

Assessing the Effectiveness of the Internal Control System in the Commercial Banks of Ethiopia: A Case of Hawassa City

Tekalign Negash

Lecturer, Hawassa University, College of Business and Economics, Department of Accounting and Finance, Ethiopia

Abstract: *The main objective of this research was to examine assessing the effectiveness of the internal control system in the commercial bank of Ethiopia a case of Hawassa city. In general, the paper used a mixed research design. Data are collected by using a self-administered survey, which has both open ended and closed ended question. The questionnaire was given to commercial banks of Ethiopia staffs from both internal auditors and controllers who are found at different level. After feeding (inserting) the collected data in to SPSS for analyzing purpose, the researcher found that the company's internal control is effective in the following internal components viz., the company under study has a clear codes of conduct; managements of the company periodically reviews policies and procedures; organization under study have clear objectives, and this are communicated to all staff for direction on risk assessment; there is an adequate and strong dual control and separation of duties in the organization and there is effective reporting procedure in the organization and this also communicated to the employees. Finally the research recommends, the following points, though the bank has a human resource development plant it has to be strengthen and should be the company priority concern and the controlling environment should also need a revision regarding updating the mechanism for keeping and protecting the company vital asset from fraud perpetrators.*

Keywords: Internal Control, Commercial Banks of Ethiopia, Hawassa city

1. Introduction

The banking industry worldwide has experienced significant bank failures and crises over the years. Bank failures are of great concerns to Central banks and governments because of its systematic nature, often aggravate recessions, and act as catalyst for financial crises (Basel, 2004). Internal control problems are a common place in the banking industry, and that allowed rascal traders to cause huge financial losses to these banks.

In 2012 some large financial institutions in Europe, admitted having poor money laundering controls and was consequently fined \$ 1.9 billion after U.S senate investigations (BBC, 2012). The Ethiopian banking industry is not without its share of bank failures. An effective internal control system is the nerve center of every organization, the breakdown of which leads to the failure of organizations.

Internal control is a crucial aspect of an organization's governance system and ability to manage risk. It ensures the achievement of an organization's objectives and creating, enhancing, and protecting stakeholder value (IFAC, 2012).

Hastening the current global financial crises is the high profile corporate failures such as Enron and WorldCom in the United States of America (USA), Parmalat in Europe, and similar cases of corporate collapse around the world (Amudo & Inanga, 2009).

Failure of internal control systems and the eventual circumvention of internal controls by company executives accounted for these corporate scandals. Organizations must ensure that their internal control systems remain relevant in today's business model. Business models have changed dramatically, including increased use of shared services, outsourced service providers, regulations have also

intensified on companies, over reliance on technology, increased stakeholder expectations have increased business risks significantly (McNally, 2013), which necessitated COSO's revision of its 1992 framework in 2013.

The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The board of directors and senior management establish the tone at the top regarding the importance of internal control including expected standards of conduct. Management reinforces expectations at the various levels of the organization (Amudo & Inanga, 2009).

The control environment comprises the integrity and ethical values of the organization; the parameters enabling the board of directors to carry out its governance oversight responsibilities; the organizational structure and assignment of authority and responsibility; the process for attracting, developing, and retaining competent individuals; and the rigor around performance measures, incentives, and rewards to drive accountability for performance. The resulting control environment has a pervasive impact on the overall system of internal control (IFAC, 2012).

2. Statement of the Problem

Banks play a vital role in an economy as they hold the savings of the public to provide a means of payment for goods and services and finance the development of business. The globalization of economy, technological advancements, complexity of business and allegations of fraudulent financial reporting have recently sharpened the ever-increasing attention on internal controls and internal auditing, (Bowrin, 2004).

The incidence of internal control weakness in the banking sector have the undesired effect of not only weakening the banking sector’s ability to effectively provide service but also encourages collusion, fraud, embezzlement loss of cash(revenue), assets conversion genuine and deliberate mistakes, corruption, lack of transparency and accountability for revenue collection and other assets. The increasing interest shown in the internal control and its continuous character is the consequence of an analysis, which was made upon the causes that lead to significant losses for many banks in East Africa, (Amudo, 2008, pp.125).

The Basel committee’s analysis identified that inadequate internal control system was the major cause of those loss. Despite considerable investment; public service delivery might be unsatisfactory and deteriorating. For the enhancement of the attainment of the mission and goals of the banking sector, it is therefore necessary that these preventions removed. Therefore, the main motivating factor underlying this study was desire to emphasize the importance of having attention on strengthening internal control systems and continually evaluating their effectiveness. Internal control systems exist to help organizations meet their goals and objectives, promote efficiency, reduce the risk of loss, and ensure financial statement reliability and compliance with laws and regulations. The major question answered at the end of the study whether or not the established internal control systems are effective and are they effectively practiced in commercial bank of Ethiopia Hawassa city branches.

3. Operational Definition

The Basel Committee, (Basel 1998) along with banking supervisors throughout the world, has focused increasingly on the importance of sound internal controls. Internal control is a process affected by the board of directors, senior management and all levels of employees. It is not solely a procedure or policy that performed at a certain point in time, but rather it is continually operating at all levels within the bank. The board of directors and senior management are responsible for establishing the appropriate culture to facilitate an effective internal control process and for monitoring its effectiveness on an ongoing basis; however, each individual within a corporation must participate in the process.

- 1) Socol (2011) mentioned that the administration board and executive management promotes high standards of ethics and integrity, establish an institutional culture highlighting and demonstrating the importance of internal control on all organizational levels. All employees of the bank must be aware of the role they have in the internal control system and must be actively involved in this process.
- 2) Internal control system asserts that the system should always keep under control and supervision since people tend to think about their interests more rather than the interests of the corporation. If there is a failure in the financial accounting system of a corporation, a decrease in assets and an increase in abuses will inevitably takes place in the absence of an effective internal control system (Yayla 2006, p. 112).

- 3) Olatunji (2009) examined the impact of internal control system in banking sector and according to the findings; the lack of an effective internal control system is the major cause of bank frauds in Nigeria. It is then concluded that the management of every bank should create and establish a standard internal control system, strong enough to stand against the wiles of fraud in order to promote continuity of operations and to ensure the liquidity, solvency, and going concern concept of the bank.
- 4) Amudo and Inanga (Amudo et al. 2009) identify the following six essential components of an effective internal control system; control environment, risk assessment, control activities, information and communications, monitoring, and information technology in their study. The findings of the study under evaluation results are that measuring effectiveness of internal control is concerned with the existence and functioning of the six major control components identified by the model.
- 5) One of the, perhaps the most prominent one, vital components of a bank’s structure in modern banking system is internal control system in developed or developing countries. Because effective and efficient performance of the system indicates that, the bank operates as desired. Consequently, investors and other customers in the market will prefer to use the services of that bank since they will have confidence and peace of mind about bank’s financial stability (Yavuz, 2002).

Research Methodology

To achieve the objectives of the study, a descriptive research design was used in order to allow the researcher to make to an appropriate level of conclusion. To do so the researcher collect primary data by using a structured questionnaire which have questions which focuses on the effectiveness of internal control systems used by Commercial Banks of Ethiopia. The target population of the study consists of all branches of commercial banks of Ethiopia found in Hawassa city limiting the area only to the internal audit and control department. The total number of employees included in the study was fifty-six staff members, this is twelve branch managers, twenty customer service managers, twelve senior branch controller and twelve controller/checkers/. In order to collect as much relevant material for this study as possible, primary sources of data used

4. Results and Discussions

This section of the study presents the analysis and findings of the study as set out in the research objective. The data collected using questionnaire from 53 (with a response rate of 96.36%) of employees of CBE Hawassa city branches.

Table 1: Staff Holding Positions

Staff Position	Frequency	Percent
Branch Manager	12	22.6
Customer service manager	19	35.8
Senior branch controller	11	20.8
Controller or maker checker	11	20.8
Total	53	100.0

Source Survey 2019

As indicated in the above table 22.6% of the respondents are branch managers. 35.8% of the respondents are customer service managers, 20.8% of the respondents are senior branch controller, and 20.8% of the respondents are controller or maker checker. This indicated that almost all respondents are professional to respond to the questionnaire

Effectiveness of Control Environment

Control environment considered as a “tone on the top” in internal control system. It indicates the general atmosphere of internal control, which included the policies, and procedures of internal control, management structure, reporting structure, competence of employees and discharging responsibility and others. The survey is mad based on those components of control environment and the result is scaled as follows.

Control environment			
	N	Mean	Std. Deviation
Codes of conduct or ethical policies exist in the company	53	4.34	1.018
Policies regarding the importance of internal controls are communicated to all staff	53	3.96	.960
Audit or other control systems exist to periodically test for compliance with policies	53	4.00	1.019
The bank provide adequate training for all staff	53	3.38	1.259
The controls for authorization of transactions are established at an adequate high level	53	4.00	.920
The bank's internal and external auditors periodically assess the adequacy of the banks internal control system	53	4.06	.908
Management periodically reviews policies and procedures to ensure that proper controls are in place	53	4.11	.776

Source; Survey 2019

The highest mean 4.34 indicates that majority of respondents agreed that there is a clear codes of conduct exist in the company. The second highest mean 4.11 indicates that majority of the respondents agreed that managements periodically reviews policies and procedures, and mean 4.06 shows that there is strong assessment of internal control system, mean 4 shows that there is segregation of duties for authorization of transaction this means majority of the respondents agreed that the clear line of responsibility enables achievement of objectives and mean 3.96 indicated that majority of the respondents agreed that policies exist in the company’s are communicated to all staff and mean 3.38 indicates that relatively minority of the respondent is agreed that there is adequate training in the bank. As indicated in the above table the overall mean of the control environment indicate an agreement in practices of control environment. The control environment is the foundation of all the control components, the board and senior management should be setting the right tone at the top, giving direction to the rest of the organization on the importance of effective internal controls. The overall control environment score was 3.98. This means that the majority of the respondents agreed that the control environment component of internal control system is effective in the CBE.

Effectiveness of Risk Assessment

Risk assessments become an important part of internal control system. The management is responsible to identify and assess control risk caused by failure of internal control. There should be strategies of identifying Risk, system to respond to risk and reduce the risk. The survey result on this issue therefore, is presented as follows.

Risk Assessment			
	N	Mean	Std. Deviation
The company has clear objectives and these are communicated to provide effective direction to employees on risk assessment and control issues	53	4.17	.849
There are sufficient staff members who are competent and knowledgeable to manage company activities	53	3.75	1.108
Significant internal and external operational, financial, compliance and other risks are identified and assessed on an ongoing basis	53	3.87	.921
Risk are assessed with regard to each transaction cycle	53	3.70	.911
Responses are given timely to identified risks	53	3.57	1.010

Source; Survey 2019

From the above table the mean value 4.17 indicated majority of the respondents agreed that organization have clear objectives, and this are communicated to all staff for direction on risk assessment. The mean value 3.87 indicated that risks related to operational and others identified and assessed on an ongoing basis. The mean value 3.75 indicated that majority of the employees are agreed that there is sufficient and competent staff to manage company activities, mean value 3.70 indicated that majority of the respondents agreed that risks are assessed with regard to each transaction cycle and mean 3.57 indicated that minority of employees agreed that responses are given timely to identified organization risks. Risk assessment is responsibility of management. The management should identify and assess control risk caused by failure of internal control. There should be strategies of identifying risk, system to respond to risk and reduce the risk. Therefore the banks have sufficiently designed appropriate strategy of identifying risk and there is sufficient system designed to respond to risk.

Effectiveness of Control Activities

Control activities include methods, preparation of reliable reports; update documentation, authorization of transactions, independent review and others. The results of the study indicated in the table below.

Control Activity			
	N	Mean	Std. Deviation
policies and procedures exist to ensure critical decisions are made with appropriate approval	53	4.13	.761
Processes exist for independent verification of transaction	53	4.04	.831
There is a system in place to ensure that duties are rotated periodically	53	4.02	.820

People in the company have the knowledge, skill and tools to support them in their duties in order to effectively manage risk and achieve company objectives	53	3.87	1.001
key managers review and approve all financial transaction	53	3.92	.895
The bank provides adequate physical security for each and other assets subject to theft	53	3.91	.986
There are dual controls over bank assets and separation of duties provided for in the banks organizational structure	53	4.15	.886

Source; Survey 2019

The highest mean 4.15 indicated that majority of the respondents agreed that there is strong dual control and separation of duties in the organization, and the second highest mean 4.13 indicated that majority of respondent agreed decisions are made with appropriate agreement, the mean value 4.04 indicated that majority of the respondent agreed that Processes exist for independent verification of transaction, mean 4.02 indicated that majority of respondent agreed that there is a system that organization have duties are rotated periodically, mean 3.92 indicated that majority of the respondent agreed that key managers review and approve all financial transaction, mean 3.91 indicated that majority of respondent agreed that there is adequate physical security in the organization, mean 3.87 indicated that minority of the respondent agreed that all employees in the company have the knowledge, skill and tools to support them in their duties in order to effectively manage risk and achieve company objectives. Control activities are specific methods and procedures of implementing internal control. Effective internal control has a list of those methods and procedures that are to be implemented consistently. Therefore, in the above table shows there is an effective control activity in CBE.

Effectiveness of Information and Communication

Based on frameworks of an effective information and communication in an internal control system the survey result and interpretation presented below.

Information and Communication System			
	N	Mean	Std. Deviation
There are effective reporting procedure in communicating a balanced and understandable account of the company position and procedure	53	4.21	.817
There are established channels of communication for individuals to report suspected branches of laws or regulation	53	3.83	1.014
All staff understands their role in the control system	53	4.06	.969
The key information about the organization's operations are identified and regularly reported	53	4.13	.708
Information is available on a timely manner	53	3.66	1.108
The client complaints are taken seriously investing and acted upon	53	3.64	1.094

Source; Survey 2019

In the above table mean 4.21 shows majority of the respondents agreed there is effective reporting procedure in

the organization and this also communicated to the employees, mean value 4.13 indicated that majority of the respondent agreed that the key information about the organization's operations are identified and regularly reported, the mean 4.06 indicated that all staff understands their role in the control system, and mean 3.83 indicated that there are established channels of communication for individuals to report suspected branches of laws or regulation, mean 3.66 indicated that information is available on a timely manner, mean 3.64 indicated that The client complaints are taken seriously investing and acted upon. Therefore the fourth component of internal control system is effective in CBE.

Effectiveness of Monitoring

An ongoing monitoring of internal control is essential to ensure whether internal control is achieving desired objectives. The result and interpretation of the survey is presented as follows.

Monitoring			
	N	Mean	Std. Deviation
The bank routinely evaluates the overall effectiveness of internal control system	53	3.77	1.031
There are spot check transactions, records, and reconciliations to ensure they meet the required expectation	53	3.94	.886
There are performance evaluations where employees and supervisors discuss expectations, goal and performance	53	4.09	.791
Reports on significant failings or weaknesses are reported to management on a timely basis	53	3.98	.866

Source Survey 2019

In the above table, mean value 4.09 indicated that majority of the respondents agreed there is performance evaluations where employees and supervisors discuss goal and performances, mean 3.98 indicated that reports on significant failings, reported to management on a timely basis. Mean 3.94 indicated that there is spot checking about the companies' transaction and mean 3.77 indicated that the bank routinely evaluates the overall effectiveness of internal control system.

References

- [1] AICPA, Auditing Standards Board. "SAS No. 94: The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit" .April Committee of Sponsoring Organizations of the Tread way.
- [2] Amudo, A., and Inanga, E. L. (2009). Evaluation of internal control systems: A case study from Uganda. *International Research Journal of Finance and Economics*, 3, 124 –144
- [3] Amudo, A., and Inanga, E.L. (2009), Evaluation of Internal Control Systems: A case study from Uganda, *International Research Journal of Finance and Economics*, Issue: 27, 1450-2887
- [4] Armour, M. (2000). Internal Control: Governance Framework and Business Risk Assessment at Reed

- Elsevier, *Auditing A Journal of Practice & Theory*, Vol. 19
- [5] Basel Committee on Banking Supervision, (1998). *Framework for internal control system in Banking organizations*, Basel.
- [6] Basel Committee on Banking Supervision(1999) *OECD Principles of Corporate Governance*, downloaded from www.bis.org/publ/bcbs56.pdf on 1 January 2009
- [7] Bowrin, A. (2004) 'Internal control in Trinidad and Tobago religious organizations', *Accounting, Auditing and Accountability Journal*, Emerald Group Publishing Limited, Vol.17, No. 1, pp.121-152.
- [8] BBC. (2012, December 11). BBC News. Retrieved August 6, 2014, from BBC: <http://www.bbc.com/news/business-20673466>
- [9] COSO (1992) *Internal Control-integrated Framework*, Committee of Sponsoring Organizations of the Tread way Commission, Coopers and Lybrand, New York, NY.
- [10] Dandago, K. I., and Suleiman, D. M. (2005). *The Role of Internal Auditor in Establishing, Honesty, and Integrity: Are the Watch Dogs Asleep*, In Proceedings of the Third National Conference on Ethical Issue in Accounting. Vol, 3GidanDabimo Publishers, Kano Nigeria.
- [11] Denise D. Margaret O. and Jon R, (2012). *Frameworks for establishing and evaluating internal controls, a primer and case study*. Journal of Case Research in business and Economics.
- [12] Haskins. M. (1987). Client Control Environments; *An examination of auditors' Perceptions*. The accounting Review, pp.542-563
- [13] McNally. S, (2013). *The 2013 COSO framework and SOX compliance*. Durham, COSO.
- [14] <http://etd.aau.edu.et/bitstream/123456789/6173/1/Tseda%20Lemi>.
- [15] "Internal Control Systems." Encyclopedia of Business and Finance, 2nd ed.... *Encyclopedia.com*. 15 May. 2017 <<http://www.encyclopedia.com>>