). The study is in contrast with the study done by Kinyua, Gakure, Gekara, & Orwa, (2015) who examined the Effect of Internal Control Environment on the Financial Performance of Companies Quoted in the Nairobi Securities Exchange. The results and findings concluded that there was a significant association between internal control environment and financial performance. Similarly, the study results were in contrast with the findings of Ahmed & Ng'anga, (2019) who examined the effect of Internal Control Practices and Financial Performance of County Governments in the Coastal Region of Kenya and found a positive and significant effect between risk assessment, monitoring, control environment, information and communication on financial performance.

6. CONCLUSIONS

The aim of the study was to establish the effect of internal control environment on the performance of banks in Ghana, the study results suggest there is an insignificant effect of internal control environment on the performance of banks in Ghana, hence the study concludes that internal control environment does not play a significant role in the management of financial performance in banks, hence there is the need to pay more attention to the activities that make up the internal control environment and ensure that all activities are well developed, well-structured and are in line with the reason for which they were established. The study further concludes that control environment and control activities need to be improved to ensure the system is fully safeguarded. It is also concluded that there are other factors other than internal audit practices that affect the performance of banks in Ghana.

7. RECOMMENDATIONS

The study recommends that the management of banks should strengthen the control environment, by enhancing the policies and procedures adopted by the banks in safeguarding assets and properties, there is the need to continuously review the existing policies, procedures and activities performed to ensure that they have not outlived their usefulness in the wake of changing competitions and advancement in technology and management orientation. The banks should appraise continuously the internal control environment to ensure that the activities are up to date and up to the task they are designed to perform. The study is not without limitations, the study focused on five banks, it is recommended that future studies consider expanding the scope to include the entire banking sector. The study further did not consider all internal control variables, there is the need for future studies to consider expanding the scope to include all control Variables.

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