

Contingency Characteristics of A Manufacturing Company: Predictors of Internal Control System and the System's Relationship to Organizational Performance

Czarina Joyce G. Castro, Camille Iane F. Del Mundo, Katherine Anne V. Molina,
Bernadette Baran
Bachelor of Science in Accountancy

ABSTRACT

To keep up with the trend in this ever-changing world, businesses must have a mindset of continual improvement. The rapid pace of change in rules, standards, and laws adds to the complexity, prompting businesses to consider internal control implementation. This research aims to give manufacturing companies a clear understanding of how important contingency characteristics are when implementing an Internal Control System. This way, the companies can implement and focus only on creating and implementing relevant controls in the operations resulting in better organizational performance. The study was guided by the objectives of determining the predictors that have an impact on the Internal Control System through the use of Contingency Theory and determining if there is a significant relationship between the Internal Control System to the organizational performance. With this, the researchers made use of a quantitative approach to collect data. The researchers gathered data from 30 employees under the Finance Department of a Batangas-based manufacturing company through Google forms. The result of the study concluded that the main predictor of an Internal Control System is a strategy being present in four out of the five Internal Control System components. It is further determined that there is a significant relationship between the internal control system and organizational performance.

Keywords: *contingency characteristics, internal control system, organizational performance, predictors, significant relationship*

INTRODUCTION

In this changing world, businesses should have a spirit of continuously improving to be able to cope with the trend. The pace of changes in rules, standards, and regulations has its complexity that makes companies look closer to the internal control implementation. As such, businesses should reassess if their Internal Control System was able to help in the efficiency and effectiveness of operation that can lead to accurate financial reporting. This Internal Control System varies according to the nature of the business. According to the paper of Sukarma, Hendra, Effendi, and Mohamad (2020), before a manufacturing company can pursue efficiency and adaptability, it should first improve its capability on effectiveness. An effective Internal Control System helps management achieve the three main objectives in connection with the measurement of organizational performance such as operating in an effective and efficient manner, reporting financial information that can be relied upon, and complying with any laws and regulations governing the business.

Committee of Sponsoring Organizations (COSO) Framework helps management as to the conclusion of what really is an effective internal control; the five components of internal control and the principles relevant must be functioning and present. Functioning and present Internal

Control System can imply that the management has successfully minimized deficiencies as long as its aggregation did not result in a major one (COSO Framework, 2013). However, one of the most difficult deficiencies to minimize is fraud where there is connivance in the management, just like the Enron Scandal. The chain of command that is supposed to provide reasonable assurance on the reliability of financial reporting is the one tampering with the documents for their own benefit. Such Financial Scandal led to the creation of the Sarbanes Oxley (SOX) Act of 2002, which imposed new rules for accountants, auditors, and top management officers when it comes to record-keeping.

Regardless of the strength of reliance the management allots to the internal control structure, there is no assurance that the controls alone can achieve the maximum efficiency and effectiveness of the company in achieving its goals. One should also take into consideration the management style that the company adopts. One of the common management styles is the Contingency Theory, where effective leadership style evolves around creating good rapport as well as interpersonal relationship (Abba, 2018). This type of management style will depend on the organizational structure of the company, its perception of uncertainties in its environment, and its strategy. The Internal Control System as mentioned in the COSO framework presents a standardized structure and objectives for internal control. However, it still varies depending on the firm's characteristics. With this in mind, it is only appropriate to have a plan that will consider a lot of factors before implementation. Implementing internal control without considering the contingent characteristics of the organization may result in administering controls that do not add value or improve the organizational performance. Therefore, it will only be costly as it lacks the benefits that an effective internal control should give. This study will give the organization an opportunity to improve the system it has.

Review of Literature

Various Internal Control Systems are adopted by multiple companies depending on the unique characteristics they possess. The following operational descriptions for each variable are provided.

Internal Control System

As the globalization in the market continues and business models changed significantly, COSO Framework has to be reviewed and updated to be able to retain its relevance.

As defined by Philippine Standards on Auditing (PSA) 315, Internal Control is a process impelled by the entity's management and other employees with the purpose of delivering reasonable assurance in accordance with the achievement of compliance, operation, and reporting, which is the primary objective. In support of this, the study conducted by (Jay Tee Suleiman, 2018) states that organizations that invest to ensure that they have effective internal control have led to a more improved financial performance if it will be compared to those organizations who do not focus much on internal control systems.

The internal control components will help organizations achieve the primary objectives as to compliance, operation, and reporting that will lead to an excellent organizational performance as long as the entity's management will be able to determine what controls are applicable to their organization.

Control Activities

Control Activities are the guidelines, procedures, and policies of entities that can aid to ensure that the directives of management as to the response to reduce identified risk are being carried out. The design and implementation of control activities vary from the organization as it depends on the risk identified in the process of risk assessment. Authorization, segregation of duties, verification, etc. are the common control activities of entities.

Risk Assessment

Risk is the possible threats the entity might encounter that will hinder the accomplishment of objectives. Risk assessment is the way an organization identifies and analyzes risk to be able to prevent it; if possible, to meet with the objectives of the entity. Preventing risk is not always possible; in such cases, accepting, reducing it to an acceptable level, or avoiding it are the choices the management can make. To be able to achieve the objectives, ensuring that each risk was assessed and handled properly should be the primary focus of the organization.

Information and Communication

Information and Communication is the exchange of information among people in the organization in a timely manner to support decisions; as well as communication with outside parties such as regulators, suppliers, and customers. Information should be communicated in a timely manner for the responsibilities to be carried out effectively that can allow management to identify and detect anomalies in the operation.

Monitoring

Monitoring is the assessment and evaluation of the organization's implementation of control as to whether it is operating in the way the management intends them to. If the assessment of the current internal control is deemed to be ineffective; the management should modify the control that still causes deficiency. Monitoring must be done with quality assurance of the organization to be able to achieve the objectives and its purpose.

Control Environment

Control Environment is the basis of the other four components because it arranges how the top management establishes internal control in accordance with the style, philosophy, attitude, morale, competence, ethics, and integrity of the people in the organization. It is important that those charged with governance participate in the internal control system as they should be set as an example to the employee on how serious the controls are. One example of control in this

component is knowing who the right person is to report to in the organization as this limit the chance of overriding the result.

Contingency Characteristics

In general, Contingency Theory says that no widely recognized organization model adequately describes the company's control system, thus each system is dependent on contingent elements or variables relevant to the firm's circumstances. According to previous literature reviews on Contingency Theory (Otley, 2016), various contingent variables such as strategy, environmental uncertainty, and organizational structure create the different elements of a control system. These variables form the Internal Control System of an organization. This theory was developed by Fred Fiedler, a scientist who examined the psychology and qualities of leaders, during the mid-1960s.

Strategy

Depending on the categorization of the strategy employed, strategy has been speculated to impact control system design in a variety of basic ways. A business strategy, according to Chen et al. (2016), is a key driver of both material flaw auditor assessment and viable business. The Internal Control System of organizations varies depending on the applied strategy they have as it changes the behavior, flow, and treatment they have with their system. These competitive strategies were classified into four categories based on Miles and Snow's original typology, which is a descriptive and normative method for categorizing businesses that have been further examined by various academics (Ingram et al. 2016; Heiens et al., 2018; Shoham & Lev 2015) in other sectors. According to Miles and Snow (1978), there are four strategic types and are the analyzer, prospector, defender, and reactor. The Reactor was considered the weakest of them all as it lacked consistency. Prospectors concentrate on innovation, the creation of new markets, and the restriction of uncertainty (Zohreh, 2017). They are usually decentralized and have more powerful control mechanisms. Defenders, on the other hand, focus their creative efforts on process concerns, stressing cost control in a stable environment. Lastly, Analyzers are considered to contain the best qualities of both defenders and prospectors (Otley, 2016). As stated by Bouhelal and Kerbouche (2016), the strategies mentioned had their own distinct control features that affect the company's environment. These control features dictate the success of the company's operations and performance.

Environmental Uncertainty

The environmental uncertainty has risen throughout time, in part because of the global economy's development and greater competitiveness (Otley, 2016). It is a major issue that the firm must address in its operations and management because it will affect the distribution of business resources and cause duplicate resources to flow to business activities that are critical to success (Tang & Wang, 2017). When there is more uncertainty, the control system becomes more critical. The high level of uncertainty in the environment makes it difficult for investors to observe specific operating management activities in enterprise management, and self-seeking

behavior by management can lead to inefficient investment, lowering enterprise performance and increasing agency costs, supporting the hypothesis of managerial ownership. The appropriate strategy will enable the firm to not just react to or adapt to changes in the environment, but also to generate change proactively (Djharuddin et al., 2018). To keep their Internal Control System up to date, companies should continually evaluate the dangers that exist in the environment, and what matters the most is how they respond to these uncertainties.

Organizational Structure

An internal pattern of responsibilities, communication, authority, and connections is referred to as organizational structure (Jokipii, 2017). To ensure that every department has equal power in the business cycle, organized structures are implemented. Effective governance promotes profitability, improves stability, and supports corporate growth by ensuring Internal Control System (Shabri et al., 2016). These internal controls are implemented based on the company's organizational structure. They can be centralized or decentralized. In a centralized environment, decision-making power is distributed at high levels, minimizing the need for monitoring, and regulating activities during the decision-making process (Dawson, 2015). On the other hand, under decentralized organizational, several people with different viewpoints on a business issue might generate issues. Hence, when it comes to making decisions, keeping them on the same page is difficult to handle. Owners can change their organizational structure depending on the company's growth and needs (Vitez, 2019). So, the company must choose wisely what kind of organizational structure they will implement since it has a direct beneficial influence on the company's performance (Nikpour, 2017).

Theoretical Framework

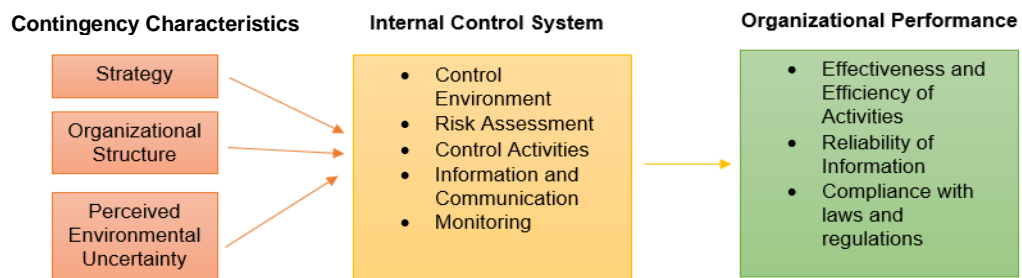


Figure 1. Conceptual Framework

Adapted and modified from Jokipii, A. (2017). Determinants and consequences of internal control in firms: a contingency theory-based analysis. Journal of Management & Governance, 14(2), 115–144.

Figure 1 shows how the contingent characteristics influence the Internal Control System of an organization in attaining the company's objective of having the best possible organizational performance. It is based on the COSO framework and Contingency Theory mentioned above.

Once the Internal Control System has been established by the company, the organizational performance of the company will then be assessed. Internal control must be tightly enforced to keep the company running smoothly and efficiently resulting to an outstanding organizational performance. Hence, this research examines which among the three contingent characteristics affect the Internal Control System of the company and determines whether their organization performance has a significant relationship to their Internal Control System.

Objectives of the Study

This study aimed to determine which among the contingency characteristics are the predictors of the Internal Control System, and the system's relationship to organizational performance. Specifically, this study aimed to achieve the following: (1) to determine the contingency characteristics in terms of strategy, environmental uncertainty, and organizational structure; (2) to determine the Internal Control System in terms of control activities, risk assessment, information and communication, monitoring, and control environment; (3) to determine the organizational performance in terms of efficiency and effectiveness of activities, reliability of information, and compliance with laws and regulations; (4) to determine which among the contingency characteristics are predictors or have an impact on the Internal Control System; (5) to determine if there is a significant relationship between the Internal Control System and organizational performance; and (6) to provide recommendations to improve the company's Internal Control System based on the results of the study. As a result, each company can select the most appropriate control system for their business based on the predictors or the contingency characteristics.

METHODOLOGY

The researchers used the quantitative method of gathering data to determine the company's contingent characteristics, internal control, and organizational performance.

The data was gathered with the help of a modified survey questionnaire. The analysis of data was divided into three (3) computations which were computed using the SPSS software. The researchers used a 4-point Likert Scale, 4 as Strongly Agree and 1 as Strongly Disagree. Weighted and Composite mean, Regression analysis, and Spearman Rho were used to analyze the data that will be taken from the respondents' answers. For determination of each variable under objectives one to three, weighted and composite mean were used. Regression analysis, on the other hand, concentrates on the independent variable changes that might affect the dependent ones and it was used for the fourth objective. For the fifth objective, Spearman Rho was used. It is a measurement used to assess the relationship between two variables.

RESULTS AND DISCUSSIONS

Table 1 shows that strategizing had the highest composite mean among all other contingency characteristics. Companies implemented strategies to have a concrete plan in achieving their objectives. The result was supported by the study that discussed finance as a significant factor in strategizing as it would be involved when identifying and allocating resources,

analyzing returns and maximizing the company's net present value (Ekpo, Etukafia, & Udofot, 2018). Organizational Structure, on the other hand, depicts its importance in implementing internal control system as it resulted to a 3.50 composite mean. A formal orientation program for new hires got the highest weighted mean on the said component. Employees who go under practical new employee orientation have less role uncertainty and conflict as awareness was imposed, as supported by Raub, Borzillo, Perretten, & Schmitt's (2021) study.

Table 1. Determination of Contingency Characteristics

Contingency Characteristics	Composite Mean	Interpretation
Strategy	3.64	Strongly Agree
Organizational Structure	3.50	Strongly Agree
Environmental Uncertainty	3.31	Agree

Notes: 1.00 – 1.49 Strongly Disagree; 1.50 – 2.49 – Disagree; 2.50 – 3.49 – Agree; 3.50 – 4.00 Strongly Agree

Lastly, environmental uncertainty refers to the challenge of predicting the future with a high degree of accuracy. Manufacturing companies faced challenging business environments marked by rapid technology development and increased global rivalry, according to Krishnan, Geyskens, & Steenkamp (2016). The supplier's behavioral uncertainty had the highest weighted mean on the said component. Their actions tend to concern companies, affecting their resources, operations, and budget. According to Jokipii (2017), the environmental uncertainty and prospector strategy were the most important contingency variables. This means that unpredictability in the environment is important to consider while putting in place an internal control system to prevent risk and be ready for changes. The three variables mentioned above were all significant, but there are still certain variables that are noticeable depending on the internal control system the company has.

Table 2 demonstrates how crucial monitoring was in the installation of internal controls in a company. As a result, management should continue to develop internal controls in line with the suggestions made by the internal and external auditors in order to address the inadequacies discovered as soon as possible (Awen, B.I., et al., 2018).

Table 2. Determination of Internal Control

Internal Control Components	Composite Mean	Interpretation
Control Activity	3.44	Agree
Risk Assessment	3.41	Agree
Information and Communication	3.36	Agree
Monitoring	3.49	Agree
Control Environment	3.36	Agree

Notes: 1.00 – 1.49 Strongly Disagree; 1.50 – 2.49 – Disagree; 2.50 – 3.49 – Agree; 3.50 – 4.00 Strongly Agree

Table 3 indicates that efficiency and effectiveness of activities has the highest mean among all other organizational performance components. Employee participation in the procedures that would aid the company in achieving its operational objectives is highly desired. According to Cojucaru and colleagues' study from the year 2021, proactive managers are able to maintain strong staff morale, which encourages productivity and effectiveness to increase inside the business. The managers will now assess the organization's compliance with the enacted rules

and regulations that demand the functioning of their industry once they have offered a clearer picture of how the employees would be able to contribute to the organization's aim. According to Oktyawati (2019), effective internal controls motivate employees to perform their tasks more meticulously and attentively, which enables them to generate and present financial statements that are more trustworthy. An organization must guarantee the correctness and reliability of the data after following to the rules and regulations that apply to their sector in order to provide both its internal users and outside users trust in the report.

Table 3. Determination of Organizational Performance

Organizational Performance Components	Composite Mean	Interpretation
Efficiency and Effectiveness of Activities	3.32	Agree
Reliability of Information	3.20	Agree
Compliance with Laws and Regulations	3.31	Agree

Notes: 1.00 – 1.49 Strongly Disagree; 1.50 – 2.49 – Disagree; 2.50 – 3.49 – Agree; 3.50 – 4.00 Strongly Agree

Table 4 presents the predictors of the internal control system components and their corresponding sig. value. Control activities are actions outlined in standards, procedures, and many other documents that help manage risks to guarantee the project's success. Depending on the company's goals as they relate to its plans and strategies, these control actions change. similar to how businesses plan and separate their staff and organizational structure to reduce the chances of employee and management fraud (Rentor et al., 2018). Gitman et al. (2018), who explored how power fluctuates based on the degree or position the person has, endorsed it. Employees may find it difficult to determine who they should report to if there is no formal organizational structure in place, therefore organizational structure is advantageous since it clarifies their job description and accountability.

The risk is another element of the internal control system. Risks can impact a company's performance since they might impede operations, result in poor production quality, and have a smaller potential payoff. Three methods are frequently employed to manage risks, according to Aven (2016). These include risk-informed, preventive or cautionary, and argumentative or discursive tactics.

Table 4. Predictors of Internal Control System

Dependent Variable		Predictors	Sig. Value
Control Activities	R = .756 R Square = .571	Strategy	0.012
		Organizational Structure	0.005
Risk Assessment	R= .672 R Square = .452	Strategy	0.007
		Environmental Uncertainty	0.044
Information & Communication	R= 0.733 R Square = .537	Strategy	0.010
		Environmental Uncertainty	0.003
Monitoring	R = .665	Organizational Structure	0.008

	R Square = .442		
Control Environment	R=.623 R Square = .388	Strategy	0.023

Note: Predictor if the Sig value is less than 0.05 level of significance

Another Internal Control System component is the monitoring activities which are done periodically or continuously to ensure all five components of internal control are working. Monitoring activities include managing and monitoring people, promoting communication and coordination inside the operations function between the organization's other business functions. Once a company uses a different organizational structure, it will adopt a different monitoring style depending on its structure. Decision-making power is distributed at high levels, reducing the need for supervision and regulation during the decision-making phase.

The control environment as defined by the 2013 COSO Framework was in accordance with the style, philosophy, attitude, morale, competence, ethics, and integrity of the people. The alignment of strategy and control environment present in the organization shall also be observed to fully utilize the strategic plan of the management. Business strategy is an organization's goal in the long run and how they plan to reach it.

Table 5 shows each factor in the internal control system has a direct relationship with each factor in organizational performance. Having an established and implemented internal control system will help managers reduce risk within their business activities, which can improve the organization's performance. Risk assessment, information and communication, monitoring, and control environments all had compliance with laws and regulations as their highest correlation. This is because the control activities were anchored to the business operation in terms of the policies and procedures that the manufacturing company would implement.

Table 5. Relationship between the Internal Control System

Dependent Variable	Parameters	Correlation Coefficient	Interpretation
Control Activities	Efficiency and Effectiveness of Activities	0.774	Significant
	Reliability of Information	0.647	Significant
	Compliance with Laws and Regulations	0.749	Significant
Risk Assessment	Efficiency and Effectiveness of Activities	0.706	Significant
	Reliability of Information	0.691	Significant
	Compliance with Laws and Regulations	0.726	Significant
Information & Communication	Efficiency and Effectiveness of Activities	0.643	Significant
	Reliability of Information	0.599	Significant
	Compliance with Laws and Regulations	0.725	Significant

Monitoring	Efficiency and Effectiveness of Activities	0.680	Significant
	Reliability of Information	0.686	Significant
	Compliance with Laws and Regulations	0.842	Significant
Control Environment	Efficiency and Effectiveness of Activities	0.731	Significant
	Reliability of Information	0.765	Significant
	Compliance with Laws and Regulations	0.824	Significant

Notes: Correlation is significant at the 0.01 level (2-tailed)

Table 6 indicates the proposed action plans for the improvement of the components of the internal control system that garnered the lowest weighted mean. The recommended action plan's goal is to improve these controls by providing activities to cater to the key area with the lowest weight mean, duration of implementation, people involved, and plan overview.

Table 6. Proposed action plans for the improvement of Internal Control System

Control Environment	Activity is entitled 4R's (<i>Review, Re-assess, Re-align, Revise</i>). Duration: Once a year
Risk Assessment	Activity: PDSS (<i>Professional Development Seminar Series</i>). Duration: Monthly
Information and Communication	Activity: Safety Security and Cyber Security . Duration: Quarterly
Monitoring	Activity: Project Task Tracker System . Duration: At the end of the day or every activity
Control Activity	Activity: Employee Appreciation & Incentive Program . Duration: Monthly

CONCLUSIONS

Strategy had the greatest composite mean of the contingency characteristics. The organization's internal control system predictor would be chosen based on contingency characteristics. Monitoring had the highest composite mean of the internal control system. In terms of the predictors, strategy has been a predictor for four out of the five internal control systems. Only the internal control Monitoring was not anticipated by the plan but rather by the organizational structure. The researchers advise future researchers to undertake the same study, taking into account the respondents' demographics and area of employment. Additionally, by obtaining information from other businesses and using both qualitative and quantitative research methodologies, such as focused group talks in addition to survey questionnaires, the study may be enhanced.

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