

INFLUENCE OF INTERNAL CONTROL COMPONENTS AND EFFECTIVENESS OF INTERNAL CONTROL SYSTEM OF PEOPLES' BANK IN SRI LANKA

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ABSTRACT:- This study aims to examine the effect of internal control components on effectiveness of internal control system of Peoples Bank in Sri Lanka. While strong internal control system establishes and practice in the banking sector in Sri Lanka, there are indications of frauds and exploitations and corruptions. It is required to examine to what extend the established internal control system is effectively practice. The study considered five independent variables such Control environment, risk assessment, control activities, information & communication system and monitoring and a dependent variable effectiveness of internal control system. Data was collected using structured questionnaire which was circulated to bank branch managers who are more conscious in the practice of internal control system in banking sector. 173 middle level bank branch managers' contributed to the study. Descriptive statistics and inferential statistics were used to analyze the collected data. The results revealed that there are significant and positive relationships among the internal control components (such as control environment, risk assessment, control activity, information and communication system and monitoring) and effectiveness of internal control system and it revealed that the management of Peoples Bank has recognized and practiced the strong internal control system.

Keywords: Control environment, Risk assessment, Control activities, Information & communication system, Monitoring, Effectiveness of internal control system

I. BACKGROUND

"Internal control is the process designed and affected by those charged with governance, management and other employees to provide sensible assurance about attainment of entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. It follows that internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives." E1‡

Banking sector plays major role in the any economy and is delivered various facilities to their customers as well as managers manage huge bulk of resources every day. Because of this situation, internal control systems functions of the banks are cannot be neglect. The effective internal controls are much more important for having the nature of safe and sound banking system. Strong control systems guarantee the achievement of goals and objectives of the banks and it assists to accomplish long period targets and keep trustworthy monetary and managerial reporting. This kind of method supports to confirm that the particular bank conforms to policies, laws and regulations, internal rules, plans and procedures and minimizes the risk of unpredicted damages to the bank's status. Strong internal control system of bank helps to authorities defends resources of the bank's, provide trustworthy financial reports and confirm with laws and regulations. Besides the system assists to reduce risks of occurring considerable faults and irregularities and support in their appropriate detection when errors arise. The reasons for those kinds of errors may be affected by individual interference, negligence and wrong in judgment.

Two state commercial banks function in Sri Lankan financial system as Peoples' Bank(PB) and Bank of Ceylon (BOC) and this study examines the effectiveness of internalcontrol system of Peoples' Bank (PB) only. Peoples' Bank was established on 1st July1961 and Duke Street branch is the first branch opened at Colombo. In 1963 the Bank started its Pawning Facilities and its Co-operative Rural Banking System.

Table 1.1 Financial and Nonfinancial highlights of the bank

Operating performance (Rs. Billion)	2016	2017
Interest income	110.0	149.2
Profit before tax	20.8	25.9
Profit after tax	15.0	18.2
Retained profit	6.8	13.0
Financial position (Rs. Billion)		
Total assets	1302.0	1467.1
Gross loans and receivables	950.8	1074.2
Total deposits	1077.8	1244.0
Shareholders' funds	59.6	77.5

Performance ratios (%)		
Return on average assets (before tax)	1.7	1.9
Return on equity	27.5	26.6
Non- performing loans ratio	1.9	1.9
Total capital ratio	12.1	
Shareholder ratios		
Earnings per Share (Rs.)	14,995	18,250
Non- Financial		
• Number of permanent employees		
• No of customers (mn)	8249	8454
• National contributors as tax payer (Rs.mn)	17.9	18.6
• Investment in corporate social responsibility (Rs.mn)	12,292	14,804
	40.3	56.3
Branch network	737	737

(Source: Peoples' Bank annual reports 2017) £2‡

II. PROBLEM STATEMENT

In last era, it was highlighted that the reasons of accounting scandals of the World were internal control weaknesses. Central Bank of Nigeria emphasized that one of the causes for backward development in Nigeria was cause to faults in the internal control systems of the banks £3‡

It clearly showed that how fraud has been breached in the financial strength of Nigerian Banks. Therefore, internal control is highly significant in fraud detection and preventions in banking sector too. Well-established banking system is practice in Sri Lankan economy and it comprises nearly 26 LCB, including more than thousands bank branches over the country. But sometimes, it has evidences about the frauds, mismanagement and corruptions. Some of them can be highlighted as follows: Table 1.2 presents the details of bank's internal and external frauds in 2015, 2016 and 2017.

Table 1.2: Details of Peoples' Bank's external and internal frauds.

Year	External Frauds		Internal Frauds	
	Number	Value (Rs. mn)	Number	Value (Rs. mn)
2014	3570	684.51	62	225.61
2015	312	631.43	05	70.57
2016	236	522.96	12	102.84
2017	244	36.4	00	00

(Source: Peoples' Bank annual reports 2015, 2016,2017)

Basel report (1998) demonstrates that inadequate internal controls can lead to significant losses for banks. The Types of control failures naturally seen in problematic bank cases can be clustered into five types:

- Absence of adequate management understanding and answerability and establish appropriate control culture inside the bank.
- Insufficient appreciation and valuation of the risk of particular banking actions, it could be with or without balance sheet.
- In lack, failure and catastrophe of core control structures and events as sanctions, confirmations, reconciliations, and assessment of operational performance.
- Insufficient flow of communication of information between management levels the bank staff, particularly in the bottom to top communication problems.
- Insufficient or unsuccessful audit programs and monitoring undertakings.

Therefore, Basel framework presents the 14 principles for the assessment of internal control systems that concerns on control environment, risk assessment, control activities, information and communication system and monitoring.

Basel Committee on Banking Supervision's Framework for Internal Control Systems states that the effective working of these five elements (control environment, risk assessment, control activities, information and communication system and monitoring) is the key to an organization achieving the performance, information, and compliance objectives.

Thus, there are occurrences that involving with frauds in banks as well in Sri Lanka. Therefore, it is unquestionable that due to the absence or lack of appropriate establishment of sound internal control system and weaknesses in performing them, then organizations connect with numerous problems and risks. If this situation continuously occurs, this status will

lead to decrease the company's growth, goodwill, and employees as well as make issues in customers' satisfaction and welfare of employees, loss of investors, insolvency and lastly indicates many issues towards administration.

Few researches are concentrates on investigating about Sri Lankan internal control system. Therefore, continuing a research is more significant of finding the formal implementation of the internal control system in the Peoples bank that is one of state commercial bank and play the key role in Sri Lankan economy . This will lead to avoid the similar situation in the future.

Based on the circumstances, having the sound system of internal control and the practice is more important to Peoples' bank that plays larger financial, economic and social roles. Every bank in economy must have solid system of internal control and practice. Therefore it is an essential to investigate that ***“Does the Peoples' bank have effective internal control system and what is the influence of internal control components on effectiveness?”***

III. OBJECTIVES OF THE STUDY

A. MAIN OBJECTIVE

The main objective of this study is to examine the influence of internal control components on the effectiveness of internal controls system of Peoples' Bank in Sri Lanka

B. SPECIFIC OBJECTIVES

1. To examine the relationship between control environment and effectiveness of internal control system of Peoples' Bank in Sri Lanka.
2. To investigate the relationship between risk assessment and effectiveness of internal control system of Peoples' Bank in Sri Lanka.
3. To study the relationship between control activities and effectiveness of internal control system of Peoples' Bank in Sri Lanka.
4. To find the relationship between information and communication system and effectiveness of internal control system of Peoples' Bank in Sri Lanka.
5. To examine the relationship between monitoring and effectiveness of internal control system of Peoples' Bank in Sri Lanka.

IV. RESEARCH QUESTIONS

With the purpose of achieving the research objectives the following research questions are raised

1. Is there any relationship between control environment and effectiveness of internal control system of Peoples' Bank in Sri Lanka?
2. Is there any relationship between risk assessment and effectiveness of internal control system of Peoples' Bank in Sri Lanka?
3. Is there any relationship between control activities and effectiveness of internal control system of Peoples' Bank in Sri Lanka?
4. Is there any relationship between information and communication system and effectiveness of internal control system of Peoples' Bank in Sri Lanka?
5. Is there any relationship between monitoring and effectiveness of internal control system of Peoples' Bank in Sri Lanka?

V. SIGNIFICANCE OF THE STUDY

The encouragement of the present study is to examine the effectiveness of internal control system and how frauds, corruptions and mismanagements will be minimized by using the internal control system in Peoples' Bank. Significance of the study can be described as follows:

- Even though there are plenty of researches on the internal control system. There are fewer researches in the Sri Lankan Context. Therefore current study fulfills the vacuum of the empirical gap in the Sri Lankan context.
- The findings support the Peoples' Bank to set up activities for their regular management how to safeguard the assets, avoid and identify of frauds, errors and irregularities.
- The study will also enhance the good image of Peoples' Bank which is accomplished the internal control system effectively.
- There are limited researches and text books on effective internal controls. Hence this study can be used as the reading material for students and researchers and managers can use this as the manual in banks and other financial organizations too.
- The findings will be helpful to the future researchers to conduct their researches more successfully by further improving it.

VI. SCOPE OF THE STUDY

The present research focuses on the area of different components required to the existence of internal controls in banking sector and relationship between those components. The scope of the thesis confines to the effective practice of internal control systems in Peoples' Bank and its branches function in all over the country. The research focused on seven provinces in Sri Lanka except two provinces which were suffered under thirty years war and still in developing stage. Particularly, 173 middle level bank branch managers considered as the sample.

VII. LITERATURE REVIEWS (Empirical)

Evidences of some of empirical studies illustrates in Table 1.3 as follows:

Table 1.3 Details of Empirical Studies.

Author(s) / Year	Title	Findings
Amundo & Inanga (2009)	Evaluate the Internal Control Scheme in public sector plans financed by ADB in Uganda	Though they have effective system, some control mechanisms are lacking. Present control structure is inefficient.
Sultana & Haque (2011)	Evaluate the Effectiveness of the developed Internal Control System of banks in Bangladesh	Some banks in the sample are lacking about some control components
Fazil , Haron & Jantan (ND)	Evaluate the Internal Auditing Practices and Internal Control System of listed companies in Malaysia	Internal Auditing Practices significantly affect to the quality of internal control system
William & Kwasi (2013)	Evaluate the significance of Internal Control System in rural banking sector	The found that strong internal controls exit in banks in Ghana
Ayagre, Applian-Gyamerah and Nartey (2014)	Evaluate the Effectiveness of Internal Control System of in Ghana banks	The revealed that strong internal controls exit in banks in Ghana
Mawanda (2008)	Identify the effect of Internal Control on Financial Performances in education sector	There is a positive relationship between internal control and financial performance
Douglus (2011)	Effectiveness of internal control system in Greek banks	Recommended to establish internal audit unit in each branch

VIII. METHODOLOGY

A. OPERATIONLIZATION

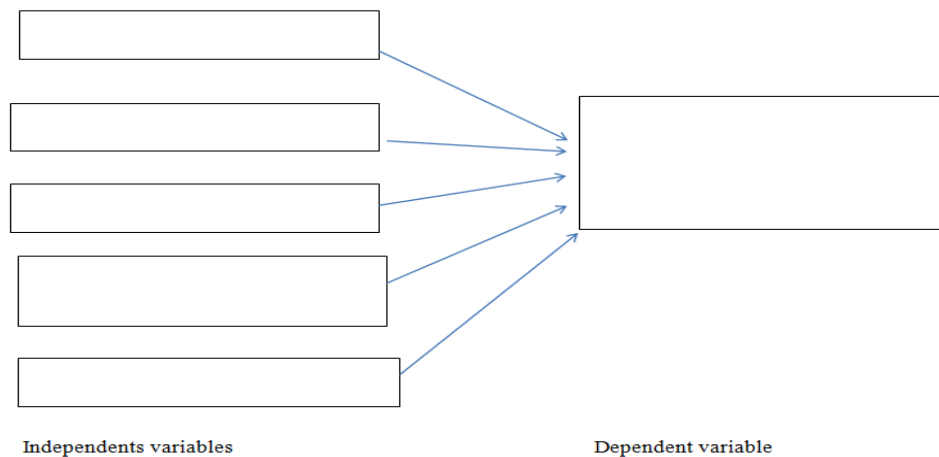
Operationalization primarily comprises of recognizing the variables and the criteria for each variable, how each variable is measured. In the study five independent variables and the dependent variable discussed. Based on Committee of Sponsoring Organizations (COSO) model 1992, 2002, 2013 internal control system must compromise five components as controlling or governing environment, risk assessment, controlling or governing activities, information and communication system and monitoring.

1.4: Operationalization of Variables

Variables	Dimensions	Measurement	Question No.	References
Control Environment	Integrity and ethical values, Management philosophy & operating styles, Organizational structure, Authority & responsibility and Human resources	5 point Likert Scale	Section B.1 1-15	Noorvee (2006) 6, Douglas (2011) 7, Frimpong (2012) 9, Millichamp (2002) 11, Amudo&Inanga (2009) 12, SLAuS 315(2015) 1, Douglas (2014) 8, Kumuthinidevi (2016) 13
Risk Assessment	Importance of financial reporting objectives, Identification and analysis of financial reporting, Assessment of fraud risk.	5 point Likert Scale	Section B.2 16-27	
Control Activities	Establishment & development of control activities, elements of a control activities, control activities linked to risk Assessment	5 point Likert Scale	Section B.3 28-37	

Information and communication systems	Information needs, Management communication.	5 point Likert Scale	Section B.4 38-42	
Monitoring	On -going monitoring, separate evaluation, reporting deficiencies.	5 point Likert Scale	Section B.5 43-49	
Effectiveness of Internal control system	Effectiveness and efficiency of operations, Reliability of financial reporting, Compliance with Laws and Regulations	5 point Likert Scale	Section B.8 63-73	

B. CONCEPTUAL FRAMEWORK



C.HYPOTHESES

Following five hypotheses are developed to achieve the research objectives of the study.

- H₁: Control environment (CE) significantly effects on effectiveness of internal control system (EICS) of Peoples' Bank in Sri Lanka.
- H₂: Risk assessment (RA) significantly effects on effectiveness of internal control system (EICS) of Peoples' Bank in Sri Lanka
- H₃: Control activities (CA) significantly effects on effectiveness of internal control system (EICS) of Peoples' Bank in Sri Lanka.
- H₄: Information & communication system (ICS) significantly effects on effectiveness of internal control system (EICS) of Peoples' Bank in Sri Lanka.
- H₅: Monitoring (M) significantly effects on effectiveness of internal control system (EICS) of Peoples' Bank in Sri Lanka.

D. POPULATION & SAMPLE

In the study, population is 173 middle level branches spread over the country (Peoples Bank Internal Circular, 2015 latest issue). The purposive sampling method was used to select the sample as managers are more aware about the practice of internal control system in the respective branch and study concerned only seven provinces in the country two provinces which were 30 years under sever war excluded from the study. Questionnaires were distributed among 173 middle level branches of the Peoples Bank (PB), only 168 duly completed questionnaires were returned. Thus response rate is 97% and acceptable for the present study.

E. DATA COLLECTION & ANALYSIS

Main instrument of data collection is questionnaire survey. The questionnaire was developed and administered to respective managers of the each bank branches. This questionnaire covers up 73 questions. The questionnaire used for the study consisted of two sections. Section A of the questionnaire was used to gather demographic factors about respondent and section B on internal control components practice in the selected branches and effectiveness of internal control system in the respective branch.

Data analysis is done using Statistical Package of Social Science (SPSS) 21 software. The relevant statistical techniques used are descriptive analysis, correlation and multiple Regression analysis.

IX. RESULTS AND DISCUSSIONS

A. DEMOGRAPHIC FACTOR ANALYSIS

According to the results obtained 71% represents more than ten years work experience. There is no big difference between male and female composition between PB bank branch managers as the sample indicated that 49% of the respondents are male and 51% are represented by female respondents.

Out of 168 respondents majority of respondents have degrees (60%), 14.3% have Diplomas and 7.1% have achieved the professional qualifications. Only 32 out of 168 have passed only Advanced Level examination along. That means to carry on duties as the bank manager it need the higher level of educational qualification. Meantime the most of male managers have better qualifications than female managers. This generally affects the Sri Lankan culture as females have multiple responsibilities in the family life than males.

A.1 DESCRIPTIVE STATISTICS

Based on descriptive statistics, Mean value for Control Environment (CE) is 4.215, this mean score belong to Mean>3.(within 1-5 Likert scale) Thus this finding is suggested that there is a good control environment in the selected Bank. Mean value for Risk Assessment (RA) is 4.172, this result suggested that the bank management have better understanding about RA. Control Activity (CA) mean score is Mean>3 this finding suggests that CA well practice in the Bank. Information and Communication System (ICS) mean score also Mean>3 this result shows that better ICS is available in the Bank. Meantime 4.12 result shows that good monitoring is available in the Bank. According to the table "Mean" with respect of the variables of CE, RA, CA, ICS and M are 4.20, 4.17, 4.27, 4.11 and 4.12 respectively. For dependent variable Effectiveness of Internal Control System (EICS) Mean is 4.28. Based on Mean value it indicates that respondents most agree that they are having effective internal control system in Peoples' Bank.

A.2 CORRELATION ANALYSIS

The correlation results for all the independent variables are significant with the dependent variable. There is a significant and positive relationship between CE, RA, CA, ICS, M, and EICS ($r = 0.613, 0.749, 0.734, 0.648, 0.545$ respectively.) with the p value $< .05$ for all variables. Five variables point to a statistically significant relationship with dependent variable, Effectiveness of Internal Control System (EICS) as their sig values are lesser than 0.05. All variables are significant according to analysis.

This results support the five hypotheses such as H_1 : Control environment (CE) significantly effects on effectiveness of internal control system (EICS) of Peoples' Bank in Sri Lanka, H_2 : Risk assessment (RA) significantly effects on effectiveness of internal control system (EICS) of Peoples' Bank in Sri Lanka, H_3 : Control activities (CA) significantly effects on effectiveness of internal control system (EICS) of Peoples' Bank in Sri Lanka, H_4 : Information & communication system (ICS) significantly effects on effectiveness of internal control system (EICS) of Peoples Bank in Sri Lanka, H_5 : Monitoring (M) significantly effects on effectiveness of internal control system (EICS) of Peoples Bank in Sri Lanka. Accordingly, the first five specified objectives are achieved.

A.3 REGRESSION ANALYSIS

Multiple regression analysis was used to test the influence of the independent variables on the dependent variable of the study.

According to the regression results the R^2 value is 0.704. It means 70.4 % variation of EICS can be explained by the predictors of control environment, risk assessment, information & communication system, control activity, and monitoring. And the ANOVA results shows that the significance value is 0.000 which is less than 0.05 this indicates that overall regression model is indicated that all independent variables are explaining that there is a significant relationship with dependent variable. Hence this model is considered as a fit model. Beta values for CE, RA, CA, ICS and M are 0.152, 0.286, 0.191, 0.159, 0.215 respectively with $p < 0.05$.

This result supported hypotheses H_1 : Control environment (CE) significantly effects on effectiveness of internal control system (EICS) of Peoples' Bank in Sri Lanka, H_2 : Risk assessment (RA) significantly effects on effectiveness of internal control system (EICS) of Peoples' Bank in Sri Lanka, H_3 : Control activities (CA) significantly effects on effectiveness of internal control system (EICS) of Peoples' Bank in Sri Lanka, H_4 : Information & communication system (ICS) significantly effects on effectiveness of internal control system (EICS) of Peoples Bank in Sri Lanka, H_5 : Monitoring (M) significantly effects on effectiveness of internal control system (EICS) of Peoples Bank in Sri Lanka.

Therefore the first five hypotheses are accepted and one to five specified objectives with main objective also achieved.

X. CONCLUSION

Under the data analysis part of the research, data which were collected from 168 respondents by using questionnaires and analyzed by using SPSS 21.

Firstly checked the reliability of the variables and found that all variables are reliable as Cronbach's Alpha Value of all variables is more than 0.7.

Then use Descriptive statistics to identify the basic nature of the research variables. According to that Mean is deviated from 3-4. It means all respondents are agreed that five independent variables need to exist to achieve the effectiveness of internal control system.

Then, it is conducted the correlation analysis to measure the relationship between two variables. When consider the results of correlation analysis it is revealed that there is a significant and positive correlation for all independent variables with dependent variable.

Finally, multiple regression analysis used to test the five hypotheses, it is discovered that all independent variables have significant effect with dependent variable. Thus all the objectives including main, are achieved. Table 1.5 shows the coverage of objectives of the study.

Table 5.1: Coverage of Research Objectives

Objectives	Justification	Remarks
1. To study the relationship between control environment and effectiveness of internal control system of Peoples' Bank in Sri Lanka.	Hypothesis -1	Achieved
2. To examine the relationship between risk assessment and effectiveness of internal control system of Peoples' Bank in Sri Lanka	Hypothesis -2	Achieved
3. To examine the relationship between control activities and effectiveness of internal control system of Peoples' Bank in Sri Lanka	Hypothesis -3	Achieved
4. To study the relationship between information and communication system and effectiveness of internal control system of Peoples' Bank in Sri Lanka.	Hypothesis -4	Achieved
5. To examine the relationship between monitoring and effectiveness of internal control system of Peoples' Bank in Sri Lanka.	Hypothesis -5	Achieved
6. The main objective is to study the influence of internal control components on the effectiveness of internal controls system of Peoples' Bank in Sri Lanka	Hypothesis -1, Hypothesis -2, Hypothesis -3, Hypothesis -4, Hypothesis -5	Achieved

Based on results obtained, it can conclude that Peoples' Bank management has established strong internal control system and they are practiced it effectively. Due to the heavy day to day work load and the reliance on subordinates and inherent limitations as collusion, human mistake may be reasons for present frauds in the bank.

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