

INTERNAL CONTROL AND PROBLEMS OF MODERN MANAGEMENT IN THE INTERNATIONAL ENVIRONMENT

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Abstract: Internal control has entered a period of extreme challenges. Internal auditors must be involved in things that are happening in the organization. They must have knowledge about the complex issues affecting the operations of their companies. Furthermore, they must identify the risks which managers may not be aware of. The international aspect of doing business complicates the existing accounting problems. Even though there is a large activity on harmonizing accounting regulations with a purpose of simply of international business and even though the accounting is in a form of international business is already close of blending in to a unique set of international accounting standards business in front of the accounting exports there is still a long and exhausting way of complete dealing with this problem. A basis for managing these problems is well placed system of internal control. The factors such as business development and the history of financial disasters affect the public expectations concerning internal control and therefore its development. Although there is no method of internal control that is generally accepted throughout the world, there is a growing knowledge about what internal controls should cover. The key role of an auditor has changed from that of a detective or someone who shows what is wrong in the organization to the member of a management team that ensures that the organization continues to grow and prosper. The main objective of this paper is to define and present the role of internal control as a management system in modern international business. Apart from introduction, conclusion and list of references, there are three other parts in this paper. The first part explains the historical aspect of internal control and its role in international business today. Furthermore, in the second part, the tasks of internal control are defined as a modern management system in an international environment. In this context, the realization of the tasks should contribute to the certainty that business organizations are able to quickly and effectively withstand adverse conditions and contribute to their limit. Finally, the third part deals with elements of internal control and the emphasis is placed on: control environment, accounting system, control procedures and monitoring.

Key words: Control, management, accounting system, risk, organization, business environment.

INTRODUCTION

The international revision standards define internal control as "policies and procedures (of internal controls) that the management of a company accepted for assistance in achieving its security goals so as to provide, to the extent possible, legal and efficient work of a legal entity, which includes adherence to the policy leadership, the integrity of resources, prevention and detection of fraud and error, the accuracy and completeness of accounting records and preparation of reliable financial information on time."

Internal control consists of all policies and procedures adopted by the management of an institution to ensure economical, effective and efficient fulfillment of the objectives of the institution, to ensure operation in accordance with applicable laws, regulations and management policies, to ensure protection of resources against the loss caused by waste, abuse, wrong management, mistakes, fraud and other irregularities, to ensure development and

maintenance of reliable financial and management data and their publishing in periodical reports. Effective control systems are designed to provide reasonable assurance that management resources are used in accordance with the laws, regulations and policies, and that they are protected from waste, loss and misuse.

The word "control" refers not only to financial matters. The internal control covers a wide range of activities of an institution. The system of internal control of an institution will affect the control environment which encompasses the organizational structure and individual characteristics of its employees, including integrity, ethical values and competence.

2. ROLE OF INTERNAL CONTROL IN INTERNATIONAL BUSINESS

Primary role of internal control was to test the business operations within the organization on a temporary basis so as to check whether the organization works effectively and efficiently. External auditors are also concerned with the effectiveness of internal control system, because it is the primary basis for their audit strategies, that is, the nature, timing and extent of their financial audits. In its essence, the internal control is the system of controls and balances that determine whether the management policies and procedures are effectively implemented, whether the financial transactions are properly reported and whether the organization's resources are properly protected. At the entity level, internal control consists of ethical behavior, accounting systems, risk assessment and monitoring made by the management. It is therefore important to recognize that internal auditors are not only part of the management, but they also control the management. It has been spotted that the internal control requires a certain level of independence in its work. Internal auditors work better when they are required to report directly (when they are directly responsible) to the board of directors and/or the audit committee of the directory board. In many cases, internal auditors report to the executive management, to the board of directors, and to the revision. When the internal control works properly, the external auditors can rely on its reports while developing their audit plans, and the cost of the external audits can be significantly reduced. In the current business environment it is essential that internal auditors focus their attention on the code of ethics management ("tone at the top"); how the top management behaves in relation to the organization's policies, concerning issues such as personal expenses and transactions with related persons. If the top management does not respect the company's property policy, how can it be expected from other employees.

In the United States, professional internal controller evolved from the data verifier and fraud identifier to the member of the management team. He is an active participant in the process of risk management. For instance, internal auditors are also active participants in the mergers and acquisitions, because the internal control resources can be used to avoid expensive tax consultants, to identify potential problems, and to prevent unnecessary expenditures. They have also become "management consultants who have a great role in the development of new flows and control processes in the redesigned operation, collecting and reporting key performance information, and monitoring the stability of operations during the transition."

The internal control can be done in several ways. It is believed in some companies that it is essential for the management trainees to spend some time in internal control if they are being trained for the leadership positions. For example, General Electric believes that the management trainees can not progress within their company if they did not spend some time in the function of internal control. Some companies also argue that the experience in internal control is a prerequisite for advancement. Progressive companies recognize the value of internal control experience of their management.

There are distinct differences in internal control practices between countries and companies, so it is difficult to generalize the practice of internal control at the global level. This

is mainly due to different national contexts within which an internal control operates. There is a link between the management view of the role of internal controls and the key areas of internal control. In some countries, if the management understands the business value of internal audit, the operational audit is considered as important as the financial audit.

The scope of internal controls also reflects a variety of business priorities in each country. In Japan, which is highly industrialized and populous, internal auditors emphasize the audits related to environmental management, hazardous materials and safety products and services. Australian companies, however, responded to increased competition by adopting a quality perspective in an attempt to provide a value for the customer. As a result, internal auditors make a significant quality system audit.

At first, internal auditors were focused on the protection of a company's assets and detection of fraud. As noted in the report of the National Industrial Conference Board in 1963, "The auditors paid the most attention to examining financial records and verifying the easily approved transactions." The popular idea among people in management one generation earlier was that the main purpose of the audit is to serve as a psychological factor to prevent fraud by the employees. The role of internal control has changed considerably by adapting significant changes in the business world. High technology has enabled many manual tasks to be automatically checked. In addition, the need for reducing costs and increasing efficiency gained greater importance. In order to decrease costs of attracting qualified individuals into the function of internal control it was important for auditors to provide inputs evaluated by the management.

The broader role of internal audit is best described by the IIA in its Statement of responsibilities of internal audit (1957). According to this publication, services provided by the internal auditors include:

- Reliability review and assessment, accounting adequacy and application, financial and operational control;
- Level of compliance with established policies, plans and procedures;
- Determining the extent to which organizational resources are calculated and securely protected from losses of all kinds;
- Determining the reliability of accounting and other data developed within the organization;
- Assessment of the quality of work in carrying out assigned duties.

There is no perfect way to make the internal control unified at the global level. Some companies are organized on a decentralized basis and employ local auditors for the full-service branches. In such cases, local management is expected to handle all financial issues, including local inflation and the exchange rate questions, relying on the capability of local management of planning potential problems. Consequently, the top management and the audit committee are satisfied with the work of local auditors who understand the local environment and with it associated customs and rules. The disadvantage of this method includes more restrictive form of promotion of internal controls involved at the local level.

Some international organizations have centralized control over its foreign operations to the extent that the key financial decisions, including planning for inflation and foreign exchange issues, are dictated and controlled by the top of the company. In such situations the internal control is centralized. As a result, more experienced personnel and/or specialists in the field of foreign exchange planning can be employed. However, the disadvantage of this methodology is the lack of understanding of local customs, language and related issues.

It is evident that any of these techniques can be successful. It all depends on the top management's commitment to its policy. Indeed, a system that works in one market or for one type of management may not be applicable to other markets and management teams.

The impact of modern technology is also present. In the world of internal controls,

controllers must become skilled in modern technology. They must also be able to track new applications, to become security experts for data testing, and to teach other examiners how to use the data that modern technology makes available.

3. DUTIES OF INTERNAL CONTROL

The internal control system should be put to the fore in the future. Skilled internal controls are essential for the skillful management although they are not a guarantee for the success of the organization.

So:

- Effective internal controls can not solve all problems of business organizations and institutions but ineffective internal controls or the lack of internal controls can cause serious problems for business organizations;
- Internal control (system) becomes a part, but not the whole process, of management and even the most effective internal control techniques can not be a cure for weak and bad decisions, ineffective management or unforeseen external events;
- Good management and effective internal controls can help a business organization to be able to withstand adverse conditions quickly and effectively, and may also help in limiting their worst consequences;
- Similarly, it can be stated:
 - The first task of internal control system is to create adequate conditions for administrative staff to facilitate business management, by making it more confident, and consequently the right decisions are made faster, both in good and bad times;
 - The second but no less important task is the provision of resources and ensuring accuracy of data and accounting systems.

The lack of positive evaluation and the lack of internal control can make operating activities remain outside of the adequate monitoring. This is particularly important at the time when the economic conditions make achieving good financial results relatively easy. This can hide the fact that some of the activities still do not take the right goals and so they require greater surveillance by the directory board.

Understanding the nature and purpose of internal controls can be a problem for many executives, board members and supervisory committees. They do not have time to read long and often quite boring reports and other documents, nor to listen to opinions of many experts of which almost everyone makes this topic more complicated than it really is.

Internal control system:

- helps the organization achieve its goals;
- ensures its effective functioning;
- protects the organization from losses.

In spite of that, someone has to watch over the effectiveness of the internal controls because of its efficiency and the confirmation that the procedures and control activities are duly respected and that the deficiencies and weaknesses are identified and corrected. In fact, it is the role of internal audit. The internal audit monitors and evaluates the effectiveness of internal controls, risk management processes and even the bank management as well.

Ten years ago, the control was supposed to be "a sudden attack" on the individual with the aim of detecting as many abuses and irregularities. At the same time, it was not clear what it really meant, because the meaning of "control" was different for each individual. Today there are many definitions of control, for example:

- COSO: Internal control is a process (activity) conducted by the leadership (supervisory board, board of directors, etc.), created to ensure the achievement of goals in the following categories:

- Effectiveness and capacity of operations;
- Credibility of financial statements;
- Compliance with legal documents and regulations.
- COSO describes five elements of internal control:
 - Control environment and culture;
 - Risk assessment;
 - Control activities;
 - Information and communication
 - Deficiencies monitoring and correction

INTOSAI: "Internal control is a management instrument used to obtain rational certainty that the organization's objectives have been achieved. Therefore, the responsibility for the utility and efficiency of the structure (system) of internal control should be taken by the management. The director of each institution should provide adequate internal control structure and its periodical audit so that it can be constantly improved.

Today we distinguish:

- The internal control system: "INTERNAL CONTROL" (processes, mechanisms, techniques, principles, tasks, procedures, control activities, etc) and
- Internal Audit: "INTERNAL AUDIT" (monitoring and evaluation of internal control).

IIA Internal Auditing Definition: Internal auditing is an independent, objective insurance and advisory activity, which aims to improve and promote the operations of an organization. It helps an organization achieve its goals by bringing a systematic, disciplined attitude towards evaluation and improvement of the effectiveness of risk management, control, and the bank itself. An effective internal control system and a skillful internal audit protect the organization from potential losses and fraud. There are still cases when the best system of internal control and the most skilled internal audit can not protect the organization from losses. It is primarily in the case of fraud and embezzlement done by one person at a very important position, or two or more persons working in the plot. In certain favorable conditions, such person or persons will easily steal from the organization and even conceal their fraud for a long time. The IIA-UK research shows that more than 80% of fraud is done by persons within the organization. The biggest danger in this respect does not threaten the company from the outside (attacks, burglaries), but from the inside: from their own employees: 39% of the frauds done by the managers and 42% by the ordinary workers. There are interesting data about the effectiveness of internal control systems and ordinary daily control activities in detecting the frauds. About 62% of all violations and frauds are revealed. It is the right lesson: internal control systems and related control activities are the first line of defense against fraud and embezzlement. If this protection line is not effective the company goes bankrupt. It has been proved by several examples in the last decade with companies going to ruin with loss of hundreds of billions of dollars. Therefore, internal control systems have two distinct forms: one - the protection of assets of the company, the second – the strengthening of the management process. Nowadays, internal audit has a leading role in monitoring the effectiveness of internal control systems. Discovery of fraud and embezzlement is not the key role of internal audit; for this task the experts (educated professionals) are required.

4. ELEMENTS OF INTERNAL CONTROL

Elements of internal control are:

1. Control environment;
2. Accounting system
3. Control procedures;
4. Monitoring

4.1. CONTROL ENVIRONMENT

Client control environment represents the views and actions of the management and the board regarding internal controls which reflects the importance of internal control in the terms of operational management. According to the "Risk assessment and internal controls, "audit standards, the control environment is defined as"... general attitudes, awareness and actions of directors and management regarding internal control systems and the importance of the system ...". Key factors that affect the control environment are:

- The function of the board and its executives;
- The business style and philosophy used by the management;
 - Entity structure and methods for establishing authority and responsibility
 - Control system applied by the management, including the internal audit function, personnel policies and separation of duties

a) The function of the board and its executives

The key presumption for the effectiveness of the directory board is its independence from the bank management. The directory board delegates its responsibility for internal controls to the operational management. In the field of internal controls its task is to supervise the established internal controls and ensure their periodical review. An active and objective directory board can significantly reduce the possibility of errors in the financial statements. Directory board may appoint an auditing committee with responsibility for overseeing the financial reporting process. The audit committee is also responsible for the communication with external and internal auditors. The independence of the audit committee is an important determinant of the effective evaluation of internal controls.

b) Management business philosophy and style

Bank management plays the key role in the formation of an adequate control environment. Their activities should give a clear signal to employees about the importance of the internal controls. In the absence of these signals, the quality control environment will be greatly compromised. Characteristics of management philosophies and management style that significantly affect the control environment are:

- Manager's approach to business risk acceptance and monitoring;
- Importance given by the management to financial and operational objectives;
- Management's attitudes and actions concerning the financial reports.

c) Organizational structure and methods of determining the authorities and responsibilities

The lines of responsibility and allocation of authority within the bank are defined by its organizational structure. The organizational structure can significantly contribute to improving the quality of the control environment by providing an adequate framework for planning, coordination and control. The organizational structure defines the formal communication routes.

d) Applied control system, including the internal audit function, personal policy and separation of duties

Within this element it is necessary to pay particular attention to the existence and position of internal audit in the organizational structure of a bank. Internal control can significantly contribute to the control environment through the assistance in monitoring other control policies and procedures. Internal auditors may provide useful suggestions for improving internal controls. It is essential that the internal audit is independent, and its independence must be institutionalized in the company through an appropriate organizational structure. If the independence does not exist, then the internal audit has limited achievements.

4.2. ACCOUNTING SYSTEM

Accounting system is a set of company's procedures and records that regulate business events processing for making accounting reports. This system identifies, collects, analyzes, calculates, records, summarize and makes reports on financial changes and other events. The accounting system consists of methods and techniques established by the management for recruiting and reporting transactions and events made in a period of time. The purpose of audit concerning the accounting system is to understand:

1. The main groups of transactions processed in the system;
2. The movement of the transactions;
3. Records, documents and accounts used in processing and reporting the transactions;
4. Transaction processing;
5. The procedures for financial reporting.

In most cases these activities usually include a series of related business functions which are reflected in the accounting system. These cycles are always complex. Thus, in the financing function, funds are received from the shareholders or creditors and then made available for use in investing. The working capital is used to purchase goods or services from business partners, and the means borrowed are returned in due time. Since the cycle consists of connected homogeneous transactions that are repetitive and can be grouped, the number and nature of cycles varies from region to region and from client to client. Focusing on the cycle of the transaction does not mean ignoring the individual accounts and groups of assets, the auditor focuses on the processes so as to understand the accounts.

The amounts on some accounts actually result from transactions processed through more than one cycle. The cash balance results from the cash received from the buyer, the cycle proceeds from the sales and customers i.e. production/sales and consequently the amount of the checking account reflects the net result of transactions processed through three cycles. Individual accounts will be important for the auditor if he understands the cycle that applies to the accounts and their financial amounts. Links between cycles, transactions and business activities can be summarized as follows:

CYCLES	ACCOUNT GROUPS
Sales / Billing	Sales income Claims Funds
Purchase / Payment	Assets
Employees / Wages	Liabilities Obligations and staff expenses
Production (Services)	Funds Inventories
Financing	Fixed assets Reproduction costs Investment Long-term borrowing

Table 1.

4.3. CONTROL PROCEDURES

Control procedures are related to the information about the company's policies,

procedures, control environment and accounting system established to provide reasonable assurance for the realization of specific goals. The auditor's objective is to gain knowledge of the control procedures necessary for planning the audit, and these procedures have different aims and appear in different forms depending on the client's business and profession.

Authorization and execution of transactions

All transactions must be approved by authorized persons according to the range of their authorities and responsibilities. The authorization for transactions depends on their nature, extent and frequency. Specific authority is the authority that is required each time a transaction is proposed and is usually associated with rare materials and unusual projects. In contrast, general authority means that the client has established policies and procedures which are respected by the employees in order to avoid questioning whether the proposed transaction or project is approved. Without the general or specific authorization, the transaction should not be executed.

Segregation of duties

System policies and procedures can not prevent secret activities and agreements, irregularities or illegal acts committed by two or more persons with an intention to make a fraud. Even if different employees authorize, execute and record cash payments, there is no accounting system that could prevent frauds. In order to achieve the optimal segregation of functional responsibilities, the client's management should separate the accounting and internal monitoring function and pass them to various employees. This means that the following authorities should be separated:

- Authority to initiate transactions (management function);
- Authority to execute transactions (monitoring function);
- Authority to record transactions (accounting functions);
- Independent performance verification (internal accounting control).

In the case when one employee is responsible for all four functions the possibility of fraud would be limitless, and if an employee is responsible for two or three functions the possibility of abuse is progressively reduced but not completely eliminated. Optimal segregation suggests that no employee is responsible for more than one function. Limiting the authority of an employee to one position means that it takes at least four independent employees to authorize, execute, record and periodically calculate transactions. With one person running two, three, or four functions the protection system weakens progressively.

Design and use of documents and records

In order to obtain accurate and reliable accounting information the transaction must be correctly recorded and properly classified in the accounts. The documents are physical evidences of the transactions and they are important trails for auditors while auditing the transactions in the accounting system.

The design of documents and accounting records has a significant impact on the efficiency of the accounting system and the effectiveness of audits. Documents must be:

- Designed for multiple use so as to minimize the number of different forms;
- Chronologically ordered so as to provide control over unused and those who are missing;

- Relatively easy to complete, allowing the employees to complete them on time.

The process of recording transactions and the accounting reports must be clearly and unambiguously described in the procedural manual. The procedural manual is an important source of audit evidences.

Access to property and documents

Bank assets and records must be protected from unauthorized access and use. Otherwise, the property can be stolen and altered and the records destroyed. In such

circumstances, normal operations and even the very existence of the bank may be affected. If the bank is computerized, special attention should be paid to the protection of computer equipment, programs and files.

For the control of access to computer resources the following measures are recommended:

- Locking the rooms in which these resources are located,
- Control of environmental conditions in places where computers are used (humidity and temperature),
- Provision of an adequate place to store programs and files with accounting data (programs and data library).

4.4. MONITORING

Reliability of the internal control system should be periodically evaluated by the employees. Monitoring is an independent verification of the functioning of internal control system whose aim is to make the internal controls more efficient. Independent controls intend to identify weaknesses in internal controls. In order to maximize the potential effectiveness of an independent verification the principle of suddenness should be implemented by the employees independent from the control functions and should result in an appropriate action. Monitoring is less effective if conducted by an employee responsible for making accounting records.

5. CONCLUSION

Business organization is required to implement the system of internal controls capable of providing continuous monitoring and measurement of risks that could adversely affect the achievement of identified business objectives, and to develop internal control system in a manner that allows periodical evaluation of existing and new risks. Internal control is the establishment of order in a business organization with control over all activities performed within it.

In the framework of internal control four components should be implemented:

1. Plan,
2. Do,
3. Check,
4. Act.

They operate orderly in one unit, and that unit is called the Deming cycle.

Today, the good news is that the internal controller moved to a higher position of a member of financial management team. The work of internal auditors is recognized as a key to success of the company for which they work. Their study of risk management is very important, and their advice is desirable. The controller is no longer a detective and a necessary evil to prevent frauds. Instead, the internal controller is a trusted adviser who takes a proactive approach to risk management and who is recognized by the progressive managers as necessary and beneficial.

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