Global Scientific JOURNALS

GSJ: Volume 9, Issue 7, July 2021, Online: ISSN 2320-9186
www.globalscientificjournal.com

THE INTERNAL CONTROLS IN SECURING THE HEALTH OF A BUSINESS AND ITS OPERATIONAL EFFICIENCY

Lanilyn P. Siazon
MBA Student, University of Rizal System - Antipolo Chapter
Antipolo City, Rizal, Philippines

ABSTRACT

Internal controls are the methods, rules, and procedures applied by a company to ensure the integrity and reliability of financial and accounting information and secure operational efficiency. These are designed in a systematic approach to promote accountability, secure company assets and interests and prevent fraud in accordance with the national and local laws that govern the activities of companies. These laws differ depending on the location of the business. The management of the business believes that sound internal controls are effected by the company policies to ensure the attainment of set corporate goals and objectives.

The defectiveness of the internal controls, obviously could result to high risk and losses to the company. Complex duties give negative results in the operations productivity. Business financial data would not be reliable for the management to come up with a sound and good decision on its financial health status.

This is the purpose of the study. The study will stress that internal controls are very significant to every business to observe and implement in securing its financial health and operational efficiency. Further to this, the result of this study is to see how internal controls mediate between the perceived business risk and organizational performance to improve the operations of the business.

In this article, there will be cited affirmations from the reviewed related articles in order for the author to corroborate the owned assertions mentioned in this study.

Index Term:
Internal controls, business risk, organization, business financial health, organizational performance, operational efficiency

INTRODUCTION

The business environment is dynamic and has become more complex, effectual and ambiguous as there is a rapid emergence in technology and globalization. A business faces various jeopardies raised from external business environments which may be technological, political and legal (Hoque, 2005; Kannadhasan, Aramvalarthan and Tandon, 2013; Saiful, 2017). Hence, the business activity is complex and challenging as compared to the last century (Power, 2013). Business risk and uncertainties occur. As one of the components of internal controls, risk assessment identifies and analyzes the risk that could prevent the organization from achieving its objectives. Therefore, business owners as well as the assigned management should identify, assess, manage and control various factors that contribute to risk and uncertainty. But the ability to perceive risk varies depending on risk culture and the business management viewpoint towards risk, therefore each organization has different internal controls to balance the risk, eliminate the risk and if not, at least reduce the risk.

Competitive markets and unsustainable environments such as Covid-19 disease, climate changes, diversity of customer needs and so on are external factors of firms' doing businesses that have rigorously changed (Dr. Hanh Hong HA). Internal factors of the firms' business practices including organizational vision, top management support, resource readiness, corporate strategies, operational techniques, and employee competency have enhanced their success, survival and sustainability (Valtakoski, 2017).

In order to actively respond and adapt to the changing business environment, firms need to enhance their performance, operation and control activities. In addition, an entity needs to improve the relationship among external and internal stakeholders to improve the quality of the understanding of the managers to see the changes that occur both inside and outside the organization, so that the top managers will quickly and accurately respond (Edward, 2011). According to COSO (2013) internal controls are a crucial component of an enterprise's governance system and ability to manage risk, and it is fundamental to supporting the achievement of an enterprise's objectives and creating, enhancing, and protecting stakeholder value. Sound internal controls help ensure that transactions are properly authorized, that supporting IT systems are well-managed, and that the information contained in financial reports is reliable. Internal control is a process, affected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives.

DISCUSSIONS

The Functions of Internal Controls in the Financial Performance of the Business

Internal controls positively affect financial performance of the business. Internal controls are the basic organizational elements that help management effectively deliver services to stakeholders; helps ensure reliability of financial statements and compliance with the laws and regulations (COSO, 1992/2004). Organizations with defective or weak internal controls run the risk of failure. This fact is supported by the findings of the Treadway Commission Report of 1987 in the USA which confirmed that the absence of, or weak internal controls is the primary cause of many cases of fraudulent company financial reporting. The Sarbanes-Oxley (SOX) Act of 2002 was introduced in response to well-publicized accounting scandals of the 21st century that were witnessed at Enron and WorldCom and required all public companies to disclose internal controls over financial reporting. Section 404 of SOX requires management of public companies to issue an internal control report in which they take responsibility for maintaining adequate internal controls, and make assertions concerning their effectiveness (Asiligwa, and G. Rennox, 2017).

According to Mawanda (2008), designing and implementation of proper internal controls will always lead to improved financial performance. Weak internal control systems have been known to be perfect fertile ground for perpetration of fraud and scandals. Such was the case for financial scandals of this decade witnessed at Enron and WorldCom. The response to these scandals has resulted in bringing into the law the "Public Company Accounting Reform and Investor Protection Act" commonly known as the "Sarbanes-Oxley Act (SOX Act)". The SOX Act stipulates clearly that the management should take full responsibility for the internal control system over financial reporting within the company and provide assessment of its effectiveness. Mawanda (2008) postulates that the Board of directors ought to supervise the management of an entity, but it has always turned out that the Board merely implements recommendations made by the management committee of an entity. This in fact is possible due to information asymmetry existing between the managers and the Board of Directors (Asiligwa, and G. Rennox, 2017).

It is believed that properly designed and enforced internal control systems will normally lead to better financial reporting procedures as well as giving rise to a reliable report that improves management accountability function of an institution (Doyle, et al. 2007). However, the prospect of achievement is determined by limitations inherent in all internal control systems. In this respect, Emasu (2007) explains that internal control systems can only ensure reasonable rather than complete guarantee to the achievement of the organization’s objectives which are instituted by an institution’s management and board of directors (Ibrahim, Sahabi & Diibuzie, Gordon & Abubakari, Mohammed, 2017).

Brief Literature Review

The relationship between internal controls and financial performance has been extensively discussed in the literature as explained by notable theories - the agency theory and the stewardship theory. The agency theory accounts for the existence of mechanisms in resolving problems that exist in principal-agent relationships. This theory contends that internal audit facilitates in maintaining the cost-efficient contract between owners and management just like other intervention mechanisms such as financial reporting and external auditing (Ibrahim, Sahabi & Diibuzie, Gordon & Abubakari, Mohammed, 2017).

Agency theory concentrates on the behavioral relationship between the owners (principals) and those others (agents) who are contracted by the owners to execute duties on behalf of the principal where the agent is granted some decision making power. It is also used to define the relationship between managers and investors by defining the duties and responsibilities run by the manager on behalf of the investor and the reward that the manager receives from the investor (Jensen & Mckling, 1976). The theory further hovered that managers are more informative than investors making it challenging for investors to effectively determine whether their interests are well taken care of. Therefore, the theory stated that there is a need to have proper and adequate contracts in an organization to minimize opportunistic behaviors by the managers (Mwangi, 2012). To address the interest of both the manager and investor, the contract should be drafted in a manner that secures the interests of both parties. A good agent-principal relationship is whereby the investor has systems that enable them to effectively monitor the work of their managers (Jussi & Petri, 2004). The theory also stated that incomplete contract information on the expectation of the investors as well as the managers could have adverse effects on the general performance of the organization. The managers will have inadequate knowledge on what is expected of them by the agents resulting in under-performance. Therefore, this theory assumes the nature of the relationship between managers and agents is based on wealth maximization (Jensen & Meckling, 1976).

Stewardship theory emitted from the research done by Schoorman and Donaldson (1997), who defined a steward as a person who ensures that the investor's wealth is well secured in order to maximize organizational profits. Donaldson and Davis (1991) stated that this theory focuses on the ability of the management of the organization to align their goals with the institutional goals. They further specified that stewards' satisfaction and motivation is driven by the success of the organization. Donaldson and Davis (1991) contended that effective stewardship requires employee empowerment and provision of independence based on trust. Stewardship theory states that there should be maximum independence between employees or management and investors for maximum wealth creation. Shleifer, Andlei and Vishny (1997) said that the financial return given to the investors by the managers builds good reputation and it also encourages the investors to re-invest with them. In Agency theory, Meckling and Jensen (1994) stressed that agency cost is usually lower when the investors form part of the management of the organization for monitoring purposes. However, stewardship theory as a complete opposite of the agency theory, does not advocate for investors monitoring of the organizational performance through internal audit. Nonetheless, Donaldson and Davis (1991) further noted that better financial returns are experienced when these theories are jointly exercised in an organization. Based on this theory, this study works on the view that managers of institutions of higher learning act as caretakers of suppliers, shareholders, consumers, creditors and employees of these institutions (Andrew Govedi Kisanyanya, 2018).

The Functions of Internal Controls in the Operations Management

Strong internal control system provides an environment in the organization in which managers and staff can maximize the efficiency and effectiveness of their operations. This is attested as based on the framework for the internal control which are control environment, risk assessment, monitoring and reviewing, information and communication and control activities (Protiviti KnowledgeLeader, 2020). The control environment is created by management through communication, attitude and example. This includes a focus on integrity, a commitment to investigating discrepancies, diligence in designing systems and delegating responsibilities to the employees and every part of the organization. Processes are reviewed regularly to make sure that these are being carried out accordingly based on the set policies. Information is clearly communicated to every employee in order to know whom to report to and what is being expected based on the given tasks and responsibilities.

To illustrate further, an effective internal control can provide reliable internal management reports that can lead to good external reporting and compliances. For example, purchases that are supported by matched necessary documents such as delivery receipts, receiving reports and sales invoices are vouched in a timely manner will make the inventory levels updated, will lead to an effective material requisition planning, costing, budgeting, forecasting and tax planning.

Over-forecasting of sales can result in too much provision of productive inputs and consequently increased costs in the form of inventory obsolescence, storage, and idle capacity. Under-forecasting of sales requires an under provision of productive inputs and eventually increased costs in the form of unplanned sourcing of potentially more expensive raw materials or rushed overtime work. In both cases, the result is inefficiency due to higher input costs incurred for a given amount of outputs. Furthermore, ineffective internal control can cause misstatements in operating expenses which will give inaccurate unit cost information, sub-optimal pricing decisions, poor control of costs, and ultimately lower operational efficiency. To top it all, defective internal control can result in operational inefficiency by impairing the quality of internal reports that ends in poorer decision making (Qiang, Beng Wee and Jae Bum, 2018).

CONCLUSION AND RECOMMENDATION

The articles reviewed present the significance of having a sound and effective internal control in a business. Internal control is implemented to secure not only the financial health of the business but also to improve the process from time to time as there is a consistent change in the business environment. Thus, with the given framework, internal control is a system to provide reasonable assurance that information is reliable, accurate and timely, of compliance with applicable laws, regulations, contracts, policies and procedures and lastly, the reasonable assurance of the reliability of financial reporting. Though the study is limited only to the subject on how internal control contributes in achieving the good health of the financial performance of the business and operational efficiency, it is hereby recommended that to strengthen the internal control system, there should be a regular review of the process being carried out in the operations and a metrics in reviewing the performance of the organizations. Since internal control is also a process and effected by those charged with the governance, management and the external environment of the business. Thus, a further study is recommended on how to enhance the internal control system being applied in the business operations.

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