



## **The Effects of Internal Control Systems on Cooperative's Profitability: A Case of Koperasi ABC Berhad**

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### **ABSTRACT**

This study investigates the effect of internal control systems on cooperative profitability. Internal control is described by Committee of Sponsoring Organizations of the Treadway Commission (COSO) Framework, which is limited to Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring. This study was conducted using a qualitative approach, where a case study method was applied. Data were collected through interview sessions and documentary evidences. From the findings of study, it was concluded that the internal control systems applied in Koperasi ABC Berhad can be considered effective and satisfactory. This was based on the implementation of all components of internal control systems, as described by the COSO Framework within the cooperative. However, financial losses occurred in the cooperative, caused by inefficient cost control and not due to weak internal controls. Profitability can be improved with a new development plan as well as implementation of effective internal control systems within the cooperative. Good or strong internal control systems would have an effect on the cooperative's profitability as well as help the stability and growth of the cooperative movement in Malaysia.

**Keywords:** Internal Control Systems, Cooperatives, Profitability

**JEL Classifications:** H10, B51

### **1. INTRODUCTION**

Cooperatives have long been acknowledged as an important sector for the economic stability and global employment. The cooperative can be defined as "an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise" (International Cooperatives Alliance, 1995). The establishment of cooperatives in developing nations of Asia, Africa and South America and the industrialized countries in Europe and North America indicate the significant role played by the cooperatives to the nation's economy around the world (Azmah and Fatimah, 2008).

The international summit of co-operatives held in 2014 revealed that the global revenue contributed by the cooperative sector grew by 11.6% to 2.2 trillion USD in 2012 compared 2011, indicated

the significant contribution of cooperatives to the world economy. Similarly, cooperative sector are a critical component of the Malaysian economy as this sector is targeted to be the third engine of economic development in the Ninth Malaysian Plan after the public and private sectors (Idris et al., 2010). Besides that, the National Cooperative Policy 2011-2020 was launched on 16<sup>th</sup> July 2010 to provide a platform for the cooperative movement to develop and strengthen the role of cooperatives within the context of national economic development (KPDNKK and SKM, 2010).

Performance of cooperatives can be determined using operating profit as an indicator (Nurjihan and Mahir, 2011). In order to survive like any other businesses, cooperatives need to generate profit to fulfill their social objective to maximize the benefits and increase standards of living of their members. A proportion of the cooperatives profits will be allocated usually to provide benefits and returns to the members. Two types of members' benefit are

members' fund and dividend payout (Nurizah et al., 2012). Higher dividend payout will attract members to participate in every business activity engaged by cooperatives.

However, the researcher take into account what factor that may determine the cooperatives profitability, leading to increase participation of members and hence, help in growth of cooperatives' activities. Based on the literature and current phenomenon, the effectiveness of internal control systems is considered an influence on the cooperatives profitability and give impact to the cooperative's objectives in terms of operations, financial reporting and compliance. The enforcement of proper internal control system has always become a requirement to the business organization to lead them to improve financial performance (Mawanda, 2008) as well as to achieve business objective (International Federation of Accountants, 2012). Moreover, internal control is a major part in managing an organization which is helps manager achieved desired results (Arad and Jamshedy-Navid, 2009). In addition, previous study found that all components in internal control systems play an important tool to business success and survival (Karagiorgos et al., 2011). Furthermore, good internal control systems can be used by the organizations to assist in operating its activities directly, and achieve the profit projected (Muraleetharan, 2011).

Based on the above description, it would be imperative to acquire further details on the internal control systems and profitability of cooperatives. Effective internal control systems is an important element that organization should address to ensure that good governance can be maintained, which resulted in generated higher profit and also can help in the stability and growth of cooperative movements in Malaysia. Previous studies have looked into the effectiveness on internal control systems in public and private organization (Cortesi et al., 2009; Wardiwiyo, 2012; Saidu and Zabedah, 2013; Mary et al., 2014); and higher learning education (Mawanda, 2008; Wang, 2010; Popescu and Dascalu, 2012), but only a few studied on cooperatives especially on profitability that was known to be an important mechanism for promoting the growth of the cooperatives movement.

The findings of this study would contribute to the existing literature on the effects of internal control on organization's profitability more specifically the cooperatives. Generally, empirical studies on the investigation on the effect of internal control systems on cooperative profitability is very limited and not yet fully explored particularly in Malaysia. This study will also examine whether effective internal control systems will generate high profit to the cooperatives. High profit will help to increase the dividend payout to cooperatives members. Further, members who believe they will get good benefits from cooperatives will be encouraged to participate of members to join cooperatives and directly increase the cooperative movement as well as maintain the stability of high income generated from the cooperatives sector in Malaysia.

In practical terms, the findings of this study provide additional information to management and those in charge with governance of cooperatives sector as well as the supervisory agency such as the Suruhanjaya Koperasi Malaysia (SKM) to create conducive environment for the business and entrepreneurship of the

cooperative movement. In addition, the findings can also be used as a reference or guidance for all those involved in the internal control systems in cooperatives. It is hoped that the findings of the study would initiate discussion, debate and actions among the cooperatives management leading to positive changes in the cooperatives governance as well as performance of cooperatives.

Therefore, this study will investigate the effect of internal control systems imposed at the Koperasi ABC Berhad by assessing all the components in the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control Framework which are: Control Environment, Risk Assessment, Control Activities, Information and Communication and Monitoring whether it will affect the cooperatives profitability. Thus, the objectives of this paper are to establish the internal controls that are in place within the Koperasi ABC Berhad and to investigate the effects of internal control systems on Koperasi ABC Berhad's profitability.

The organization of this paper is as follows: The next section reviews the existing literature related to the internal control system and cooperative's profitability. Then, the research methodology will be presented, followed by descriptive and interview findings. Finally, the paper ends with conclusions and recommendations.

## 2. LITERATURE REVIEW

Internal control systems established by management in order to carry on the business in efficient manner (Mawanda, 2008; Abiola and Oyewole, 2013) and to achieve overall organizational goals (Ayagre et al., 2014). The COSO defines internal control systems as a process designed, implemented and maintained by people charged with governance, management and other staff that can be expected to provide only reasonable assurance to the entity's management and board to the achievement of business objectives regarding the effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations (IFAC, 2012). The internal control systems consist of five interrelated components namely control environment, risk assessment, control activities, information and communication, and monitoring (Deshmukh, 2004; Wang, 2010; Takahiro and Jia, 2012; Wardiwiyo, 2012; Mary et al., 2014; Ayagre et al., 2014).

### 2.1. Control Environment

The control environment is the foundation for all other components of internal control that provide discipline and structure, which is its set the tone of an organization by influencing the control consciousness of its people (Ratcliffe and Landes, 2009). Dickins et al. (2009) further asserts that control environment often defines as the "tone at the top" which is means that the components should get more attention from the people in the organizations. For example, Ayagre et al. (2014) found that control environment consider effective if top management support for integrity and ethical values, establish codified standards of conduct to guide behavior, activities and decisions in order to pursuit company objectives. For cooperative organizations, the factors related to the control include the integrity and ethical values, commitment

to competence of employees, management's philosophy and operating style, organizational structure, assignment of authority and responsibility, human resources policies and practices, and the activities of the board of directors or audit committee towards organizational objectives (Mendoza, 2012; Mary et al., 2014).

## 2.2. Risk Assessment

Risk assessment is the process of identification and analysis of the internal and external risks which may affect the management, financial reporting and legal compliance (Takahiro and Jia, 2012). In cooperatives organization, risk assessment used by identifies and analyze of relevant risks towards the achievement of the objectives and to determine how the risks should be solved (Mendoza, 2012). According to Co-operative's Best Practice Guide, Republic of Mauritius (2011), the risk assessment should be conducted regularly by board of directors to identify the risk's areas. The list of duties of officers and employees of the society should be included as risk identification in line with ethical risk areas. After that, the identified risks should be clearly documented for them to plan for an action to manage the risks.

## 2.3. Control Activities

Control activities occur throughout the organizations at all levels and in all functions. Control activities are the policies and procedures used in various organizations to ensure management directives are carried out and necessary actions are taken to address risks to achievement of various objectives (Ratcliffe and Landes, 2009). Mendoza (2012) list out in his research that the control activities of internal control systems in cooperatives governance can be divided into nine activities: Authorization, segregation of duties, information processing, physical controls, adequate documents, verification, reconciliation, review of operating performance and supervision. The objectives of the entity can be achieved through better control activities which is all necessary action should be taken with the aim to address risks (Saidu and Zabedah, 2013).

## 2.4. Information and Communication

All businesses must identify, capture and communicate important information to enables people to carry out their responsibilities. This system is imperative for entity to obtain and exchange the information in order to conduct, manage and controls its operation while the control activities are implemented (Frazer, 2011). Information system also imperative to guide in organization operation process (Wardiwiyo, 2012). For example, studies by Hanim et al., (2005) found that the greater is the information and communication, the better the performance of audit work which is the person in charge with audit work must identify, analyze, evaluate and record sufficient information to achieve desired objectives. For cooperative organizations, sufficient information and communication are required in order to obtain and transmit important cooperative information for decision making, customer service and business operations (Weber, 2009).

## 2.5. Monitoring

Monitoring is the fifth component that ensures all the components internal control system continues to operate effectively

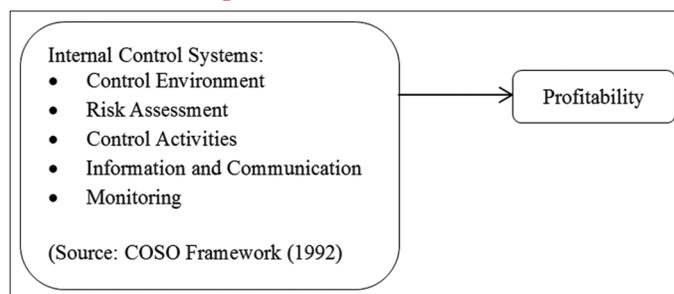
(Ionescu, 2011; Ayagre et al., 2014). Periodic assessments of the effectiveness of internal controls by managers, internal auditors, and external auditors is one of the monitoring activities (Dickins et al., 2009). Studies by Wardiwiyo (2012) found that monitoring in financing system should be implemented from the beginning to the end of process. For example, supervision mechanism can be done by appointing external auditor to monitor the customer's activities in use fund. Therefore, monitoring components must be implemented in both corporate and cooperative boards to monitor the performance of management, to form long-term strategic plans, to evaluate proposals presented by management and to observe the financial and strategic actions undertaken by them (Keeling, 2005). The checking on performance of overall internal control systems can be followed-up by implementing monitoring components because it plays as a circle that improved control activities, information systems as well as control environment (Noorvee, 2006).

Reviews of literature indicated that internal control systems have positive effect on performance (Mawanda, 2008; John, 2011; Muraleetharan, 2011; Mary et al., 2014). For example, Hanim et al. (2005) have determine the effects of internal control system on performance of audit work. They found that every components in internal control system positively influenced performance of audit work and audit reporting of the internal audit reporting. Besides that, Ayagre et al. (2014) concluded that aggressive mechanisms of internal control systems have to adopt for achieving better performance over time.

In cooperatives sector, performance are measured by looking at the profitability that can be divided into two types: Gross profit that generates from every ringgit of income earned by the cooperatives and net profit that measures the efficiency of cooperative in managing the operating expenses (SKM, 2011). In order to strengthen organization's position in the market as well as optimize profitability, management should introduce a really effective system of internal control to avoid mistakes and fraud (Lakis and Giriunas, 2012). Wambua (2011) asserts that to increase the profitability and efficiency of organizations, the management should have good corporate governance. Then, it will enhance the ability to create wealth for shareholders, opportunities to increase employment with better terms for workers and benefits to stakeholders.

Based on the literature review and in line with the research questions and objectives of this study, Figure 1 represents the research framework in this study.

Figure 1: Research framework



### 3. METHODOLOGY

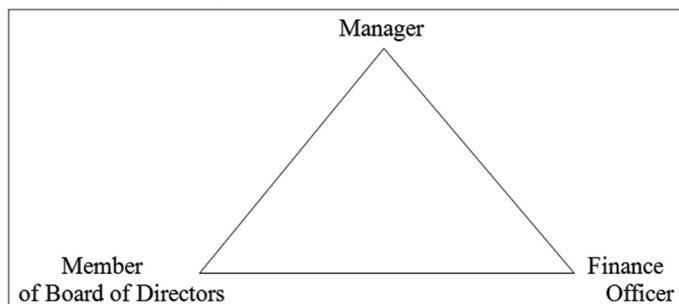
Qualitative research approach was used in order to gain a better understanding on the effects of internal control systems on cooperatives profitability. Using a case study, Koperasi ABC Berhad was chosen as a representative of the cooperative movement where the findings of the research may be replicated and some of the findings may be applied to other cooperatives in Malaysia. In-depth interview was applied in the study to gather data that was later transcribed, analyzed and deduced into conclusion. The researcher went to the cooperative for face-to-face interviews in order to understand the information the participants of research try to tell regarding the internal control systems implemented in cooperative and the effects it has on cooperative profitability. Interview sessions that were conducted at the participants' offices were recorded and transcribed for analysis.

Data are basically collected from the Manager, Finance Officer and a member of Board of Directors of Cooperative who are directly in charge with the operation and financial activities of the cooperative. Three of them were interviewed. The study basically targeted top and middle level management staff because there are directly dealing with the day to day management of the cooperative and the person responsible for the internal controls of the cooperative. Greater emphasis was laid on top management staff because the information needed could be obtained from those who were involved in the operations and financial activities of cooperative. The researcher also hopes the obtained information that could help address the objectives of the study that is to examine the effects of internal control systems on cooperative profitability. By interviewing the three officers, balanced views is expected as they represent the different category of officers within the cooperative (Figure 2).

### 4. FINDINGS

First, the control environment is the foundation for all other components of internal control. If the control environment is not positive, the overall system of internal control will not be as effective as it should be. Based on the interviews conducted, the researcher perceived that the cooperative already has positive control environment in place because of the cooperative's long-term establishment and the experience of their employees have in the cooperative area.

**Figure 2:** Interview participants



Second, there are three ways of risk management that the cooperative adopted. It is whether they accept the risk, prevent or reduce the risk, or avoid the risk at all. From the interviews, all the participants agreed that every entity will face a variety of risks from external as well as internal sources. It is just the way the management identifies, analyzes and addresses the relevant risks to achieve certain objectives that differentiate successful organization from others.

Third, control activities are activities that will help identify, prevent or reduce the risks. The researcher posed the question as to whether the control activities are implemented or not in the cooperative. Based on the interviews conducted, the control activities are imposed or implemented because the management gets maximum benefit at the lowest possible cost when designing and implementing the activities. According to participants, so far, the management is still able to control all the activities of the cooperative as management will inform immediately all employees regarding all policies and procedures of operational and activities of the cooperative. The following Table 1 show the way of cooperative implementing the control activities by type.

Fourth, with regard to question about information and communication in the cooperative, the pertinent information must be identified and communicated within the time frame that enable the employees to have ample time to carry out their tasks. From the interviews, the cooperative's management informs or conveyed new policies and procedures as well as any important message to the employees. On the other hand, there are slightly negative reactions from the participants about the employees in the cooperative regarding this issue. Then, it is apparent that the management is having problems with the attitude of employees who are not serious with the information that the top management is trying to disseminate.

Besides that, the management tries to solve the problem by having meetings with the employees to re-inform or get feedbacks from employees regarding the information that has been disseminated. The cooperative strive to communicate to all employees a clear message from top management regarding their responsibilities in the operation of cooperative. In addition, the cooperative also has good communication between the board of directors and employees based on the interview above. Thus, all of participant seemed to understand their own role in the cooperative as well as how the individuals relate to the works of others because effective communication in a broader sense must be two-ways communications.

Lastly, all of the components of internal control systems that are in place should be monitored to ensure the achievements of the organization objectives. Based on the interviews conducted, participants unanimously stated that the monitoring of cooperative is carried out by internal members of cooperative, that is, the manager, board of directors and the audit committee. It gives a picture that the cooperative implement on-going monitoring to determine whether controls are operating as intended and modifications made to the control system when needed. However,

**Table 1: The cooperative's ways of implementing control activities by type**

1	Supervision	Established certain committees such as development committee to separate the tasks in accordance with their respective area
2	Performance reviews	The manager participate in the supervision of operation to review if there is any problem or error during the supervision
3	Verification	The cooperative's manager will perform the duties
4	Authorization	The responsibility of Boards of Directors who have the power to approve the transaction or event
5	Segregation of duties	The management will give a briefing to the employees regarding the task they need to do before they start work
6	Documentation	All documentation is complete, contrived and recorded timely

other participants clearly stated that monitoring activities can also be done by external parties, SKM.

Furthermore, the participant gave a reason why monitoring activities by external parties is important. Among the reasons is to give 'check and balance' process to the whole monitoring activities and also that it is done by independent party. In summary, the cooperative has in place a complete monitoring from internal and external parties in ensuring that the cooperative's operation is running smoothly. The following Table 2 is summary of the interview analysis conducted. A tick "✓" in the boxes denotes the components that had implemented in cooperative in accordance with the responses by each of participants.

Based on documentary evidence collected, Koperasi ABC Berhad has experienced losses in the consecutive years. However, Koperasi ABC Berhad was able to reduce losses which the reduced figures are quite an improvement for Koperasi ABC Berhad. In this study, the profitability of KPRASB has not improved although internal control systems seemed intact and in operation. However, the participants acknowledged that the internal control systems have effects on cooperative profitability although from the researcher observations on the audited financial statements, for the last three years Koperasi ABC Berhad have shown losses. Participant seems defensive and think that the losses occurred are not because of the system of internal control is not good, but, it is because of an increase on cooperative's expenses while the earning still at the same level.

## 5. CONCLUSIONS

This study aims to achieve two main objectives. First, it attempts to establish the internal controls that are in place within the Koperasi ABC Berhad. The findings indicate that cooperative implement all the component of internal control systems as described by COSO Framework (1992), which is widely accepted as the key factors that help organizations in achieving business objectives and at the same time, have good organizational performance. Although participants during the interviews seemed unsure of the correct terms to refer to when describing components that they need to impose to have an effective internal control systems, but from responses made about the activities they do in running the operations of cooperatives, the researcher are able to conclude that the activities that they described refer to the components in internal control systems. It is concluded that internal control systems applied in Koperasi ABC Berhad are effective and satisfactory.

Second, this study attempts to investigate the effects of internal control systems on Koperasi ABC Berhad's profitability. The

**Table 2: Summary of the interview analysis**

Internal control systems	P1	P2	P3
1. Control environment			
Integrity and ethical values	/	/	/
BOD at audit committee participation	/	/	/
Assignment of authority and responsibility	/	/	/
Management's philosophy and operating style	/	/	/
Human resources policies and procedures	/	/	/
Commitment to competence	/	/	/
Organizational structure	/	/	/
2. Risk assessment	/	/	/
3. Control activities			
Supervision	/	/	/
Performance reviews	/	/	/
Verification and authorization	/	/	/
Segregation of duties	/	/	/
Documentation	-	/	-
4. Information and communication	/	/	/
5. Monitoring	/	/	/

findings indicate that Koperasi ABC Berhad has experienced losses over a period through the internal control system components are in place and in operation. But, participant seems defensive and think that the losses occurred are not because of the system of internal control is not good, but, it is because of an increase on cooperative's expenses while the earning still at the same level. Furthermore, the cooperative management is confident that the cooperative's profit can be improved with new development plan as well as implementation of more stringent and effective internal control systems in cooperative.

As a conclusion, having good or strong internal control system alone will not effect on cooperative's profitability, but more need to be done in order to help the stability and growth of cooperative movement in Malaysia. Effective internal control systems are believed to have the ability to increase the profitability of cooperatives, which will directly help to promote the stability and growth of the cooperative. Finally, the management of cooperative should appreciate the findings and thus, initiate discussion and action plan to improve the cooperative governance as well as the cooperative profitability.

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