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Internal Controls Over Financial Reporting

Asaad Farhan Hamid
Financial Controller
Federal Board of Supreme Audit
Asaad_F_Hamid@yahoo.com

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Abstract :

Financial reporting is a way that management uses to provide the necessary information to interested parties. As a result, these information must be accurate and reliable in order to be useful. Therefore, management is required to have in place an effective internal control system that prevents and detects any fraud or misuse of the assets. The effective internal control system enables the management to provide reasonable assurance about the financial reporting. Control systems help the management to assure the effectiveness and efficiency of company's operations and its compliance with regulations. Thus, the control system helps the management to achieve its goals and to provide financial information that is reliable. In order to implement good internal controls, companies must have control activities implemented by the internal control department. These activities help to prevent, detect misuse and assure the effectiveness and efficiency of the operations. Since management is the body who is responsible for the financial reporting, therefore they are responsible of having effective internal control system to help them achieve their goals.

المستخلص

التقارير المالية هي طريقة تستخدمها الإدارة لتوفير المعلومات اللازمة للأطراف المعنية. نتيجة لذلك ، يجب أن تكون هذه المعلومات دقيقة وموثوقة حتى تكون مفيدة. لذلك ، يتعين على الإدارة أن يكون لديها نظام رقابة داخلي فعال يمنع ويكشف أي احتيال أو سوء استخدام للأصول. يتيح نظام الرقابة الداخلية الفعال للإدارة توفير تأكيد معقول بشأن التقارير المالية. تساعد أنظمة التحكم الإدارة على ضمان فعالية وكفاءة عمليات الشركة وامتثالها للوائح. وبالتالي ، فإن نظام التحكم يساعد الإدارة على تحقيق أهدافها وتوفير المعلومات المالية التي يمكن الاعتماد عليها. من أجل تطبيق ضوابط داخلية جيدة ، يجب أن يكون لدى الشركات أنشطة رقابة تنفذها إدارة الرقابة الداخلية. تساعد هذه الأنشطة في منع وكشف سوء الاستخدام وضمان فعالية وكفاءة العمليات. نظرًا لأن الإدارة هي الجهة المسؤولة عن إعداد التقارير المالية ، فهي مسؤولة عن وجود نظام رقابة داخلي فعال لمساعدتهم على تحقيق أهدافهم.

Problem of the research:

Financial crises have increased in recent decades and that has led to lack of trust of the financial reporting. Financial reporting is the responsibility of management. Therefore, management is responsible for having a good internal control system over its financial reporting. This system has failed various times and caused a huge problem for interested parties such as investors and creditors. As a result, reliable and effective internal control over financial reporting is vital. Hence, to avoid this problem a sound internal control system has to take place in each entity to help achieving the objectives of that entity and to provide reliable financial reporting.

Importance of the Research:

The importance of the research comes from the role that internal control system plays in providing effective and reliable financial reporting. It’s the tool that management uses to provide reliable information for internal and external parties. Furthermore, it helps the management to achieve the goals of the company. A good internal control system ensures that policies were followed, assets were safeguarded and goals were achieved. Based on the effectiveness of the internal control system, management can assure that financial reporting is reliable and it is not misleading. Therefore, it is important to research this topic to examine the objectives and the deficiencies of the system.

Hypothesis of the Research:

This research hypothesizes that:

1. Internal controls help to provide reasonable assurance and not absolute assurance.
2. Internal controls prevent misstatements and detect fraud.
3. Internal controls help management in achieving goals.
4. Internal controls provide reliable financial reporting.
5. Internal control components are the basic elements to have a good internal control system.
6. Control activities are necessary for achieving the objectives.
7. Management is responsible for implementing sound internal controls.
8. Limitations can adversely impact on the effectiveness of internal controls.

Research Methodology :

The research methodology was based on observing related resources and examining the problem. The literature review is the method

that used in this research to come to the conclusion. The information was collected from various resources and it was explained and described in a way to make to topic easy to understand. All the collected information was described in a way that makes it clear and concise for readers.

Introduction

Internal control is an effective way to help managements achieve their goals and provide investors, lenders, and other users with necessary information. In addition, it is a legal obligation to have effective internal controls over financial reporting since 1977. Managements are required to assess their internal controls systems and report it to the public. Therefore, it is important for each accountant to get enough knowledge about what internal control is and what its objectives, its components, how it does work and management's responsibilities. Also the Audit Committee of the Board of Directors Oversight Responsibility over Internal controls, the limitations facing it, and all other related information.

This paper is a guide to provide an overview of the internal controls over financial reporting (ICFR). Companies need effective internal controls to provide reliable financial reporting, manage its business effectively, and accurately. Hence, importance of internal controls is obvious to accomplish these objectives. Companies are not able to raise money from investors unless place a strong level of confidence on its financial statements. Internal controls are an important department to provide reliable information (for internal and external use), safeguards assets, and ensure a company has complied with applicable laws. Effective internal controls are a good tool to reduce the risks of materials misstatements since there is no absolute assurance that financial reports won't contain any materials misstatements.

I. Definition of Internal Controls

Internal controls have been defined as a "process, designed and effected by an entity's board of directors, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives in the following categories: (1) reliability of financial reporting, (2) effectiveness and efficiency of operations, and (3) compliance with applicable laws and regulations. "(Messier, Glover & Prawitt, 2008:192).

Internal control is an important aspect of an entity's governance system. A good internal control system manages the risks and leads an

organization to achieve its objectives. In addition, it supports to create, enhance, and protect stockholder value. Internal control is a crucial division at a company because it enabling an entity to interest from opportunities and offsetting the threats. This feature will lead to save time and money and help to create a value for the stocks. Lastly, companies with effective internal control able to take on additional risks and that will create a competitive advantage (International Federation of Accountants, (2012:4).

From this definition people can tell that internal controls include all the processes and procedures that management puts in place. The goal of these process and procedures is to make sure the assets are protected and safeguarded. As well as the other activities are implemented in accordance with the policies and procedures. These procedures are designed and managed by the management and the other people from the entity itself. Most importantly, it designed to provide reasonable assurance “not absolute” of achievement of these goals. Therefore, accountants should know what reasonable assurance means as explained next.

b. The Concept of Reasonable Assurance.

Providing absolute assurance by an internal control system is impossible. It is also designed and implemented based on the related cost and benefits) which is always used to determine the effectiveness of internal controls (Walker. 1999:6). Therefore, designing and implementing effective internal controls may be affected by its costs. Internal control systems are operating by humans and humans always make mistakes. Additionally, management override, collusion, fraud, all are intentional misconducts and prevent the system from operating effectively, regardless of how well it was designed. All these are reasons explaining the impossibility to provide absolute assurance. As a result, internal controls systems are designed and implemented to provide reasonable but not absolute assurance about the reliability of financial statement (Center for Audit Quality, (n.d: 5).

Management is required to provide reasonable assurance that the transactions and the other functions are recorded according to the laws or regulations. In order to provide a reasonable financial statement, it must be complied to the Generally Accepted Accountants Principle (GAAP) (Ashbaugh-Skaife, Collins, Kinney, and Lafond, (2008:220). In addition, the expenditures and the receivables should be authorized from the

company. When there is an adequate authorization, the company will be able to provide reasonable assurance about its financial statement preparation. The management is also required to provide reasonable assurance that its internal controls functions lead to prevent or timely deductions of any unauthorized transaction related to the assets whether it was acquisition, use, or disposition (Public Company Accounting Oversight Board (PCAOB, 2005: 2).

II. Objectives of internal controls.

An internal control objective defined by Messier, et all, as "An objective for ICFR generally relates to a relevant financial statement assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis" (2008:71). In short, the objective of internal control is to provide an assurance that misstatements have been detected or prevented by the implemented procedures. As indicated above in the definition, the objectives of internal controls consist of three categories as follows:

a. Reliability of financial reporting.

Financial statements must be prepared in a way makes it reliable by its users. Messier, et al, (2008:235) stated that whether interim or annul financial statements should be reliable to place the public trust in the provided information. Reliability is a crucial element of financial statements. Without a high level of reliability in financial reporting entities cannot get the needed funds to continue its functions. Users of financial statements build their decisions of whether to invest or not in a company depending on the confidence level they have about the financial reporting. Reliability can be achieved by adhering to the applicable laws and the effectiveness of the operation as well (Ashbaugh-Skaife, et al, (2008:218).

b. Effectiveness and efficiency of operations.

This category aims to provide an assurance about basic objectives of an entity. It is also including the effectiveness and the efficiency of using the entity's resources (Walker, 1999:5). As well as it addresses the performance, profitability goals, and safeguarding of resources. From that people can see the importance of this category. Operations are the most important stage in the process of achieving objectives. Achieving management's objectives depend as a whole on the effectiveness of the

perform operations. In other words, effective operations help to achieve the goals while defective operations mislead the achievement of the goals.

c. Compliance with applicable laws and regulations

The third category deals with complying with those laws and regulations to which the entity is subject. The activities that are conducted by the entity should be done in accordance with applicable laws and regulation. Companies should know which laws and regulations apply to them in order to specify compliance objectives (Dodaro, 2014: 13). By adhering to the applicable laws companies would have added a level of confidence to the financial statements. Every law has specific rules that governing different aspects of the performance. Therefore, if the company adheres to all of these applicable laws that would definitely provide reasonable assurance of the operations. As a result, the financial statement would be more reliable and the objectives would be achieved.

III. Components of internal controls.

a. Control environment which is the tone of an organization, influencing the control consciousness of its people. It is the foundation for effective internal control, providing discipline and structure. The control environment includes the attitudes, awareness, policies, and actions of management and the board of directors concerning the entity's internal control and its importance in the entity (Tunji, 2013: 5). Control environment is a key component of internal controls. Success of internal controls depends on the culture of the company. In other words, management should establish the "tone at the top" that focuses on the crucial of the ethical values and the integrity which lead to reliable financial statement (Center for Audit Quality, n.d:3). Indicating a strong control environment need to be demonstrated by actions from both board of directors and the senior management. Control environment is the corporate atmosphere that reflects to an effective system of internal control**.** Examples for that are: supporting effective controls, training programs, and issuance of an ideal code of conducts.

b. The entity's risk assessment process is a process for identifying and responding to business risks and the results thereof. For financial reporting purposes, the entity's risk assessment process includes how management identifies risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles, estimates their significance, assesses the likelihood

of their occurrence, and decides upon actions to manage them (Messier, et al, 2008:242).

Businesses are always surrounding with risks whether it is internal or external. These risks must be assessed by the management that maintains effective internal controls. Risks assessment process aims to achieve entity's objectives by identifying and analyzing these risks (Tunji, 2013:5).

c. **The entity's information system and related business processes relevant to financial reporting, and communication** The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, record, process, and report entity transactions and to maintain accountability for the related assets, liabilities, and equity. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting (Messier, et al, 2008:193).

d. **Control activities** are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels (Walker, 1999:11)

- physical controls
- information processing controls

(1) General controls

(2) Application controls

(3) Performance reviews

Control activities are key components of internal controls. Most of the financial reporting involved with risks and the procedures taken by control activities lead to mitigate these risks. These procedures are differed among business based on the activities. The following concepts are helpful in understanding control activities (Center for Audit Quality, n.d:5).

1. Segregation of duties means assigned different people to process different parts of a transaction or activities. In other words, not letting one employee doing the entire process from the initial till the end. Risks of error, misuse, and fraud can be reduced by segregate responsibilities and key duties among different people. Authorizing, processing, recording,

and reviewing transactions should be done separately and no one person controls all the process (Tunji,2013:6). The idea behind segregation is that the collusion between two parties is less likely than misconduct by one person. Furthermore, it reflects that the same error will not occur or will be detective by one of the parties. An example of segregation of duties is that the person who maintains the records of supply room is not allowed to have physically access to the supply room(Center for Audit Quality, n.d:6).

2. Preventive Controls and Detective Controls are two categories where controls fall into. Preventive controls are designed to prevent mistakes from being occurred. At the same time it reduces unauthorized transactions risks from being happened (Center for Audit Quality, n.d:6). Examples for preventive controls are: approval and payment to a vendor should not being authorized to initiate and sign by the same person. The access to the IT system should be limited as well is a preventive controls example.

   The other category is detective controls which are designed to detect errors and unauthorized transactions after they occurred. As a result, these errors and mistakes can be corrected in a timely manner. Example for that is reconciliation of two records relating to the same transaction to detect the differences such as reconciliation of cash at the books to the balance at the bank. Another example is monitoring of the performance by comparing the actual to the budgeted results or from one period to another could also detect some deficiencies or unusual activities .There are two other controls often used. First one is used to provide reasonable assurance that entity's objectives as a whole are met which so called "Entity-Level- Controls." Second one is designed to operate at the transactions, process, and application level which is so called "Process-Level – Controls."

e. Monitoring of controls A process to assess the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions.

According to (AICPA, 2007:8), internal control may fail to perform as planned and procedures may change. The quality of internal control system is effective when designed and operating as intended. To keep the quality of internal controls, it needs to be monitored over time. Monitoring internal control will help ensure that the controls are effective and provide the planned prevention and detection. Monitoring process

should be designed in a way makes it effective in identifying and correcting the weaknesses. As a result, monitoring is an important component that helps viewing the design and operation of the controls. This procedure should be done continually to enable management to know if the system provides the desired results or not (Tunji, 2013:7). Lastly, monitoring procedure helps to detect the deficiencies in the internal control and thus making the corrections as needed.

IV. Responsibilities in implementing effective internal controls.

According to Dodaro (2014:16), management's design, implement, and operate of internal control should be overseen by the oversight body. The overseen should be conducted over all the five components of internal controls. Following is a brief explanation for Management, board of directors, and internal auditors responsibility over implementing effective internal control system.

1. **Management**, The chief executive officer is responsible of the internal controls system. Chief executive officer is the person who sets the "tone at the top" that affects integrity and ethics and other factors of control environment (Messier, et al, 2008:235). Tone at the top is a significant factor of success or failure of internal control. It is the culture and the ethical framework of an entity. A good tone at the top is a significant factor in organizational success while failure of organizations is also resulted from poor tone at the top.

   International Federation of Accountants (2012:9) stated that management should assume overall responsibility of internal control. Design, implement, maintain, monitor, evaluate and report on effectiveness of internal control system are management's responsibility. Management is the owner of the risk of the system. Hence, chief executive officer and other management persons should pay attention to the system in all of its stages from designing through evaluating and reporting on it. Any deficiencies in the system will effect on achieving entity's objectives. Since management wants to achieve these objectives, they should design and implement an effective internal control system

2. **Board of Directors**, provides governance, guidance and oversight over management. Effective board members are objective, capable and inquisitive. They also have a knowledge of the entity's activities and environment, and commit to the time necessary to fulfill their board responsibilities (AICPA, 2005; 2).

3. **Internal auditors,** play an important role in evaluating the effectiveness of control systems, and contribute to ongoing effectiveness. Because of organizational position and authority in an entity, an internal audit function often plays a significant monitoring role.

V. The limitations of an entity's internal control

An internal control system should be designed and operated to provide reasonable assurance that the entity's objectives are being achieved. Reasonable assurance means that the cost of an entity's internal control should not exceed its benefits. The effectiveness of an entity's internal control could be restricted by the following limitations:

1. Management override of internal controls. Managers sometimes ask an employee to tweak the numbers or assigned him or her to record a transaction in a particular way. Managers have a control over the employees and they always tell them what to do. Managers can terminate or promote employees since they are supervising them. Therefore, employees sometimes being overridden by assigning them to do a transaction as management wants oven if they know it is violating the internal control. Employees usually do that because of the fair of losing their job (Tunji, 2003:8).
2. Human error or mistakes. It is a general knowledge that human always makes mistakes whether intentionally or unintentionally. Internal controls mostly implement and perform by personnel. The internal control system is only as effective as these personnel are. Sometimes breakdowns of internal control might occur because of human failures such as simple errors or mistake (Messier, et al, 2008:209). These errors and mistakes always occur but it might be reduced by train the employees who are working in internal control departments.
3. Collusion: collusion is one of the most common types of fraud. It occurs intentionally by more than one employee. It happens because of the lack of segregation of duties. A good segregation of duties might restrict the collusion (Messier, et al, 2008:209). Example of collusion is the person who receives the cash and the person who records it in the books are decided to conceal one or more of the receivables, they can do it easily and it is going to be hard to detect it. In other words, because more than one employee participated in this fraud from different function, it is rare to get caught. Finally, the best thing is to have an effective segregation of duties.

Effective Internal Control

Effective internal control system provides reasonable assurance that an entity would achieve its objectives by implementing it. Effective internal control system has the five components of internal controls designed effectively, implemented, and operated. Furthermore, these components should be operated together in an integrated manner to be more effective.

The first stage is to design a good internal control by the management to be able to achieve the objectives. The control should be effectively designed in order to be effectively implemented. In other words “a control cannot be effectively operating if it was not effectively designed and implemented (Dodaro, 2014:15)”.

Deficiencies of Internal Controls

Deficiencies mean that the design or operation of control activities do not allow management or employees to detect or prevent misstatements on a timely basis in the normal course of performing their duties. These deficiencies are classified as significant or material weaknesses (Ashbaugh-Skaife, Collins, Kinney, and Lafond, (2007:170). Significant deficiencies are a deficiency or a combination of deficiencies in internal controls which is less affect than a material weakness. At the same time, it is still important to bring attention of people who are responsible for oversight of financial reporting. The significant of deficiency is assessed by its effect on achieving the objectives.

Material deficiency is more important and more severe than significant deficiency. It is also defined as deficiency or a combination of deficiencies in internal control system when there is a reasonable possibility that a material misstatement in the financial statements will not be prevented or detected on a timely manner (PCAOB, 2005:2).

According to Dodaro, A deficiency can be existed in the design of the control when a necessary control of meeting the objectives is missed. The control objectives cannot be met if the control designed improperly. Deficiency occurs when the control implemented is not designed properly which is the opposite of the improperly designed, (2014:16).

Conclusion

Internal control is one of the most important procedures that management should implement in a company. It helps in preventing fraud and misuse assets and enables the management to achieve the objectives. Based on the effectiveness of internal control, management can provide reasonable assurance regarding the financial reporting. A good internal

control system enables the management to provide reliable financial reporting. Creditors and investors need to have reliable financial reporting in order to be able to make a decision. In addition, a good internal control system can make operations more effective and efficient. It is a way that management uses to make sure that policies and regulations were followed.

On the other hand, limitations also exist and affected the procedures of internal control. It might be overridden by management to show incorrect or inaccurate financial reporting. The design of the system or the activities sometimes doesn’t allow management and employees to detect and prevent misstatement or fraud. Even though, a sound internal control still an effective way to provide reliable and accurate financial reporting. As well as, it helps in achievement of the objectives of the company as a whole.

Recommendations:

The recommendations of this research are following:

1. Internal control system must be designed and implemented carefully to achieve the objectives.
2. Financial reporting must be reliable.
3. companies must have an appropriate internal control system over its financial reporting.
4. The control system must be able to prevent and detect any fraud and misstatement.
5. Assets must be safeguarded.
6. Segregation of duties is important for the company.
7. Components of internal control must be well designed and be effective.
8. Deficiencies must be identified and eliminated.

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