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## EFFECTS OF CONTROL ENVIRONMENT AS A COMPONENT OF INTERNAL CONTROL SYSTEM ON THE QUALITY OF FINANCIAL REPORTING INFORMATION IN LOCAL GOVERNMENTS OF RWANDA

<sup>1</sup> Aminadab Ntahondereye, <sup>2</sup> Dr. Gordon O. Opuodho, PhD & <sup>3</sup> Dr. Robert Gitau, PhD

<sup>1</sup> PhD student, School of Business, Jomo Kenyatta University of Agriculture & Technology, Kenya

<sup>2</sup> Lecturer and Finance Consultant, School of Business, Jomo Kenyatta University of Agriculture & Technology, Kenya

<sup>3</sup> Senior Lecturer, School of Business, Kirinyaga University, Kenya

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### ABSTRACT

*Control environment is one of the elements of internal control systems that enables management to remain focused on the entity's pursuit of its operations and the production of high-quality of financial reporting information. Despite the adoption of an internal control system, including a control environment, by Rwandan local governments, there are numerous recurring issues with their financial reporting information. These issues include unrecorded transactions, a lack of evidence of approval of modifications, fraud, and embezzlement. This study investigated how control environment affected the quality of financial reporting information in local governments of Rwanda. The study was carried out in 30 districts. Primary data was collected using the questionnaire and secondary data was collected from district financial reports and the reports from Office of Auditor General. To analyse data both descriptive and inferential statistics were used. Descriptive study's findings revealed that the degree of control environment was high, with a mean of 4.02 and a standard deviation of 0.78 and the level quality of financial reporting information was high. Primary data revealed a poor quality of financial reporting information in the local governments. Using inferential statistics, the model summary of control environment on financial reporting information showed that a unit change in environmental control may explain 68.4% of the change in quality of financial reporting information. Linear equation revealed control environment as independent variable significantly predicts the quality of financial reporting information in local governments of Rwanda. Training about financial report analysis and interpretation for the members of Board of directors of the districts should be organized.*

**Key Words:** Control Environment, Quality of Financial Reporting Information

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## INTRODUCTION

According to the Committee of Sponsorship Organization of the Treadway Commission [CSO] (2013), control environment is a process used by the members of the board of directors, the top management and other employees in charge of providing assurance to achieve the institution's objectives relating to operations, reporting, and compliance.

When an internal control system serves to lower the risk of failure and ensures that the plans in place are thorough and precise, it is considered effective. Again, if financial reporting information is accurate and the institutions activities are executed in compliance with laws and regulations, it is successful. Little or no protection is available as the internal control mechanism is inadequate (American Institute of Certified Accountant [AICPA], 2014). If a financial report is of high quality, it gives a positive effect on capital providers and other stakeholders in allocating existing resources and making decisions to increase efficiency (Provasi, 2015).

As part of the internal control system, the control environment establishes an institution's tone and influences its people's control consciousness. Integrity and ethical ideals, commitment to competence, and accountability, leadership philosophy and operational style, how management distributes authority and responsibility, organizes and develops its people and policies and procedures are examples of control environment characteristics. All other parts of internal control are built on this foundation, which provides discipline and organization. Leaders of each department, location, or activity create a local control environment (Provasi, 2015).

Several research related to internal control and how it affects the financial reporting information performed by different scholars (Mihaela & ulian, 2011). In Nigeria, Augustine et al. (2013) found that an organization's department of internal control process should be considered more. They showed that it can trigger fraudulent acts when there is a poor internal control system, particularly in banking institutions. They suggested that a strong internal control system including control environment should be implemented for each organization to counter fraud.

Agbenyo, Jiang & Cobblah (2018) carried out another study in Ghana, and analyzed the government's revenue authority financial reporting information and how it has been affected by the internal control system. They found a positive correlation between the two variables. They showed that bribery was reduced by using internal control. This provides good financial reporting performance such as accuracy. In view of the above findings and recommendations, the organization should implement an internal control system strategically.

The research of Nyakundi et al (2014) in Uganda showed that about 90% of Ugandan SMEs collapse within 3 years because of lack or weak of internal control system including control environment. Other study by Ntongo (2012), on internal control, financial accountability, and financial management in health sector in Uganda, showed that internal control systems influenced the financial reporting information and accountability. Ileri and Wagoki (2014), conducted research to determine the role of internal control systems, including the control environment, at Kenyan public universities. The study discovered poor internal control measures in Kenyan universities. The study recommended strengthening training the staff on internal control systems including control environment.

The forms of local governments in Rwanda are based on districts. Districts are self-governing bodies with the right to create their own budgets. Districts are formed as a unit for the decentralized provision of services to the population and for the efficient and effective use of public resources. Districts are autonomous entities, which are responsible to implement government plans. Districts oversee the overall economic development coordination and ensuring the coordination of planning, financing, and implementation of service delivery (Minecofin, 2011). The districts and other public entities have been recommended to adopt the internal control

structure in compliance with COSO framework to achieve the objectives, including providing good quality of financial reporting (Minecofin, 2011).

Since 2009, Districts adopted internal control system including internal control environment, in the intention of helping them producing good quality of financial reporting information (Minecofin, 2011). The primary objective of internal control system was to secure the organization against budgetary misfortune and misuse of assets, advancing productivity in open monetary administration and advancing responsibility, to avert, to distinguish, to hinder deceitful activities and other rebelliousness of the laws and guidelines of laws, anticipating and identifying mistakes, protecting resources, advancing moral practices, improving proficiency and viability of government projects and undertakings, expanding unwavering quality of money related report and improving consistence with laws and guidelines (Minecofin, 2011). A decent inward control framework looks to deliver reasonable data in the budget reports which give clarification of the state businesses to the outer partners (Agbenyo, Jiang, and Cobbblah, 2018).

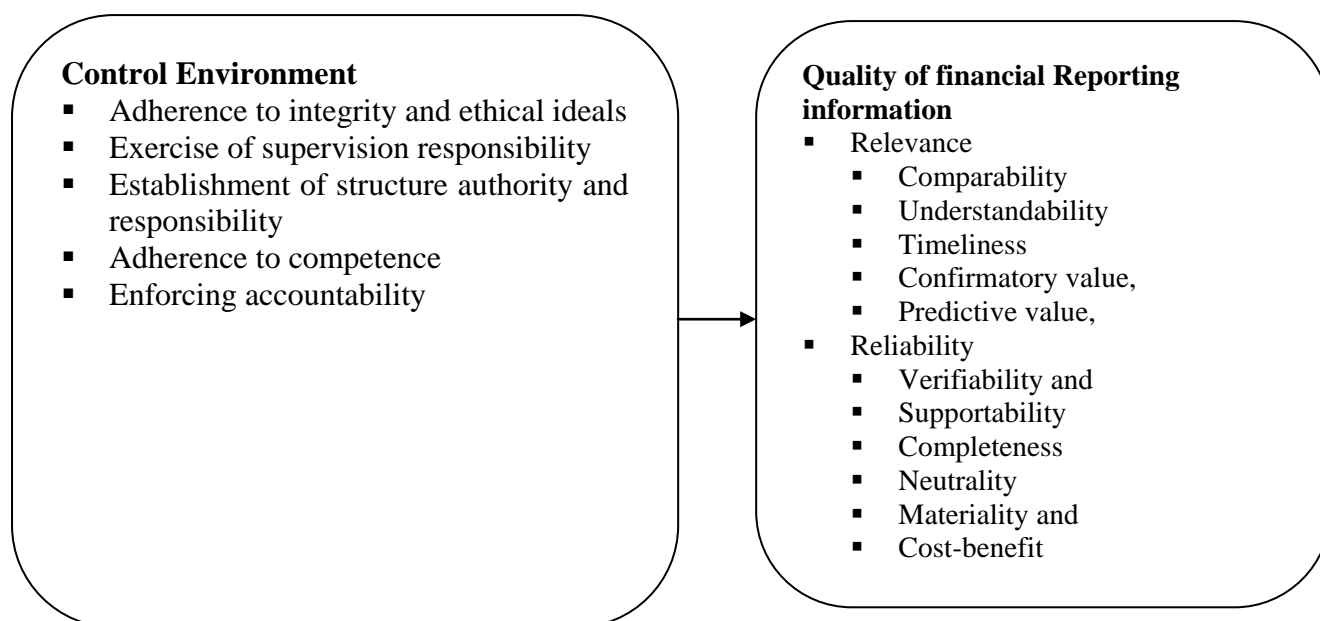
Given the adoption the adoption of control environment, the standard of financial reporting information is poor. From 2010 to now, the reports of the Office of Auditor General [OAG] of Rwanda had been showing poor quality of district financial reports, including unrecorded transactions, omitting balances, misappropriation of received revenue, unexplained discrepancies, unused balances. There were cases of delayed banking for revenue collections in various Districts, errors of adjustments in the books of accounts with no documentation and supporting documents. Absence of evidence of approval of the adjustments by the Chief Budget Managers and Directors of Finance and Administration. Districts did not maintain cashbooks or debtors accounts for balances held by each of the Non-Budget Agencies (NBAs) under their control, within their books of account. Utilizing collections at source to meet operational expenses before being banked and utilized later, contrary to public financial management regulations (OAG, 2018).

There were cases of receipt books issued but not returned. There has been a weakness in the management of bank accounts where many dormant bank accounts were identified. In the Districts, there was inadequate tracking of funds disbursed to Non-Budget Agencies. There were cases of forged guarantees submitted by suppliers to budget agencies. The reports showed that there were projects which received loans while they were inexistant. There were significant delays in making transfers for direct payments to public works (OAG, 2011 to 2019).

Despite of the above information, little studies have been done in this field of internal control system and financial reporting information in Rwanda. The purpose of this study was to establish the effect of control environment as part of internal control on the quality of financial reporting information in Local Governments of Rwanda.

### **Conceptual Framework of the study**

Conceptual Framework of the study has two variables, an independent variable, as well as the dependent variable. The Control Environment is the independent variable, while the quality of financial reporting information is the dependent variable. The following figure presents the structure of the conceptual framework.



**Independent Variable**

**Dependent Variable**

**Figure 1: Conceptual Framework**

## LITERATURE REVIEW

The control environment is the management mindset of a company and staff towards their defined and maintained understanding of internal control. It is a product of the managers' ethos, personality, style, competencies, honesty, and morality of the employees (Mahadeen et al., 2016). The key factors in the management system are the structure of the company and its relationship to the responsibility of the employees. Standard internal control structure is directed towards a constructive management environment. This helps workers have discipleship, responsibility, ethics, and honesty (Provasi, 2015).

Control environment principles are ethical values and integrity, style in operations, management philosophy, organizational structure, financial reporting competencies, authority and responsibility, and human resources are all factors to consider (Shanszadeh & Zolfaghari, 2015).

Mahadeen et al. (2016), said that ethical values and integrity are the important parameters contributing to control environment. They form the standards for employees' conduct in taking proper daily decisions. If managers fail to communicate such values, or don't implement them themselves, this could weaken the organization's ability to accomplish its mission.

Management promotes professionalism through the creation and publication of a code of conduct, according to Mahadeen et al. (2016), and workers must comply with that code of conduct. Therefore, rewarding the dedication of workers to ethical practices should not be compromised because this can help to enforce discipline for all ethical violations (Grigoropoulos, 2019).

### **Effect of control environment on the quality of financial reporting information**

Different scholars have conducted many studies on internal control systems and the accuracy of financial reporting information in various nations and enterprises. For instance, Onyulo (2017) conducted a study to analyse the reliability of financial reporting data in Kenyan public institutions. The agency being investigated was the Natural Resources Ministry. Results showed that the internal control process contributed 45.54% to the quality of the Ministry's financial statement.

Some of the most fraudulent, financial misreporting can be traced back to a weak control environment (Waren et al, 2016). Lord (2017) did a study at the University of Texas on the control environment and the accuracy of financial reporting information. Findings from multivariate regression showed an association between control environment in terms of management attitudes and styles and quality of financial reporting information. He emphasized that some management traits appear likely to affect the probability of material misstatement.

The research of Ibrahim (2016) has shown that between control environment and revenue generation there was a significant positive correlation in Nigerian Public revenue generation. He found taking other variables taken to zero, the increase of one unit in control environment causes the increase of 0.26 billion Naira. Aramide & Bashir (2013) showed a significant correlation between internal control systems in terms of control environment, and they conclude that control environment can predict accountability in financial reporting.

Again, the study of Aramid & Bashir (2015), in their study related to effect of internal control system on the financial accountability, they demonstrated that control environment contributed significantly to the financial accountability of Bandung's elementary schools in Indonesia.

Basing on the above findings, the researcher started thinking how to increase the quality of financial reporting information in the Districts of Rwanda by using control environment as the component of internal control.

## **METHODOLOGY**

**Research Philosophy:** The study was based on interpretivist research paradigm. According to the interpretivist research paradigm, different people in society perceive and understand reality in different ways, and while there may be only one reality, everyone interprets it according to their own point of view. To analyze the situation of the variables under research, qualitative and quantitative approaches such as interviews, survey, focus groups, observations of a phenomena, or gathering documentation on a phenomenon (e.g., reports or information from websites) should be used (Alharahshah and Pius, 2020). In this study, survey and documentation were used.

**Study Design:** Descriptive research design was used with a mixed qualitative and quantitative approach. The reasons for using this approach of combining qualitative and quantitative methodologies yields a more comprehensive understanding of a study problem than either strategy alone (Bowling, 2014).

The study was cross-sectional research. Cross-sectional study involves gathering data at a single point in time (Zangirolami-Raimundo, Echeimberg & Leone, 2018). Data was collected once in 2021.

**Population:** The population of this study was made of 30 Districts making the local governments in Rwanda.

**Data Collection Instruments:** To collect primary data, the researcher used the questionnaire as instrument of the study. According to (Kumar, 2011) a questionnaire is one of the main instruments that is used to collect primary data. About secondary data, the researcher used financial reports from the districts and reports from Office of Auditor General of Rwanda.

**Data analysis:** Data were analysed by using descriptive statistics and inferential analysis

**Descriptive Statistics:** Descriptive statistics were used especially, the percentage, the mean and standard deviation (Bhandari, 2020).

**Inferential analysis:** Correlation and simple regression were used. Correlation is a statistical measure that reveals how much two or more variables fluctuate in tandem. A positive correlation indicates how much one variable increases while the other lowers; a negative correlation indicates how much one variable increases while the other declines (Ahmed Zaid, 2015).

The aim of simple regression analysis is to describe the functional relationship between two variables, where one variable predicts the response variable (Elmanani ,2020). In this study, simple regression was used to test the influence of control environment on the quality of financial reporting information.

$$Y = \beta_0 + \beta_1 X_1 + \varepsilon$$

With:

Y= quality of Financial Reporting Information

$\beta_0$  = constant and

$X_1$  = Control environment

$\varepsilon$  = errors

## FINDINGS AND DISCUSSIONS

### Descriptive statistics

To assess the level of control environment, ten assertions were used. For each assertion, we computed the percentage, mean, and standard deviation. Table 1 summarizes the findings.

**Table 1: Level of Control environment**

Assertions	SD (%)	D (%)	NS (%)	A (%)	SA (%)	Mean	Std. Dev.	Comments
The employees misconduct reports are not many	-	3.3	16.7	43.3	36.7	4.13	0.81	High
The employees are accountable for their responsibility	-	-	13.3	53.3	33.3	4.20	0.66	Very high
The employees strive for a good reputation of the District	-	-	10.0	43.3	46.7	4.37	0.66	Very high
District Employees are trustful	-	10.0	16.7	30.0	43.3	4.07	1.01	High
The board of Directors are independents from the management	-	3.3	20.0	40.0	36.7	4.10	0.84	High
The board of Directors exercise oversight of the development and performance of internal control system	-	20.0	23.3	46.7	10.0	3.47	0.93	High
Management and the boards establish structures, reporting lines in the pursuit of objectives	-	3.3	-	66.7	30.0	4.23	0.62	Very high
Management and the boards establish appropriate authorities and responsibility in the pursuit of objectives	-	3.3	10.0	46.7	40.0	4.23	0.77	Very high
The District demonstrate a commitment to attract, develop and retain competent individual in alignment with objectives	-	23.3	36.7	33.3	6.7	3.23	0.89	Moderate
The District holds individuals accountable for their internal control responsibilities in the pursuit of objectives.	-	-	13.3	56.7	30.0	4.17	0.64	High
<b>Average</b>						<b>4.02</b>	<b>0.78</b>	<b>High</b>

**Legend:** 1-1.8 = extremely low level; 1.8-2.6 = low level; 2.6-3.4 = moderate level; 3.4-4.2 = high level; 4.2-5 = very high level

Source: Output SPSS,2021

Table 1 results revealed that misconduct reports are not many at a high level with the mean of 4.13, and the standard deviation of 0.81, the employees are accountable at a very high level (mean of 4.20, standard deviation of 0.66), the employees strive for a good reputation a very high level, with a mean of 4.37 and a standard deviation of 0.66, the employees of the district are trustful at a high level with the mean of 4.07 and standard deviation of 1.01, the board of Directors are independent at a high level, with a mean of 4.10 and a standard deviation of 0.84, the board of Directors exercise oversight of the development and performance of internal control system at a high level with the mean of 3.47 and standard deviation of 0.93, Management and the boards establish structures, reporting lines in the pursuit of objectives at a high level with the mean of 4.23 and standard deviation of 0.62.

Management and the boards establish appropriate authorities and responsibility in the pursuit of objectives at a high level with a mean of 4.23 and a standard deviation of 0.77, the Districts demonstrate a commitment to attract, develop, and retain competent individuals in alignment with objectives at a moderate level with a mean of 3.23 and a standard deviation of 0.89, The Districts hold individuals accountable for their internal control responsibilities in the pursuit of objectives at a high level with the mean of 4.17 and standard deviation of 0.64.

In general, the level of control environment was high, with a mean of 4.02 and a standard deviation of 0.78. The implication of these findings is that the local governments have a chance of having disciplined employees, as it was said that high level of control environment helps workers have discipleship, responsibility, ethics, and honesty. However, retaining competent employees is still a challenge.

**Table 2: Quality of financial reporting information**

<b>Variables</b>	<b>Mean</b>	<b>Standard deviation</b>	<b>Comment</b>
Relevancy	4.11	0.77	High
Reliability	3.93	0.78	High
<b>Mean</b>	<b>4.02</b>	<b>0.78</b>	<b>High</b>

Legend: 1-1.8 = extremely low level; 1.8-2.6 = low level; 2.6-3.4 = moderate level; 3.4-4.2 = high level; 4.2-5 = very high level

Source: Output SPSS, 2021

Findings showed that the level of relevancy of financial information was high with the mean of 4.11 and the level of reliability of financial information was also high with the mean of 3.93. In general, the quality of financial reporting information was high with the mean of 4.02 Standard deviation of 0.78.

In addition to the above primary findings, the study assessed secondary data related to the financial reporting of local governments. For instance, in fiscal year ended 30 June 2021 different poor quality in financial reports in local governments of Rwanda has been identified.

In Kigali city, Bridge works costing Frw 2,024,536,965 were delayed. The contract had an initial completion date of November 23, 2020. The contract was extended to 19 months and amended to Frw 7,774,274,830. However, the supervision report, dated February 2022, claimed that work was at 58.32% completion. 311 water supply systems were built in ten (10) districts at a total cost of Frw 43,203,701,254. However, 18% were non-functional, while 36% were partially operational, meaning that 54% (Frw 23,329,998,677) misused. This should delay the target of giving access to clean water to all Rwandans by 2024. Out of 9,610 constructed biogas plants, 54% were not operational, due to a lack of capacity to maintain biogas plants, implying a waste of 54% of the project's cost.

Schools' funds totaling Frw 2,583,042,875 were transferred to schools with delays of up to 244 days in twelve (12) districts, while school feeding funds totaling Frw 1,455,280,779 were transferred to schools with delays of up to 212 days in thirteen (13) districts. This had a severe impact on school operations, student well-being, and, ultimately, educational quality.

There was a delay of up to 432 days in transferring money totaling Frw 5,344,353,050 from SACCOs to beneficiaries in ten (10) districts and a delay of up to 143 days in transferring monies totaling Frw 4,885,232,650 from Districts to SACCOs in seven (7) districts.

Community Health Workers (CHWs) deposited user fees totaling Frw 718,967,043 was idle in bank accounts of twenty-three (23) districts. This was due to a lack of guidance from the Ministry of Health and MINALOC on how this money would be used. Then there was the loss of value for money.

The Frw 247,611,275 transferred by MINAGRI to the districts for the purchase of lime for distribution to farmers to increase agricultural output was not used in nine (9) districts. This negatively affected the crop production in the country. In the financial year 2022, in Kigali City, 67% of the expected cost of Kigali Infrastructure Project was not reported.

In Gisagara District, the water supply system with the cost Frw 919,693,250 was reported completed while it was not operational. 43% of constructed water supply systems in Muhanga, Nyabihu, Nyagatare, Rusizi, Gatsibo, and Karongi districts were either partially operating or non-functional, while it was reported finished.

Out of 10,913 biogas plants constructed, 8,354 biogas plants, representing 77%, were not operating, while the report showed that they have been paid. This was observed in all districts and the City of Kigali. All this information shows that there is a big gap in the quality of financial reporting information.

Comparing findings from primary data and that from secondary data we found a gap. Primary data showed a high quality of financial reporting information while the secondary data showed a poor quality. This may imply a lower skill of the members of district boards in analyzing and interpreting financial information. Training should be organized to increase their skills.

Financial reporting assists stakeholders in planning, analyzing, and comparing results, as well as taking appropriate action to move them in the proper direction. It is also one of the key messages for stakeholders in the organization to have faith in their relationship. It also helps to understand how finances are obtained and used. Another important purpose for keeping financial reporting is to improve the social welfare of employees, trade unions, and other government departments. It is critical that businesses employ financial reporting data to comply with the regulations (Al Balushi et al, 2019). Financial reports assist stakeholders in analyzing the reports to benchmark and make appropriate decisions. It also assists businesses in mobilizing funds from both internal and external sources. High-quality financial reporting is critical for conforming to and complying with various statutes and regulatory requirements. Furthermore, financial reporting facilitates mandatory audits. Financial statements give users more authority and flexibility to make decisions and invest, which improves the quality of financial reporting (Pristine, 2017). Improvement is required for Local government of Rwanda to increase the quality of their financial reporting information and increasing the skills of board members in analyzing financial reporting information.

### **Inferential Analysis**

Inferential statistics tend to clearly explain why and how certain variables relate (Northouse, 2013). Inferential analysis was conducted by using correlation and regression analysis.



### Correlation analysis

Table 3 presents findings from correlation analysis

**Table 3: Analysis of the relationship between the Control Environment and the Quality of Financial Reporting Information**

			Control Environment	Quality of Financial Reporting information
Spearman 's rho	Control Environment	Correlation coefficient	1.000	.848**
		Sig. (2-tailed)	.	.000
		N	30	30
	Quality of Financial Reporting information	Correlation coefficient	.848**	1.000
		Sig. (2-tailed)	.000	.
		N	30	30

\*\* . Correlation is significant at the 0.05 level (2-tailed)

Source: Output SPSS, 2021

The spearman rho correlation between Control environment and Quality of financial reporting information was 0.848 and the P-value of 0.00. This suggests that there is a highly positive relationship. The P-value is less than 0.05, indicating that this relationship is significant and coefficient of determination is 71.91%.

### Regression analysis

In this study, simple regression analysis was also used where the model summary, variance (ANOVA) and standardized coefficients were applied.

**Table 4: Model Summary of Control environment**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.827 <sup>a</sup>	.684	.673	.20868

a. PredPredictors: (Constant), Control environments

Source: Output SPSS, 2021

The linear regression model yielded  $R^2 = 0.684$ , indicating that a unit change in control Environment can account for 68.4% of the change in financial reporting information quality, with the remaining 31.6% explained by other factors. These findings are summarized in table 5. This data indicates that control Environment is an important component of quality of financial reporting information in Rwandan local governments.

**Table 5: ANOVA of Control environment**

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	2.641	1	2.641	60.641	.000 <sup>a</sup>
	Residual	1.219	28	.044		
	Total	3.860	29			

a. Predictors: (Constant), control Environment

b. Dependent Variable: Quality of financial reporting information.

Source Output SPSS, 2021

The analysis of variance (ANOVA) test revealed that the F-statistic is 60.641 with a P value of 0.000. As the P-value is less than 0.05, this shows that there is a positive and significant association between control of the environment and quality of financial reporting information.

Table 6 shows the results of the model's regression coefficients test.

**Table 6: Linear model of Control environment and quality of financial reporting information**

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.544	.324		4.763	.000
	Control environment	.627	.080	.827	7.787	.000

a. Dependent Variable: Quality of financial reporting information.

Source: Output SPSS, 2021

$$Y = 1.544 + 0.627X_1$$

With:

Y = Quality of financial reporting information

$X_1$  = Control environment

The constant 1.544 indicates that if the control environment as an independent variable, is held constant, then there will be a positive change in quality of financial reporting information by 1.544. For every 1-unit increase in control Environment, quality of financial reporting information is predicted to increase by 0.627 units. This implies that control environment significantly affects quality of financial reporting information of local governments of Rwanda.

## CONCLUSION AND RECOMMENDATIONS

According to descriptive statistics, the overall level of control environment was high. The quality of financial reporting information was also high while secondary data showed a poor quality of financial reporting information. The results of inferential analysis revealed that control environment had a substantial effect on the quality of financial reporting information.

From findings, the researcher constructed the recommendation to different stakeholders:

### To the management of Local Governments of Rwanda

- The districts should increase the commitment to attract, develop and retain competent employees as this indicator was at a moderate level. Competent personnel are universally regarded as one of the most vital resources, essential for any sort of firm, regardless of its nature or field of operation. Without them, the organization could not function, let alone survive in the long run. This should be accomplished using various types of motivation.
- Relevancy and reliability of financial information of the districts should be practically improved to close the gap between primary data and secondary data. This can be done by hiring competent employees and using information technology in all district transactions.
- Local Governments of Rwanda should organize training for the members of board of Directors about analysis and interpreting District financial reports. This will help them to identify gaps and take correction majors on time.
- More effort is needed to increase enforcing control environment practices because it affects the quality of financial reporting information of the districts.

### Suggestion for Further Research

This study should be conducted in other public institutions which have poor quality of financial reporting information, like government owned business enterprises and the institutions of central Governments in Rwanda. Like Ministries.

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