

UNIVERSITY OF PORT HARCOURT JOURNAL OF ACCOUNTING AND BUSINESS
DEPARTMENT OF ACCOUNTING
UNIVERSITY OF PORT HARCOURT, CHOBA
PORT HARCOURT, RIVERS STATE
NIGERIA
VOL. 3 NO. 2 JUNE 2016

EFFECTIVE INTERNAL CONTROL SYSTEM AND THE ROLE OF THE INTERNAL
AUDITOR

CHIAM EMMANUEL BEDFORD
Department of Accounting
Ignatus Ajuru University of Education
Port Harcourt
Email: chiiamemmanuelbedford@yahoo.com
Tel: 08030903272

ABSTRACT

The focus of this paper is on Effective Internal Control System and the Role of the Internal Auditor. The profitability or growth of an organization is a function of the effectiveness of its internal control systems. In the same vein, no organization would optimize its productivity except that its internal auditor is proficient in exhibition of the fundamental and professional etiquette demanded of his designation. From our study, it was apparent that many business organizations could not see the light of the day because basic internal control tenets like segregation of duties, internal checks, etc, were neglected and also certain persons placed in the positions of internal auditors are only appendages to management policies. They are indeed not professional accountants. To this end, we recommend that automation of the entire organization, especially the finance and production departments should be encouraged in addition to ensuring that a person entrusted the responsibility of overseeing the internal audit section is not only a well trained professional but also a man who has been tried, tested and proved to be worthy in character. In addition, the internal auditor's remuneration should be appropriated from dividend to enable the internal auditor be truly independent in the discharge of his onerous assignment. If these are done, then an effective internal control system that will in turn result in optimization of production can be guaranteed.

Keywords: Effectiveness, Control System, Internal Auditor, Optimization of production.

INTRODUCTION

Internal control is the bedrock of auditing both from the point of view of management and the auditor. Any attempt to tackle an audit related problem either in practice or for examination purposes will certainly involve a critical analysis of controls relation to the matter under consideration.

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Internal control, therefore, is the whole system of controls, financial or otherwise, established by management, in order to secure as far as possible, the accuracy and reliability of the records, run the business in an orderly manner and safeguard the company's assets; its objective being the prevention or early detection of fraud and errors (Aguolu: 2008:134). Internal control may include internal auditing.

Internal control system is a topical issue following global fraudulent financial reporting and accounting scandals in both developed and developing countries. A proactive preventive approach to the problem requires a critical evaluation of existing internal control structures in organizations to determine their capacity to ensure that organization's activities are carried out in accordance with established goals, policies and procedures.

If a company suddenly goes out of business, the likely question is what went wrong? A breakdown in the internal control system is the usual cause. Internal control is the process that guides an organization towards achieving its objectives. These objectives include operational efficiency and effectiveness, reliability of financial reporting and compliance with relevant laws and regulations. Absence of these variables often results in organizational failure. Absence of or weak internal controls are primary causes of many cases of fraudulent company financial reporting. (Woolf 2005:17).

STATEMENT OF PROBLEM

This paper intends to:

- (a) Ascertain whether internal control provides adequate internal framework of checks and balances to ensure that funds are utilized solely and wholly for intended purposes;
- (b) Provide a basis for understanding the operations of the above framework of checks and balances established by both the private and public sectors and whether such systems comply with globally accepted internal control mechanisms:
 - What role should the internal control system (internal auditor) play in an organization?
 - What internal control systems are currently in use? Do they include all the expected elements to internal control systems?
 - Are internal control systems in our contemporary companies adequately documented and regularly updated as changes occur?

REVIEW OF RELATED LITERATURE

A lot of the literature on internal control frameworks includes information and communication as one of the internal control components. Smooth flow of information and communication across and within the organization is influenced by the nature of the working organization within the organization at all levels and the working relationship within the organization at all levels. The working relationship exists in an organization if delegation of responsibilities is achieved. However, when a communication gap exists for any reason, sub optimization results with adverse consequences (Asein: 2008:5).

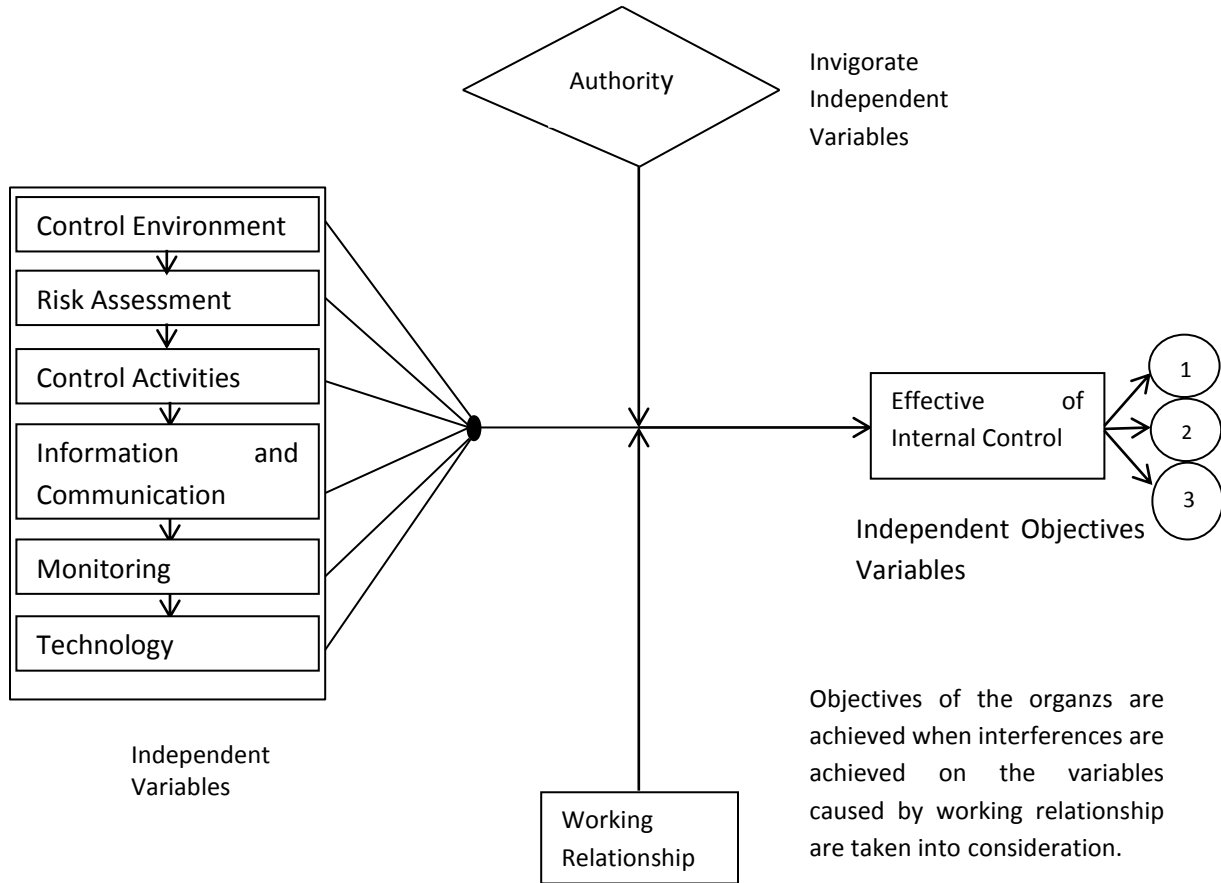
Some internal control frameworks place unnecessary emphasis on detailed explanation of the different components of the system and methods for their design. They ignore details on

How each of the components can be measured to assess their effectiveness. This causes a dilemma. For example, where two managers use different methods to measure the same subject and arrive at different conclusions. A challenge arises in ascertaining who is right or wrong. When a common benchmark for evaluation of measured results is missing, knowing the right approach becomes difficult (De Paula, 2008: 54).

Other internal control frameworks ignore where one or more components are missing within a given structure, but are compensated for with other controls in other components, for example, in small companies, segregation of duties is not possible, but is compensated by management's involvement in the day _ to _ day supervision, verification and review of records and processes to ensure control function effectively. Under the situation, all components of an effective internal control system may not be present but the system could still function effectively. The challenge is ascertainment of the effectiveness of the system. When such management styles extend to large organizations, unscrupulous managers of these organizations can manipulate the organizations to meet their personal goals.

After addressing the above limitations, internal control is a process of integrating sets of activities originated by top personnel of an organization and embedded within all the organization's activities to achieve goals. This comprises two sets of variables: dependent and independent. The independent variables function to generate the outcome of the dependent variable.

Figure 1: Conceptual framework of internal control



Source: Amudo, A et al (2009:128), Conceptual Framework of Internal Control

The objectives, depicting overlapping interrelationships as numbered 1,2, and 3 in figure 1.(1) include efficiency and effectiveness of operations. (2) Accuracy and reliability of informative financial reporting and (3) compliance with applicable laws, regulations, policies and procedures.

The independent variables determine the effectiveness of an internal control system. The presence and proper functioning of all the components of the independent variable ensure effectiveness of internal control system. This achieves each category of objective 1, 2 and 3 in figure 1.

The independent variables comprise major and minor components jointly fed into and form a specific major independent variable. The measurement of major independent variable locates any weakness existing in the major independent variables. The major independent variables include:

- Control environment
- Risk assessment

- Control activities
- Information and communication
- Monitoring
- Information Technology

The minor independent variables include:

- Authorization and approval procedures
- Human resource policies and practices
- Assignment of authority and responsibility
- Ineligible expenditure
- Accountability obligations
- Segregation of duties
- Controls over access to resources
- Presence of internal auditors
- Verification
- Reconciliation
- Review of operating performance
- Supervision

A direct relationship exists between the outcomes of the dependent and the independent variables. All the independent variables are relevant to each category of objectives. Internal control processes (minor independent variables) affect the effectiveness of internal control systems, which is subject to the organization's determined objectives. All the independent variables are relevant to each category of objectives. Internal control processes (minor independent variables) affect the effectiveness of internal control systems, which is subject to the organization's determined objectives. All the independent variables are interdependent but each has an impact on the effectiveness of internal control systems.

Different approaches to the evaluation of effectiveness of internal controls are available

OBJECTIVES OF EFFECTIVE CONTROL SYSTEM

Aside from the maintenance of an adequate method of processing accounting data, safeguard of the company against possible financial loss due to fraud or errors, an effective control system should ensure that:

1. All income or revenue due to the company are received and accurately recorded in the books;
2. All expenditure incurred by the company are correctly recorded and payments properly authorized;
3. All assets are correctly recorded and adequately safeguarded against loss, damage or waste;
4. All liabilities are recognized, correctly recorded and adequate provision made for known and anticipated losses (Aguolu: 2008:134).

CLASSES ON INTERNAL CONTROL

Internal control can be classified as

- (a) Methods of keeping books and records
- (b) In-built control techniques and
- (c) Management techniques.

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(a) **Methods of keeping books and records:**

For an internal control to be effective, the following principles should be observed with respect to the books and records:

- (i) The records should be as simple as possible and tailored to suit the purpose for which they are designed so that staff who keep the books can understand them thoroughly, hence, minimizing the risk of error.
- (ii) Books should be kept in permanent form, ie, they should be written in ink or typed. The books should be written regularly and not allowed to fall into arrears; otherwise fraud may remain undetected for a long time.
- (iii) The books should be balanced at regular intervals normally monthly, and such balancing should include the reconciliation of control accounts with the detailed records.

(b) **In-built Control Techniques**

Some common control techniques that are built into the system are:

- (i) **Pre-numbering of Documents:**
Documents should be numbered sequentially on printing. The issue of these documents is controlled and all numbers are accounted for subsequently.
- (ii) One document should be matched against a related document received subsequently. A file or register should be maintained of unmatched documents so that the receipt of the related documents is controlled and long outstanding documents can be investigated. This technique provides both completeness and accuracy.
- (iii) **Batch Totals**
A total is established of documents to be processed at a time. Such value total is checked and agreed with the processed total after the processing. By this, processing error is localized and the completeness of processing is ensured.
- (iv) **Control Accounts**
Value totals are entered into control accounts while the details are recorded in subsidiary accounts. The balance on the control account is agreed with the total of balances on the subsidiary accounts.
- (v) **Authorization**
Before documents are finally sent for processing, they should be checked by a responsible official. Such a check is normally evidenced by a signature. This control ensures the validity of the transaction being processed.
- (vi) **Scrutiny**
Scrutiny is an independent review of the work of one man by another with a view to identifying the errors which may have occurred in spite of earlier techniques. Scrutiny differs from supervisory control in that it is performed by staff on the same authority level.
- (vii) **Direct Verification**
This involves the physical verification of assets and liabilities that are recorded in the books e.g stocks or fixed assets. It also includes the direct agreement of balances. Such controls ensure the validity of account balances.

- (C) **Management Techniques Control:**
While the first two sets of controls, “methods of keeping books” and “inbuilt controls’ techniques” are generally referred to as basic control, management techniques” deals with the disciplines over basic controls. These are the various techniques which management may adopt in order to ensure that the basic controls are functioning.
- (d) **Custodial Controls:**
Custodial controls are designed to ensure that assets e.g stock, cash or security documents such as cheques, LPOs are maintained securely. The control may involve:
- Suitable physical arrangement for items of stock for easy identification and checking;
 - The use of safe and enclosed barriers for cash and security documents;
 - Suitable locked stores for sensitive items;
 - The installation of fire devises to prevent/fight fire;
 - The prevention of access to the stores to unauthorized persons;
 - The protection of certain stocks against rain or rough weather and;
 - The erection of concrete walls or wire fence for company premises.
- (e) **Supervisory Controls**
Supervisory controls are the same with authorization controls whereby the jobs performed by one staff is subject to the approval of a more responsible official. This could take the form of:
- Direct supervision by superior officials
 - Checks carried out on the job of subordinates
 - Authorization from a more responsible official for a job to be performed
 - Direct controls to enforce the performance of a job, and
 - Follow-up action to ensure that a specified corrective action is carried out in cases where an established control fails to operate.
- (f) **Segregation of Duties Control**
There should be a well-defined separation of duties between departments and individuals. Such that no one person or department handles a particular transaction from the beginning to the end. Segregation of duties for the purpose of effective internal control is designed to ensure that no one person is in a position, both to misappropriate an asset and conceal his action by falsifying the relevant records.
- (g) **Management Structure**
In order to prevent friction and ensure the smooth running of the business, there should be a clear organization structure defining the authority and responsibility of each official or department. It is an essential feature of internal control that responsibilities must be well-defined together with officials in whom such responsibilities are vested.

LIMITATIONS TO THE EFFECTIVENESS OF INTERNAL CONTROL

Some of the limitations in practice to the effectiveness of internal control include:

- (i) Staff collusion;

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- (iii) Abuse of authority;
- (iv) Management overriding established controls;
- (v) Staff incompetence;
- (vi) Alteration in the system and
- (vii) Obsolescence

(i) **Staff Collusion:**

Where the system of internal control requires the segregation of duties, the essence is to ensure that no one person carries out the three aspects of any transaction, i.e, authorization, custodial and recording. Collusion is the compensating relaxation or inter-related checks by staff who operate complementary roles for their mutual benefits. An examples is where the production supervisor agrees with the wages supervisor to include ghost names in the payroll, the two sharing the cash.

(ii) **Abuse of Authority:**

Authorization controls can be abused by the official in whom such authority is vested. This is a situation where an official fails to perform an expected control or performs such control to the detriment of the establishment. An example is where the marketing manager agrees to grant a higher than the approved rate of discount for an expected personal advantage.

THE ROLES OF THE INTERNAL AUDITOR

There are no precise roles to be played by the internal auditor since he does not have any statutory responsibilities. However, the roles or functions of an internal auditor are specified by the management who appointed him or more recently by an audit committee where it exists. The roles played by an internal auditor vary from one organization to another but will usually include the following:

- (i) Review of data and various management information made available to management for decision making.
- (ii) A continuous review of the system of internal control within the organization for adequacy to report and recommend to the management any required amendments;
- (iii) Carryout, on a continuous basis, a review of the transaction of the organization for compliance with the established procedure;
- (iv) Carry out, special investigations on the specific aspects of the business as may be directed by the management or the audit committee;
- (v) Liaison with the external auditor in order to ensure the efficiency and effectiveness of the examination and which may also result in some cost savings; functions, the internal auditor should have the following qualities;
- (vi) Providing technical support and know-how to management for the establishment, implementation and improvement in the systems of internal controls.

It should be noted that it is not the duty of the internal auditor to establish the system of internal control. This remains the duty of line management. However, being skilled in

Accounting and auditing and being part of the management team, the internal auditor is expected to make substantial contributions in setting up a good system of internal control. Once set up, it becomes his responsibility to ensure its efficiency and effectiveness. Nevertheless, the internal auditor should never be relied upon to initiate control measures in an organization.

If this is the case, the internal auditor may not be able to carry out an independent review of the new measure since no one will be expected to objectively review any system he was responsible for.

QUALITIES OF THE INTERNAL AUDITOR

In addition to the independence which is required for the effective and efficient performance of the internal audit functions, the internal auditor should have the following qualities:

- (i) He should be a qualified accountant adequately supported by staff of the right number, grade and experience;
- (ii) The team should be appropriately trained in their assigned duties;
- (iii) There should be a constructive working relationship between the internal auditor, the rest of the management team and the external auditor.
- (iv) He should be able to approach his work with the same level of care and skill as that expected from an external auditor.
- (v) He should be able to plan his work such that systematically, all aspects of the organization should be covered;
- (vi) He should be able, in the course of his work to collect evidence which are sufficient, relevant and reliable for his report.
- (vii) His report should be timely, accurate and comprehensive in order that management may have a perfect understanding of the affairs of the organization and to be able to make informed decisions.

RECOMMENDATIONS

For there to exist an effective internal control system in an organization, the following recommendations are necessary:

- (i) The internal auditor should be hired, remunerated and fired by the shareholders themselves.
- (ii) Automation and computerization of the organization will guarantee speedy processing of information and timely detection of error and fraud.
- (iii) The office of the internal auditor should only be occupied by not just a qualified accountant but a person who has been tried, tested and trusted as being worthy in character and integrity.

CONCLUSIONS

As evidenced in this paper, the success, effectiveness and profitability of an enterprise is a function of the effectiveness of its internal control system. Where the internal control system is porous, failure is bound to ensue but where internal control system is vibrant; the sky becomes the limit of the success of the organization. Be this as it may; only a person with

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An impeccable and virtuous character can excel in occupation of the position of an internal auditor. In other words, the continuous existence or profitability of the organization depends on how effective the internal auditor is in discharge of his onerous responsibilities.

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