

# PERSPECTIVES OF INTERNAL CONTROL SYSTEM

BY

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## Abstract

This paper which looked at the concept of internal control including its classification into financial and administrative forms, was anchored on the agency theory. The problem of the study was inability of management to identify indicators of weak internal control system in organizations. The objectives of the paper were to (1) discuss elements of internal control system and (2) identify indicators of weak internal control in organizations. Descriptive methodology was utilized. Basic tests to determine whether reliance should be placed on internal control during auditing were also examined. The paper concluded that a strong internal control system is a necessary condition, among others, for organizational growth.

## INTRODUCTION

One of the major indices of organizational growth is return on capital employed (ROCE). While management of corporate organizations look unto it (ROCE) as a measure of their managerial ingenuity, shareholders see it as a definition of their investment objective. Even, financial analysts view increasing ROCE as a good and reliable sign of corporate viability.

Sometimes, managerial efforts towards enhancing organizational growth could be vitiated by leakages in internal control system. It may be necessary to state that some leakage

points may be easily detectable while others are not. Put differently, while some lapses in internal control may result in immediate pecuniary loss, others may take a relatively long time before their impacts on organizational growth which may or may not be pecuniary would become noticeable. The nature of effects of lapses in internal control happens to be one of the bases for its (internal control) classification into financial or administrative.

## THEORETICAL FRAMEWORK

This work is anchored on the agency theory. An agency relationship exists whenever one or more individuals, called principals, hire one or more individuals, called agents to perform some service and then delegate decision-making authority to the agents. The primary agency relationships in business include those between;

- (a) Shareholders and managers
- (b) Debtholders and shareholders (Eisenhardt, 1989).

However, we shall concentrate on the relationship between shareholders and managers here. Once managers are appointed, shareholders expect them to take all necessary actions that will maximize their (shareholders) wealth including protecting and safe-guarding the assets of the organization. In practice, the relationship is not always harmonious, thus giving rising to agency conflicts or conflicts of interest between agents and principals. This manifests in managers seeking to maximize their own utility at the expense of corporate shareholders (Shankman, 1999).

Managers who desire to maximize their welfare will obviously not design an effective internal control system capable of checking abuse of assets, errors and frauds.

Attempts by shareholders to curtail the self-interested behaviour of managers usually result in some agency costs. Michael and Mechling (1976) identify three major types of agency costs viz:

- (1) Expenditures to monitor managerial activities, such as audit costs.
- (2) Expenditures to structure the organization in a way that will limit undesirable managerial behaviour, such as appointing outside members to the board of directors or restricting the company's business units and management hierarchy.
- (3) Opportunity costs which are incurred when shareholder imposed restrictions, such as requirements for shareholder votes on specific issues, limit the ability of managers to take actions that advance shareholders wealth.

### STATEMENT OF PROBLEM

The state of internal control system in any organization is usually central to the functions of an external auditor. Sometimes, he finds it difficult to take a decision concerning whether or not to place reliance on an organisation's internal control.

Most times, when he finally decides not to place reliance on it, he is looked upon by management team as being difficult. This stems from the fact that members of the team do not understand, in practical terms, what constitutes weak internal control.

### OBJECTIVES

The general objective of the article is to highlight the role of good internal control system in organizational growth. However, the specific objectives are:

- (1) To examine types of internal controls.
- (2) To discuss elements of internal control system.
- (3) To identify indicators of weak internal control system in organizations.

### METHODOLOGY

The article reviewed previous publications including text books, journal articles and conference papers on various aspects of the subject matter. It adopted a descriptive methodology in an attempt to harmonize some divergent issues relevant to the topic.

### The Concept of Internal Control System:

Internal controls within business entities, also referred to as operational controls, have existed from ancient times. In Hellenistic Egypt, there was a dual system of administration, with one set of bureaucrats charged with collecting taxes and the other with their supervision. Similarly, in the Republic of China, the control Yuan, one of the five branches of government, is an investigatory agency that monitors the other branches of government (van Creveld, 2004).

Internal control in any organization is not limited to accounting functions as many people erroneously believe. It is a network of activities that span through the length and breath of organizations. In line with the above, the Institute of Chartered Accountants in England and Wales (ICAEW) Statements of Auditing U4 sees Internal Control as

not only internal check and internal audit, but the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records.

The Institute of Chartered Accountants of Nigeria (ICAN) aligns itself strictly with the ICAEW definition except that it adds "operational efficiency" to it.

The American Institute of Certified Public Accountants (AICPA) defines internal control thus:

Internal control comprises the plan of the organization and all the co-ordinate methods and means adopted within a business to safeguard its assets, check

the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies.

Anderson (2008) defines internal control as a process effected by an organization's structure, work and authority flows, people and management information systems, designed to help the organization accomplish specific goals or objectives. He further states that it is a means by which an organization's resources are directed, monitored and measured. Millichamp (1990) states that internal control does not only safeguard assets (both tangible and intangible) but plays an important role in preventing and detecting fraud. He believes internal control has two levels, the organizational and transactional levels. At the organizational level, internal control objectives relate to the reliability of financial reporting, timely feedback on the achievement of operational or strategic goals, and compliance with laws and regulations. At the specific transactional level, internal control refers to the actions taken to achieve a specific objective (e.g how to ensure the organization's payments to third parties are for valid services rendered, etc). Internal control procedures reduce process variation, leading to more predictable outcomes. In fact, internal control is a major element of the Foreign Corrupt Practices Act (FCPA) of 1977 and the Sarbanes-Oxley Act of 2002, that demanded improvements in internal control of public corporations in the United State (Labyrinth, 2011).

COSO (1992) defines internal control as a process effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- (a) effectiveness and efficiency of operations
- (b) reliability of financial reporting and compliance with laws and regulations.

In our own view, we see internal control as a system of policies and procedures that operate within an organization to protect its assets from fraud and abuse, ensure timely and

accuracy of financial records as well as enforcement of regulatory requirements.

A cursory look at the above definitions reveals the following as being common to them: That internal control mechanisms are designed;

- (a) by the management of the organization. They are not imposed from outside (hence the word, 'internal') and they are meant to be specific to each organization.
- (b) to protect the assets of the organization from fraud and misuse
- (c) to ensure accuracy and reliability of financial data
- (d) to maintain regulatory policies.

The implication of the above definition is that any form of regulation put in place by management of any organization to protect its assets and promote orderly conduct of its activities and reliability of its records, is part and parcel of its internal control system.

Nwoko (1997) classified internal control into two distinct but interrelated parts viz:

- (1) accounting (financial) controls and
- (2) administrative controls.

#### **Accounting (Financial) controls:**

These controls are directly concerned with financial or monetary measures aimed at safeguarding and protecting cash of organizations from embezzlement or misappropriation. They are usually non-administrative and often geared towards the achievement of quantitative objectives. Their impact on internal control is more directly and positively noticeable than the impact of administrative controls.

Nwoko (1997) further states that a lapse in accounting controls can result in a more immediate pecuniary disadvantage unlike a lapse in administrative controls which may take some time before being translated into quantities or before being exploited.

Accounting controls include the following:

- (a) Internal checks and balances: The thrust of internal checks and balances is that every one is capable of committing

errors or fraud and so should be checked by other people. This principle tends to negate what is generally regarded as "trust" in performance of corporate responsibilities. With good checks and balances in place, errors or frauds are likely to be detected. However, organized criminal networks can beat even the best internal control mechanism anywhere in the world.

- (b) Budgetary controls: This principle ensures organizations make systematic, planned and co-ordinated progress. It helps to avoid waste and distractions in corporate management; and as a result preserves organizational assets and resources.
- (c) Accounting policies: These policies are expected to specify procedures for authorizing and recording transactions, valuation of assets, depreciation, custody of assets, etc. Accounting policies usually form reference points for audit work in organizations.
- (d) Internal audit: Routine internal audit work helps management of organizations to adhere to internal control policies. It also helps in the modification and strengthening of faulty internal policies which may be detected from time to time.

### **Administrative controls:**

Internal control measures other than accounting controls are generally regarded as administrative. They are often non-pecuniary in nature and their effects are usually non-quantifiable in the short-run. However, continuous lapses in administrative controls may make an organization vulnerable to collapse of its financial controls.

Nwoko (1997) believes that the following are integral constituents of administrative controls:

- (i) Organigram: This is a chart that summarizes authority line and responsibility in an organization. It usually shows separation of duties among operating, financial, marketing and other duties.

- (ii) Evaluation and appraisals: Evaluation and appraisal of staff for purposes of promotion and reward should be hinged on clear and well defined criteria that are objective.
- (iii) Discipline and code of business ethics: Here, organizations define their business ethics as well as sanctions for their violation. The ethics guide the managers and rank-and-file members in their transaction for and on behalf of their organization.
- (iv) Rotation of duties, transfers and vacations: This component of administrative control allows independent checks on officers' duties when their schedules are given to other people or when they are on transfer or vacation.
- (v) Education and training programmes: A clear education and training programmes as well as fidelity coverage for employees and officials when fairly implemented, serves as a motivation for workers to give out their best.

However, two important components of administrative controls not mentioned above need to be discussed especially in view of their central role in promoting safety of organizational assets. They are physical safeguards and information and technology (IT) security.

- (a) Physical safeguards: These are measures introduced to prevent unlawful or authorized use or removal of assets. Such measures include but are not limited to locks, physical barriers, use of security cameras, presence of security staff to protect property.

- (b) IT Security: In view of technological growth across the entire universe, it is not only necessary but also imperative that organization should employ some internal measures to safeguard their IT. Measures such as usage of passwords, access logs, encrypted files, etc are required to restrict access to information and technology only to authorized

personnel.

### Elements of Internal Control

There are some elements that are key or rather important towards the realization of the objectives of internal control system. These elements are seen by many as vital components of the control system as a whole. In line with this view, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) (1992) state that internal control has the following five components (elements):

- (a) **Environmental control:** This refers to the attitude and behaviour of management and employees. In fact, environmental control sets the tone for the organization and influences the control consciousness of its people. For effective environmental control, the management should be alive to its responsibility or enacting policies and procedures that are capable of driving employee behaviour and attitude. This element is the bed rock for all other components of internal control. Adeniji (2010) states that factors often included in environmental control include:
  - (i) The functions of the board of directors and its committees.
  - (ii) Management's philosophy and operating style.
  - (iii) The entity's organizational structure and methods of assigning authority and responsibility.
  - (iv) Management's control system including the internal audit function, personnel policies and procedures and segregation of duties.
- (b) **Risk Assessment:** COSO (1992) believes that risk assessment is about a company's ability to analyze business or react accordingly. In principle, risk assessment is a management responsibility which in practice, is often integrated into day to day activities performed by employees.
- (c) **Information and Communication:** This component presupposes that systems and processes should favour identification, capture and exchange of

information in a way it would be timely and accurate to facilitate unhindered discharge of responsibility. Communication should be able to flow downwards, laterally and upwards in organizations.

- (d) **Monitoring:** Monitoring encompasses all strategies put in place to ensure that internal controls are functioning as intended. Without proper monitoring, even the best internal controls in the world could fail to produce the desired results. Again, monitoring helps to identify clumsy and/or impracticable control measures and recommend their retooling, replacement or complete elimination to ensure the internal controls achieve their desired objectives.
- (e) **Control Procedures:** Control Procedures are the policies and procedures that facilitate carrying out the environmental controls, the risk assessment, the monitoring and the information and communication in order to ensure smooth functioning of internal control system. Control procedures mainly comprise accounting checks and balance that subject one's responsibilities to inspection and scrutiny by another person.

### Indicators of Weak Internal Controls

Weak internal controls in organizations often result in accounting and financial scandals of various degrees. The scandals depending on the magnitude inevitably make organizational growth to be stunted or even result in outright failure to thrive. It was in response to incessant accounting and financial scandals that the US Congress in 2002, passed the Sarbanes Oxley Act. The Act requires public companies to evaluate their internal controls and to publish those findings with their SEC filings (Anderson 2008).

Indicators of weak internal control may also be classified into administrative and financial types.

## Financial Indicators

1. Inability to Detect Error/Fraud: One of the commonest financial indicators is the inability to detect an error or fraud at the next one or two levels of checks. In some instances, the non-detection could also be an indication of an organized or multi-stage fraud. This often results in loss of revenue to the organization.
2. Frequent Changes In Accounting Policies: This may be employed deliberately either to make comparability of organizational results unnecessary or to find an explanation for unfavourable results that could be occasioned by errors or frauds.
3. Internal Auditing as a Mere Formality: When internal audit unit is stripped of all forms of independence and the unit merely does its work as a formality, it depicts weak internal control.
4. Absence of Rigid Cash Control Policy: Fragrant disregard to established cash control policies is an obvious indication of ineffective internal control. There is no gainsaying that cash handling is tempting and therefore needs to be guided by rigid policies that will tend to reduce handlers duration of exposure to it.

## Administrative Indicators

These are encapsulated in non-adherence to organizational rules. It could be rules on lines of authority, transfers, promotion, discipline, recruitment of staff and so on. Blatant violation of rules of organization is always a clear indication of existence of weak internal control. It does not matter whether the rules are violated at high or low level in the organization.

## Tests for Internal Control

Presence of indicators of weakness in internal control system may not be noticed until activities of organizations are subjected to scrutiny usually through external auditing.

External auditors usually carry out substantive and compliance tests to ascertain whether or not to place any form of reliance on the internal control system of organizations. Presence of any or combination of the afore-mentioned indicators is a sign of weak internal control, which tends to put the external auditor on alert in the course of his duty. Aguolu (2002) and Cook and Winkle (1980) see these tests thus:

### 1. Substantive Test:

This test seeks to confirm principally, the completeness, accuracy and validity of information contained in the accounting records and financial statements. If and when discrepancies are noticed in these records, it shows that the internal control system is not worthy to be relied upon for any objective assessment by the external auditor.

### 2. Compliance Test:

Compliance test is done to confirm the effectiveness or otherwise of an existing controls in an organization. Non-compliance to rules or procedures in organizations is a sign of weak internal control.

## CONCLUSION

Internal control system, whether administrative or financial, has the potential of preserving assets of organizations when it is well designed and in line with the peculiarities of the firm. When this is the case, internal control tends to promote organizational growth in that, incessant losses from theft, fraud, etc that would have been replaced by resources of the organization would be prevented.

However, when areas of weakness exist in the internal control system of any firm, its internal control acts as a conduit pipe through which gains made by the firm could be drained. Such leakages interfere with managerial efforts to advance the fortunes of organizations to an appreciable level. In view of this, it could be

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