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Internal Control System: A Review of the Research Literature

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ABSTRACT

The internal control system is a procedure for making sure accomplishment of a corporation's targets in operational are effectiveness and efficiency, reliable financial reporting, and conformity with regulations and policies,the internal control system is essential to all corporations without having any exception, either large, medium or small. This research aimsto deliver a comprehensive review study about the mechanisms of internal control system and to discuss how the concept of internal control system can reduce the risk of misappropriation. Books, articles, and other sources relevant to the study topic being investigated, literature review was designed to provide an overview of how internal control can minimize the risk of misappropriation. A comprehensive information in relation to the research topic being provided. Several methods on how internal control can minimize the risk of misappropriation being provided.

KEYWORDS : Internal Control System, Misappropriation

INTRODUCTION

During recent years, demand has significantly increased for better accountability and transparency in the corporate work execution. The sovereign and independent audit activity has become the vital mode for ensuring optimal accountability. Hence, in the corporate world, they consider this as the evolution of an audit society. Similarly, a meaningful collective development has been the progress of internalcontrol systems which was once considered as only a private matter for technical assurance specialists. Today, it is an independent field of proficiency and a method of tackling uncertainty. Conventionally, internal control has maintained a reasonably direct relationship with the financial records. The progressive and advanced approaches to internal control have broadened its limitations significantly, way beyond the accounting data and financial reports.Internal control has developed into a comprehensive process and an extensive technique.

The internal control system is essential to all corporations without having any exception, either large, medium or small. For this reason the intention of internal control is to control business risk, such as finding the harmonized strategies as well as way of the system of internal control to cut down the risk associated with business, and to build the information which would be a fundamental background for making business choices [1].

BACKGROUND

A crucial problem managers in the 1990s faced was how to practice optimal control in businesses that demand flexibility, uniqueness and innovation. Competitive firms with demanding and up-to-date customers must depend on the ability of employees to take initiatives so that opportunities can be identified and timely responses can be made to ever changing consumer needs[2].

Pursuit of opportunities can open firms to excessive risk or draw behaviors that can hurt a company's integrity. So how do top managers protect and secure their businesses from control failures when determined and empowered employees are motivated to redefine their job execution process? How can the leadership ensure that workers with entrepreneurial tendencies are not putting the well-being of the business at risk? A solution could be to look back to the basics of control formulated in the 1950s & 1960s for machine oriented bureaucracies.

During that era, senior managers applied control by informing people how to perform their jobs and monitoring them with continuous surveillance to avoid any surprises. While this technique sounds very outdated for modern businesses, it is still very much effective given standardization is pivotal for efficiency and productivity. However, in most businesses operating in diverse and highly competitive markets, senior managers cannot use all their time and effort on making sure that every employee is doing what is expected of him/her. Nor is it realistic to believe that managers can actually achieve optimal control by simply employing good people, giving incentives and blindly hoping for the best. Rather, today's managers should motivate employees to take initiatives which can lead to process improvements and identification of new methods of responding to consumer needs in a controlled way.

COMPONENTS OF INTERNAL CONTROL SYSTEMS

The core design and implementation of an Internal Control System depends on various factors, which include; size of the business, corporate risks and the complexity of the firm. Businesses that are smaller in size can achieve the goals of an Internal Control System more easily with less formal mediums and simpler processes and structures.

Based on The Committee of Sponsoring Organizations of the Tread way Commission (COSO), which is a "joint initiative of the five private sector organizations and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence" [3], the components of Internal Control System are furthermore divided into the following 5 categories:

i. **Control Environment:** The layout or structure of the control environment of an organization comprises several of factors and the way management or leadership influences the processes in thecompany.These include guidelines for the delegation of tasks and duties, communication and implementation of integrity, morals andethical values, determination towards efficiency and commitment to competence, leadership roles and management style, organizational structure and, interaction with the employees and customers in the organization.
ii. **Risk Assessment:**In every organization, there is a need to be aware of the risks that it is facing and can face in the near future, hence, it is pivotal to learn how to manage these foreseeable risks. The risk assessment process generally involves: clear specification, identification of risk, risk assessment, communication and information transfer, and risk management.
iii. **Control Activities:** All companies must outline and implement instructions and guidelinesto make sure that the activities which are considered important or necessary by the Board of Directors and the Executive Board are effectively executed [4].
iv. **Monitoring**: By monitoring the danger and the performance of control procedures frequently, an agency can easily respond dynamically to changing circumstances. The two forms of monitoring are: ongoing monitoring and periodic monitoring.
v. **Information and communication**: Communication can be formal by means of reports, training, policy guidelines, accounting and financial handbooks, etc. Information is likewise communicated informally by e-mail, dialog, actions of administration and also other agency employees.

TASKS AND RESPONSIBILITIESOF INTERNAL CONTROL SYSTEMS

The core responsibility for the proper implementation of an internal control system is with the Board of Directors and then respectively it's the audit committee. Mainly, the Board has to ensure that the appropriate control steps are being taken so that misstatements and misappropriations of transactions and other related statements can be prevented detected and corrected. However, the management is mainly responsible for the operation and supervision.The main tasks and responsibilities regarding the ICS can be as follows [5]:

i. Board of Directors (Audit Committee):

- Implementation and maintenance of a functional internal control system as the core monitoring function of the BoDagainstthe accounting of the company.
- Confirming the enforcement of the measures and steps to be taken by themanagement in relation to the framework of the internal control system
- Establishing an adequate check of the effectiveness of theICS.

ii. Management: Effective implementation of the instructions defined by the Board of Directors:

- A well-orderedsystemized approach to the collection of an adequate controlstructure.
- Establishment and development of required processes for the identification, evaluation, assessment and control of the identified risks.
- Identification of major controls and their check and balance, making sure that corrective measureisbeing taken.
- The development and documentation of an organizational structure which specifically functions parallel to all the assigned tasks, responsibilities and information flows.
- Ensuring the provision of all necessary technical and human resources which includes quality of staff, training and experience.

iii. Auditors: Proper verification of the actual existence of the internal control system.The Board of Directors every now and then comes across the following fundamental issues regarding the ICS:

- Are all relevant risks in the business processes known and assessed?
- Identification of measures that minimize these significant risks to an optimal level for the company.
- Is the internal control system actually effectiveand operating efficiently?
- Does the corporate culture and organizational environment allow for continuous improvement of processes and control systems?

HOW INTERNAL CONTROL REDUCE THE RISK OF MISAPPROPRIATION

Effective internal controls are necessary no matter how small the size of the company, for many vital reasons. Fraud prevention, embezzlement detection, conflict of interest and accurate financials are all valid reasons to place good internal control systems.

i. Tone at the Top Management

Top management and leadership's determination and commitment to enforcing strict internal control and how well they adhere to their own internal controls sends a very strong signal and message to all the employees in the organization about the importance and relevance of internal controls, embezzlement, fraud prevention and financial records accuracy.In small businesses, usually the management comprises only of the business owner and mainly one or two managers, theirmain concern and primary focus is on their business and not on accounting.Such behavior and attitude is present in most of thefraud cases prevalent in small businesses.

ii. Written Ethics Policy

Another effective tool management must strongly consider is developing a written policy that clearly articulates a simple policy for integrity, morals and ethics. Leadership should ensure that this policy is well known to everyone throughout the company. It is pivotal that the management createsa strong example by setting the behavior that is expected from the employees in the organization.Policies should be considered for review and revision at least on annual basis to adjust for changes in the work environment.

iii. Segregation of Duties, Policies and Procedures

Full access to financial data and information should be given to limited employees and thus it should be restricted and properly controlled. It should not be given asaone-person task, ensure that there is a proper separation of duties amongst the employees and no single employee has too much responsibility within the system. Within the company, it is immensely important to divide the responsibilities related to financial matters amongst the management team.

iv. Access and Authorization Controls

Access and authorization controls were developed to make sure only the right staff members may enter into transactions or possess the authority to access corporation assets, paperwork, as well as information. Samples of these kinds of controls involve. Successful authorization and access controls minimize possibilities to make as well as hide fraud. It is difficult to rob assets which you don't have accessibility to, and fraudsters cannot modify records or information without having authority to access to them.

v. Internal Control in Information Technology

Information technology (IT) controls are an essential element of a highly effective internal control structure. Important elements involve, IT helps to protect vulnerable data like officials documents, duty paid documents, staff social security members, is also a significant challenge. According to Ricchiete (1982:263), there are actually two distinct attributes of IT system which including[6]:

- IT application control assist in giving control over the information which was added into the system like duty paid.
- IT general control assists in providing the appropriate operation of IT systems over time.

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