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Association Between Internal Control and Financial Performance in Blue Chips Companies of Bangladesh

Soiloor Nandini Arunima

Abstract

The aim of this paper is to examine internal control of Bangladeshi listed companies whether the companies follow all the five components of internal control as per suggested by COSO. The paper has aim to show the relationship between internal control and financial performance of those sample companies. The methodology of this paper is quantitative. Out of 655 listed companies of Dhaka Stock Exchange, 30 blue chips companies (DSE 30 index) are the sample size. These blue chips companies included all sectors excluding mutual funds, debentures, and bonds. Data has been collected for the recent year 2020-2021. Here, hypothesis has been developed and econometrics model (OSL) has been used to find out result.The analysis found that nine out of thirty companies follow all the components suggested by COSO. It has showed the positive significant relationship between profit margin and internal control. The return on asset, return on equity and earning per share are unrelated to internal control. The findings have some practical implications. It reflects the internal control system followed by the companies whether it is effective or not. Most importantly, it will be helpful for the decision makers to improve the internal control systems if they have any deficiency.In Bangladesh, there are few papers on internal control and financial performance of the listed companies. Most of them are on only banking sector. Other sectors were not properly focused for research purpose. Again, there is no article on internal control which has been focused on index of Dhaka Stock Exchange (DSE30). This research gap has been mitigated here.

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1. Introduction

As per World Bank report, Bangladesh has an outstanding track record of development. The country needs rapid industrialization to become developed country from least developed country. But business without control cannot ensure fastest growth to compete with modern world. Corruption and fraud are obstacles in both public and private organizations. So, Business organization needs to establish internal control to the benefit of the investors as well as the country. Internal control is a mechanism that ensures reliability and transparency of financial information; efficiency and effectiveness of business transaction and compliance with laws and regulations that can prevent fraud. It also ensures good corporate governance to make accountable to all parties inside the organization. The Committee of Sponsoring Organizations (COSO) suggests five components of internal control: control environment, risk assessment, control activities, information and communication and monitoring activities. Those components come to meet up with operational objectives, reporting objectives and compliance objectives. Strong internal control systems and financial performance are important for business continuity and prosperity (Kiabel, 2012; Aigbe and James, 2011; Bejide, 2006; Hermanson and Rittenberg, 2003; Eiseberg, 1998).So, this paper has focused on the relationship between internal controls with financial performance. In Bangladesh, there are few papers on this topic. Most of the papers of internal control have focused on only banking sector. Other sectors were not properly concentrated for research purpose. This research gap has been mitigated here. In this paper, data has been collected from DSE (Dhaka Stock Exchange) 30 index which is called blue chips companies. All these companies have combined occupied 51% of market shares. Blue chips companies are taken for better representation of Bangladeshi listed companies as it includes all sectors excluding mutual funds, debentures, and bonds.

2. Objectives

The objectives of this paper are based on examining whether companies follow five components of internal control and come up with the results of the relationship between overall internal control and financial performance of the sample companies. The paper examines the findings of Al- Thuneibat et al. (2015) to applicable in Bangladeshi listed companies' context.

3. Literature Review

Al- Thuneibat et al. (2015) studied the impact of Saudi internal control standards on the profitability of Saudi shareholding companies. A questionnaire was used to determine if internal control was met. Profitability was measured by EPS, ROA, ROE, and margin (PM). Internal control and its components have a positive effect on ROA and ROE but a statistically insignificant effect on PM and EPS. Zhou et al (2016) investigated whether internal control and corporate life cycle affect firm performance. Data was collected from an emerging market China. Authors used the index of internal control of Chen, Dong, Han, and Zhou's (2013) and Dickinson's (2011) proposed firm life cycle based on cash flow patterns.They found a link between internal control and firm performance. In addition, excessive managerial ownership can reduce firm value. Akisik and Gal (2017) investigated how CSR and internal control affects financial performance and the decision on two major stakeholders: employees and customers. Data was taken from North America and Global Reporting Initiative data from 2006 to 2012. The result was that the decision of stakeholders is influenced by CSR and internal control. Shin and Park (2020) studied the relationship between internal control and operational efficiency. The 2011-2015 Korean Stock Exchange was studied. Operational efficiency was the dependent variable, and internal control manager attributes, firm size, firm age, sum of foreign currency-related accounts, number of business segments, market share, free cash flow, leverage ratio, return on total assets, and ratio of outside directors in the board of directors and largest shareholders' shareholding ratio were the independent variables. This study found that a manager's task- and firm-related knowledge increases operational efficiency.Kuhn and Morris (2017) determined the relationship between the announcements of the weakness of IT related internal control to SEC and the share prices of public companies. It was an event study, and the result was IT related weakness doesn't affect the market. Gao (2018) examined the effect of internal control weakness (ICW) on financial decision. The result found that ICW firm has more interest in external finance especially in equity financing than non-ICW firms. Dashtbayaz et al (2019) investigated family ownership on the relationship between internal controls weakness and financial reporting quality. Data was taken from 139 Iranian listed firms for the period of 2013–2017. 28 out of 139 firms were the family firm. Dependent variable was financial reporting quality, and the independent variable was internal control weakness. The result showed a negative relationship between the variables. If internal control weakness is increased, financial reporting quality will be decreased. Ashfaq and Rui (2018) studied the effect of audit committee and audit board on internal control disclosure in 100 non-financial companies in India, Pakistan, and Bangladesh from 2013-2015. Independent variable was ICDISC, and dependent variables were board size, foreigner on board, female board member, independent director, CEO duality, non-executive directors as chairman and CFO on board. Independent variable was ICDISC, and dependent variables were audit committee size, meeting, independence, financial expert, audit committee shareholdings, independent audit committee chairman, women on audit committee and foreigner on audit committee size. Public sector companies in South Asia disclose more internal control information than private sector. Multivariate analysis found that board and audit committee characteristics and ownership by public companies positively affect ICDISC, but female or foreign audit committee members negatively affect ICDISC. Salehi et al (2019) showed the relationship between internal controls on audit fee over 190 listed companies on the Tehran Stock Exchange during 2009–2016. The result found that companies, having lower audit fees, have a stronger relationship between managerial ability and internal control quality.Nalukenge et al. (2017) investigated corporate governance and internal control on financial reporting in Ugandan MFIs. Independent variable was Internal Controls over Financial Reporting (ICFR) and dependent variables were board role performance, board independence, CEO duality, and financial expertise of the board. Board role performance, expertise, and MFI association in Uganda have a significant relationship with the ICFR. However, board independence and separation of CEO and chairman roles are meaningless. Jorge (2017) examined whether internal control affects financial information's usefulness for internal decision making. Local politicians and chief officials were surveyed. Internal control and financial and budgetary information for internal decision makers are positively correlated.

4. Methodology

4.1. Research Method

The research has been conducted on quantitative method. Here, hypothesis has been developed and econometrics model has been used to find out result.

4.2. Population and Sample

The population is considered all the listed companies of Dhaka Stock Exchange. So, the population is 655. Among them, 30 blue chips (DSE 30 index) companies are taken as sample size. DSE 30 index includes all sectors except mutual fund, debenture, and bond.

4.3. Data Collection

Data has been collected from annual reports of the companies. The annual report has been taken of the recent year of 2020-2021. Data has also been collected from financial portal like Lankabangla Financial Portal and Royal Capital Portal. All the data has been come from secondary sources.

4.4. Descriptive Analysis

Total six variables are taken here to examine the relationship between dependent and independent variables. Here, internal control is independent variable, firm size is control variable, and all other four variables are dependent variables. Profit margin, ROA, ROE have been taken for profitability measurement. EPS has been taken for marketability measure.

Dependent/Independent Variable	**Variables**	**Measurement**
Independent variable	Internal control	Performing the components of internal control as per COSO
Dependent Variables	Profit margin	Net income/ Sales
	Return on asset	Net income/ total assets
	Return on equity	Net income/ Total equity
	Earnings per share	Net income/ Share outstanding
Control variable	Firm size	Total assets

4.5. Hypothesis Development

Internal control and its components affect profitability, according to Al- Thuneibat et al. (2015). It affects ROA and ROE positively but not PM.

H_1: Firms' profitability is significantly affected by internal control.

Internal control and EPS are unrelated, according to Al- Thuneibat et al. (2015).

H_2: Firms' earning is significantly affected by internal control.

4.6. Econometrics Models

Ordinary least square model examines dependent and independent variables. The dependent and independent variables of the paper has been listed above. Based on the variables the following model is established:

$$\mathbf{FP = \beta_0 + \beta_1 IC + \beta_2 CV + \varepsilon}$$

Where, FP is the financial performance which has the following variables: profit margin (PM), return on asset (ROA), return on equity (ROE), earning per share (EPS). Here, IC is Internal Control, and CV is control variable.

5. Analysis and Findings

5.1

pm	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
ic	.1149254	.0407965	2.82	0.009	.031218	.1986329
fs	.0093159	.0249806	0.37	0.712	-.0419401	.0605719
_cons	-.4200384	.6158665	-0.68	0.501	-1.683692	.8436152

As per regression analysis, profit margin has a positively significant relationship with internal control (p> t = 0.009) whereas firm size doesn't have any impact on profit margin. The adjusted R^2 is 18.39%.
The analysis found the opposite result of Al- Thuneibat et al. (2015).

5.2

roa	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
ic	.0145167	.010907	1.33	0.194	-.0078626	.036896
fs	-.0073483	.0066786	-1.10	0.281	-.0210517	.006355
_cons	.2039569	.1646526	1.24	0.226	-.1338822	.5417961

Internal control and firm size doesn't have any impact on return on asset (p> t = 0.194) which is also the opposite result of Al- Thuneibat et al. (2015).

5.3

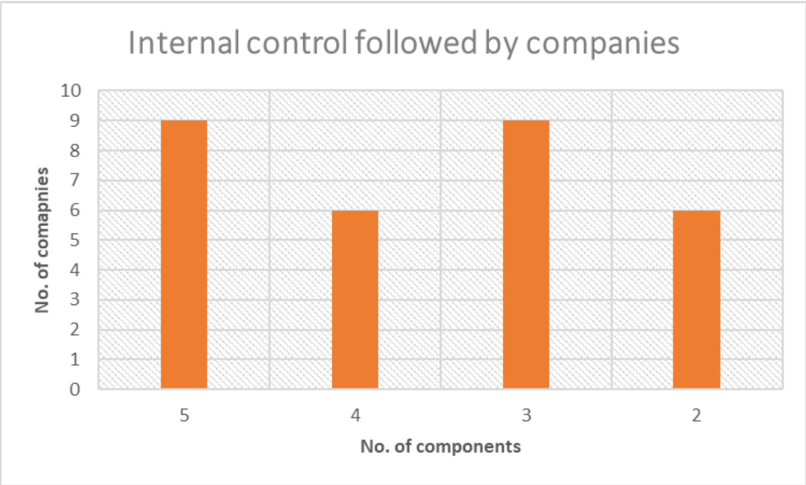
roe	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
ic	.0225004	.0224217	1.00	0.325	-.0235051	.068506
fs	-.0003009	.0137293	-0.02	0.983	-.0284712	.0278693
_cons	.0853648	.3384798	0.25	0.803	-.6091384	.779868

Internal control and firm size doesn't have any impact on return on asset which is also the opposite result of Al-Thuneibat et al. (2015).

5.4
As p>t = 0.443, earning pershare and internal control are unrelated which has also been proved by Al- Thuneibat et al. (2015).

eps	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
ic	1.464464	1.879999	0.78	0.443	-2.392976	5.321904
fs	-.1881279	1.151167	-0.16	0.871	-2.550128	2.173872
_cons	9.450066	28.3806	0.33	0.742	-48.78212	67.68225

5.5



Here, the graph represents the companies that followed the number of components suggested by COSO. Out of 30 companies, the nine companies follow all 5 components which is 30% of sample size. Six companies follow four components, nine companies follow three components and again 6 companies follow only two components.

6. Conclusion and Recommendations

Internal control helps the organization to establish set of standards to assess and manage risk, implement control activities which will ensure authentic transaction and safeguard of asset. Continuous monitoring and communication to appropriate authority will support the organization to be proactive against fraud and corruption. The blue chips companies which have been occupied largest market shares need to ensure the stakeholders that their organizations have long term economic sustainability through effective internal control mechanism. If the companies fail to attain all the components of internal control, the ultimate result will be the repetition of world's big accounting scandals. After analyzing, the recommendations are suggested that organizations have to be follow all the components of internal control; control activities must be properly investigated; control environment has to reflect top management's awareness, accountability and transparency of internal control and it should be reported properly and timely to all stakeholders.

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Appendix

Serial No	Name of the Companies
1	British American Tobacco bangladesh Company Limited
2	Beacon Pharmaceuticals Limited
3	Bangladesh Export Import Company Ltd
4	Bangladesh Submarine Cable Company Limited
5	Bangladesh Steel Re-Rolling Mills Limited
6	Beximco Pharmaceuticals Ltd.
7	Fortune Shoes Limited
8	Grameenphone Ltd.
9	GPH Ispat Ltd
10	LafargeHolcim Bangladesh Limited
11	Meghna Petroleum Limited
12	Olympic Industries Ltd
13	Orion Pharma Ltd
14	Power Grid Company of Bangladesh Ltd
15	Renata Ltd.
16	Robi Axiata Limited
17	Singer Bangladesh Limited
18	Square Pharmaceuticals Ltd
19	Summit Power Limited
20	Titas Gas Transmission & Dist. Co. Ltd
21	United Power Generation & Distribution Company Ltd
22	BBS Cable Limited
23	Brac Bank Limited
24	City Bank Limited
25	Eastern Bank Limited
26	Islami Bank Limited
27	LankaBangla Finance Limited
28	Pubali Bank Limited
29	IDLC Finance Limited
30	Delta Life Insurance Company Ltd.

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