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# Internal Control on the Private Sector

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## Abstract

Companies in the Private Sector struggle every day to remain competitive and to have sustainable growth. So, they need to push their costs to a minimum and their revenue to a maximum, increasing their profit.

A big chunk of a company's costs and losses may be due to errors or frauds, putting in jeopardy its own survivability. However, the implementation of an internal control system will effectively reduce the probabilities of frauds and errors to occur, by establishing preventive measures such as settling regular checks on the activities, assuring that every worker understands the policies and procedures, and analyzing periodically the accounting information to detect any deviations.

**Keywords:** Internal Control System; Private Sector; Errors; Frauds.

## Introduction

Credibility is one of the main concerns in a company. Therefore, one of the ways to assure its credibility is by having a strong internal control (DeepSky, 2010). The problem is whether the system fits the organization. Hence, in pursuance of the review on the suitability of the internal control system, one must analyze the efficiency of the operations and information flows and its cost/benefit (Neves, 2008).

In its essence, the importance of the internal control is translated by the system that guarantees the execution of the pre-established processes and plays an essential role in preventing fraud or errors, protecting the assets of the company (DeepSky, 2010).

The extracted information from the various operations should generate reliable results that will be used by the management to make decisions. Not so reliable results, wrong, or temporarily late, may lead to incorrect decision making. Therefore, the internal control system must enable the information that reaches the management to be correct. On the other hand, the importance of the internal control system depends on the analysis of the corporate's development, as the processes get more complex and beyond reach and control (Neves, 2008).

Internal control is present in all the organization's structure and every procedure represents a part of it. The internal control system is implemented within the organization's structure and revolves around administrative aspects that affect accounting aspects directly. Nevertheless, a reliable accounting system must be based on an adequate system, and that is the only way to trust the information provided. Distorted accounting information may lead to incorrect conclusions and consequent harmful decision making for the organization (Neves, 2008).

Having an efficient internal control system will make possible to answer questions associated with strategic, operational and management issues - which activities may go well or badly, what problems should be addressed and what are the most appropriate methods to accomplish a task.

According to Bazmi, Rehman & Rehman (2016, p.15) “it is generally agreed that finance is the main stay of any economy, be it private or public sector. It is equally true that no meaningful development could be achieved without finance and proper management”. This means that if organizations have the goal to be successful, they must establish different systems of internal control in order to ensure smooth running of their business.

When creating an organization one must know what will be the main activities and what to achieve from them. Therefore, the organization must establish a mission, the objectives it wants to achieve and strategies that help formulate the plans to reach them. Being the main goal of a business, in the private sector, to achieve profit, it means reducing costs to a minimum and maximizing the efficiency of the operations. To accomplish that goal, it is necessary to know what activities and processes to cut down and what to develop and enhance. That is only possible by having a process that is constantly analyzing the execution of the business. That is where the process of internal control takes place. COSO[2] (2011) refers that exist five main components of internal control that support the organization to achieve its objectives: control environment; risk assessment; control activities; information and communication; and monitoring activities.

Since, understanding and implementing internal control is taking another step for success and accomplishing predetermined goals, this study aims to answer the question: “In which way can Internal Controls help benefit an organization?”. So, the purpose translates into, according to the literature on private sector’s internal control, providing an overall and integrative definition of the concept of internal control, its key control system components and its importance on risk and fraud management.

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[2] COSO stands for Committee Of Sponsoring Organizations and its mission is to provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations. Retrieved from https://www.coso.org/Pages/aboutus.aspx.

**The Concept of Internal Control**

Many scholars, researchers and professional organizations pointed out the importance of correctly defining the concept of Internal Control[3].

The first professional organization to define the concept was the Institute of Chartered Accountants in the United States (*apud* Rababa'h, 2014, p. 67):

> "Include internal control over organizational plan administrative, and how to coordinate as well as a means adopted by the facility to protect the assets, as well as to ensure accuracy calculations of accounting information and beside it aims internal control to improve competence productivity and to monitor the implementation of administrative policies set by management and labor to walk within the plans drawn".

The definition of internal control is intentionally broad because it captures key concepts fundamental to how companies and other organizations design, implement, conduct, and evaluate internal control, providing a basis for application across various types of organizations; and because it accommodates subsets of internal control. Those who want to may focus separately, for example, on internal control over reporting or controls relating to complying with laws and regulations (COSO, 2011).

KPMG[4] (1999) argues that risk management and control should be viewed by businesses as a mean to maximize their opportunities and to reduce potential losses associated with unwanted events. Risk management and internal control should come hand in hand with entrepreneurship, increasing shareholder value and reducing risk[5] to a minimum. Then, it is essential for the top management and staff to be aware of the best methods for identifying, and subsequently managing those risks.

This topic is not new though. In the modern business world, corporates fight to keep up with the constant changes in the evolving and development of the markets in which they are

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[3] The essential elements of control are the purpose, engagement, monitoring and learning. It is made up by the resources, systems, procedures, culture, structure and tasks, by helping the workers and fulfilling its objectives (Flostoiu, 2012).

[4] "KPMG is a global network of independent member firms offering audit, tax and advisory services. The firms work closely with clients, helping them to mitigate risks and grasp opportunities", retrieved from https://home.kpmg.com/xx/en/home/about/overview.html.

[5] "Risk can be defined as real or potential events which reduce the likelihood of achieving business objectives. Or, put another way, uncertainty as to the benefits. The term includes both the potential for gain and exposure to loss" (KPMG, 1999, p.14).

inserted. With these changes in the markets, comes along the changing of the risk. Therefore, a system of internal control must be able to predict those risks in order to give proper responsive shifts. Effective risk management and internal control depends on a regular evaluation of the nature and extent of risks – the enhancement of business performance is dependent on embedding risk management (KPMG, 1999).

For defining the system of internal control KPMG (1999, p.19) quotes the Turnbull Committee[6] which refers to it as "a system that encompasses the policies, processes, tasks, behaviors 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. This includes the safeguarding of assets from inappropriate use or from loss and fraud, and ensuring that liabilities are identified and managed.
- 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.
- Help ensure compliance with applicable laws and regulations, and also internal policies with respect to the conduct of business".

Bazmi et al. (2016, p.16) depict an Internal Control as a "system within an organization designed to provide reasonable checks regarding the achievement of the organizational objective".

Therefore, in general, "internal controls refer to all the policies and procedures established and maintained by the managers of an entity to help ensure, as far as is practical, the orderly, efficient and profitable conduct of its business" (Mbeba, 2007, p.22).

For COSO, (2011) the internal control is not merely one event or circumstance, but a dynamic and iterative process, effected by a board of directors, management, and other personnel, designed to provide reasonable support regarding the achievement of objectives in effectiveness and efficiency of operations; reporting reliability; reduction of the risk of asset loss; preventing fraud and mistakes; and assuring compliance with applicable laws and regulations.

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[6] The Turnbull Committee was the Committee responsible for the publishing of the first Turnbull Report in 1999, which set out best practice on internal control for UK listed companies. Retrieved from https://www.icaew.com/en/library/subject-gateways/corporate-governance/codes-and-reports/turnbull-report

Abiola (2013) stresses the aspect that a dynamic process accompanies the company's course towards profitability goals and achievement of its mission, minimizing surprises along the way, by enabling management to deal with rapidly changing economic and competitive environments, shifting customer demands and priorities, and restructuring for future growth.

## Internal Control vs. Internal Audit

One should not confuse internal control and internal audit. The concepts are related but are distinct. Internal control involves the systems, policies, and procedures that institutions design to control risks, safeguard assets, and achieve objectives whereas internal audits help directors and officers evaluate the adequacy of internal control systems by providing independent assessments of internal controls, operational activities, and information systems (Federal Deposit Insurance Corporation, 2015).

Internal control is an integrated process in the organization's structure on all levels of management that states findings, settles responsibilities and watches over the improvement of findings and issue mandatory rectifications. However, internal audit is a planned mission performed by an independent structure within the organization and organized by the highest level of organization's management, stating findings and issuing optional recommendations and conclusions (Flostoiu, 2012).

## Branches of Internal Control

Internal controls can be broken down into two not mutually exclusive categories – accounting and administrative/managerial controls. According to the World Council of Credit Unions (2003):

- Accounting Controls – are controls that provide an assurance that the transactions performed by the staff are in line with their authorization level and are according to the management instructions. The following controls may be part of the internal control environment in order to enhance managerial effectiveness and perform risk and fraud assessment:
    - Daily Posting – elaborating and posting daily records of every day's activities makes locating errors much easier, as well as enabling a lower time-responsive corrective measure.

  - Internal Reports – An organization should elaborate internal reports necessary to review key areas of operations and staff members should have them reviewed on a regularly basis to report, promptly, any eventual irregularities identified, to the supervisory or general manager.
  - Recording of Transactions – All accounting records have to be elaborated according to the accounting principles internationally accepted.
  - Audit Trail – Records and systems should provide an audit trail, i.e. paper documentation, which allows for the tracing of each transaction from its inception to completion.
- Administrative Controls – Administrative control establish lines of authority and responsibility, segregate the operating and recording functions, and provide for the hiring of qualified employees. Effective Administrative Controls should contain the following:
  - Accounting System – "The board should adopt an accounting system that is flexible in its capacity and rigid in its controls and standards. The system should provide timely, accurate, and useful data to all employees. All staff should be adequately trained on the system prior to performing transactions that affect general ledger and member accounts" (World Council of Credit Unions, 2003, p.3).
  - Written Policy and Procedure – Organizational policies and procedures should be written by operational staff. These policies and procedures describe imperative actions that must be understood by every element of the organization.
  - Board Approval and Monitoring of Information – The board controls the business by analyzing reports on a regular basis, monitoring the financial condition.
  - Cash Control – Include the prevention of officials or employees inappropriately taking cash for their personal use.
  - Segregation of Duties – "The participation of two or more persons in a transaction creates a system of checks and balances and reduces the opportunity for fraud considerably" (World Council of Credit Unions, 2003, p.4).

- Dual Control – Every important storage should have two defense methods under the control of at least two different people.
- Protection of Assets – An organization should establish a hierarchy of security levels, specifying authorized personnel for each one of them.
- Zero Tolerance – Some organizations may undertake a zero tolerance policy towards excessive errors or frauds, establishing severe consequences for them.
- Personnel Policies – Personnel policies state the consequences for fraudulent acts and excessive errors and the schedule for their reviews – every employee should understand these policies.
- Rotation of Personnel – "From time to time, employee job functions should be rotated unannounced" (World Council of Credit Unions, 2003, p.5) – this will enable the detection of any fraud and cross-training of employees as well as incapacitating them to perform other tasks in case they are needed.
- Succession Planning – Every organization must know who will fill key management positions in case of resignation or retirement, providing long-term stability to the organization.
- Quality Control – The board of directors should establish a review process to determine that management and staff comply with the organization's policies and procedures.

**Maintaining and Implementing a Sound System of Internal Control – The COSO Framework**

The Committee Of Sponsoring Organizations released an Internal Control-Integrated Framework where the three categories of objectives (operations, reporting and compliances – columns in Figure 1) are related with five components (rows in Figure 1) and with the overall structure of the business (third dimension of Figure 1's cube), which will be depicted next. This framework gained widespread acceptance and is the most widely used throughout the world (Johnstone, Gramling, & Rittenberg, 2014).

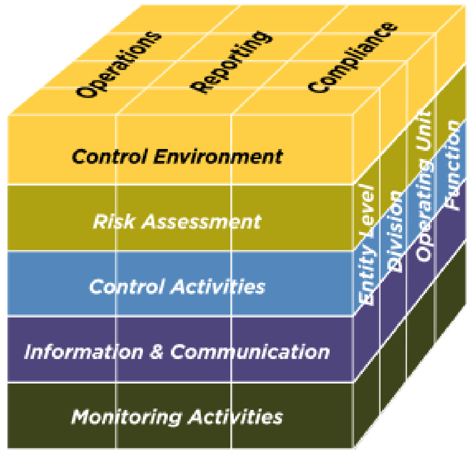


**Figure 1 –** COSO's Internal Control-Integrated Framework (COSO, 2011, p. 5).

According to this framework, an Internal Control System comprises of five main components, related with seventeen principles, among which:

- Control Environment: component that provides discipline, process and structure, providing the basis for carrying out internal control across the organization – previously determined by the board and senior management. There are five principles that should be taken into account:
  - Commitment to integrity and ethical values.
  - Independence of management and effort in development and performance in internal control.
  - Authorities and responsibilities aligned with the objectives and established by management.
  - Commitment to attract, develop, and retain competent individuals in alignment with objectives.
  - Individuals are accountable for their internal control responsibilities.
- Risk Assessment: involves a dynamic and iterative process for identifying and assessing the risks that may affect an organization from achieving its objectives. Risk assessment needs to be conducted before an organization can determine the other necessary controls. This component will form a basis for determining how risks should be managed. Risk assessment comprises four principles:

- Objectives must be clarified in order to enable the identification and assessment of risks related to them.
- Ways of managing risks must be previously determined.
- Potential for fraud must be considered.
- To know what risks may imply changes that will influence the system of internal control.

- Control Activities: are the actions established by policies and procedures to help ensure that management's directives to mitigate risks to the achievement of objectives are carried out. Control activities occur at all levels within the organization. There are three principles related:
  - Control activities must contribute to the mitigation of risks to the achievement of objectives to acceptable levels.
  - Control activities are developed and selected by technology that give information regarding the objectives.
  - Policies must be translated into control activities.
- Information and Communication: pertinent information must be identified, captured and communicated in a form and timeframe that enables people to carry out their responsibilities. The information comes either from internal or external sources. All personnel must receive a clear message from top management that control responsibilities, enabling them to know their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders. We should consider the following principles:
  - The quality information obtained is used to support the functioning of other components of internal control.
  - Information is communicated internally, transmitting the essential information related to objectives and activities used by internal controls.
  - External parties may generate information that influences other components of internal control.

- Monitoring Activities: are the activities that verify that the controls, within all five components, are correctly implemented, and continue to function effectively, according to the objectives of the board and top management. These consist of ongoing evaluations and/or separate evaluations. Any deviation and deficiency detected must be reported in a timely manner, to senior management and to the board. These comply with the next principles:
    - Regular separate and/or ongoing evaluations to ascertain whether the components of internal control are present and functioning.
    - Deviations and deficiencies have to be reported in a timely manner to the parties take appropriate and effective corrective action.

**Internal Control Objectives**

COSO (2011, p.6) states that "setting objectives is a prerequisite to internal control and a key part of the management process relating to strategic planning". Since it relates to strategic planning, they must be aligned with the business' mission and value, creating, preserving and realizing value not only for the business per se but also for its shareholders and stakeholders. Then, management must elaborate the objectives taking in to account internal and external factors[7] that will influence direct or indirectly the success of the business.

As said before, internal control, applied by the management, provides continuous checks on the achievement of objectives by analyzing its activities, predicting, preventing and identifying probable risks, frauds and failures. However, the specification of these objectives must be done with proper detail and it must be assured that every worker, on every level, is capable of understanding them. Not understood objectives, are objectives not achieved. So, staff should articulate specific, measurable, attainable, relevant and time-bound objectives (COSO, 2011).

According to the Integrated Framework published by COSO (2011), there should be three categories of objectives:

- Operations Objectives: are related with the achievement of an entity's basic mission and varies based on management's choices relating structure, industry considerations and performance of the entity. These objectives cascade into related sub-objectives for

[7] Internal and external facts such as "operation's needs, on laws, regulations and standards" (COSO, 2011, p.6)

operations within the divisions, subsidiaries, operating units and functions, directed at enhancing effectiveness and efficiency in moving the entity toward its ultimate goal.

- Reporting Objectives: are applied on the preparation of reliable reports assuring that they are prepared according to the international accounting standards (DRA410, 2000). These may relate to financial or non-financial reporting and to internal or external reporting.
    - External Financial Reporting Objectives: entities need to achieve external financial reporting objectives to meet obligations. They are a prerequisite to accessing capital markets and may be critical to the awarding of contracts or to dealing with suppliers – external entities depend on the entity’s financial statements to assess performance and compare to other businesses in the market.
    - External Non-Financial Reporting Objectives: Management may report external non-financial information in accordance with regulations, standards, or frameworks, including reporting on internal control and operational processes, if this works for the benefit of the entity – e.g. report publicly on operations in accordance to International Organization for Standardization (ISO) for quality management.
    - Internal Financial and Non-Financial Reporting Objectives: reliable internal reporting provides management with information needed to manage the organization. It supports management’s decision making and assessment of the entity’s activities and performance. Internal reporting objectives are based on preferences, judgments, and management style. Internal reporting objectives vary among entities because different organizations have different strategic directions, operating plans and expectations.
- Compliance Objectives: are the ones that should be in accordance with applicable laws and regulations – related to reporting on internal control over financial reporting and environmental compliance or international norms.

Summing up, the internal control procedures have the objective of on one hand, to perform a check on the compliance of the activities with the applicable legislation, values, norms and internal rules of the entity. On the other hand, to analyze the accounting, financial and management reports to check if they correctly reflect the activity and the situation of the entity, preventing and correcting undesired situations (Lenghel, 2013).

More specifically, Rababa'h (2014, p. 67) quotes Al-Amrat (1990, p. 41) to refer which specific objectives internal control pretends to achieve:

- Review and evaluate the internal control system.
- Determine the extent of the commitment of personnel policies and procedures implemented in all structure on the business.
- To protect the assets of the entity.
- To prevent fraud and errors, detecting if signed.
- Making sure that accounting and financial reports accurately reflect reality.
- Do regular and periodic checks on different activities, report findings and elaborate recommendations to senior management.
- Assessing the performance of individuals in general.
- To participate in programs to reduce costs and establish the necessary procedures.

**Assessing the Effectiveness of Internal Control Systems**

Effectiveness of Internal Control Systems depends on whether it is being capable or not of detecting and identifying, on time, eventual frauds and errors, and assessing the probability of certain risk activities. Consequently, when implementing a sound Internal Control System there are some characteristics that help it be effective and act according as planned, as Rababa'h (2014) refers:

- Organizational plan: board and senior management must write a plan where it states the responsibilities of all staff and which goals should be achieved.
- Implementing financial control procedures: since the protection of assets is one of the main goals of an internal control system, there should be procedures for accreditation and registration, protecting assets from illicit exploitation or abuse.
- Administrative supervision and follow-up performance: management has to supervise and control administrative and operational activities of the business on a regular basis in order to assess the company's financial position and identify any casual deviation.

COSO (2011, p.15) states that a system of internal control is effective when "senior management and the board of directors determine to what extent the principles and, in turn, the corresponding attributes associated with each component are present and functioning”. Thus, one must evaluate how principles and attributes are being applied. This means making sure that the principles are according the business’ views, are correctly and consistently applied across the entity and the personnel itself. Nonetheless, there are inherent limitations in the effectiveness of internal control system:

- “The quality and suitability of objectives established as a precondition to internal control.
- The realities that human judgment in decision making can be faulty.
- Knowing that decisions on responding to risk and establishing controls must consider the relative costs and benefits.
- Breakdowns that can occur because of human failures such as simple errors or mistakes.
- Controls that can be circumvented by collusion of two or more people.
- The ability of management to override internal control decisions (COSO, 2011, p.11)”.

According to Rababa’h (2014), these limitations arise from misunderstood application instructions; error in diligence and judgement; domination and control of senior management due to the lack of support of the Board of Directors of the internal audit department on control procedures; and from being difficult and not absolute to quantify the earnings that internal control enable, face to its costs.

As stated by the World Council of Credit Unions (2003) there may be signs of warning that act as indicators that “internal controls are not adequate do discourage dishonest or fraudulent acts”. Hence, management has to adopt corrective action to reduce the chance of fraud by having regulatory authorities develop plans to enhance the internal control system. Accordingly, the effectiveness of the internal control system will be affected by having little or no internal controls; inadequate segregation of duties; inactive supervisory committee; numerous record keeping problems; management reports and accounting records destroyed or missing; lack of information security policies; or poorly trained staff.

## Conclusions

This article's purpose was to, based on a literature review, to provide a guide for implementing an Internal Control System in organizations in the Private Sector. So, along the study, were stressed out the aspects of internal control itself, its branches the difference between internal controls and internal audit, objectives and the COSO framework.

Thus, one can say that Internal Control consists of an iterative and dynamic process including ongoing tasks and activities, acting as a mean to an end, and not as an end in itself. This process is effected by people at every level of an organization, as well as policy manuals, systems and forms previously written by the board and top management. It exists to provide a somewhat reasonable assurance to an entity's senior management and board by trying to detect and prevent frauds and errors. Consequently, internal controls work as a way of a business to accomplish its objectives by performing operations that were established at the beginning, while protecting its assets and maintaining or enhancing its market value.

This concept should not be confused with internal audit. While the first is an integrated process, internal audit consists of a planned mission performed by an independent structure within the organization with the goal of providing corrective suggestions and recommendations.

Following the Internal Control-Integrated Framework elaborated by COSO, it is widely accepted that internal control have three categories of objectives, operations objectives related with the achievement of an entity's basic mission; reporting objectives associated with the internal and external financial accounting reports; and compliance objectives that assure that activities are performed according to the law. These objectives are within five different components risk assessment; control environment; control activities; information and communication and monitoring.

However, even though an entity that adopts this framework correctly should have maximum efficiency on its internal control, there are always limitations that should always be taken into consideration.

Finally, the purpose of this article is met, by arranging important information on Internal Control Systems and by highlighting certain aspects that one should always bear in mind when implementing them, making them efficient. Moreover, by doing so, organizations will benefit from a better working place where little to no frauds or errors are done and the goals and aims are achieved – attaining better performance and profits.

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