RELIABILITY OF FINANCIAL STATEMENTS THROUGH AN EFFECTIVE INTERNAL CONTROL: A LITERATURE REVIEW

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Abstract. *This literature review delves into the important role of internal control in providing reliability to the financial statements which examines the different roles and components of internal control which includes assessing the risk, controlling of activities and management of the risk, systems, monitoring and communication. It is crucial to understand the role of internal control to detect fraud by following laws, rules, and regulations and provide an over- all credibility to the financial statements through a robust internal control that safeguards the assets of the organizations. This paper highlights the importance of a strong tone at the top, organizational culture, and ethical values in fostering an environment conducive to effective internal controls. There are several challenges involving reliability of financial statements in different organizations and awareness of the functions of the internal control provides an avenue to continually improve the reliability and transparency of financial reporting. Overall, this paper emphasizes the critical need for organizations to adopt a holistic approach to internal control to instill confidence among stakeholders and uphold the integrity of financial statements in today's dynamic business landscape.*

Introduction:

Financial statements are important reports issued by business organizations. These reports are instruments used by users to make decisions like the management. The management of different business organizations depends on the data provided by financial reports in making important business decisions and therefore it is very crucial that information presented in financial statements are free of any fraud or material misrepresentation. Many stakeholders also depend on these financial reports and statements to protect their own interest, goals and objects like employees, government agencies, suppliers, business partners and investors. It is the responsibility of the top management to ensure that the financial statements issued represent the true and fair financial status of a company.

Many business organizations in the world encounter different challenges and one of the biggest challenges is how to protect company assets to maximize the use of those assets to produce more assets increasing the value for shareholders. The objective of many business organizations is to increase its potential for many reasons and that includes making shareholders satisfied and happy. This objective of the organization can be a reason that companies may resort to fraud and misrepresentation especially if the company is undergoing financial trouble or is obsessed with pleasing shareholders and other stakeholders.

Scandals involving financial statements include the cases of Enron, WorldCom, Lehman Brothers and many more. These big scandals have brought damage and shock around the world especially in the USA. These corporate scandals show how management can manipulate financial statements and deceive people and even governments. This is the reason why the U.S. congress has passed the Sarbanes-Oxley (SOX) Act of 2002 requiring the management organizations to express and assume the responsibility to the fairness of the assumptions on the financial statements as well as

the duties and responsibilities of those involved in the preparation including the audit of the financial statements.

A good internal control is a process which is designed specific to the organization that provides a reasonable assurance for achieving the objectives of an organization affected by an entity's stakeholders including board of directors, top and middle management and other personnel who are responsible to develop internal control culture to maintain the effectiveness and efficiency of operations and complying the applicable laws and regulations that results minimizing the misuse or wastage of resources and presenting reliable financial statements which shows true and fair picture of the company's financial position to the stakeholders and help them to make their best investment decisions(Abbas & Iqbal, 2012).

RESEARCH AIMS AND OBJECTIVES:

This paper examines available literature and researches on the topics of Internal Control. The objective of the review is to answer the following questions:

A. What are the objectives of Internal Control in ensuring that Financial Statements are free from material misstatements?
B. How can Internal Control prevent Fraud and Misrepresentations in the Financial Statements?

METHODOLOGY:

The researcher examines available literatures discussing the topic of Internal Control and its role in preventing fraud and misrepresentation in the Financial Statements.

LITERATURE REVIEW:

DEFINITION OF INTERNAL CONTROL

The Committee of Sponsoring Organizations of the Treadway Commission defines Internal Control as a process, effected by a company's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance (COSO, 2013).

Objectives of Internal Control:

Operations Objectives- These pertain to an entity's effectiveness and efficiency in operations, including operational and financial performance goals, and safeguarding assets against losses.

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 standards setters, or the entity's policies.

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

DEFINITION OF FINANCIAL FRAUD OR MISREPRESENTATION

Fraud is defined as an intentional perversion of truth in order to induce another to part with value or to surrender a legal right or as an act of "deceiving or misrepresenting". Fraud is a generic term and embraces all the multifarious means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false presentations. No definite and invariable rule can be laid down as a general proposition in defining fraud, as it includes surprise, trickery, cunning and unfair ways by which another is cheated. The only boundaries defining it are those which limit human knavery" (Akers & Gissel, 2006)

The first approach to ensuring quality control in the financial statements is identifying the risks involve in transactions. Modern risk management program integrates the method of risks identification and description, qualitative and quantitative assessment of the risks, choice of risk

management strategies and their monitoring. In many large companies, where there are resources and capabilities available, separate department and employees deal with internal control of business processes. In small organizations, this can be an issue as there are not enough manpower to ensure proper implementation of internal control procedures if available. Most of the time, the characteristic of internal control depends on the size of the organization. Those organizations which are big are able to afford not only employees that will look into the implementation of proper business procedure but at the same time can engage the services of professionals like auditors to ensure reliability of financial statements (Vovchenko, et.al, 2017).

In order to be useful, the information from the accounting reports have to respect a series of qualitative attributes or characteristics, such as: intelligibility; relevance significance step; credibility loyal representation; the prevalence of the economic over the juridical, neutrality, prudence, exhaustively; information comparability. Some of these attributes, with the necessary amendments could be enlarged also over the fiscal information, over which there could be added the objectivity reported. In order to accomplish the targeted objectives by the users, the accounting information have to be easily understood, respectively to be intelligible. In practice, this characteristic is difficult to accomplish since the users could have difficulties regarding understanding the information referring to the complex problems presented in the accounting reports, and this aspect could not be a reason for eliminating this type of information. The relevance is put into evidence when the information supplied influence the taken decisions, contributing also to the evaluation of the past, current or forecasted events, confirming or infirming the previous evaluations, in order to make the necessary adjustments. The relevance is influenced by its nature and the established significance margin as a reference system for its appreciation. In this respect it is mentioned that, if through the omission or the erroneous declaration of the information the decision-making process could be influenced, as a consequence this could be considered significant. The loyal representation of the described operations or transactions is the essential condition for insuring the credibility of the information. Hence, through this characteristic the targeted users are given the assurance that, the information does not contain significant errors and that they are objective. In this way the risks that could affect the credibility of the information are eliminated or diminished, offering the users a plus of security (Danescu, et. Al, 2012).

THE ROLE OF CORPORATE GOVERNANCE

In July 2002, President George W. Bush signed the Sarbanes-Oxley Act giving collective consciousness to global business leader and governments around the world. The objective of this act is to conduct reforms in accounting, reporting and corporate governance which deals with the responsibility of the management on the information provided in the financial statements. The Sarbanes-Oxley Act makes company executives explicitly responsible for establishing, evaluating, and monitoring the effectiveness of their company's internal control structure. For many executives, the intricacies of compliance and the implications of failure can be daunting. Yet the situation may not be as dire as imagined. That's because almost every public company already has in place some semblance of an internal control structure (Deloitte & Touche, 2003).

Corporate governance is based on a set of attributes, including ensuring accountability to shareholders or stakeholders, creating mechanisms to control managerial behavior, ensuring that companies are run according to the laws and answerable to all stakeholders, ensuring that reporting systems are structured in such a way that good governance is facilitated. These aspects we also find in the OECD Principles, first adopted by the 30 member countries of the OECD in 1999, which have

become a reference tool for countries all over the world. Corporate governance represents "the system by which companies are directed and controlled". The control aspect of corporate governance includes the notions of compliance, accountability, and transparency (Dumitrascu and Savulescu, 2012).

Business organizations depend on the Internal Audit department to perform functions to ensure the effectiveness of the internal control, which is essential for effective governance, management of risk and the internal control process. Some of the functions of the internal audit department includes:

Assess and manage the risk which may be present across different operations of the organization. The Internal audit identifies potential risk, analyzed their impact on the organization and develop any necessary strategy to reduce or mitigate the risk. (The Institute of Internal Auditors , 2017).

The Internal Audit department evaluates the effectiveness of the internal control as part of their functions by reviewing different policies, process and procedures and systems to understand, establish and ensure compliance of employees and key people with different regulations and objectives of the organizations (IIA, 2017). Internal auditors examine various financial and accounting records and documents to look for discrepancies and irregularities. This also include looking into the operation to observe how employees follow certain policies and to make sure that employees comply with the laws, regulations and the policies of the business organizations. This function is helpful in detecting and preventing fraud which may happen to the business (ACFE, 2020).

HOW INTERNAL CONTROL PREVENTS FRAUD AND MISREPRESENTATIONS IN FINANCIAL STATEMENTS?

The function of internal control begins with identifying what type of control should be applied to ensure credibility of financial statements. Internal controls can be detective which means it is designed to detect errors or irregularities. Corrective internal control is design to correct errors or irregularities that have been detected and preventive internal control is designed to keep errors or irregularities from happening in the first place.

The COSO (2013) provides the fundamental framework of internal controls which includes the components that management must perform. The components are listed below:

1. Control Environment which demonstrates the commitment to integrity and ethical values, exercises oversight responsibility, establishes structure, authority and responsibility, demonstrate commitment to competence and enforces accountability.
2. Risk Assessment specifies suitable objectives, identify and analyzes risks, assess fraud risk and identify and analyzes significant changes.
3. Control Activities selects and develops control activities, selects and develops general controls over technology and deploys through policies and procedures.
4. Information and Communication uses relevant information, communicates internally and communicates externally.
5. Monitoring Activities conducts on going and/or separate evaluations and evaluates and communicates deficiencies.

These components of the Internal Control must be applied by organizations to ensure that risk is evaluated and any irregularities are detected and corrected.

AICPA (2014) stated that there is always a possibility that errors and fraud may happen, it is important to establish mechanism to safeguard the assets of the company and this is done by an effective internal control system. An effective internal control systems reduces the risk of asset loss

and helps ensure that information are complete and accurate, and financial statements are reliable. This is performed by following applicable laws and regulations. Internal control protects the company from unintentional errors and intentional fraud that may harm the company and the other is discovering small errors before they become big. It added that internal control provides a process for policies and procedures that allow segregation of duties and responsibilities among employees to reduce the likelihood of deliberate fraud can occur. It also ensures that only qualified staff are assigned to perform the function and qualified staff must follow sound practices in performing their responsibilities.

CONCLUSION

The effectiveness of the Internal Control plays a very crucial role in ensuring the reliability of Financial Statements issued by business organizations. An effective Internal control ensures accuracy, integrity, and trustworthiness of financial reporting. Through the review of different works of scholars and researchers relating to the function of Internal Control, it gives stakeholders of business organization more specifically the top management, an understanding of the multifaceted role of Internal Control suck as assessing the risk and how to manage this financial related risk through a very good internal control systems that can prevent and detect fraud in business organizations. This control system must start with the top management in their desire to impose compliance of existing policies and law by all employees in the organization responsible for the preparation of the financial report.

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