

# Internal Control and Financial Performance of Small Restaurants

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## Abstract

Businesses are always accompanied by business risks. Restaurants are not an exemption. The implementation of internal control is an option to mitigate risks and provide reasonable assurance of achieving the objectives of a business. Internal control is for any size of an organization but its implementation is affected by factors such as size of the entity and financial capability. The main purpose of this study is to evaluate the internal control and financial performance of small restaurants located in La Trinidad, Benguet. At the same time, it aims to determine the relationship between the quality of internal control employed by small restaurants and their financial performance. Descriptive survey method was used in the study. The study concludes that small restaurants in La Trinidad, Benguet employed high quality internal control and their financial performance in terms of gross profit margin and net profit margin are average. Pearson's correlation coefficient revealed that there is a high positive correlation between internal control quality and financial performance in terms of gross profit margin and net profit margin of small restaurants in La Trinidad, Benguet.

**Keyword:** Internal Control, Small Restaurants, Gross Profit Margin, Net Profit Margin

## Introduction

Establishing a business is one of the good ways to earn profit. Some of the benefits of owning a business includes control over management, flexibility over time and unlimited income. However, anyone who wants to put up a business should consider many factors such as demand. Nowadays, food industry is a trending business. According to Masigan (2019), the Philippine food service industry is expected to generate more revenues for the coming years that is why it is no surprise that everyone wants to put up a restaurant. Another factor to consider in establishing a business especially a restaurant is the location. Accordingly, La Trinidad, Benguet is a promising location for this kind of business. It is regarded as the most developed and fastest growing economy among the municipalities of Benguet. Its tourism is blooming along with Baguio City and other neighboring municipalities making it an ideal location for restaurants.

As enticing as it may be to have a restaurant in La Trinidad, all businesses are accompanied by business risks. Business risks are uncertainties that results from significant conditions, events, circumstances, actions, or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from setting of inappropriate objectives and strategies (Cabarles, Ocampo, & Valdez, 2019). A business cannot survive for long due to these risks if not managed. In the case of restaurants, Masigan (2019) stated that the rate of closure is nearly just as high as the rate of new openings.

To counter risks, the Committee of Sponsoring Organizations (COSO) developed internal control framework to provide reasonable assurance that objectives of the business such as reliability of financial reporting, effectiveness and efficiency of operation, and compliance with applicable laws and regulations can be attained. Implementing internal control is expected to result to good financial performance since it assures effective and efficient operation. As stated by Njeri (2014) in her study, improved financial performance is attained by manufacturing firms that had invested on effective internal control as opposed to those who had weak internal control. Kinyua (2016) agreed that internal control has a significant relationship with financial performance and that internal control system is a positive significant predictor of financial performance. The companies studied by Njeri and Kinyua are large companies who are capable of implementing the overall COSO internal control framework. For small companies, Nyakundai, Nyamita and Tinega (2014) and Umam, Inneh and Ojo (2014) concluded in their study that internal controls significantly influence financial performance of small businesses. However, the study of Oseifuah and Gyekye (2013) revealed that internal control practices among small business sector enterprises is low. This is seconded by the study of Frazer (2012) indicating that majority of the study group perceived small restaurants' internal control system to be inadequate compared to the COSO internal control integrated framework.

The quality of internal control depends on how it is implemented. Mostly, large companies use the full internal control system because it is more appropriate for them than small enterprises. Although the framework is updated to make it adaptable to every size of company, factors such as limited resources, cost consideration and other circumstances limit small companies from fully implementing internal control.

To summarize, internal control affects financial performance of both large and small-medium enterprises. Large companies adequately implement the COSO internal control framework while small companies often do not employ fully the elements of internal control and as a result, failure rates are notably higher for small companies. However, Ireneo, Ireneo and James (2012) argued that although controls of small and mid-size companies may be less formal and less structured, they can still have effective internal control. Question arises now whether internal control as a whole affects the financial performance of small companies' especially small restaurants.

There appear to be no empirical research in the Philippines and in La Trinidad, Benguet on the effect of internal control on financial performance of small restaurants. Hence, there is need to investigate the quality of internal control and effect, if any, of internal control on the financial performance of small restaurants in La Trinidad. Thus, the general objective of this research study is to assess the quality of internal control and the level of financial performance by small restaurants located in La Trinidad, Benguet.

There is a give and take relationship between businesses and the country. In La Trinidad, or any place, tourist destination's view does not provide full satisfaction itself without services provided by eateries. Part of travel experience is the taste and quality of services delivered by food industry within the destination. This means that restaurants are important in promoting tourism. Thus, this study will benefit the existing restaurants, the municipality and the community as a whole.

The findings in this study will help the existing restaurants in assessing their internal control. It will also educate restaurant owners and/or managers who are not familiar with internal control. Knowledge will help in the planning and development of the company. The study will provide a basis also for those who wants to put up a restaurant or other kinds of business. As the saying goes, prevention is better than cure.

The municipality and other concerned government agencies also will have an idea how to help small business to grow and expand in size in order to effectively employ internal control measures to avoid business failures due to inadequate internal control. A successful business will then offer more employment to the community. The success of small businesses will serve as stepping stone in becoming global company. The study will also further the knowledge of the researcher which is very useful in enhancing the quality of his service. The knowledge acquired by the researcher will then be shared to the students, the backbone of a nation. They will be a key in helping restaurants and other businesses to be at their best in the future.

### Methodology

This study utilized the descriptive-survey method. It used a questionnaire to gather data. The questionnaire is divided into six parts. The first five sections of the questionnaire are intended for assessing the quality of each internal control element. They are based on the guidelines in the internal control integrated framework 2013 provided by COSO. The last section is for determining the level of financial performance of the respondents. The data was gathered from 13 restaurants who qualify for the criteria in selecting the population.

The gathered data on the quality of internal control was processed using excel. Weighted means are computed then the results are interpreted. For the purpose of the study, the interpretations presented below were used.

**Table 1: Interpretation of Quality of Internal Control**

Numerical Value	Statistical Limit	Qualitative Value	Interpretations
4	3.25 – 4.00	Always	Very high. The attribute is present and always implemented
3	2.50 – 3.24	Most of the time	High. The attribute is present and most of the time implemented
2	1.75 – 2.49	Sometimes	Low. The attribute is present but sometimes implemented
1	1.00 – 1.74	Never	Very low. The attribute is not present at all

The restaurant industry standard for gross profit margin and net profit margin were used to determine the level of financial performance of the respondents.

Data gathered for gross profit margin and net profit margin is for one year only, specifically 2019 data. Since the study focuses only on relationship of variables, the use of one-year data is deemed sufficient. The use of 2019 data only is also due in part to the limitations in gathering more than a year-old financial data.

For the purpose of the study, the level of financial performance is categorized as above average, average, and below average as illustrated below.

**Table 2: Level of Financial Performance in Terms of Gross Profit Margin and Net Profit Margin of Restaurants**

Level	Gross Profit Margin	Net Profit Margin
Above average	73 % and above	6% and above
Average	65% - 72%	3% to 5%
Below average	64% and below	2% and below

Pearson's Correlation Coefficient. This was used in determining the relationship of internal control quality and financial performance of small restaurants in La Trinidad, Benguet.

The following interpretations were used in analyzing the Pearson's Coefficient result:

**Table 3: Pearson's Correlation Coefficient Interpretations**

Size of Correlation	Interpretation
.91 to 1.00	There is a very high positive correlation between quality of internal control and financial performance of small restaurants
.71 to .90	There is a high positive correlation between quality of internal control and financial performance of small restaurants
.51 to .70	There is a moderate positive correlation between quality of internal control and financial performance of small restaurants
.31 to .50	There is a low positive correlation between quality of internal control and financial performance of small restaurants
.00 to .30	There is a negligible correlation between quality of internal control and financial performance of small restaurants
.00 to -.30	
-.31 to -.50	There is a low negative correlation between quality of internal control and financial performance of small restaurants
-.51 to -.70	There is a moderate negative correlation between quality of internal control and financial performance of small restaurants
-.71 to -.90	There is a high negative correlation between quality of internal control and financial performance of small restaurants
-.91 to -1.00	There is a very high negative correlation between quality of internal control and financial performance of small restaurants

Positive correlation indicates that if the internal control of a small restaurant is effective (ineffective), then its financial performance is also high (low).

Negative correlation indicates that if the internal control of a small restaurant is effective (ineffective), then its financial performance is low (high)

## Results and Discussion

### 1. Quality of Internal Control

**Table 4: The Quality of Internal Control Employed by Small Restaurants**

Internal Control Elements	Weighted Mean (WM)	Interpretation
Control Environment	3.00	High. The attributes are present and most of the time implemented.
Risk Assessment	2.95	High. The attributes are present and most of the time implemented.
Control Activities	3.30	Very High. The attributes are present and always implemented.
Information and Communication	2.89	High. The attributes are present and most of the time implemented.
Monitoring	3.01	High. The attributes are present and most of the time implemented.
<b>Total</b>	<b>3.02</b>	<b>High. The attributes are present and most of the time implemented.</b>

Determining whether an overall system of internal control is effective is a subjective judgement resulting from an assessment of whether each of the five components of internal control are present and whether the five components of internal control are operating together (COSO, 2011). Since the attributes of internal control are present and most of the time implemented as shown by Table 4, it is assessed that the quality of internal control employed by small restaurant in La Trinidad, Benguet is high. The finding aligns with the statement of Frazer (2016) that effective internal controls can still be possible for small entities despite limitations in implementing it. This is a good indicator that the small restaurants may stay in business for long since they implement high quality internal control. However, it is worth noting that both risk assessment and information and communication elements received lower weighted means at 2.95 and 2.89, respectively. These results conformed with the explanation of Public Company Accounting Oversight Board (n.d.) that in small entities, the risk assessment process as well as information and communication process must be present but normally, they are less formal and less structured than in large entities. On the brighter side, the attributes of these elements are present and still implemented by the small restaurants most of the time. It implies that small restaurants who are prone to greater risk because of the nature of its industry can commit to high quality internal control. If small restaurants can, then it is also possible to other businesses.

### 2. Financial Performance

**Table 5: Gross Profit Margin and Net Profit Margin**

Respondents	Gross Profit Margin	Net Profit Margin
Restaurant 1	73%	10%
Restaurant 2	58%	1%
Restaurant 3	72%	5%
Restaurant 4	55%	2%
Restaurant 5	75%	16%

Restaurant 6	60%	4%
Restaurant 7	70%	6%
Restaurant 8	69%	3%
Restaurant 9	64%	3%
Restaurant 10	65%	2%
Restaurant 11	62%	2%
Restaurant 12	70%	5%
Restaurant 13	60%	3%
<b>Weighted Average</b>	<b>66%</b>	<b>5%</b>

Table 5 presents the respondents gross profit margin and net profit margin of the respondents. The weighted average gross profit margin is 66% while the weighted average net profit margin is 5%. Both the indicators of financial performance are within the industry standard. The result is in line with the statement of Masigan (2019) that food industry which includes restaurants is a good business to venture into.

### 3. Relationship of Internal Control Quality and Gross Profit Margin

**Figure 1: Relationship of Internal Control Quality and Gross Profit Margin**

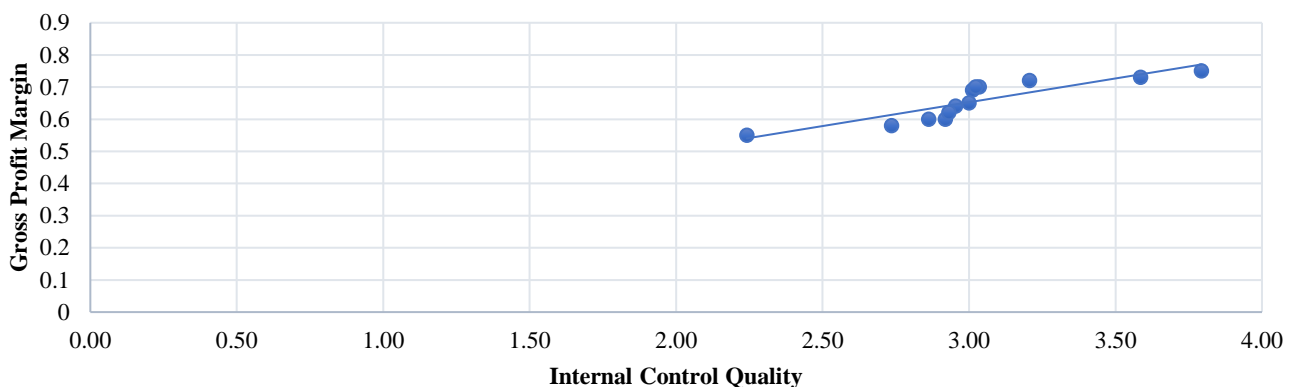


Figure 1 presents the scatter graph that shows the relationship of internal control quality and gross profit margin of the 13 respondents. The graph shows an upward line which demonstrate that there is a positive relationship between internal control quality and gross profit margin. This is validated by the computed coefficient (r) using Pearson's correlation coefficient. The computed Pearson's r is equal to 0.87 which means that there is high positive correlation between quality of internal control and financial performance of small restaurants in terms of gross profit margin. The relationship between internal control quality and gross profit margin is positive in such a way that if there is an increase in internal control quality level there is also an increase in gross profit margin.

## 4. Relationship of Internal Control Quality and Net Profit Margin

**Figure 2: Relationship of Internal Control and Net Profit Margin**

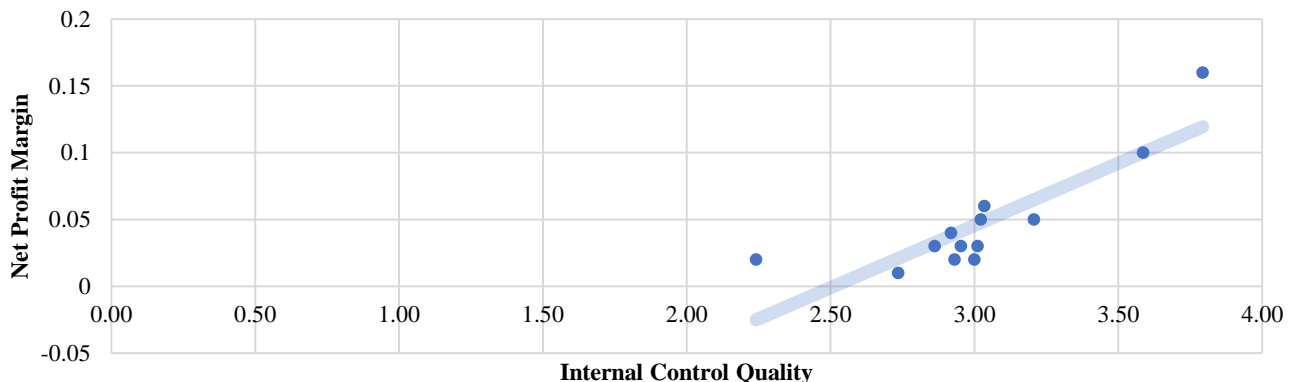


Figure 2 is all about the graphical presentation of the relationship of internal control quality and net profit margin of the respondents. The line is upward which implies that there is a positive relationship between internal control quality and net profit margin. The computed Pearson's  $r$  is 0.85 which means that there is a high positive correlation between quality of internal control and financial performance of small restaurants in terms of net profit margin. It indicates that as the internal control quality levels up the net profit margin also increases. However, it does not necessarily mean that internal control quality is the sole reason why there is a positive change in the net profit margin.

In summary, the study revealed that there is a positive relationship between internal control and financial performance. This conforms with the findings of Kinyua (2016) that internal control is a positive significant predictor of financial performance. It also validated the purpose of internal control according to COSO (2013) that it provides a reasonable assurance that reliability of financial reporting, effectiveness and efficiency of operation, and compliance with applicable laws and regulations are attained. The study suggests then that effective internal control leads to better gross profit margin and net profit margin for small restaurants.

## Recommendations

Based on the results and findings of the study, it is recommended that the respondents and other businesses should strive to achieve a very high quality of internal control. The COSO internal control framework may be used as a guide in implementing and assessing their internal control. However, be reminded that there should be a balance between the cost and benefit of the desired level of internal control.

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