

THE INTERNAL CONTROL PRACTICE OF JUMHOURIA AND SAHARA BANKS IN LIBYA: THE TOP MANagements' PERSPECTIVES BASED ON COSO FRAMEWORK

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ABSTRACT

The rapid change on economic environment highly requires organizations to control the risks related to the financial and operative purposes. Furthermore, monitoring is also crucial for the management and the board of directors in providing them significant information related to the performance and the effectiveness of internal control systems. Internal audit as a part of internal control system has helped organizations manage and mitigate the risk as well as understanding the position where their risks are. In the effort of achieving the objective, COSO framework gives a concrete alternative for organizations to mitigate the risks related to the validity of financial reporting. This study is aimed at understanding the internal control implemented in Jumhouria and Sahara banks in Libya according to the top managements' perspectives based on COSO framework. This study is qualitative descriptive research. Data was collected through questionnaire that was distributed by E-mail. Furthermore, an interview was also done to gain deep information done by e-mail as well. The findings of this study revealed that control environment has not been well implemented by the Jumhouria and Sahara banks although the integrity and ethical value are communicated effectively throughout the organization. However, there is no consistency between the works done by the management of operating units with the senior management. Furthermore, it is believed that COSO Framework brings some benefits for the banks although the implementation of its components has not been recognized. A good internal control is important, because it may give the bank an idea of how it is performing.

Key words: *Internal Control, COSO Framework, Libyan Banks*

INTRODUCTION

COSO standing for “Commission of Sponsoring Organizations” is a private commission employed to evaluate, investigate and report on the improvement of financial reporting quality based on business ethics, effective internal controls and corporate management”. Some of the organizations sponsoring COSO are as follows: American Institute of Certified Public Accountants, the Institute of Internal Auditors, International Financial Executive, Institute of Management Accountants, and American Accounting Association. COSO arranged a document in 1992 concerning on internal controls or integrated framework. Because internal control has different significances to different parties, COSO attempts to establish a common definition and standard for each party. Based on COSO report (cited in July Edition of COSO Internal Controls-Integrated Framework, “COSO Report,” 1994), Internal Control is broadly defined as a process effected by the entity of the board of directors, management, and other personnel.

Internal Control—Integrated Framework (henceforth, COSO Framework) published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992—is one of the leading frameworks applied to design internal controls for large-scale business activities. The primary purpose of COSO and its framework is giving a concrete alternative for organizations to mitigate the risks related to the validity of financial reporting. The COSO framework has further been applied towards financial reporting for business operations as well. Moreover, COSO has recently published a revised version of the framework proposed by (COSO, 2013) to support the changing business environment.

At the end of the 20th century, a new concept of management and corporate governance was developed for the public sector. If we wish to understand the message of this new concept we have to understand key terms. Internal control systems in the public sector consist of a network that establishes an organization whose goal is to provide: 1) enforcement of the law, regulations, rules and procedures; 2) economical, efficient and designated use of assets; 3) safeguarding assets and investments against losses, abuse, mismanagement, fraud or corruption; and 4) integrity and reliability of information, accounts and data, and fair disclosure of these data in timely reports.

RESEARCH QUESTIONS

The problem discussed in this study is the modern concepts of internal control systems like COSO which is not well implemented. The researcher attempts to investigate how the influence of the internal control implemented by the corporate management in mitigating the bad impacts on the sustainability of the organizations economic activities. Therefore, the main research question of

this research is: “How is the Internal Control practice in Jumhouria and Sahara banks in Libya based on the Top Managements’ Perspectives?”

THEORETICAL REVIEW

Agency Theory

According to Jensen and Meckling (1976), ownership is widely held by shareholders at least in US jurisdiction. In the other hand, German, French and Dutch jurisdiction and managerial actions deviate from the required maximization of shareholder returns Zeckhauser and Pratt (1985). On the other hand, Fama (1980) utilized the principal-agent theory to examine the hierarchical inter-manager relationships that exist within large firms. In this context, the firm’s chief executive officer is viewed as the principal who attributes the right decision to the lower level management (agents) and thus inducing agency costs due to information asymmetry.

COSO Framework Theory

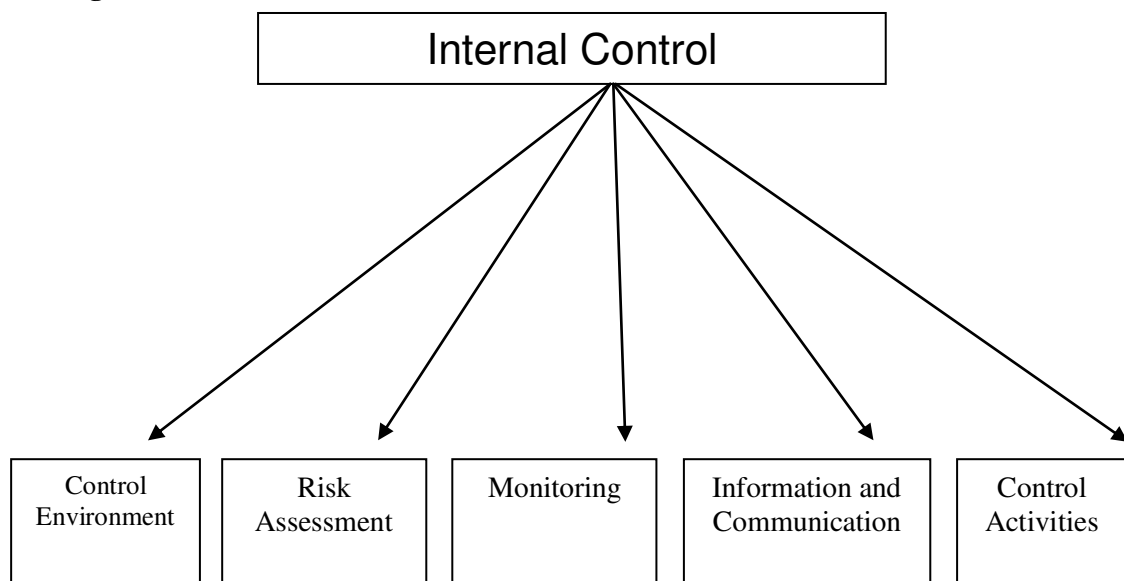
The primary theory that is used in this thesis is related to COSO itself. COSO published some articles on its framework and how it should be implemented in practice. The theory about internal control regulation is also relevant for this thesis. If new rules related to internal control are established, audit firms might have to adapt their practices in order to comply with those rules. This can result in a change in how auditors work by following several rules. The requirement of rules can be an explanation for the change in observed practices (why auditors perform their job in a certain way). In sum, regulation has an effect on audit practices. The SOX regulation and its Dutch variant, The Dutch Corporate Governance Code deal with internal control and are therefore relevant to be used in this thesis.

The COSO framework has become the most quoted framework in discussions on control systems within corporate governance committees (Corporate Governance Committee 2008) and by regulators PCAOB (2004). The COSO control framework appears to be an institutional rule and seems to function as a myth, which is embraced and legitimized by auditors, firms, regulators, and others, but does not enhance survival prospects of the firm (Meyer & Rowan, 1977). The concept of control implied by the COSO-framework can even decrease the real control (system) of a firm, focusing attention on a narrow definition of control restricted to maintain legitimacy in a regulatory environment instead of survival. Recent problems with a number of firms, some of which published an in-control statement based on the COSO framework, raise questions with respect to the effectiveness of the control system of these firms. Therefore, it raises questions regarding whether the COSO framework is a complete framework to achieve a sufficient system of control, or that quintessential elements or aspects might be missing.

COSO explicitly states that publicly traded companies should report on internal control. Within the section reporting to external parties in the framework, COSO mentions examples of private sector bodies as The Cohen

Commission, the Financial Executives Institute, and the Treadway Commission framework that support the importance of management reporting on internal control (COSO 2013). The Treadway Commission further refers to those potential investors which have a legitimate interest with regard to the extent of management responsibilities for the company's financial statements and internal control. The Commission noted that the management's opinion on the features of the internal control system is crucial because it provides the basis for the preparation of financial statements. In the framework, COSO provides detailed suggestions on what companies may report on related to internal controls COSO (2013) and Deumes (2004). However, investors should be cautious by solely relying on what is reported on internal control. Reporting on internal control is not an adequate proxy for the effectiveness of an internal control system.

Diagram for Internal Control



Source: COSO Framework (2013)

RESEARCH METHOD

In order to develop a deeper understanding of the role of the different types of control measures and their impact on the performance of the organization, the qualitative descriptive method utilized in this research. Furthermore, this study describes the accounting systems, techniques, and procedures used in practice. The findings can help answering the research question on how COSO is used and why COSO is used.

DATA AND SOURCE OF DATA

The data were obtained from two chosen banks among a group of Libyan Banks: Jumhouria and Sahara Banks. It has been selected because they are the oldest established Bank and Commercial power in the Libyan state. This bank is from Al Khums city. The research participants involved the Audit Board Committee (ABC), Chief executive Officer (CEO), Chief Finance Officer (CFO) in Libyan Banks. They were chosen as survey participants for two key reasons. Firstly, they are in a senior position and thus, are expected to have a very good understanding of the quality of internal control procedures. Secondly, financial controllers are often actively involved in the oversight of any system reviews and changes, and thus would be aware of any control weaknesses or malfunctions of internal control procedures.

FINDINGS AND DISCUSSIONS

Questionnaire Results of the Implementation of Internal Control in Jumhouria and Sahara banks in Libya from the Top Managements Perspective

The result of the analysis reveal the practice of Internal Control in Libya's Banking industry from the Internal Auditor's perspective. For an organization to achieve its organizational objectives, the five control components of control environment, risk assessment, control environment, information and communication and monitoring must be integrated into management processes over the entire organization.

Control Environment

The findings discover the implementation of internal control seen based on the COSO Framework in two major Libyan banks including The Sahara Bank and Jumhouria Bank. The result is based on the perspective of Chief Executive Officers, Audit Board Committees, and Chief Finance Officers of the two banks. Their analysis explores variations in perceived control strength at the individual control element level in public organizations providing information about the practice of internal control according to COSO framework with five key elements.

The commitment to integrity and ethical values

The finding shows that the oldest commercial power banks in Libya has implemented integrity and ethical value within the organization and they are communicated fully from management operating units to board of directors.

Independence from management and exercises oversight of the development and performance of internal control

Based on the finding it is found that the expertise the board members is evaluated regularly to ensure the quality of the board members.

The establishment of structure, authority and responsibility by the management with board oversight

The result also presents the condition of management in two major banks in Libya. Surprisingly enough, there are not adequate policies and procedures for authorization and approval of transactions by the appropriate level. Each of the banks does not have a clear policy which talks about the legal decisions regarding the transactions in the Banks.

The demonstration of commitment to competence

The findings describe the condition of bank competence and how it maintains its competency in banking industry. According to the responses, all CEO of the two banks mentioned that the banks do not have standards and procedures for hiring, training, motivating, evaluating, promoting, compensating, transferring and terminating the employment of personnel that are applicable to all functional areas.

The organization establishes and enforces accountability

The findings describe the accountability of the two Libyan major banks. Based on the findings, it is revealed that there is not any mechanism in place to regularly educate and communicate to management and employees the importance of internal controls, and to raise their level of understanding of control.

Risk assessment

The findings reveal the practice of internal control seen based on the COSO Framework in two major Libyan banks including The Sahara Bank and Jumhouria Bank. The result is based on the perspective of Chief Executive Officers, Audit Board Committees, and Chief Finance Officers of the two banks. The analysis discovers the practice of risk assessment.

The organization of specifies relevant objectives with sufficient clarity to enable identification of risks

The analysis of the questionnaire responses reveals that the two banks specify their objectives using several methods. All of the respondents agree that their organization determines goals and objectives by identifying significant financial statement accounts and disclosures. Moreover, the objectives are also specified by examining relevant assertions, underlying transactions and events, and taking a closer look at the processes supporting those accounts and disclosures. Obviously, all of the CEO, CFO, and Audit Board Committees of the two banks apply the same method in their banking industry. Financial statement evaluation is crucial for the banking industry as it reflects the actual condition of the bank and the internal audit needs to focus their work on it to prevent fraud and minimize the risk treating the organization.

The organization identifies and assesses risk

Banking organizations will set objectives for the efficiency and effectiveness of activities, reliability and completeness of financial and management information, and compliance with laws and regulations. Risk assessment entails the identification and evaluation of the risks involved in meeting those objectives. This process helps to ensure that the bank's internal controls are consistent with nature, complexity and risk of the bank's on- and off-balance sheet activities.

The organization considers the potential for fraud in assessing risk

The result of the questionnaire response analysis reveals the performance of organization on a risk assessment which is related to fraudulent finance and loss assets potential. It is started from the two banks, practice the assessment of the financial reporting, management override, and potential loss of assets and corruption which can prevent the existence of fraud in the organization.

The organization identifies and assesses changes that could significantly impact the system of internal control

Another risk assessment sub point based on COSO framework that some Banks have assessed significant changes which may impact on the internal control. However, some Banks do not pay attention on the changes which may influence the system within internal control. To sum up, risk assessment of changes in management activities are practiced by a merely small number of Libyan banks.

Control Activities

The finding shows that control activities are implemented by the majority of Libyan banks. The practice includes selecting and developing control activities and general control over technology and deploying through policies and procedures.

The organization selects and develops control activities

The banks use manual and automated to prevent and detect problems in the organization.

The organization selects and develops general control activities over technology

this means that the oldest banks have implemented technology application to control.

The organization deploys control activities through policies and procedures
the control activities are not deployed through policies and procedures folly.

Information and Communication

The information system of an organization produces formal as well as informal reports on how well the organization's objectives are met; this information makes it possible to run and control the organization. Every organization must capture and identify relevant information relating to both external and internal events. The finding of the results of the questionnaire responses for information and communication in Libyan banks is described in the following sub-chapters.

The organization obtains or generates and uses relevant, quality information The analysis result of quality information in the Libyan banks shows that Libyan banks obtain and generate relevant quality information.

The organization internally communicates information

The practice of information and communication is partially done within the internal control of the organization. The CEO and Audit Board Committee of Sahara Bank believe that members of the board of directors in this bank do not have direct access to employees without interference from management. The management arranges the access between the board of director member and the employees. The board of directors cannot directly communicate the information to the employees. Similarly, this is applied to the other two banks in which communication internal from the board of directors to employees is done by the help of organization management.

The organization communicates with external parties

the external parties are informed about the organization's activities that relates to matters of internal control evaluated by management. It is very important to have external communication to maintain the relationship with the external parties. Matters affecting the achievement of financial reporting objectives are communicated with outside parties.

Monitoring

The finding of the analysis reveals the practice of monitoring in two major Libyan banks and Sahara Bank, Jumhouria Bank. The two major banks in Libya implement monitoring within the organization. The practice of monitoring in Libyan banks is by selecting, developing, and performing ongoing and separate evaluations. Moreover, monitoring is also done by evaluating and communicating deficiencies.

The organization selects, develops and performs ongoing and/or separate evaluations

The findings discover the implementation of internal control seen based on the COSO Framework in two major Libyan banks. The bank internal control members conduct an evaluation of processes in place to assess whether controls within each of the five components of internal control are present and functioning as intended. They monitor by developing and performing an ongoing and separate evaluation on the five components.

The organization evaluates and communicates internal control deficiencies

Deficiencies are communicated to those parties responsible for taking corrective action, senior management and the board of directors or audit committee. Moreover, the management takes adequate and timely actions to correct deficiencies which are reported by the internal audit function and by other monitoring activities. On the other hand, in evaluating and communicating deficiencies, management does not respond timely and appropriately to the findings and recommendations of the independent auditors regarding internal control and policies and procedures of the organization.

CONCLUSIONS

This study examines the internal control in Jumhouria and Sahara banks in Libya from the top managements' perspectives with the focus on the implementation of components of the COSO Framework in audits for two major banks in Libya. Two major banks in Libya are the samples. The first is Sahara Bank which has 53 branches all over Libya. It is a corporation type bank with the capital base as discipline and dedication to work. The second sample is Jumhouria Bank which has operated 71 branches based on general partnership company. It can be summed up that the auditor team consists of an audit team which includes a partner, one auditor or senior auditor, one or two team leaders, one or two senior assistants, and one or two assistants. The data are presented through a qualitative descriptive research developed from questionnaire results, together with interviews with auditors. The analysis of the qualitative descriptive research and the interviews reveals that auditors use part of the COSO Framework components.

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