Internal Control and Audit System Adopted in Manufacturing Industries – An Analysis

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ABSTRACT

This paper is attempted to explore the internal control mechanisms used in the manufacturing industries in Karnataka. The results of the research can be used by the companies concerned to improve their internal control systems. The recommendations can also be interesting for other companies and organizations in Karnataka, indicating the general weaknesses and specific features that should be developed to achieve an effectiveinternal control mechanism. Conclusions of this study can also be used as a basis for further studies in the field of internal control and risk management.

Keywords: *internal control, risk management, corporate governance, manufacturing industries.*

1. INTRODUCTION

It also requires auditors to provide independent attestation regarding the assessment by management. Sarbaneys-Oxley is binding for the listed companies in the US and their subsidiaries, and, as a consequence, indirectly influencing a part of private sector companies in Estonia. In Europe, no regulation can be considered equivalent to Sarbaneys-Oxley. In the EU, the European Commission is proposing new requirements for listed companies and other public interest entities; active discussions over the necessity and forms of regulating the management's responsibility to maintain and report on the effectiveness of internal control system are ongoing.

With regard to Estonia, there is limited research about the changing nature of internal control in organizations and the actual evaluation of the internal control systems in a company. At the University of Tartu and at Tallinn University of Technology, few works have been written concerning the creation and improvement of internal control system in public sector organizations, but research regarding internal control systems in private sector has been limited. Furthermore, in Estonian business environment appears a need for testing the evaluation methods of internal control over financial reporting andbenchmarking the results against best practices.

CONCEPT OF INTERNAL CONTROL SYSTEM

- The Scope And Size Of The Business Entity Has Become So Complex And Widespread That Management Must Rely On Numerous Reports And Analyses To Effectively Control Operations;
- The Check And Review Inherent In A Good System Of Internal Control Affords Protections Against Human Weaknesses And Reduces The Possibility That Errors Or Irregularities Will Occur;
- It Is Impracticable for Auditors to Make Audits of Most Companies within Economic Fee Limitations without Relying on the Client's System of Internal Control.

However, with the aim of minimizing litigation risk, the AICPA amendments in 1958 and 1972 focused managements', accountants' and auditors' attention on traditional internal accounting controls, thereby again narrowing the focus of control.

Big audit failures in the 1980s were influential in prompting re-evaluation of internal control. The National Commission on Fraudulent Financial Reporting (Treadway Commission) in the US, the Commission to Study the Public's Expectations of Audits (MacDonald Commission) in Canada, and the Committee on the Financial Aspects of Corporate Governance (Cadbury Report) in the United Kingdom, were established to investigate the reasons behind the large number of company failures, fraud and audit failures. Key findings from these reports highlighted the importance of having an effective internal control system and confirmed the lack of consensus around the definition of internal control.

In India, the organisations which sponsored Treadway (COSO - Committee of the Sponsoring Organizations) produced a further report in 1992, specifically addressing the role of internal controls in securing improved corporate governance: the COSO framework, which is regarded as the foundation of the modern approach to control (Spira et al 2003: 647). COSO 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:

- Effectiveness And Efficiency Of Operations;
- Reliability Of Financial Reporting;
- Compliance with applicable laws and regulations. (COSO 1994: 13)

The comparison of the scope, objectives and focus of the aforementioned concepts is described in table 1.1. The basic ideas that all adopt and implement are the responsibility and accountability of managers for establishing, supervising and developing an internal control framework in an entity and a dynamic process-view of internal controls. As results from the table, the audience of internal control information can be different. Subjects having an interest in the effectiveness of a company's internal control system include managers, board of directors, the audit committee, internal and external auditors, regulators, suppliers and customers, investors and lenders. Internal control information provides the users better assurance on (a) the likelihood that the company has addressed significant risks and can address them in the future and (b) the likelihood that interim financial data for decision making will be accurate (Rittenberg et al 2005: 146)

The need for more advanced and appropriate internal control models appeared also in other countries. In fact, shortly after COSO, the Canadian Institute of Chartered Accountants developed the Criteria of Control Framework a definition of control and a series of criteria for assessing its effectiveness. CoCo defines control as comprising those elements of an organization (including its resources, systems, processes, culture, structure and tasks) that, taken together, support people in the achievement of the organization's objectives (Luscombe 1995: 3). This reflects a much broader approach to control and risk, directly related to the achievement of organizational objectives (Spira *et al.* 2003: 648). The objectives of CoCo are similar to those of COSO, adding the reliability of internal reporting and compliance with internal policies. CoCo (Luscombe 1995: 3) argues that internal control needs to be understood in a broad context. For example, control is as much a function of people's ethical values and beliefs as it is of standards and compliance mechanisms (tone at the top). The general approach and the specific objectives which CoCo strives to achieve are described in appendix 3.

2. OBJECTIVES OF THE STUDY

This study has the following objectives:

a. To explore the overview of Internal Control Mechanisms in India.
b. To explore the components of Internal Control system used in the organization.

3. METHODOLOGY USED IN THE STUDY

The researcher has used secondary data for this study such as published reports, articles, books, journals etc. For fulfillment of objectives, the researcher had a review of various published papers to assess and explore the components of Internal Control system used in the organization.

4. COMPONENTS OF INTERNAL CONTROL SYSTEM

This framework is widely implemented in India, in the private and public sectors, and is usually used for evaluating and benchmarking the internal control system of companies. Internal control consists of five interrelated components, which will be further discussed in following sub-chapters:

- Control Environment;
- Risk Assessment;
- Control Activities;

- Information And Communication;
- Monitoring.

CONTROL ENVIRONMENT

The literature suggests that at the heart of effective control is the control environment component. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Weaknesses at the "tone at the top" have been associated with almost all financial failures during the past decade. The main principles to be taken account in assessing the effectiveness of control environment are described in

RISK ASSESSMENT

Every entity faces a variety of risks from external and internal sources that must be assessed and managed. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with changes.

5. CONCLUSION

The need for an effective internal control framework to help companies and organizations to achieve their objectives has grown during the last years. This results also from the difficulties experienced in mature economies, such as the India, where weaknesses, wrongdoings or frauds seriously undermined the capacity of the organizations to reach their objectives. The internal control framework should not be considered as a static model but an evolving system following the strategic development of the companies. In fact, the companies should regularly assess the increasing risks related to the growth of the activities and adequately adapt their internal control framework to the new needs. In the long term, even though an effective internal control does not ensure the achievement of financial results, it will contribute to the achievement of the companies' objectives and indirectly also the realization of financial performance can be expected.

A company can benefit of effective internal control several ways. Through enhanced structure of internal control, the possibility of error and fraudulence and illegal conduct can be diminished to a minimum. In highly competitive market, a well-managed internal control system helps to improve the competitiveness and improve employees' understanding of company's objectives. However, every internal control system has its inherent limitations that explain why internal control, no matter how well designed and operated, can provide only reasonable assurance regarding the achievement of the company's objectives. Mistakes in judgments, breakdowns, collusions or management override can all contribute to the failure of a control system.

6. REFERENCES

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