Internal Control System and Financial Performance in Non-Governmental Organisations in Uganda: A Case Study of International Union for Conservation of Nature

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Abstract

The study set out to investigate the role of internal control system in the financial performance of non-governmental organisations in Uganda. Specifically the study sought to establish the effect of control environment on the financial performance of International Union for Conservation of Nature, to investigate the effect of control activities on the financial performance of International Union for Conservation of Nature, and to examine the significance of monitoring on the financial performance of International Union for Conservation of Nature. The findings of the study revealed a significant relationship between control environment, control activities, monitoring, and financial performance. The study recommended that control environment, control activities, and monitoring should be enhanced in order to further improve the financial performance of International Union for Conservation of Nature. Additionally, performance standards should be established and communicated to employees of International Union for Conservation of Nature in a bid to improve financial performance.

Keywords: Internal control system, control environment, control activities, monitoring, financial performance

1. Introduction

This paper investigates the role of internal control system (ICS) in the financial performance of non-governmental organisations (NGOs) focusing on International Union for Conservation of Nature (IUCN) Uganda as a case study. NGOs have become important players in social development and economic intervention throughout the world. This is evidenced by a major shift in development funding routed through NGOs, which have become the preferred agents over governments. For example, in 1999 NGOs in Africa handled $3.5 billion in external aid compared to under $1 billion in 1990. NGOs can be defined as intermediary organisations engaged in funding or offering other forms of support to communities and other organisations (Goddard & Assad, 2006).

In recent years, a great deal of attention has been made to the applicability of business practices to NGOs. For example, Lewis (2001) points out that "concerns about NGO accountability and performance remain . . . an ability to confront these issues may be the key to the survival of the NGO movement". Alonzo (2007) even goes further to assert that because of fraud and corruption cases involving organisations such as Enron, WorldCom, Tyco, United Way, and Red Cross, one way to demonstrate accountability in NGOs is through the use of a strong accounting ICS.

According to Siayor (2010), ICS refers to all the policies and procedures (internal controls) adopted by the directors and management of an entity to assist them in achieving their objectives of ensuring, as far as practicable, the orderly and efficient conduct of a business, including adherence to internal policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. Internal control systems (ICSs) have become so significant due to the increasing number of business failures and some widely publicised frauds. COSO (2013) framework identifies five main elements of an ICS, namely: control environment, risk assessment, control activities, information and communication, and monitoring.

The quality of an organisations ICS has a significant impact on the accuracy of management guidance (Feng, Li, & McVay, 2009). Similarly firms that disclose ineffective ICSs have larger tendencies of experiencing management errors in their operation than those firms that report effective ICSs (Feng et al., 2009). Furthermore, Kinyua, Gakure, Gekara, and Orwa (2015) inform that the institution and enforcement of proper ICSs will always lead to improved financial performance. Moreover, it is a general belief that properly instituted systems of internal control improve the reporting process and also gives rise to reliable reports which enhances the accountability function of management of an entity (Spira & Page, 2003).

Financial performance can be defined as the process of measuring the results of a firm's policies and operations in monetary terms (Trivedi, 2010). Measuring financial performance represents a vital mechanism for improving the work of NGOs since these organisations face complicated challenges in delivering their programmes and services. Considering the financial performance of NGOs, fundraising efficiency is the main variable that has been heavily mentioned and highlighted in academic literature. Andreasen and Kotler (2008) conceptualise fundraising efficiency as the process of obtaining funds for NGOs survival. Lewis (2009) further adds that resource generation ratio is another measure used to evaluate fundraising efficiency.

Although fundraising efficiency is the most related measure in evaluating the financial performance of NGOs, other measures linked to financial transparency are also considered. Financial transparency means that NGOs must make information about their financial activities available to relevant stakeholders (Ramadan & Borgonovi, 2015). This involves preparing accurate, complete and timely financial reports (budget reports and financial statements) and making them accessible to stakeholders, including donors.

The structure of the paper is as follows: First a review of literature is covered in Section 2, followed by methodology in Section 3. Secondly, the results of the study are presented in Section 4 of the paper. Finally, a summary, conclusion, recommendations and future research directions are presented in Section 5.

1.1   Statement of the Problem

Although prior research suggests a link between accounting control practices and financial performance, the majority of prior studies have concentrated mostly on the budgeting aspect of accounting controls (Bariyima, 2012). Besides, the available studies so far have dealt exclusively with large privately owned companies especially in advanced countries. Little is known, at present, about the influences of ICSs and financial performance in NGOs in Uganda.

Furthermore, whereas internal control is an essential factor that affects firms, the evidence of a fully functioning ICS within IUCN Uganda is almost non-existent. For instance, in testing of transactions by auditors, it was noted that programme officers approved their own travel funds in the absence of their heads (Audit Report, 2012). In addition to this, the Audit Report (2013) also brings out instances where project staff failed to account for cash advanced to them to a tune of UShs 15 million. This clearly reflects the fact that financial performance has not been given the attention it deserves in IUCN.

1.2   General Objective of the Study

The general objective of the study was to investigate the role of ICS in the financial performance of NGOs focusing on IUCN Uganda as a case study.

1.3   Specific Objectives of the Study

The study strived to achieve the following specific objectives:

1) To establish the effect of control environment on the financial performance of IUCN Uganda.
2) To investigate the effect of control activities on the financial performance of IUCN Uganda.
3) To examine the significance of monitoring on the financial performance of IUCN Uganda.

2. Literature Review

The aim of this section is to review the arguments for ICSs and financial performance. This will be done by providing an account of the theories that explain the existence and necessity of internal controls. Besides, we will also review literature on each of the three study objectives.

2.1 Theoretical Review

In this sub-section we will introduce and explore two contrasting, and perhaps supplementary theoretical perspectives that help to explain the shape and form of various ICSs of organisations. The first theoretical orientation is the agency theory considered by many to be a mainstream view of control. Agency theory provides a primarily economic explanation for the design and form of control systems. The second theoretical orientation is the institutional theory that offers a contrasting explanation for the development and form of control systems and uses a perhaps more sociological approach.

2.3.1 Agency Theory

Agency theory was originally developed by Jensen and Meckling (1976). According to this theory, the firm is viewed as a nexus of contracts between different stakeholders of the organisation (Ibid, 1976). Thus, the owners and executives of an organisation may have differences in opinion with regard to the best interests of the organisation. Consequently, executives may be seen as using organisations to get as much as they can at the expense of the owners.

Agency theory explains the application of controls as being primarily based on economic cost benefit analysis, where controls are installed in order to reduce information asymmetries between principals and owners. Additionally, the theory has been used to explain demands for monitoring controls such as the financial statement audit, external directors on boards and committees, audit committees, internal audit and compensation schemes (Arwinge, 2013). Thus, internal controls, financial reporting, budgeting, audit committees, and external audits are some of the many mechanisms used in business to address agency problems (Jensen & Payne, 2003). Policy-makers and control professionals can also be expected to find agency theory more helpful in diagnosing situations and designing controls.
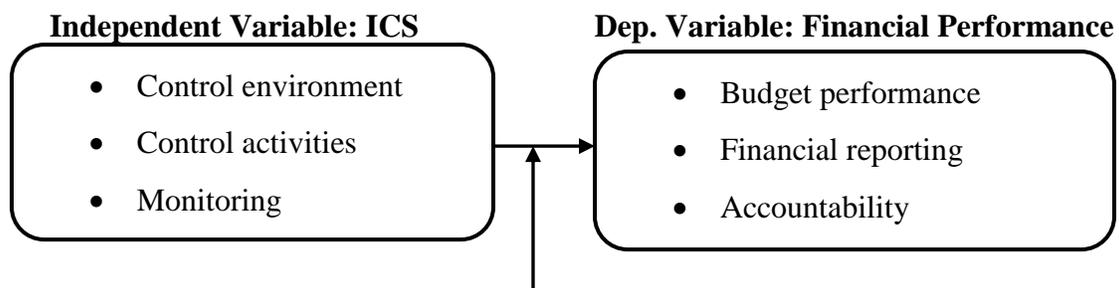
2.1.1 Institutional Theory

Institutional theory is the other theoretical orientation which offers a contrasting explanation that may be used to understand the adoption and design of control practices within organisations. The theory, more sociological in character, originates from the work done by Meyer and Rowan (1977) and DiMaggio and Powell (1983). The theory states that companies adopt systems and management practices that are considered legitimate by other companies in the same industry (Etengu & Nasieku, 2015). Thus, organisational practices are either a direct reflection of, or response to, rules and structures built into their larger environment.

Arwinge (2013) further documents that in as far as institutional theory is concerned, management is not only concerned with cost benefit concerns and risk-reward trade-offs but looks to management fads, industry norms and firm traditions when adopting and designing new control practices.

In comparison with agency theory, institutional theory provides a different explanation as to why controls exist in an organisation by stating that controls are adopted and designed in order to gain legitimacy, as symbolic displays and imitation or as practices from the outside environment (Ibid, 2013). From institutional perspectives, controls are installed in order to gain legitimacy and other less rational factors. The installation of certain governance arrangements and controls such as risk assessments, compensation committees, and policies, among other things, may thus be made partly in order to gain legitimacy. These controls display seriousness about certain matters and are adopted largely due to industry standards, imitation of other firms, firm tradition and management fads (Ibid, 2013).
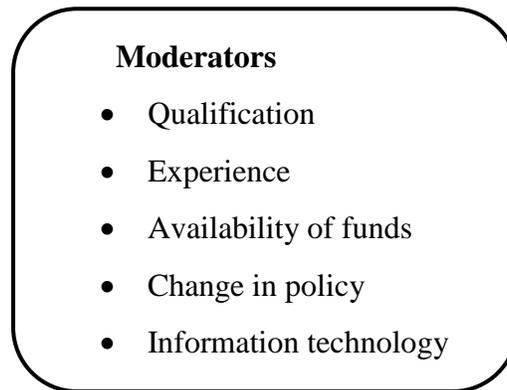
2.2 The Conceptual Framework

Independent Variable: ICS   **Dep. Variable: Financial Performance**

- Control environment
- Control activities
- Monitoring

- Budget performance
- Financial reporting
- Accountability

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│          Moderators             │
│   • Qualification               │
│   • Experience                  │
│   • Availability of funds       │
│   • Change in policy            │
│   • Information technology      │
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Figure 2.1: A Conceptual Framework on ICS and Financial Performance

2.3 Empirical Review

Having discussed the theories on internal controls and exhibited schematically the relationship between ICS and financial performance, in this sub-section we explore each of the three objectives spelt out in sub-section 1.3, namely: the effect of control environment on financial performance, the effect of control activities on financial performance, and the significance of monitoring on financial performance.

2.3.1 *The Effect of Control Environment on Financial Performance*

Kgabo (2013) defines control environment as a set of policies and procedures that must be followed in the implementation of internal controls within an institution. Control environment creates a frame of mind within which an ICS can function at all levels in the institution (COSO, 2013).

Several studies have attempted to highlight the effect of control environment on financial performance. Among the list are the studies conducted by Muraleetharan (2013), Ali (2013), and Kinyua et al. (2015), among others. Muraleetharan (2013) conducted study to examine whether ICSs lead to an increase in the financial performance of an organisation and found a statistically insignificant relationship between control environment and financial performance.

Ali (2013) in his study on the contribution of ICS to the financial performance of financial institutions found a significant positive relationship between control environment and financial performance of financial institutions. Similarly, Kinyua et al. (2015) in their study on the effect of internal control environment on the financial performance of companies quoted on the Nairobi Securities Exchange (NSE) found a significant association between internal control environment and financial performance.

2.3.2   The Effect of Control Activities on Financial Performance

Visser and Erasmus (2008) put it that an ICS contains certain control activities, including policies and procedures with regard to approval, authorisation, verification, reconciliation, review of operational activities, safeguarding of assets, and segregation of duties. Control activities can be conceptualised as the policies and procedures that help ensure management directives are carried out (Whittington & Pany, 2001). They help to ensure that necessary actions are taken to address risks to the achievement of the entity's objectives (Muraleetharan, 2013).

Amongst the former studies conducted on the effect of control activities on financial performance that warrant discussion here are studies by Muraleetharan (2013) and Ejoh and Ejom (2014). Muraleetharan (2013) in his study on control activities and performance of organisations established a positive relationship between control activities and performance. Ejoh and Ejom (2014) did a study to establish the relationship between internal control activities and financial performance in Tertiary Institutions in Nigeria. The findings of their study revealed no significant relationship between internal control activities and financial performance.

2.3.3   The Significance of Monitoring on Financial Performance

According to Gamage, Lock, and Fernando (2014) monitoring is the evaluation of an organisation's events and transactions to gauge the quality of performance throughout the period and to decide whether controls are effective. Monitoring incorporates all management oversight of the organisation's systems of internal controls (Boyle, Cooper, & Geiger, 2004). Moreover, monitoring can be used to evaluate the quality of an enterprise internal control performance by

tracking and monitoring the internal control frame and operational status, and taking the necessary actions to ensure that internal controls operate effectively (Mwachiro, 2013).

Most of the studies on ICS and financial performance tend to examine the various variables under ICS and financial performance individually and therefore fail to consider how monitoring for instance relates with financial performance. Hermalin and Weisbach (2003) perhaps appear to be among the few researchers who examined the role of monitoring on firm performance. The authors (Ibid, 2003) argue that strong board monitoring can promote corporate policy and even improve firm 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 to the improvement of firm performance in Taiwan. Furthermore, Bongani (2013) asserts that ICS is the primary accountability and governance tool an organisation (NGO) can establish and use to provide accountability to its stakeholders (donors) and safeguard its assets. Effective internal control over financial reporting is intended to provide reasonable assurance about the reliability of a company's financial statements and the process of preparation of those statements.

3. Research Methodology

3.1 Research Design

The research design adopted for the study was a survey design and the approach employed was the quantitative approach. The survey design was chosen because it provides a quantitative description of trends, attitudes, or opinions of a population by studying the sample of that population (Fowler, 2002). The study was also cross-sectional in the sense that it represented a snapshot of one point in time. The quantitative approach was adopted so as to be able to describe and explain relationships between variables.

3.2 Sampling Technique

From a population of 85 respondents a sample of 70 respondents was selected. This sample was deemed to be sufficient to yield results that reflect the views and experiences of the respondents.

This is in line with Delice (2010) who argues that if the research has a relational survey design, the sample size should not be less than 30.

After determining the number of respondents, simple random sampling was applied to select respondents from each of the four departments in IUCN (Finance and Administration, Water and Biodiversity, Forest and Natural Resource Governance, and Gender and Climate Change). Additionally, purposive sampling was also employed in selecting samples. The unit of analysis was the managers in each of the four departments and employees in Finance and Administration Department because they were deemed to be dealing with issues associated with internal controls more regularly.

3.3 Data Collection Methods

The methods of data collection used in the study are the primary data collection method and the secondary data collection method. The survey method was used to collect primary data from the respondents through the use of self-administered questionnaires of the delivery and collection type, and structured interviews. Secondary data was collected through documentary review of various policy documents and audit reports of IUCN, published books, journal articles, and dissertations on ICS and financial performance.

3.4 Validity and Reliability

The instruments for data collection were assessed in terms of validity and reliability to ensure quality. Validity in this case refers to the ability of an instrument to measure what it has been designed to (Saunders, Lewis, & Thornhill, 2009). Face and content validity was ensured by establishing a logical link between each question and the objectives. Reliability on the other hand is the ability of the instruments to consistently yield the same results when repeated measurements are taken of the same individuals under the same conditions (Koul, 2004). This was ensured by carrying out Cronbach's (1964) alpha (α) test. The results of the test yielded a coefficient above 0.6 which meant that the study variables were reliable and consistent.

3.5 Data Analysis

The quantitative data obtained from the field was collated and analysed using the Statistical Package for Social Scientists (SPSS) software programme. Regressions were done in order to examine the effect of the independent variable on the dependent variable. Qualitative data was analysed to establish patterns, trends and relationships from the information gathered in order to come up with some conclusions and recommendations on the data quantified in form of graphs, frequency distributions and tables, by use of content analysis.

4. Results

4.1 The Effect of Control Environment on the Financial Performance of IUCN

The first specific objective of the study was to establish the effect of control environment on the financial performance of IUCN. In order to test this, a simple regression was run to establish the relationship between control environment and financial performance in IUCN. The results of this are shown in the Table 4.1:

Table 4.1: Model Summary of Regression

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.473[a]	.224	.212	5.995

a. Predictors: (Constant), Control Environment
b. Dependent Variable: Financial Performance

The model summary of regression in Table 4.1 produced an adj. R^2 of .212. This means that holding other factors constant, control environment contributes about 21% of the changes in financial performance. The remaining 79% is contributed by other factors beyond the scope of the study.

Furthermore, to ascertain whether there was at least one slope coefficient of the simple regression model that is not equal to zero and therefore infer on the overall significance of the model, an ANOVA (F-test) was performed. The results of this are shown in Table 4.2:

Table 4.2: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	705.087	1	705.087	19.616	.000
	Residual	2444.184	68	35.944		
	Total	3149.271	69			

a. Predictors: (Constant), Control Environment
b. Dependent Variable: Financial Performance

The F-test result of 19.616 with a significance of 0.000 means that a significant relationship is present between control environment and financial performance because the probability of the results occurring by chance was less than 0.005 (P < 0.005) at a 95% significance level.

Finally, a t-test was carried out in order to determine whether a particular coefficient is significantly different from zero or not. The results of this are shown in Table 4.3:

Table 4.3: Coefficients

Model		Unstandardised Coefficients		Standardised Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	51.040	12.620		4.044	.000
	Control Environment	1.472	.332	.473	4.429	.000

a. Dependent Variable: Financial Performance

The t-test results for control environment was 4.429 with the probability of this occurring by chance being equal to 0.000, that is, P < 0.005 (95% confidence interval, two tailed) implying this was statistically significant.

4.2 Effect of Control Activities on the Financial Performance of IUCN

The second specific objective of the study was to investigate the effect of control activities on the financial performance of IUCN. In a bid to achieve this, a simple regression was run and the results of this are shown in the Table 4.4.

Table 4.4: Model Summary for Regression

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.498[a]	.248	.228	2.669

a. Predictors: (Constant), Control Activities
b. Dependent Variable: Financial Performance

The model summary of regression in Table 4.4 produced an adj. R^2 of .228. This means that holding other factors constant, control activities contributes about 23% of the changes in financial performance. The remaining 77% is contributed by other factors outside the scope of the current study.

From the ANOVA table (see Table 4.5) an F value of 12.534 with a significance of 0.001 was obtained implying that a significant relationship exists between control activities and financial performance because the probability of the results occurring by chance was less than 0.005

Table 4.5: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	89.290	1	89.290	12.534	.001
1	Residual	270.710	38	7.124		
	Total	360.000	39			

a. Predictors: (Constant), Control Activities
b. Dependent Variable: Financial Performance

Lastly but not least, the t-test results for control activities was 3.540 with the probability of this occurring by chance being equal to 0.001, that is, $P < 0.005$ (95% confidence interval, two-tailed) implying this was statistically significant – see Table 4.6.

Table 4.6: Coefficients

Model	Unstandardised Coefficients		Standardised Coefficients	t	Sig.
	B	Std. Error	Beta		

1	(Constant)	-1.107	4.868		-.240	.811
	Control Activities	.393	.111	.498	3.540	.001

    a. Dependent Variable: Financial Performance

4.3 Effect of Monitoring on the Financial Performance of IUCN

The third objective of the study was to establish whether monitoring had an effect on the financial performance of IUCN. The model summary of the regression test produced an adj. R^2 of .258 which meant that monitoring contributed 26% to financial performance – see Table 4.7.

Table 4.7: Model Summary for Regression

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.518	.268	.258	5.821

    a. Predictors: (Constant), Monitoring
    b. Dependent Variable: Financial Performance

From the ANOVA table (Table 4.8) an F value of 24.952 with a significance of 0.000 was obtained implying a significant relationship exists between monitoring and financial performance.

Table 4.8: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	845.389	1	845.389	24.952	.000
	Residual	2303.883	68	33.881		
	Total	3149.271	69			

    a. Dependent Variable: Financial Performance
    b. Predictors: (Constant), Monitoring

Furthermore, the results from the coefficients table yielded a beta of .518 with a $P < 0.05$ which indicates that monitoring is a strong contributor to financial performance.

Table 4.9: Coefficients

Model		Unstandardised Coefficients		Standardised Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	57.979	9.807		5.912	.000
	Monitoring	1.532	.307	.518	4.995	.000

    a. Dependent Variable: Financial Performance

5. SUMMARY, CONCLUSION, RECOMMENDATIONS, AND FUTURE RESEARCH DIRECTIONS

5.1 Summary

This study set out to investigate the role of ICSs in the financial performance of NGOs focusing on IUCN Uganda as a case study. We arrived at three findings: Firstly and foremost, we found that control environment significantly affects financial performance. Secondly, we also established that control activities significantly affect financial performance. All these findings are inconsistent with William's (2005) study which found no direct relationship between accounting control practices and the overall firm performance. Finally, we established that there's a statistically significant relationship between monitoring and financial performance.

5.2 Conclusion

In conclusion, it may be necessary to point out that the absence of a very significant relationship between ICS and financial performance as exhibited by low values of the adj. R square means that the internal control system in IUCN has become a necessary but not sufficient enough to get to see the financial performance of IUCN glimmer.

5.3 Recommendations

Based on the findings of the study, we recommend firstly and foremost that the components of the ICS (control environment, control activities, and monitoring) should be enhanced to further improve the financial performance of IUCN. Secondly, performance standards should be established and communicated to the employees of IUCN Uganda in a bid to help them achieve these standards and perform well.

5.4 Future Research Directions

Albeit, the present study offers some contributions to our understanding of the relationship between ICSs and financial performance, our suggestion is that future research should incorporate non-financial measures such as quality, employee satisfaction in addition to financial measures in order to further enrich our understanding of the ICS/financial performance relationship. Additionally, organisational factors like technology, management structure, and age of the firm have not featured anywhere in this study. Perhaps future studies should focus on some of these factors in an attempt to shape up the relationship between ICSs and financial performance.

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