

Internal Control Activities and Risk Assessment Effect on the Operations of Quoted Banks in the Nigerian Stock Exchange

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ABSTRACT

Banks are more likely to fail from operational risk than from credit risk, and internal control at banks create operational risk losses. This study investigated internal control activities and risk assessment on operational risk of quoted banks in Nigeria. 16 quoted banks from 2013-2020 were studied based on the 2012 banking reform on corporate governance by the then CBN governor Sanusi Lamido Sanusi's "Project Alpha Initiative" (PAI). The analysis carried out included pooled OLS regression, fixed and random effect and Hausman tests utilizing E-View 9 software. The findings showed that internal control activities has a negative correlation and internal control risk assessment has positive significant effect on operational risk. The researchers therefore recommend that internal check of staff at banks should be sustained as there was an inverse relationship between internal check and operational risk at banks. Penalties should be spelt out for banking staff who are non-compliant with bank policies and guidelines especially in the area of breach in software codes. Banks should ensure that internal control unit personnel are qualified and adequately trained especially IT staff.

Keywords: Internal Control, Control Activities, Risk Assessment and Operational Risk

INTRODUCTION

An internal control activities as part of the internal control system of an organization is designed and established by the management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the completeness and accuracy of the records [1, 2, 3, 4, 5]. Internal control activities is the backbone of every company and the successful attainment of the goals of most companies depends upon the effectiveness of their policies and internal control system. The lack of an internal control activities which duty is to keep the risks or major breakdowns within an existing internal control system under

control pose a threat against the success of the banking sector [6, 7, 8, 9, 10]. One of the main reasons for banking failures which results in major financial loss and even bankruptcy is high risks taken by bank management on an excessive scale and inability of controlling them. The lack of an internal control system which duty is to keep the risks or major breakdowns within an existing internal control system under control pose a threat against the success of the banking sector. These operational risk has risen drastically in recent times.

According to [11, 12, 13, 14] Banks are more likely to fail from operational risk than from credit risk. It is believed that internal control at banks create

operational risk losses, and many institutions with such losses are repeat offenders [15, 16, 17].

Due to recent financial scandals and economic crisis, banking sector all across the globe has become vulnerable to fraudulent actions, rising uncertainties and development of more instruments have pressurized the banking organizations to look for the appropriate internal measures to transform their business organization as risk and uncertainty proof. Control activities are policies and procedures that help ensure that management directives are carried out, [18]. Control activities are the actions supported by policies and procedures that help assure management directives to address that risks are carried out properly and timely. According to [19] control activities include range of tasks such as approvals, authorizations, verifications, reconciliation, and review of operating performance, security of assets and segregation of duties. [20], has categorized control activities as adequate separation of

duties, proper authorization of transactions and activities, adequate documents and records, physical control over assets and records and independent checks on performances. The banking sector consolidation exercise of 2004/2005 had some salutary impact on the Nigerian economy and led to the emergence of bigger banks which, before the global financial crisis, created a general belief that the banking sector was sound and growth would be encouraged. However, this sentiment proved misplaced following the outbreak of the global financial and economic crises of 2008/2009 and some interdependent factors that led to the manifestation of an extremely fragile financial system. These Internal control weaknesses are revealed in operational losses in banks. The main objective of this study is to investigate the effect of internal control activities in curbing operational risk of quoted banks in Nigeria. This research work is anchored on Contingency theory.

EMPIRICAL REVIEW

[21], analyzed the risk disclosure of publicly listed Italian companies and argues that the quantity of disclosure is not a good proxy for the quality of disclosure, and that researchers need to focus on what is disclosed and found that companies disclose information about company strategy, financial structure of the company, and business processes. Much of the information does not explain how the risk might affect company performance, and when this is discussed, it is mainly how the company could be affected positively. Voluntary disclosure was used to discuss management's thoughts and expectations rather than risk-management actions taken for the future. [22], in their work Optimal versus realized bank credit risk and monetary policy. They utilized Regression analysis to study data gotten from USA listed Banks. Their findings were that optimal leads the business cycle. In good periods it is above the realized level while in periods of stress it is below. The optimal monetary policy in smoothing business cycles always leads to

an increase in the gap between the optimal and realized risk.

Abdullah, [23]. A Comparative study of Credit Risk Management: a case study of domestic and foreign banks in Pakistan. The paper evaluates firm's level aspects which have more influence on the Credit risk managing of domestic and foreign banks in Pakistan. Secondary data for the period of 2001 to 2010 is used, taken from various data sources. Augmented Dickey Fuller test is used for checking stationary, while for long run relationship Johansson's Co integration test is used. Linear regression model is used for coefficients analysis with OLS techniques. The result of R2 shows that the model is best fit for both Domestic and Foreign banks. Bank size have positive and significant relationship with credit risk in domestic banks and positive and insignificant in foreign banks. Liquid assets and credit risk have positive and insignificant relationship in domestic banks and negative and significant in foreign banks. [24], in their theoretical research on Risk management, capital

structure and lending at banks, found that banks that rebalance their loan portfolio exposures by both buying and selling loans - that is, banks that use the loan sales market for risk management purposes rather than to alter their holdings of loans - hold less capital than other banks; they also make more risky loans (loans to businesses) as a percentage of total assets than other banks. Holding size, leverage and lending activities constant, banks active in the loan sales market have lower risk and higher profits than other banks. [25], carried out a study to establish the impact of internal control design on banks' ability to investigate staff fraud and staff lifestyle and fraud detection in Nigeria. Data were collected from 13 Nigerian banks using a four point likert scale questionnaire. The study found that internal control design influences staff attitude towards fraud such that a strong internal control mechanism is deterrence to staff fraud while a weak one exposes the system to fraud and creates opportunity for staff to commit fraud. In a similar study on the impact of internal control system in the banking sector in Nigeria. [26], used descriptive and inferential statistical methods on data obtained on some banks in Nigeria. He concluded that the function of fraud prevention, detection and control are interwoven. He stated that the three work together to eliminate fraud and fraudulent tendencies and that internal control is highly significant in fraud detection and prevention in the Banking sector in Nigeria. [27], in his research on effectiveness of internal control system and the issues of independent and confidentiality in an organization, used survey method of data collection, aiming to generate and reliable data for the study. A simple percentage method was used to

analyze the data. The result obtained shows that, there is a significant relationship between internal control and external control system and confidentiality in business and public organization. [28], examined Internal Control Information and Communication effect on Operational Risk of Quoted Banks in Nigeria. The analysis carried out included pooled OLS regression, fixed and random effect and Hausman tests to determine the most suitable model for result interpretation. This was conducted with the aid of E-View 9 software. The findings shows that feedback-FDB, feed forward-FDF, time lag-TLG, bank size-BKS and leverage-LEV were all insignificant at P value greater than the level of significance of 0.05 with a positive coefficient value for each except for FDF and BKS that had a negative coefficient value. [29], investigated Risk Assessment of Internal Control System and its effect on the Operations of Quoted Banks in the Nigerian Stock Exchange using Regression to analyse panel data in E-views7 software. The findings showed that The independent variables: employee turnover-ET, personnel quality-PQ, bank size-BKS and leverage-LEV were all insignificant at P value greater than the level of significance of 0.05 with a negative coefficient value for each except for leverage (LEV) that had an insignificantly positive coefficient value [30]. Studied the effect of Internal Control Environment on Operations of Quoted Banks in Nigerian included pooled OLS regression, fixed and random effect and Hausman tests conducted with the aid of E-View 9 software. The findings shows a positive coefficient value for some external environment proxies and a positive coefficient value for some of the proxies of the internal environmental factors.

METHODOLOGY

The ex-post factor design type was used in this research work because it deals with historical facts and is designed to test an event that has already taken place [31, 32]. Secondary data was used in this work. The data machinery adopted for secondary data was Panel data set from banks published annual reports, NDIC report,

CBN statistical bulletin, CBN fact books and banks' Pillar III disclosure report was utilized for this study. The panel covers a time frame of 5 years from 2013-2017 and a cross section of 16 banks from the population of 23 commercial Banks quoted in the Nigerian Stock Exchange as at 28 September 2018. However, Heritage bank,

Savannah bank, Sky bank, keystone bank, Enterprise bank, Rand bank and Jaiz bank were eliminated based on availability of data, commencement of operation and Islamic bank with different characteristics from commercial banks. The sample size is justified based on the theory of [33], that a good sample covers at least 10%-30% of the representative population. Thus, at 67% coverage the sample is a fair representation of the population and sufficient for this study. Multiple regression analysis technique was used in this study. Panel data regression model was adopted in order to control for individual unobserved heterogeneity, obtain more accurate results because it

provides more observations and information to work with, it allows a follow up on individual dynamics and before and after effect can be easily estimated [34]. Cross-sectional and time series data are pooled in the regression to overcome the problem of insufficient degree of freedom. The Fixed Effects model (FEM) can be used to control the unobserved characteristics. Random effects model (REM) assumes that firm specific characteristics are not constant and the time effects are absent. The Hausman's specification test in Panel data models was conducted for fixed and random effects test of individual characteristics or time effect.

Table 1: Operational definition of variables

		Variables	Proxy variables
Dependent	Operational Risk:	3 years Gross income @ 15% divided by 3	OPR
Independent	Control Activities	Internal check	ICK
		Compliance and Prudence	CLP
		Internal auditors	IAD
	Risk Assessment	Employee turnover	ET
		Personnel Quality	PQ
Control Variables	Bank Size	Total no of bank in the year	BKS
	Leverage	Debt to total assets	LEV

Source: Author's conception, 2021

We indicate that there are bank-specific and other variables which could affect the dependent variable in one way or the other

and must be controlled. These variables are bank size and Leverage.

Table 2: showing definition of Proxy variables

	Proxy Variables	Derivation	Source	Aproprari expectations
	OPR	3 years Gross income @ 15% divided by 3	Pillar III disclosure of Banks	
Model 1	ICK	No of internal control staff in the year	Adapted from Ellis and Jordi 2016	Positive
	CLP	Compliance and prudence		
	IAD	No of internal audit department members		
Model 2	ET	<u>%No of employee who have left</u>	Pillar III disclosure	Positive
	PQ	%Employees at the beginning of the year + employee at year end/2 No of errors and bugs in software codes		

Source: Author's conception, 2021

Model 1: The effect of control activities on operational risk

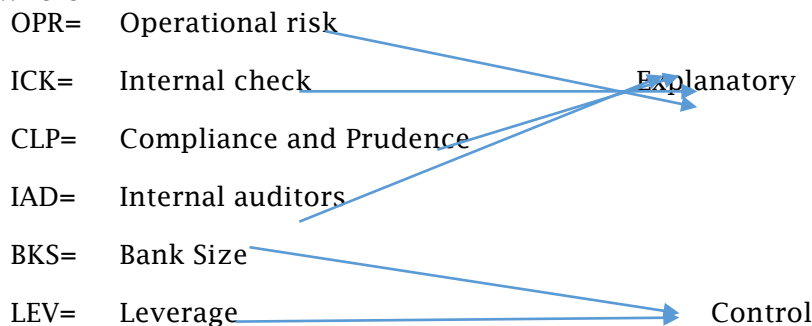
$$opr = f(ick, clp, iad, bks, lev) \text{ -----1}$$

$$opr_{it} = a_{0it} + b_1 + ick_{it} + b_2 + clp_{it} + b_3 + iad_{it} + b_4 + bks_{it} + b_5 + lev_{it} + \epsilon_{it} \text{ -----2}$$

$$opr_{it} = a_{0it} + ick_{it} * clp_{it} * iad_{it} * bks_{it} * lev_{it} + \epsilon_{it} \text{ -----3}$$

$\beta_0, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5$ = coefficients
 ϵ_i = error terms.

Where:



Model 2: The effect of risk assessment on operational risk

$$opr = f(et, pq, bks, lev) \text{ -----1}$$

$$opr_{it} = a_{0it} + b_1 + et_{it} + b_2 + pq_{it} + b_3 + bks_{it} + b_4 + lev_{it} + \epsilon_{it} \text{ -----2}$$

$$opr_t = a_0 + \beta_1 et_t + \beta_2 pq_t + \beta_3 bks_t + \beta_4 lev_t + \epsilon_t \text{-----} 3$$

$\beta_0, \beta_1, \beta_2, \beta_3, \beta_4$ = coefficients

ϵ_i = error terms.

Where:

OPR= Operational risk

ET= Employee turnover

PQ= Personnel Quality

BKS= Bank Size

LEV= Leverage

Explanatory Variables

Control Variables

$\beta_0, \beta_1, \beta_2, \beta_3, \beta_4$ = coefficients

ϵ_i = error terms.

DATA PRESENTATION AND ANALYSIS

Table 3: Descriptive Analysis for Internal Control activities and risk assessment on Operational Risk variable from 2013-2020

VARIABLES		COMMERCIAL BANKS			
		Mean	Max	Min	Std. Dev.
Dependent Variable	Operational Risk	5.38	6.87	4.30	30.09
Control Activities	Internal check (ICK)	56.54	6.00	23.00	40147.89
	Compliance and Prudence (CLP)	0.99	776.00	0.00	124.99
	Internal auditors (IAD)	382.64	137.00	147.00	2428.09
Risk Assessment	Employee turnover (ET) (%)	68.85	14.10	29.00	47670.20
	Personnel Quality (PQ)	7.55	14.10	4.40	314.20

Source: Output generated using Eviews 7

Control Activities is represented by three (3) proxy variables ICK, CLP and IAD explained as follows: Internal Check measured as no of internal check staff showed a mean of 56.54, maximum value of 6.00, minimum of 23.00 and standard deviation of 40147.89. (ii) Compliance with Accounting Principles measured by number of time there was a deviation from accounting principles. It showed an average value of 0.99, maximum value of 776.00, minimum of 0.00 and standard deviation of 124.99. (iii) Internal Audit members measured by total number of audit staff showing an average value of 382.64, maximum value of 137.00, minimum value of 147.00 and standard deviation of 2428.09.

Risk Assessment is represented by two (2) proxy variables ET and PQ explained as follows: (i) Employee turnover measured percentage number of employee who have left divided by the percentage number of employee at the beginning of the year plus percentage number of employee at the end of the year divided by two showed a mean of 68.85, maximum value of 14.10, minimum of 29.00 and standard deviation of 47670.20. (ii) Personnel Quality measured by number of errors and bugs in software codes showing an average value of 7.55, maximum value of 14.10, minimum of 4.40 and standard deviation of 314.10.

Normality Test

Table 4: Result of Jarque- Bera Statistics for the test of normality
VARIABLES COMMERCIAL BANKS

		Jarque-Bera	Prob.
Dependent Variable	Operational Risk	1.59	0.35
Control Activities	Internal check (ICK)	8.09	0.01
	Compliance and Prudence (CLP)	57.48	0.00
	Internal auditors (IAD)	6.38	0.04
Risk Assessment	Employee turnover (ET) (%)	3.94	0.13
	Personnel Quality (PQ)	61.33	0.00

Source: Output generated using Eviews 7

Jarque-Bera test of normality was used to identify the normality of error term. It is tested at 0.05 level of significance. The decision rule is to reject the null hypothesis, when P. value is less than 0.05 level of significance, otherwise, do not reject. The null hypothesis that error terms

are normally distributed is rejected at 5% level of significance for all the variables. Thus, error term is not normally distributed. The variable used in the study lacks normality for selected commercial banks quoted in the Nigerian Stock Exchange.

Test for Multicollinearity

Table 5: Correlation Matrix for test for multicollinearity in Operational Risk (OPR) and Control Variables (BKS and LEV) of the study.

	OPR	BKS	LEV
OPR	0.729393		
BKS	0.065918	0.798290	
LEV	-0.218296	-0.345518	0.747946

Source: Output generated using Eviews 7

The test is conducted to check for suitability of the of the control variables in the model. Bank size and Leverage being control variables were tested for the existence of multicollinearity between variable using correlation matrixes as shown on table 4. The existence of collinearity shows that the regression cannot precisely intercept the influence of independent variable towards dependent variable [28, 29]. High pair wise correlation between two variables means there is a serious multicollinearity problem in the

regression model. The level of high multicollinearity exist when the correlation between two variables exceed 0.8 [30]. The result on table 4 showed correlation matrix for quoted banks. The highest pair wise correlation is 0.79 and the lowest is -0.21. Since it is not more than 0.8, the researcher conclude that the two variables do not suffer from serious multicollinearity and that the model in which the objective of the study is anchored is suitable for regression analyses.

Test of Hypothesis

H₀: Control activities does not have significant effect on operational risk

Decision Rule: If the probability value of the chi-square is greater than 0.05, the estimation will be based on the Random effects model (REM) and if the probability value of the chi-square is less than 0.05,

the estimation will be based on the fixed effects model. (FEM). Based on the above decision rule, fixed effect is the most preferred model.

Table 6: showing the effect of control activities on operational risk

Independent Variables	PLS	Fixed Effect (Preferred Model)	Random Effect
Constant (C)	5.612601* (12.99178)	5.615702* (12.50482)	4.870071* (6.234542)
Internal Check (ICK)	-0.009437* (-2.806589)	-0.009480* (-2.739738)	-0.002051* (-0.354322)
Compliance Principle (CLP)	-0.052043* (-1.033823)	-0.053243* (-1.017637)	-0.005497* (-0.234809)
Internal Audit Dept. (IAD)	0.002038* (0.0000)	0.002037* (4.490175)	0.000942* (0.737127)
Bank Size (BKS)	-0.097963* (0.0570)	-0.097874* (-1.854999)	-0.052716* (-1.269378)
Leverage (LEV)	0.007169* (3.499688)	0.007167* (3.391316)	0.011460* (1.449637)
R-Squared	0.290638*	0.292507*	0.899063*
F-Statistics (Prob.)	(0.000093)	3.215653(0.002575)	26.27619(0.000000)
Durbin Watson (DW)	0.252821	0.248353	1.577831
Hausman Test		157.193595(0.0000)**	2.042970(0.8432)**

Legend: Dependent variable: operational risk (OPR), significant at *1%, **5%

Source: Output generated using Eviews 7

Five variables representing model 3 on the effect of control activities on operational risk were employed to test the hypotheses of this study. From the regression analysis result as shown on table 9 above, it is observed that r^2 for panel least square, fixed effect (preferred model) was 0.29. 29% of the independent variables: ICK, CLP, IAD, BKS and LEV are explained by the dependent variable (OPR). The fixed effect model 157.193595 is preferred because the probability of the Chi Square 0.0000 was less than the level of significance of

0.05%. The coefficient value and probability value of the independent variables: IAD (0.002037: 4.490175) and LEV (0.007167: 3.391316) had an insignificantly positive effect on the dependent variable OPR. While, ICK (-0.009480: -2.739738), CLP (-0.053243: -1.017637) and BKS (-0.097874: -1.854999) had an insignificantly negative effect on the dependent variable OPR. This implies that any increase/decrease in the independent variables will result in an increase/decrease in the dependent

variable. Probability values of the coefficient at 0.1 - 0.7 implies that the regression parameters are significantly different from zero and the probability for

the variables reveal a normal curve. The F-statistics is 3.215653 (0.002575) to show that the coefficient of explanatory variables has a good fit.

H₀: Risk Assessment does not have significant effect on operational risk.

Decision Rule: If the probability value of the chi-square is greater than 0.05, the estimation will be based on the Random effects model (REM) and if the probability value of the chi-square is less than 0.05,

the estimation will be based on the fixed effects model. (FEM). Based on the above decision rule, fixed effect is the most preferred model.

Table 7: showing the effect of risk assessment on operational risk

Independent Variables	PLS	Fixed Effect (Preferred Model)	Random Effect
Constant (C)	6.054713* 12.50767	6.065558* 912.00376)	5.771321* (7.683438)
Employee Turnover (ET)	-0.001527* (-0.547416)	-0.001564* (-0.541901)	-0.000845* (-0.619636)
Personnel Quality (PQ)	-0.112711* (-3.444401)	-0.112860* (-3.353223)	-0.090053* (-1.595204)
Bank Size (BKS)	-0.004921* (-0.081899)	-0.005191* (-0.094551)	-0.040891* (-1.006760)
Leverage (LEV)	0.004921* (2.201661)	0.004929* (2.144093)	0.010973* (1.417564)
R-Squared	0.197572*	0.199011*	0.902741*
F-Statistics (Prob.)	(0.002188)	2.205049(0.036983)	29.31108(0.000000)
Durbin Watson (DW)	0.184976	0.181003	1.549253
Hausman Test		170.341648(0.0000)**	0.526373(0.9709)**

*Legend: Dependent variable: operational risk (OPR), significant at *1%, **5%*

Source: Output generated using Eviews 7

- Four variables representing model 4 on the effect of risk assessment on operational risk were employed to test the hypotheses of this study. From the regression analysis result as shown on table 10 above, it is observed that r^2 for panel least square, fixed effect (preferred model) was 0.19. 19% of the independent variables: ET, PQ, BKS and LEV are explained by the dependent variable (OPR). The fixed effect model 170.341648 is preferred because the probability of the Chi Square 0.0000 was less than the level of significance of 0.05%. The coefficient value and probability value of the independent variables: ET (-0.001564: -0.541901), PQ (-

0.112860: -3.353223) and BKS (-0.005191: -0.094551) had an insignificantly negative effect on the dependent variable OPR. While, LEV (0.004929: 2.144093) had an insignificantly positive effect on the dependent variable OPR. This implies that any increase/decrease in the independent variables will result in an increase/decrease in the dependent variable. Probability values of the coefficient at 0.1 - 0.7 implies that the regression parameters are significantly different from zero and the probability for the variables reveal a normal curve. The F-statistics is 2.205049 (0.03983) to show that the dependent and independent variables has a good fit.

FINDINGS, CONCLUSION AND RECOMMENDATIONS

- Control activities effect on operational risk:** The independent variables: internal check ICK,

compliance and prudence-CLP, internal audit-IAD, bank size-BKS and leverage-LEV were all

insignificant at P value greater than the level of significance of 0.05 and they all had a positive coefficient value for each variables except for ICK, CLP and BKS that had a negative coefficient value. This findings meet the approrari expectation of this study which is a positive coefficient value for control activities.

Internal check staff at banks should be sustained as there was an inverse relationship between internal check and operational risk at banks. Penalties should be spelt out for banking staff who are non-compliant with bank policies and guidelines especially in the area of breech in software codes. Loan-to-deposit ratio which is a proxy variable for compliance and prudence found under the control activities element of the internal control framework significantly should be adequately controlled to reduce operational risk. Internal audit unit/division should be re-evaluated and constantly monitored to reduce the risk from operations.

2. Risk assessment effect on operational risk: The independent variables: employee turnover-ET, personnel quality-PQ, bank size-BKS and leverage-LEV were all insignificant at P value greater than the level of significance of 0.05 with a negative coefficient value for each except for leverage (LEV) that had an insignificantly positive coefficient value. This findings did not meet the approrari expectation of this study which is a positive coefficient value for risk assessment except for leverage which was positive.

Banks should ensure that internal control unit personnel are qualified and adequately trained especially IT staff. Since employee turnover and personnel quality showed an insignificantly negative effect on operational risk, employees who deviate from banking laws should be dismissed in order to reduce risk. Intending staff's previous work experience should be evaluated and investigated as well as record with law enforcement agencies.

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