Proceedings of the Sixth Academic Sessions, University of Ruhuna 2009
Vol. 6 pg s 213 - 218

Impact of Internal Controls on Organizationlal Effectiveness : Case study of Harischandra Mills

S. A. S. Priyadarshani and H. V. D. I. Abeywickrama
Department of Accounting & Finance, Faculty of Management & Finance, University of Ruhuna
✉ *sasagarika@mgt.ruh.ac.lk*

Abstract
Identifying the contribution of internal control system is significant part of any organization. Existence of system of internal controls in an organization enable management to deal with rapidly changing economic and competitive environment, shifting customer demands, priorities and restructuring for future growth. However, it's very rare to find previous researches conducted to examine the importance of internal controls to an organization, especially in the southern province in Sri Lanka. This research was conducted to investigate the impact of internal controls to achieve the effectiveness of organizational activities. The study was done as a case study and Finance Division of Harischandra Mills PLC was selected as the research site. Data for the study was collected by depth interviews with managerial executives and account clerks as well as by participationary observation. Collected data was analyzed using quantitative methods which included cost-benefit analysis, profitability analysis and trend analysis. The study found that internal controls exert a significant positive influence on organizational effectiveness. Accordingly, the study results showed that, it minimizes occurrence of frauds, errors and other irregularities, assures a high degree of accuracy and reliability of financial data, safeguard assets, promotes operational efficiency and encourages adherence to the established managerial policies. The study further highlights that the organization needs to pay considerable attention on internal control system so as to respond the inflationary effects and unavoidable weak points are inherent even in 100% accurate system of internal controls.

Keywords: Internal Control System, Organizational Effectiveness, Cost-benefit, Profitability

Introduction

Existence of an efficient system of internal controls in an organization can be of great help to the management to keep the company on course toward profitability goals and achievement of its mission. Internal control is a process, affected by an entity's stake holders, designed to provide reasonable assurance regarding the achievement of objective in the categories of (a) effectiveness and efficiency of operations (b) reliability of financial reporting (c) companies with applicable laws and regulations (Dessalegn and Aderajew, 2007). According to Gramling (1999) existence of system of internal controls in an organization enable management to deal with rapidly changing economic and competitive environment, shifting customer demands, priorities and restructuring for future growth. Internal controls are effective when all of the people and the surrounding environment work together (Yuchtman and Seashore, 1967). Collier and Gregory (1996) define effectiveness as it is a measure of the match between stated goals and their achievement. Jensen (1993) defines effectiveness as the extent to which objectives are met (doing the right things). Hamilton and Chervany (1981) define it as an output of specific review that measure (the quality of) the achievement of a specific educational goal. It is different from efficiency, which is measured by the volume of output or input used. Jeong, Byron and Zhang (2008) investigate the effect of internal control effectiveness on bank loan pricing. Banks charge higher interest rates for the loans to firms with weak internal controls. Therefore, it highlights that the significance of internal controls on effectiveness in an organization.

Research Problem

As a result of high competitiveness in the business world, almost every organization mostly retain on profit seeking. Therefore, organizations have to face a tremendous problem of how to get a clear picture of the internal controls should be followed by them to achieve the effectiveness of their activities. Although many organizations persistently pay much attention on internal controls, they have to face difficulties when they are going to substitute these internal controls into relevant targets. Therefore, organizations generally face to the following problem in regulating their internal controls towards achieving their effectiveness.

What is the nature of impact of internal controls in achieving organizational effectiveness?

However, large scale organizations rely on internal controls by spending large amount of money and time than small scales, possibility to fail Internal Control System (ICS) is increased due to their awareness is in a low level of the impact of internal controls on operational activities (Chun, 1978). Jensen (1993) highlights that the last two decades indicate corporate ICS have failed to deal effectively with the changes that are experiencing declining costs, increasing average productivity of labor and especially slow growth. Due to the possibility of occurring failures of ICS, identifying the impact of internal controls on the effectiveness of organizational activities is become a vital part to sustain the organization without any failures in the competitive business world.

This paper is aimed to investigate conceptually the impact of internal controls on organizational effectiveness. For this purpose, researcher aimed to examine the recognized research problem which is the nature of impact of internal controls on organizational effectiveness by giving special reference to Harischandra Mills PLC. Finance division was selected as the research site. Data for the study was collected by depth interviews with CFO and Accounts Clerks as well as by participationary observation.

The organization: Harischandra Mills PLC

Established in 1949, Harischandra Mills PLC is one of the market leaders among manufacturing organizations in Sri Lanka. The initiator of Harischandra Mills Plc was Mr.C.A.Harischandra. The Harischandra Mills PLC has wide distribution network and diversification products network bind with factory complex in Matara which is located at No: 11, Delkada Road, Matara. Role of Harischandra Mills PLC is manufacturing soap and food products. Mission of the company is to provide the public with an ever increasing variety of nutritious food products of high quality soaps and to maintain increasing returns to shareholders. ICS have been introduced for the seven key divisions of the company. Chief Finance Officer (CFO), Mr. Saman Rasaputhra; head of the finance division is the responsible person to update and maintain the systems. At the very beginning of the company, initiator didn't have the sufficient knowledge of the importance of internal controls. Possibility of occurring wastages, frauds, errors and theft were high due to the increasing of operational activities by a lapse of time. To overcome these barriers, importance of proper ICS was aroused. At present, company has established a formal Internal Audit Committee under the guidance of CFO. Although the company does not maintain an internal control manual, they implement a proper ICS except in written. According to CFO, internal controls of the company were designed to provide reasonable assurance that:

Records are valid, complete and accurate.

Recorded transactions are duly authorized and recorded at proper time.

Transactions are properly posted to the ledger accounts and correctly summarized.

To achieve the following objectives, internal controls were designed also in the company.

Effectiveness and efficiency of operations

Company has achieved this objective by obtaining high profit, sales volume, increasing returns to shareholders and safeguarding company resources due to ICS of the company.

Reliability of financial reporting

To send annual reports to the shareholders and stock exchange quarterly basis which is a requirement of public limited company and other selected financial data and interim audit reports at the scheduled time, internal controls provide a great level of comfort.

Compliance with laws and regulations

Requirements that public limited company should comply in accordance with Companies Act No.7 of 2007 have been fulfilled by the company due to established internal controls.

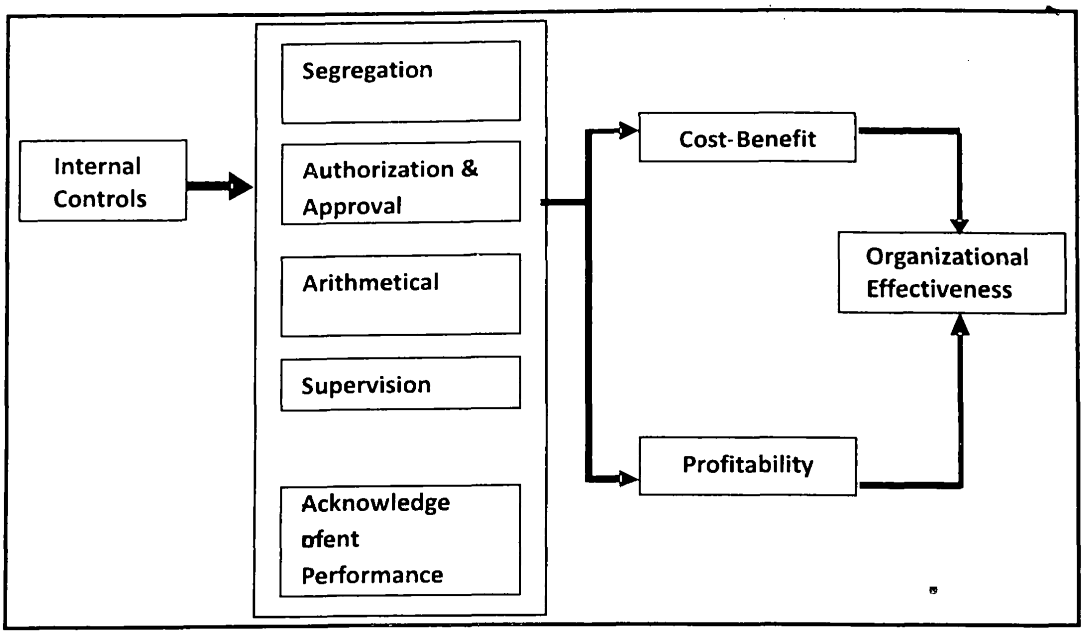

Figure 1. Relationship between Internal Controls and Effectiveness

Internal Control System of the company

According to CFO's view, ICS of the company consist of mainly five types of internal controls and they directly affect on cost-benefit and profitability and ultimately contribute to achieve the effectiveness of operational activities. This relationship between internal controls and effectiveness is indicated through following diagram in Figure 1.

According to Cuaig, Norman and Marks (2007) the preponderance of evidence indicates that segregation of duties is the most over-rated and often cost-effective control design option available. Jensen (1993) highlights that; it is difficult for small companies with less ability to achieve segregation of duties to have effective internal control. Accounts clerks and other staff members of the company have to do their task which is assigned to each person. Moreover, considering a transaction (like purchase) in the company one person involves in one task during the process of transaction due to segregation of duties.

According to Ha on and Chervany (1981) the lack of or inadequate review and approval could result in the errors may be overlooked resulting in misstatements that could affect financial, as well as, operational decisions, inaccurate or incomplete information in accounts and/or reports and the inability to detect irregularities. Each step in the process of transaction is not done without proper authorization and approval of a senior of each section who has the power to authorize and approve each transaction (CFO, Accountant, and Assistant accountant).

According to Millichamp (1978) two major controls can be identified of an accounting system are accurate posting of transactions and adequate account review and reconciliation. To ensure the arithmetical accuracy of transactions in posting data to the system, recording manually in the books, established arithmetical and accounting related controls has considerable importance in the company.

Macky and Boxall (2007) highlights that the bank conducts limited monitoring of the extent to which bank staff carry out required supervision at the project level, regional or the bank-wide level. Most of transactions especially in cash and bank related transactions are done under the supervision of the book keeper in the company. Mainly, to acknowledge the completed tasks done by each person in the company, rubber stamping, signatures and security passwords are used. A.H.Millichamp (1978) express that responsible person of a section never sign a blank form and never give the password to anyone.

According to CFO's view, they measure the effectiveness achieved due to internal controls mainly, considering the cost-benefit of internal controls and contribution to profitability of the company which is a tremendous task that most organizations are not going to apply.

Internal Controls and Cost-Benefit

According to Sangjae and Ingoo (2000) the evaluation of Electronic Data Interchange (EDI) controls is important in ensuring the high performance of an EDI system and although the penetration level is strongly associated with performance, the benefits derived arise from the usage level of EDI controls. Company bears a considerable cost to maintain the ICS. A policy was established by the company that the cost of maintaining internal control system should not be exceeded the benefit. If the company has the ability to satisfy this policy within a certain period, the effectiveness of operational activities can be achieved.

Different types of internal controls are added time to time, when the organization size is improved. To determine the cost and benefit of ICS of the company, overall knowledge which only can be obtained by the active participation to introduce, maintain and amend the ICS and the profound experience is vital. Therefore, CFO is the person who has the ability for this purpose. Analysis of cost-benefit during year 2000-2007 is shown in Table 01 and Figure 1.

Table 1. Cost -Benefit Analysis regarding Internal Controls

Year	Cost	Benefit
2000	15,750,249	393,887,358
2001	15,800,730	433,009,700
2002	15,817,558	446,815,614
2003	15,834,385	489,816,738
2004	15,901,694	530,879,293
2005	15,935,348	621,549,174
2006	15,952,175	713,878,118
2007	16,827,189	872,859,711

Source: Annual Reports of Harischandra Mills PLC, Year 2000-2007

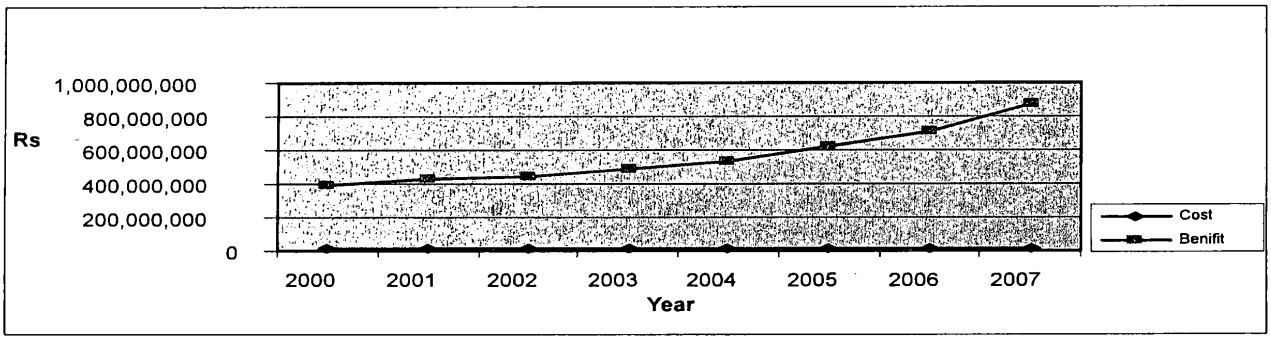

Figure 1. Cost-Benefit Analysis of Internal Controls

Table 2. Profitability analysis of Internal Controls

Ratios	2000	2001	2002	2003	2004	2005	2006	2007
ROA (%)	13.76	28.07	19.39	14.75	14.86	11.52	14.54	10.31
ROCE (%)	17.33	33.18	20.38	16.51	16.39	13.16	16.61	12.73
ROSE (%)	11.81	25.96	15.64	11.49	12.83	8.79	10.98	7.80
ROS (%)	3.40	7.97	6.35	5.35	6.23	3.98	4.69	2.89
Asset Turnover (times)	2.2	2.1	1.74	1.62	1.57	1.67	1.78	1.97

Return on Assets - ROA
Return on Capital Employed - ROCE
Return on Shareholders Equity- ROSE
Return on Sales - ROS

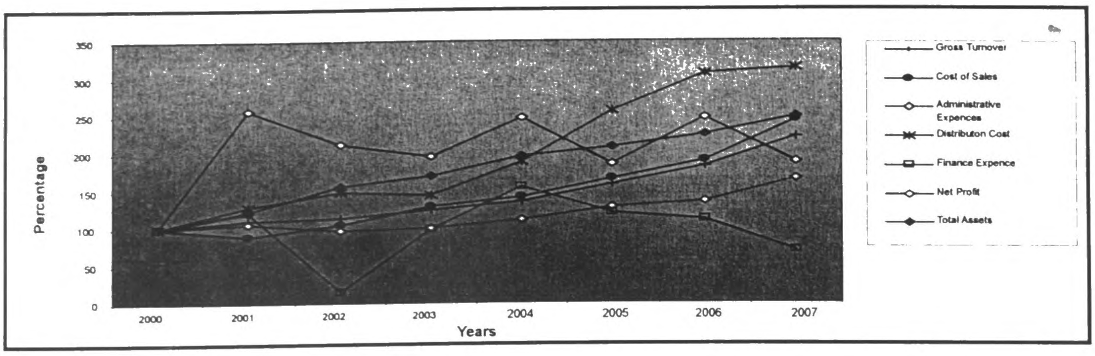

Figure 2. Trend Analysis of Year 2000-2007

Considering the behavior of cost curve which has gone in a parallel line and the benefit curve has gone up fast during 2000-2007. Therefore, benefits achieved due to ICS has been increased than the cost spent by the company for internal controls and the policy that the company to be adherence regarding internal controls has been satisfied.

Internal Controls and Profitability

According to CFO's view, analysis of profitability is the major measurement of the effectiveness of operational activities. To continue the activities successfully, ICS provides great level of support. To measure the long term profitability status of the company, profitability ratios were calculated based on published financial data of the company and they are shown in Table 2.

At a glance the behavior of profitability ratios of the company indicates an unfavorable position. The idea given as unfavorable which was indicated by the ratios can't be determined as a true view without analyzing the items and figures consist of each ratio. Trend analysis during the period of eight years provides the analytical figures to analyze the status which was pointed out by the profitability ratios and it is shown in Figure 2.

Considering the long term behavior of profitability, it indicates that, in 2007 cost of sales, distribution and administrative expenses has risen up and gross turnover and net profit has fallen down due to high inflation and cost of living. Total asset is the major indicator of ability of earning and profit making which has risen during 2000-2007. However, long term behavior of ratios and items of income statement and balance sheet indicate a favorable position even if a small deduction in 2007 due to inflationary condition of the country.

Overall analysis points out that;

- Cost of internal controls < Benefit of internal controls Favorable
- Long term behavior of profitability Favorable

Due to favorable condition of major determinant of effectiveness, the study found that internal controls exert a significant positive influence on organizational effectiveness and it implies that, having ICS minimizes occurrence frauds, errors and other irregularities, assures a high degree of accuracy and reliability of financial data, safeguards assets, promotes operational efficiency and encourages adherence to the established managerial policies.
(Chun, 1997).

Discussion

This paper aimed to identify the nature of impact; the internal controls have on organizational effectiveness especially in the southern province. Due to favorable condition of major determinant of effectiveness, the study found that internal controls exert a significant positive influence on organizational effectiveness and it implies that, having ICS minimizes occurrence frauds, errors and other irregularities, assures a high degree of accuracy and reliability of financial data, safeguards assets, promotes operational efficiency and encourages adherence to the established managerial policies. (Chun, 1997).

The study emphasizes that the organizations need to pay considerable attention on internal control system so as to respond the inflationary effects and unavoidable weak points are inherent even in 100% accurate system of internal controls.

References

Chun C. (1997). On the functions and objectives of internal audit and their underlying conditions. *Journal of Managerial Auditing*, Vol.12 (4-5), PP 247-250.

Collier P. and Gregory A. (1996). Audit Committee Effectiveness and the audit fee. *Journal of Accounting; Business and Management*, Vol. 14 (5-6), PP 177-198.

Cuaig M. and Marks N.(2005). Reliance on segregation of duties. *Managerial Auditing Journal*, Vol.10 (2-3), *PP*255-258.

Dessalegn G. M. and Aderajew W. Y. (2007). Internal audit effectiveness: an Ethiopian public sector case study.

Hamilton S. and Chervany N.L. 1981). Evaluating Information System Effectiveness.

Jensen M.C. (1993). Modern industrial revolution, exit and the failure of internal control systems. *Journal of Finance*, Vol.12 (4-5),PP 35-44.

Jeong B. K., Byron Y. S., and Zhang L. (2008). Internal Control Effectiveness and Bank Loan Pricing.

Macky K. and Boxall P. (2007), High-performance work systems and organizational performance: Bridging theory and practice.

Millichamp A.H. (1978). Types of Internal Controls. *Auditing; An Instructional Manual for Accounting Students*, PP 120-129.

Sangjae L. and Ingoo H. (2000). The impact of EDI controls on the relationship between EDI implementation and perfprmance. *Journal of Information Resources Management*, Vol. 8 (4), PP25-33.

Vrises R. E., Robert A. R. and Tharsi C.B.T. (1998).Need for supervision and its impact on leadership effectiveness. *Journal of Applied Behavioral Science*, PP 486-501.

Yuchtman E. and Seashore S.E. (1967). A System Resource Approach to Organizational Effectiveness. *American Sociological Review*, PP 891-903.