



# EFFECT OF INTERNAL CONTROL ON FINANCIAL PERFORMANCE OF SOME SELECTED COMMERCIAL BANKS IN MOGADISHU SOMALIA

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## ABSTRACT

*The purpose of this study was to investigate the effect of internal control on financial performance of commercial banks in Mogadishu Somalia. The objectives of the study included, to describe the effect of control activities on financial performance of commercial banks in Mogadishu Somalia. to examine the effect of control environment on financial performance of commercial banks in Mogadishu Somalia. to determine the effect of Risk Assessment on financial performance of commercial banks in Mogadishu Somalia. to evaluate the effect of information and communication system on financial performance of commercial banks in Mogadishu Somalia. The study was carried out using descriptive research design. The target population is 110 participants. The sample size comprised of 86 respondents those came from our specific target groups especially financial directors, internal audits, supervisors, chief cashier and head departments. Data was collected by use of questionnaires and was analysed by use of descriptive statistics and Pearson Product Moment Correlation Coefficient. The findings of this study reveal that majority of commercial banks in Mogadishu has clear organizational structure and has enough cash to meet its obligations effectively. The study recommends that banks should build and maintain effective internal controls because of the banking sector's riskiness and its impact on financial performance.*

**KEYWORDS:** *Internal control, financial performance, risk assessment, Control Environment, Information & Communication, control Activities.*

## 2.1 INTRODUCTION

Internal controls are procedures taken by a company to ensure that its goals, objectives, and missions are achieved. A department's procedures and strategies are used to ensure that an organization's transactions are handled correctly, minimizing waste, robbery, and asset theft. Internal controls are policies and procedures established and implemented by individuals in charge of governance, management, and other employees to provide reasonable assurance that an entity's financial reporting accuracy, operational effectiveness, and compliance with applicable laws and regulations will be managed to meet (Mwindi, 2008). Internal controls, it should be noted, provide as a reasonable but not absolute assurance to an entity's management and board of directors that the organization's goals will be met (Ndifon Ejoh et al., 2014).

Financial performance relates to an organization's capacity to acquire and allocate resources over a period of time as assessed by capital adequacy, liquidity, solvency, effectiveness, leverage, and profitability. Financial performance, the company's

capacity to oversee and control it possess assets. Cash flow, balance sheet, profit-loss, capital change can be the basis of data for corporate directors to form decisions. It is critical to obtain critical examination and technical analysis, as well as to memorize funds in order to obtain the company's budgetary behavior via financial matters, financial management, and accounting. (Didin Fatihudin et, 2018).

Globally. As developing nation, Malaysia's banks play a major part in financing improvement. In Malaysia, commercial banks are contributing to their financial intermediation part. The execution evaluation of commercial banks is ordinarily related to how well the bank can utilize its resources. Commercial banks' benefit is inferred from their fundamental trade which is able take the short-term stores and changing them into a long term (Mokhtar, 2006). Goh & Michael (2010) demonstrated that the assessment of firms or banks execution more often than not by utilizing the financial proportion approaches, since it gives a clear data almost the firm's financial execution. The request of their significance is vague since on each study referred to a distinctive proportion a bit like the best



sign of viable sign of approaching issues. Additionally, based on past thinks about done by Kumbirai & Webb (2010), expressed that financial proportions enable investors to recognize special banks' qualities and shortcomings, which are able to educate the banks' productivity, liquidity and credit quality. Capital amplexness hypothesis is well related to the banks' execution as the hypothesis demonstrated that banks may be within the position of 'buffer' of abundance capital when their capital amplexness proportion is unsteady in arrange to not drop beneath legitimate capital requirements (Sahaida et al, 2017).

In Africa, Tanzania as a developing country tries to fortify the internal control system, through their organizations such as the Central Bank. The Ministry for finance empowers the financial institutions to accentuations on implementation of viable internal control framework. The board of chiefs of each financial institution might favor legitimate approaches and methods, and satisfactory in general internal control frameworks, for monitoring and controlling the dangers for each line of trade and market served by such bank or financial institution, including credit, budgetary, market, operations, legitimate and any other hazard influencing or likely to influence such bank or financial institution (BAFIA, 2006). The People's Bank of Zanzibar Restricted (PBZ) as a financial institution slowly its expanded its financial performance amid 2000's after major rebuilding made by the government such as; redundancies the incompetents and long term workers and utilized the proficient one, introducing the modern managing an account framework called Center Managing an account Framework, unused banking arrangements and presenting the unused division called Risk Management Office and strengthened the internal review office so as to make strides the internal control framework ( khamis H. , 2013).

In Somalia, Since the former central government of Somalia collapsed in 1991, there has been an issue of inadequate financial performance and management of finances. Due to the collapse of centralized government in 1989, Somalia had a fairly simple banking and credit system governed by the Central Bank and a small number of (mainly foreign-owned) commercial banking institutions. Even before the collapse of the Barre administration, the banking sector had little impact on or engagement with the lives of ordinary Somalis. In 1990, a new Somali Commercial Bank was founded with a capital of 2 billion Somali Shillings, after an agreement with the IMF to implement a free private oriented economy. This sum of money was divided into 2,000 shares, each worth one million Somali Shillings. One billion was paid jointly by the government and the Somali Central

Bank, while one billion was left to private investors, with just 22 shares taken up. The bank, along with the country's formal financial structure, disintegrated in 1991 as a result of the civil war (Franklin Amoo ,2009).

However. This study we will examine the effect of internal control on financial performance of commercial banks in Mogadishu Somalia.

### 3.1 LITERATURE REVIEW

#### 3.1.0 Introduction

This chapter discusses the literature related to the effect of internal control on financial performance. The review focuses mainly on prior studies of the effect on internal control on financial performance. Therefore, the research focus on, effect of control activities, information & communication system, control environment and risk assessment on financial performance.

#### 3.1.1 Control environment and financial performance

The control environment refers to an organization's entire control consciousness, which is influenced by rules, ethical standards, procedures, and monitoring systems. This represents the UCUMUC council's board of directors and management's decision to implement internal control. The control environment includes management philosophy, which may be observed in the organization's goal and mission, as well as the organization's battle to maintain proper financial accountability. The control environment is the UCUMUC management and staff's attitude toward internal control and control consciousness that they have built and maintained (Hevesi, 2005).

The institute of Internal Auditors looks at control environment as one that dictates upon organizational members a feeling of consciousness that their continued stay at an organization is assured by demonstration of their expected level of competence as well as their comprehension of authority and responsibility limits. In this respect, organizational members feel and realize that they are accountable to the organization (Dublin, 1999).

Khamis (2013) discovered that the internal control system (control environment) and financial performance of financial institutions had a substantial positive link. According to Mawanda's research, there is a



favorable association between control environment and financial performance of Ugandan higher education institutions, as evidenced by his case study of Uganda Martyrs University.

### 3.1.2 Risk assessment and financial performance

Risk assessment refers to the assessment of factors that may have an inherent possibility of affecting the attainment of the organization objectives. The risk assessment process enables the organization to actively analyze all the relevant risk facing the firm (Karagiorgos et al., 2009). Within most organizations the management is mandated with the responsibility of ensuring that only acceptable risk face the firm. It is the managements responsibility to design internal control systems that will ensure efficiency and effectiveness is ensured. In addition, the internal control system ensures that the institution's financial reporting is accurate and compliant with regulatory and compliance standards. The control systems are reviewed and evaluated on a regular basis to ensure this.

Many banks that have incurred big losses have failed to notice and assess the risks of new products and activities, as well as to update their risk assessments when significant changes in the environment or business conditions occurred. The majority of recent incidents demonstrate that control systems designed for traditional or simple products are incapable of handling more sophisticated or complicated items. Banks are in the business of risk-taking ((Karagiorgos et al., 2009). Banking is a business mostly associated with risk because of its large exposure to uncertainty and huge considerations. Risk assessment is one of the most important practices to be used especially in banks, for getting assurance about the reliability of the operations and procedures being followed. In today's dynamic environment, all banks are exposed to a large number of risks such as credit risk, liquidity risk, foreign exchange risk, market risk and interest rate risk, among others which may create some source of threat for a bank's survival and success Due to such exposure to various risks, efficient risk management is required. Once risk has been identified and understood, one of the first tasks to be completed is risk management. Risk and return are inextricably linked, which

implies that increasing one will always raise the other, and vice versa (Basle, 1998).

Effective risk management leads to a more balanced risk-reward trade-off, resulting in a stronger future position (Fatemi & Fooladi, 2006). Recently, it has also been recognized that risk assessment is arguably more crucial in the financial sector than in any other area of the economy. It becomes clearer when it is understood that the primary goal of financial institutions is to maximize revenues and provide maximum value to shareholders by facilitating a variety of financial services, particularly risk management (AlTamimi & Al-Mazrooei, 2007). The primary motivation for implementing risk assessment procedures is to avoid future failure. Risk assessment, on the other hand, is unquestionably not free. In fact, it is costly in terms of both resources and disturbance to institutions. However, the cost of postponing or ignoring appropriate risk management can have negative consequences, such as a bank's failure and even a banking system's failure.

### 3.1.3 Information & communication on financial performance

According to Aldridge and Colbert (1994), internal control requires that all pertinent information be identified, captured, and communicated in a form and time frame that enable people to carry out their financial reporting responsibilities. Effective communications should occur in a broad sense with information flowing down, across, and up within all the sections of the organization (Theofanis et al., 2011). Recent literature on internal control system frameworks has raised some concerns on information and communication as one of the internal control system components because of their importance in influencing the working relationship within the organization at all levels (Amudo & Inanga, 2009). Hence, such information must be communicated throughout the entire organization in order to permit personnel to carry out their responsibilities with regard to objective achievement.

Some losses in banks occur because relevant personnel are not aware of or do not understand the bank's policies. In several instances, information about inappropriate activities that should have been reported



upward through organizational levels is not communicated to the board of directors or senior management until the problems became severe. In other instances, information in management reports is not complete or accurate, creating a falsely favorable impression of a business situation. Adequate information and effective communication are essential to the proper functioning of a system of internal control. From the bank's perspective, in order for information to be useful, it must be relevant, reliable, timely, accessible, and provided in a consistent format. Information includes internal financial, operational and compliance data, as well as external market information about events and conditions that are relevant to decision making. Internal 10 information is part of a record-keeping process that should include established procedures for record retention (Theofanis et al., 2011).

#### **3.1.4 Control activities and financial performance**

Control activities refer to policies, procedures, and mechanisms put in place to ensure directives of the management are properly carried out (Aikins, 2011; Rezaee et al., 2001). Appropriate and accurate documentation of policies and procedural guidelines helps to determine how the control activities are to be executed. It also provides adequate information for auditors' examination of the overall adequacy of control design over financial management practices (Aikins, 2011). These control activities ensure that all necessary actions should be taken with the aim to address risks so that organizational objectives are achieved. According to Rezaee et al. (2001), internal control activities occur throughout the organization. They include a range of activities like; approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of asset and segregation of duties. Most of them are made possible through the help of the internal audit function.

Banks' department or division level management receives and reviews standard performance and exception reports on a daily, weekly or monthly basis. Functional reviews occur more frequently than top-level reviews and usually are more detailed. A manager of commercial lending, for example, could go

over weekly data on delinquencies, payments received, and interest revenue earned on the portfolio, whereas a senior credit officer might look over comparable information monthly and in a more summary form that covers all lending areas. The control activity, like the top-level review, is represented by the questions that are generated as a result of evaluating the reports and the responses to those questions. Control efforts are most effective when they are considered as an essential part of, rather than an addition to, the bank's everyday operations by management and all other workers (Rezaee et al., 2001).

When controls are considered as an add-on to daily activities, they are typically viewed as less significant and may not be used in instances where people are under pressure to complete tasks in a short amount of time. Furthermore, controls that are part of daily activities allow for quick responses to changing situations and the avoidance of unnecessary costs. Senior management should ensure that effective control activities are an important component of all relevant personnel's everyday functions as part of establishing an appropriate control culture within the bank. Simply establishing proper policies and procedures for the bank's numerous activities and divisions is not enough for senior management. They must check for compliance with such policies and procedures in all departments of the bank on a regular basis, as well as ensure that existing policies and procedures are still adequate. Internal auditing typically plays a key role in this area (Basle, 1998).

#### **3.1.5 Internal control and financial performance**

A company's financial performance can be improved by removing waste in benefits services procedures and systems. The degree to which a company achieves its defined aims and mission in terms of efficiency, effectiveness, and economy is referred to as the "key success factor." The information derived from a solid internal control system and reflected in financial statements will give a report on a firm's financial performance and position that will be valuable to a wide variety of users in evaluating stewardship and making economic decisions (Doyle, Ge, & McVay, 2007). According to thesis of Douglas conducted on internal control contribution on efficiency and effectiveness in Eco Bank Ghana



limited revealed that internal control systems in Eco Bank Ghana Limited and the Banking sector in general. However, the effectiveness of the internal controls could not be described very effective since monitoring is less effective. (Douglas, 2012).

Internal control systems, such as internal audits, are designed to increase the accountability of information providers in an organization, either directly or indirectly, in order to improve the reliability of financial performance (Jenning et al., 2008). Internal control therefore has a much broader purpose in the organization level. Internal controls give an unbiased assessment of managerial performance in carrying out assigned obligations in order to increase revenue (Donald & Delno, 2009).

Lembi N. (2006) The control environment component, it appears, is at the heart of effective control. The control environment lays the foundation for an organization, affecting the people's control consciousness. While long acknowledged as crucial, it serves as the foundation for all other aspects of internal control, giving discipline and structure (Basu et al 1997), It's clear that the control environment is given a lot of attention. Risk assessment, goal setting, control activities, information and communication systems, and monitoring activities are all influenced by the control environment (COSO 1994).

Internal controls establish explicit criteria for preventing certain staff behaviors within the organization. Internal controls are commonly used to avoid fraud. Internal controls are used by business owners to guarantee that one employee does not perform too many accounting duties. Employees that perform numerous accounting duties (such as posting deposits and reconciling bank statements) are more likely to tamper with data, commit fraud, or embezzle funds from the organization (Main, 2000).

### 3.2.1 Empirical Reviews

Several researchers have conducted research to determine the relationship between internal control and financial performance. Hanoon, R. N et al, (2021) researched the Impact of Internal Control Components on the Financial Performance, in the Iraqi Banking Sector. The aim of this study was to investigate the impact between Internal Control Components and the Financial Performance of the Iraqi banking sector. The

data was gathered through a non-random purposive sampling of respondents that included the CFO, CEO, Accountants, Internal Auditors, and Audit Committee. The results of this study indicated that the Internal Control Components have a significant impact on Financial Performance.

Ayimpo et al (2020) studied Effects of Risk Assessment, Control Environment and Control Activities on Performance of Listed Banks in Ghana. This study examined the effect Control Environment, Risk Assessment and Control Activities on financial performance. The methodology employed in the study was descriptive and quantitative research design and data was collected using closed ended questionnaires. Regarding objective one of this study, the study found that there is a significant effect of control environment as an internal control system on financial performance of listed banks in Ghana's stock Exchange market Regarding objective one of this study, the study found that there is a significant effect of control environment as an internal control system on financial performance of listed banks in Ghana's stock Exchange market.

Bayyoud and Sayyad (2015) studied the impact of internal control and risk management on banks in Palestine. The purpose of this study was the attempts to analyze the impact of internal control and risk management on banks in Palestine. a structured survey questionnaire was prepared and distributed to the managers and administrative level personnel in 10 banks. The investigation aided in determining the effects of new banking reforms and legislation on risk assessment, detection, and mitigation in financial institutions. Overall internal control and risk management systems in Palestine have a beneficial impact on banks' quantitative and qualitative performance, according to the findings.

Ayagre, et al. (2014) researched the effectiveness of Internal Control Systems of banks: The case of Ghanaian banks. This study evaluated the control environment and monitoring activities components of Internal Control Systems of Ghanaian Banks using COSO's principles and attributes of assessing the effectiveness of internal control systems. The data of this study was gathered from questionnaires administered to managers



(including audit managers) of all banks in Ghana. Strong controls exist in the control environment and monitoring activities components of Ghanaian banks' internal control systems, according to this study. The conclusions of this study suggested that bank boards in Ghana should not rest on their laurels, but instead work hard to maintain regular, separate internal control monitoring to ensure that controls are in place and functioning correctly.

Ngugi (2011) carried out research aimed to find out the practice in regard to design and implementation of internal control systems in the private and the public sector and whether there was any difference in effectiveness and efficiency as the result. The research focused on the key components of internal control systems namely control environment, risk assessment, control procedures, information and communication and finally monitoring. The study explored the designs of the respective sectors to find out their similarities and differences. Data of this study was collected by questionnaires and focused group discussion. The data collected was analysed by use of descriptive and inferential statistics. The findings revealed that the private sector has a stronger internal control system than the public sector across the board. However, there is no major difference in monitoring and control activities between the public and private sectors, and the public sector even includes stronger aspects of preventative controls.

#### 4.1 METHODOLOGY

This study was employed a descriptive research design. As argued by Kumer (1999) descriptive research design is used to describe the nature of the existing conditions. Seyoum and Ayalew (1989) also agreed that "descriptive survey design is the more appropriate to gather several kinds of data in a broad size to achieve the objectives of the study". In the same line of argument, Best and Kahn (2003) have argued that descriptive design is concerned with conditions or level of performance that exist, opinions that are held, process that are going on, effects that are evident or trends that are developing.

This study focused on three commercial private banks which were Dahabshiil Bank, Premier Bank and Salaarn Somali Bank in Mogadishu Somalia. The target population of this

study was 110 participants which includes financial directors, supervisors, chief cashiers, internal auditors and managers of departments. This population is seeking because it possessing an adequate understanding of internal control and also, they are aware of the weaknesses or malfunctions of the financial performance.

The researcher uses questionnaire for collecting data in this study. The rationale for choosing questionnaire was guided by the nature of data to be gathered, the time available, as well as the objectives of this study and data analyses with the help of the statistical program SPSS 25.

#### 5.1 SUMMARY OF FINDINGS

This study was guided by four objectives; to describe the effect of control activities on financial performance of commercial banks in Mogadishu Somalia. To examine the effect of control environment on financial performance of commercial banks in Mogadishu Somalia. To determine the effect of Risk Assessment on financial performance of commercial banks in Mogadishu Somalia. To evaluate the effect of information and communication system on financial performance of commercial banks in Mogadishu Somalia.

On the major findings of background of respondents, this study indicates that the gender of 72.1% of the respondents were male, while the other 27.9 % of them were female. The researcher indicates that the majority of the respondents were male. And also, according to the age of respondents the result of this study shows that the age of 36.0% of the respondents were between 26-35, 31.4% of them were between 36-45 years, 20.9% of them were between 18-25 years on the other hand 11.6% of them were above 46 years old. That means according to age of respondents the major of respondent were between 26-35 years old. However according to marital status of respondents, this shows that most of the respondents 77.9% were marriage, while 22.1% were single. This indicates that the majority of the respondents were married. While the result of respondent's educational background shows the most of respondents of this study 59.3% were Bachelor level, 29.1% were Master level, while 11.6 were diploma. so, the researcher indicates that the most of respondents were bachelor level so the most of respondents are bachelor. However according to the experience of respondents the research shows the most of respondents of this study 54.65% were above two years, 23.26% were



one year, and 12.79% were two years and 9.30% were less than one year. So, the researcher indicates that the most of respondents were above two years. So, their most of respondents were more than two years experiences.

On the major findings of risk assessments of commercial banks in Mogadishu. The results indicated that the variable risk assessments total average 3.96 which indicated very good. First this study found out there is appropriate organizational objectives 4.15 which indicated very good. Second this study also found out the banks identify the risks that affect achievement of the objectives in a timely manner 4.08 which indicated very good. The study also found out bank has a criterion for ascertainment of the risks that are most critical to the organization 4.06 which indicated very good. The study also reveals bank has in place mechanisms of mitigating critical risks that may arise during the course doing business 3.83 which indicated very good. There is frequent escalation and reporting of bank's departmental risks to the management to assist in solving early enough before it develops to loss 3.69 which indicated very good.

On the major findings of communication and information system of commercial banks in Mogadishu the result of variable of communication & information system total mean is 3.94 which indicated is very good. First this study found out commercial banks have effective communication that helps to evaluate how well guidelines and policies of the bank are working and being implemented 4.29 which indicated very good, and also there is reporting system on organizational structures spells out all the responsibilities of each section/unit in the bank 4.24 which indicated very good. However, this study found out Management has identified individuals who are responsible for coordinating the various activities within the bank to ensure appropriate communication on internal controls 3.84 which indicated very good. This study reveals all employees understand the concept and importance of internal controls, including the division of responsibility 3.78 which indicated very good. And also, this study found out sufficient information is identified and communicated in a timely manner to enable people perform their responsibilities 3.59 which indicated very good.

According to major findings of control activities of commercial banks. The results indicated that the variable control activities total average 4.02 which indicated Very good. First this study found out the commercial banks have clear

separation of duties 4.17 which indicated very good. and also, all changes to employee status or pay rate are duly approved by an appropriate official 4.09 very good. This study also found out there is adequate controls over information systems 4.07 which indicated very good. This study found out Staffs are trained to discharge their responsibilities diligently 4.02 which indicated very good. However, this study found out there is adequate control over access to resources belonging to the bank 3.76 which indicated very good.

On the major findings of control environment of commercial banks, the result of variable of control environment total means 4.04 which indicated very good. First this study found out the banks have clear organizational structure 4.18 which indicated very good. second the policies, procedures and guidelines are documented 4.12 which indicated very good. And also, all employee is aware of the guideline 4.04 which indicated very good. the study all found out All staffs perform their responsibilities as per the regulation and guideline 4.01 which indicate very good. And also, this study reveals Compliance to bank guidelines can lead to reliable financial reporting 3.86 which indicated very good.

According to major findings of financial performance of commercial banks. The result of variable of financial performance total average 3.79 which indicated Very good. first the study found out that the commercial banks in Mogadishu has enough cash to meet its obligations effectively 4.16 which indicated every good, and second that the accountability process is adequate in the banks 3.89 which indicated every good. The study further reveals that Problems of outstanding cheques are solved in time to reconcile the Bank balance of an account and book balance of the customer 3.74 which indicated every good. However, it was also found that a good financial performance measure should ask how well the firm has generated operating profits, given the amount of capital invested to produce those profits 3.62 which indicated is every good and also financial performance is the measurement of the results of a firm's policies and operations in monetary terms 3.57 which indicated is every good.

Lastly. The result in the above table shows the relationship between financial performance and control environment is positive ( $r=0.757$ ,  $p=0.000$ ) and statistically significant. this implies that an improved financial performance is associated with an increase in control environment. The study



results also found out there is positive relationship between financial performance and risk assessment which statistically significant ( $r=0.631$ ,  $p=0.000$ ). the correlation findings further showed that there was positive correlation between financial performance and information & communication system which was significant ( $r=0.623$ ,  $p=0.000$ ). meaning that these variables tend to increase together that is, increase financial performance is associated with increase in communication and information system. Findings also showed a negative correlation between financial performance and control activities which was statistically insignificant ( $r=-0.012$ ,  $p=0.876$ ).

## 6.1 CONCLUSION

According to the study's findings, banks have an effective internal control system, which is backed by the study's findings of clear separation of roles, adequate controls over access to bank resources, and a clear organizational structure. However, there are adequate controls over information systems. There is also compliance to bank guidelines that can lead to reliable financial reporting. There is good risk management and effective communication system in commercial banks.

On the financial performance of commercial banks in Mogadishu, the study concludes that the liquidity position of commercial banks in Mogadishu is appropriate, with details provided directly in the study, even though the study reveals that the accountability process of commercial banks in Mogadishu is adequate.

The final conclusion of this study is that the internal control system has positive significant relationship to commercial Banks's financial performance.

## 7.1 RECOMMENDATIONS

This study recommended that banks effectively build and maintain internal controls because of the banking sector's riskiness and impact on the country's economic growth. As a requirement of Corporate Governance, banks must have an independent Board of Directors and its committee. Furthermore, each bank branch should have its own independent audit department to help with the implementation of internal controls.

And also, this recommended the Banks should have an information system in place that enables for the timely, relevant, and reliable transmission of information to stakeholders, as

well as the free flow of information between management and employees. Integrity and competence should be improved, and ethical norms in decision-making should be adhered to. Managers must first and foremost guarantee that their banks have a culture of mutual trust. Banks should establish and organize regular seminars and workshops to train their management and employees in finance, accounting, and internal audit departments on internal controls, policies, and procedures in order to strengthen their professional abilities and practices.

Lastly this study recommended to improve commercial banks' financial performance, the owners and managers of commercial banks should design an effective professional competency framework, such as such as alternative ways of following audit ethics, that makes professional competency simple and flexible.

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