

# Considerations Regarding the Contents of Internal Control

Victoria Isabela Dragomir  
*University of Craiova, Economic Direction*  
[isabela\\_dragomir@yahoo.com](mailto:isabela_dragomir@yahoo.com)

Marioara Avram  
*University of Craiova*  
*Faculty of Economics and Business Administration*  
[marioaraavram@yahoo.com](mailto:marioaraavram@yahoo.com)

Sorinel Domnişoru  
*University of Craiova*  
*Faculty of Economics and Business Administration*  
[domnisorusorin@yahoo.com](mailto:domnisorusorin@yahoo.com)

## Abstract

*The wrongful and limited understanding of the notion of control can have a negative impact on the individual as an integrating part of a democratic society, who in view of his past experiences may be reluctant to control.*

*In time there have been many attempts to define this notion and integrate it in current activities, whether referring to the control exerted at the level of one country or the control in an entity be it public or private.*

*Throughout the present endeavour we shall focus on debating the contents of the internal control in view of the necessity of implementing it in the activities developed within the entity as well as in other external aspects that come to influence it.*

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## Introduction

The interest in control has not developed recently but continues to represent the object of current preoccupations in relation to the benefits and the added value that it can bring to an entity, being a fundamental component of a good corporate governance.

Controls have existed from all times. In Hellenistic Egypt there was a double administration, in the sense that a branch of the bureaucrats was responsible for collecting taxes and another with the monitoring of the first branch. In the Republic of China, control Yuan, one of the five branches of the government was an investigation agency that monitored the other branches of the government. (Wikipedia, the free encyclopaedia).

While maintaining this basis, the notions regarding control have continuously evolved, leading to an increase of classifications and conceptual nuances brought to one's attention. We shall not focus on the classifications (which are very likely to be the object of another thesis), but we shall enunciate certain ideas, starting from the division of control in internal and external, regarding the definitions and ambiguities, contents and limitations of internal control.

### 1. The definitions of the notion of internal control

Throughout history, the phrase „internal control” has been strictly limited to the financial-accounting activity (Steven, J.R., 1998, p.74) from within the entity, being considered that the object of exerting internal control was that of avoiding any fraud to be committed and any errors to

be made. In 1916 an idea appeared according to which internal control was an attribute of the management, being one of its functions.

Between 1948-1949, the American Institute of Certified Public Accountants (AICPA), considered internal control as a system of the organization containing the plans of the organization and all the methods and measures taken to secure assets, control the accuracy and reliability of accounting information, promote operational efficiency and encourage adherence to the established management policies.

In 1977, the Order of Accounting Experts in France defined internal control as being represented by all the measures contributing to the holding of control over a company.

Treadway, an American Senator set the basis of a research regarding internal control and its role in organizations, the Treadway Commission thus being established. As a result of the recommendations of this commission the Committee for Sponsoring Activities was established and later issued a thesis regarding internal control called „Internal control-general framework”, who set the basis of the COSO internal control model. Within this committee, in 1992, the internal control was generally defined as being a process accomplished by the Board of directors, the managers and other employees of an organization with the purpose of providing reasonable insurance with regards to meeting the following objectives: the efficiency and effectiveness of operations, the credibility of financial reporting and the conformity with applicable laws and regulations (Landsittel, 2013, p. 3).

In 1995, The Canadian Institute of Certified Accountants (CICA), who set the basis of the COCO control model, defined internal control as being represented by the structure of the organization that includes resources, systems, procedures, structures, organizational culture and other elements that together contribute to the reaching of (the Romanian Court of Auditors, p.10). In our opinion, this view over internal control is interesting as it extends control over all activities, tends towards perfection but as everything is connected to the law of relativity it will never come to reach it.

Moreover, we consider that among the objectives of specialized literature in Romania there have not been any preoccupations towards paying a special attention to the study of internal control who would break through to the inevitable area of nuances.

In Romania, the Internal/Managerial control code approved through order no. 400/2015 of the General Secretariat of the Government of Romania, takes over the definition provided by the law (Government Order 119/1999), in whose acception internal control represents the assembly of control forms exerted at the level of the public entity, including internal audit, established by the management in accordance with its objectives and legal regulations, in view of administering public funds economically, efficiently and effectively; these include also organizational structures, methods and procedures. Within the internal control code 16 standards of internal control have been introduced, defined in a non-comprehensive manner, allowing for their applicability by all managers of public institutions, while taking into account the diversity of the area and the specificity of public institutions. Thus, the establishment of internal control is the responsibility of the management of public institutions, by fulfilling the legal, organizational, personnel, financing specificities.

As can be observed, this code refers to public entities that are financed from public resources, without taking into account private entities. We agree with the obligation of establishing an internal control within public institutions for the premises created by management for the institution and can build the confidence of the stakeholders in the respective institutions, especially in the context of the present reality in which certain public institutions have to face the low confidence among the population. But that does not mean that only the management of the public entities is interested in a control that would ensure the smooth running of the activity of the company he is managing.

The necessity for the existence of an internal control of one sort or another is clear also in the case of private entities, whether created for economic purposes or not, because their „creator” shall be the more interested to receive signals of how the entity he helped create evolves, seeing as the financing source is ensured from its own patrimony.

If we analyse the definitions of the phrase „internal control” we will notice that there is no contradiction between them, they do not exclude nor deny each other. Each of them captures an angle of the vast notion of control and each of them wants to offer reasonable insurance to the

manager/owner, the so called „ownership”, with regards to the fulfilment of goals and objectives envisaged. In terms of the insurance it wishes to offer, we should not make the mistake of confusing internal control with a „watch dog” but notice that on the contrary, the entities in which there is internal control are as „a dog that has an owner”.

## **2. The contents and effectiveness of internal control**

The contents of internal control are the result of the assembly of policies, procedures, processes, operations adopted that have as attribute the fulfilment of the goals of the entity (Domnişoru et Vinătoru, 2008, p. 40). For the above it is needed to understand the activities developed by the entity, know the environment in which it operates to foresee, prevent and face the challenges and risks that may occur during the development of the activity.

Another vision on the contents of internal control consists of the assembly of the policies and procedures issued and implemented by the management of the public entity to ensure: meeting the objectives of the entity in an economic, efficient and effective way; fulfilling the regulations specific to the field, complying with the policies and decisions of the management; protecting assets and information; preventing and discovering fraud and errors; the quality of accounting documents as well as supplying in due time reliable information to the management (Law no. 672/2002).

In practice there are also organizations/companies that do not enunciate clearly and explicitly a framework for implementing a system for internal control but by issuing a set of procedures, job descriptions, by segregating tasks, implementing an accounting control, regular reporting, etc. thus ensure a control of their activity.

Organizing and implementing a control system is left to the management or leadership of the organization.

The aspects that must be considered in implementing an internal control need to take into consideration items such as: the internal and external environment, objectives set, events that can prevent the accomplishment of these objectives, assessment of the risks that can occur as a result of the development of the entity, but also risks specific to the sector of activity and the method of preventing their occurrence, the control of each activity developed, organizing a preventive as well as a detective financial control (such as accounting control), segregation of tasks, information and communication, so as to combat any anomalies that may interfere with the good development of the entity.

Although the opinions of the specialists differ, in our opinion, internal control is both an objective and a means to an end, and in order for it to produce its effects what is needed mainly is for the human resource, regardless of its level in the hierarchy, to act with professionalism, and to act with diligence in order to ensure compliance with policies and procedures of internal control, because in the end the people are those who add value and ensure the operation of any system.

The management must take into account the social and political evolutions, the ever so more complex structure of businesses, the legislative and operational dynamics as a result of the evolution of information technology; to adjust to the approaches of internal control in correlation with the above, which is also recommended by those who set the basis of COSO control mode, who, being aware of the changes that operate in society, were constantly preoccupied with correlating with the realities of society the work issued in 1992 entitled ”Internal control-General framework”, the latest amendment being contained by the third edition published in 2014.

We consider that in this context we may speak of an efficiency of the control within an organization only if its items are coherent and manage to correspond and fulfill the envisaged objective and are in a perpetual assessment in view of adjusting to changes, granting a certain freedom of action, considering that in the context of limitation there can be no evolution and performance seeing as any hyper control creates reluctance, blocking the activity and killing creativity.

If we position ourselves in the spirit of COCO, we may state that to accomplish the desired effectiveness, internal control is called upon to ensure:

- Identification and assessment of internal and external risks;

- The policies and the management plan aiming at fulfilling the objectives of the entity must be expressed clearly and without any doubt, so as to be known and understood by all persons employed by the entity;
- Connected objectives and plans must be exposed with the help of quantifiable performance indicators;
- A framework for the work must be established, the focus being on respecting ethical values and integrity;
- Creating an internal flow of the documents in order to ensure fulfilment of all activities with their due term and avoid any sanctions from external partners (state institutions can apply penalties for late payment of taxes and fees, suppliers may calculate penalties for not paying invoices on time);
- Human resource policies must be created to reward the professionalism and sanction any deviation from them;
- Regular and concise reporting must be implemented to allow the management to take correct decisions and respectively take and apply necessary measures;
- Focus must be on confidentiality in view of avoiding the leak of information that may affect the image of the company;
- Harboring an environment in which social abilities have an important role for ensuring cooperation among the persons that develop their activity within the various departments that contribute efficiently to the prompt enactment of activities.

One should also take into consideration that other domains are part of the contents of internal control, such as the business strategy and finances (Tophoff, 2013, CECAR translation). Designing and setting up efficient internal controls isn't always an easy task and cannot be accomplished through a small set of policies.

We consider that all the above aspects must be taken into consideration and included in a code of the internal control by every entity, in order to ensure a unitary implementation, as well as acknowledgement by all the personnel of the entity and even by actors from the external environment. The general manner in which this code would be issued might require the existence of certain norms or procedures for the implementation and application of the internal control that might describe explicitly the aspects to be considered while verifying every action ran by the entity. In view of the fact that effectiveness is considered to be the quality of an action/a system to produce the desired results (Avram, 2010, p. 110-111), and performance represents the measure of maximizing results consequently with diminishing efforts, we inevitably reach the idea that appreciating these nuances becomes very important indeed. Thus, the effectiveness and performance of internal control can be tested by performing an audit mission that certifies the good construction/establishment of the internal control, its conformity with the goals of the entity and the legislation applicable in the field of operation of the entity, as well as the quality of the information and communication that the internal regulations generate. The relation between the evaluation-assessment behaviour is one of part to equal, considering that one of the activities that the internal control implies/integrates is the audit itself.

### **3. The ambiguities and limitations of internal control**

An ambiguity of internal control is expressed by the popular belief: *«Is it broken? No! There's nothing to fix then...»*, because internal control, through its findings, must fight with the state of comfort brought by custom, the decisional linearity at every hierarchical level of the entity and manage to keep up with the environment, keep alive the spirit of proficiency and help the entity correlate its goals with the reality of daily life so as to prevent it from becoming obsolete.

Two models of internal control were created worldwide: COSO and COCO, whose value has been unanimously accepted in the economic literature and practice and whose principles were inserted in the internal regulations of the states and also in international standards regulating principles applicable to certain professions – especially the recommendations of COSO model (for instance audit standards). Nevertheless, even an ad literam compliance with their recommendations

in implementing a system of internal control may lead the entity to noticing the existence of deficiencies in the control implemented.

The ambiguity consists in the fact that even though it holds the recipe and knows the steps to follow to perform the control, the management finds itself in the situation of not obtaining the desired results, which is a consequence of the fact that it all depends on skills, ingredients and how they are mixed together.

A pertinent question arises, even when prudence, understanding and compliance are applied: *can internal control face limitations?* Without question, the answer is positive. Limitations can occur during internal control, being generated by:

- A good internal control cannot turn an incompetent manager in an efficient one (Kaplan Financial Knowledge Bank). We are of the opinion that, regardless of the information he comes to hold, a manager is required to use its „*sense of judgement*”, meaning his objectivity, overall vision and power of decision. We must also take into account that a manager may find himself in the position of taking radical decisions in a very short period of time, decisions that reflect in the good running or failure of the entity. We consider that in this case, „the ownership” of the entity will also be called upon to face this alarm signal and even if it is not involved directly in it, it should also be informed of the status of the entity; from a risk assessment view we could say that internal control is at the forefront of problem solving;
- The occurrence of judgement errors in taking decisions, human errors, secret arrangements (Kaplan Financial Knowledge Bank) even among basic professionals, in view of the principle demons were once angels, of the occurrence of conflicts of interest. On the other hand the management may not take into consideration the contents of the control. All of these do not mean anything else than the fact that any control supplies relative insurance, not absolute ones.
- The wrong perception over the purpose of control, by implementing a tyrannical control whose only result will be to prevent the entity from meeting its goals by making it difficult to develop its activities and lose its specialists who faced with a hostile environment in which they cannot express their convictions, will chose to leave. The skillset of the management shall be proved by the ingenuity with which it will be able to find the perfect balance between rigor and suppleness when issuing the entity’s internal control policies;
- Although the responsibilities of the management include maintaining a proper internal control system, (Avram, et all, 2010, p. 309), the price that the control implies must be weighed and compared with the benefits it brings (Kansas State University), including with the degree in which it manages to create and added value by its ability to predict, avoid and reduce the risks envisaged.

We agree that an internal control, no matter how well implemented, would have to face uncertainties both from the internal environment, but mostly from the external environment (the evolution of the business environment, the attitude of the law maker, etc.), but, most certainly, the information and counselling offered to the management would help considerably to reduce any negative impact over the entity.

## **Conclusions**

The control performed in an entity has as purpose supporting the entity in meeting its goals, acquire visibility, be transparent for the actors in the external environment, maintain the trust of its stakeholders. Internal control must target all the activities of the entity and not fall into the trap of attributing more importance to some more than to others, because it is often than the smallest problems come to create the biggest losses or are the ones to point to the existence of major shortcomings.

Implementing internal audit is the task of the management, but the responsibility of the internal audit belongs to all the levels of the hierarchy. By accomplishing an actual internal control the aim is mainly to provide the management with reasonable assurance that the objectives of the company are met. Emphasizing an internal audit that is limited only to a verification of the economic activity shall prove to be detrimental to the entity as the management will not be able to form a clear picture of the development and evolution of the other activities. Any deviations, errors, attempts of fraud may be found in any of the activities of the entity (for instance the personnel in the

purchasing department of the entity can have secret arrangements with suppliers, and by favouring one over another they may pursue benefits for themselves; within the human resource department there might be hirings that do not take into account the skills of the candidates but the advantages that they create for the persons selecting them), internal control being called upon to prevent the above from happening or if already occurred, to limit their effects on the patrimony and image of the entity.

Although until present no undeniable content was enunciated, not even in international literature, on long term internal control contributes not only in achieving the management's targets but also to the entity's prestige and longevity by helping it continuously modernize itself through the implementation of systems and concepts that correspond to the present time and by distancing the entity from concepts such as: „if it's broken don't fix it”

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