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## The Control Environment on Expenditure Cycle: The Case of a Non-Formal Education Institution in Indonesia

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### Abstract

The control environment is the foundation of an internal control system. The control environment must be sturdy in order to support other internal control components to form a good control atmosphere. The control environment is a form of inculcation of culture, ethics, structure, and responsibility in an entity both business and non-business entities. This paper aims to analyse and give suggestion on control environment expenditure cycle of a non-formal education institution in Indonesia. The internal control is described by Committee of Sponsoring Organizations of the Treadway Commission (COSO). This paper is conducted using qualitative method where a case study approach is applied. Data is collected from interview and document analysis. The analysis of control environment concludes that a leveling authorisation policy on payment process is insufficient, several employees are not aware of the existence and the function of operational standards and there is no regular training for accounting team. From the findings we recommend several suggestions, first, there must be an adequate authorisation policy. Second, there must be regular outreach to every existing operational procedure. Third, there must be an adequate employee competency training policy.

**Keywords:** Control environment; COSO; expenditure cycle; internal control system; non-formal education institution.

### 1. Introduction

Internal control systems have become popular since the Enron scandal happened in 2001 (Baker, Cohanier, & Leo, 2017). Enron was an energy producer company that doing its scandal by inflating its revenue (Haswell & Evans, 2018). The scandal was caused by its directors and it indicated the weakness of company's control environment (Haswell & Evans, 2018). Therefore, the government paid attention to the effect of that scandal developing regulation about the needs of internal control system for listed companies in the stocks exchange that was called the Sarbanes-Oxley Act 404 (Baker et al., 2017). This regulation requires listed companies in the stock exchange to strengthen their own internal control over financial reporting.

Financial scandal also occurred in a French Bank in, Société Générale, 2008 because the management failed to detect the fraud (Baker et al., 2017). The fraud was committed by Kerviel, the bank's employee, due to insider trading (Baker et al., 2017). Kerviel changed the bank's trading information system to deceive the risk manager of the bank, so he could easily conduct insider trading (Baker et al., 2017). Responding to the case of Kerviel, the government also paid

more attention to internal control systems, especially in banking industries to prevent financial scandal (Baker et al., 2017).

In Indonesia, internal control systems have also become required of companies in running their business. The need for internal control is manifested into a regulation in local government that is called government regulation number 24 Year 2008 (Yurniwati & Rizaldi, 2015). Local government applies the government regulation number 60 Year 2008 based on the Committee of Sponsoring Organisations (COSO) internal control framework (Yurniwati & Rizaldi, 2015). The COSO internal control framework can be implemented, not only for government business practices but also outside government business practices (Moeller, 2013).

Meeting their objectives is the goal of any type of company or organisation (Rosman, Shafie, Sanusi, Johari, & Omar, 2016). However, in the process of meeting their objective, companies often face several risks (Romney & Steinbart, 2015). Risk defined as the events that may possibly occur to companies and harm the company's objectives (COSO, 2013). The risk is divided into three categories according to their objectives (COSO, 2013): the risk that can harm the operational objectives, financial reporting objectives and the compliance objectives.

Consequently, companies need effective internal control to manage risks (Lenard, Petruska, Alam, & Yu, 2016); (Länsiluoto, Jokipii, & Eklund, 2016). An effective internal control will help a company to increase their financial reporting quality (Romney & Steinbart, 2015). According to the explanation above, this research has been conducted to analyse and improve internal control systems for the research's objective of using a COSO internal control framework. This research is hence focused on analysing aspects of the control environment.

The object of this research is a non-formal education institution in Indonesia. The reason for choosing this research's object is because of its unique business nature. Its unique business nature is usually reflected by the structure of its operational office that contains a head office and branch offices. The company forms the branch office in the expectation of strengthening its financial performance (Harimaya & Kondo, 2016). The branch offices are legally part of their home or head office (Liang, Ching, & Chan, 2013). In this form of business, the head office is required to monitor its branch offices (Liang et al., 2013).

The monitoring process from the head office to its branch offices can use the internal auditor evaluation (Maguire, 2014). The internal auditors evaluate the company by comparing their actual operations with their internal control procedures then documenting them in the internal auditor's report (Botez, 2012).

This research begins by reviewing the internal auditor's report dated November 2014 to September 2016 to find the problem of the research object. The report shows some findings in the expenditure cycle of the research object. The expenditure cycle begins with purchasing product or service to payment process (Romney & Steinbart, 2015). The findings show some expenditures that are not supported with sufficient evidence, such as the goods receipt and original invoices. There are also some expenditures that are not authorised by the person responsible and have a different balance from the supporting documents. Another finding indicates that the expenditures are not recorded on the right account. The excess of text books purchased by the research object has also become one of several findings from internal auditors.

From the internal auditor findings, there are some risks faced by the research object. For example, the expenditures with no supporting evidence bears the risk of fictitious purchase or the purchase of unreceived goods (Romney & Steinbart, 2015). Fictitious purchase or purchase of unreceived goods can harm the operational objective of the company (COSO, 2013; Romney & Steinbart, 2015).

It is important to conduct the research according to two research questions. First, how the analysis of the existing internal control system works in the research object. Second, how we should analyse the proposed improvement of internal control system in the research object.

## 2. Literature Review

A control environment is an entity culture that will influence how entities are defined and used as a strategy, a structure of business activities and how entities identify, assess and respond to the risks of existing entities (Romney & Steinbart, 2015). According to Stringer & Carey in Rae, Sands, & Subramaniam, (2017), entity culture is defined as an awareness of the organisation's ethical values and integrity in developing the employee accountability culture that is reflected in the scope of their monitoring procedures. Therefore, a control environment sets the tone from the top of a whole internal control system because it deals with a company's culture and ethic (Maguire, 2014). Thus, a control environment helps entities strengthen other internal control components (Rae et al., 2017).

Previous research has showed that conducive control environment can contribute to the successful implementation of a whole internal control system in local government practices (Yurniwati & Rizaldi, 2015). A conducive control environment is proved by the leadership factor of the leader and transparent and proper apparatus rotations policies (Yurniwati & Rizaldi, 2015). A control environment also influences the risk management process because strong leadership will influence the culture of the company in managing their risks (Romney & Steinbart, 2015). In contrast, a control environment has no significant influence on the effectiveness of their risk management process (Bruwer & Siwangaza, 2016). This finding may be a result of the respondent's dishonesty in answering the survey, thus leading to no significant influence of the control environment on the risk management process (Bruwer & Siwangaza, 2016).

Previous research has also shown that the supportive control environment can affect the effectiveness of internal audits (Barišić & Tušek, 2016). The control environment is considered as the most important internal control component in the administrative process that affects the company's performance (Al Shobaki, Abu Naser, & Ammar, 2017). The other finding also shows that there is a positive significant relation between the control environment and the company's financial performance in the Nairobi Securities Exchange (Kinyua, Gakure, Gekara, & Orwa, 2015).

Noland & Metrejean, (2013) state that fraud in the Blue Grass Airport shows the function of the control environment and the control procedures needed for the company. Fraud in the Blue Grass Airport occurs because of its lack of integrity and ethical value Noland & Metrejean, (2013). When the control environment does not produce a positive impact on the company, then the four other COSO internal control component may be broken Noland & Metrejean, (2013). In

Blue Grass Airport's case, the board of director failed to implement their oversight function, shown by the absence of the important control in their expenditure cycle.

From the previous research explained above, the control environment is the basis of the reinforcement of the other four component of COSO internal control framework (Maguire, 2014). It is very important for the company to build or strengthen its control environment (Maguire, 2014). COSO (2013) establishes five principles in defining the company's control environment component. The five principles of the control environment component are commitment and integrity, oversight of the development and performance of internal controls, organisational structures and welfare, commitment to human resource development, and accountability for internal control.

### 3. Methodology

The research object is a non-formal education institution called Unit A. Institution which is a legal entity consisting of wealth separated and designated to achieve certain goals in the social, religion and humanitarian fields with no members (Indonesia, 2001). Unit A is one of six business units owned by its parent institution. We chose Unit A as our research object because Unit A is the oldest and largest unit compare with the five others business units. Unit A provides language teaching services. Thus far, Unit A operates its teaching services in 20 branches and 50 branches of cooperation spread across Indonesia. Unit The headquarter is located in Jakarta, Indonesia.

The type of research used in this paper is qualitative research with a case study approach. The qualitative research approach is used to gain better understanding of the research's problem (Shabri, Saad, & Bakar, 2016). Case study is a method that fits with qualitative research objectives (Starman, 2013). Unit analysis is the unit under study than may be a person, group, division, company, etcetera (Pacho, 2015). The unit analysis of this study is the accounting and finance department, the procurement department, the internal audit department, the human resource department and the board of directors.

The types of data used in this research include:

#### a. Primary Data

This research obtains primary data through direct interviews and observation with the unit analysis. Respondents from the interview were the deputy finance director, the accounting and finance manager, the procurement manager, the human resource manager, the internal auditors and the accounting & finance and procurement staffs.

#### b. Secondary Data

The research obtained secondary data from documents produced by Unit A. The data used here was comprised of the internal auditors report, the company policy and the operational standard of accounting, company policy and operational standard of procurement, organisational structure, the job list & responsibility of procurement's manager, the matrix approval for payment transaction, the company's strategic plan, the budget report of the procurement department, a bundle of cash expenditure transactions in January, 2017 and the document of core values.

The process of the data analysis consist of:

- Step 1: This research analyses the existing internal control of Unit A with the control environment principles.
- Step 2: This research analyses the finding from step 1. The findings define a condition of the existing internal control of Unit A that is not in line with the control environment principles. We then analyse the proposed internal control system based on a previous study to place the findings in context.

#### 4. Discussion

The findings and discussion below is divided into two parts in line with the two research questions. The analysis uses the COSO control environment principles.

##### **Analysis between Existing Internal Control System with the Control Environment Principles**

To begin with, this research will conduct analysis comparing existing internal control condition with control environment principles.

##### **1) Commitment and integrity**

To demonstrate commitment and integrity, the parent institution sets the tone of the top by establishing its vision and mission statements. From our interview with the board of director, this vision and mission statement functions as a first step in shaping the company's culture and behavior. Previous research into the public sector shows that directors who provide a clear vision and mission can make their employees more motivated to help the company in achieving its goal (Aziz, Rahman, Alam, & Said, 2015). Other previous research into the university's internal control shows that vision and mission statement are the basic formula for organisations to achieve its goals.

To demonstrate these values of commitment and integrity, the parent institution interprets commitment and integrity by establishing its own ethical core value as its basic standard of conduct. Information from interviews with the board of directors reveals that this core value functions as a behavioural standard for all employees. The previous study in local government shows that integrity and ethical value are proved to be components creating a conducive control environment that affects the whole internal control system (Yurniwati & Rizaldi, 2015). Leaders who uphold ethical values make their employees responsible for their work and create accountability for the organisation (Aziz et al., 2015). In the other study, it was found that strong ethical value help organisations to attract employees that support company goals (Al Shobaki et al., 2017).

The parent institution also interprets commitment and integrity by evaluating adherence; in this case, the expenditure cycle is evaluated. The parent institution establishes the procedure for procurement and cash payment transactions. The parent institution also makes sure that adherence to this procedure is evaluated by an independent party and so conducted by an internal auditor. The importance of internal audit monitoring is also shown in previous research which states that most entities need internal auditors to help them in achieving efficiency or operational objectives (Petraşcu & Tieanu, 2014).

Internal auditors help entities to achieve efficiency by monitoring risks, preventing fraud and detecting fraud (Petraşcu & Tieanu, 2014). The internal auditor role should also be firm about the entities' efficiency in achieving company goals (Abuazza, Mihret, James, & Best, 2015). In contrast, research into state universities shows that the internal auditor role does not have an impact

onorganisation's accountability (Sari, Ghozali, & Achmad, 2017). This indicates that organisations use the internal auditor monitoring only for symbolic compliance (Sari et al., 2017).

### 2) Oversight of the development and performance of internal control

To demonstrate second principles, the parent institution establishes the supervisory board for monitoring its business units internal control system. In the expenditure cycle, the supervisory board is more focused on monitoring procurement of text books because text books are the main assets that contribute income to Unit A. Commonly, the supervisory body is created to advise and monitor the board of directors (Judge & Talaulicar, 2017).

In China, the supervisory board monitor the company's operation, while the board of directors perform day-to-day operation (Ran, Fang, Luo, & Chan, 2015). Information from interviews with the board of directors and supervisory board shows experience in handling organisations and understanding about Unit A's operation. In addition, research into the banking industries states that the supervisory board must possess adequate experience and competence to monitor and direct the organisation (Kramaric & Pervan, 2016).

The supervisory board is helped by internal auditors in monitoring and evaluating the internal control system. Internal auditors not only monitor the company but also improve the effectiveness and risk management process (Abuazza et al., 2015). Internal audits also help the company to prevent possible fraud (Petraşcu & Tleanu, 2014). Based on our interview and document analysis, the internal auditor is usually engaged with auditing the Unit A business process related to operational and financial activities, including procurement and payment process.

The internal auditor chooses the audit object randomly, not based on risk. Information from our interview states that internal auditors have not selected objects based on risk because they have knowledge limitations for doing it. Previous research in Ghana states that there has been a shifting in the focus of internal audit from the process-based audit to the risk-based internal audit (Ayagre, 2014). The risk-based internal audit considers the company's strategy and risks in forming their audit plan. However, in applying a risk-based internal audit, the company should consider the technological elements that can best support that internal audit method (Terer & Ngahu, 2017).

### 3) Organisational structures and welfare

To demonstrate the third principle, the parent institution establishes the overall organisational structure for all business units. This organisational structure helps Unit A to clarify the responsibilities, tasks, relationships and reporting lines. Organisational structure is created as a structural approach to figure out the nature of organisation (Ibrahim, Diibuzie, & Abubakari, 2017). Previous research states that, in a small business, the control environment is supported by the hierarchical type of organisational structure allocating the company's human resource (Piskunov, Manyayeva, Tatarovskaya, & Bychkova, 2016).

The procurement and the accounting & finance department in Unit A is responsible to the finance and administration vice director. Every organisation must develop its relevant organisational structure to create good control

environment that attracts employees to work in line with the organisation's objectives (Al-Thuneibat, Al-Rehaily, & Basodan, 2015).

To demonstrate the third principle, Unit A also performs a segregation of authorities in payment called approval matrix. Top management does not have much time and effort to invest in the operational activities; therefore, the company should consider the existence of an approval matrix for division at the authorisation level (Romney & Steinbart, 2015). Below we can see the table that describes the approval matrix in the authorisation of check signing/current account/bank's administration matters.

**Table 1**  
**Partial Approval Matrix in Authorisation of Check Signing/Current Account/  
Bank's Administration Matters**

Number	Amount (In Million Rupiah)	Person in Charge
1	≤ 100	Head of branch/accounting and finance manager in head office & vice director of finance
2	≤ 101 up to ≤ 300	Director of Unit A and vice director of finance

Source: A Parent Institution (2016), has been modified.

From the table above, the finance vice director should authorise the payment transactions from the smallest amount. This finding is also supported by our interview with the accounting manager that shows the finance vice-director should be involved in payment authorisation above 200.000 rupiah. Payment transactions under 200.000 rupiah are categorised as petty cash expenditure that does not require approval from the finance director. This raises the consequence of having the finance vice director to sign and check all the related supporting documents. This is proven by the internal auditors finding that shows many supporting documents are not signed by the finance vice director.

Organisation makes the segregation of authorisation or duties to delegate the responsibility that enables management or employee to decide something (COSO, 2013). The board of directors should focus on the strategic matters of day-to-day operations, so the organisation makes the leveling authorisation (Romney & Steinbart, 2015). For example, the manager approves sales up to USD 5000 and the director approves the sale above USD 5000.

#### **4) Commitment to human resource development**

To demonstrate the fourth principle, the human resource department establishes policy that a senior staff and manager must be at least a graduate from a Bachelor degree and for general staff must graduate from high school. Based on our review, there is also employee selection process performed by the human resource department and related department due to obtain competent personnel. Attracting competent personnel is one of company's effort to make good internal control because the employee is the one who operates internal control system (COSO, 2013). Previous research in the United States shows that more highly educated employees demonstrate fewer internal control weaknesses and financial restatement (Call, Campbell, Dhaliwal, & Moon, 2017).



Information from our interview indicates that all members in accounting and finance department have no accounting educational background. Information from interviews with the accounting department states they know about their job technically from the hand-over process with the previous employee. An organisation will attract employees that fit with the company's culture and who have the competence to help the company in achieving its goals (COSO, 2013). Information from the interview also shows that there has been no regular training for finance and accounting personnel since all members have no accounting educational background. To meet the company's expectations, they should have training regarding their task and procedure related to their tasks. Previous research in Ghana states that employees should get regular training, especially regarding to their job responsibility (Owusu-Boateng, Amofa, & Owusu, 2017).

Employees are vital elements for the implementation of the overall internal control system (Romney & Steinbart, 2015). Therefore, employees must manage the function of company procedures and regulation to work towards achieving company's objectives/goals (COSO, 2013). However, information from our interview with procurement and accounting staffs shows that in performing daily tasks, they usually refer to common practice and direction without referring to operational standard. It also says that one of the key control implementation functions is to avoid the auditor's finding.

In the beginning, the organisation must attract the employee that in line with their vision, mission and objectives (COSO, 2013). After attracting the employee, the company must retain the employee (COSO, 2013). In retaining the employee, the company should have a leader who commits with their responsibility and implementation of internal control, so the employee can follow his commitment (Yurniwati & Rizaldi, 2015).

##### **5) Accountability for internal control**

To demonstrate the fifth principle, from our interview Unit A performs an annual assessment of employee performance by comparing performance criteria with employee actual performance. The annual assessment determines the salary increase for every employee as the reward for them. The company expects that the assessment can affect employee's work motivation that also influences the quality of internal control (COSO, 2013). A company may create a reward mechanism to motivate the employee to participate actively in their responsibility (Tan, Abdullah, Latif, & Ting, 2012). Reward is the high level factor in motivating employee's contribution to the company (Tan et al., 2012).

##### **Analysis of findings and propose improvement for Unit A**

From the analysis in previous part, there are several existing internal control which are not in line with the COSO internal control framework. Although it is not obligatory for institution to adopt standardised internal control implementation, it is suggested that institutions implement good internal control related to the realisation of their objectives (Rosman et al., 2016).

Unit A has an insufficient approval matrix because it requires the vice-director of finance to authorise expenditure transactions above 200 thousand rupiah. Hence, this research proposes Unit A to identify the suitable leveling authorization that can make the director of finance concentrate more in his job. Leveling authorisation is one of the common procedure to help the company

achieve their operational objective because it is not efficient if the board of directors must authorise the small amount transactions (Romney & Steinbart, 2015). The board of directors plays an important role in the control environment (Krishnamoorthy & Maletta, 2016). The board of directors hence establishes structure, discipline and monitoring for the manager (Khan & Ibrahim, 2015).

Most employees in the finance & accounting department and procurement department have not been aware of the existence and function from the operational procedure for the procurement and payment process. Thus, this research proposes accounting and procurement managers to provide an example about the implementation of proper internal control. This research also proposes managers to make routine activities in discussing the importance of the operational procedure in achieving the company's goal. From the other perspective, this proposed improvement has motivated the leader to give an example of good internal control implementation for their followers.

Unit A does not have regular training, especially in the accounting domain for related employees. Hence, this research proposes that Unit A considers regular training for employees in improving their skills. Based on our interview and document analysis, accounting staff are used to book the transaction in incorrect account. We thus hope that regular training can help them become more effective in performing their task. Training is the way to help employees understand their task and responsibilities (COSO, 2013).

## 5. Conclusion

From the findings and the discussion section, we have reached some conclusions in this research regarding the existing internal control condition of Unit A that are not in line with the COSO's internal control framework. Unit A has an insufficient approval matrix because it requires the vice director of finance to authorise expenditure transactions above 200 thousand rupiah. Hence, this research proposes that Unit A identifies a suitable leveling authorisation that can make directors of finance concentrate more on his job.

Most employees in the finance & accounting department and procurement department have not been aware of the existence and function from the operational procedure for procurement and payment process. Hence, this research proposes accounting and procurement managers to provide an example about proper internal control implementation. This research also proposes that managers have routine discussions or outreach of the importance of the operational procedure in achieving the company's goal.

Unit A does not have regular training, especially in accounting practice for related employees. Hence, this research proposes that Unit A considers regular training for employees in improving their skills.

The focus of this research is only on the components of the control environment. The internal control environment is the focus of this study because the main problem of the research object is the component. For further research, researchers can develop research using other components of the internal control framework such as risk assessment, control activities, and so on.

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