# INTERNAL CONTROLS IN ENSURING GOOD CORPORATE GOVERNANCE IN FINANCIAL INSTITUTIONS

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**ABSTRACT:** *This paper assessed factors that influence the internal controls in ensuring good corporate governance in financial institutions in developing economies with special reference to Zimbabwe. The research paper assessed how lack of internal controls affected good corporate governance and aimed to bring out elements of good corporate governance. It emerged that failure to effectively implement internal controls contributed significantly to poor corporate governance. The study discovered that internal control system overrides and the issue of "fact cat" directors also contributed to poor corporate governance. The study recommended that there is need for the board of directors to guarantee an organizational structure that clearly defines management responsibilities, authority and reporting relationships. There is also need to ensure that delegated responsibilities are effectively carried out to ensure compliance with internal controls of the financial institution concerned.*

**KEY WORDS:** *internal controls; corporate governance; ethical behaviour.*

**JEL CLASSIFICATION:** *G21, G28; G30; G38.*

## 1. INTRODUCTION

The year period December 31 2003 to December 31 2004 witnessed the collapse of a number of financial institutions in Zimbabwe. This period witnessed a 27.5% decline in the number of registered financial institutions from forty (40) to twenty nine (29). The impact of effective internal controls can thus not be overemphasized in ensuring good corporate governance practice and consequently

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survival of financial institutions. The main cause of this crisis has been blamed on ineffective internal controls that would be used in measuring the compliance levels of managers in the day to day running of the financial institutions by the board. When one speaks of management it is essentially speaking of internal controls. Laxity of implementing effective internal controls, greedy and in some instances poor or lack of board supervision emerged as contributors to poor corporate governance in many financial institutions.

The study is set to clarify how ineffective internal controls contribute to lack of good corporate governance. The research defines internal controls and corporate governance structures and shows how the relationship can contribute towards improved operational procedures. Cartwright (1999) asserted that effective internal control is a tool that enhances good access to capital and ensures sustainability. Cartwright argued that effective internal controls also provide a moral compass that guides leaders and staff when faced with ethical dilemmas making it the foundation and building block upon which good corporate governance is built and sustained. He indicates that effective internal controls demand an oversight by senior management and board members, and this oversight should be accompanied by unquestionable commitment to the programme by the two leadership groups, with their behaviour being exemplary providing the ’tone at the top’. This is so because ethical behaviour of firm’s leaders has a strong impact on the ethical behaviour of its employees.

## 2. RESEARCH QUESTIONS

The paper thus strives to give answers to the following questions:

- How has internal control systems been effective in the Zimbabwean banking sector?
- How can efficient internal controls be implemented to promote corporate governance?

## 3. METHODOLOGY

A qualitative research design was used to assess internal controls in ensuring good corporate governance in financial institutions. Data was gathered through document review, questionnaires and structured interviews to clarify hanging issues in interviews. Targeted respondents included Chief Executive Officers (CEOs), managers from different levels from 8 commercial banks and 2 building societies. A total of ten (10) questionnaires and nine (9) interviews were used. The questionnaire had twelve (12) questions designed for the company secretaries, managers and CEOs from those banks so that they would not have any difficulty in responding to the questions. The questionnaire was divided into three (3) parts that is; part A which had two (2) questions constituting the respondent profile; part B with two (2) questions that formed the administrative section where the research was obtaining information about the financial institution and; finally part C formed the main body from which the crucial data for the research was obtained. Document review was also used to obtain much data as possible for a comprehensive, detailed and informed analysis of the study. The research is a study designed to explore the problems bedevilling the effectiveness of internal controls in financial institutions and their consequence on the good corporate governance of these institutions.

## 4. LITERATURE REVIEW

According to Harvey and Brown (1998), the major components of internal controls are control environment, accounting system and control procedures. Smircich (1983) subscribes to the same sentiments by highlighting that the tone at the tog has implications on the direction taken by employees. Furthermore, Jansen (1998) pointed out that historically internal controls, has focused conforming employees' actions to the desires of management.

An internal control system available to a firm according to Grieves (1998) consists of: management oversight and the control culture; risk recognition and assessment; control of activities and segregation of duties; information and communication and monitoring activities and correcting deficiencies.

Control environment reflects the overall attitude, awareness and actions of the board of directors, management and stockholders. The accounting system consists of the methods, records and report on entity's transactions to provide complete, accurate and timely financial information. Finally the control procedures are essentially specific procedures put in place by management to provide assurance that the company's objectives will be met. They usually come in the form of authorizations, segregation of duties, design and use of adequate documentation and records, adequate safeguards or access to assets and independent checks on performance.

The control environment reflects the overall attitude, awareness and actions of the BOD, management and stockholders. Borerwe (2004) consented to Deal and Kennedy (1982)'s views and defined corporate governance from the banking industry as a manner in which boards of directors govern the business affairs of individual institutions and senior management, affecting how the banks:

- run the day to day operations of the business;
- align corporate activities and behaviours with the expectation that banks will operate in safe and sound manner, compliance with laws and regulations; and
- set corporate objectives (including generating economic returns to shareholders and protect the depositor's interests.

Robbins (1992) defines internal control systems as the whole system of controls, financial and otherwise, established by management in order to carry out the business of the enterprise in an orderly and efficient manner, ensure adherence to management, safeguard the assets and secure as far as possible the completeness and accuracy of the records. According to Khan (1994), internal controls are designed to protect an institution from loss or misuse of its assets. They also ensure that all transactions are properly authorized and thus guarantee or foster good corporate governance.

Corporate governance has been defined as a manner in which the business of an enterprise is directed and controlled, how the corporate objectives are set and how corporate activities and expectations of the stakeholders are aligned (Coyle, 2003).

Corporate governance involves the combination of the body of directors, management and controls that guide the firm.

Borerwe (2004) reiterated that corporate governance is concerned with holding goals. The aim is to align as near as possible the interest of individuals, corporate and society this can be ensured by having effective internal control system. Magaisa (2004) supported this view when he says that effective internal control is an attempt to encourage employees, managers, board members to think about and make decisions through the doctrine of shared values.

According to the King Report (2002) the corporate discipline, transparency, independency of board members and committees, fairness, accountability and social responsibility are the essential pillars of good corporate governance. For a corporate to achieve good corporate governance it must adopt a clear stance on the following: Strategy, Stewardship, Corporate culture, Corporate reporting, IT systems and Board operations. Pheysey (1993) added another dimension to the above definition by defining corporate governance as the way business is conducted in accordance with the shareholders desire which generally is to make as much money as possible.

According to the Reserve Bank of Zimbabwe (RBZ) a corporate governance guideline protect the integrity of the sector and cultivates confidence within investors and deposited, conditions that result in free circulation of funds thus making it easy for banks to undertake their day to day operations without difficulties. This entails economic development as a result of free circulation of money within the economy. Magaisa (2004) substantiated the RBZ governor's statement by indicating that poorly governed financial institutions are a liability to the economy and are a functional equivalent of circulatory problem in human beings.

Harvey and Brown (1998) are of the view that the exclusive focus of corporate governance should maximize shareholder wealth to the extent that wealth maximization conflicts with the interests of other stake holder's interests. Those interests should be ignored unless management is legally required to take interests into account. Coyle (2003) added that the main corporate governance problem is rooted in the Blake and Mouton (1985) paradigm of separation of shareholders ownership and management's control in institutions. This resulted in the emergence of the agency problem, which is the need of ensuring that management is always acting in the best interest of the shareholders rather than theirs (Davis and Militelo, 1994).

Buchanan (1975) views the firm as a system of stakeholders operating within a larger system of a host of society that provide necessary legal and market infrastructure for the firm's activities. Khan (1994) supported this view by stating that the goal of directors and management should be maximizing total wealth creation by the firm.

RBZ (2004) recommended that boards of commercial banks and building societies must have at least five directors. The major reason for this recommendation was that large boards are for corporate performance because they have a range of expertise to help make quality decisions and makes it difficult for powerful CEOs to dominate.

Blake and Mouton (1985) indicated that monitoring by boards could deal with at least some problems of corporate governance. Johnson (1992) proposed that board of directors could solve agency problems if the company under performs in a health industry because under this situation boards would find it easier to evaluate performance of the management. Weibach (1998) tested hypothesis advanced by Fama (1980) and discovered that outside directors behave differently from inside directors and behave differently from inside directors and boards dominated by outside directors performed better that firms with boards dominated by insider directors to remove the chief executive officer.

RBZ (2004) critique the concept of multiple appointments, the reason being directors who hold such appointments are ineffective in discharging their function to monitor managers. Magaisa (2004) concurred with this view and highlighted that members who sit on multiple boards do not have enough time to think of ways of improving the institutions in which they lead and it is very difficult for one to have the level of commitment that is necessary for effective governance to all companies it on board. King Report (2002) recommended high frequency of board meetings per annum. This suggests that meeting frequency is critical dimension of an effective board. French and Bell (1999) found that board meeting time is an important resource in improving the effectiveness of the board and most widely shared problem directors face is lack of time to carry out their duties.

Green (1997) suggested that the board and senior management of financial institutions are responsible of financial institutions are responsible for promoting high ethical and integrity standards and for establishing a culture within the organization that emphasis and demonstrated to all levels of personnel the importance of internal controls. Khan (1994) suggests that an effective internal control system requires that there are reliable information systems in place that cover all significant activities of that bank. The systems must be secured, monitored independently and support adequate contingency arrangements Deal and Kennedy (1982) argued that effective internal control systems requires effective communication.

## 6. RESULTS

Responses were obtained from nine interviews and ten (10) questionnaires distributed to different banking institutions. Majority of respondents (92%) agreed that effective internal controls are an essential ingredient of good corporate governance. The remaining (8%) was of a different opinion saying corporate governance does not have any relationship with effective internal controls since some banks can outsource the services of control department.

The argument the respondents in the affirmative gave was that when the firm adopts sound and effective internal controls it avoids the risks of poor board oversight and issue of directors who sit on the board just to selfishly enrich themselves.

From the study, it also emerged that 80% of the banks have internal control departments, which typically includes internal audit, compliance officer, internal control unit, transaction authorization and verification. The other ones did not have such a department and relied on subcontracting services. In seven of the financial institutions investigated the function of the control unit were identified as verifying compliance with regulators, ensuring competences and accuracy of financial statements, implementing risk management policies, reviewing related party transaction and mitigation conflict of interest and separation of duties.

The research suggests that an internal control or internal audit department is an essential component which ensures good corporate governance. Therefore the audit committee is necessary to ensure that the banks assets are protected and that good corporate issues are respected.

On the importance of the key elements of good corporate governance the findings were that all respondents suggested transparency, principle of responsibility, fairness and discipline. However, the principle of social responsibility had 85% and that of independence was mentioned by 77% of the respondents. This conclusion alludes to the assertion that good corporate governance is a function of several factors or elements.

Asked on whether the banks had internal controls which aid in mitigating challenges associated with poor corporate governance all the respondents gave answers which can be classified broadly under the headlines of general and application control. Respondents indicated that general controls included staff loans policy, vacation policy, segregation of duties, lending control and physical control. It emerged that application controls are associated with computer packages. The findings indicate that a greater proportion of banks have come to realize the importance of internal control in banks so as to ensure good corporate governance in all operations of banks.

On answering the question on how Board of Directors BOD ensures that systems of internal control continue to operate effectively and efficiently in banks the following responses were obtained:

- Risk management reviews are made
- The board sets targets in place
- The audit committee has powers to summon members to give evidence
- Directors have access to the internal and external auditors
- The board updates and reports from executives in meetings

Respondents revealed that the cause of corporate failures in Zimbabwe was due to one or more of the following factors:

- Overriding internal controls
- Fraud
- Disregard of prudential laws and regulations
- Overtrading
- Failure to have substantive risk management team
- Poor risk management practices

The results also revealed that lack of adequate safeguards and checks, insufficient segregation of duties/responsibilities and internal control deficiencies lead to poor corporate governance. Respondents also identified excessive pressure on management by senior management, few independent non executive directors and inter twined board settings as weaknesses that occur in banks in Zimbabwe. The weaknesses centre on the ineffectiveness of he boards in ensuring adequate controls to ensure good corporate governance. Results from respondents points out hat futile internal controls systems are the major cause of corporate failures in the Zimbabwean banking system.

On the necessary components of an effective internal control system, 69% of the respondents identified the control environment, control activities, information communication, risk assessment and monitoring as the necessary components of an effective internal control system. Respondents indicated that control environment was the heart of effective control. An analysis of the responses revealed that control activities should include approvals, verifications, reconciliations, and reviews of operating performance, security of assets and segregation of duties.

All the respondents concurred on the definition of internal controls by Minnesota State Auditor (2007) which defined internal controls as policies and procedures designed to protect an institution from loss or misuse of its assets and also to ensure that all transactions are properly authorized and thus guarantee or foster good corporate governance. In addition to the aforesaid the respondents also indicated that:

- Poor capacity utilization
- Liquidity Crunch
- Poor capacity utilization
- Lack of resources both human and capital
- Poor data management
- Disintegration of systems across departments
- Stringent regulatory requirements could affect effectiveness of their internal control systems and hence corporate governance in the future

Finally majority of the respondents indicated that although there were internal control systems in most banks their effectiveness was affected by poor supervision from the body of directors and the reasons for poor supervision by the body of directors ranged from multiple sitting on boards to what the respondents termed “fat cats” who set a the board for enriching themselves at he expense of monitoring performance of subordinates. This they resulted in poor corporate governance and subsequently poor performance of a bank indicating the positive correlation between effective internal controls and good corporate governance.

## 7. DISCUSSION

According to the base committee on banking supervision, focus is increasingly on the importance of internal controls to ensure good corporate governance. This heightened interest in internal controls has in part a result of significant losses incurred by several banking organizations. An analysis of the problems related to these losses indicated there could probably have been avoided had the banks maintained effective internal control systems (Financial Stability Board, 1998).

Although most banks have effective internal controls, mediocrity of boards caused by selection on the basis of “olds boy club” rather than merit has seen these boards fail for supervise chief executive officers effectively. That is why RBZ turned down the proposal to appoint Mr D Simba as an executive director at its licensing stage due to his glaring lack of pre-requisite academic and professional qualifications as well as his questionable integrity.

Other factors such as lack of accountability due to there no being separation of ownership and control such as where an executive director is the majority shareholder.

This was the case before the collapse of the Barbican Bank when Dr Mtuli Ncube was the major share holder and chief executive officer. The chief executive officer dominated in the board meetings which resulted in the body of directors being a rubber stamping board.

In the United Kingdom in 1991, the Bank of Credit and Commerce International (BCCI) collapsed due to fraud by top executives costing depositors and investors large sums of money amounting to 6 billion pounds nearly half the banks assets. In the 1970s in the US, during a period which more than 400 firms engaged in corrupt activities a commission called Tread Way or Committee of Sponsoring Organizations of the Tread Way Commission (COSO) was formed to deal specifically with financial reporting fraud. The first report was published in 1985.

Magaisa (2004) suggests that larger boards are less effective and easier for a chief executive officer to control because as boards become too large, it becomes difficult to coordinate and process problems. This was the case with the body of directors of Trust Bank who said they were unaware of the scenario were a significant amount of the banks loans were non performing and were granted without formal agreement facilities. In his research Pheysey (1993) found a negative correlation between board and profitability of a firm.

Despite RBZ (2004) critique on multiple appointments Cook, who retired as chairman and chief executive officer of Deloitte and Touché in 1999 and sits on boards of five American companies, commented that there is considerable value being on multiple boards and the experience across boards can be of real value to governance (Cook, 2002).

As with all other areas of financial institutions activities, body of directors has a critical role to play in overseeing internal control functions of the bank. The Basel Committee on Banking Supervision (1999) stipulates that the board should develop effective internal controls and adopt the necessary policies and procedures for conducing such. The internal should be approved and be reviewed periodically by the board.

In other instances top management wilfully violated internal controls as they tried to be creative and innovative in order to enhance shareholder interests of profit maximizing and in their desire to please the body of directors and be rewarded for good performance. In other occasions managers will not agree with internal controls and view them as stringent measures aimed to frustrating their endeavors.

In some case of banks such as Trust Bank of Zimbabwe, it was noted that though there were adequate internal control measures these were however principality reactive and non-proactive as these measures did not raise alarm to the board to take corrective action before the damage had been severe. Also in most instances, decoctions from such policies and procedures were not independently investigated and addressed by relevant parties. In the case of Barbican Bank the body of directors tried to “sweep the mess under the carpet” pretending that everything was well until the RBZ surveillance time exposed the precarious situation in which the bank was operating under before it went on into liquidation. According to the Reserve Bank of Zimbabwe majority of financial institutions have internal controls and if these internal controls were religiously adhered to good corporate governance would be the order of the day in these financial institutions. However a number of factors discussed below have been militating against the soundly implementation of effective internal controls.

Borerwe (2004) saw economic confusion in the last decade in Zimbabwe, insatiable appetite for riches, corruption and double standards by senior management who preach good corporate governance during the day and do not walk their talk by awarding themselves heft packages which when it comes to the attention of workers would see management as insensitive and thus they will work towards evading internal controls so that they themselves will get rich.

There should be board oversight responsible for ensuring the following in financial institutions:

- Ensuring that senior management has not only developed but they have also implemented a properly structured internal control system.
- Periodic discussion with senior management concerning the effectiveness of the internal control system is held.
- Ensuring timely reviews of evaluations of internal controls are performed by internal and external auditors.
- Periodic checks to ensure that management has promptly acted on recommendations and concerns expressed by auditors and regulatory authorities on internal control weakness.

For the internal controls to be effective they do not only need to be precise and well presented for everyone to know, but there also needs to be appointed compliance officers whose mandate is to oversee compliance issues. They should be equipped with necessary skills and expertise, the level of which should be commensurate with the complexity of the institutions activities. Cook (2002) suggested that the board and senior management of Banks are responsible for promoting high ethical and integrity standards and for establishing a culture within that organization that emphasizes and demonstrates to all levels of personnel the importance of internal controls. All personnel at a bank need to understand their role in the internal controls systems and be fully engaged in the system.

## 8. CONCLUSION

The results obtained from the research clearly support the assertion that the effectiveness internal control systems contributed to a greater extent to good corporate governance in financial institutions in Zimbabwe. Therefore effective internal controls contribute to better performance by financial institutions. The success of the system depends on positive internal control culture. Banks should have in place a comprehensive internal control management process to identify, measure, monitor and control internal control system effectiveness and compliance. There is also need for financial institutions to cultivate a culture of ethically doing business from the top management which should see this culture cascading down to he most junior worker or employee in the organization so as to promote adherence to internal controls of the organization which are essentially management tools on measuring compliance to an organizations way of doing business in a competitive environment.

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