CHAPTER NINE

Internal Control

Meaning of Internal Control

Internal control may be defined as the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure, as far as possible, the accuracy and reliability of its records. The scope is therefore quite wide and covers not only financial and accounting checks but even those controls that are designed to improve operational efficiency and ensure adherence to company policies.

Objectives of Internal Control

The principal objectives of internal control are to ensure that:

(a) The company receives and records in its accounting books all the income or revenue to which it is entitled.

(b) All expenditure is properly authorized and recorded.

(c) All assets are properly recorded and safeguarded, i.e. their acquisition, usage and disposal is duly authorized and in accordance with company's policies and requirements.

(d) All liabilities are properly recorded and provision is made for all known or expected losses.

(e) The accounting records provide a reliable basis for the preparation of accounts and are maintained, where applicable, in accordance with the requirement of the relevant laws or standards.

(f) Company's operations are carried out in accordance with its policies and towards achievement of its objectives.

Tools of Internal Control

These can be classified into four broad groups, viz. Basic Controls, Supervisory Controls, Internal Check and Internal Audit.

Basic Controls

These are designed to ensure that the company's transactions are valid (i.e. proper, bona fide and duly authorized) and that they are recorded completely and accurately in the books of accounts. Common techniques used for this purpose are set out below:

(a) Drawing up detailed procedures for carrying out the various duties and setting limits for approval and expenditure authority, etc. Having a formal procedure manual for each department or group of activities ensures that there is only one way of handling each activity – and every one follows that particular way. This serves to ensure proper recording as well as adherence to laid down system of basic controls. Procedure manuals are the most basic and effective of all internal control tools. Great care and expertise goes into drafting of these manuals and where necessary a board may take help from external professional consultants in ensuring that the company has a comprehensive set of procedure manuals.

(b) Pre-numbering of the primary documents, such as sales invoices, receipts, cheques, credit notes, etc. and keeping a full account of all numbers so that any missing document is immediately noticed. As far as possible all transactions must be originated and authorized on specified preprinted pre-numbered forms so that completeness of recording of transactions could be assured.

(c) Maintaining Total or Control Accounts to provide overall control over subsidiary ledgers. Regular reconciliations should then be prepared between totals of individual ledger accounts and balances on relevant control accounts. This can eliminate a number of errors.

(d) Checking of one document against another. For example comparison of cheque drawn in settlement of an invoice with the relevant invoice, goods received note, copy of the order given, etc. will provide assurance that the cheques represents a valid payment. This technique also extends to comparison of company's internally prepared documents or records with those received from outsiders e.g. cash books' balance with bank statement.

(e) Regular verification of physical existence of the assets to their respective records, for example continuous stock-taking, surprise cash counts, inspection of fixed assets etc.

(f) Regular balancing of ledger and extraction of trial balance to check on the arithmetical accuracy.

(g) Making proper arrangements for physical custody of assets (like stocks and cash), significant documents (like cheques, important contracts) and other valuable items. Arrangements would include both actual security and laying down of procedures for handling such items.

(h) Most importantly, choosing the right persons for jobs and keeping them motivated to do their best.

Supervisory Controls

Supervisory (or administrative) controls are intended to provide a check over basic controls and may take any of the following forms:

(a) Authorizations of documents after examination and checking by a responsible officer before any further processing takes place, e.g. payment vouchers are checked before a cheque is prepared.

(b) Final approval of documents after they have gone through the basic controls but before the action authorized by them actually takes place e.g. final approval of payroll before the wages are withdrawn from bank and distributed.

(c) Review of basic control techniques by a supervisor e.g. inspection of reconciliations, checking control account balance and going over explanations for missing items etc.

(d) Pre-audit of major expenditure or disbursements. In particular capital expenditure involving large sums of money must be audited before commitment to expenditure is made and also before the actual payment is made.

Supervisory controls should only be regarded as being effective where the signature of the supervisor exists on the relevant documents to evidence the control function carried out by him.

Internal Check

Also known as segregation of duties, internal check includes the following techniques:

(a) There should be a well defined division of responsibilities between departments, sections and individuals, so that no one person handles a transaction from its beginning to its end. The objects of such a division of duties are firstly to detect innocent errors and secondly to ensure that no one person is in a position both to misappropriate funds and also to conceal his action by falsification of the relevant records.

(b) Each employee should be given the precise limits of his responsibilities and authority, preferably in writing. Similarly, all procedures should be documented.

(c) Where practical, staff should be rotated in various jobs so that no one person deals with one aspect of a transaction for too long. This has other advantages as well e.g. preparing staff for greater responsibility when a need arises.

(d) Employees should be encouraged to take their annual leave. If an employee is reluctant to do so, his area should be carefully checked by internal auditors and if possible he should be rotated to another job.

Internal Audit

This is a very effective tool of internal control though it is available only to large scale companies who can afford the expense of setting up an independent internal audit department. In order to ensure that an internal auditor is able to retain his independence from the manager whose work he audits (namely the CFO), the Internal Audit department is not made a part of the Accounts Department. The general arrangement is that an Internal Auditor reports administratively to the CEO and functionally to the chairman of the Audit Committee.

Duties of Internal Auditor

The principal duties of an internal auditor include:

a. Regular examination of all accounting records, checking it against source documents;
b. Verifying that all documents are properly authorized before being acted upon, by ensuring that all basic and supervisory controls are in place and are actually working.
c. Reviewing on a continuous basis the internal control procedures and methods to ensure that these are regularly improved upon and revised in light of changing circumstances.
d. Keeping the management aware of internal control efficiency or weakness and to assist in improving where necessary.

Advantages of Internal Audit

Advantages of internal audit include the following:

a. The basic advantages are of course the attainment of the objectives listed under (a) above.

b. Managers are responsible for maintenance of proper records and preparation of accurate financial statements. Internal audit helps achieve this.
c. If internal control is effective, it can cut down the detailed worked to be done by the external auditor. This can greatly reduce company's audit costs as external auditors are far more expensive than internal auditors.
d. Presence of internal auditors prevents a lot of frauds as employees know that these will be unearthed quite soon.

Limitations of Internal Auditors

Advantageous as it is, internal audit is not without its limitations. An internal auditor is employed by and is answerable to those who run the company, namely the directors. His loyalty is therefore to them and not to shareholders. This places some limitation on the scope of his work and acceptance of his report. His objective is not to report on the things as he finds them, but to discover errors and frauds and to assist the management in rectification of errors and prevention of frauds. Shareholders, creditors and other parties will be reluctant to accept internal auditor's report on the financial health of the company at its face value due to his loyalty to management.

Differences between Internal & External Auditors

Extent of Independence

Internal auditor is an employee of the company he serves, his independence is therefore limited. The external auditor is appointed direct by shareholders and is not answerable to the company's management; he is therefore more independent. He is not under any influence from any quarter to withhold any facts or to present a distorted view of affairs of the company.

Interests Served

Internal auditor is part of internal control system of the company. He is responsible, as a member of the company's management team, for maintaining proper and error free records. It is therefore in his interest that the company obtains a clean audit report from the external auditor. External auditor, on the other hand, has no such interest. He is merely required to give his opinion on how he finds the accounting records and financial statements. If he finds them inadequate or inaccurate, he simply says so because it is not his responsibility to ensure that the situation is corrected.

Scope of Work Undertaken

The extent of work undertaken by the internal auditor is determined by the management whereas that of the external auditor arises from the responsibilities placed on him by the Law. Again, internal auditor has relatively greater time at his disposal and he is therefore able to carry out more detailed checking work whereas the external auditor must of necessity rely on test-checking.

Reliance of External Auditor on Internal Auditor

The extent to which the external auditors may rely upon the work done by the internal auditor will depend largely on his assessment of the effectiveness of the internal audit functions. In making this assessment, the external auditor will be concerned with:

a. The degree of independence enjoyed by the internal auditors from those whose responsibilities he is reviewing.
b. The strength and quality of internal audit staff.
c. The scope, extent, direction, timing and frequency of the tests made by the internal auditor.
d. The evidence available of the work done by the internal auditor.
e. The extent to which management takes action based upon the reports made by the internal auditor.

If the external auditor is satisfied with the effectiveness of the internal auditor's work, he may considerably reduce the number of his own tests.

Setting Internal Controls

This involves the following stages:

1. Draw up internal control policy. This is done at board level.
2. Design the overall internal control systems for each division or department of the company. The management prepares these and the board approves them.
3. Document all procedures, i.e. draw up formal procedure manuals for each group of activities. Take external help if necessary.
4. Train the staff in the prescribed procedures to ensure that they understand and follow them.
5. Ensure that the procedures are being faithfully followed. One way of ensuring it to institute internal audit and internal checks.
6. Curb exceptions. As far as possible, no exception to the laid down procedure should be permitted.

Monitoring Internal Controls
The following aspects need to be paid attention to while monitoring internal controls:

Whatever system of internal control is prescribed, it must generate reports. These reports should be prepared at reasonable frequency and in reasonable details. Some reports, e.g. cash balances, may be prepared daily, others e.g. sales may be prepared weekly, others e.g. income statements may be prepared monthly, yet others e.g. staff matters reports may be prepared quarterly, etc. Again, the extent of information to be covered in each report should be proportionate to the importance of the report and its usage. There is no point in over-loading managers with unnecessary or repetitive data, just as it is very important to ensure that they do get all the necessary data at due time.

Officers receiving the reports must act on them. Getting reports and just filing them does not serve the control objective. Follow up and investigation of lapses is essential.

The procedures must prescribe certification at critical stages of various tasks by suitably authorized officials to ensure that all procedures are controlled effectively. For example, payments to creditors must be approved at different stages by different officials to avoid the possibility of over- or undue payment.

Some of the reports may be discussed by forums rather than individual officers. For example, income statements must be reviewed by the board rather than by CFO alone.

Reporting by Board on Internal Controls
While the Pakistan's Code of Corporate Governance issued by SECP is relatively silent on this aspect, the Combined Code of CG of UK and the Turnbull Guidelines prescribe that the company's annual financial reports must include a statement from its Board of Directors on its internal controls, either as a separate statement or within the body of Chairman's report covering the following:

Risk assessment: Clear objectives, communicated to all concerned, significant risks assessed regularly, and clear understanding of risks being retained.

Control environment: who controls, are they independent, are controls and authorities clearly defined, are responsibilities and accountability processes defined, does the company culture permit controls, is there is a demonstration of will by management to control, are all control processes clearly communicated to all concerned and how are adjustments made to procedures when necessary?

Information and communications: how frequent and adequate are the reports generated by the internal control system, who receives these reports, at what intervals, how reliable are these reports, what checks are in place to ensure the reliability of these reports?

Monitoring: are control processes a part of the normal operational procedures, are special reports sent to the Board by the management, etc.

WHISTLEBLOWING

The mere mention of the word whistle-blowing sends chills down the spines of most corporate managers. This reaction is not confined to the developing countries where managers have perhaps several skeletons in their cupboards and hence very legitimate reasons to fear dissatisfied employees. In fact more evidence of formalized gagging is available from companies in the developed countries than their more infamous counterparts in under-developed or developing countries. But then this could perhaps be due to the fact that corporations listed at the more advanced stock exchanges of the world are under much greater media scrutiny than in our part of the world.

Definition of Whistle-blowing

Lord Borrie QC prescribed the following definition of whistle-blowing in 1995: "the disclosure by an employee (or a professional) of confidential information which relates to some danger, fraud or other illegal or unethical conduct connected with the workplace, be it of the employer or of fellow employees". Despite its apparent adequacy, this definition does not draw any distinction between internal and external whistle-blowing, i.e. it does not attach any importance to the "body to which the disclosure is made". Peter B. Jubb is more specific. He said in his 1999 paper that Whistle-blowing is a deliberate non-obligatory act of disclosure, which gets unto public record and is made by a person who has or had privileged access to data or information of an organization, about non-trivial illegality or other wrongdoing whether actual, suspected or anticipated which implicates and is under the control of that organization, to a external entity having potential to rectify the wrongdoing.

The essential elements of Jubb's definition are that the disclosure is:

1. both deliberate and non-obligatory;

2. made by a person who has privileged access to information;
3. about non-trivial illegality or wrongdoing regardless of whether it has actually taken place, or is suspected to have taken place, or is anticipated to take place and finally
4. made to an outside party that has the potential to rectify the wrongdoing. This may include a regulatory body, a professional association, or media.

The apparent disparity in the above two definitions can be resolved by classifying whistle-blowing in two types: internal and external. While Lord Borrie appears indifferent to the party to whom the disclosure is made, Jubb states that disclosures made only to an external body properly belong to the formal meaning of whistle-blowing. We feel that disclosures, whether made to an internal party or to an external party, both constitute whistle-blowing. It may be helpful to call a disclosure made to a person or committee within an organization as *"soft whistle-blowing"* whereas disclosures made to a person or body outside the organization may be termed as *"hard whistle-blowing"*. Proper handling and facilitation of soft whistle-blowing can not only improve the governance of the company but also save it from the potentially more damaging external or hard whistle-blowing.

Classification of Whistle-blowers

Before embarking upon on the potential benefits and procedures for formal handling of soft whistle-blowing, it would be wise to have a look at the various types of whistle-blowers. Briefly, these are as follows:

Tipster: generally an anonymous person who simply sends a tip or piece of information about an alleged wrongdoing.

Squealer: a person who has a direct knowledge of mainly because he participated in it and is now exposing it.

Witness: a person who formally supplies information under an oath.

Complainant: a person who is aggrieved by an incidence of wrongdoing and is willing to provide information on it.

Mischief Maker: a person who alleges wrongdoing without having any real substantive evidence generally to level personal scores.

Watchdogs: a group of individual whistleblowers who band together to provide information about an alleged wrongdoing.

Reporter: generally an outsider who makes a profession of reporting on wrongdoings in various organizations.

Quite typically, whistleblowers claim to be motivated by altruistic objectives and guided by their conscience. However, many are aggrieved parties and would not have come forward except for their personal loss. Another characteristic of whistleblowers is their above average education and intelligence.

Importance of Handling Soft Whistle-blowing

Running a corporation is a complex process. Managers are bound to encounter a number of problems in achieving their corporate objectives. Not all of these problems are immediately visible to them. Some of these problems can unfortunately stay unnoticed till it is too late. Setting up a formal procedure for handing internal (or soft) whistle-blowing can enable the management to get to know the problem while there is still time to take remedial action. It can serve as a corporate safety valve which blows up before the pressure reaches the dangerous level.

An attitude to ignore whistle-blowers as nuisances or gripers does not solve the problem, it compounds it. I have heard managers dismissing the need for a formal procedure to handle internal whistle-blowing on the grounds that all such schemes eventually turn into "complaint centers" where employees simply play games to improve their personal lot. But, even if a whistle-blower is simply being a nuisance, or is motivated purely by malice, it is important that the truth be established and dealt with. More often than not, whistleblowers are punished (or at least not accorded due protection) rather than rewarded for honest whistleblowing. Even in the Western countries, there are hundreds of cases where whistleblowers have been harshly treated, even dismissed from employment on one pretext or the other.

International Chamber of Commerce (ICC) has issued some interesting guidelines on whistle-blowing. These encourage the enterprises to establish, within their organization and as integral part of their integrity program, a formal system to handle whistle-blowing, commensurate with their size and resources. The guidelines provide for seeking external professional help where appropriate. The key provision here is that the exercise should be carried out as an integral part of the company's integrity program. With all the attention being heaped upon corporate governance these days the world over, institution of an integrity program in a company is fast becoming a corporate necessity. And no integrity program can be meaningfully complete without prescribing a formal process for handling internal whistle-blowing.

Setting up a Whistle-blowing System

There are three stages to setting up a formal system.

In the first stage, the company must define its integrity policy. It should draw up its Code of Ethics and Business Practices. It is only in the environment of declared adherence to good business practices and ethics that a system of whistle-blowing can function properly.

In the second stage, the procedure should be drawn up, guidelines drafted and circulated among all employees. Professional help may be taken from external parties where necessary to ensure that the procedure is as effective as possible. While the exact details of whistle-blowing procedure may differ from company to company, some guiding principles are applicable to almost all situations. Some of these principles are discussed later in this chapter.

The third and most important stage is sincere and strict application of the prescribed procedure.

What should the procedure include?

A good whistle-blowing procedure should include the following:

a. Who should the whistle-blower report to?

Many companies ask their staff to submit their "reports" to their line managers, unless the line manager is the subject of the report. Others designate the chief executive for this purpose. However, it is preferable that all reports about an impropriety should go to a person who does not have an executive responsibility in the organization. The ideal person, therefore, is the head of the Audit Committee of the company. In fact, the Combined Code of Corporate Governance includes supervision of company's internal whistle-blowing process within the functions of the Audit Committee.

b. The format of the Report

Some companies provide a standard form for filing reports. Given that the nature of each report may be vastly different, the format of report should be kept simple and flexible, allowing the reporter sufficient latitude to express his views freely. It is important that employees should be provided explanation (and example) of what constitutes a wrongdoing (as opposed to a mistake or procedural error), what needs to be covered in the report and the relationship between what he is reporting and the actual consequences for the company. In certain cases, the initial report may not carry a lot of details. It is then the task of the report handler to institute investigation to get due details.

c. *Procedure of Handling the Report/ Investigation*

This is the crucial part of the procedure. The person receiving the report should have adequate authority to get it investigated, using internal or external personnel. The exact depth of investigation will of course depend on the nature of the report, yet no report should be taken too lightly. All investigation must be formal and fully documented. The procedure should clearly spell out the steps that must be taken during the process.

d. *Confidentiality*

For the whistle-blowing system to work effectively, employees must have confidence in it. It is therefore extremely important that full confidentiality must be maintained. If the "reporter" is to be interviewed, it should be done discreetly and in a manner that it does not draw any one's attention. The findings of the investigations should also be kept confidential until it is proper to formally disclose them to relevant quarters.

e. *Sticks and Carrots*

The procedure must provide for due reward for an honest whistle-blower, including an assurance of protection from retaliation by affected parties. At the same time, the procedure should clearly state what consequences can follow a malicious and unfounded report. Distinction must be drawn between an incorrect, but honest, report made with honest intentions, and a malicious report made to get even with someone. No employee should be punished for blowing a whistle as long as he does it with all sincerity, honestly believing his report to be true.

Advantages of Handling Soft Whistle-blowing effectively

The history of corporate governance is full of incidences where companies ignored internal whistle-blowers, forcing them to go out of the organization and thereby bringing a lot of misery and expense to the company's management. Perhaps the most famous is the case of Enron whose Board chose not only to ignore but suppress an internal whistle-blower and paid the price by getting the company liquidated.

A formal and efficient internal whistle-blowing handling system is an essential part of company's overall internal controls. It can save the company from a lot of headache and expense. It can help the management arrest the situation before it gets out of hand. It can give an air of confidence to the employees that they are working for an ethical company. An efficient system can also weed out malicious whistle-blowers and habitual gripers. All these steps lead to improve efficacy and better controls at work place.

QUESTIONS

1. What is meant by internal control?
2. Discuss the objectives and tools of internal control available to the management of a company.
3. Describe and distinguish between basic controls and supervisory controls.
4. Write an essay on having formal procedure manuals covering all the operations of a company.
5. How does the term internal control differ from internal check?
6. How does the work of an internal auditor differ from that of an external auditor?
7. Study the Turnbull Report (from the internet) and write a summary of its recommendations for your company.
8. Who is whistleblower? What are the different types of whistleblowers?
9. Discuss the statement: "Whistle-blowing is not a curse – it is a corporate safety valve that can save the company from blowing up".
10. How does soft whistleblowing differ from hard whistleblowing? Which is more damaging?
11. What should be the contents of a good whistleblowing policy?