Chapter 6

Corporate governance and accounting ethics
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Internal control and audit procedures

Learning Objectives

At the end of this chapter, students should be able to:

1. Define internal control and explain its importance in corporate governance.
2. Describe the five components of internal control as defined by the COSO framework.
3. Understand the objectives and types of internal audits and external audits.
4. Identify the responsibilities of auditors in promoting transparency and fraud prevention.
5. Evaluate the relationship between internal control systems and financial reporting quality.
6. Apply internal control and audit procedures to practical case studies within Nigerian organizations.

6.1. Introduction

The quality of the financial reporting and the security of corporate resources is highly dependent on the quality of the internal control systems and efficiency of audit processes. The core element of good corporate governance is internal controls, which help to make sure that the organizational goals are attained in a cost-effective and ethical manner.[1,2]

Various corporate scandals in African countries, including the Cadbury Nigeria financial misstatement, Oando Plc governance failures, and failures in the financial sector, have emphasized the significance of strong internal control and auditing systems in the Nigerian business environment. According to the Nigerian Code of Corporate Governance,[3] Companies and Allied Matters Act and Financial Reporting Council (FRCN), firms must have in place and implement effective internal control systems and submit to external and internal audits.

6.2. Meaning and definition of internal control

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) defines internal control as:

An activity, performed by the board of directors, management, and other employees of an entity, and aimed at ensuring that there is reasonable assurance as per the accomplishment of the objectives that can be related to operations, reporting, and compliance.[1]

Internal control therefore gives a model of assuring the credibility of the financial reporting, protection of assets and adherence to legislations and regulations.

Important purposes of internal control are:

1. Both quality and fullness of financial information.
2. Asset security against fraud or abuse.
3. Adherence to the corporate policies and the external regulations.
4. Effective resource utilization.
5. Elimination and timely identification of mistakes and anomalies.

The first line of defense is internal controls against corporate fraud and ethical misconduct.

6.3. Internal Control Systems Components (The COSO Framework)

According to the COSO Internal Control-Integrated Framework, there are five components that make up an effective control environment, which are all interrelated.

6.3.1. Control Environment

This is the basis of the rest of the elements. It involves values of the company, integrity, management philosophy and the organization structure.

Elements include:

1. Adherence to ethical principles.
2. Board-level independence and control.
3. Staff competence and responsibility.
4. Precise corporate hierarchy.[2]

6.3.2 Risk Assessment

All organizations are exposed to risks that could make it fail to attain its goals. Risk assessment is a process of identification and analysis of these risks and subsequent decision on how to manage them.

Proper risk assessment has the effect of making internal controls preventive as opposed to reactive.

6.3.3 Control Activities

These are the actual measures that have been put in place by policies and procedures to control risks. Examples include:

1. Approval and authorization processes.
2. Segregation of duties
3. Asset physical controls.
4. Reconsolidations and performance appraisals.

6.3.4 Information and Communication

There should be flow of relevant and timely information to all levels within the organization. Effective communication would make employees aware of their control responsibilities and report irregularities in time.

6.3.5 Monitoring Activities

Monitoring refers to active or regular evaluation of internal control effectiveness by conducting internal audit reviews, management assessment, and external evaluation.[4]

6.4 Types of Internal Controls

1. Preventive Controls: Intended to prevent mistakes or fraud prior to their occurrence (e.g. authorization restrictions, passwords).
2. Detective Controls: Report or detect error or irregularities after they have arisen (e.g. reconciliations, variance analysis).
3. Corrective Controls: Take actions to rectify identified errors or anomalies (e.g. update of policies, training of employees).

Such types collaborate to guarantee accountability and reliability of operations.

6.5 Importance of Internal Controls

In the context of corporate governance, internal control systems are effective because they increase the overall governance framework by:

1. Cultivating good corporate culture.
2. Ensuring quality financial reporting.
3. Improving confidence of the investors.
4. Minimizing fraud and inefficiency in operation.
5. Maintaining regulatory conformity.

Internal control mechanisms are ethical checks and balances, which ensure that managerial activities are equated to the responsibility and transparency objectives of the organization.

6.6. Internal Audit Function

One of the pillars of the corporate governance process is the internal audit. Internal auditing has been defined as: an independent, objective, assurance and consulting activity that aims at value addition and enhancing operations of an organization. Internal auditor gives an ongoing evaluation of the sufficiency and capabilities of internal control system, risk management processes, and structures of governance.

The main internal auditor tasks are:

1. Risk management procedure appraisal.
2. Determining the adequacy of internal control.
3. Checking of the accuracy of financial and operating information.
4. Fraud detection and prevention.
5. Checking the regulations and laws adherence.
6. Recommending efficiency to the management.

Internal auditors are administratively accountable, but functionally to the Audit Committee of the board, so as to be independent.

6.7. External Audit and Corporate Governance

Where internal auditors give continuous evaluation, external auditors are independent in giving stakeholders an assurance of fairness of financial statements.

The functions of external auditors are specified by the International Standards on Auditing (ISA), the Companies and Allied Matters Act, and IFAC Code of Ethics.

The key roles of external auditors are:

1. Financial statement and supporting records examination.
2. Assessing internal control reliability.
3. Identifying and reporting material misstatements.
4. Giving audit opinions (unqualified, qualified, adverse, or disclaimer)
5. Increasing the integrity of stakeholders regarding finances.

Another important accountability measure of the board and management is external auditors. Their objectivity and independence are essential to good governance.[5]

6.8. Association between Internal Control, Risk Management and Audit

Incorporate mechanisms in corporate governance such as internal control, risk management and auditing are interdependent.

- Internal control reduces the risks by use of policies and procedures.
- Risk management recognizes and ranks the possible threats.
- Auditing measures, the efficiency of internal control as well as risk frameworks.

These elements need to coexist in a sound governance system that would guarantee the integrity, accountability, and sustainability of operations.[6]

6.9. Audit Committee and Supervisory Roles

CAMA[7] and FRCN[3] in Nigeria also require that all companies in the market that are public shall have an Audit Committee with an equal number of shareholders (not exceeding six) and board members.

The major roles will be:

1. Checking the areas and results of internal and external auditors.
2. Managing internal control and financial reporting systems.
3. Assuring rotation and independence of auditors.
4. Checking the risk management procedures.
5. Recommending financial integrity and ethics to the board.

Audit committee is therefore a very important interface between the management, auditors, and the shareholders.

6.10. Basic Weaknesses in Internal Control and Auditing Systems

Although codes and laws exist, several areas of weaknesses continue to develop in the developing economies like Nigeria, this basic weakness are:

1. Lack of good segregation of duties.
2. Inadequate documentation and record keeping.
3. Absence of independence of the auditors.
4. Poor employee training and skills.
5. Poor governance codes enforcement.
6. Control override by the management.

Osemeke et al.[8] have noted that most of the Nigerian companies implement a compliance-focused approach to governance, which restricts the performance of the audit mechanisms.

6.11. Enhancing Internal Control and Audit Effectiveness

Organizations should have to increase the contribution of internal control and audit in the governance.

1. New culture of ethics and accountability at the top.
2. Make the auditors independent and competent.
3. Carry out regular internal audits of risk.
4. Monitor in real time (e.g. data analytics, AI-assisted audit).
5. Put in place whistle-blowing and fraud reporting systems.
6. Secure effective rotation and disclosure of audit fees.
7. Implement periodical governance and control training of workers and board members.

6.12. Case Study of Internal Control Failures and Lessons

The following is case study of internal control failure and lessons:

Cadbury Nigeria Plc scandal entailed manipulations with financial statements to the value of

N 13 billion. Weak internal controls, management override as well as poor auditor oversight were found during investigations. The scandal made the company reorganize its audit committee, enhance internal audit independence, and implement COSO framework of internal controls.

This case highlights the importance of having good internal controls and the independent audit of the company as a prerequisite to ethical corporate governance.

Corporate governance integrity is based on internal control and audit procedures. Good controls preserve property, maintain proper accounting and maintain integrity. Internal and external auditors are watchdogs that identify irregularities, improve transparency and assure the stakeholders of credibility of financial information.

A governance system that lacks strong control and audit systems is prone to ethical irregularities, mismanagement and collapsing of the corporation. Therefore, there is a need to reinforce these systems to attain corporate sustainability and investor confidence.

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