Role of Internal Control in Company Management Procedures: Theoretical Aspect

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Abstract

Existence of the current economic conditions makes efficient company management a more important factor at companies and analysis of management procedures is an essential condition thereof. This analysis enables identification and assessment of the role of the inner control emphasizing that establishment of an efficient inner control system is one of the main company management instruments at major companies. Mastering and use of this instrument under the modern economic conditions create preconditions for achieving competitive advantage over other companies. The article deals with the functions, elements of the internal control and the place thereof in the company management procedures as well as the expedience of this control. The objectives of the internal control and the expected results thereof as well as the role of this control in management procedures provided in scientific readings have been identified and analysed. Therefore, assessment of the internal control in respect of strategic control and management control has been identified as the most important objective of the study. Theoretical analytical aspects are analysed in order to achieve this objective aiming to identify the factors influencing the place of the internal control in company management procedures and how this affected the internal control assessed from the managerial perspective.

Introduction

The internal control of the company and management thereof is becoming a more important factor in existence of relatively high business competition in the domestic market where companies emphasise not only profit maximization but also efficient management and control thereof. Therefore, precisely establishment of an efficient internal control system is one of the main company management instruments at major companies; mastering and use of this instrument under the modern economic conditions create preconditions for achieving competitive advantage over other companies. Rapidly changing market forces to change the approach to the internal control: from approach where the internal control is considered only in financial terms to control in the field of management procedures. It is for this reason why the internal control, in its essence, is becoming an increasingly significant risk control instrument and management tool enabling the company to achieve its set goals and objectives. Therefore, any kind of corporate managers need exactly such a control management system which would not only enable effective management of the company's activities but also would be helpful in controlling certain company management procedures and networks thereof. Moreover, A. J. Pfister (2009) emphasizes that the internal control existing in a company is helpful in ensuring productive economic activities, making sure that laws, regulations, and relevant rules adopted by the company are complied with, introducing appropriate techniques for protection of the company's assets, avoiding mistakes and exposing abuses, etc. However, A. M. King (2011) claims that the internal control reveals the company's development prospects, it is helpful in noticing risks posing threat in respect of the company's existence – in this way this control becomes an important risk management tool. The following Lithuanian authors also wrote about the internal control, improvement and assessment as well as prospects thereof: R. Bičiulaitis (2001), E. Gimžauskienė (2007), L. Giriūnas, G. Jakštonytė (2010), V. Kačergienė (2005), R. Kanapickienė (2007, 2008, 2009), V. Lakis (2007), J. Mackevičius (1999, 2001, 2008) and others. However, their papers lack attention to the factors influencing the place of the internal control system in the company's management procedures. Nevertheless, it should be emphasized that despite of scarce analysis of this topic by scientists, identification of the place of the internal control in the company's management structure is becoming a very important task in order to introduce and foster efficient internal control in respect of maximizing its benefits. Thus the subject of this scientific study is the internal control.

The objective of this study is to identify the place of the internal control in the company's management procedures.

The following tasks have been set for the study in order to implement the set objective successfully:

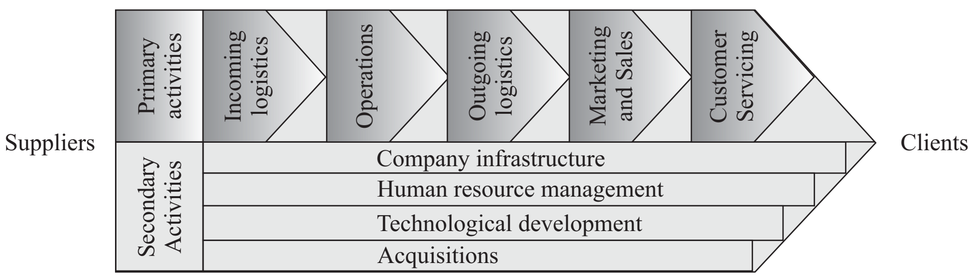
- To identify the internal control as one of the functions of the management system;
- To determine the effect of the internal control on the company's management procedures;
- To analyse the correlation of the internal control and operational control, strategic control, and management control.

The present research article contains analysis of Lithuanian and foreign research papers, empirical studies and economic readings as well as practice study on the issues of the company's internal control and assessment thereof at the company.

Results of the Study

In order to operate efficiently, companies must establish such a management control system that would assure receipt of high quality information and prompt submission thereof to the internal and external users. Established efficient management control system would ensure not only rational use of resources, but also management of accounting work and accountability, it would maximize the use of information data in company management and enable control of communication procedures. Meanwhile, it is not completely clear where this control could be encountered at companies. According to D. Pfaff, F. Ruud (2007), the activities implemented by the company must be divided into activities generating the primary value, consisting of incoming logistics, operations, sales, and secondary activities, consisting of human resource management, infrastructure, and acquisitions (see Fig. 1).

Figure. 1. Company value chain



(source: M. E. Porter (1985), A. J. Pfister (2009))

It should be emphasized that management objects are involved in both primary and secondary activities, ranging from suppliers and to customers, in all existing companies: precisely this kind of formation enables revealing all management functions in the value chain. For example, when a company faces problems with selling the products, when the products developed by the company are sold in the domestic or foreign markets, this involves using not only all management functions but also the internal control, which serves like assistance in ensuring implementation of the company's goals and optimum profitability of the company's activities. If the activities cannot be implemented as it was expected, the staff could get involved in writing of the so-called fraudulent financial reports, embezzlement, inefficient use of the assets and failure to ensure safety thereof, failure to implement their duties and assigned tasks, failure to prevent undesirable events etc. In case of assessment of an employees performance, first of all wage is taken into account, which means that the employee's income is taken into account even though it might be inflated meanwhile costs might be underestimated, therefore in countries characteristic of high individualism cultures (the United States of America, the Great Britain, the Netherlands) it is expected that an employee's performance-based stimuli, such as wage, bonuses for meeting the performance targets, would be more efficient than any other management control. Although many practitioners analysing the modern management control systems put more and more emphasis on control of the results, which is based on employee's performance-based stimuli systems, nevertheless, some scientists claim that control directed to the secondary activities instead of the procedures of the primary activities is much more efficient. In addition to this, control emphasizing the company's performance, such as sales or production scopes at companies, is a much tighter management control, it will give results faster than most of the soft forms of control like control of the company's organizational culture or staff. However, every strict management control has its restrictions as well, therefore, based on the practice, the most efficient approach would be a combination of both strict and soft principles of control.

It should be noted that it is not very clear where the internal control exists in companies, therefore R. Kanapickienė (2008) claims that first of all the internal control should be studied as a separate function of the control system and then equated to the management control before analysing the internal control. Meanwhile, other foreign and Lithuanian scientists such as B. Neverauskas, J. Rastenis (2000), A. Sakalas (2000), S. Stoškus, D. Beržinskienė (2005), J. A. F. Stoner, R. E. Freeman, D. R. Gilbert (1999) argue that the internal control is analysed as one of the management functions, although H. Fayol (2004), R. Garison, E. Noreen, P. Brewer (2009), F. S. Butkus (2003), B. Neverauskas, V. Stankevičius (2000), V. Kučinskas, R. Kučinskienė (2002), P. Zakarevičius (1998) identify the internal control with management control (see Table 1).

Table 1. The Matrix of Control and Management Functions

Author	Control functions	Author	Management functions
H. Fayol (2004)	planning	B . Neverauskas,	prognostication
	organization	J.Rastenis(2000)	planning
	management		organization
	coordination		motivation
	control		control
H. Fayol (2004) R. Garison, E. Noreen, P. Brewer (2009)	planning	A. Sakalas (2000); S. Stoškus, D. Beržinskienė (2005); J. A. F. Stoner, R. E. Freeman, D. R. Gilbert (1999)	planning
	management and motivation		organizational Control
	control		management
F. S. Butkus (2003)	planning		
	organization		
	promotion		
	control		
	regulation and wage		

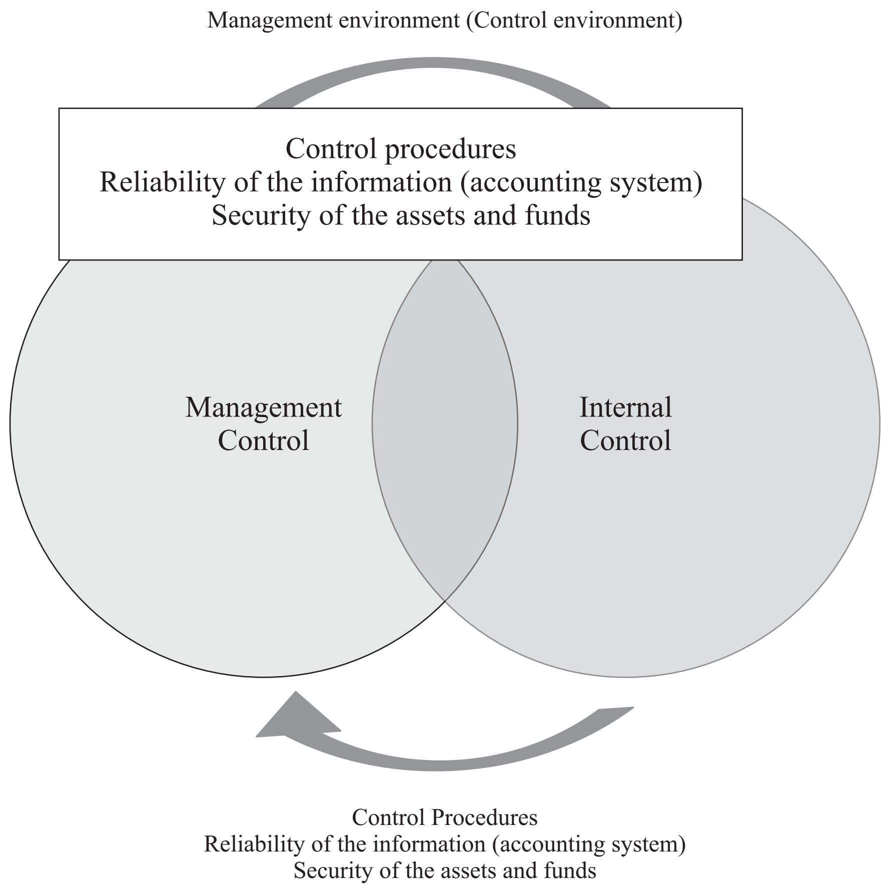
B. Neverauskas, V. Stankevičius (2000); V. Kučinskas, R. Kučinskienė (2002)	planning		
	organization		
	motivation (management)		
	control		
P. Zakarevičius (1998)	prognostication		
	planning		
	organization		
	control		
	regulation		

(source: compiled by the author)

Two common parameters can be seen among the control and management functions distinguished by the authors in the matrix: i.e. planning and control. Whereas such scientists as P. Zakarevičius (1998), F. S. Butkus (2003) classify regulation as a control function, meanwhile H. Fayol (2004) suggests that the parameter of coordination should be classified as a control function, we may claim that there is no significant difference between the functions of control and management, therefore further analysis of control functions would be more expedient because classification of the latter is both more detailed and more logical. According to J. G. Fisher (1998), company management control system is focussed on two areas: implementation of the strategy and pursuit of the expected results. Precisely this approach and classical attitude to management functions is also suggested by Lithuanian scientists such as E. Gimžauskienė (2007) or A. Vasiliauskas (2007) who claim that management control focuses on the quality of management solutions and use of the accumulated knowledge in the planning process in order to ensure analysis and assessment of information about the company's activities and the conditions of the external environment. The highest level of control is encountered during planning, therefore management control appears in the middle link of the company because the latter is accountable to the higher link of the company for implementation of the plans and, according to R. L. Daft, N. B. Macintosh (1984), formulation and execution of specific tasks as well.

Analysis of the main elements of the internal control system enables revealing the convergence between management control and the internal control, when one of the greatest challenges at companies is precise determination where the internal control actually starts, therefore the internal control system is often confused with management control, so their functions are often confused as well. Therefore, inadequate identification of the elements of the internal control system or the functions performed by it can make the latter ineffective and inefficient. Such scientists as E. Vaassen, R. Meuwissen, C. Schelleman (2009) also agree on such important classification, however, in many cases the internal control can be perceived not only in terms of accounting or audit, but from the aspect of management as well (see Fig. 2).

Figure 2. Correlation of Management Control and the Internal Control



(source: E. Vaassen, R. Meuwissen, C. Schelleman (2009))

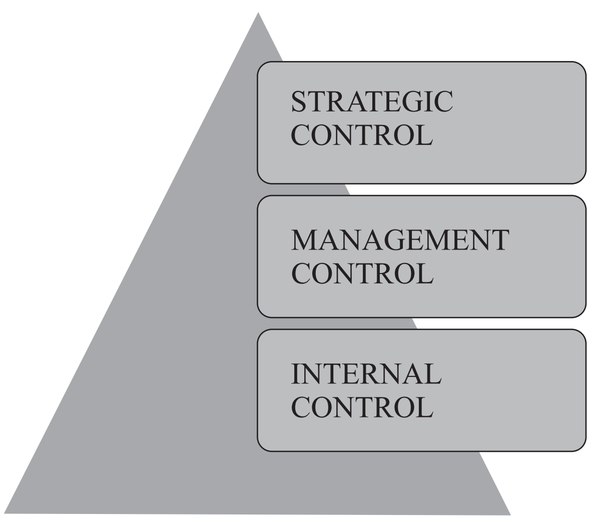
In order to able to identify management or the internal control or even introduce it at the company, it is necessary to know their similarities and differences. Attempts to solve the synthesis of these two areas show that apparently management control has evolved from problems associated with implementation of the strategy. Therefore, management control is driven by strategy. On the other hand, it seems that the internal control has evolved from the need to organize operations at companies and among them. Thus the internal control is driven by operations. So management control starts at the top level of the integrated management system and goes down until implementation of the strategy. On the other hand, the internal control starts at the lower level of the system and rises towards management control. Another difference between these disciplines is that management control tries to influence the organizational decisions made by the employees, meanwhile the internal control tries to help people in making decisions by providing reliable information. The third difference is that management control tries to implement the set goals through behavioural measures, meanwhile the internal control tries to implement that through mechanical measures, involving procedures, inspections, and balances, as well as distinguishing of responsibilities and ignoring the human factor.

Therefore, the main differences between management control and the internal control are as follows:

- Management control is driven by strategy and the internal control is driven by operations.
- Management control focuses on influencing the decision-making and the internal control focuses on assistance in making decisions.
- Management control has a dominant behavioural orientation, meanwhile the internal control has a more mechanical orientation (Giriūnas, L. (2012)).

Meanwhile, there is another opinion prevailing in the scientific readings emphasizing that the control existing in the company can be classified hierarchically and provided in certain levels which are based precisely on the internal control (see Fig. 3).

Figure 3. Levels of Control Existing at a Company

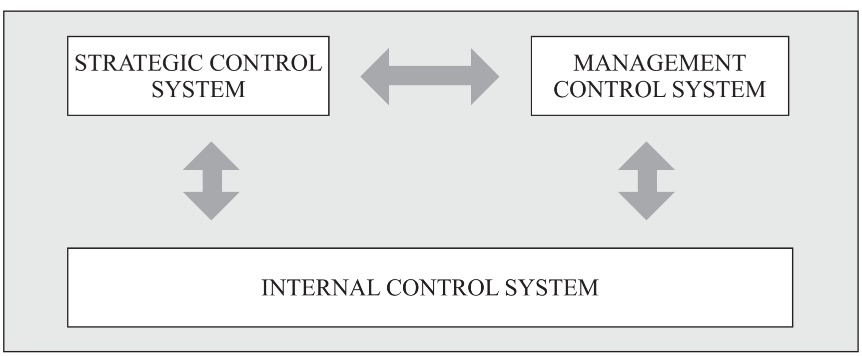


(source: compiled by the author based on J. G. Fisher (1998), F. Mahbub (2011))

It should be noted that three main levels of control have been distinguished, i.e. strategic control, management control, and the internal control. Strategic control is at the top level of the pyramid and in this way it is emphasized as the highest level of management which must ensure target-oriented activities of all entities seeking for the company's goals. Management control is on the lower level of the pyramid and ensures efficient use of resources. Managers, employees seek for their goals, plan their activities and ensure the company's progress. Meanwhile, the internal control is at the lowest level of the pyramid because the latter includes individual tasks and actions and integrates group work. Therefore, some scientists claim that the main task of this control is making sure that the company's production programme is being implemented, i.e. compliance with the requirements and regulations and certain guarantees that the work would be completed.

However, it should be noted that such classification of control is not accurate because no specific place of the internal control system is established at the company's pyramid of the levels of control. For example, R. Bičiulaitis (2001) claims that distinguishing of the internal control system, as a separate level of control, is essential, because it is a part of the company's management system. The place of the internal control system can be established only upon establishment of the relations of the internal control system with other controls (see Fig. 4).

Figure 4. Relations between Strategic Control, Management Control, the Internal Control



(source: L. Giriūnas, 2012)

R. Simons (2000) claims that that the internal control is the basis of all controls existing at a company; therefore it is placed at the bottom of the figure. The internal control system ensures reliable and valid information, therefore other systems of the company established on the basis of the former are reliable and it is deemed that its assets are being protected. It should be emphasized that information received by means of the internal control system is used by strategic and management control systems as certain assistance to formal or informal solutions of strategic or management control systems. So the arrows show how the internal control system, management control system, and strategic control are correlated. The existential basis is pointed out by the statement that information received by means of the internal control system is used by strategic and management control systems as one of the means facilitating decision-making and implementation thereof under the influence of the latter. The internal control system cannot prevent wrong strategic and operational decisions and precisely this correlation is reflected by the flow of information depicted in Figure 4 specifying the exact interaction between the internal control, management control, and strategic control.

Based on the analysis of the scientific readings we may claim that the internal control takes the major and probably the most important and the most significant place not only among the control systems existing at the company, but also in the company's management system: the internal control is primarily oriented not only to the micro environment but also to the macro environment of the company. Interaction of the internal control and the management control enables to anticipate the company's strengths, weaknesses, opportunities and limitations, the use of which enables it to gain competitive advantage in the level of strategic control and to compete with other companies. For example, managers of a company operating in a mining industry set a goal to mine a certain quantity of minerals per year, to sell them profitably in this way ensuring maximization of the company's profit. In order to achieve this goal, the managers develop a short-term strategy of activities intended for achieving the set goal by means of taking into account and relying on the available strengths of the company, by eliminating its weaknesses and by using its opportunities. Only the management control existing at the company decides how the goal set by the company can be achieved by using the available resources, for instance, monetary resources, technical and human resources. The internal control, as a function of control system and management, is particularly important to companies, because the latter includes all areas of the company's operations and activities not only from the highest and the lowest level of management, but also from control of structuring to control of the employees' behaviour. Minimization of specific control and management functions is defined as reduction of the internal control functions such as regulation and authorities, authorizations given to subdivision managers entitling them to choose what products should be placed on the market at their own discretion. However, such an interpretation should not be permitted, because more and more problems are faced in relation to control of the company's activities along with expansion or growth of the company: the number of subdivision managers relatively increases and they start competing with each other by placing a lot of similar and related goods or services on the market. In this case the employees of the company violate the authorities given to them and entitling them to work independently in order to gain advantage over others, furthermore, lack of discipline and work coordination with other subdivisions is also noticeable. Nevertheless, development of the company and organization of the processes is impossible without mistakes, planned or actual deviations and identification thereof requires not only subsequent corrective actions but also specific preventive measures and scheduled implementation thereof.

Conclusion

Based on the made analysis of scientific readings, we may claim that the internal control takes the major and probably the most important and significant place not only among the control systems existing at the company but also at the company's management system. Precisely the internal control forms the basis of all types of control existing at the company, therefore it is shown as not only interacting with the strategic control or management control but also as forming the basis thereof. Moreover, only efficient internal control system has a positive effect on all other company control systems. A company having an efficient internal control system may not only successfully compete with other companies operating in that filed, it also can seek for new strategic goals set by the management. The internal control, as a function of control system or management, is particularly important to companies, because it includes all areas of the company's work and activities, not only from the highest to the lowest management levels, but also from structuring to control of the employees behaviour.

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