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How internal control system affects risk management: the case of commercial banking

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Abstract

This research explores the concept of the effect of Internal Control System on Risk Management in Malaysian Commercial Banking sector via a quantitative research method through conduction of primary data collection. The finding attained in this study revealed that internal control is the basic and most important risk management practices for banks and financial institutions and risk can be controlled by monitoring and reviewing the internal activities. In conclusion, most aspects of the internal control system have been taken and implemented by commercial banks in Malaysia, but with the exception on the regular review and improvement on the system.

Key Words: Commercial, Bank, Internal Control, Risk.

Cómo afecta el sistema de control interno a la gestión de riesgos: el caso de la banca comercial

Resumen

Esta investigación explora el concepto del efecto del Sistema de Control Interno en la Gestión de Riesgos en el sector de la Banca Comercial de Malasia a través de un método de investigación cuantitativa a través de la recopilación de datos primarios. El hallazgo alcanzado en este estudio reveló que el control interno es la práctica de administración de riesgos básica y más importante para bancos e instituciones financieras, y el riesgo se puede controlar mediante el monitoreo y la revisión de las actividades internas. En conclusión, la mayoría de los aspectos del sistema de control interno han sido tomados e implementados por bancos comerciales en Malasia, pero con la excepción en la revisión y mejora periódica del sistema.

Palabras clave: Comercial, Banca, Control Interno, Riesgo.

1. INTRODUCTION

Banking industry supports the entire economic developments in a country, and therefore it is the most vulnerable industry in the entire economy. It is essential for banking management and governments to reliably identify the risks involved in the banking sector, give precautions and preventions of these risks in order to avoid negative impacts that lead to the financial crisis in the country. The corporate governance is viewed as the set of ground rules and regulations that help organizations to maintain healthy and contented operation environments, and therefore eliminate most of the risks that banks and

organizations will face. With such, it gives the researcher higher motivation to study how corporate finance will impact on the risk management practices in the Malaysian banking industry, and how well has the corporate governance eliminate risks and internal frauds in commercial banks in Malaysia. Banking industry supports the entire economic developments in a country, and therefore it is the most vulnerable industry in the entire economy. It is essential for banking management and governments to reliably identify the risks involved in the banking sector, give pre-cautions and preventions of these risks in order to avoid negative impacts that lead to the financial crisis in the country.

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institutions in the United States were bankrupted and liquidated due to the severe economic downturn happened in the previous year. The reason to the large failures and bankruptcies were due to ineffective risk management practices adopted by U.S banks, where commercial banks were concentrated on maximizing returns and profits during economic recession, granting significant amounts of loan transactions, and led to the significant losses as companies and organizations were unable to repay the loan (Dorfman, 2007; Mamahit, et.al. 2013; Amadi and Amadi, 2014; Romli and Ismail, 2014; Fung, 2015; Dabari and Saidin, 2015; Khan, et al., 2016).

2. LITERATURE REVIEW

The banking industry is one of the most sensitive industry to an economic or nation, it determines the fate and paces of the overall economic development of the country, and governments paid excessive efforts and implement strict policies in regulating the bank operations in the industry. The risk involved in the banking industry is relatively higher compared with other industries (Faisal et al., 2016; Hussain et al., 2018; Imran et al., 2018). According to Hubbord, the nature of banking operations highly relies on the income generated from business operations such a loan, mortgage, and credit card. The maturation transformation processes help banks to gather funds and invested in profitable operations and projects for seeking higher returns. Therefore, the nature of business in the banking industry determines the high level of risks involved in all banking industries around the world. The internal control system is the set of policies and the procedure helps to ensure the company's objective is

reliably achieved and obtained. According to Rezaee, the use of internal control system helps to improve the efficiencies and effectiveness of business operations, provide reliable ground for financial and corporate reporting, and ensure the compliance with relevant legal frameworks and laws. Other than these uses, the priority objective of the internal control system is to provide the identification and actions in relation to the risks and uncertainties involved in the business operations. The internal control helps to prevent the internal fraudulent and insider dealing activities in many of large organizations (Okoye, et.al. 2017; Kakanda and Salim, 2017; Chowdhury and Shil, 2017; Kabir and Aftab, 2017; Hallunovi and Berdo, 2018; Noor et al., 2018; Ramli et al., 2018).

According to NIVRA, the internal control system consists of internal control activities, policies, and procedures that occur in the daily business operations. An effective internal control system includes two best practices; preventive and detective. The preventive practices mainly focus on detecting the errors, mistakes and risks earlier in the business operations, such as occurred in a transaction, upcoming events, or project before its occurrence, and through documentation and authorization practices to make reminder to employees and management for the risk and requiring action plans taking to mitigate the risks in the business operations. The detective practice is somehow differing with preventive, the detective practice implemented after the risks being occurred in the business operation, the detective control activities identify the undesirable occurrence of the risk and taking appropriate actions to reconcile the risks to reduce the impacts and effects. According to Hubbard, the risk management is the processes of identification, analysis, and either acceptance or mitigation of uncertainty in investment decision making.

The risk management can be in different forms for managers and users, it can be a policy designed and developed to govern the business operations, or assistant tool when managers making its decisions. In the banking industry, the risks involved are relatively higher comparing with other sorts of industries and markets, and the high level of risks and uncertainties are mainly derived from the courses of business operations conducted by banks and financial institutions. Based on Arcot (2005), the majority of incomes of banks and financial institutions are derived from risky projects and investments. For instance, banks collect funds from individual deposits, and transfer these funds to support other profitable banking operations, such a loan, mortgage, and cred+-it card, investment in stock market or long-term fund trust account. Nevertheless, all these projects and operations carry a high level of risks, and banks suffer may suffer different losses (Abidin, Haseeb, & Islam, 2016).

2.1. Elements of Internal Control System

A sound and effective internal control system should include and considers the five main elements in order to fulfill its functions and benefits provided to the business and organizations. Especially for banks and financial institutions, the effectiveness of the internal control system largely relies on the five key elements discussed in the following. Control Environment. The control environment refers to the efforts and supports given by the management. In most of the organizations, the support from the management determines the efficiencies and effectiveness of the business operation, as some

managements are forced to adopt certain systems and approaches, but management showed little interest in enforcement. Therefore, the control environment is only effective if the full effort and support are given by the management. In order to deliver such support, the management and directors should communicate the objectives of the internal control system, strictly follows the policies and standards outlined by the internal control system. Risk Assessment. The risk assessment is the control that focuses on identifying and evaluating the risks involved in the business operations. The internal control system should place control to activities and operations which might exist loopholes, and hence the control procedure will help to prevent and avoid the errors and mistakes. For instance, a loan should be granted and proved only when the client limit is checked, and their financial statements are reviewed rigidly.

Monitoring and Reviewing. The management and directors should consider the effects of changing environments on the effectiveness and efficiencies of the internal control system. The management should periodically review the internal control system and compare with the changing environment to review the control activities and procedures for making relevant improvements and enhancements. To examine the internal control procedures and policies, the control activities should not be obsolete or lose. Information and Communication. The information and communication are important in the internal control system, the effective internal control system should help to store all data available and important to the company, such as the proper records of accounts. Besides, the

communication request employees and staffs to communicate issues and problems discovered in the business operations to the management, and hence control activities and actions can be taken immediately to respond to the risk. Control Activities. The control activities are basically the activities and procedures implemented help to identify and detect the uncertainties and risks involved in the banking operation. Detailed control activities should include authorization, documentation, reconciliation, security, and separation of duties.

3. METHODOLOGY

This paper mainly conducts quantitative research method through conduction of primary data collection, obtain data from the distribution of research questionnaires to the selected samples, the banking employees to understanding the risk management practices at major commercial banks. This research uses a structured survey questionnaire that consists sets of close ended questions, using five-Likert scaling to evaluate the satisfaction levels of respondents toward the subject matter. There are 120 respondents set for the population, and all respondents are obtained and collected through non-probability sampling strategy, in which it allows researchers to select respondents based on her own preferences. The research is conducted in certain locations in Selangor, Malaysia, and there were different commercial banks were selected to collect opinions and information from their employees.

4. DATA ANALYSIS

Respondents Gender

Gender	Frequency
Male	23
Female	112
Total	135

Respondents Income

Income	Frequency
Rm1,000 – 2,000	32
Rm2,000 – 3,000	72
Rm3,000 – 5,000	19
Above Rm5,000	11
Total	134

Respondents Working Experience

Years	Frequency
Less than 1 year	39
1 – 2 Years	42
3 – 5 Years	37
5 – 10 Years	13
More than 10 Years	2
Total	134

4.1. Impacts of Internal Control System Implemented in Managing Risks

The internal control system is the sets of control policies and regulations imposed in every aspect of the business operation to guide

employees to carry out their works effectively and efficiently. The purpose of the internal control system is to reduce errors and mistakes made during the business operations, but according to Jackson, the internal control system is effective in controlling and managing risks involved in the business operations. Especially in the banking industry, the effective internal control systems and policies served as the essential need to reduce risks involved in the banking operation, and it is normally viewed as the work procedure in the employee's works in commercial banks.

4.2. Descriptive Analysis

By analyzing the response obtained from respondents on internal control system implemented among Malaysian banks, there are majority of respondents who agreed that their banks with sound and effective internal control system, this shows the mean of 3.4 falls in the category of agreement, with the median of 4.0, and mode of 5.0 that indicated that most frequently chosen item is strongly agreed. Therefore it can draw conclusion that all Malaysian commercial banks with sound and effective internal control system in place to manage risks.

5. RESULTS AND DISCUSSION

Many past types of research and studies contented that the internal control system is the most effective and efficient approach to

managing risks in commercial banks around the world. Therefore, the internal control system has been used as the tool by banks to manage and control its risks. Other than this, the internal control system has been required under the corporate governance, as the key component to be considered by companies, and this should be implemented by the internal audit department of the company. Other than this, for the set of rules, policies, and regulations involved in the internal control system, the results showed that all employees agreed that they have clear rules and policies under the internal control system. For the data obtained, the mean for this item is 4.1 which fells in the category of strongly agree, and with the median of 4.0, and the mode is 5.0 that indicated the majority of respondents chose strongly agrees for this. The conclusion can be made that rules and policies are clearly understood and performed by employees in commercial banks, and therefore risks can be reliably reduced in the Malaysian banking industry. For assessing the segregation of duties, the trend showed that the overall agreement on this, with the mean of 4.0. However, the mode for this item is 5.0 which indicated that majority of respondents and employees chose strongly agreed for certain works require two employees to carry out, and this is mainly to give supervision and control on each other's actions and behaviors in the work to prevent errors and mistakes been made. For reviewing the internal control system periodically to make improvement and enhancement, the feedback and response from respondents showed the majority of employees and respondents have relevant knowledge whether the internal control system has been updated.

Apart from this, for the control activities and policies implemented in every aspect of the banking operations, the result showed that the trend of disagreement. This indicated that control policies only carried out at importation banking operations, but it is not involved in every business operation. Through the interview, a respondent provided that cleaning employees have no control policies implemented for their works, they are flexible to carry out their works, and the same situation happens in other departments as well, but it is differing to the extent on the strictness of the internal control policies been implemented. For the data obtained for the study, the mean is 2.6 that within the range of neutral and median is 3.0. However, the mode for this study is 2.0, which refers that most of candidates and response chose disagreement on this, as the management left out unimportant business operations to control and manage risks. For assessing on the communication channel, the clear and effective communication channel is the key component that forms the internal control system for a company, and therefore it is essentially important to determine how management take actions to improve the internal control system and manage the different risks effectively and efficiently. The results obtained from respondents showed the trends of an overall agreement to that the banks have a clear communication channel for employees to report issues and mistakes.

Items	Mean	Median	Mode	Standard Deviation
There is a sound and effective internal control system in the company.	3.4	4.0	5.0	1.7
There are clear set of rules in guiding the work conductions	4.1	4.0	5.0	1.6
Main works are carried out by two employees for the segregation of duties.	4.4	5.0	5.0	1.3
The company regularly reviews the current internal control system to make improvements on the control activities.	2.8	3.0	3.0	1.4
The control activities or control policies are implemented at every aspect of the banking operations.	2.6	3.0	2.0	1.4
There is clear communication channel for employees to report issues and problems relating to frauds, mistakes and errors.	3.6	4.0	4.0	1.2
Computers and lockers with password and keys that only to be held to key employees.	4.3	5.0	5.0	1.6
Computer systems are not allows random entry and changes in system structure.	4.2	4.0	4.0	1.8
Authorization such as signature is always required for transactions such as loan and credit card.	3.9	4.0	5.0	1.4
There is effective client screen procedure for loans and mortgage for clients.	4.1	4.0	5.0	1.7
The company maintains a proper record and documentations for transactions in every department	3.4	4.0	4.0	1.3
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The overall analysis of the internal control system used as the tool for risk management practices among commercial banks in Malaysia is effective and efficient. It shows that most aspects of the internal control system have been taken and implemented by commercial banks in Malaysia, but with the exception on the regularly review and improvement on the system, as most of the employees

have poor understanding whether their internal control system been regularly reviewed and improved, as it is the responsibility of banks to decide for the improvement. In the context of Malaysia, all commercial banks in Malaysia achieve the most efficient and effective internal control system in place to monitor and prevent the risk occurring. According to Ellul (2015), the role of risk management in the corporate governance showed that the main purpose of corporate governance is to make sure of the proper functioning of risk management practices being effective and efficient to ensure the best interests of shareholders.

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