

Internal Accounting Controls

Alireza Azimi Sani , Shahram Chaharmahalie

Abstract—Internal controls of accounting are an essential business function for a growth-oriented organization, and include the elements of risk assessment, information communications and even employees' roles and responsibilities. Internal controls of accounting systems are designed to protect a company from fraud, abuse and inaccurate data recording and help organizations keep track of essential financial activities. Internal controls of accounting provide a streamlined solution for organizing all accounting procedures and ensuring that the accounting cycle is completed consistently and successfully. Implementing a formal Accounting Procedures Manual for the organization allows the financial department to facilitate several processes and maintain rigorous standards. Internal controls also allow organizations to keep detailed records, manage and organize important financial transactions and set a high standard for the organization's financial management structure and protocols. A well-implemented system also reduces the risk of accounting errors and abuse. A well-implemented controls system allows a company's financial managers to regulate and streamline all functions of the accounting department. Internal controls of accounting can be set up for every area to track deposits, monitor check handling, keep track of creditor accounts, and even assess budgets and financial statements on an ongoing basis. Setting up an effective accounting system to monitor accounting reports, analyze records and protect sensitive financial information also can help a company set clear goals and make accurate projections. Creating efficient accounting processes allows an organization to set specific policies and protocols on accounting procedures, and reach its financial objectives on a regular basis. Internal accounting controls can help keep track of such areas as cash-receipt recording, payroll management, appropriate recording of grants and gifts, cash disbursements by authorized personnel, and the recording of assets. These systems also can take into account any government regulations and requirements for financial reporting.

Keywords—Internal controls, risk assessment, financial management.

I. INTRODUCTION

ACCOUNTING and auditing are two mutually interrelated concepts. Auditing wouldn't exist without accounting correspondingly accounting would be nothing without auditing in that auditing entails accounting. Auditing without accounting is groundless and accounting wouldn't be safe without auditing. In almost all countries auditing is a superior notion which precedes accounting. Financial auditing, which raises the reliability of accounting information by examining the compliance of financial statements to accounting standards pursuant to auditing standards, is an integral part of economical system in developed and developing countries. Reports rendered by auditors take notice from all stakeholders which are in need of reliable information particularly from capital market investors. Financial auditing developed in correspondence with economic developments in very

countries. The first practices of financial auditing came with the assignment of court experts in courts and allocation of tax audit authority in accordance with the pertinent tax laws. Subsequently, the professionals of this field have become organized by themselves, establishing the legal status of the profession and raising a consciousness of accounting and auditing within the society by means of training facilities and activities [1].

II. FRAMEWORK AND SCOPE OF INTERNAL CONTROL

There is no simple definition of "internal control". However, where appropriate, this guide adopts the definition and conceptual framework described in the COSO report, which the Institute regards as a useful model [13].

The COSO report defines internal control as a process designed to provide reasonable assurance regarding the achievement of objectives in relation to the following:

- *Effectiveness and efficiency of operations*
- *Reliability of financial reporting*
- *Compliance with applicable laws and regulations*

Internal control is fundamental to the successful operation and day-to-day running of a business and it assists the company in achieving its business objectives. As indicated above, the scope of internal control is very broad. It encompasses all controls incorporated into the strategic, governance and management processes, covering the company's entire range of activities and operations, and not just those directly related to financial operations and reporting. Its scope is not confined to those aspects of a business that could broadly be defined as compliance matters, but extends also to the performance aspects of a business. (Figure 1)

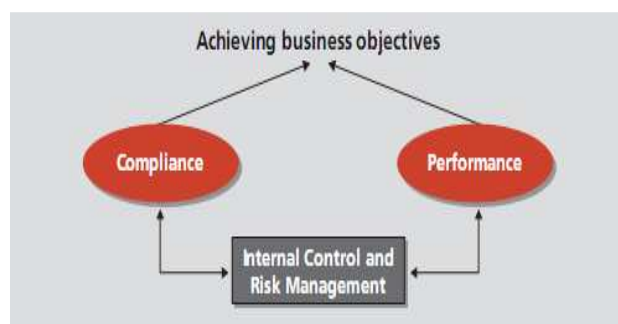


Fig. 1 Internal control framework

Internal controls need to be responsive to the specific nature and needs of the business. Hence, they should seek to reflect sound business practice, remain relevant over time in the continuously evolving business environment and enable the company to respond to the specific needs of the business or industry [2]. It is important that control should not be seen as a

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burden on business but, rather, the means by which business opportunities are maximized and potential losses associated with unwanted events reduced. Furthermore, successful companies should not allow themselves to become complacent or blinded by their own success. There are numerous examples of companies whose success has been jeopardized by a lack of, or deficiencies in, internal controls.

At the same time, the cost/benefit equation is also relevant to any internal control system.

Cost/benefit considerations should be taken into account both in the overall design of the system and in the context of risk identification, assessment and prioritization [12].

III. FUNCTION OF INTERNAL CONTROL

Control is not synonymous with managing and does not constitute everything involved in the management of a company. While it aims to support the achievement of business objectives, and should serve as an early warning system of possible impediments to achieving those objectives, internal control does not, on the other hand, indicate what objectives to set. While it can help to ensure that reliable information is made available for decision-making, implementation and monitoring, and can facilitate assessment and reporting on the results of actions taken, it does not take the place of the management in making strategic and operational decisions. In addition, decisions about whether to act and what action to take are outside the scope of internal control [5].

It follows from the above that there are inherent limitations in control. A sound and well designed system of internal control reduces, but cannot eliminate, the possibility of poor judgment in decision-making; human error or mistake; control activities and processes being deliberately circumvented by the collusion of employees or others; management overriding controls; and the occurrence of unforeseeable circumstances.

A sound system of internal control therefore helps to provide reasonable, but not absolute, assurance that a company will avoid being hindered in achieving its business objectives, or in the orderly and legitimate conduct of its business, by circumstances that may reasonably be foreseen. A system of internal control cannot, however, provide protection with certainty against a company failing to meet its business objectives or against all material errors, losses, fraud, or breaches of laws or regulations[7].

As noted in above, no two companies will, or should, have identical internal control systems. Companies and their control differ by industry, size and organizational structure, and by culture and management philosophy. Therefore, while all companies need each of the components to ensure adequate control over their activities, each will have a unique internal control system tailored to meet its own circumstances. The management will have to exercise its judgment, driven by the particular needs of the company, to determine the nature of the controls that should be in place and whether they are functioning effectively in achieving the company's objectives.

IV. ELEMENTS SYSTEM OF INTERNAL CONTROL

An internal control system encompasses the policies, processes, tasks, behaviors and other aspects of a company that, taken together [4]:

- facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks in relation 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; and
- help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.

Internal control can be analyzed into five inter-related components, which also serve as criteria for the effectiveness of the internal control system in supporting the achievement of the separate but overlapping operational, financial reporting and compliance objectives. This is illustrated in Figure 2. The components are [6]:

- (i) Control environment – the foundation for the other components of internal control, which also provides discipline and structure. Factors include ethical values and competence (quality) of personnel, direction provided by the board and effectiveness of management.
- (ii) Risk assessment – identification and analysis of risks underlying the achievement of objectives, including risks relating to the changing regulatory and operating environment, as a basis for determining how such risks should be mitigated and managed.

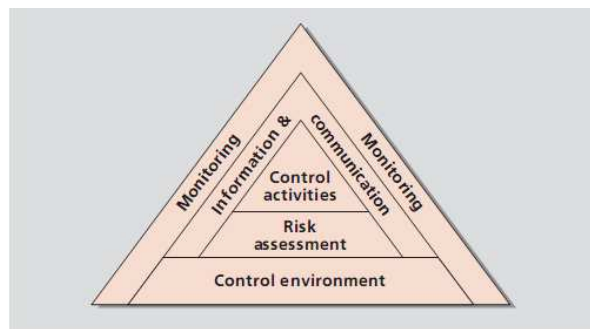


Fig. 2 Internal control components

- (iii) Control activities – a diverse range of policies and procedures that help to ensure management directives are carried out and any actions that may be needed to address risks to achieving company objectives are taken.

- (iv) Information and communication – effective processes and systems that identify, capture and report operational, financial and compliance-related information in a form and timeframe that enable people to carry out their responsibilities.

- (v) Monitoring – a process that assesses the adequacy and quality of the internal control system's performance over time.

Deficiencies in internal controls should be reported to the appropriate level upstream, which may be, for example, senior management, the audit committee, or the board.

A company's system of internal control will reflect its control environment, which encompasses its organizational structure.

The system of internal control should [14]:

- be embedded in the operations of the company and form part of its culture;
- be capable of responding quickly to evolving risks to the business arising from factors within the company and changes in the business environment; and
- include procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified, together with details of corrective action being undertaken.

Internal control procedures should, as far as possible, given the nature of the individual company concerned, be kept simple and straightforward and have regard to the need to ensure that (a) the costs do not outweigh the benefits and (b) staff at all levels can "buy into" the importance of maintaining adequate control and are not alienated by unnecessary complexity in implementing it [17].

V. NEED FOR TRAINING

Directors and management should be provided with appropriate training to enable them to gain a proper understanding of internal controls, their function and scope, including reporting. While this should help to facilitate compliance with the regulatory requirements on internal controls, equally importantly, it should also provide greater assurance that business objectives can be achieved. Training programmes may be provided in-house, or through training institutes or professional bodies [9].

VI. RISK MANAGEMENT

Submission The process of risk management involves:

- understanding organizational objectives;
- identifying the risks associated with achieving or not achieving them and assessing the likelihood and potential impact of particular risks;
- developing programmes to address the identified risks; and
- monitoring and evaluating the risks and the arrangements in place to address them

Risk may affect many areas of activity, such as strategy, operations, finance, technology and environment. In terms of specifics it may include, for example, loss of key staff, substantial reductions in financial and other resources, severe disruptions to the flow of information and communications, fires or other physical disasters, leading to interruptions of business and/or loss of records. More generally, risk also encompasses issues such as fraud, waste, abuse and mismanagement [10].

Risk management is essential for reducing the probability that corporate objectives will be jeopardized by unforeseen

events. The board must determine the type and extent of risks that are acceptable to the company, and strive to maintain risk within these levels. Internal control is one of the principal means by which risk is managed.



Fig. 3 Fundamentals of good risk management and internal control



Fig. 4 Potential benefits of effective risk management and internal control

In the business world, a company's objectives and the environment in which it operates are continually evolving and, as a result, the risks that it faces also change. A sound system of internal control depends on a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed. The systems and processes of control need to be sufficiently flexible to be able to change and adapt as the environment and the company's organization, objectives and activities develop over time [16].

Since profits and increases in shareholder value are, in part, the reward for successful risk taking in business, the purpose of internal control is to help manage and control risk appropriately, rather than to eliminate it.

The fundamentals of good risk management and internal control and an indication of some potential benefits of effective risk management and internal control are illustrated below in Figures 3 and 4 respectively.

VII. INTERNAL FINANCIAL CONTROL

Effective financial controls are a vital element of internal control. They help in identifying and managing liabilities to

ensure that the company is not unnecessarily exposed to avoidable financial risks (e.g., losses from derivatives and financial instruments) and that financial information used within the business and for publication is reliable. They also contribute to the safeguarding of assets from inappropriate use or loss, including the prevention and detection of fraud.

Internal financial control is also a key part of the fundamentals of good risk management that should underpin the wider aspects of business risk. It is needed to provide the board and senior management with information of sufficient quality to make good business decisions and meet their regulatory obligations. Important areas include the maintenance of proper financial records in support of financial budgets, projections, other management information (e.g., monthly management accounts and reports, comparison of budgetary versus actual performance) and reliable interim and year-end reporting [18].

VIII. BUSINESS PLANNING AND BUDGETING

Budgeting is an important management tool and a key control process in business planning.

An efficient and effective budgetary system should be linked to business plans, containing measurable statements of the company's objectives, policies and priorities, strategies for achieving objectives/targets and a resource framework. This encourages a clearer company vision, enables proper forward planning to take place and facilitates the best use of resources.

The assessment of risk is, therefore, also relevant to the budgeting and business planning process, at both the preparation and monitoring stages. It is important to conduct regular reviews of business plans and budgets for their continuing relevance and to monitor performance and progress against the budgets [11].

IX. EMBEDDING THE PROCESS

Many employees may have some responsibility for internal control as part of their accountability for achieving objectives. They, collectively, need to have the necessary knowledge, skills, information and authority to establish, operate and monitor the system of internal control. This will require an understanding of the company, its objectives, the industries and markets in which it operates and the risks that it faces.

Control should be embedded within the business processes by which a company pursues its objectives. It follows that, rather than developing separate risk reporting systems, it is best to build early warning mechanisms into existing management information systems. Overly cumbersome or elaborate risk management processes can be a distraction from the key point, which is that incorporating control within existing processes enables each person in the organization to become more focused on meeting the business objectives and in managing significant risks that relate to the tasks that he or she performs [3].

Opportunities exist through embedding risk management to remove duplicate or unnecessary controls and to create an environment where, subject to sound risk management

practices, there is more empowerment for people within the company to work to satisfy the needs of customers/clients.

A key issue that can be addressed is the extent to which executive management puts significant risk management issues on its agenda. Where there is a risk committee, it should avoid usurping the role of the executive management. It can encourage and foster good risk management and awareness, but it should not take over the role of the executive management [8].

Senior management and the board need to ask whether they have enough timely, relevant and reliable reports on progress against business objectives and significant risks. For instance, do they have enough qualitative information on customer satisfaction and employee attitudes?

Also, as risks change, do they have the necessary business information to respond effectively?

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