

Internal Control and Internal Audit in the Function of Supervising the Operations of Companies

Zoran Todorović

Auditing-Mont, Ltd., Podgorica, Montenegro

Univerzitet Mediteran Podgorica, Podgorica, Montenegro

Božo Vukoja

UHY Revident doo Mostar, Mostar, Bosnia and Herzegovina

The management of a modern company is faced with the need to make business decisions regarding the achievement of business goals. Increased interest in establishing internal control is affected by the presence increased corruption and the erosion of business morality. For internal controls, everyone is interested, from external auditors to management, board of directors, shareholders of large public companies and the state. With the constant growth of the company, the decentralization of business has been compounded by the management process. Therefore, in addition to internal control, internal audit is required. The company's management cannot deal with oversight because it has to deal with strategic issues. This is where internal audit is performed as an expert service. The results of the conducted empirical research showed that the stages of development of internal control in enterprises in Montenegro do not correspond with the achieved degree of development of this profession in the countries of the developed market economy.

Keywords: internal control, internal audit, business quality, testing methods

Introduction

Internal control and internal audit seeks to establish an adequate internal control system in order to ensure well-organized business and thus achieve its goals. Internal audit ensures that internal controls quickly and accurately report on all transactions executed, and to ensure proper protection of funds. The internal audit determines whether organizations comply with laws, regulations, and whether management takes appropriate measures to address weaknesses in control. The regular work of the organizational unit of internal audit is to enable independent assessment, examination, and evaluation of the organization's activities. The significance of the internal audit is also revealed by the fraud and losses of five billion euros in Societe Generale Bank, the cause of which was the failure of the internal control system. Another example of lack of internal control is the case of Barings Bank that failed to comply with the procedures for the separation of duties.

Zoran Todorović, PhD., full professor, CPA, CEO at Auditing-Mont, Ltd. Company; professor, Univerzitet Mediteran Podgorica, Podgorica, Montenegro.

Božo Vukoja, Ph.D., professor, auditor in BIH and CRO, Ltd. Company UHY Revident doo Mostar, Mostar, Bosnia and Herzegovina.

Correspondence concerning this article should be addressed to Božo Vukoja, Barise Smoljana 1H, Mostar 88000, Bosnia and Herzegovina.

The internal audit examines and assesses the overall functioning of the entire business system and gives opinions and suggestions for improving its business. The role of internal audit in the business decision-making process stems from the fact that the internal audit determines the reliability, reality, and integrity of financial and business information coming from different organizational units, based on which appropriate business decisions are made at all levels of government. It is a body of business management whose main tasks are planning, organizing, dispensing, coordination and supervision. Internal audit is significant because it plays a key role in preventing and detecting errors and illegal actions, plays an important role in assessing and managing the risks of an organization, thereby safeguarding the security of its business. The basic principles defined by the code of professional conduct of internal auditors are: independence and skepticism, integrity, objectivity, confidentiality and competence. The quality and usefulness of the information determine the effectiveness of internal audit, while the external audit assesses the effectiveness of internal audit. Internal audit protects the business system from within, protects owners and management from misconduct of associates, and at the same time, owners of the management of the organization and in the broadest sense protect the interests of the public. Internal auditing must increasingly focus its potential on the future by providing advice on anticipated future risks in particular areas of business. One of the basic tasks of internal audit is to advise management on the possibilities of risk management, primarily in terms of designing and monitoring the appropriate internal control system as a risk management instrument. The subject of research in the work is general data on organizations, organization of internal audit, its responsibility, i.e. subordination, as well as tasks.

Development of Internal Audit and Literature Review

In the course of 1947, another significant step was made in the United States in the direction of strengthening and further development of internal audit. The Institute of Internal Auditors has issued and published the Statement of Obligations and Responsibilities of Internal Auditors, which further defined their position. This Statement is the first step towards the adoption of the standard of professional practice of internal audit (Poznanić, 2011). Institute of Internal Auditors of the United States (Pickett, 2011). From developed countries, the practice of internal audit extends to all countries of the world.

Concerning the theoretical framework of internal audit, we will cite some of the most significant internal audit definitions that contain the purpose, objective, and tasks of this function. The internal audit task is to investigate, examine, and evaluate the internal control system and its effectiveness in the operation of each particular business system, to report on findings, and to propose solutions to management (Meigs, Whittington, & Pany, 1988). The internal audit examines the organization and functioning of the accounting system and the related internal controls, the credibility of financial and operational information, assesses the economy, efficiency, and effectiveness of business operations and controls, and the application of policies, plans, and procedures. The American Institute of Chartered Public Accountants (AICPA) defined the audit as a systematic process of objectively collecting and evaluating evidence of allegations of economic actions and events up to the level of reliability of the correspondence of these allegations and established criteria, as well as the communication of results to interested parties users. Internal audit is an effective instrument of managerial control. Although it is often limited to account revisions, it relates to business performance assessment as a whole (Munro & Stewart, 2011). Both internal auditors, in an attempt to verify the credibility of documentation, also evaluate policy, procedures, quality of decision-making and management, the effectiveness of methods

and procedures, and other specific business problems (Krogstad, Ridley, & Ritterbeg, 1999). The internal audit of the bank is defined as an “independent management function that includes a continuous and critical assessment of the bank in order to give suggestions for its improvement, create value and strengthen the overall management mechanism including entity risk management and the internal control system” (Rossel, 2007, p. 18). The internal audit task is to “investigate, examine and evaluate the internal control system and its effectiveness in the operation of each particular business part, to report on findings and to propose solutions to management” (Allen, Sneathen, & Tim, 2007, p. 156). According to R. Moeller, internal audit is an independent assessment of business functions established in an organization with the purpose of examining and evaluating its activities, and thus represents a service that is provided to that organization (Boynton & Johnson, 2006). In professional practice, internal audit is defined as “the activity of independent, objective persuasion and consulting activity designed to create added value and improve the operations of the bank” (Spahić, 2008, p. 11).

From these definitions of the audit it follows that internal audit is a consulting activity that, in addition to regular tasks, enables the creation of added value of the bank, that is, adding value to the actions of the owner.

Methods of Testing the Internal Control System

The internal control system is one of the most important defense mechanisms of society and as such should be controlled, controlled and tested. Bearing in mind the functioning of the testing process and the necessary considerations in designing control tests, we distinguish several methods, namely, the testing technique:

- interview,
- Inspection,
- observing,
- reconciliation,
- re-performance,
- Confirmation.

Interview is the most common and most used test method. The interview examines how the procedures and rules of practice are implemented in practice, whether certain business procedures and policies are properly communicated to employees (if employees have not heard about the existence of procedures and regulations, it is necessary to ask what is the general way of informing employees of their duties and responsibilities). But the information collected by the interview cannot serve as sufficient audit evidence, nor can it serve as a basis for reducing control risk. When conducting control tests, the interview should always be combined with one more method.

The inspection is a test technique where the auditor or the conductor of the tests confirms the physical existence of the test subject. The examination is more reliable proof of the interview since the paper's evidence of the conducted transactions on the basis of the sample (accounts, status reports, construction books, etc.) is reviewed and the physical stability of the said property is also confirmed.

Observation is a testing technique carried out by the auditor himself or by the conduct of control tests. Observation includes the process of monitoring the functioning of the control mechanism in progress (i.e., “live”). Observation is reliable evidence, and as such serves as a basis for making an assessment of the effectiveness of control mechanisms.

The basis of the adjustment process is above all the basic accounting principle of double entry and equity of assets and liabilities. The process of alignment is present in the day-to-day business of the company, and the auditor or the conductor of the control can carry out the reconfiguration of the existing alignment if it considers it necessary and on the basis of the test results to evaluate the effectiveness of the control mechanism.

Re-performance is the most reliable technique for testing control mechanisms. It consists of re-carrying out a particular transaction or control mechanism by the auditor or the conductor of the control tests and the comparison of the results obtained with the data subject to testing.

Verification is the most credible testing technique. Confirmation implies the confirmation of the balance of the individual balance sheet positions by the receipt of a confirmation by an independent party.

These methods of testing should be combined in such a way that as many different sources as possible can obtain a confirmation of the efficiency or inefficiency of the control mechanisms.

In addition to the above test methods, an auditor or a tester, control can also be used with additional methods, e.g. use of experts for particular areas.

Methodology of Research

The research survey was carried out in the fourth quarter of 2017 using a cross section study-surveys. An empirical study of the role of internal audit in increasing the quality of operations was carried out on a sample of 100 companies. The survey was sent to accountants and to internal auditors, but also to employees who supervise the conduct of business activities in the company. Survey questionnaires were sent to respondents via e-mail. Survey questionnaires contained most of the questions of closed type, with one or more answers being offered. Some questions have the possibility for the respondent to write down his answers, experiences, and suggestions. In the observed period, the survey questionnaires were returned by a total of 97 respondents, which makes the rate of return 97% which can be considered acceptable in this type of research, therefore it can be concluded that the results of the research were formed by the basic significance data, thus fulfilling research requirements.

In the research of the role of internal supervision in increasing the quality of Montenegrin companies' business, the following objectives of the research were set: 1) to explore the existing situation and the presence of internal control in enterprises in Montenegro, 2) to explore instruments for measuring the quality of business.

Table 1

The Structure of Respondents

Crosstab		Company size					Total
		No answer	Micro	Small	Medium	Large	
	No answer	1	0	3	1	0	5
Legal form of company	General partnerships	0	0	2	0	0	2
	Limited partnership	0	0	0	1	0	1
	Limited liability company	0	31	23	12	5	71
	Joint stock company	0	0	3	10	5	18
Total		1	31	31	24	10	97

From 97 respondents four did not provide the size legal form of company while one respondent did not provide legal forma and size of company. Looking at the legal form most of the respondents come from limited liability companies, and looking at size micro and small are dominant.

Table 2

Number of Companies With Set Up Internal Controls

Does your company have rules for internal control?		Frequency	Percent	Valid percent	Cumulative percent
Valid	No answer	1	1.0	1.0	1.0
	Yes	34	35.1	35.1	36.1
	No	62	63.9	63.9	100.0
	Total	97	100.0	100.0	

From total number of returned responses 63.9% responded that they do not have rules for internal controls, which is not a surprise having in mind that companies in Montenegro, especially micro and SME set up specific rules and functions only when required by law.

Table 3

Rules for Internal Control and Company Size

Crosstab		Does your company have rules for internal control			Total	
		No answer	Yes	No		
Company size	No answer	Count	0	1	0	1
		% within Size of company	0.0%	100.0%	0.0%	100.0%
		% within Does your company have rules for internal control	0.0%	2.9%	0.0%	1.0%
	Micro	Count	0	2	29	31
		% within Size of company	0.0%	6.5%	93.5%	100.0%
		% within Does your company have rules for internal control	0.0%	5.9%	46.8%	32.0%
	Small	Count	1	11	19	31
		% within Size of company	3.2%	35.5%	61.3%	100.0%
		% within Does your company have rules for internal control	100.0%	32.4%	30.6%	32.0%
	Medium	Count	0	13	11	24
		% within Size of company	0.0%	54.2%	45.8%	100.0%
		% within Does your company have rules for internal control	0.0%	38.2%	17.7%	24.7%
	Large	Count	0	7	3	10
		% within Size of company	0.0%	70.0%	30.0%	100.0%
		% within Does your company have rules for internal control	0.0%	20.6%	4.8%	10.3%
Total	Count	1	34	62	97	
	% within Size of company	1.0%	35.1%	63.9%	100.0%	
	% within Does your company have rules for internal control	100.0%	100.0%	100.0%	100.0%	

Looking at the table above it is easily noticed that the smaller the company is the greater number of those who don't have internal controls. This is also not surprising because most of the micro and also SME companies are usually run by owners which are CEOs, who have two to three employees and hire external accountants for book keeping. In this manner the owners have full control over business operations.

In the recent past most frauds were done by handing money directly from hand to hand, evading transactions over bank accounts.

Table 4

Rules for Internal Control and Cash Transactions

Crosstab			Does your company have rules for internal control			Total
			No answer	Yes	No	
Does your company do cash transactions	No answer	Count	0	2	0	2
		% within Does your company do cash transactions	0.0%	100.0%	0.0%	100.0%
		% within Does your company have rules for internal control	0.0%	5.9%	0.0%	2.1%
	Yes	Count	1	8	19	28
		% within Does your company do cash transactions	3.6%	28.6%	67.9%	100.0%
		% within Does your company have rules for internal control	100.0%	23.5%	30.6%	28.9%
	No	Count	0	24	43	67
		% within Does your company do cash transactions	0.0%	35.8%	64.2%	100.0%
		% within Does your company have rules for internal control	0.0%	70.6%	69.4%	69.1%
	Total	Count	1	34	62	97
		% within Does your company do cash transactions	1.0%	35.1%	63.9%	100.0%
		% within Does your company have rules for internal control	100.0%	100.0%	100.0%	100.0%

According to answers 69.1% does not do cash transactions, but most of them do not have internal controls.

Table 5

The Effect of Implementation of Internal Controls

How much implementation of internal control would improve business operations?		Frequency	Percent	Valid percent	Cumulative percent
Valid	No answer	4	4.1	4.1	4.1
	Significant improvement	54	55.7	55.7	59.8
	Some improvement	28	28.9	28.9	88.7
	No effect	11	11.3	11.3	100.0
	Total	97	100.0	100.0	

Most of the respondents have the opinion that implementation of internal controls would benefit their companies but still are delaying its implementation.

Conclusion

Market operations provide enormous opportunities, but they also represent a potential source of deviance in the behavior of individuals and businesses. The process of globalization has further complicated the forms of organization of business entities that often have exchanges in one branch in many other countries of the world. Therefore, the importance of control and monitoring is progressively increasing. Supervision and control are mainly viewed from the point of view of the entity that organizes them. In the case of internal control, there is internal control and internal audit. When it comes to external supervision, the inspections and independent audits are dominated. Internal control in business systems is organized by company management. This control can be narrower—financially and wider—business. It consists of daily, ongoing, occasional, periodic, prior and subsequent controls. Above all these controls there is an internal audit that checks the results of all internal controls. Finally, external audit appears as a global controller of the legality of business of businesses. In addition, it helps to better manage businesses and overcome difficult situations.

A number of goals that the organization wants to achieve in the company's internal control system can be achieved under the common name: to ensure successful business processes and achieve the goals of the company's business objectives. In this context, the management organizes an internal audit with a task of supervision and evaluation of the functioning of the internal control system in the sense of monitoring the achievement of its goals and tasks. The internal audit determines the reliability, reality, and integrity of financial and operational information coming from different organizational units, on the basis of which appropriate business decisions are made at all levels of governance. Business decision making becomes safer, since it is based on a previously verified information basis, from professional and independent internal auditors. Internal audit critically examines plans, programs, policies, and procedures to assess enterprise planning. The internal audit evaluates the appropriateness of organizational solutions in the company that should enable the achievement of the planned objectives. We could easily establish that the internal audit focuses on the business of the company in the broadest sense with the aim of providing assistance and support to the management in successfully fulfilling its many tasks and goals, in preventing possible problems and correcting our problems.

In line with the results of the empirical research carried out, it can be concluded that the level of development of internal audit in enterprises in Montenegro does not correspond with the achieved development of this profession in the countries of a developed market economy. Furthermore, it is necessary to point out the need for continuous education in accordance with the stated trends in the development of the profession of internal auditors, not only internal auditors, but also the management of Montenegrin companies in terms of increasing the level of awareness and acting in relation to certain forms of internal control over the business operations of enterprises.

In the end, it may be decided to perform an audit of the business, or only after such an audit, the right picture and performance in the business for a certain period of time are determined. Finally, it is important to point out that there is no such internal control and internal audit system that would provide perfect results of the company's protection against unwanted activities each time. Each control that is carried out, and in the work is presented the possibility of showing the basis of internal control, internal audit and business auditing, results in certain costs, with the notion that a greater number of controls gives better results, but also increases the costs for the company. It is management that makes decisions and leads the whole process to a desired and optimal plane, which is in line with the goals set before management.

References

- Allen, D., Sneathen, D., & Tim, K. (2007). The effects of fraud and going-concern risk on auditors' assessments of the risk of material misstatement and resulting audit procedures. *International Journal of Auditing*, 11(3), 149-163.
- Boynton W., & Johnson, R. (2006). *Modern auditing* (8th ed.). New Jersey, NJ: John Wiley & Sons, Inc.
- Chorafas, D. N. (2001). *Implementing and auditing the internal control system*. Chippenham, Wiltshire: Antony Rowe Ltd.
- COSO. (1992). *Internal control-integrated framework*. Jersey City, NJ: Committee of Sponsoring Organizations.
- Eremić-Đodić, J., Savanović, N., & Sikimić, V. (2012). Upravljanje procesom interne kontrole. *Poslovna ekonomija*, 6(2), 291-313.
- Gramling, A., Rittenberg, L., & Johnstone, K. (2012). *Auditing* (8th ed.). Canada: South-Western.
- Ivaniš, M. (2003). Osnovne Vrste i Forme Revizorskih Izveštaja. *Revizor*, 6(24), 17-30.
- Jorion, P. (2001). *Value at risk: The new benchmark for managing financial risk* (2nd ed.). McGraw-Hill.
- Krogstad, J., Ridley, A., & Ritterberg, L. (1999). Where are we going? *Internal Auditor*, 56(5), 26-33.
- Kukoleča, S. (1995). *Osnovne ekonomije*. Beograd, Srbija: Savremena Administracija.
- Lee, T., & Alan, P. (1984). The nature, scope and qualities of auditing. In S. Carsberg (Ed.), *Current issues in auditing*, Philip Alan.

- Lynch, F. (2007). *Finansijske Informacije Za Menadžment*. Beograd: Savez računovođa i revizora Srbije.
- Ljubisavljević, S. (2011). Revizijakao instrument provere kvaliteta finansijskog izveštavanja. U Stojanović, R. (ured.), Kvalitet finansijskog izveštavanja—izazovi, perspektive i ograničenja, 42. Simpozijum “ačunovodstvo i poslovne finansije u savremenim uslovima poslovanja”, Zlatibor (162-179). Beograd: Savez računovođa i revizora Srbije.
- Ljubisavljević, S. (2000). *Uloga eksternog revizora u okruženju*. Kragujevac, Srbija: Ekonomski Fakultet.
- Ljutić, B. (2005). *Revizija: Logika, principi i praksa*. Beograd: Ljutić, B.
- Meigs, W., Wittington, O., & Pany, K. (1988). *Principles of auditing*. McGraw-Hill, Irwin.
- Milojević, D. (2006). Revizija finansijskih izveštaja. Beograd, Srbija: FTB, BBA.
- Milosavljević, S., & Radosavljević, I. (2003). *Osnovne metodologije političkih nauka*. Beograd, Srbija: Službeni glasnik.
- Ministarstvo finansija—Vlada Republike Srbije. (2011). Pravilnik o zajedničkim kriterijumima organizovanja i standardima metodološki muputstvima za postupanje izveštavanja interne revizije u javnom sektoru. Službeni glasnik RS, 99/2011.
- Munro, L., & Stewart, J. (2011). External auditors' reliance on internal auditing: further evidence. *Managerial Auditing Journal*, 26(6), 464-481.
- Pickett, S. (1997). *Profesionalna praksa interne revizije*. Beograd, Srbija: Savez računovođa i revizora Srbije.
- Pickett, S. (2011). *The essential guide to internal auditing*. London, UK: John Wiley & Sons.
- Poznačić, V. (2011). Uloga odbora za reviziju u korporativnom upravljanju. *Revizor*, 13(53), 10-24.
- Popović, S. (2014). *Socio-ekonomski faktori ograničenja razvoja agrara*. Novi Sad: Univerzitet Privredna akademija.
- Popović, S., Eremić-Đodić, J., Grublješić, T., & Mijić, R. (2014). Internal control management functions. In IV International Symposium on Engineering Management and Competitiveness (pp. 373-377). Zrenjanin: Tehnički fakultet “Mihajlo Pupin”.
- Raschenberger, M. (1929). *Internationale revision und treuhandwesen*. Wien.
- Renard, J. (1997). *Theorie et pratique de l'audit interne*. Paris, Les editions d'organisation.
- Root, J. S. (1999). *Beyond COSO: Internal control to enhance corporate governance*. New York: John Wiley & Sons, Inc.
- Sarens, G., & De Beelde, I. (2006). The relationship between internal audit and senior management: A qualitative analysis of expectations and perceptions. *International Journal of Auditing*, 10(3), 219-241.
- Soh, D., & Martinov-Bennie, N. (2011). The internal audit function: Perceptions of internal audit roles, effectiveness and evaluation. *Managerial Auditing Journal*, 26(7), 605-622.
- Soltani, B. (2009). *Revizija: Međunarodni pristup*. Zagreb: Mate.
- Spahić, N. (2008). Izveštaj interne revizije. *Revizor*, 10(41), 5-19.
- Stanišić, M. (2006). Modeli interne kontrole. *Računovodstvo*, 50(9-10), 22-35.
- Stuart, I. (2012). *Auditing and assurance services: An applied approach*. New York, NY: McGraw-Hill, Irwin.
- The internal auditing pocket guide: Preparing, performing, reporting and follow-up* (2nd ed., Vol. 4, 10-25). Milwaukee, Wisconsin: American Society for Quality Press.
- Vitorović, B. (2002). Uspostavljanje organizovanja interne revizije. *Revizor*, 5(17), 63-77.
- Vitorović, B. (2004). *Interne kontrole interna revizija*. Beograd: Savez Računovođa I Revizora Srbije.