

Banking and Accounting Issues

Chapter 7

Evaluating the Internal Control System in Deposit Money Bank

Horsfall, Kaine Anwuli

Department of Accounting, Faculty of Business Studies

Ignatius Ajuru University of Education, Port Harcourt, Rivers State, Nigeria

kainesjoy@yahoo.com

Concept of Internal Control

Effective internal control systems are very important in the detection and prevention of fraud. Aguota (2002) cited in Idogei, et al. (2017), stated that internal control is a gamut of measures that seek to detect errors, fraud and irregularities to ensure that all transactions are correctly processed and ensure that all assets are safeguarded through restriction of access to authorized persons only. He emphasized that the internal control system enables work to be performed by a person and any omission or error can be traced to that person and to make the work of the auditors easier. Mayo and BPP (1988) defined internal control as the measure taken by an organization to protect its resources against wastes, fraud, inefficiency, ensuring accuracy and reliability in accounting and operating data, security compliance with organizational policies and evaluating the level of performances in all divisions of the organizations. The committee of sponsoring organizations (COSO) (1994) defined internal control as a process effected by an entity's board of directors, management and other personal designed to provide reasonable assurance regarding the achievement of objectives concerning the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

The Institute of Chartered Accountants of England and Wales (ICAEW) defined internal control as "the whole system of controls, financial or otherwise, established by management to carry on the business of an 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. In a nutshell, internal control can be said to be a system that comprises of the plans of an organization and the methods adopted within the organization to safeguard its assets check the accuracy and reliability of its accounting data, promote operational efficiency and adherence to prescribed policies of the management. Internal control objectives thus are channelled towards ensuring adherence to managerial policies and achieving organizational goals in general.

The basel commission on Banking Supervision (1998) which emphasized that evaluation of the problems and challenges that resulted in the collapse of several reputable organizations revealed that the losses acquired by these organizations could have been prevented if there were effective internal control systems in place: such systems would have prevented or enabled earlier detection of the problems. The committee report stressed that the internal control systems must be structured so that it can deliver reasonable assurance to management and stakeholders to all revenues accrued to its benefits, all expenditure is fully authorized and properly disbursed, all assets are properly safeguarded, all liabilities are recorded, all statutory requirements relating to the provision of accounts are complied with and all financial provisions followed.

Banking and Accounting Issues

Benjamin (2011) defined internal control system as the whole system of control, financial and otherwise established by the management to carry on the business of the enterprises in an orderly and efficient manner. It involves the control environment and control procedures, all the policies and procedures adopted by the directors and management of an entity to assist in achieving their objectives including adherence to internal policies, the safeguarding of assets, the prevention and detection of fraud and error as well as the completeness and accuracy of records with the timely preparation of reliable financial information.

Internal control refers to the measures instituted by an organization to ensure attainment of the entity's objectives, goals, and mission. They are a set of policies and procedures adopted by an entity in ensuring that an organization's transactions are processed appropriately to avoid waste, theft and misuse of organization resources. According to Mawanda (2018), internal control is processes designed by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of an entity's objective with regards to the reliability of the financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulation.

This is used for checking the validity of information management, protection of assets, and for minimizing mistakes. More so, the Audit Committee on methods of auditing procedures which emanated from the American Institute of Certified Public Accountants (AICPA), defined internal control as "organizational plan and all methods and procedures developed by the company management, which aim to preserve the company's assets and ensure the accuracy and correctness of accounting information, increase the reliability and operational efficiency, and to verify the employee commitment to administrative policies set by the administration" (Mawanda, 2018).

Components of Internet Control System

Internal control is made up of five interrelated components which provide the foundation for fraud detection (COSO, 1994). Internal controls promote the attainment of goals in an organization, for example, internal controls mitigate errors and fraud (Rae & Subramaniam, 2008); assist in auditor's fraud risk assessment (Mohd-Sanusi, et al., 2015), and serves as a a guide to processes within the organization. Internal controls pervade every part of an organization's operations and contribute to organizational goals (INTOSAI, 2004). Internal controls refer to a system put in place by management to ensure adherence to policies and procedures and the attainment of goals of an organization. Internal controls consist of aspects such as control environment, control activities, risk management, monitoring, information and communication. Internal controls are dynamic and so the need for continuous monitoring to ensure the system is effective. Internal auditors assist management in ensuring controls is regularly updated. These five components include:

a. Control Environment

The control environment includes the governance and management functions as well as the attitudes, awareness and actions of those charged with governance and management towards internal controls and its importance to the organization. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is a formulation for all other components of internal control, providing discipline and

Banking and Accounting Issues

structure. Thus, the control environment is the atmosphere created by management that shapes the way things are done and how organizational members behave towards the achievement of organizational objectives.

b. Risk Assessment:

An internal control system should be able to address risks relevant to achieving corporate goals. Business out risks is any factor, pressure or force that may prevent an entity from achieving its objectives operating profitability and surviving. Risk assessment is the achievement of corporate objectives, determination of how much risk should be managed. Also, identification and analysis of risks relevant to the achievement of corporate objective determination or how much risk should be managed and implementation is a process that can address such risks. Factors which may pose risk to an organization and which serve as bases for the measurement of risk include incompetent management and staff legislation, poor strategy and financial, structure political changes competition, technological, changes, accounting pronouncements, natural disaster etc.

c. Control Activities

Control activities are policies and procedures that ensure that management directives are carried out. They are ongoing actions that organizational members take to ensure proper execution of operations and are particularly designed to support accurate, complete and reliable financial transaction processing. Examples of control activities which also serve as indices for the measurement of internal control include; segregation of duties, authorization, supervision, physical controls, performance reviews etc.

d. Information and Communication

This includes the identification, capture and exchange of financial, operational and compliance-related data promptly. People within an organization who have timely, reliable and understandable information are better able to manage and control operations. Information and communication stress and quality of information should be appropriate, timely, current, accurate and accessible. All these elements are extremely important and must be applied by the internal control system design, otherwise, the components of the internal control systems will be unable to operate as a whole.

e. Monitoring

Monitoring refers to the assessment of the quality of internal control. Monitoring activities provide information about potential and actual breakdowns in a control system. Monitoring can occur through self-assessments, external audits or direct testing of a control.

Relatively few studies have examined the relationship between internal controls and performance. Some studies have related internal controls to various aspects of the firm's operations (Haron, et al., 2010). Haron et al. (2010) argued that boards can increase the value of shareholders through a combination of resources and processes of which internal control is part. Thus, effective internal controls can translate to quality service delivery and safeguard the financial health of public sector organizations. In a study of six local governments in six countries, Baltaci and Yilmaz (2006) identified inadequate internal control as a major factor accounting for the widespread performance failures in local governments. They advocated effective internal controls and audit as tools to promote local government efficiency and effectiveness. Relatively few studies have examined the relationship between internal controls and performance (Aikins, 2011; Alic & Rusjan, 2010; Feng et al., 2015; Haron et al., 2010) and Baltaci and Yilmaz (2006) acknowledged the paucity of studies in the public sector of developing countries. In Nigeria, few studies have been conducted and results and measures of internal controls are largely insufficient as

Banking and Accounting Issues

results are merely descriptive (Adeyemi, 2012; Babatunde, 2013). Hence, the need to examine this construct in the Nigerian context.

Elements of the Internal Control System

The internal control system is an organizational plan for a range of actions and issues adopted by the facility which consists of basic elements. However, these elements must be provided by the management and committee to achieve their objectives (Rashid, 2012). They are:

a. Separation of Responsibilities

An established department must separate the responsibilities of its employees, and even reduce possible fraud or inadvertent errors in the financial statements and management. Thus, it is based on this assumption hard collusion between employees or more is used in the implementation of manipulation or hides any unintentional errors. If the proper separation between the responsibilities of employees depends on the separation of the functions of retained assets or possession of the evidence in the records and the certification authority (i.e. workers who have the authority to authorize operations), the cashier who keeps cash and account manager and his staff are doing a job of proof in the records. The Director of the Administrative and Financial Department approval of the job is the financial director of the administrative department. Thus, it is the person responsible for granting approvals.

b. Clear Lines of Authority and Responsibility

Large number of employees performs various functions in the facility. In order to achieve effective control over all the jobs, they must be held accountable through the allocation of specific responsibilities to specific individuals. In addition, it must be done through the manual mode (job description and powers), which should be known and not available to all employees.

c. Administrative and Organizational Plan

The system depends on the presence of an organizational plan and specific management objectives which clarifies the overall framework to guide and adjust the institution activity. This is done by having an organizational structure capable of clarifying authority's policies, determine responsibility, and provide procedures which do not allow anyone to breach internal control system through the creation of a clear link between the different functions.

d. Accounting System

Accounting system is based on an integrated set of documents, records, and classified evidence for calculations taken into account. Generally accepted accounting principles, documents, and records are considered as an essential foundation for documenting an enterprise's operations and information source for management decision-making. In addition, it aims at benefiting from the parties. Also, the statements cannot imagine the success of any facility in the provision of information without installing its operations in documents and in the records of any of its employee's memory. The document is the beginning of the accounting system point. It contains the necessary data to prove the placement of each process in the institution. They are documenting what is going on from the activities and daily operations. Based on registration records and the issuing of various reports required by management or third parties (externally), great care should be taken by the employee. Group accounting books is the basic support of the accounting system.

Banking and Accounting Issues

Thus, it is considered as a tool for recording, analysis, and presentation. Furthermore, it also serves as a means for the preparation of financial statements and various reports that serve multiple objectives.

e. Protect Assets and Records

Institutions must have the necessary capabilities and procedures to protect and prevent all of the assets and records from damage, loss, waste, and misuse. Therefore, this is done through written instructions shown through work methods, protection procedures, and the follow-up personnel's commitment to these instructions. Thus, these instructions include saving money procedures and deposit in the bank, and the procedures for organizing stores. In addition, it helps to protect them from theft and manipulation, as well as noncurrent assets. For the records, it must be kept in places to prevent unauthorized access and make illegal adjustments. Also, a second copy of the records should be kept in the case of possible work.

f. The Efficiency and Integrity of Staff

The effectiveness of internal control depends on the efficiency and integrity of the employees in the institutions. Thus, this is despite the clarity of authority, lines of responsibility, and the correct distribution of jobs in accordance with the internal control system. However, there is a failure of any system in achieving its objectives due to inefficiency of the secretariat staff in the institution to perform the responsibilities entrusted to them. Internal control system may be a good and effective to talented and qualified staff and Trustees. Although this system does not include specific detailed functions and authorities, it must therefore follow institution policy in hiring new employees or upgrading existing employees. This is done by taking into consideration the job description and qualifications required for occupancy jobs.

g. Financial Effectiveness Procedures and System

Owolabi (2010) says that financial effectiveness is more of installing and operating good and efficient management information systems. This is to include appropriate accounting information systems which will take care of all policies, rules, procedures and practices as well as the physical element that are used to record, process and communicate the financial information of an institution. A good accounting information system should be able to meet the need of the management, employees, students, tax authority, investors, suppliers and other stakeholders. Each of these groups should be able to collect statement of account as at when required. The financial situations of these parties should be able to be confirmed at any time. This enhances confidence, trust, reliability, and therefore quality of service delivered. Safeguarding of securities, insurance policies and other valuable papers are essential. The inquisitiveness to proffer lasting panacea to the ever-skyrocketing alleged insufficient funds allocation and fund mismanagement in tertiary institutions has given spur to increasing the debate on whether or not strengthening of internal controls can have any effect on financial effectiveness of tertiary institutions in Nigeria. This is viewed in the perspectives of developing countries.

Objectives of Internal Control

The main purpose of internal control is to facilitate the achievement of the objectives of an organization COSO (1992) opined that internal controls are designed achieve the following specific objectives.

Banking and Accounting Issues

1. Efficiency and Effectiveness of Operations

To be efficient means the ability to optimize resource utilization i.e ensuring that there is a rewarding relationship between resources employed and the results achieved, while to be effective implies attaining the specific objectives set and achieving the intended results controls within an organization are meant to encourage efficient and effective use of resources including personnel to optimize the company's goals.

An important part of these controls is accurate information for internal decision making. Another important part of effectiveness and efficiency as pointed out by Arens et al. (2003) is safeguarding of assets and records. The physical asset of an organization can be stolen, misused or accidentally destroyed unless they are protected by adequate controls. The same is true of non-physical assets such as account receivables, important documents and records, thus, internal controls are designed to enable an organization execute its operations in an orderly, efficient and effective manner.

2. Reliability of Information

Financial reports communicate information about an entity's resources, obligations and owner's equity. To ensure that financial reports contain and communicate valid information to assist users in making informed economic decisions, control measures are necessary. Internal controls ensure that information is fairly presented in accordance with applicable reporting requirement such as generally accepted accounting principles (GAAP), International Financial Reporting Accounting Standards (IFRSs), etc.

3. Compliance with Applicable Law and Regulations

Organizations are required to comply with many laws and regulations within and even outside the jurisdictions they operate. Examples of laws and regulations an entity may be required to comply with include environmental protection laws, civil rights laws, income tax regulations, money laundering regulations, etc. internal controls are required to identify applicable laws and regulations, prevent non-compliance with such laws and regulations and as such avoid penalties and damages to the organization arising from non-compliance with relevant laws and regulations.

Internal Control Quality

The most effective way of reducing frauds is to establish an internal control system. Arena and Azzone (2010), defined internal control quality as the capacity to obtain results that are consistent with targets objectives. Dittenhofer (2001) noted that internal control qualities is the ability toward the achievement of the objectives and goals. Badara (2012) stressed that internal control systems operate at different levels of effectiveness. Internal control can be judged effectively in each of the three categories respectively if the board of directors and management have reasonable assurance that they understand the extent to which the entity's objectives are been achieved, published financial statements are being prepared reliably and finally applicable laws and regulations are being complied with. Effective internal control requires appropriate accounting procedure and system division of duties (separation of responsibilities) especially those of authorization, regular verification of supervision of each person's work by their superior officers.

Ayagre et al. (2014), stressed that the effectiveness of an internal control system is dependent on how fluid the system interact with itself and how embedded it into organizational business processes. Again, for an internal control system to be effective

Banking and Accounting Issues

and provide that needed assurance to the board, there should be some agents of effectiveness.

According to Izedonmi (2000) primary responsibility for the prevention and detection of errors and irregularities rest with the management of the organization; this responsibility arises out of a contractual duty of care by directors and managers and also because directors and other managers act in a stewardship capacity with regard to the property entrusted to them by the shareholders or other owners. Izedonmi (2000) also stressed that the responsibility for the prevention or detection of fraud and errors within an enterprise rest with the management. This responsibility is discharged by management through the establishment of an adequate system of internal controls including internal check and internal Audit. It is therefore, pronounced that the management of any banking organization is totally responsible for the prevention and election of fraud majority by the establishment of an adequate, efficient and effective internal control system.

REFERENCES

- Adeyemi, O. O. (2012). Corruption and local government administration in Nigeria: A discourse of core issues. *European Journal of Sustainable Development, 1*(2), 183–198.
- Aikins, S. K. (2011). An examination of government internal audits' role in improving financial performance. *Public Finance and Management, 11*(4), 306–337.
- Ayagre, P. Appiah-Gyamerah, C., Nartey, J (2014). The effectiveness of internal control systems of banks. *International journal of Accounting and Financial Reporting, 4*(2).
- Babatunde, A. S. (2013). Stakeholders perception on the effectiveness of internal control system on financial accountability in the Nigerian public sector. *International Journal of Business and Management Invention, 2*(1), 16–33.
- Badara, M. S. (2012). The role of internal auditors in ensuring effective financial control at local government level: the case of Alkaleri L.G.A., Bauchi State. *Research Journal of Finance and Accounting, 3*(4), 57-65.
- Baltaci, M., & Yilmaz, S. (2006). Keeping an eye on subnational governments: Internal control and audit at local levels. Retrieved from World Bank Institute <http://siteresources.worldbank.org/WBI/Resources/InternalControlandAuditatLocalLevel-INA>
- Benjamin, E. (2011). *O'level Economics of West Africa*. Ibadan: Onihanjo Press.
- COSO (Committee of Sponsoring Organizations of the Treadway Commission) (1992). Internal Control- Integrated Framework, AICPA, New York, NY.
- Dittenhofer, M. (2001). Internal auditing effectiveness. An expansion of present methods: *Managerial Auditing Journal, 16*(8), 23-41.
- Feng, M., Li, C., McVay, S. E. & Skaife, H. A. (2015). Does ineffective internal control over financial reporting affect a firm's operations? Evidence from firm's inventory management. *The Accounting Review, 90*(2), 529-557.
- Haron, H., Ibrahim, D. D. N., Jeyaraman, K., & Chye, O. H. (2010). Determinants of

Banking and Accounting Issues

internal control characteristics influencing voluntary and mandatory disclosures: A Malaysian perspective. *Managerial Auditing Journal*, 25(2), 140–159.

Idogei, S. O., Josiah, M. & Onomuhara, O. G. (2017). Internal control as the basis for prevention, detection and eradication of frauds in banks in Nigeria. *International Journal of Economics, Commerce and Management*, 5(9), 61–88.

Izedomni, O. (2000). *Auditing standards*. Denmark; Frederiksberg Publishers.

Mawanda, S. P. (2018). Effects of

Internal Control System on Financial Performance in Uganda's Institution of Higher Learning. Dissertation for award of MBA in Uganda Martyrs University
Mohd-Sanusi, Z., Mohamed, N., Omar, N., & Mohd-Nassir, M.-D. (2015). Effects of internal controls, fraud motives and experience in assessing likelihood of fraud risk. *Journal of Economics, Business and Management*, 3(2), 194–200.

Owolabi, S.A. (2010). Repositioning for quality service delivery in tertiary institutions: the role of accountants. *An International Multi-disciplinary Journal, Ethiopia*, 4(2), 1994-9057.