EFFICACY OF INTERNAL CONTROL AND CONTROLLING BUSINESS RISKS

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Abstract

Companies can gain additional efficiency in designing and implementing or assessing internal control by focusing on only those financial reporting objectives directly applicable to the company's activities and circumstances, taking a risk based approach to internal control. It is important for any organization to have reliable financial data for internal decision-making purpose. Financial information is often useful in many internal decisions such as product or service pricing. This is why the most important function of the controller is to create and maintain the corporate financial control system. Today's corporation operates in an increasingly complex environment and the controller's role is to advice the management of current or future problems of the business environment or to prevent the fraud.

Key-words: *internal control, business risks, control framework, efficacy of internal control*

JEL Classification: H83, M41, M42

Introduction

The purpose of this paper is a survey on what an internal control means. Internal control cannot ensure by itself the achievement of its general objectives; internal control consists of five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring. According to INTOSAI, the control environment sets the tone of an organization, influencing the control consciousness of its staff. Thus, internal control is not an event or circumstance, but a series of actions that permeate an entity's activities, that occur throughout an entity's operations on an ongoing basis, and that are pervasive and inherent in the way the management runs the organization.

This research is important because the internal control could prevent fraud. There are many studies and articles on this subject, but the fraud became more complex than ever and the government witnesses soaring levels of business fraud.

The aim of this paper is to present that an effective internal control system can provide only reasonable assurance to management about the achievement of an entity's objectives or its survival. Internal control can give management information about the entity's progress (or lack of it) toward achievement of the objectives; an effective system of internal control reduces the probability of not achieving the objectives. This paper is related to other papers that presented similar concepts and methods of internal control.

Literature review

The paper has based its conclusions on the researches of the following persons:

Jagannathan, M. (1996), *Internal Control Mechanisms and Forced CEO Turnover: An Empirical Investigation*, who presented his final conclusions in this PhD dissertation at Virginia Polytechnic Institute and State University. Jagannathan empirically examines the efficacy of internal control mechanisms by analyzing 94 forced turnovers of chief executive officers (CEOs).

Dunn, J. (1996) in *Auditing, Theory and Practice*, presented the professional guidance of the auditor's responsibilities for the detection of fraud. Thus, auditors might have to develop their work based on the internal control.

COSO (2006), *Internal Control over Financial Reporting. Guidance for Smaller Public Companies*, is an important study to understand internal control. Thus, the characteristics of smaller companies provide significant challenges for cost-effective internal control. "Among the challenges are: obtaining sufficient resources to achieve adequate segregation of duties; management's ability to dominate activities, with significant opportunities for management override of control; recruiting individuals with requisite financial reporting and other expertise to serve effectively on the board of directors and audit committee; recruiting and retaining personnel with sufficient experience and skill in accounting and financial reporting; taking management attention from running the business in order to provide sufficient focus on accounting and financial reporting".

KPMG (1999), *Internal Control: A Practical Guide*, Service Point is presenting an internal guide for internal control. KPMG recommends that all directors, including the nonexecutive directors, ensure that they are satisfied that the Board's statement on internal control provides meaningful high-level information that enables shareholders to evaluate how the principles of good governance have been applied.

Internal control

Jagannathan empirically examines the efficacy of internal control mechanisms by analyzing 94 forced turnovers of chief executive officers (CEOs); poorly performing managers are removed faster in firms that have a larger percentage of independent outside directors on their board, that have higher equity ownership by the non-CEO directors and lower equity ownership by the CEO, and that separate the positions of CEO and chairperson. "The separation of ownership and control that characterizes the modern corporation creates potential conflicts of interests between managers and shareholders. The corporate governance system that helps resolve such conflicts consists of the internal control system, the external market for corporate control, and the discipline of the product and factor markets." (Jagannathan, M., 1996).

Jagannathan quantifies the association between the probability that a CEO will be replaced before significant declines in performance and these board characteristics by estimating a logistic regression, and investigates changes in internal corporate governance characteristics following turnover to determine whether crisis-response firms institute more significant changes in internal governance. Jagannathan examines the changes in compensation structure and in pay-to-performance sensitivity, following CEO turnover, for the forced turnover sample and for a control sample of normal turnover, and examines the changes in market-adjusted operating performance following CEO turnover. Jagannathan analyzes the pre-turnover board characteristics of the crisis-response and non-crisis-response subsamples of firms, compares the changes in these board characteristics following turnover, documents changes in CEO compensation structure and pay-performance sensitivity pre-to-post turnover (the changes in performance around CEO turnover are estimated and related to the changes in board characteristics and compensation structures). "The board of directors of a corporation is the primary force within the organization for motivating and monitoring managerial decisions. They are responsible for designing incentives that motivate managers to make decisions consistent with firm value maximization, supervising managerial actions, evaluating managerial performance, and removing poorly-performing managers." (Jagannathan, M., 1996). Boards of directors are reluctant to remove poorly performing top managers. "While the observed negative relationship between firm performance and the probability of managerial turnover and significant improvements in operating performance subsequent to forced turnover suggest that boards of directors are effective monitors of management, the small probability of CEO turnover in even the most poorly performing firms and the degree of external control activity that surrounds forced turnover suggest that they are weak monitors at best." (Jagannathan, M., 1996)

Jagannathan remarks that outside directors (especially if they are truly independent) are better monitors of management than are inside directors. "Managerial ownership creates two opposing forces in governing managerial behaviour:

(1) a larger fractional ownership by management ensures a greater alignment of managers' and shareholder's interests, as management's higher stakes in their firms mean that they bear more of the wealth consequences of their actions. This 'convergence of interests' hypothesis suggests that larger managerial stakes will be associated with higher firm value;

(2) the 'managerial entrenchment' hypothesis suggests that higher firm ownership by management increases their ability to pursue non-firm-value maximizing decisions that improve their own wealth and job security without fear of reprisal." (Jagannathan, M., 1996)

Jagannathan contends that, in theory, the CEO of a corporation is endowed with the power to make investment decisions, while the board of directors (led by the chairperson) is responsible for monitoring the CEO by setting goals, designing appropriate compensation packages, and evaluating managerial performance. "Agency theory suggests that tying managers' compensation to stock performance will increase managers' incentives to make decisions that are consistent with maximizing firm value. […] The agency argument implies that effective boards will design compensation contracts that align a large portion of managerial earnings with improvements in share value." (Jagannathan, M., 1996)

COSO states that the characteristics of smaller companies provide significant challenges for cost-effective internal control. “Among the challenges are: obtaining sufficient resources to achieve adequate segregation of duties; management’s ability to dominate activities, with significant opportunities for management override of control; recruiting individuals with requisite financial reporting and other expertise to serve effectively on the board of directors and audit committee; recruiting and retaining personnel with sufficient experience and skill in accounting and financial reporting; taking management attention from running the business in order to provide sufficient focus on accounting and financial reporting; maintaining appropriate control over computer information systems with limited technical resources.” (COSO, 2006)

Companies can gain additional efficiency in designing and implementing or assessing internal control “by focusing on only those financial reporting objectives directly applicable to the company’s activities and circumstances, taking a risk based approach to internal control, right sizing documentation, viewing internal control as an integrated process, and considering the totality of internal control.” (COSO, 2006)

COSO says that management will review to determine whether its documentation is appropriate to support its assertion. “When management asserts to regulators, shareholders or other third parties on the design and operating effectiveness of internal control over financial reporting, management accepts a higher level of personal risk and typically will require documentation of major processes within the accounting systems and important control activities to support its assertions. […] In considering the amount of documentation needed, the nature and extent of the documentation may be influenced by the company’s regulatory requirements. This does not necessarily mean that documentation will or should be more formal, but it does mean that there needs to be evidence that the controls are designed and working properly.” (COSO, 2006)

COSO writes that determining whether a company’s internal control over financial reporting is effective involves a judgment. “Internal control has five components that work together to prevent or detect and correct material misstatements of financial reports. When the five components are present and functioning to the extent that management has reasonable assurance that financial statements are being prepared reliably, internal control can be deemed effective. While each component must be present and functioning, this does not mean, however, that each component should function identically or even at the same level in every company. Some trade-offs may exist between components. Accordingly, effective internal control does not necessarily mean a ‘gold standard’ of control is built into every process. A deficiency in one component might be mitigated by other controls in that component or by controls in another component strong enough such that the totality of control is sufficient to reduce the risk of misstatement to an acceptable level.” (COSO, 2006)

Curtis and Borthick contend that many accounting firms have changed the way their auditors evaluate internal control; instead of preparing flowcharts documenting transaction flows, they only document the controls that have a bearing on specific financial statement assertions. As Curtis and Borthick put it, this shift in documentation marks a change in the structure of the internal control evaluation task from transaction flow to control objective. This case presents documentation organized by control objective for internal control of a company's purchasing cycle (the case includes discussion and objective format questions and is relatively short, which means it can be used as an in-class or out-of-class exercise or an in-class testing or assessment device on internal control evaluation). (Curtis, M.B., Faye Borthick, A., 1999)

USGAO notes that federal policymakers and program managers are seeking ways to improve accountability. "As programs change and as agencies strive to improve operational processes and implement new technological developments, management must continually assess and evaluate its internal control to assure that the control activities being used are effective and updated when necessary." (USGAO, 1999)

According to USGAO, internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations. Internal control is a continuous built-in component of operations, is affected by people, and provides reasonable assurance (not absolute assurance). USGAO argues that the five standards for internal control are: control environment, risk assessment, control activities, information and communications, and monitoring. USGAO reasons that these standards define the minimum level of quality acceptable for internal control in government and provide the basis against which internal control is to be evaluated. "These standards apply to all aspects of an agency's operations: programmatic, financial, and compliance. However, they are not intended to limit or interfere with duly granted authority related to developing legislation, rule-making or other discretionary policy-making in an agency. These standards provide a general framework. In implementing these standards, management is responsible for developing the detailed policies, procedures, and practices to fit their agency's operations and to ensure that they are built into and an integral part of operations." (USGAO, 1999)

USGAO contends that management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management; internal control should provide for an assessment of the risks the agency faces from both external and internal sources; internal control activities help ensure that management's directives are carried out (the control activities should be effective and efficient in accomplishing the agency's control objectives. USGAO provides several examples of control activities: top level reviews of actual performance; reviews by management at the functional or activity level; management of human capital; controls over information processing; physical control over vulnerable assets; establishment and review of performance measures and indicators; segregation of duties; proper execution of transactions and events; accurate and timely recording of transactions and events; access restrictions to and accountability for resources and records; appropriate documentation of transactions and internal control.

USGAO says that information should be recorded and communicated to management and others within the entity who need it and in a form and within a time frame that enables them to carry out their internal control and other responsibilities; internal control monitoring should assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved. USGAO writes that rapid advances in information technology have highlighted the need for updated internal control guidance related to modern computer systems. Internal/management control helps government program managers achieve desired results through effective stewardship of public resources. “Internal control is not one event, but a series of actions and activities that occur throughout an entity’s operations and on an ongoing basis. Internal control should be recognized as an integral part of each system that management uses to regulate and guide its operations rather than as a separate system within an agency. In this sense, internal control is management control that is built into the entity as a part of its infrastructure to help managers run the entity and achieve their aims on an ongoing basis.” (USGAO, 1999)

USGAO asserts that risk assessment is the identification and analysis of relevant risks associated with achieving the objectives, “such as those defined in strategic and annual performance plans developed under the Government Performance and Results Act, and forming a basis for determining how risks should be managed. Management needs to comprehensively identify risks and should consider all significant interactions between the entity and other parties as well as internal factors at both the entity wide and activity level. Risk identification methods may include qualitative and quantitative ranking activities, management conferences, forecasting and strategic planning, and consideration of findings from audits and other assessments.” (USGAO, 1999)

USGAO maintains that management should track major agency achievements and compare these to the plans, goals, and objectives established under the Government Performance and Results Act; managers need to compare actual performance to planned or expected results throughout the organization and analyze significant differences. “Management should ensure that skill needs are continually assessed and that the organization is able to obtain a workforce that has the required skills that match those necessary to achieve organizational goals. Training should be aimed at developing and retaining employee skill levels to meet changing organizational needs. Qualified and continuous supervision should be provided to ensure that internal control objectives are achieved. Performance evaluation and feedback, supplemented by an effective reward system, should be designed to help employees understand the connection between their performance and the organization’s success. As a part of its human capital planning, management should also consider how best to retain valuable employees, plan for their eventual succession, and ensure continuity of needed skills and abilities.” (USGAO, 1999)

KPMG recommends that the focus should be on developing and implementing an embedded process; this may mean not being in a position to comply fully in year one. KPMG recommends that for most organizations the formulation of a Risk Committee would be beneficial and appropriate (it is important that Audit Committees do not become overburdened and deflected from their already significant obligations). KPMG recommends that the organization adopt/devise a control framework as a standard against which to assess the effectiveness of its system of internal controls.

KPMG recommends that all directors, including the nonexecutive directors, ensure that they are satisfied that the Board's statement on internal control provides meaningful high-level information that enables shareholders to evaluate how the principles of good governance have been applied. KPMG recommends that the Board ensure that internal audit is in a position to provide the Board with much of the assurance it requires regarding the effectiveness of the system of internal control (it should not only assess the "parts", but also the "corporate glue" holding the parts together.

KPMG recommends that material joint ventures and associates should, as far as possible, be dealt with as part of the group for the purposes of applying the Turnbull guidance; even some of the largest groups have recognized that even though they may believe they have all the necessary controls in place, they are not in a position to state so with certainty, or that all components that contribute to the system of internal control are adequately codified. "Internal control is one of the principal means by which risk is managed. Other devices used to manage risk include the transfer of risk to third parties, sharing risks, contingency planning and the withdrawal from unacceptably risky activities. Of course, companies can accept risk too. Getting the balance right is the essence of successful business – to knowingly take risk, rather than be unwittingly exposed to it."(KPMG, 1999)

According to KPMG, the advantages of embracing Turnbull may include: exploitation of business opportunities earlier, increased likelihood of achieving business objectives, increased market capitalization, more effective use of management time, lower cost of capital, fewer unforecast threats to the business, more effective management of change, and clearer strategy setting.

KPMG notes that an internal control system encompasses the policies, processes, tasks, behaviours and other aspects of a company that, taken together: facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives, help ensure the quality of internal and external reporting (this requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organization), and help ensure compliance with applicable laws and regulations, and also internal policies with respect to the conduct of business.

KPMG contends that the costs of control must be balanced against the benefits, including the risks it is designed to manage; the system of control must include procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified together with details of corrective action being undertaken; control can help minimize the occurrence of errors and breakdowns but cannot provide absolute assurance that they will not occur; the system of control should be embedded in the operations of the company and form part of its culture.

KPMG argues that linking the identification of key business risks to the company's strategic business objectives may be part of the normal financial calendar supporting the strategic planning and budgeting process (it will be important to ensure this process is sufficiently balanced in its appraisal of the financial and non-financial risks). KPMG states that an effective risk assessment process addresses both financial risks (such as credit, market and liquidity risk) and non-financial risks (such as operational, legal and environmental risk); the process should include an evaluation of the risks to determine which are controllable by the company and which are not. "The board should identify controls appropriate to maintain the key business risks within the defined risk tolerance levels set by the Board, bearing cost/benefit considerations in mind, or review the process by which this is done and endorse the conclusions. The Board should also be satisfied that suitable individuals have a clear responsibility for maintaining dynamic risk identification and assessment process and related internal controls. The Board may not know the fine detail of how all risks that could lead to a material loss are controlled but should be satisfied that proper control policies, procedures and activities have been established to support their control objectives. The design of controls should be based on generally accepted control criteria which have been approved by the Board for this purpose and include both preventative and detective controls." (KPMG, 1999)

KPMG reasons that although internal audit should maintain independence from management, they can perform more than just a monitoring role. "In many companies they also act as facilitators and internal advisors to management on effective means of controlling business risks. Internal audit arrangements naturally vary, but they have the potential to play a central role within the monitoring process. […] Responsibility for reviewing and concluding on the effectiveness of internal control rests with the Board. However, the external auditors are likely to have helpful knowledge and access to specialist consultants with expertise in specific aspects of risk management and control evaluation. Such procedures are outwitting the scope of the statutory audit, but could be provided as part of a separate engagement." (KPMG, 1999)

Conclusions

The reports from management and/or others qualified to prepare them in accordance with agreed procedures should provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in the area covered. "The Board's annual assessment should consider issues dealt with in the reports it has reviewed during the year together with additional information necessary to ensure the Board has taken account of all significant aspects of internal control for the company's accounting period and the period up to the date of approval of the annual report and accounts. This suggests that the Board must, at least, update its annual assessment directly before the annual report and accounts are approved." (KPMG, 1999)

KPMG remarks that disclosure goes beyond internal financial account; emphasis is on how the Board has reviewed the process for identifying, evaluating and managing the company's key risks rather than a description of key controls in place. The Board may wish to provide additional information in the annual report and accounts to assist the understanding of the company's risk management process and system of internal control. KPMG argues that the disclosures go beyond internal financial control (many of the disclosure requirements do not refer directly to control at all, but to risk); the disclosures are, in the main, concerned with how the Board has reviewed the effectiveness of the system of internal control; no opinion on the effectiveness of the system of internal control is required; additional disclosures are no longer required in respect of weaknesses in internal financial control that have resulted in material losses, contingencies or uncertainties which require disclosure in the financial statements or in the auditors' report. "Companies in the habit of providing shareholders with meaningful governance disclosures should have few problems with the new disclosures. However, those companies who traditionally take a minimalist approach should not see the new requirements as an opportunity to disclose virtually nothing about their risk management process and system of internal control. Such an approach neither encourages high standards of corporate behaviour nor provides shareholders with a meaningful insight into how the Board has maintained a sound system of internal control to safeguard their investment and the company's assets. Indeed, the guidance encourages Boards to provide additional information in the annual report and accounts to assist understanding of the company's risk management processes and system of internal control." (KPMG, 1999)

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