INTERNATIONAL JOURNAL OF SOCIAL Sciences and Information Technology
ISSN 2412-0294 www.ijssit.com
http:// www.ijssit.com

CURBING INCIDENCES OF MANAGEMENT OVERRIDING INTERNAL CONTROLS

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Abstract

Internal control procedures in organizations make an important component that management is expected to observe in order to safeguard the assets of an organization, ensure accuracy and reliability of the accounting data so as promote efficiency in the operation of an organization. Management is expected to lead by example in adhering to the guidelines put in place. The church organizations are not exceptional to this requirement. The auditors have the mandate to test the workability of the internal controls by conducting various tests. The audits have indicated that the incidences of management overriding internal controls are on the increase and have become diverse despite the same reported year after year. There is need for management boards to address this challenge by conducting continuous training to management in order to improve the level of understanding and appreciation of the need to strengthen the internal controls, also to take stern and observable actions on culprits who are fond of overriding internal controls, to also conduct thorough orientation to new management staff and finally to strengthen the audit and finance subcommittee of the Board to be able to curb this problem of management overriding internal controls.

***Keywords**: Internal controls, Management, Overrides, Audits*

1. Introduction

Organizations have internal control and operations procedures that are adopted by their management Boards forming part of the operating procedures of the same organization. These procedures are there to be followed by both management and all staff to enable the organization achieve its mission and objectives.

1.1 Background of the study:

Committee on Auditing Procedure of the American Institute of Certified Public Accountants defined internal Control as: “the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies”(Bower & Schlosser, 2016). This definition captures the main components and concerns regarding the internal control. It does not only define internal control but it goes further to state the main components of internal control and what can be viewed as the scope of internal control(Beasley et al., 2008).

It is clear from this definition that internal control comprises two main components that make what is referred to as internal control. These components are Accounting and administrative controls. Accounting controls safeguard of assets, accuracy and reliability of accounting data while administrative controls has to do with promotion of operational efficiency and encouraging adherence to prescribed managerial policies(Basilico, 2008).

Accounting controls include but not limited to authorization and approvals, separation and segregation of duties, record keeping and maintenance, assets custody, and the internal auditing function. In the process of recording transactions, summarizing, analyzing and reporting the same through financial statements, internal controls is concerned with proper authorizations and approvals of the same. It ensures accounting staff do not perform incompatible jobs in the performance of accounting duties (Childs, 2007).

Administrative controls has to do with policies and adherence to defined policies which promote the operational efficiency and focus on the mission of the organization. It also deals with coming up with methods of reporting, employee issues and general quality issues.

It follows therefore that internal control is there to influence or control human behavior especially accountants who design, operate, implement and maintain these systems. The goals of these systems is promotion of reliability, productivity and safeguarding of assets (Carmichael, 1970)

It should be the goal of all employees and management to safeguard these controls as they help any organization in achievement of its goals. Incidences of overriding internal controls need to be reduced to minimal levels if not eliminated completely. This should be the goal of every person involved in handling assets of an organization.

1.2 Statement of the problem:

Management of an organization are required to lead in ensuring the internal control systems are adhered to by all in an organization. They should review the internal control systems from time to time to tighten the gaps noted so that the objectives of an internal control system are achieved. Every employee should be aware of the internal controls and adhere to them. The minimum expectation in an organization of any employee is to ensure the internal controls are strictly followed.

In many organizations self interest of both employees and management make it hard for many to follow the internal control procedures. Management do not review the existing internal controls so that the gaps are exploited to render benefits to management that should not be. As management override these controls it makes other employees follow after them and this ends up rendering the internal control systems completely unworkable.

In spite of the expectation from management to lead organizations into following the existing internal controls and because management having a desire to exploit the gaps in enriching themselves by taking advantage of weaker internal control systems, most organizations experience reports of management overriding internal controls by auditors year after year. The overrides keep becoming complicated and enhanced year after year.

The situation of management overriding internal controls leads to organizations losing its assets and the problem becomes infectious to the extent of moving from management to other employees. Many organizations conduct trainings and workshops to discuss this problem but it still becomes more prevalent amongst many organizations. It is a subject that requires serious consideration by management and Boards of management especially on addressing minimizing incidences of management overrides if not eliminating its occurrence. Many researchers have extensively addressed this aspect of what comprises management overriding internal controls but how to reduce its happening has remained less studied and focused.

1.3 Objectives of the study:

The objective of this study is to find out the methods that can be used to minimize incidences of management overriding internal controls. This is due to the fact that organizations' audits have constantly kept reporting incidences of overrides by management every year. Each financial year unearths new overrides in addition to the ones reported in the previous years.

This study will focus on sampled church organizations in Kenya.

1.4 Research Question:

The study will attempt to provide an answer to one specific question: What methods can organizations adopt to curb the incidences of management overriding internal controls?

1.5 Significance and scope of the study:

The study will help church organizations in Kenya struggling with occurrences of management overriding internal controls in dealing with the question of minimizing or eliminating the vice. It will guide Boards of Management and executive committees to come up with policy guidelines on checking the number of incidences of management overriding internal controls.

1.6 Scope and Limitations of the study:

The study focuses on the incidences of management overriding internal controls within the sampled church organizations within the Country of Kenya. The study involves the review of documents that analyze the incidences of management overriding internal controls as reported by different auditors.

One notable limitation of this study is that the study is confined to the incidences reported by the auditors in Kenya and thus the possibility of not taking into account those types of overrides not detected and reported by the different Auditors.

1.7 Definition of terms:

Internal Control - the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies.

Management – In this research paper, management refers to the cadre of staff whose responsibility is to oversee the smooth running of the organization. They take part in making decisions that define the smooth running of the organization.

Overriding – This is used here in this paper to mean actions performed by those in management that do not adhere to the set down regulations and guidelines or procedures of operations.

Auditing- This refers to the independent examination of financial or other records with the view of making an opinion as to whether the financial statement presented reflects true and fair view of the state of affairs of the organization.

Financial statement fraud – Deliberate actions in the financial statement so that it doesn't reflect the true position and state of affairs.

2. Review of Literature:

2.1 Introduction:

This chapter attempts to review various literature related to internal control procedures of different organizations and how management are expected to be in the forefront in enforcing the controls. The chapter looks at what various scholars and authors on how they have written about the subject under study. It analyses the grounds within which the findings and recommendations are made and conceptualized.

2.2 Historical setting of the Study:

Internal controls in organizations operate like a wall that limits the far one can go in the performance of certain duties and responsibilities. The reason it is believed internal control's main function is to influence the direction taken by human beings (Carmichael, 1970). The way human beings especially those who do the design and operations of the accounting and audit function to a great degree influence the success and respect of the internal control procedures.

The main objective of setting up internal control procedures is mainly to safeguard the organization's assets, enhance productivity and promote reliability of the financial reports in an organization's decision making process. This means the economical application of an organization's assets to achieve greater production and the reports produced which are able to guide in strategic directions of an organization.

Management guide an organization in setting strategic goals and objectives that the organization exists for. The internal control system promotes to a greater extent the fulfilment of these goals and objectives. Failure of the internal controls delays and sometimes prevents achievement of the goals and objectives. Poor governance has been identified to be the major stumbling block in implementation and adherence to the set internal control systems or procedures (Jensen, 1993). Governance, Internal control procedures or systems and the characteristics of the governance team have a very direct influence on the overall direction that an organization takes(Johnson, Hoskisson, & Hitt, 1993).

There has been a trend in the recent past where management have been involved in sweetening the financial position of companies by what professionals call financial statement frauds. In the past years financial statement frauds have grown dramatically in both the number occurring and the size of the losses. In 1998 a Business week held its forum of CFOs where 67% of them reported that they had been asked by senior company executives to misrepresent the financial results of their corporations. In this same meeting 12% of those admitted to have in fact actually misrepresented the financial results. This is what happened with the Enron, WorldCom, Xerox and many others (Owusu-Ansah & Ganguli, 2010).

Organizations adopt internal control procedures that if followed help safeguard the assets of an organization. When management by virtue of their positions and influence by pass these procedures then an incidence of override is considered to have occurred. There are many forms of such which are known as management fraud when the financial statement does not reflect the true position of the state of affairs of an organization (Daniel et al., 2015).

2.3 Internal control over Financial Reporting

In the USA, what is known as, "Committee on Sponsoring Organizations" (COSO), identifies five major components of internal control. They are:

Control Environment – Deals with control consciousness of the people working in an organization. It provides discipline and structure through components like integrity, ethical values, competence of the employees, management style, assignment of authority and responsibility, development of the people and the style adopted by the board of directors(Behrman, 1998).

Risk management – it deals with how risk is identified and managed to minimize the effects in case it occurs(Campbell & Hartcher, 2013).

Control functions – issues dealing with approvals, authorizations, verifications, and reconciliations, reviews of operating performance, assets safeguard and segregation of duties(Beasley et al., 2008).

Communication – deals with identification of pertinent information that needs to be communicated, production of reports and feedback, and external and internal information that guides in making decisions affecting the organization.

Monitoring and evaluations – This is a continuous assessment of the controls to identify how they are working and those that require improvement.

Source: COSO, Internal Control – Integrated Frame work (1992).

While a company's Chief Executive Officer has an overall responsibility in the management of an organization, the Chief Finance officer has a direct responsibility to ensure smooth running and implementation of internal controls. The understanding and respect of these controls should be overseen by the management who are to lead by example in a way that they are supposed to respect these controls.

The role of the Audit Committee of the Board of Directors in enforcement of internal controls

The Board of directors have a responsibility to oversight all organization's operational efficiency. This includes preparation of financial statements and the design and operation of controls. This responsibility of the Board is delegated to the Audit subcommittee of the Board.

This audit committee interrogates all staff and management with the aim of enforcing controls which make it harder to commit fraud and easier to be detected. Management have an overall responsibility to put measures in place to ensure it is harder to commit a fraud of any nature and easier for any fraud to be detected. The committee employs different test methods to ensure and get assurance of this and report the same to the Board.

Therefore management have a responsibility to foresee the implementation of internal controls and to make sure they are effective. The incidences where management are part of the system that overrides these controls is not only serious but detrimental to the survival and achievement of established objectives and goals.

Identified components that leads to a satisfactory internal control systems are; logical organizational plan identifying lines of authority and responsibility which segregates incompatible duties, adequate accounting system, complete reporting structure, prompt recording of transactions, hiring of competent personnel full of integrity, observations of authorities given, adequate physical security of assets, paper documentation and electronic data, controlled access to assets, actual checking of assets recorded in the books and continuous review of an organizations' operations.

The effects of weak internal controls may lead to:

- Increase in the organization costs of operations

- Financial statement fraud
- Erroneous decisions made due to inadequate and wrong information
- Loss of organizations resources and assets
- Exposure to all kinds of risks.

Due to these serious effects of a weaker internal control system, management which is expected to have good understanding of their role in internal control should have less or none of the incidences reported relating to management overriding internal controls. It is expected of management to be transparent and put all efforts to strengthen internal controls to make it easy for detection of any incidences of internal control.

3. Research Methodology

3.1 Introduction:

This section brings out the approach employed in the research process. It illustrates the research philosophy and design. It goes further to discusses the data collection methods, sampling techniques, data processing, ethical consideration, presentation and analysis methods used in the study ("Expectations for Banks Observations on Internal Controls Examiner Assessment of Internal Controls," 2013).

3.2 Research philosophy and Paradigm:

The philosophical worldview in this study was constructivism —where we believe that there are multiple realities, which are constructed through the lived experiences and interactions that we encounter in our daily lives. It further looks at reality as co-constructed between the researcher and the researched which ultimately is shaped by experiences(Cresswell, 2007). The researcher who has worked in the accounting offices in different church organizations has accumulated different experiences that was coupled with the entities researched aids in making reality.

3.3 Research Design:

Research design brings out the plan and strategy in the study used as guide for the researcher in an attempt to tackle the research problem. It is a guide to be used by the researcher to conduct the study. This study has been approached by way of examination of documents which are the audit reports of different church entities in Kenya. In the review of the documents major emphasis is placed on one phenomenon of management overriding internal controls. An in-depth review of the incidences in terms of their occurrences was done with a view to the research problem. Multiple forms of data collection were applied which included review of documents, interviewing auditors and observations of practices of management in different organizations (Cresswell, 2007).

3.4 Sampling Techniques:

A sample is defined as a portion of the population that is selected for study representing the whole. The sample is intended to show the characteristics of the whole.

In this study convenience sampling was used. This was due to the fact that it is mostly used when subjects of study are easy to reach(West, 2006). The researcher in this study decided to choose the church institutions that are audited by different auditors in Nairobi Kenya due to the proximity and easy to reach. The 25 organizations are sampled for this study.

The following table looks at the different types of overrides that are reported by the auditors. The incidences of overriding internal controls in this table shows how many organizations that the override incident was reported out of the organizations that were studied. The percentage shows the percentage of the incidents considering the 25 organizations that were studied.

Number	Type of override	Incidences	Percentage of the whole
1	Abuse of travels	20	80%
2	Non-deduction of loans	15	60%
3	Salary advances beyond	22	88%
4	Allowances available to employees' dependants	13	52%
5	Non approval of budgets by governing boards	10	40%
6	Approval and signing of self-cheques	23	92%
7	Approval of self-expense reports	21	84%
8	Involvement in procurement	16	64%

Table 3.1

3.5 Data Collection Methods:

In this study the researcher used documentary review and interview to a small scale whenever it was necessary to clarify points here and there. The researcher basically reviewed audit reports from all the twenty five organizations and during the review any items that needed further explanation, the researcher interviewed the head of the audit team that conducted the audit.

Interview:

The researcher used two interview sessions. The first interview was done prior to the start of the study between the researcher and the head of each audit unit to be able to define the purpose of the study. The interview was basically to address ethical issues that may arise during the study. The other interview was to look at the best approach that do not compromise the secrecy of the audits and issues of audit. The interviewee for reasons of secrecy and confidentiality of the information gathered during the field work requested not to provide any raw documents for publications(Wolfe et al., 2009).

Documentary review:

The researcher was supplied with the audit reports from the twenty five organizations. The researcher reviewed the portions of documentary evidence where incidences of management overriding internal controls were reported. Again due to confidentiality no names of organizations were recorded down where these incidences were reported by auditors. The incidences were coded as shown in table 3.1 above.

3.6 Ethical issues in the study:

In this study the researcher and the auditors who conducted the audits and made the reports made a prior agreement to observe the confidentiality of the reports. The researcher treated this with the confidentiality it deserved as agreed. Due to this, the researcher signed for all audit reports and audit working papers that were supplied by the different audit offices. The researcher conducted this reviews within the protected premises of the auditors and was not allowed to carry any document outside the premise. Due to this agreement the research has not mentioned any names of organizations in this study.

3.7 Data presentation:

In this study both descriptive and explanatory methods were employed, descriptive technique was used where data collected through interview was coded, put into themes and patterns to be able to address research questions. In addition exploratory method was used to provide detail account or in-depth explanation of the qualitative data collected.

4. Research Findings, Analysis and Interpretation

4.1 Introduction:

This chapter presents the findings from the study conducted by the researcher, regarding the incidences of management overriding Internal controls as reported by auditors. This chapter also deals with the relationship of the findings with the research questions.

4.2 Incidences of management overriding internal controls

The data available through the review of audit reports show that the incidences of management overriding internal controls have been reported constantly in all the years that audits have been done. The auditors have reported these incidences constantly as it was apparent from the reports made available to the researcher.

The overrides in order of occurrences amongst the 25 church organizations are:

1. Approval and signing of self – cheques at 92%
2. Taking salary advances beyond policy at 88%
3. Approval of self-expenses at 84%
4. Abuse of travels at 80%
5. Management involvement in procurement at 64%
6. Non-deduction of loans of management at 60%
7. Allowances available to dependents of management at 52%
8. Operating budgets before they are voted by the governing boards at 40%

The research found out that of the 25 organizations all of them have reported cases of management overriding internal controls. These incidences have constantly been reported by the auditors in all recent audits. The research found out that the management of all these organizations in response to management letters from auditor enumerated steps taken to eliminate these incidences of overriding internal controls.

ISSN 2412-0294
Vol V Issue III, March 2019

The research discovered that instead of these incidences reducing they have instead increased. One notable feature of these incidences is one override that is reported in the previous year goes down while the other increases. And as the other is reported by the auditor, the next financial year the reported one reduces while a new one comes up.

4.3 Measures put in place by supervisory bodies of the organizations to mitigate this trend:

The research found out that the supervisory bodies of these organizations have put up measures to check on the emerging incidences of management overriding internal controls. The measures identified in the audit working papers are:

- Ensuring all organizations have developed an internal control procedure document and presented it to the management board for adoption. It was found that twenty out of the twenty five have developed the document and voted it in their management boards.
- Signing of conflict of interest statements by all members of the management team and management board with disclosures of any potential conflict.
- The supervisory bodies of these organizations do regular tests to ascertain the working of the internal controls especially as regards the management reinforcement of the internal controls.
- The supervisory bodies of these organizations writes to administrators involved in any kind of override requiring a written response with explanation of what circumstances led to the override and the plan put in place to avoid it happening in the future.
- The auditors sending audit reports and findings to the supervisory organization taking note of those issues that need the attention of management of the supervisory organization.
- The auditor making presentation of findings to the management Board immediately after it is conducted.

All these measures as found by the researcher did not lead to decrease in the incidences of management overriding internal controls.

The researcher comes up with the following proposals regarding dealing with incidences of management overriding internal controls:

Proposal one:

There is a relationship between the continuous training of management and incidences of management overriding internal controls. There should be effort to conduct continuous training of the management teams.

Proposal two:

There is a relationship between actions taken by management boards on culprits and incidences of management overriding internal controls. The supervising organizations should take stern actions on the management teams that override internal controls.

Proposal Three:

There is a relationship between the orientation process of the management on appointment and incidences of overriding internal controls. There should be an elaborate and intensive orientation process and procedure to all new managers.

Proposal Four:

There is a relationship between the activities of the finance audit committee of the organization and incidences of management overriding internal controls. All church organizations to establish independent and working audit committees.

5. Conclusions and Recommendations:

5.1 Conclusion:

The question of organizational ethics that was highlighted by the 2001 "Enron Scandal" that brought down a major US corporation has all to do with management observing internal controls. Management overriding internal controls is basically an aspect of ethics. Organizations take effort to develop internal control procedures to be able to safeguard the assets of an organization and reliability of the financial statements as presented to the shareholders, government and other stakeholders.

The different churches whose organizations this research was about are encouraged to take the aspect of management overriding internal control seriously. This was evident in the research where the supervising organizations undertook specific steps to address incidences of management overriding internal controls that were reported by the auditor.

The objective of the study was to curb and probably bring down if not eliminate incidences of management overriding internal controls. The research found out that incidences of management overriding internal controls are on the rise in the organizations under study. This aspect seemed to be getting complicated each passing year. New overrides are discovered by audits every year with less or no improvement of the situation. Each organization in the twentyfive organizations has several incidences of management overriding internal controls. The study found out that this is a real serious issue that needs to be addressed by management boards as it reflects a serious lapse originating from management.

The steps adopted by management boards to address these incidences are bearing no fruits. The different types of overrides seems to be taking a vicious cycle where a decrease in one type of overrides leads to an increase in the other overrides. The study in the review of the audit reports of the twenty five organizations found out that indeed the problem of management overriding internal controls is indeed real and exist in virtually every organization. There remains the research question of how do we curb this problem of management overriding internal controls in the organizations.

5.2 Recommendations:

Organizations have put in place efforts to mitigate the challenge of management overriding internal controls in the organizations. The study found out quite good measures implemented with the intention of curbing management overriding internal controls.

The following recommendations can help in curbing the problem of management overriding internal controls:

i. Continuous training of management on the need to observe integrity and internal controls in the organizations.

ii. The management boards should come up with guidelines on dealing with culprits involved in overriding internal controls as well as reward system for the whistle blowers.

iii. The management boards should develop an elaborate orientation program of new administrators at the start of their career in the organization as well as continuously to review the internal control procedures with the new innovations.

The boards of management to activate and empower the audit and finance committees of the boards and give them teeth to deal with risky practices by management to deter management from overriding the internal controls.

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