

# THE CONCEPT OF INTERNAL CONTROL SYSTEM: THEORETICAL ASPECT

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**Abstract.** *Analysis of the concept of internal control system is an important subject that involves the analysis of the latest scientific results, and on its basis to perform an updated analysis of the concept of internal control system which meets the modern business conditions and tendencies. Such an assumption has been made upon exploring famous scientists' concepts of internal control system, in which the basic values needed for internal control system: (honesty, trust, respect, openness, skills, courage, economy, initiative, etc.) were not included. Only a modern concept of internal control might ensure an effective internal control system.*

*The main purpose of the authors was to explore control, the concepts and conceptions of control, internal control and the system of internal control, as well as to present their own idea of the concept of internal control system and to compile a structural scheme of their conception. The structural scheme may alleviate the process of compiling a new model of an effective internal control system. The structural scheme of the conception may also be used in compiling a model of internal control system in different branches of industry.*

**Key words:** *control, internal control, internal control system, conception of control, concept of internal control system*

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## Introduction

One of the basic instruments of enterprise control, whose implementation in modern economic conditions provide conditions for achieving a competitive advantage over other enterprises is the creation of an effective internal control system. In the industry sector, the market is constantly changing, and this requires changing the attitude to internal control from treating it only in the financial aspect to the management of the control process. Internal control as such becomes an instrument and means of risk control, which helps the enterprise to achieve its goals and to perform its tasks. Only an effective internal control in the enterprise is able to help objectively assessing the potential development and tendencies of enterprise performance and thus to detect and eliminate the threats and risks in due time as well as to maintain a particular fixed level of risk and to provide for its reasonable security .

The increasing variety of concepts of internal control systems requires their detailed analysis. A detailed analysis of the conceptions might help find the main reasons for their

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increasing number. It may also help to elaborate a structural scheme of the generalized concept of internal control. Consequently, it may help decrease the number of mistakes and frauds in enterprises and to offer the precautionary means that might help to avoid mistakes and build an effective internal control system.

The purpose of the study: to compile the definition of the concept of internal control system and to elaborate the structural scheme of the generalized conception for Lithuanian industrial enterprises.

The object of the research: internal control.

To achieve the aim, the following tasks were carried out:

- to examine the definitions of internal control;
- to design a flowchart for the existing definitions of internal control;
- to formulate a new internal control system definition;
- to identify the place of the internal control system in a company's objectives and its management activities.

Study methods: for the analysis of the conceptions of control, internal control, the concept of internal control system, systematic and comparative means of scientific methods of analysis were used.

## **1. Research of control conception**

According to J. Walsh, J. Seward (1990), H. K. Chung, H. Lee Chong, H. K. Jung (1997), control may be divided into two types – internal and external controls those might help to equalize authority or concerned party's attitudes to some certain organization control. Internal control involves the supreme enterprise control apparatus and enterprise shareholders, whereas external control might be defined as the power in the market or branch, competitive environment or state business regulation. Such analytical division is essential when analysing industrial or other enterprises, because this attitude to control makes it more specific and properly defined.

The identification of an appropriate primary theoretical base is an important task in forming the structure of knowledge about the study subject. Appropriately selected conceptions enable to elucidate the essence of the processes, to characterize them and to realize their interplays and interaction principles. Conceptions may be defined as a summation of empirical cognition which transforms practically achieved results into conceptions. The above ideas might be taken as abstractions and lead to an ungrounded conclusion, and through conceptions the reality might be lost. Operating with more than one conceptions allows to form a universal opinion about the reality. Noteworthy, when operating with conceptions an optimal agreement might be found between theory and practice: using the common point of contact – conceptions – a theorist and a practitioner will always find the way and understand one another.

The main problem of internal control is related to the definition of control conception and the identification of the place of internal control in an organization. Constant changes of the extent, functions and roles of internal control enable to form a common definition of internal control and to identify its place in an organization.

Analysis of the concept of internal control and its interpretation are essential for assessing the internal control system, because the conception of control is widely used not only in scientific research, but also in the daily activities of an enterprise; therefore the same conception might have a lot of various meanings and interpretations. Analysis of the concept provides conditions for the further research, because it is impossible to form a model of internal control assessment if the research object is unknown. A lot of definitions and variations of control can be found in the publications by Lithuanian and foreign scientists and in public information sources. For example, in the Dictionary of International Words (2002), control is defined as:

- supervision, inspection of something; comparison of actual and required conditions;
- an enterprise or a group of people that control the work and responsibility of other enterprises or groups of people;
- maintenance of something.

On the other hand, in the specialized Dictionary of Economic Terms (2005), control is defined as a performance with a definite influence on the management of an enterprise, as rights based on laws and contracts that involve proprietary rights to the whole property or its part, or any other rights that enable to exert a significant influence on the management and performance of an enterprise, or state supervision. Even in common information sources the definitions of control are formulated differently, although the common meaning is quite similar. Analysis and practical studies of Lithuanian scientists' works enable to state that there is no one solid concept, definition or description of control. For example, E. Buškevičiūtė (2008) says that when control is more particularly defined, its rules and requirements are described in more detail, it becomes more effective, more specific, more psychologically suggestive, it gives more freedom limits of choice for supervisors and less possibilities of lawlessness for people under control when. Identifying the object of the research, it should be noted that different definitions of control are given in scientific studies by Sakalas, 2000; Navickas, 2011; Katkus, 1997; Buškevičiūtė, 2008; Drury, 2012; Bičiulaitis, 2001; Lee Summers, 1991; Patrick, Fardo, 2009; Spencer, Pickett, 2010; Gupta, 2010 and other Lithuanian and foreign scientists (see Fig. 1).

The different conceptions and their interpretations indicate that there is no solid opinion about how to define control, and even scientists and practitioners themselves do not agree upon a unified definition or description of control or the conception of internal control and its interpretations. In scientific literature, different interpretations of control

K.A. Merchant, 2011	• Control is a comparison of planned (required) and actual states.
F.R. Jacobs et al., 2011	• Control is a summation of accepted decisions or rights established by state or company for particular subjects .
A. Katkus, 1997	• Control is defined as observation, supervision of specific processes in social systems (state, society, institutions, departments, collectives, etc.), development of established result, comparison and assessment based on settled goals, normative acts and standards.
E. Buškevičiūtė, 2008	• Control is defined as inspection of obeying responsibilities of established decisions or state requirements for specific subjects.
C. Drury, 2012	• Control is a connection net through which the performance of an enterprise is controlled to ensure its right actions in the future.
R. Bičiulaitis, 2001	• Control is means to provide possibilities to avoid or identify and fix disorders that might disrupt the system.
K.A. Merchant, 2011	• Control is skills and possibilities to regulate.
N.B. Macintosh, 2010	• Control is a function which ensures an effective working of the system or creates the desirable profit.
K.H.S. Pickett, 2010	• Control is a process started by specific settled standards and finished by their successful implementation and further improvement and prevention.
P. Gupta, 2010	• Control is a financial and operation magement of the enterprise aimed to achieve profit from its performance.

FIG. 1. Variety of control conceptions

Source: compiled by the author.

conceptions are usually related to different aspects of this conception, and their meaning in different situations may be defined in different ways depending on the situation and other external factors. According to A. Katkus (1997), C. Drury (2009), R. Bičiulaitis (2001), D. R. Patrick, S. W. Fardo (2009), K. H. S. Pickett (2010), during a long-term period control is usually related to achieving the already settled goals, their improvement and insurance. In other information sources (Dictionary of International Words, 2002; Sakalas, 2000; Buškevičiūtė, 2008; Lee Summers, 1991) control is emphasized as a certain means of inspection which provides a possibility to regulate the planned and actual states

and their performance. Despite these different opinions, control might be reasoned and revealed as a traditional function of any object of control, emphasized as one of the main self-defence means from the possible threats in the daily performance of an organization. There is also a more modern approach. For example, V. Navickas (2011) and P. Gupta (2010), presenting the concept of control, name it not only as one of the main factors that influence the organization's performance and influences its management, but also as one of the assessment means of the taken decisions and achieved values. Such interpretation of the conception of control shows the main role of control. For example, R. Kanapickienė (2008) has analysed a big number of control definitions and says that only an effective and useful control should exist in an enterprise because each enterprise tries to implement its purposes and avoid the possible losses, i.e. mistakes and frauds. According to J.A. Pfister (2009), there are several types of control, and they can be grouped into strategic, management, and internal control. Thus, different researchers give different definitions of control, their descriptions have different goals, but different control definitions lead to numerous variations in the analysis of the conception of control. Thus, to create an effective control, the presence of its unified concept becomes a necessity and the basis for ensuring an effective control of the organization's performance. The existence of different conceptions of control also indicates that there might be different types or kinds of control.

## **2. The conception of internal control**

Historical development of internal control as individual enterprise system is not as broad as other management spheres in science directions. The definition of internal control was presented for the first time in 1949 by the American Institute of Certificated Accountants (AICPA). It defined internal control as a plan and other coordinated means and ways by the enterprise to keep safe its assets, check the coventness and reliability of data, to increase its effectiveness and to ensure the settled management politics. However, the presented definition of control concept has been constantly improved, and nowadays there is quite an extensive set of conceptions that indicates the system of internal control as one of the means of leadership to ensure safety of enterprise assets and its regular development. In 1992, the COSO model appeared; its analysis distinguished the concepts of risk and internal control. Nnow, the concept of internal control involved not only accounting mistakes and implementing means of their prevention, but also a modern attitude that might identify the spheres of control management and processes, and also a motivated development of their detailed analysis. The Worldwide known collapses of such companies as Enron, Worldcom, Ahold, Parmalat and others determined to issue in 2002 the Law of Sarbanes–Oxley in the USA, in which attention is focused on the effectiveness of the enterprise internal control system and its assessment. Such a significant law as that

of Sarbanes–Oxley has clearly show that not only the internal control system must be concretized and clearly defined, but also the means of implementing the internal control system and assessing their effectiveness must be covered. The concept of internal control was further improved by such Lithuanian and foreign scientists as A. Сонин (2000), D. Robertson (1993), M.R. Simmons (1995), I. Toliatienė (2002), V. Lakis (2007), R. Bičiulaitis (2001), J. Mackevičius (2001) and the international scientific organizations COSO, INTOSAI, CICA, IT Governance Institute (see Fig. 2).

COSO, 1992	• Internal control is an executive process of board of directors, authorities and other employees to achieve purposes in these categories: efficiency and effectiveness of operations, reliability of financial accountability; obeying laws and legal acts.
A.M. King, 2011	• Internal control is a process through which the enterprise reaches its goals, results, also plans authority performance, arrangement, monitoring in the whole enterprise or separate subdivisions.
INTOSAI, 2004	• Internal control is an integrated process performed by organization authorities and employees and aimed to identify risk factors and according to the mission of organization performance to assure reasonable implementation of the common goals: - to implement the performance regularly, ethically, economically, efficiently and effectively; - to carry out payment responsibilities; - to obey valid laws and normative legal acts; - to protect resources from loss, from wrong usage and damage and to control the related risk factors.
CobiT, 2007	• Internal control is a process including norms, procedures, performance and organizational structure established to ensure reasonable guarantees so as to achieve the settled business goals and avoid undesirable events, or they could be indicated and fixed.
A.J. Pfister, 2009	• Internal control is a system of avoiding, identifying and correcting mistakes that might appear during information processing.
C. Barnabas, 2011	• Internal control is a summation of company's components (including its resources, systems, processes, culture, structure and tasks) that help the employees to achieve the company's.
M.R. Simmons, 1995	• Internal control is broadly set process needed to establish wise guarantees that these goals will be accomplished: -effectiveness and economic performance; -reliability of financial accounting; -obeying laws and rules.
J.K. Shim, 2011	• Internal control is part of the enterprise management system. That is a plan of enterprise internal control, means and ways to protect property, to check rightness of the performance, guarantee the effectiveness and politics of the performance. It helps to avoid mistakes, to find and correct them in time, to achieve the goals and to suppose perspectives.
V. Lakis, 2007	• Internal control is a control system made by enterprise authority to arrange the enterprise performance properly according to the established strategy and to ensure safety and rational use of property, particularity and accuracy in accounting data.
R. Bičiulaitis, 2001	• Internal control is a system of coordinated methods and facilities that enables to control information risks of business environment, processes and management.
J. Mackevičius, 2001	• Internal control is a system that must be taken as a summation of certain rules, norms and means to assure enterprise's business politics and economic processes and to achieve enterprise goals.
DiNapoli, 2007	• Internal control is defined as a system linking up enterprise performance, plans, attitudes, politics, integration of systems, management of human resources that helps the organization to achieve the settled goals and to follow its mission.

FIG. 2. Variety of conceptions of internal control

Source: compiled by the authors.

A comparative analysis of the introduced concepts of internal control shows that the usage of the concept of internal control is quite broad as it is supposed to involve the performance not only of the state, but also of the private sector. Although the conception of internal control is defined in different ways emphasizing its different aspects, the essential term still remains the same in all authors' definitions: internal control is the inspection, observation, maintenance and regulation of the enterprise's work (see Fig. 3.).

It should be also be mentioned that the system of internal control may be defined in different ways every time. For example, R. T. Yeh and S. H. Yeh (2007) pay attention to the fact that usually such values as honesty, trust, respect, openness, skills, courage, economy, initiative, etc. are not pointed out, although they definitely can influence not only the understanding of the concept of internal control, but also its definition, because in different periods of time and in different situations it can obtain slightly different shades of meaning. Control and people, and values produced by people or their performance are tightly connected; consequently, internal control must be also oriented to the enterprise's values, mission and vision; it does not matter how differently authors define the conception assessment limits: significant attention must be paid not to internal control itself, but to the identification of its functions and evaluation. Mostly internal

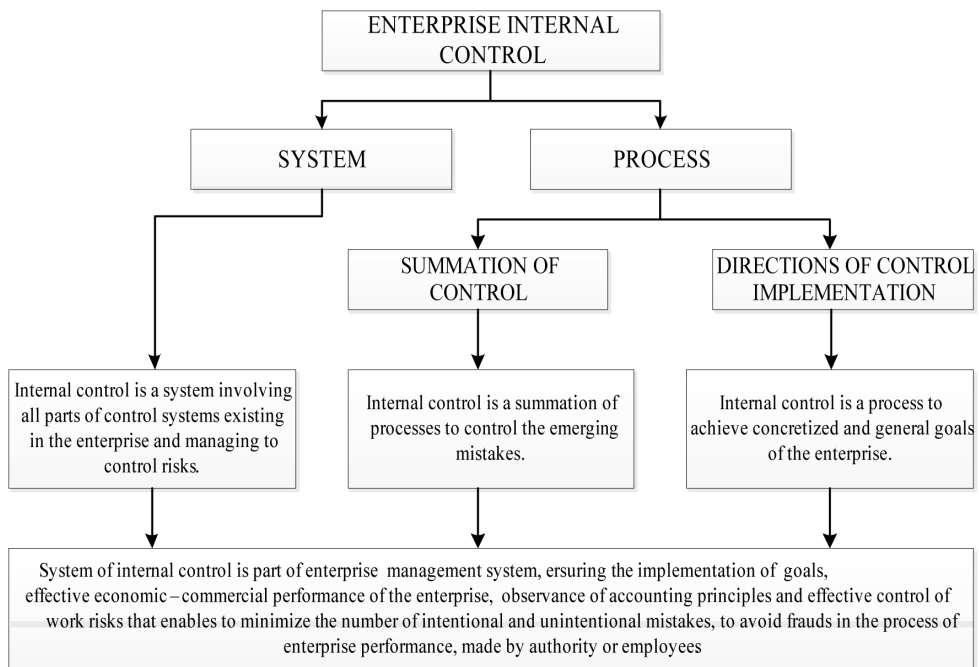


FIG. 3. Structural scheme of enterprise's internal control

Source: compiled by the authors.

control is concerned with authority management tools that help to control processes and achieve enterprise goals (COSO, 1992; Сонин, 2000; INTOSAI, 2004; CobiT, 2007; Toliatienė, 2002; Coco, 1995). C.J. Buck, J.B. Breuker (2008) declare internal control as a mistake detecting and correcting system; although J. Mackevičius (2001) and R. Bičiulaitis (2001a) state that internal control is defined as a summation of certain rules, norms and means, actually such definitions are identical, but internal control must be related to safety, the rational use of property and the reliability of financial accounting.

Results of a comprehensive analysis of internal control enable to state that, although different authors give different definitions of internal control, there are still some general purposes of the system of internal control, aimed, to ensure reliable and comprehensive information, to protect the property and documents, to ensure an effective economic performance, observation of accounting principles and presentation of reliable financial records, obeying laws and executive acts, enterprise rules and the effective control of risk. Analysis of concept of internal control, presented in both foreign and Lithuanian literature enables to formulate its generalized definition: the system of internal control is part of enterprise management system, which ensures the implementation of its goals, effective economic and commercial performance, observance of accounting principles and an effective control of risks, which enables to minimize the number of intentional and unintentional mistakes and to avoid frauds in the process of enterprise performance, made by its authority or employees (see Fig. 4).

The internal control system in a company must cover and help to properly organize and control the entire activity of the company; thus, according to majority of authors, internal control is all-inclusive activity in financial and management accounting, as well as in the strategic management of projects, operations, personnel and the total quality management. However, the most important thing is that internal control should not only cover the entire activity of the company, but also take into account its objectives, goals and tasks in order to make its economic-commercial activity as effective as possible. Analysis of scientific literature in the field shows that it is important not only to predict the particular areas of internal control and interrelate them, but also to stress that the most important objective of internal control is the effective management of risk by identifying and eliminating errors and frauds inside the company. Therefore, the concept of internal control offered by the authors covers a company's areas of activities, its tasks and objectives; also, it provides for the main goal – an effective risk management.

Despite the quantitative indicators used for goal assessment, each enterprise and especially extractive industry enterprises where attention should be focused on avoiding mistakes and fraud should elaborate and introduce a really effective and optimal system of internal control and accounting so as to strengthen its position in the market and optimize profitability.



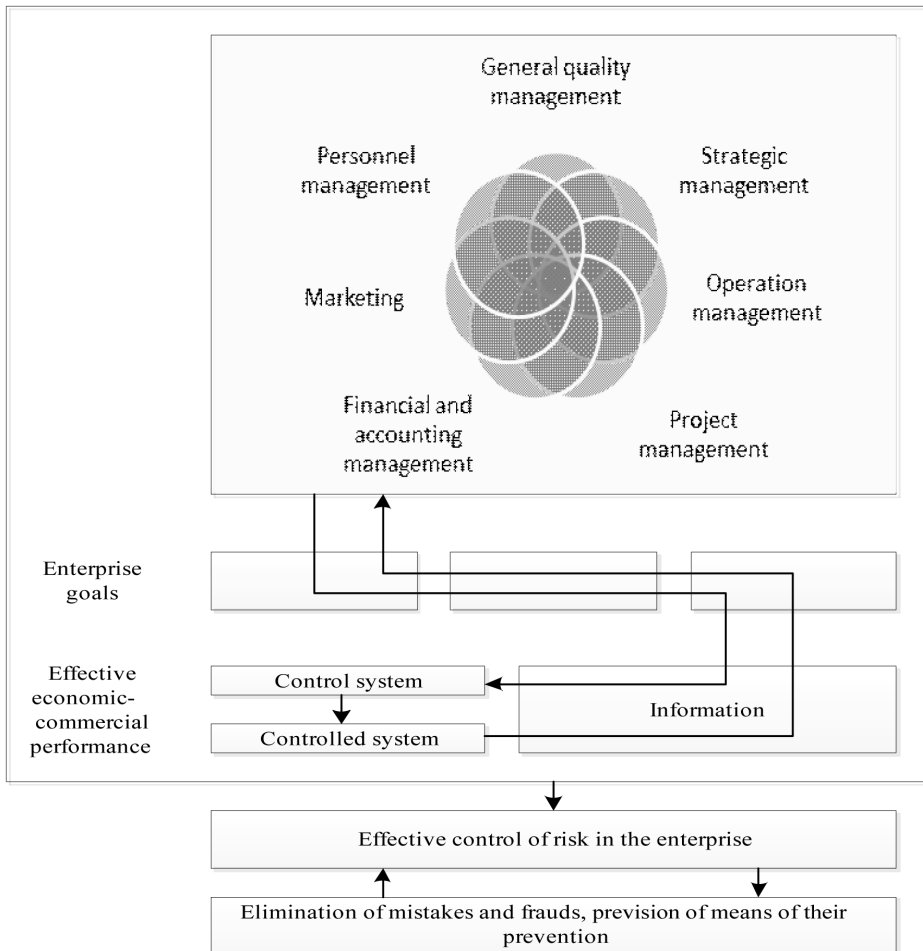


FIG. 4. Structural scheme based on generalized conceptions of enterprise internal control

Source: compiled by the authors

## Conclusions

The analysis of control definitions has shown that rather wide variations of definitions and their interpretations prove control to be a wide concept, mainly due to the fact that control has quite many different aspects and its meaning in different situations may be also defined differently.

Nevertheless, there are still some general aspects of the system of internal control, which include ensuring reliable and comprehensive information, protecting the property and documents, to ensure an effective economic performance, keeping to the principles of accounting and presenting reliable financial records, obeying laws and executive acts, enterprise rules and ensuring an effective control of risk.

As a result of the study, the authors present an inclusive and generalizing definition of internal control: the system of internal control is part of the enterprise management system that ensures the implementation of the enterprise's goals, its effective economic-commercial performance, observance of accounting principles and an effective control of work risks, which enables to minimize the number of intentional and unintentional mistakes, and to avoid frauds in the process of enterprise performance, made by its authority or employees.

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