CHAPTER 1
INTRODUCTION

1.1 INTRODUCTION

A system of internal control refers to the process by which organizations maintain environments that encourage incorruptibility and deter fraudulent activities by management and employees. An organization’s components of internal control are evaluated during the planning phase of an independent financial statement audit. Internal control as defined in accounting and auditing is a process for assuring achievement of an organization's objectives in operational effectiveness and efficiency reliable financial reporting and compliance with laws regulations and policies. A broad concept internal control involves everything that controls risks to an organization. It is the integration of the activities, plans, attitudes, policies, and efforts of the employees of a department working together to provide reasonable assurance that the department will achieve its mission.

Internal control being one of the five main functions of management, is a process of monitoring operations so as to detect whether the operations fulfil their functions as planned or not, and if there is a deviation, the control process determines the reasons of this deviation and takes the necessary steps to eliminate it (Ozten et al. 2012, p.1). The main purpose of control is to raise concern over errors, and detect the points of failure in order to prevent their re-emergence. Internal control system can be generally defined as a system which has the features of maintaining the assets of a company, ensuring accuracy and reliability of information and reports related to accounting and other operations, and increasing the effectiveness of the operations. Additionally, the system also covers all assessment and methods that are adopted in order to detect the suitability of operations in accordance with policies determined by management, implementing a chart of accounts and reporting system, specifying the duties, authority and responsibilities, and organization plan of the cooperation (Cook et al. 1980, p.198). In other words, internal control system which is created by management and implemented by management and employees is a process which is designed to ensure reasonable assurance to achieve pre-specified objectives.
(Doyrangöl, 2002). According to the definition by COSO in 1992, an internal control system is defined as a set of methods, designed and controlled by senior management and board of directors to provide a limited assurance regarding reliability of financial reporting, effectiveness and efficiency of operations and their compliance with laws and regulations (Aksoy, 2007). W.W. Bigg explains internal control in clear terms, “Internal control is best regarded as indicating the whole system of controls, financial or otherwise established for the conduct of business including internal check, internal audit and other forms of control.

Internal control systems operate at different levels of effectiveness. Internal control can be judged effective in each of the three categories, respectively, if the board of directors and management have reasonable assurance that:

- They understand the extent to which the entity’s operations objectives are being achieved.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.

Internal controls structures are defined as the plans of an organization, including management's attitude, methods, procedures, and measures that provide reasonable assurance that the objectives are being achieved. Those objectives are

- promoting orderly, economical, efficient, and effective operations and quality products and services consistent with the organization's mission;
- safeguarding resources against loss due to waste, abuse, mismanagement, errors, and fraud and irregularities;
- adhering to laws, regulations, and management directives; and
- developing and maintaining reliable financial and management data and fairly disclosing that data in timely reports.
1.1.1 Key Concepts of Internal Control

- Internal control is a process. It is a means to an end, not an end in itself.
- Internal control is affected by people. It’s not merely policy manuals and forms, but people at every level of an organization.
- Internal control can be expected to provide only reasonable assurance, not absolute assurance, to an entity’s management and board.
- Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.
- Weak internal control systems lead to corporate losses and failure
- Internal control systems are the responsibility of directors. Managers and employees but they are the particular responsibility of the board of directors.
- Financial controls are important, but non-financial controls may be just as important
- Some internal control systems are formal; others are informal (for instance, unwritten rules observed by members of a team) both formal and informal systems are important. The latter may lead to a corporate environment which is either favourable or hostile to control
- Internal control is a moving target. It must be monitored and adapted to fit the circumstances. If it is neglected it will deteriorate, lose relevance or prove ineffective

1.1.2 Objectives of Internal Control

An internal control system comprises the whole network of systems established in an organisation to provide reasonable assurance that organisational objectives will be achieved. Specifically, the general objectives of internal control are as follows:

1. To ensure the orderly and efficient conduct of business in respect of systems being in place and fully implemented. Controls mean that business processes
and transactions take place without disruption with less risk or disturbance and this, in turn, adds value and creates shareholder value.

2. To safeguard the assets of the business. Assets include tangibles and intangibles, and controls are necessary to ensure they are optimally utilised and protected from misuse, fraud, misappropriation or theft.

3. To prevent and detect fraud. Controls are necessary to show up any operational or financial disagreements that might be the result of theft or fraud. This might include off-balance sheet financing or the use of unauthorised accounting policies, inventory controls, use of company property and similar.

4. To ensure the completeness and accuracy of accounting records. Ensuring that all accounting transactions are fully and accurately recorded, that assets and liabilities are correctly identified and valued, and that all costs and revenues can be fully accounted for.

5. To ensure the timely preparation of financial information which applies to statutory reporting (of year end accounts, for example) and also management accounts, if appropriate, for the facilitation of effective management decision-making?

1.1.3 Responsibility For Internal Control

Management

The chief executive officer is ultimately responsible and should assume “ownership” of the system. More than any other individual, the chief executive sets the “tone at the top” that affects integrity and ethics and other factors of a positive control environment. In a large company, the chief executive fulfils this duty by providing leadership and direction to senior managers and reviewing the way they’re controlling the business. Senior managers, in turn, assign responsibility for establishment of more specific internal control policies and procedures to personnel responsible for the unit’s functions. In a smaller entity, the influence of the chief executive, often an owner-manager is usually more direct. In any event, in a cascading responsibility, a manager is effectively a chief
executive of his or her sphere of responsibility. Of particular significance are financial officers and their staffs, whose control activities cut across, as well as up and down, the operating and other units of an enterprise.

**Board of Directors**

Management is accountable to the board of directors, which provides governance, guidance and oversight. Effective board members are objective, capable and inquisitive. They also have knowledge of the entity’s activities and environment, and commit the time necessary to fulfill their board responsibilities. The board should discuss with senior management the state of the entity’s system of internal control and provide oversight as needed. Senior management is accountable for internal control and to the board of directors, and the board needs to establish its policies and expectations of how members should provide oversight of the entity’s internal control. The board should be apprised of the risks to the achievement of the entity’s objectives, the assessments of internal control deficiencies, the management actions deployed to mitigate such risks and deficiencies, and how management assesses the effectiveness of the entity’s system of internal control. The board should challenge management and ask the tough questions, as necessary, and seek input and support from internal auditors, external auditors, and others. Sub-committees of the board often can assist the board by addressing some of these oversight activities. A strong, active board, particularly when coupled with effective upward communications channels and capable financial, legal and internal audit functions, is often best able to identify and correct such a problem.

**Internal Auditors**

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.
Other Personnel

Internal control is, to some degree, the responsibility of everyone in an organization and therefore should be an explicit or implicit part of everyone’s job description. Virtually all employees produce information used in the internal control system or take other actions needed to effect control. Also, all personnel should be responsible for communicating upward problems in operations, noncompliance with the code of conduct, or other policy violations or illegal actions.

Other Management and Personnel

Managers and other personnel should review the changes made to this version and assess implications of those changes on the entity’s system of internal control. In addition, they should consider how they are conducting their responsibilities in light of the Framework and discuss with more senior personnel ideas for strengthening internal control. More specifically, they should consider how existing controls affect the relevant principles within the five components of internal control.

1.1.4 Forms of Internal Control

Various forms of internal control help in ensuring correct and reliable records of transactions and operational efficiencies. Let us discuss them in detail.

Accounting Control

It ensures correct and reliable records of transactions in conformity with normally accepted accounting principles. Such controls comprise primarily the plan of organisation and the procedures and records that are concerned with and directly related to the safeguarding of assets and liabilities of financial records. Accounting financial controls include budgetary control, standard cost control, self balancing ledger, bank reconciliation and internal checks and internal auditing. Accounting controls deal with the process of recording of transactions, safeguarding the assets and adherence to prescribed managerial policies.
Administrative Control

The scope of this control is very wide. They also include accounting controls. Such controls comprise of the plan of organisation that are concerned mainly with operational efficiencies. In short they may include anything from plan of organisation to procedures, record keeping, distribution of authority and the process of decision making. They include controls viz. Time and motion studies, quality control through inspection, statistical analysis and performance evaluation etc. An auditor should make a careful review of accounting controls as they have a direct bearing on the reliability of the financial statements. He is primarily concerned with the accounting controls.

1.1.5 Requisites of a Good Internal Control System

The following are the essential requisites of a good internal control system:-

i. A well developed plan of organisation with proper delegation of functional responsibilities should be advised. No internal control system can be effective without such plan of organisation.

ii. A scientific system of authorisation and record procedure should be developed with a view to provide proper control over assets, liabilities, revenue and expenses of the organisation. It should be developed in such a fashion as to ensure that a) assets are under proper custody and they are not improperly applied, b) expenditures are incurred on getting proper authorisation and c) revenues received are duly accounted for.

iii. A system of healthy practices and traditions should be developed with a view to discharge the duties and functions of the various departments of the organisation smoothly.

iv. Since internal control system is to be exercised by the personnel employed in the organisation, there should be a team of people with sound character and integrity who are properly trained and capable of discharging their responsibilities.
v. Constant managerial supervision and periodical review of the system should be introduced with a view to make the system more efficient and effective.

1.2 TYPE OF INTERNAL CONTROL

1. Internal Audit

2. Internal Check

In the private sector, company directors are responsible for determining policy, monitoring performance and taking corrective action if either policy or its implementation is defective. Internal control provides a means of assurance that corporate objectives are being achieved. Thus the directors are responsible for internal control. The Institute of Internal Auditors defines internal control as follows:

- a process within an organisation designed to provide reasonable assurance regarding the following primary corporate objectives:
- the reliability and integrity of information
- compliance with policies, plans, procedures, laws and regulations
- the safeguarding of assets
- the economical and efficient use of resources the accomplishment of established objectives and goals of operations or programs

Definition of Internal Audit

Internal auditing is an independent appraisal function established within an organization which examines and evaluates its activities as a service to the organization. The objective of internal auditing is to assist the organization, in particular managers and members of the board of directors, to discharge of their responsibilities effectively. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, advice and information concerning the activities reviewed. The audit objective includes promoting effective control at reasonable cost. This is how the Institute of Internal Auditors defines internal
auditing. It can also be regarded as the means by which management learns if its internal control systems are appropriately designed and in fact working.

1.3  INTERNAL AUDIT

Internal audit is an evaluation and analysis of the business operation conducted by the internal audit staff. It is the part of overall system of internal control established in an organization. Internal audit is the independent appraisal activity within an organization for the review of accounting, financial and other business practices as protective and constructive arms of management. It is a type of control which functions by measuring and evaluating the effectiveness of other type of controls. According to Howard F. Stettler, "internal auditing is an independent appraisal activity within an organisation for the review of operations as a service to management.” Professor Walter B. Meigs, “Internal auditing consist of a continuous, critical review of financial and operating activities by a staff of auditors functioning as full time salaried employees.” In big organization, an internal audit is carried out by the team of professionals in the organization. The internal audit is not mandatory but organization gets the internal audit done with a view to evaluate the effectiveness of internal control, the soundness of financial system, effectiveness of business processes etc. This provides management an assurance about the control process in the organization and it aids in early detection of inefficiencies/fraud etc. it helps the statutory auditors too in getting the statutory audit done effectively.

1.3.1 Regulations on Internal Audit

As per company audit report order, 2003, statutory auditor also requires to comment whether the company is having sound internal audit system or not. Internal Audit Section 138 of the Companies Act, 2013 contains provisions regarding internal audit. As per Companies Act, 2013, certain class or classes of company as may be prescribed shall appoint an internal auditor who will conduct an audit of the functions and activities of the company and make a report thereon to the Board of Directors. Any chartered Accountant (except statutory auditor of the company) or Cost Account or other professional as may be decided by the Board, can be appointed to conduct the internal audit. According to Rule 13 of
The Companies (Accounts) Rules, 2014 following class or classes of companies shall be required to appoint an internal auditor or firm of internal auditors, namely:

a. Every listed company;

b. Every unlisted public company having
   i. Paid up share capital of 50 crore rupees or more during the preceding financial year; or
   ii. Turnover of 200 crore rupees or more during the preceding financial year; or
   iii. Outstanding loans or borrowings from banks or public financial institutions exceeding 100 crore rupees or more at any point of time during the preceding financial year; or
   iv. Outstanding deposits of 25 crore rupees or more at any point of time during the preceding financial year; and

c. Every private company having
   i. Turnover of 200 crore rupees or more during the preceding financial year; or
   ii. Outstanding loans or borrowings from banks or public financial institutions exceeding 100 crore rupees or more at any point of time during the preceding financial year: The rules also provide that every existing company covered under above criteria in Financial Year 2013-14 shall comply with requirements of Section 138 and Rule 13 of Companies (Accounts) Rules, 2014 before 30th September, 2014 (within 6 months of the commencement of Section 138, i.e. 01st April, 2014).

1.3.2 Objective of Internal Audit

(i) Proper Control: The purpose of internal Audit is to keep proper control over business activities. When there is proper control there is maximum
efficiency. The internal control can determine the degree of control over work.

(ii) Accounting System: The purpose of internal audit is to evaluate the accounting system. It is concerned with checking proper authority for transactions like purchase, retirement and disposal of fixed assets. The voucher can be compared with entries in order to determine that figures and facts.

(iii) Help Management: The purpose of internal audit is to help the management. Internal auditor can point out the weaknesses. The internal audit can be used as a tool to correct the situation. The management functions can be performed properly.

(iv) Working Review: The purpose of internal audit is to review the working of business. The working of current year can be reviewed in detail. There is a need to locate the weak points. The corrective measures can be taken for proper working.

(v) Asset Protection: The purpose of internal audit is to protect the assets. The proper records of assets must be there. Internal auditor can examine the valuation, verification and possession. The purchase and sale of assets must be made under proper authority.

(vi) Internal Check: The purpose of internal audit is to evaluate the internal check system. There is division of duties among the employees. When all staff member are working properly it means there is effective internal check system. The work of an auditor is reduced. He can apply test checks to complete audit duty.

(vii) Fair Statements: The purpose of internal audit is to detect the error in the accounting records. The work of internal audit can help the management to see that accounting record is in order.

(viii) Check Error: The purpose of internal audit is to detect the errors in the accounting records. If the work of internal auditor goes side by side therefore there are minimum chances of errors. The accounting staff can
rectify mistake to prepare accounts at the end of year in order to help the external auditor.

(ix) Detect Fraud: The purpose of internal audit is to detect frauds in the books of accounting. When the work of accounting staff is over the internal audit is started. Accounting staff remains alert because there is no time gap between recording and checking. Thus detection of fraud is possible with it.

(x) Determine Liability: The purpose of internal audit is to determine liabilities of employees. The duties are divided among the staff. It is easy to note the negligence on the part of employees. The internal audit can pinpoint the person responsible for carelessness.

(xi) Help in Independent Audit: The purpose of internal audit is to help an independent audit. The external auditor can rely on internal auditor and there is no need of cent percent checking. In this way there is saving of time and money due to internal audit.

(xii) Performance Appraisal: The purpose of internal audit is to check the performance appraisal. The management must achieve the targets fixed in budgets and plans. The internal audit is a tool to evaluate the working of each management function.

(xiii) Provide Suggestions: The purpose of internal audit is to provide suggestions for improvement of business activities. The internal audit staff can suggest the ways and means to remove the difficulties. Anyhow the internal auditor cannot compel the management to implement suggestions.

(xiv) New Ideas: The purpose of internal audit is to seek new ideas relating to procedures, marketing, financing and other business matters. The internal audit staff can provide new ideas about various business matters. The viable ideas can be put in to practice for the benefit of business.

(xv) Use of Resources: The purpose of internal audit is to determine the proper use of resources. The misuse of resources can increase the cost of doing
the business. The proper use of resources means there is efficiency on the part of management.

(xvi) Accounting Policies: The purpose of internal audit is to examine the accounting policies. The understanding of accounting system and procedure is helpful to device the effective audit plans & procedures. The internal auditor may find any weakness in the internal control. He can comment on the accounting policies.

(xvii) Special Investigation: The purpose of internal audit may be to conduct special investigation about any business matter. Internal audit can be used as a tool to note the effectiveness of management function.

1.3.3 Benefits of Internal Audit

(i) Proper Accounting System: The benefit of internal audit is that proper accounting system is introduced. Accounting system is a chain of activities in an entity by which transactions are processed for maintaining financial record. There is a need of orderly devices to achieve desirable results.

(ii) Better Management: The benefit of internal audit is that there is better management of business concern. The auditor can point out the weak areas of management. The goals of business can be achieved if there is proper internal control, internal check and internal audit. It should be noted that management could rely on internal audit for best results.

(iii) Progressive Review: The internal audit is beneficial to review progress of a business concern. The figures of previous years are compared with this year. Moreover the performance result of similar companies can be compared to determine the progress made by the entity. The management can review progress through internal audit.

(iv) Effective Control: The internal audit is helpful to have effective control over business activities. Control is a management function, which is related to supervision and direction of ongoing activities. The manager concerned can remove the difficulties for smooth working of business.
(v) Assets Protection: The assets protection is possible through internal audit. The management can use the assets for the benefit of business only. The assets cannot be used for private purposes. The embezzlement of cash, misappropriation of stock and misuse of other assets is not possible as the internal auditor keeps close watch over assets.

(vi) Division of Work: The internal audit is helpful to apply division of labour. The division of labour is necessary to watch the activities of all employees including management. The auditor can suggest the way and means to improve the performance of business.

(vii) No Error and fraud: The internal audit is used to protect accounting records from errors and fraud. The accounting and auditing go side by side when accounting work is over the audit will start. In such situation errors and fraud committed by the accounting staff will easily be detected and rectified.

(viii) Fixing Responsibility: Internal audit is used to fix the responsibility of people having poor performance. The management establishes the performance standards. The internal auditor can evaluate the result of all persons. The people can be held responsible for below standard work and action can be taken against them.

(ix) Helps External Auditing: The work performed by internal auditor can help external auditor in carrying out the audit. The audit procedure of internal and external audit is almost the same. The auditor can go through the internal audit report at the time of starting audit work. Anyhow external auditor is responsible for external audit.

(x) Performance Improves: Internal auditor is helpful to improve the performance of the organization. The achievements of previous year are the basis of preparing budget for the next years. The projected income statement and balance sheet are drawn up. An attempt is made to get the positive result. Thus internal audit improves performance of business and employees.
Proper Use of Resources: Internal audit is used to check the proper use of resources. The misuse of resources can increase the cost of organization. The optimum use of resources can be determined to control the cost of output. In this way internal audit is a tool to use the resources in the best interest of the business.

Investigation: Internal audit is of help to investigate in to the business matters. In case of doubt internal auditor can be asked to examine the facts and figures to confirm or clear any doubt. The internal auditor can investigate the matter in any manner. Such investigation can be made at the request of management or owners.

1.3.4 Limitations of Internal Audit

(i) Staff Shortage: The limitation of internal audit is staff shortage. There may be need of reasonable audit staff to examine the record. The shortage of staff is a hurdle to get benefit of internal audit.

(ii) Time Lag: The limitation of internal audit is that it starts when accounting ends. Thus there is a time lag between recording and checking of entries.

(iii) Error: The limitation of internal audit is that there may remain undetected errors in the books of accounts as it depends upon the expertise of internal audit staff to detect such errors. If audit staff is competent there is less chance of error being undetected. In case of poor audit staff there is no guarantee that audited accounts are free from errors.

(iv) Responsibility: The limitation of internal audit is that management may not feel their responsibility in completing the audit formalities. The audit staff may give suggestion for proper working of business. The top level management may not pay attention to suggestions. In this way the audit work cannot help the business.

(v) Duties: If the duties of audit staff are not properly divided then the purpose of internal audit may be defeated.
1.4 INTERNAL CHECK

Internal check is a system enforced in business under which the recording of business transactions is arranged in such a manner that the work of one staff member will automatically be checked by others in the course of recording of transaction itself.

Spicer and Pegler have defined a system of internal check as "an arrangement of staff duties whereby no one person is allowed to carry through and record every aspect of a transaction such that without collusion between two or more persons fraud is prevented and at the same time possibilities of errors are reduced to a minimum"

De Paula has defined internal check as "a continuous internal audit carried on by the staff itself by means of which the work of each individual is independently checked by other member of the staff."

Thus, under internal check system the staff duties are so arranged that no one person is allowed to record every aspect of the transactions and the entire work is distributed among the various members of the staff in such a manner that the work of one person is automatically checked by others.

The essential elements of internal check are as under-

- Existence of checks on day to day transactions.
- The check is to be carried out continuously as a part of the routine system.
- The work is divided among the staff and each staff is assigned a specific task.
- The work of each staff though independent is complementary to the work of another.

The system of internal check is increasingly recognised by the auditor specially when the size of the concern is large. The existence of effective internal check system relieves the external auditor of detailed checking to a larger extent. The extent to which an external auditor can depend upon the system of internal check is based on the procedural tests applied by him to find out the effectiveness of the system. However the auditor cannot be relieved of his responsibility if he was
found guilty of negligence regardless of the fact that he had tested the internal check in existence in the organisation before he had accepted it as correct.

1.4.1 Objectives of Internal Check

- To reduce chance of fraud and errors that may be committed by any member of the staff and make it more difficult. If any fraud is to be committed two or more persons must collude together.

- To detect fraud and errors easily and correct them promptly.

- To exercise moral pressure among the members of the staff.

- To allocate duties and responsibilities of every person in such a way that he can be taken to task for any lapse on his part.

- To increase overall efficiency of the members of the staff by assigning duties based on the principle of division of labour.

- To have an accurate and reliable record of all business transactions.

1.4.2 Essentials of Good Internal Check System

- No single staff shall have absolute control over recording of all the aspects of business transactions by himself.

- The same staff shall not be allowed to have access to all books of accounts as well as physical custody of the assets.

- Each member of the staff should be made responsible for a specific work.

- All officials and employees holding responsibility towards cash, securities or stock should be encouraged to proceed on annual leave to prevent the concealed fraud.

- The duties of the members of the staff should be changed from time to time.

- Attempt should be made to introduce mechanical devices to prevent misappropriation of cash.

- Each transaction should pass through a definite route and through several hands.
• All books, vouchers, documents should be classified and made available for easy reference.

• Proper record must be maintained of the incoming and outgoing of goods from the business premises.

• Self balancing ledger system should be introduced to make the system more efficient and effective.

• No undue importance should be given to any staff member and too much reliance on any staff member should be avoided.

• Division and allocation of duties among the staff members must provide for an automatic check by others.

1.5 COSO HISTORY AND BACKGROUND

The COSO framework provides additional guidance to enhance the control environment at financial institution, emphasize the importance of governance and information security and also provide an opportunity for better align organizational strategy and effective internal control. It is a joint initiative to combat corporate fraud. It is dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance.

Due to questionable corporate political campaign finance practices and foreign corrupt practices in the mid-1970s, the U.S. Securities and Exchange Commission (SEC) and the U.S. Congress enacted campaign finance law reforms and the 1977 Foreign Corrupt Practices Act (FCPA) which criminalized transnational bribery and required companies to implement internal control programs. In response, the Treadway Commission, a private-sector initiative, was formed in 1985 to inspect, analyze, and make recommendations on fraudulent corporate financial reporting. The Treadway Commission studied the financial information reporting system over the period from October 1985 to September 1987 and issued a report of findings and recommendations in October 1987, Report of the National Commission on Fraudulent Financial Reporting. As a result of this initial report, the Committee of Sponsoring Organizations (COSO)
was formed and it retained Coopers & Lybrand, a major CPA firm, to study the issues and author a report regarding an integrated framework of internal control. In September 1992, the four volume report entitled Internal Control—Integrated Framework was released by COSO and later re-published with minor amendments in 1994. This report presented a common definition of internal control and provided a framework against which internal control systems may be assessed and improved. This report is one standard that U.S. companies use to evaluate their compliance with FCPA.

COSO was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private sector initiative. It is concerned with factors that can lead to fraudulent financial reporting. COSO has developed principles of internal control. COSO is a voluntary private sector organization established United States by five private sector organizations, dedicated to guide executive management and governance entities on relevant aspects of organizational governance, business ethics, internal control, enterprise risk management, fraud, and financial reporting. COSO has established a common internal control model against which companies and organizations may assess their control systems. COSO is supported by five supporting organizations, including the Institute of Management Accountants (IMA), the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), the Institute of Internal Auditors (IIA), and Financial Executives International (FEI).

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) developed a model for evaluating internal controls. This model has been adopted as the generally accepted framework for internal control and is widely recognized as the definitive standard against which organizations measure the effectiveness of their systems of internal control. The COSO model played a fundamental role in establishing a scalable framework for internal controls. While the COSO model was established in 1992, its real claim to fame came from the subsequent release of the Sarbanes-Oxley Act of 2004. During this time, COSO became the most widely used control framework used in managements’ assessment of the internal control environment. However, that is
not the model’s sole purpose, as the COSO model is relevant to all companies and institutions when establishing a solid internal control framework.

The revised COSO framework was released on May 14, 2013, but the original framework will continue to be available through the transition period ending Dec. 14, 2014. After this date, COSO will have considered the 1992 framework to be superseded by the 2013 revisions. Institutions that are currently using the 1992 COSO framework or institutions transitioning to the COSO framework should begin transitioning to the 2013 model during 2014. This will include holding discussions with external auditors and regulators on your institution’s plans to transition to the 2013 COSO framework.

1.5.1 Defining Internal Control Internal by COSO

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 relating to operations, reporting, and compliance.

This definition reflects certain fundamental concepts. Internal control is:

- Geared to the achievement of objectives in one or more categories—operations, reporting, and compliance
- A process consisting of ongoing tasks and activities—a means to an end, not an end in itself
- Effected by people—not merely about policy and procedure manuals, systems, and forms, but about people and the actions they take at every level of an organization to affect internal control
- Able to provide reasonable assurance—but not absolute assurance, to an entity’s senior management and board of directors
- Adaptable to the entity structure—flexible in application for the entire entity or for a particular subsidiary, division, operating unit, or business process

This definition is intentionally broad. It captures important concepts that are fundamental to how organizations design, implement, and conduct internal
control, providing a basis for application across organizations that operate in different entity structures, industries, and geographic regions.

Objectives The Framework provides for three categories of objectives, which allow organizations to focus on differing aspects of internal control:

- **Operations Objectives**
  These pertain to effectiveness and efficiency of the entity’s operations, including operational and financial performance goals, and safeguarding assets against loss.

- **Reporting Objectives**
  These pertain to internal and external financial and non-financial reporting and may encompass reliability, timeliness, transparency, or other terms as set forth by regulators, recognized standard setters, or the entity’s policies.

- **Compliance Objectives**
  These pertain to adherence to laws and regulations to which the entity is subject.

### 1.6 INTERNAL CONTROL COMPONENTS

According to COSO model internal control consists of five integrated components.

#### 1.6.1 Control Environment

The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The board of directors and senior management establish the tone at the top regarding the importance of internal control including expected standards of conduct. Management reinforces expectations at the various levels of the organization. The control environment comprises the integrity and ethical values of the organization; the parameters enabling the board of directors to carry out its governance oversight responsibilities; the organizational structure and assignment of authority and responsibility; the process for attracting, developing, and retaining competent individuals; and the rigor around performance measures,
incentives, and rewards to drive accountability for performance. The resulting control environment has a pervasive impact on the overall system of internal control.

**Control Environment**

1. The organization demonstrates a commitment to integrity and ethical values.
2. The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.
3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.
4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.
5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

For purposes of the Framework, the term “organization” is used to collectively capture the board, management, and other personnel, as reflected in the definition of internal control.

### 1.6.2 Risk Assessment

Every entity faces a variety of risks from external and internal sources. Risk is defined as the possibility that an event will occur and adversely affect the achievement of objectives. Risk assessment involves a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Risks to the achievement of these objectives from across the entity are considered relative to established risk tolerances. Thus, risk assessment forms the basis for determining how risks will be managed.

A precondition to risk assessment is the establishment of objectives, linked at different levels of the entity. Management specifies objectives within categories relating to operations, reporting, and compliance with sufficient clarity to be able to identify and analyze risks to those objectives. Management also considers the suitability of the objectives for the entity. Risk assessment also requires
management to consider the impact of possible changes in the external environment and within its own business model that may render internal control ineffective.

**Risk Assessment**

1. The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.

2. The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.

3. The organization considers the potential for fraud in assessing risks to the achievement of objectives.

4. The organization identifies and assesses changes that could significantly impact the system of internal control.

**1.6.3 Control Activities**

Control activities are the actions established through policies and procedures that help ensure that management’s directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of the entity, at various stages within business processes, and over the technology environment. They may be preventive or detective in nature and may encompass a range of manual and automated activities such as authorizations and approvals, verifications, reconciliations, and business performance reviews. Segregation of duties is typically built into the selection and development of control activities. Where segregation of duties is not practical, management selects and develops alternative control activities.

**Control Activities**

1. The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.

2. The organization selects and develops general control activities over technology to support the achievement of objectives.
3. The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.

1.6.4 Information and Communication

Information is necessary for the entity to carry out internal control responsibilities to support the achievement of its objectives. Management obtains or generates and uses relevant and quality information from both internal and external sources to support the functioning of other components of internal control. Communication is the continual, iterative process of providing, sharing, and obtaining necessary information. Internal communication is the means by which information is disseminated throughout the organization, flowing up, down, and across the entity. It enables personnel to receive a clear message from senior management that control responsibilities must be taken seriously. External communication is twofold: it enables inbound communication of relevant external information, and it provides information to external parties in response to requirements and expectations.

**Information and Communication**

1. The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.

2. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.

3. The organization communicates with external parties regarding matters affecting the functioning of internal control.

1.6.5 Monitoring Activities

Ongoing evaluations, separate evaluations, or some combination of the two are used to ascertain whether each of the five components of internal control, including controls to effect the principles within each component, is present and functioning. Ongoing evaluations, built into business processes at different levels of the entity, provide timely information. Separate evaluations, conducted periodically, will vary in scope and frequency depending on assessment of risks,
effectiveness of ongoing evaluations, and other management considerations. Findings are evaluated against criteria established by regulators, recognized standard-setting bodies or management and the board of directors, and deficiencies are communicated to management and the board of directors as appropriate.

Relationship of Objectives and Components A direct relationship exists between objectives, which are what an entity strives to achieve, components, which represent what is required to achieve the objectives, and the organizational structure of the entity (the operating units, legal entities, and other). The relationship can be depicted in the form of a cube.

- The three categories of objectives—operations, reporting, and compliance—are represented by the columns.
- The five components are represented by the rows.
- An entity’s organizational structure is represented by the third dimension.

**Monitoring Activities**

1. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.
2. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

**1.7 EFFECTIVE INTERNAL CONTROL**

The Framework sets forth the requirements for an effective system of internal control. An effective system provides reasonable assurance regarding achievement of an entity’s objectives. An effective system of internal control reduces, to an acceptable level, the risk of not achieving an entity objective and may relate to one, two, or all three categories of objectives. It requires that:
Each of the five components and relevant principles is present and functioning. “Present” refers to the determination that the components and relevant principles exist in the design and implementation of the system of internal control to achieve specified objectives. “Functioning” refers to the determination that the components and relevant principles continue to exist in the operations and conduct of the system of internal control to achieve specified objectives.

- The five components operate together in an integrated manner. “Operating together” refers to the determination that all five components collectively reduce, to an acceptable level, the risk of not achieving an objective. Components should not be considered discretely; instead, they operate together as an integrated system. Components are interdependent with a multitude of interrelationships and linkages among them, particularly the manner in which principles interact within and across components.

When a major deficiency exists with respect to the presence and functioning of a component or relevant principle, or with respect to the components operating together in an integrated manner, the organization cannot conclude that it has met the requirements for an effective system of internal control.

When a system of internal control is determined to be effective, senior management and the board of directors have reasonable assurance, relative to the application within the entity structure, that the organization:

- Achieves effective and efficient operations when external events are considered unlikely to have a significant impact on the achievement of objectives or where the organization can reasonably predict the nature and timing of external events and mitigate the impact to an acceptable level.

- Understands the extent to which operations are managed effectively and efficiently when external events may have a significant impact on the achievement of objectives or where the organization can reasonably predict the nature and timing of external events and mitigate the impact to an acceptable level.

- Prepares reports in conformity with applicable rules, regulations, and standards or with the entity’s specified reporting objectives.
Complies with applicable laws, rules, regulations, and external standards

The Framework requires judgment in designing, implementing, and conducting internal control and assessing its effectiveness. The use of judgment, within the boundaries established by laws, rules, regulations, and standards, enhances management’s ability to make better decisions about internal control, but cannot guarantee perfect outcomes.

1.7.1 Limitations

The Framework recognizes that while internal control provides reasonable assurance of achieving the entity’s objectives, limitations do exist. Internal control cannot prevent bad judgment or decisions, or external events that can cause an organization to fail to achieve its operational goals. In other words, even an effective system of internal control can experience a failure. Limitations may result from the:

- Suitability of objectives established as a precondition to internal control
- Reality that human judgment in decision making can be faulty and subject to bias
- Breakdowns that can occur because of human failures such as simple errors
- Ability of management to override internal control
- Ability of management, other personnel, and/or third parties to circumvent controls through collusion
- External events beyond the organization’s control

These limitations preclude the board and management from having absolute assurance of the achievement of the entity’s objectives—that is, internal control provides reasonable but not absolute assurance. Notwithstanding these inherent limitations, management should be aware of them when selecting, developing, and deploying controls that minimize, to the extent practical, these limitations.
1.8 REVIEW OF INTERNAL CONTROL

A review of internal control can be done by a process of study, examination and evaluation of the control system installed by the management. The first step involves determination of the control and procedures laid down by the management. By reading company manuals, studying organization charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system. To acquaint himself about how all the accounting information is collected and processed and to learn the nature of controls that makes the information reliable and protect the company’s assets, calls for considerable skill and knowledge.

In many cases, very little of this information is available in writing; the auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.

To facilitate the accumulative of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:

(1) Narrative record;
(2) Check list;
(3) Questionnaire; and
(4) Flow chart;

1.8.1 Limitations on Effectiveness of Internal Controls

- No internal control structure, however detailed and comprehensive, can by itself guarantee efficient administration and complete and accurate records or be foolproof against fraud, especially when those involved hold positions of authority or trust. Internal controls dependent on the segregation of duties can also be rendered ineffective where collusion by several individuals is involved. Also, authorization controls can be abused by the person in whom the authority is vested, and management is
frequently in a position to override the controls it has established. To maintain an internal control structure that would eliminate the risk of loss is not realistic and would probably cost more than is warranted by the benefit derived.

- Because any internal control structure depends on the human factor, it is subject to flaws in design, errors of judgment or interpretation, misunderstanding, carelessness, fatigue, or distraction. While the competence and integrity of the personnel designing and operating the system may be controlled by selection and training, these qualities may alter due to pressures from within and outside the agency. Furthermore, no matter how competent the staff, the control they operate may become ineffective if they do not correctly understand their function in the control process or choose to ignore it.

- Organizational changes and management attitude can have a profound impact on the effectiveness of an internal control structure and the personnel operating the structure. Thus, management needs to continually review and update controls, communicate changes to personnel, and set an example by adhering to those controls.

1.8.2 Overview of Internal Control Concepts

**Internal control can ensure an entity’s success** It will ensure achievement of basic business objectives or will, at the least, ensure survival. Even effective internal control can only help an entity achieve these objectives. It can provide management information about the entity’s progress, or lack of it, toward their achievement. But internal control cannot change an inherently poor manager into a good one. And, shifts in government policy or programs, competitors’ actions or economic conditions can be beyond management’s control. Internal control cannot ensure success, or even survival. Internal control can ensure the reliability of financial reporting and compliance with laws and regulations. An internal control system, no matter how well conceived and operated, can provide only reasonable — not absolute — assurance to management and the board regarding achievement of an entity’s objectives. The likelihood of achievement is affected
by limitations inherent in all internal control systems. These include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the collusion of two or more people, and management has the ability to override the system. Another limiting factor is that the design of an internal control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

1. Internal control is a management tool used to provide reasonable assurance that management's objectives are being achieved. Therefore, responsibility for the adequacy and effectiveness of the internal control structure rests with management. The head of each governmental organization must ensure that a proper internal control structure is instituted, reviewed, and updated to keep it effective.

2. The Supreme Audit Institution also has a responsibility for ensuring adequate internal control. It should encourage and support:
   a. the establishment of detailed organizational internal control structures for each governmental unit based on the standards presented in this document; and
   b. a review of that structure to assure that the controls are working as intended and are adequate to achieve the desired results.

3. As they are ultimately responsible for the adequacy of the internal control structure and its implementation, it is important that managements of all organizational units within government understand the nature of the internal control structure and the objectives internal controls are to achieve. An internal control structure is defined as the plans of an organization, including management's attitude, methods, procedures, and other measures that provide reasonable assurance that the following general objectives are achieved:
   a. promoting orderly, economical, efficient, and effective operations and quality products and services consistent with the organization's mission;
b. safeguarding resources against loss due to waste, abuse, mismanagement, errors, and fraud and other irregularities;

c. adhering to laws, regulations, and management directives; and

d. Developing and maintaining reliable financial and management data and fairly disclosing that data in timely reports.

1.9 PRESENT STUDY

The co-operative banking system also performs the basic functions of banking. These banks are set up under co-operative Act. The credit provided through co-operative banks is called co-operative credit. The evolution of co-operative banks are voluntary organizations set up by collective ownership and unlimited membership which are sum on democratic lines which collect the savings of their members and advance loans to them. After going through the available literature, it was found that several research studies which are related with internal control system, role of internal audit function, effect of the Internal Audit and Firm Performance, Employee's Compliance to the Internal Control System on the Reliability and Creditability of Financial Statements, Internal Control System and Financial Performance etc. but those studies are mainly focused on foreign commercial banks and companies. There were few studies related with internal control system in co-operative banks in India. Therefore, this study proposes to study internal control system in co-operative banks in Udaipur. The proposed research work has been undertaken it meets the following objectives:

1. To undertake an in depth study of literature on internal control system in co-operative banks.

2. To examine the impact of internal control system on employee.

3. To examine the impact of internal control system on performance of co-operative bank.

4. To put forth suggestions regarding betterment of internal control system.
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