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## **Coso Framework: An Internal Audit & Effectiveness Analysis of Banking Internal Control on Credit Investment Aspect**

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### **Abstract**

The role of internal audit management is very important and helpful in identifying problems. The purpose is to make the problems can be solved effectively. A company could retreat, survive or even thrive depend on how the company could overcome all the problems existed. This research aims to get a real capture of the function and position of internal auditor in a company that the performance has run effectively. This research is especially focusing to the control of investment and to determine whether the performances of the internal audit field inspection are implemented in an independent and objective way of method. The result has obtained with the following issues: Implementation of an adequate internal audit, is an evidence thru the examination stages as COSO Framework, these stages are as follows: The existences of an internal audit program, the stage of design when, where, who, and how long the inspection the implementation of the check carried out which would match the needs of the internal audit. Internal audit implementation phases by using, in the implementation stage of the internal audit include compliance, verification, and evaluation. Components of the implementation of the examination conducted by COSO method approach has been appropriate, Control Environment, Risk Activities Control, Information and Communication, and Monitoring part of the internal control system itself so as an independent deviation can be straighter forward in expressing problems arised in the company.

**Keyword:** Role of Internal Audit, Internal Control, Effectiveness, Investment Credit.

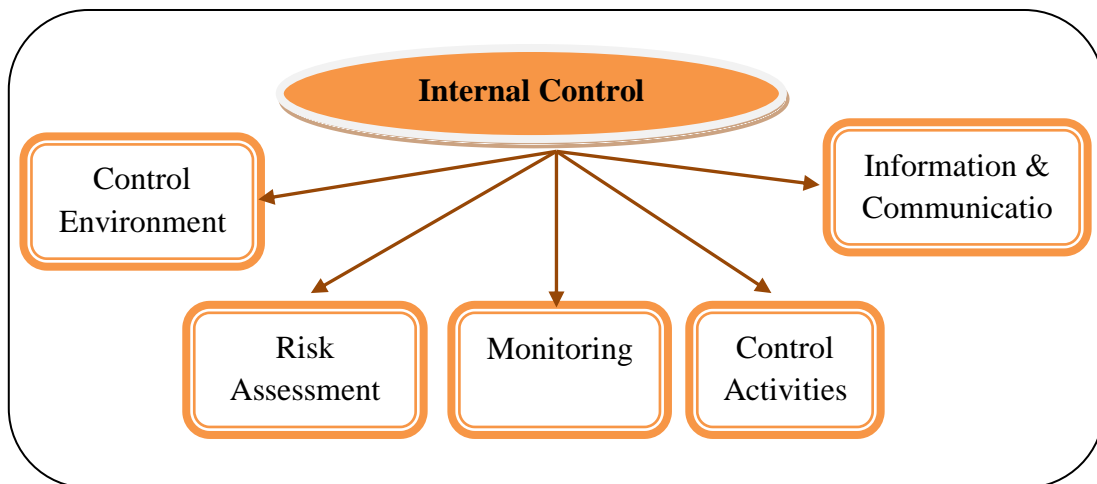
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### **I. Introduction**

Every organisation needs to put in place risk management and internal control systems in order to achieve the ultimate objectives of the organisation. An essential part of Internal Control and Risk Management is an Internal Audit. There is currently considerable interest in the topic of internal audit and its contribution to exact management of any business economic resources (Kantzos and Chondraki, 2006; Rittenberg, 2006). That, This developing role of the internal auditing is also reflected in its current definition, i.e. "Internal control is the system of internal administrative and financial checks and balances designed by management, and supported by corrective actions, to ensure that the goals and responsibilities of the organization are achieved" (Cahill, 2006). Internal control are purposed to monitor the operational of a company, keeping the asset, checking the accurateness and accounting data reliability, driving the efficiency and its management compliance role. COSO's Internal Control –Integrated framework

enables organization to effectively and efficiently develop system of internal control that adopt to changing business and operating environments, mitigate risk to acceptable levels, and support sound decision making and governance of the organization (COSO, 2013)

According to Valery (2011) COSO framework is a process, which affected by a commissioner boards, management, and other personnel of an entity, which is designed to give a proper assurance/ collateral related with the objective achievement. COSO framework consist of 5 components which is controlling environment, risk assessment, controlling activity, information and communication and monitoring. The description of those 5 components of Internal Control base on COSO framework are also describe on figure.1 (AUS 402.43 and COSO, 2009)



**Figure.1 COSO Framework**

A summary of frameworks commonly used by business organizations to establish and evaluate internal controls is provided together with an example of a recently implemented Control Self Assessment (CSA) project (Dickins, O'hara &Reisch, 2010, p1). Internal Control has taken an important role in a company. Mulyadi (2008) said that Internal Control is a process affected by Board of commissaries, management and other personals of an entity that designed to obtain a proper belief of a company objective achievement, in term of financial reliability, its suitability with the constitution and rules, its effectiveness and its efficiency. Tugiman (2006) also said that Audit Internal is an independent assessment function in an organization which purpose is to testing and evaluating the activities of an organization.

Audit internal to credit investment is a part of internal control which applied by PT. Bank BTN Cabang Surabaya. The problem found during the audit internal process on a credit division such as lack of personal in charge on audit field, error on assessment and error on document analysis due the credit proposal. Those problems are high risk included, that internal auditor could not able to perform adequate assessment and analysis towards the over all process and activities of banking credit. Therefore, the management will have difficulties to obtain the useful and accurate reporting, in order to assess the effectiveness of a

company, difficulties in creating policies and decision making to take the responsibilities of a company.

Therefore, the research introduce to PT. Bank BTN Surabaya Branch to analyze the Audit Internal Role using COSO Framework in supporting the effectiveness of Internal Control for credit investment banking sector. This framework involves the critical identification of risks associated with the operations of banks, and the assessment of management oversight functions of risks, in order to ascertain the effectiveness of these oversight functions to mitigate the impact of risks. In the process, banks would be compelled to focus more on their risk management systems to facilitate their improvement and thereby improve the overall risk management functions within their institutions (Amponsah & Williams, 2012). The main objective of internal control system for banks is to continuously track the compatibility of all banking practices and operations with international auditing standards, banking laws, regulations and rules to solve problems that may arise where necessary (Hayali et al. 2012 .p.2). In addition to this, with an effective internal control system, erroneous, fraudulent transactions and irregularities are less likely to happen in banking (Ozten et al. 2012, p. 133).

## **II. Theoritical Framework**

### **Audit and Audit Internal**

In order to understand the audit, Arens & Loebbecke (2010:4) has described the definition as follows:

*“Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent, independent person”.*

Above statement has explained that the aspect of audit consists of:

1. Auditing performing actions conclusions (*to accumulate actions*), to evaluate, to *determine*, and reporting (to report).
2. In order to perform the audit, it should have available information in verified forms and standards (or criteria) which can be used by the auditor to evaluate its information.
3. In order to complete the objective of audit, auditor should gather the evidences in adequate of quality and numbers (volume). Evidences refer to the information which is used by the auditor to determine whether the audited information is suitable with criteria.

According to Tugiman (2006:11) the definition of Audit internal are as follow:

*“Audit Internal is an independent assessment function in an organization which purpose is to testing and evaluating the activities of an organization”.*

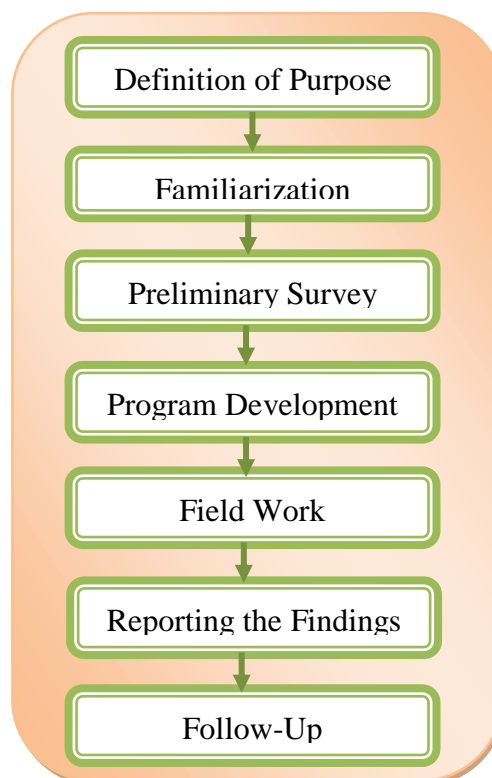
Internal audit is a dynamic profession involved in helping organisations achieve their objectives. It is concerned with evaluating and improving the effectiveness of risk management, control and governance processes in an organization (IIA, 2015). Furthermore, audit internal according to Rahayu dan Suhayati (2010:14) is *“an employee of an organization of a company that works to do audit process according to the management directions of a company, in order to help the management organization understanding the compliance of the operational executors of a company towards the company’s policies and procedures.”*

### **Audit internal Functions**

Hery (2010:93) has describe the functions of Audit Internal that “Auditor internal has a function to check and to assess the quality of controlling on financial accounting and other operational. It checks the relationship between the operational executors with the policies, plans and procedures assigned. It also audits the company’s asset used and its responsibility to keep it from its loss. Audit internal also check the accuracy of its accounting records and others provided by company. Audit internal also make the assessment of the staff/ leaders of operational related with his/ her responsibility has assigned. Hence, An important responsibility of the internal audit function is to monitor the performance of an entity's controls. When obtaining an understanding of internal control, the auditor should obtain an understanding of the internal audit function sufficient to identify those internal audit activities that are relevant to planning the audit. The extent of the procedures necessary to obtain this understanding may vary, depending on the nature of its activities.

### **Phases of Internal Auditing**

Although operational auditing (Internal Auditing) are changes from sector to sector and from firm to firm, its operational phases are similar. Internal auditing consists of three phases: a) planning, b) collecting evidence and evaluation, c) reporting and follow-up. Although there are substantial differences between operational auditing and financial auditing, they are similar in some ways. The phases of internal auditing are shown in Figure 2. (Whittington and Pany, 2013).



**Figure. 2 Phase of internal auditing**

## Internal Control and COSO Framework

Internal control is broadly defined as a process, affected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

1. Effectiveness and efficiency of operations.
2. Reliability of financial reporting.
3. Compliance with applicable laws and regulations.

(www.coso.org)

According to Afrianiswara (2004:40), Bank of Indonesia rules on SEBI No.5/22/DPNP date of 29<sup>th</sup> September 2003 which is “Pedoman Pengendalian Intern bagi Bank Umum (Internal Control Guidance for Commercial Bank)” it has kept the Internal Control with the followings conditions:

1. Compliance with the applicable law of constitutions and regulations (Compliance objective).
2. The availability of financial information and management in a correct, complete and on time (real time) conditions. (Information objective).
3. The efficiency and effectiveness of the operational banking (Operational Objective).
4. Increasing effectiveness of risk culture towards the organization (Risk Culture objective).

According to Arens dan Loebbecke (2010:261) Internal Control COSO framework consist of 5 components which is controlling environment, risk assessment, controlling activity, information and communication and monitoring

These also suitable with Deloitte, Ltd (2014) where the internal components and associated principles of COSO Framework said that the COSO Framework addresses some of the key changes in the business Environment since the original framework was published in 1992. The updated framework includes 17 principles to describe the (five) components of internal control (figure 3).

Control environment	Risk assessment	Control activities	Information and communication	Monitoring activities
<ol style="list-style-type: none"> <li>1. Demonstrates commitment to integrity and ethical values</li> <li>2. Exercises oversight responsibilities</li> <li>3. Establishes structure, authority, and responsibility</li> <li>4. Demonstrates commitment to competence</li> <li>5. Enforces accountability</li> </ol>	<ol style="list-style-type: none"> <li>6. Specifies suitable objectives</li> <li>7. Identifies and analyzes risk</li> <li>8. Assesses fraud risk</li> <li>9. Identifies and analyzes significant change</li> </ol>	<ol style="list-style-type: none"> <li>10. Selects and develops control activities</li> <li>11. Selects and develops general controls over technology</li> <li>12. Deploys through policies and procedures</li> </ol>	<ol style="list-style-type: none"> <li>13. Uses relevant, quality information</li> <li>14. Communicates internally</li> <li>15. Communicates externally</li> </ol>	<ol style="list-style-type: none"> <li>16. Conducts ongoing and/or separate evaluations</li> <li>17. Evaluates and communicates deficiencies</li> </ol>
<p><b>Per COSO, an effective system of internal control requires:</b></p> <ul style="list-style-type: none"> <li>• Each of the 17 principles to be present and functioning</li> <li>• The five components of internal control to be present and functioning</li> <li>• The five components to be operating together in an integrated manner</li> </ul>				

**Figure. 3 The 5 (Five) Components and its 17 Principles of COSO Frameworks**

### **Internal Control Limitations**

Mulyadi (2008:173) said that Internal control structure of each entity has inherent limitation. Those inherent limitation are as follows:

1. Errors during consideration process
2. Disturbance
3. Collusion
4. Management Ignorance
5. Cost vs Benefit

### **The Application of Internal Control in Banking Industries**

Some of application of internal control on banking industries, Mulyono (2007:25) said it consists of :

1. *Division of Duties* is a part of separation of duties between administrative functions, operational and storage of credit activities
2. *Dual Control* is double checking work towards the activities of credit
3. *Joint Custody*
4. *Mandatory Vacation*
5. *Number Control*
6. *Outside Activities of Bank Personnel*
7. *Rotation of Duty Assignment*

Internal control activities have been gaining a much more important presence in banking practices as the time passes. Additionally, it is also worth mentioning that modern internal control system approach has started to gain importance instead of traditional approaches and methods. It is also clear that the banks have been trying to improve and put forward distance and central internal control practices through reducing centralized audit and control functions (Hayali et al, 2012)

### **Successful indicator of the implementation of internal control system in banking industries**

According to Tawaf (2010:49) the indicator of successful execution of the implementation controlling are as follows:

1. The decrease number of customer complaints
2. The decrease number of corruption and leakage credits
3. The decrease of bottleneck activities
4. The decrease of special audit frequency and its special case
5. The increase of skilled bank staff on work execution
6. The increase of bank services efficiency
7. The increase of work discipline of staff and also its increase on passion, achievement and job productivity.
8. At the end, overall is the increase of bank's health.

### **Effectiveness**

Arens and Loebbecke (2010:789) said that effectiveness refers to the accomplishment of objectives, whereas efficiency refers to the resource used to achieve those objectives. An example of effectiveness is the production of parts without defects. Efficiency concerns whether those parts are produced at minimum cost.

### Indicator Measurement of Effectiveness

Indicator measurement of effectiveness (Afrianiswara, 2010;p59) refer to table 1.

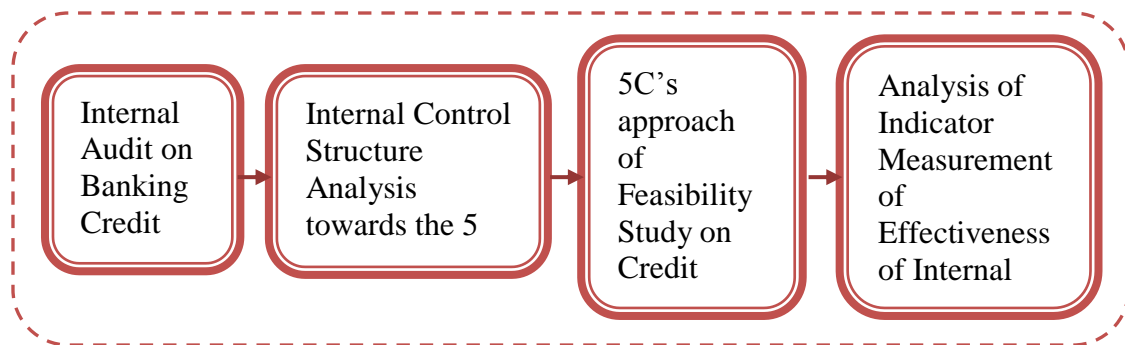
**Table 1. Indicator Measurement of Effectiveness**

Indicator	Sub indicator
1. Verification	a. Support the validity of information b. Checking a qualified and reliable documents, notes, and reports
2. Compliance	a. Doing the assessment towards the procedures and policies compliance. b. Credit allocation inspections
3. Evaluation	a. Procedures execution assessment b. Current Credit allocation assessment c. Provide an input of suggestions to a decision maker

Source: Afrianiswara (2010;p59)

### III. Research Methods

#### Model Analysis of Qualitative Research Design

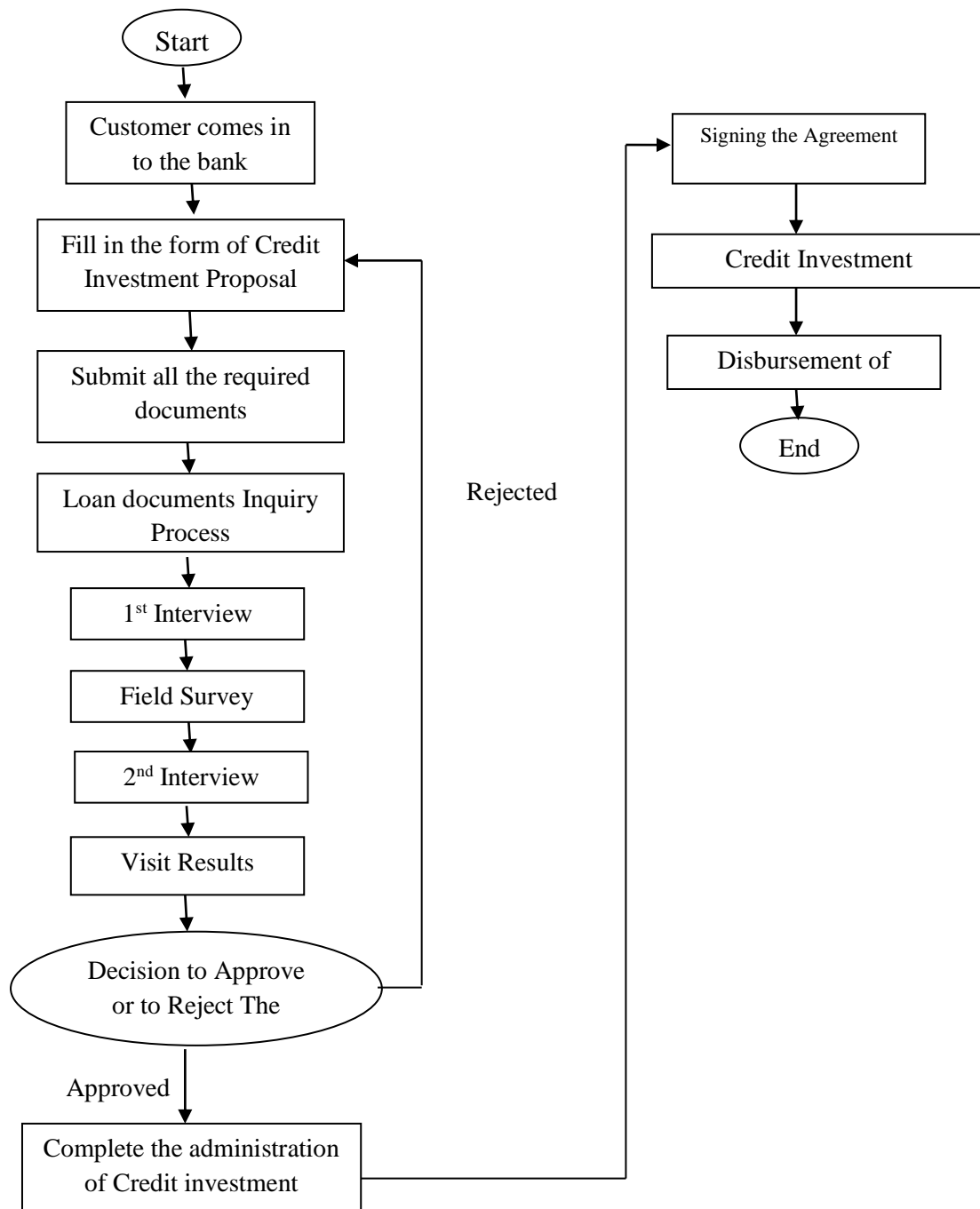


### IV. Results & Discussion

#### The produres of PT. Bank BTN Cabang Surabaya Credit Investment Allocation and its Security & Surveillance System

The procedures of Credit Investment Allocation on PT. Bank BTN Cabang Surabaya as figure 5. It applied Prudent Principles toward the Credit Investment procedures allocation.

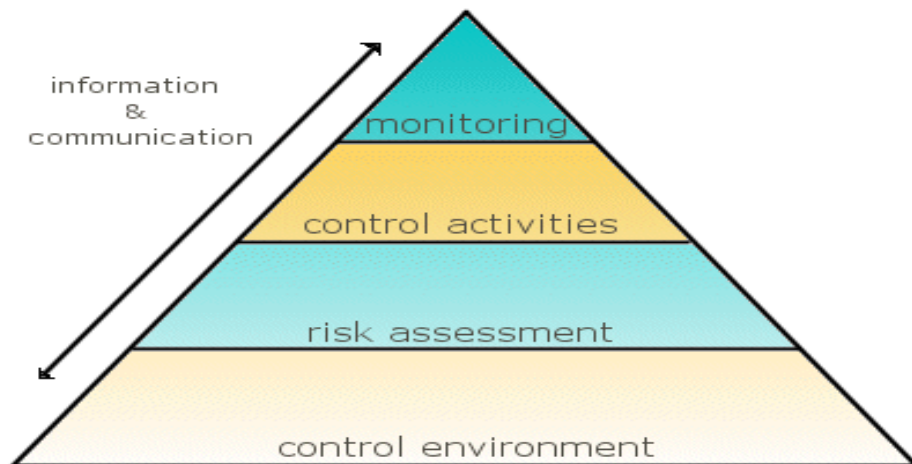




**Figure.5 Credit Investment Allocation Procesures on PT. Bank BTN Surabaya**

## **COSO Framework Internal Control Analysis towards the Credit Investment Allocation Process on PT. Bank BTN Surabaya Branch**

COSO Framework has 5 components of Internal Control as figure 6. Those 5 (five) components are connected each other. (Deloitte, 2014)



**Figure 6. Internal Control Coso Framework**

### **1. Controlling Environment Component**

In the business world, the Control Environment “may be the most critical” element of control system (Lightle et al., 2007).

The analysis of this component is consisting of as followings indicators:

1. Integrity & Ethics Value Aspect
2. Competencies Commitment
3. Board of Directors and Audit Committee
4. Phylosophy & management operational style
5. Organization Structure
6. Job Description and Responsibilities
7. Policies and Human Resources Practices

Control environment refers to all factors which are effective in determining, increasing or decreasing the effectiveness of policies, procedures, and methods specific to a process. Control environment stands out with the basic understanding adopted by senior management of the corporation to control the organization, its attitude toward problems and approach to solving problems and their perspective of the importance of moral values. Strictly speaking, control environment can be perceived as a consciousness of the senior management of a corporation to control the organization and employees (Hayali, et al., 2012).

To implement an ethics initiative based on the COSO Model, the authors suggest starting at the base of the “pyramid” and begin with efforts to enhance the institution’s control environment or “ethical culture.” (Scheider, K. & Becker, LL., 2011)

The Analysis of Controlling Environment Components base on 7 (seven) indicators of COSO Frameworks are described on Table 2.

**Table. 2 COSO Framework Controlling Environment Component Analysis on PT. Bank BTN Surabaya Branch**

<b>Indicators</b>	<b>COSO Framework Controlling Environment Indicators Description Analysis on PT. Bank BTN Surabaya Branch</b>
1. Integrity & Ethics Value Aspect	<p>a. a Branch has code of ethics and Working guidelines on Manual Book of Credit Product. Therefore, it may apply the integrity value &amp; ethic value to employee. Thus; it may give Excellent Services to customer..</p> <p>b. Code of ethics and Working guidelines are communicated to all employees. Any possible fraud (act dishonestly, violation against the law, unethical manner) may apply with sanctions whether in oral or written warning. Written warning has the following conditions:</p> <ol style="list-style-type: none"> <li>1) First written warning are applied without any salary deduction</li> <li>2) Hence, second written warning the salary will deduct at 2.5% of one month salary amount, for 3 month period since warning applied.</li> </ol>
2. Competencies Commitment	A branch has a clear specification related with job description, education background, and skill of employee with specified new position. And, only competence employee runs the system and operational procedures.
3. Board of Directors & Audit Committee	<p>a. Committee audit members PT. Bank BTN Surabaya Branch are from Main office which called as Regional Internal Control (RIC), the job is to gather the informations related implementation of credit execution process, including investment credit, the quality of credit process and its compliance toward the credits regularly and on time.</p> <p>b. Board of Directors supervise the process of investment credit allocation and contribute the solution of heavier problems</p>
4. Phylosophy & Management Operational Style	Operational management style is decentralization, whereas managers and staff have a discretion to develop his/ her own creativity and to learn decision making
5. Organization structure	Organization structure (appendix 1) shows the connection between authorities and its responsibilities
6. Job Description & Responsibilities	<p>a. A Branch provides written authorizations and responsibilities documents to each employee according to the positions. Employee should understand the contents and sign it.</p> <p>b. The credit analyst needs to increase, that, it only has 1 staff of credit analyst for in a branch. Hence, the credit analyst should adjust with the Credit Investment proposal submitted.</p>
7. Policies & Human Resources Practices	New employee has to learn and understand the manual book of credit investment, before fieldwork. It Start to apply 'learning by doing' principles. It will cause the new employee develop the knowledge actively and make a quick response to adapt with the new environment.

## 2. Risk Assesment Component

Risk Assesment COSO aspect on PT. Bank BTS are able to implement the risk assessment models, as figure

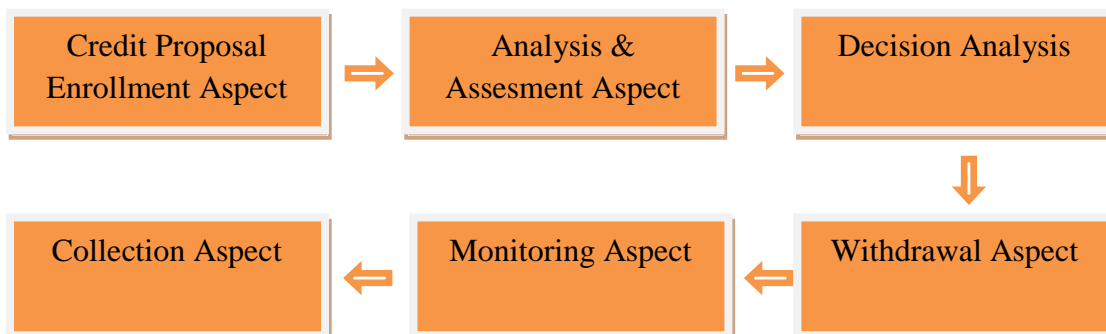


Figure7. Risk Assesment COSO Component Model

## 3. Controlling Procedure

Controlling Procedures are purposed to achieve the objective of the Audit on Credit Investment allocation. The details are shows in table 3.

**Table 3. Mapping Results: The Objective and Audit Procedures on Credit Investment Allocation**

No	Audit Objective	Audit Procedures
1	Bank will able tomonitor the debtor thru a regular financial report	Checking the updated files of Financial Report.
2.	Review and evaluate any possible fraud on Cash Flow	Cash Flow Report on Progress, Checking Credit file for any actions of credit failure
3.	Issuing Letter of repriment to any fraud occured	Checking the credit file of any letter of repriment responses is available
4.	The availability of Monitoring Evidence	Checing the monitoring forms periodically

## 4. Monitoring

### 1) Evaluation sub aspect

PT. Bank BTN, Tbk has implementing a method of evaluation by using 2 approached which are *ongoing evaluation* and *separate evaluation*. *Separate evaluation* is implementing routine and periodically. Meanwhile the *Ongoing evaluation is implemented only in systemic situation. It means that the data on the evaluation aspect are based on certain criteria/ standards, those are purposed that the staff will not make any error in data entry processing.*

### 2). Communicating the evaluation report aspect

Evaluation on the credit department and evaluated by board of directors. The evaluation process on the internal audit are as follows:

- a. Audit is reported unit, this are purposed hat the indications detected are occurred.

- b. Unit has an obligation to response the audit report. This is purpose to show the process whether the evidence is available and in the progress of accomplishment.
- c. Internal audit department will make the assistance to give solutions regarding the problems founded.
- d. Unit must report the status of accomplishment.

Those result also suitable with the research performed by (Karagiorgos, T., Drogalas, G., and Dimou, A. (2010:7) said that the vast majority of the respondents claim that the administration recognizes the importance of internal auditors work. Further, it is asked (Question 22), in what extent the internal control system is in accordance with the standards proposed by the Audit Committee, again the 80 percent of the respondents believe that internal auditors follow the Audit Committee's standards.

## **5. Information and Communication Aspect**

According to COSO *information and communication* can be explained with the following description:

- a. Information aspect
  - 1) The implementation of the feasibility of the debtor, PT. Bank BTN Surabaya Branch has trying to improve the *bank to bank information* by considering the ID Bank Indonesia of the related its potentials credit customer.
  - 2) PT. Bank BTN Surabaya Branch get the information of the potential debtor whether from the internal or external resources.
- b. Communication aspect

Communication has been implemented thru briefing and sharing Komunikasi pada Bank BTN Cabang Surabaya dilakukan melalui *briefing* dan *sharing*.

## **The evaluation of the Assesment on Procedures Feasibility toward the Credit Investment on PT. Bank BTN Surabaya**

The implementation of the credit allocations must follow the assessment credit standard./ criteria by using the 's. Below is the description evaluation::

- 1. *Character* aspect, the assessment are biography the debitur candidates, it also include the reputation of the debtor candidates on his/ her business environment.
- 2. *Capacity* aspect, the assessment are include the experience of debtor candidates ion his/ her business, and also human resources.
- 3. *Capital* aspect, the assessment of this aspect are related with the resources of its capital from its financial reporting.
- 4. *Conditions aspect*, the assessment is financial conditions thru the financial reporting including Balancesheet statement, income statement for the last 3 years covered
- 5. *Collateral* aspect, the assessment is include the collateral from debtor candidates as guarantee for his/ her credit proposal. Some criteria related with the collaterals are as follows:
  - a. Collateral must have greater value compare with credit amount.

- b. Collateral must have long term economic value compare with the credit term
- c. Collateral must not fragile..
- d. Collateral can be traded easily on the cheapest cost.
- e. Collateral insurable

## V. Conclusion

The implementation of audit internal on PT Bank BTN, Tbk Surabaya Branch has performed the audit internal functions which are including *compliance*, *verification*, and *evaluation*. As mentioned, in this study the effectiveness of internal auditing is assessed via the five criteria that are provided by COSO report (COSO, 2009; Roth and Espersen, 2002; Bowrin, 2004). Hence, for the estimation of each characteristic are used data that comes from 5C's indicators.

### 1. Compliance

This audit perspective is to determine and monitor the compliance of the staff related operational activities, the activities organization and management members according with the policies and procedures. The activities are include:

- a. Assesment the policies and procedures of the company.
- b. The implementation of the policies and investment credit procedures.
- c. Study the recording system and credit assessment according to the 5C's.

### 2. Verification

Auditor makes the assessment the fairness of the staff and the accountability of the evidences, documents, records and investment credit report. Those activities are including as follows:

- a. Checking that all the notes and documents have been recorded with its classifications.
- b. Checking the completeness of the authorization and the validity of the documents which related with credit investment.
- c. Checking the financial report created by the candidates debtor.

### 3. Evaluation

Evaluation of the audit internal has implement the on going research and also monitoring that the internal control are conducted properly. It's according to the system, procedures and policies. The activities are including as follows:

- a. Implement the analysis and evaluation toward the data of credit investment activities.
- b. Identify the weakness and perform the correction actions.
- c. Report to director of the company.
- d. Provide the suggestions and recommendations.

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