

# COMPONENTS OF INTERNAL CONTROL SYSTEM – AN ANALYSIS

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## ABSTRACT

This paper is attempted to explore the internal control mechanisms used in the manufacturing industries in India. Understanding the concept of internal control is essential for developing an understanding of its impact on the performance of manufacturing organization. The internal control system of an entity is strictly interrelated to the structure used by management to oversee the activities of the organization, or to what is defined as the entity's corporate governance. "Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently" (OECD Principles of Corporate Governance). The Board of Directors is thus responsible for providing governance, guidance and oversight for senior management and ensuring that an appropriate internal control system is in place and effective, meaning it ensures that expected objectives are attained. 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 effective internal 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

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 and benchmarking the results against best practices.

Theoretical background of the research is chosen to be wide-ranging, covering the theories of various authors and materials from sources with different academic levels. Theoretical literature relies on the

academic articles and books written by leading experts in the field, the differences between the countries are investigated based on the main internal control frameworks from the US, Canada and UK; also legislative sources are used. Due to the novelty of the subject, the original literature regarding internal control in Estonia is limited and therefore the sources are mainly from foreign authors. Even translations and originals of foreign literature on this topic are quite rare in Estonian libraries. The sources for empirical study involve the analysis of the companies' financial statements, examination of internal documents and interviews with key personnel. To create an overall framework for the assessment, but at the same time to take into account the features of each company, both quantitative and qualitative research methodologies are used.

## 2. CONCEPT OF INTERNAL CONTROL SYSTEM

It considers the traditional aspects of the concepts of internal control, collates the views of different authors and develops a comprehensive definition of "internal control" and "internal control over financial reporting" in a company, highlighting the differences between the two definitions. In addition, the importance of internal control, its inherent limitations and possible outputs in government-level regulations are discussed.

In the past the concept of "internal control" was limited to that of "internal check". In 1930, the system of internal check was defined as the coordination of a system of accounts and related office procedures in such a manner that the work of one employee independently performing his own prescribed duties continually checks the work of another as to certain elements involving the possibility of fraud (Sawyer et al. 2003: 61). It is knowingly the first definition to indicate the importance of internal control in helping also to detect or prevent fraud.

Additional internal control frameworks have been developed in the US, which contain both their own definitions of internal control and different approaches to the system:

The Information Systems Audit and Control Foundation's Control Objectives for Information and Related Technology (COBIT). This framework allows managers to benchmark the security and control practices of IT environments. COBIT has adapted the definition of control from COSO. The policies, procedures, practices and organizational structures are designed to provide reasonable assurance that business objectives will be achieved and that undesired events will be prevented or detected and corrected (CobiT 2000: 10). A brief overview of the CobiT framework can be found in appendix 1.

The Institute of Internal Auditors Research Foundation's Systems Auditability and Control (SAC). The report provides guidance on using, managing, and protecting information technology resources and discusses the effects of end-user computing, telecommunications and emerging technologies (Colbert et al. 2005). The SAC report (Mair 2002: 7) defines a system of internal control as a set of processes, functions, activities, subsystems, and people who are grouped together or consciously segregated to ensure the effective achievement of objectives and goals. See appendix 2 for the description of the SAC framework of internal control.

in a Financial Statement Audit (SAS 55), amending SAS 78 and SAS 94. SAS adopts the internal control definition from the COSO report, except that SAS places the reliability of financial reporting objective first, thus emphasizing the importance of the activity.

Although the four definitions contain essentially the same concepts, the emphases are somewhat different. COSO accentuates internal control as a process, i.e. internal control should be an integrated part of ongoing business activities. COBIT views internal control as a process which includes policies, procedures, practices and organizational structures that support business processes and objectives. SAC emphasizes that internal control is a system, i.e. that internal control is a set of functions, subsystems, and people and their interrelationships. Furthermore, only COSO focus on the overall entity where all the other frameworks mostly focus on some of its aspects.

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.

### 3. 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.

## 4. METHODOLOGY USED IN THE STUDY

The data used for the research has been extracted from the reports generated from official website of RBI and Ministry of Corporate Affairs. 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.

## 5. 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. The COSO approach to internal control is well described by the figure 1 below.

### 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.

### CONTROL ACTIVITIES

As control environment and risk assessment are broad entity-level concepts, which are often informal and difficult to evaluate due to lack of appropriate benchmark, control activities relate to already defined objectives and risks, are usually defined by entity's procedures or practice and easily measured. However, as presented below, the importance of the control activities should not be overestimated.

### INFORMATION AND COMMUNICATION

Every enterprise must capture pertinent information – financial and non-financial, relating to external and internal events. Relevant information must be delivered to people who need it in a form and timeframe that enables them to carry out their responsibilities and make decisions. Recognising the emerging importance of information and communication, COSO has included it as a separate control component.

### MONITORING

Internal control system and the application of controls change over time. This can be due to the arrival of new personnel, varying effectiveness of implementing the procedures or supervision, time and resource constraints or changes in the circumstances for which the internal control system originally was designed. Thus the management needs to determine and observe whether the internal control system continues to be relevant and effective in the entity as intended.

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.

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