INTERNAL CONTROL PRACTICES AND CASH FLOW MANAGEMENT OF ORGANIZATIONS

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Abstract

This paper centers on Internal Control Practices and Cash Flow Management of Organizations. The objectives of this study were to: Access the effectiveness of Internal Control Systems in the Organization, establish Cash Flow Management Policies, and establish the relationship between internal control practices and cash flow management with Corporate Governance as a moderating factor. This research work is based on the Theories of Formal Organization. Under the Theories of Formal Organization is pertinent to this study. Two (2) determinant of Internal Control were examined to determine their influence on Cash Flow Management Practices in Organization. It was concluded in agreement that Internal Controls grounded in COSCO’s model, have significantly positive effect on Cash Flow Management, suggesting that the management of organizations be attentive to issues of Internal Control in order to enhance Cash Flow Management and maximize business potentials, minimize risk of fraud, error, and losses etc.

Keywords: Internal control, Cash flow management, Corporate Governance

A. Introduction

Internal control and cash-flow management of organizations are of great concerns since effective internal control mechanism are meant to be risk measure to prevent an organization from any potential loss.

According to B.D Kaibel (2009), the efficient management of any organization no doubt, includes such essentials as planning, organizing, coordinating and appraising (or evaluating), but the creation of an adequate structure and making suitable arrangement for effective control systems occupy a central position in the spectrum of responsibilities. He went on to say that; controlling is the “steering wheel” or the “short rein” which keep the activities of the organization from wandering away from their primary objectives, and that all types of organization and enterprises large or small, simple or complex, fast moving or sedate, need some form of control if they have to be effective or successful.

Strategic control is exercised at the top management level and entails a close study of the organization total effectiveness, productivity and management effectiveness (Nieuwenhuizen & Rossouw, 2008)

Bruyns et al (1997) see control to mainly involve the process through which a manager ensures that activities are carried out as originally planned.

Gildehuys (1993) agrees with Bruyns et al statement by defining control as the process of cracking to determine whether or not plans are being adhered to.

Internal control comprises the plan of an organization and all co-ordinate methods and measures adopted within the organization to safeguard its assets, check the accuracy and reliability of its accounting data, prorate operational efficiency and adherence to prescribed managerial policies.

The definition of internal control is divided into Financial Internal Control and Non-Financial (Administrative) Internal Control. Financial internal control pertains to financial activities and maybe exemplified by control over an organization’s cash receipt and payments, financing operations and company’s management receipt and payments. Non-financial internal control on the otherhand deals with activities that are indirectly financial in nature i.e. control over organization’s personnel section and its operations, fixed assets control and even controls over laid down procedures (Reid and Ashbley, 2002).

A sound internal control system helps organization to prevent frauds, errors and maximize wastage. Custody of assets is strengthened: It provides assurance to the management on the dependability of accounting data eliminates unnecessary suspicion and helps in maintenance of adequate and reliable accounting records. This study therefore centers on the effect of internal control practices on cash flow management in organizations.
Therefore internal control is seen as the whole system of control, financial and otherwise established by management to carry the task of an organization in an orderly manner, ensuring adherence to organization policies, safeguard its assets and secure as far as possible, the accuracy and reliability of its records (Gupta, 1989).

In 1992, following a recommendation of the report of the National Commission on fraudulent financial reporting in sponsoring organizations of the trade way commission (COSO) introduced the first comprehensive framework for internal control. Report on the committee of sponsoring organization of the tread way commission (COSO) published in 1992, defines internal control as a process affected by an entity's of board of directors, management, and other personnel designed to provide assurance regarding the achievement of objectives in the following categories:

- **Effectiveness and efficiency of operation**
- **Reliability of financial reporting.**
- **Compliance with applicable law and regulations.**

Criteria of control (COSO) described internal control as actions that foster the best result for an organization, indicating that control comprises those element of an organization (including its resources, systems, process, culture, structure and tasks) that, taken together, support people in the achievement of the organization objectives.

On the other hand, cash flow management which is a broad term refers to the collection, concentration and disbursement of cash. It is the management and analysis of a company’s cash flows (www.businessdirectory.com).

The goals is to manage the cash balance of an organization so as to maximize the availability of cash not invested in fixed assets or inventories and to do so in such a way as to avoid the risk of insolvency.

Since factors mentioned as a part of Cash Flow Management include an organization’s level of liquidity, its management of cash and its short term investment strategies, the way to successful management therefore lies on tabulating realistic projections, monitoring collections and disbursement, establishing effective billing and collections measures, and adhering to budgetary restrictions.

**Purpose of the Paper**

Following global fraudulent financial reporting and business failures in both developed and developing countries, Internal Control System is seen as a topical issue. Low attention has been given to the issues concerning the Internal Control System towards enhancing cash flow management.

**Objective of the Paper**

This study is guided by three specific objectives

1. **To access the reliability and effectiveness of internal control practices in the organization.**
2. **To examine the cash flow management in the organization.**
3. **To determine the relationship between internal control practices and cash flow management in the organization.**

**B. Theoretical Framework**

This research work was based on the Theories of Formal Organization: These are fixed set of rules of intra-organization procedures and structures, usually set out in writing, with a language of rules which ostensibly leaves little discretion for interpretation.

Under the Theories of Formal Organization, The Classical Theory which comes from Taylor (1947) Weber (1947) and Fayol (1949) etc, is pertinent to this study. It focuses on structure, design and features like specialization, scalar chain, departmentalization, span of control, centralization/decentralization etc. the structure is created and people are appointed to run the various departments. Human beings and their interaction as part of informal social groups are not considered important. It considers organizations as closed systems with very little or no interaction with the environment forces. It emphasizes on task more than people.
Hierarchies of authority, division of work, specialization, impersonal relations, and narrow span of control are the important factors of classical theories of organization. It focuses on the following characteristics to design the organization structure:

- **Division of work to promote performance and efficiency through specialization.** It believes that division of work can increase organizational efficiency. Division of work improves performance. It believes high degree of specialization will lead to high efficiency in performance. Work should be broken down into smaller units so that it becomes simple and specialized for people to perform. Division of labor should be done for all the tasks at all the levels of organization.

- **It advocates functional departmentalization where work load is divided into different activities and similar activities are re-grouped as department.** Major functional departments in a manufacturing organization are production, personnel, finance and marketing. Functional grouping of activities helps in clear identification of work to be performed by various departments. It avoids overlapping and splitting of activities. There's neither duplication of work nor any activities remains unidentified. Every divided and sub-divided activity is allotted to the specific departments. It, thus, promotes departmentalization where people can be appointed at various levels to perform the department activities. Functional process also promotes line department and staff assistance is provided in the form of advisory body to assist the line managers in carrying out the line activities. There is clear demarcation of line and staff authority which smoothens organizational tasks.

- **It strongly supports hierarchy of relationship or the scalar chain.** Unity of control is the basis for coordinating varied activities of organizational members. One subordinates should have one boss in the basis of unity control. Functional relationships are ignored. People take orders from their seniors in command and issue directions to their subordinates. Final decision-making authority vest at the top. This creates superior-subordinate relationships in the organization and promotes coordination amongst levels in different functional areas. It also reduces conflict as every individual reports to a single superior. Obligation can be defined, and result can be measured.

- **It advocates narrow span of control as the relationships are hierarchical in nature.** People are directed to work. They do not assume responsibility on their own. Formal plans, motivational factors and communication channels are designed to get the subordinates to work. Cross functional and cross-hierarchical relationships promotes networking, specialized exchange of knowledge and, thus a wider span of control. Though narrow span of control promotes coordination and close supervision over activities of the subordinates, wide span can lead to organizational growth.
Conceptual Framework

Sources: conceptualized by the researcher (2017)

Figure 1.1 Conceptual framework on the relationship between Internal Control System and Cash Flow Management.

The conceptual framework has two variables. On the hand side is the predictor variable (Internal Control System), with a selection of two (2) out of six (6) components of Internal Control System based on COSO’s update model (Rittenberg and Landes, 2012), inter-alia, in the proper functioning of organization as dimensions, and on the right hand side is the criterion variable (Cash Flow Management), which identifies two (2) out of the various concepts of Cash Flow Management, as measures. Also indicated in the framework above, is the moderating effect of Corporate Governance on the relationship between the predictor variable and the criterion variable.

Conceptual Review

Concept of Internal Control System

Theoretical Review

A review of literature on internal control system has revealed that the most widely used framework is the American document published in 1992 entitled “internal control integrated framework” commonly referred to as COSO, an acronym of committee of sponsoring organization of the tread way commission, derived from the name of the committee which conceive the reference framework (Aldridge & Colbert 1994).

Inputs of COSO thence, has evolved into various aspects of internal control. It is
recognized globally for providing guidance on critical aspects on organizational governance, business ethics, enterprise risks management, fraud, and financial reporting (COSO, 1992).

It objectives is to presents a framework which allows a common understanding of internal control among interested parties. Control criteria are specified and tools are suggested to assist management in evaluating internal control and improving an organization’s control.

COSO defines internal control as a process affected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives with respect to the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulation (COSO, 1992).

This definition maintains that internal control is a process and not an end to itself, it is established by individuals as opposed to policy manual documents and forms; it provides reasonable assurance and not absolute assurance that objectives can be achieved and addressed the achievement of objectives in the areas of financial reporting, operation and compliance with laws and regulations. The definition connotes certain fundamental concepts.

The first is that the ultimate goal of internal control is not the control per se, but mechanisms of the controls are processes that attained other higher objectives.

The second connotation is that internal control is not an abstract document but has practical relevance at every step of an organization’s operations and by every employee at all levels of responsibility.

The third concept is that internal control does not provide a 100% guarantee but offers relative shield to the management of the organization applying the control mechanisms.

Internal control as a forth motion, is one of the mechanisms at the disposition of management which enables objectives of the organization to be attained (COSO, 2006).

Though this study centers on COSO’s framework, the opinion of other scholars with regards to internal control is also considered.

Frazer (2012) defines internal control as all policies and procedures which management uses to ensure the reliability of financing reporting, compliance with laws and regulations, and the effectiveness and efficiency operations.

ISA 315, identifying and assessing the task of material misstatement through understanding entity and its environment defines the internal control system as the process designed and effected by those with governance, management and other personnel to provide reasonable assurance about the achievement of the entity’s objectives, with regards to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

In essence Internal control are means designed to check the activities to ensure that the objectives of an enterprise is met.

The operational standard by the Institute of Chartered Accountants of England Whales (ICAEW) defines internal control as the whole system control and otherwise established by the management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible, the completeness and accuracy of the records (Olatunji, 2009).

Campbell and Harcthes (2009) emphasized that internal controls are the method or procedures adopted in a business to safeguard its assets, ensure whether financial information is accurate and reliable, ensure compliance with all financial and operational requirements, and general assist in achieving the business’ objectives.

Observing the opinion of scholars on internal control, and their various definitions, it is clear that internal control is truly a system of control financial and otherwise, established by management to execute business orderly, ensuring adherence to policies, safeguard of assets, completeness, and accuracy of records.

C. Empirical Review

Following global fraudulent financial reporting and business failures in both developed and developing countries, internal control system is seen as a topical issue.

Long (2009) conducted a study on internal control in small business and found that internal control has the efficiency of reducing the risk of fraud and promoting the efficient use
of the business resources.

A study was conducted by Amudo & Inanga (2009) on Regional Member Countries (RCM's) of African Development Bank Group (ADB) focusing on upgrade. A conceptual model to evaluate the internal control system in public sector project in Uganda was developed. The outcome of the evaluation process was that some control component of effectiveness internal control system were lacking in the project which consequently rendered the internal control structure ineffectiveness.

Eko & Harlyanto (2011) also carried out a study on the relationship between internal control system, internal audit, and organizational commitment with good governance. This study considered local government of central java in Indonesia. Questionnaires were administered in 35 districts. The research showed internal control and fraud prevention in Nigeria business organizations.

A survey was undertaken by Ozigbo & Orife (2011) in this work where they discovered that internal control has significant relationship with fraud prevention. It was concluded that internal control is a necessary safeguard which assures absentee owners of business that their fund is being utilized efficiently. It was recommended that proper accounting record should be kept at all times, authorization and approval limits of jobs should be set up and communicated to all concerned interested groups.

Related to the study on fraud, Frazer (2012) conducted a study on the effect of internal control on the operating activities in small restaurant manager's perceptions of the internal control systems on the protection assets, the segregation of duties, and the verification of transactions. Two hundred and seventy restaurants were selected through random sampling. The study revealed statistically significant relationship linking perception of assets, segregation of duties, and verification of transactions. The results indicated that majority of the study group perceived restaurants' internal control system to be inadequate compared to COSO model.

An examination of the impact of internal control designed on banks’ ability to investigate staffs fraud, lifestyle and fraud detection in Nigeria was executed by (Uket & Udoayang 2012).

Data was collected from thirteen (13) Nigeria banks using four point likert scale questionnaire and analysis using percentage and ratios. Multiple regressions were used in testing hypothesis. The study revealed that internal control design influences staff attitude towards fraud, and a strong internal control mechanism is deterrence of staff while a weak internal control mechanism exposes the system to fraud and creates opportunity for staff to commit fraud. Also, it was made clear in the study that most banks in Nigeria do not pay serious attention to life style of their staff members and most staff members were of the view that effective and efficient internal control design could detect employee fraud schemes in the banking sector. It was concluded that effective and efficient internal control system is necessary to stop the depression in the banking sector.

However, observing the above studies on the effectiveness of internal control system in organizations, it is quite clear that an effective and efficient internal control system provides reasonable assurance regarding the achievement of an organization’s objectives.

**Dimensions of Internal Control**

**Control Environment**

This refers to overall tone of an organization, which reflects the attitude, awareness, and action of the board of directors, management, and owners who influence the control consciousness of its people. (www.accountingconcern.com)

According to Sudsomboon & Ussahawanitchakit (2009), Control environment is the foundation for the component of internal controls, providing discipline and structure.

They are actions, policies, values, and management styles which influence and set the tone of a firm’s day-to-day activities (www.buisnessdictionary.com)

The control environment is the foundation on which an effective system of internal control is built and operated in an organization which strives to:

- Achieve its strategic objectives,
- Providing reliable financial reporting to internal and external stakeholders,
Operate its business effectively and efficiently,
Comply with all applicable laws and regulations, and
Safeguard its assets.

It is the major aspect of managing an organization because it influences the control consciousness of its people.

The Control Environment is the foundation of an effective internal control structure, setting the tone of the organization. With an effective control environment, employees view internal control as essential and integral to providing services to citizens, protecting state resources and providing reliable financial information. When the control environment is ineffective, employees may get the false impression that controls are nothing but "red tape" which disrupt their "real" jobs. (www.beta.mmb.state.mn.us)

Key element of an effective control environment encompass:

- Integrity and Ethical Values
- Management’s Philosophy and Operating Style
- Commitment to Competence
- Maintenance of Good Relationship with Oversight Groups Such as: The legislature, oversight committees or boards, and the Office of the Legislative Auditor.

Amudo & Inanga (2009) saw control environment as a component which in reducing the level of fraudulent activities within organizational operation and that also, the quantity of an entity’s Internal control system depends on the function and quality of their control environment.

Therefore, providing a proper control environment for an organization is quite essential to the effectiveness of the operation. An effective control environment is an environment which competent people understand their responsibilities, the limit of their authority, and are knowledgeable, mindful and committed to doing it the right way. They are committed to following an organization’s policies and procedures and its ethical behavioral standards. The control environment encompasses technical competence and ethical commitment. It is an intangible factor, essential to effective internal control (Sampson, 1999).

It’s an organization “Tone at the top,” published exclusively for senior management, boards of directors, and audit committees. The Institute of Internal Auditors underline that a strong tone at the top plays a pivotal role because the control environment represents an organization's first line of defense to mitigate the risk of financial reporting errors. Researchers prove that commitment to strong internal control by top management is often translated into better performance.

However, not only at the top management level but building a strong consciousness of control mechanisms throughout the organization’s culture is one of the ways to ensure effective control environment in the enterprise (Institute of Internal Auditors, 2005).

Control Activities

According to Aikin (2011), control activities are seen as policies, procedures, and mechanisms which ensure management’s directives are properly carried out.

They are action taken to address risk of achieving objectives and occur at all levels of an organization. There exist various categories of control activities which include:

- Segregation of duties
- Authorization of transaction
- Retention of records
- Supervision or monitoring of operations
- Physical safeguard: Usage of cameras, locks, physical, etc, to protect property.
- Analysis of result, periodic and regular operation reviews, metrics, and other key performance indicators.
- IT Security.

These actions dissuade fraud or theft activities which could lead to losses. Control activities help ensure that necessary actions are taken to address risk in achievement of an organization’s objectives. They include all policies and procedures designed to ensure that
management directives are carried out throughout the organization. Major aspect of control activities in small business are; higher concentration of decision making authority, wider breath of control, and more direct ways of communication (Sampson, 1999)

Based on the purpose or intention of the type of control desired, it is important to distinguish between preventive and detective controls. Preventive control is used to prevent the occurrence of undesirable event. Such control determines losses and proactive measures. Preventive control include; separation of duties, proper authorization, adequate documentation, and physical control over assets. Detective controls attempts to identify undesirable acts. They make it evident that a certain loss has occurred but do not prevent a loss from occurring. Detectives control includes; reviews, analysis, variance analysis, reconciliation, physical inventories, and audits (Sampson, 1999).

It is revealed that both types of control are not mutually exclusive but complimentary essential activities ensuring effective internal control system. Consistent application of control activities should be taken into accounts.

**Concept of Cash Flow Management**

According to Fayol, to manage is to forecast, plan, organize, command, coordinate, and control. Cash flow management has to do with forecasting, planning, organizing, commanding, coordinating, and controlling the movement of cash, in and out of an organization so as not to go insolvent. It is the process of monitoring analyzing and optimizing the net amount of cash receipt minus cash expense. Cash flow is the management and analysis of a company’s cash flow. Careful cash flow management allows a company to estimate the amount of cash that it will have on hand at any one time, project trends in cash inflow and cash outflow, and evaluate whether a shortfall or surplus in cash could potentially occur (businessdictionary.com).

Cash flow management is defined “having the right amount of money in the right place at the right time to meet the organization’s obligation in the most cost effective way.” According to Finney (1962), cash consist of legal tender ie. Paper money and coins, cheques, bank draft, money orders and demand deposits in banks.

With Pandey (1988), cash is money which a firm can disbursement immediately without any restriction. The term to him includes coins, currency, cheques held by firm, and cash balance in its banks account.

According to quickbooks.intuit.com, the three key element of cash flow analysis include:

- **Accounts receivable (what customers and client owe the organization)**
- **Accounts payable (what the organization owes suppliers), &**
- **Shortfalls**

An organization must effectively manage all three if it wants to navigate its business to success. Of course, the best direction to paddle a canoe is with the current. It will go faster and won’t wear itself out. By the same token, the business will be healthier if an organization manages its cash flow towards the profit line.

**Measure of Cash Flow Management**

**Management of Income and Expenditure**

Gupta (1989) observes that cash needs to be jealously controlled for a business or an organization to thrive.

According to Millicamp (1996), all invoices should be authorized, and that all cheque payments are made by an authorized person, to prevent fraud and fictitious payments.

According to ACCA audit framework (1997), supervision over cheque payments are as follows; Cheques should be in sequential order, unused cheques should be held in a secure place, and the person preparing cheques should have no responsibility over purchases.

An employee of an organization handling cash responsibilities should ensure that all funds receipt have been properly deposited and recorded (Bourdreau, 1991).

**Cash Planning**

According to Julius (1998), cash planning are techniques used to plan and control the
use of cash. An organization needs cash to invest in inventory, receivables, and fixed assets and to make payment for operating expenses in order to maintain growth. "Cash poor" position of firm can be corrected if its cash needs are planned in advance, remarks [Napier 1991].

Rezaee & Lander (1993), conduct annual audits and reporting the results to audit committee.

Encouraging audit committee to conduct periodic reviews of its activities and practices compared with current best practices to ensure that its activities are constituent with leading practice [Sawyer, 2003].

External audit is also regarded as an important cornerstone of corporate governance, particularly with respect to the prevention and detection of fraud and errors in financial statements (Adamec, Leinicke, Ostrosky & Rexford, 2005; Davidson, Godwin-Stewart & Kent, 2005).

The relationship between internal and external auditors should be one of mutual support and cooperation in order to strengthening of internal control as a result of management response by assisting management in the pursuit of value for money. This is achieved through economic, efficient and effective use of resources.

D. Conclusion and Recommendation

Conclusion

Corporate governance has to do with established rules, controls, practices and process by an organization’s board of directors (BOD), to enable or enhance the achievement of set goals and objectives.

The essence of internal control is to ensure compliance with these established rules, controls, practices, and process for an effective and efficient operation, to drive a reliable financial report with the achievement of goals and objectives as a priority.

Treba (2003), states that internal control is a tool ensuring that a firm realizes its mission and objectives.

According to Reid and Ashbley (2002), internal control is divided into “financial internal control and non-financial (Administrative) internal control,” with financial internal control responsible for financial activities exemplified by controls over an organization’s cash receipt and payments, and non-financial internal control responsible for activities indirectly financial in nature such as; controls over personnel, fixed assets, and laid down procedures

Based on survey undertaken by Ozigbo & Orife (2011), it was discovered that internal control has significant relationship with fraud prevention. It was conclude that internal control is a necessary safeguard which assures absentee owners of business that their fund is being utilized efficiently.

Long (2009), also conducted a study on internal controls in small business and found that internal control has the efficacy of reducing the risk of fraud and promoting the efficient use of the business resources.

According to Fayol, to manage is to forecast, plan, organize, command, coordinate, and control.

Cash flow management has to do with forecasting, organizing, commanding, coordinating, and controlling the movement of cash, in and out of an organization so as to go insolvent.

Gupta (1989) observed that cash that need to be jealousy controlled for a business or an organization to thrive.

Recommendations

In agreement with these scholars, for an effective cash flow management system to prevail in any organization, there must be strong internal control system which must be adhered to at all times. Although as necessary as internal control appears, it is not full guarantee but to a great extent, mitigates the level of risk exposed to the organization in handling cash. Based on the study, it is clear that there exist a relationship between internal control and cash flow management with corporate governance as a moderator. Though in several organizations, effective internal control practices and cash flow management has always been a challenge. To this end, it is ideal for management to;
✓ Ensure the establishment of a conductive control environment.
✓ Ensure transaction are authorized and recorded by authorized staff, and there will be proper division of labor in terms of fund allocation and expenditure ensuring efficient and effective use of funds.
✓ Establish arithmetic and accounting controls
✓ Ensure recruited staff are trained in their area of responsibilities.
✓ Ensure staff involved in the issue of fund are as well trained in their area of responsibilities as it will enable them carry out their responsibilities effectively in as much as daily deposit of cash receipt is encourage as a check.
✓ Adequately supervise staff, monitoring their every activity, ensuring duties and responsibilities are effectively and efficiently executed, and performance reviewed etc.

The Way Forward
Despite all the studies conducted on internal control practices and cash flow management globally, much has not been done in Nigeria.
Due to the gap in literature, there is need for yet another study on internal control practices and cash flow management. Such study should be designed to bridge the gap in literature and more importantly, help us have a Nigerian focus.

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