

# Internal control of a group company accounting essay

[Business](#), [Company](#)



## **Abstraction**

Today, the argument of internal control is progressively of import to group companies. It is normally believed that a group is rather complex which would do a hard in pull offing hazards between different parts. The bankruptcy of Enron Corporation in 2001 is a milepost in the growing history of internal control. After that incident many establishments in the universe published their studies for teaching corporations ' internal control. This thesis introduces the thought of internal control, and the comparative back uping theories of building an internal control. Besides, explore the construction of a group company, and its concern of how to set up an inside internal control system. Finally, give a constructive decision of a group 's internal control by a instance survey of BP group.

## **Aims of the survey**

In this twenty-four hours and age, the issue of internal control is progressively of import to group companies. It is normally believed that a group is so complicated which may doing a hard of pull offing the hazard occurs between the interior parts of a group. The bankruptcy of Enron Corporation in 2001 is a milepost in the development history of internal control. After that astonishing fiscal fraud instance, SEC ( Securities and Exchange Commission, U. S ) passed the Sarbanes-Oxley Act to modulate listed companies in order to accomplish a fiscal transparence. Among the act, subdivision 404 ( SOX 404 ) proposes the issue of 'internal control ' , it requires each one-year study should incorporate an internal control study which shall foremost 'state the duty of direction for set uping and keeping an

equal internal control construction and processs for fiscal coverage, and secondly contain an appraisal, as of the terminal of the most recent financial twelvemonth of the issuer, of the effectivity of the internal control construction and processs of the issuer for fiscal coverage ' ( Nadler and Kros, 2008: 243 ) . Harmonizing to this SOX 404 act, different specific establishments in different states make out the elaborate guidelines for corporations. For illustration, in U. S. COSO ( Committee of Sponsoring Organizations of the Treadway Commission ) proposed guidelines in 1992 and 2004 for pull offing a house 's hazard and modulating their internal control system. In United Kingdom, FRC ( Financial Reporting Council ) makes out the Turnbull counsel as a administration codification of internal control. Those two are similar in contents.

## **Administration of the thesis**

This thesis is divided into seven chapters and organised as follows.

Chapter 1 studies the backgrounds and aims of this survey.

Chapter 2 is a literature reappraisal about the comparative surveies of internal control and group construction.

Chapter 3 introduces the definition and how to implement an internal control by incorporating COSO and Turnbull counsel, which includes the intents, rules, and constituents of internal control activities.

Chapter 4 is about a survey of back uping theories and their deductions for set uping an internal control system, which including bureau jobs, portfolio

theories, institutional economic sciences, LLSV theories and Balanced scorecard.

Chapter 5 emphasises the internal control in a 'group ' company and the importance of scheme of a house by explicating the definition, features and an internal control frame for a group company.

Chapter 6 is a instance survey of BP Group as the research methodological analysis, by look intoing and researching BP group`s internal control construction ; roll uping comparative fiscal informations to verify the effectivity of BP group`s internal control activities.

Chapter 7 proposes a decision.

## **Literature Review**

Because of the topic of this thesis is 'internal control of a group company ' , therefore there are chiefly two sorts of articles are being collected. One is the documents about how to set up an internal control system, and the other is about the construction of a group company.

Bower and Echlosser 's 'internal control - its true nature ' in 1965 is normally believed as the earliest article in discoursing the internal control issue. This article debates the impression of internal control. He pointed out the intents of internal control are to do fiscal information system more dependable and to safeguard assets. In add-on, the true nature of internal control could be defined and saw by puting a fiscal information system. It is normally believed that a fiscal information system can run with small or no internal control.

However, the fiscal information system can be reinforced by adding an internal control. Besides, adding internal control responsibilities could straighten up the fiscal system. Such responsibilities can diminish the mistakes and fraud causation by people. 'Internal control responsibilities are necessary because of the mental, moral, and physical failings built-in in people' ( Bower and Echlosser, 1965: 339 ) . Nevertheless, due to the early clip of this article, the writers did not discourse the application of internal control on corporations.

Gauthier ( 2006: 11 ) in his article of 'Understanding internal control ' points out that the construct of internal control is not new. This article observes what each populace sector fiscal director and board member should cognize about internal control. After analyzing the indispensable grounds of fiscal studies which with a fraud ; the Treadway Commission believes that it is due to a deficiency of internal control system. Therefore, organisations supported the Treadway Commission to plan a Committee of Sponsoring Organizations ( COSO ) to modulate concern operations in endeavors. COSO defined five indispensable constituents to vouch a model of internal control inside a company is acceptable or comprehensive: a. control environment, b. hazard appraisal, c. control activities, d. communicating, and e. monitoring. However, there is no perfect model of internal control. Internal control 's nature is hazards ' variegation, instead than turning away.

Spira and Page ( 2003 ) hold the position that the release of the Turnbull counsel is a program of the UK authorities, which intend to beef up corporations ' internal control. The counsel aligns internal control with hazard

direction. Besides, this article discovers the alteration of building the argument about internal control and hazard direction with the UK company administration sphere by using a sociological position on hazard. In add-on, this article provides an of import support on the UK companies ' internal control frame.

Soderquist ( 2000: 375 ) points that 'the current legal construct of the corporation is simple: a corporation is an unreal individual, and the inquiry for legislative assemblies, tribunals, and attorneies is whether this construct serves their demands. ' This article chiefly discusses different hypotheses in building corporations, provides utile information for researching the construction of corporations. Furthermore, this essay observes the bing legal construct, mensurating its utility and uncovering its bounds, thereby suggesting a sound corporation construct.

Chandler ( 1992 ) examines concern companies ' operations and patterns from a historical position. He in add-on explores the value of the house from four economic theories, which are the neoclassical, the principal-agent, the dealing cost and the evolutionary ( Chandler, 1992: 484 ) . Furthermore, explicating the beginning and growing of modern industrial corporations. This article besides provides a utile thought in explicating internal control in different types of group companies.

Tsay ( 2010 ) deeply researches the Sarbanes-Oxley Act of 2002 ( SOX ) . He points that the subdivision 302 of the Sarbanes-Oxley Act requires direction of listed public companies should unwrap every alteration of their internal

control systems. SOX subdivision 404 to boot requires that a direction has an duty on measuring the effectivity of its internal control systems and the rating study should be audited by a registered accounting house ( Tsay, 2010: 53 ) . In January 2009 the Committee of Sponsoring Organisation of the Treadway Commission ( COSO ) published Guidance on Monitoring Internal Control Systems. The counsel runs a theoretical account to program and implement an internal control rating plan for the direction of a house. Besides, this article gives a cherished advice on uniting COSO counsel and corporations ' internal control system. More specifically, the paper solves the job of how to use COSO 's five constituents ( control environment, hazard appraisal, control activities, communicating, and monitoring ) with a corporation 's internal control system.

Kiyak ( 2004: 3 ) proposes 'a theory-driven, testable, incorporate model that specifies the interrelatedness between cardinal strategic concepts that define a planetary company: corporate planetary scheme, organisational construction, direction procedures, organisational civilization, corporate leading, and fiscal and market public presentation ' . The paper develops common definitions of the strategic concepts, and farther runs an empirical work by utilizing a web-based cross-sectional study in American transnational corporations. As the decision Kayak points that the procedure of corporate globalisation is a complicated interaction of multiple dimensions. 'Skillful coordination and constellation of these cardinal facets are necessary to accomplish the coveted benefits of globalisation in transnational corporations ' ( ibid ) . This paper provides a utile advice on

corporations ' globalisation from positions of planetary scheme, steadfast civilization and market.

## **What is internal control?**

In this twenty-four hours and age the issue of endeavors ' internal control has become a hot argument during both academic and practical degree, because of the rapid developed direction theories and information engineering. Those new alterations demand enterprises to set up the modern corporation system which so includes an internal control system, for avoiding the happening of fiscal or non-financial catastrophes. A sound effectual internal control system could assist corporations heighten the quality of accounting information, protect the investors and understate the operation hazards.

In this chapter, the definition of internal control would be discussed foremost, and so there are the grounds why a company need internal control. Finally, are the rules, intents and constituents of set uping an internal control system inside a corporation.

## **Definition of internal control**

The earliest construct of 'internal control ' occurred in 18th century, at that clip business communities used the simple mode which is to clear up comptrollers and tellers, for forestalling fraud and vouching the truth of histories. But with the increased graduated table of concern, the above simple method is going progressively uneffective in covering with complicated personal business inside company. More and more faculty



members focus on researching for a better direction of houses.

Consequently, in 1949, the American Institute of Certified Public Accountants issued a specific study entitled "Internal Control" specifying it as a "safeguarding of assets", the "ensuring of the truth and dependability of accounting informations", the "publicity of operational efficiency" and the "attachment to order direction policies" ( ABeam Consulting, 2009: 2 ).

However, this definition was criticised by some faculty members for the range of duty of hearers was extended excessively far, for doing statements in favor of a narrower account of the construct of internal control. Bower and Echlosser ( 1965: 338 ) pointed out that the last 2 of the above 4 facets of the definition of internal control, the "publicity of operational efficiency" and the "attachment to order direction policies", have created many jobs of reading for hearers. In order to clear up the confusion, Statements on Auditing Procedure ( SAP ) No. 33 and No. 29 divide internal control into two parts, "accounting controls" and "administrative controls". In add-on, SAP No. 33 farther pointed out that the independent hearer is foremost concerned with accounting controls, the ground of which is that hearers bear straight on the dependability of the fiscal information.

Accounting controls comprise the program of organisation and all methods and process that are concerned chiefly with, and associate straight to, safeguarding of assets and the dependability of the fiscal records. They by and large include such controls as the system of mandate and blessing, separation of responsibilities concerted attempt with record maintaining and accounting studies from those disquieted with operations or assets

detention, physical controls over assets, and internal auditing ( Bower and Echlosser, 1962: 338 ) .

Administrative controls comprise the program of organisation and all methods and process that are concerned chiefly with operational efficiency and attachment to managerial policies and normally relate merely indirectly to the fiscal records. They by and large include such controls as statistical analyses, clip and gesture surveies, public presentation studies, employee preparation programmed, and quality controls ( ibid ) .

However, Bower and Echloser believed that the duality of the above two controls is merely overcast the arguments, non work out the job. The intent of internal control is to safeguard assets, and to guarantee the dependability of accounting information. However, 'because of the mental, moral and physical failing inherent in people, it is necessary to set up a system of internal control in accounting study process ' ( ibid: 339 ) . By uniting their research Bower and Echloser redefined the construct of internal control as follows:

Internal control comprises the program of organisation and all of the co-ordinate methods adopted within a concern to safeguard its assets, look into the truth and dependability of the information produced by the fiscal information system ( ibid ) .

Furthermore, Bower and Echlosser ( 1965: 340 ) believed that hearers should complete seven internal control responsibilities, they are:

- Supervision
- Clerical cogent evidence
- Admitting public presentation
- Transferring duty
- Protective step
- Reappraisal
- Confirmation and rating

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ) released a study named internal control -- Integrated Framework which has been widely used in America and adapted by many other states. This study provided a cardinal counsel for set uping and implementing effectual internal control. In this papers, COSO defined internal control as follows:

Internal control is a procedure, effected by an entity 's board of managers, direction and other forces, designed to supply resalable confidence sing the accomplishment of aims in the undermentioned class:

- Effectiveness and efficiency of operations
- Dependability of fiscal coverage
- Conformity with applicable Torahs and ordinances ( COSO, 1992 ) .

This model is important in the development of internal control, because it breaks out the tradition manner that AICPA dominates the comparative research, hence doing out a more specific and applicable model. By reasoning the COSO 's definition, it could be summarised into the undermentioned points:

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First, everyone inside the corporation is the participant, including managers, direction and employees. Furthermore, all the participant of internal control is contending for the three aims ( Effectiveness and efficiency of operations, Reliability of fiscal coverage, Conformity with applicable Torahs and ordinances ) . Finally, internal control is non a separate portion of a house 's matter, while it is a procedure, which running through the whole direction and disposal of corporations.

In 1999, Turnbull Committee issued the Guidance for Directors on the Combined Code ( 1999 ) besides known as the `` Turnbull Report '' , which is a papers designed for the listed companies of London Stock Exchange. This publication defined internal control every bit good as COSO, from facets of accounting information dependability, internal control process, aims and rules. However, Turnbull study has the invention parts compared with the COSO 1992. It proposed that an endeavor ' internal control activities should be viewed as the necessary constituent of their civilization, because internal control system reflects the house 's operating environment. The study besides pointed that internal control as a important portion of hazard direction of an endeavor, would be helpful for carry throughing its strategic end. The constitution of internal control system would assist the endeavor to understate the fiscal loss, in order to forestall the strategic end from act uponing by a possible bad fiscal public presentation. Furthermore, the study believed that internal control activities could advance working efficiency and result, safeguard assets and detect fraud seasonably. Additional, because of the continually developing hazard faced by a house, internal control system

reduces, but can not extinguish the possibility of hapless opinion in decision-making ; human mistake ; control processes being intentionally circumvented by employees and others ; direction overriding controls ; and the happening of unforeseeable fortunes ( Financial Reporting Council, 2005 ) . A good system of internal control therefore provides sensible, but non absolute warrant of a house which will not be hindered in accomplishing its concern aims.

## **Reasons why companies need internal control**

Internal control system is an of import direction tool for safeguarding and protecting assets, particularly in the large, complicated corporation. By and large talking, a sensible application of internal control system could cut down losings in bring for thing activities, and prevent the inside participants breach Torahs or ordinances. Besides, it helps to make an environment in which employees feel just. Following are some elaborate points of why companies need internal control.

First of all, internal control keeps a high quality of a house 's internal and external accounting information. Under the internal control system, each accounting process runs carefully and cautiously, thereby taking a true, just and accurate accounting study, which makes inside managers and outside investors clear with the true operating circumstance of the house.

Second, internal control plays a cardinal function of diminishing a house 's operating hazard. It is normally believed that a deficiency of supervising consequences in fiscal errors, which even threatens the traveling concern of a

house. The thought of internal control gives houses ' internal hearers the counsel ; provides them a series of judgement codifications in each procedure of concern, to better oversee comparative forces.

Furthermore, a sound internal control system is a demand of a house 's accomplishment of long-run strategic end ( ibid ) . Long-time traveling concern of a house requires it has the ability of bearing tremendous operating force per unit areas. This force per unit area could be fiscal or non-finical. For illustration, a house should non merely concentrate on the external alteration of economic, policies and selling development, but besides notice the alteration of inside forces, the physique of enterprise civilization. Internal control system as a multifunction tool unifies the above demands.

Finally, in order to maintain assets ' accurate and complete, internal control system provides efficient direction and supervising manners, to forestall the human mistakes or errors from harming the safety of assets. Additional, internal control could diminish the personal business of blowing resources because it includes the control of cost as its contents.

## **Principles of internal control**

The rule of internal control means the guidelines or criterions of how to construct an internal control system.

In the first topographic point, internal control activities must see their handiness ( Spira and Page, 2003 ) . It requires the house makes out sensible and suited control ordinances for implementing. The control ordinances

should be written in the papers as houses ' subjects. However, the ordinances should be neither excessively rigor nor excessively loose, because that would impact employers and employees ' ardor of executing plants.

In add-on, planting an internal control system should to the full see the cost. The primary aim of internal control is to understate the possible hazard of losings. If the internal control activities ' cost exceeds the control additions, it would go an unfavorable action. Therefore, corporations should use sagely when planting their internal control system.

Furthermore, internal control of corporations should non cover every facet of activities. However, it should concentrate on the crucial process which will deeply impact the house operating. For case, hearers might pay more attending on the opinion of house 's investing and funding activities because those personal business are normally company with hazards, while, for the low-risk day-to-day modus operandis, excessively much investing equals a waste of resources.

## **Purpose and Components of internal control**

There are many readings about the intents of internal control. Among them, the COSO study gives the most widely recognised and sensible provide sensible confidence of accomplishing corporate mission, aims, ends and desired result while adhering to Torahs and ordinances ; let the company to accurately describe successes and results to the populace and interested 3rd parties. Serve as a common footing for directions, managers, regulators,

faculty members and others to better understand endeavor hazard direction, its benefits and restrictions, and to efficaciously pass on about endeavor hazard direction ( COSO, 1992 ) .

The constituents of internal control are normally including control environment, hazard appraisal, control activities, information & A ; communicating, and monitoring ( ibid ) . Those five parts explain what factors a sound internal control system should cover.

Control environment is the foundation of all the other constituents, it concludes the factors that would impact the house 's runing process such as a house 's unity and ethical values, set of board of managers & A ; audit commission, direction 's doctrine and operating manners, organisational construction, assignment of authorization and duty and human resource policies and procedures ( ibid ) .

A complete, sensible environment is the warrant and foundation of a sound control system, because it makes internal control system easy to be established.

Hazard means a sort of unexpected position of things, and hazards happen anytime and anyplace. A corporation may under the hazards from both internal and external in anytime ( Gauthier, 2006: 13 ) . Therefore, a house needs to measure the possible hazards. More specifically, a house should place and analyze hazards which may happen in operating activities and fiscal studies. Designation is to recognize and fix adequate steps in progress for the possible hazards. For case, a house should measure the possible



hazards of alterations in information about external competitions, macro-economic policies and the tendency of developing engineering. Furthermore, the internal policies, forces, and the operating construction. Analysing hazards means to measure the chance of hazards and how the hazards can impact the house, and how the house can understate the loss of inauspicious influence.

Control activities are proposed to accomplish detailed control aims in order to understate the hazards. They are the peculiar process, policies and patterns that are planned to safeguard concern aims. The control activities are wide-ranging, includes the undermentioned parts.

In a house, plants of mandate, recordkeeping, and detention should divide from each other to maintain the independency of section. For illustration, tellers and comptrollers ' plants should be separated clearly in order to forestall a fiscal pandemonium.

Suitable Mandate of Dealings and Activities. Inside the corporation, there are two sorts of mandate: general and specific, the former is acceptable for everyday actions for which there are general policies to follow. However, for some specific minutes, peculiar mandate is required on a individual footing.

Sufficient Documents and Records. During the house 's operating, there would bring forth immense figure of fiscal or non-financial papers and records. Internal control activities require consecutive papers so lost points are noticed. Furthermore, it requires the economic information are prepared

as near to the covering clip as possible. Furthermore, the format of records requires well-designed instructions and proper infinites.

### Constitution of process and policies

Internal control activities need a set of process to steer the patterns. In addition, backup and recovery process are besides necessary for the unexpected hazard.

Independent Performance Checks. Employers may bury or intentionally neglect to obey process, or they may be careless unless person regulates and observes their everyday plants ( Gauthier, 2006: 13 ) . Therefore, independent cheque is an indispensable process.

## **Information and Communication**

Information and communicating support internal control by conveying orders from direction to employees in a signifier and a clip frame that allow them to carry on their control activities efficaciously ( COSO, 1992 ) .

Mentoring is a process to measure the quality of internal control sporadically through ongoing and specific appraisals. Monitoring could include both internal and external supervising of internal control by direction, employees, or outside parties. For many corporations, particularly big 1s, it is indispensable to construct an internal audit section for a better proctor.

## **Supporting theories and their deductions for set uping an internal control system**

In this chapter, some interesting theories would suggest to explicate how internal control is generated, and supply academic support for a corporation to set up its internal control system.

The root of bureau job is the separation of ownership and direction. After 19 century, companies began to spread out their selling because of a development of engineering. The traditional manner of household houses which uniting ownership and direction became progressively unfavorable for roll uping money for enlargement ( mom ) . In order to work out this job, partnership, so corporations occurred. Stakeholders provide the necessary finacess and a detached direction takes duty for pull offing the company. This separation could do full usage of stockholders ' capital and the direction 's cognition.

However, there is a new job when dividing ownership and direction. First of wholly, the stockholders intend to make is to maximum their ain wealth, and derive the best return of the investing. However, the direction of a house prefers to see its ain benefits, such as the fillip, repute, working environment, vacations and so on. Therefore, it is non possible to extinguish the bureau job wholly.

Furthermore, the stockholders as the investors in selling can utilize portfolio to understate their hazards, so they hope the direction invests the high return undertaking. However, the direction is hard to diversify their input. Therefore, comparing with stockholders, direction are risk-averse, and they

normally give up those high hazard undertakings although which could increase the wealth of stockholders.

Furthermore, information dissymmetry exists between stockholders and direction. Management take part the day-to-day operation of a houses, know the current fiscal and runing information, while the proprietors lack the professional cognition, and they do non straight take part the direction work, therefore can non do a just opinion of the work of direction. In add-on, because of an already mandate, the proprietor could non carry on a entire supervising. Thus the action of inauspicious choice and moral jeopardy would be done by direction.

Through the brief sum-up of bureau job, a consequence is that it is necessary for a house to set up a sound internal control system, to organize the struggle of wealth between the ownership and direction. Although an internal control may increase the cost of operating, a company still needs it to forestall fund frauds and lower fiscal hazards. In add-on, through long-time internal control activities companies would happen equilibrium between bureau cost and value upper limit.

## **Financial hazard and portfolio theories**

'Risk is a term frequently used to connote downside hazard, intending the uncertainty of a return and the potency for fiscal loss ' ( Verschoor, 2006 ) . The consequence of a hazard might be good, or non. Following are some characters of hazards. First, hazards are non subjective, every company can non wholly extinguish them. Additionally, hazards are besides

unsure, they occur anyplace and anytime. Third, hazards are related to the return of undertakings. It means when a topic bears a high hazard, it may derive a high return. That is why person feels like put on the lining.

The type of hazards:

- hazard of macro environment. This is a comprehensive hazard implicate the outside economic environment of houses ' mark state, such as the political hazard and societal economic hazard ( ibf ) .
- hazard of profession. Because of the economic rhythm of a profession, corporations may confront the possible cycling recession which would convey the lessening of net incomes. For illustration, the market of general touristy would bear a slack season in winter.
- hazard of micro environment. This hazard peculiarly occurs in the specific houses during their operating activities, because of the errors of employees, the failure in concern determination of direction and so on ( ibf )

### **The step of hazard**

Scholars tend to utilize math theoretical accounts to measure the hazard during the concern operating. By measuring the possibility of different state of affairss may happen, an expected return can be calculated by the undermentioned equation:

Tocopherol ( R ) - expected return

R<sub>n</sub> - undertaking N 's return rates

Pn - the possibility of undertaking N

It is normally believed that a discrepancy ( VAR ) of the equation represents the hazard, therefore:

( frequency modulation )

Through this simple equation people could cipher the hazard easy, but this method is undependable because of the mistake in computation.

### **Particular concern: the fiscal hazard of a house**

'Financial hazard an umbrella term for multiple types of hazard associated with funding, including fiscal minutes that include company loans in hazard of default ' ( Investopedia, 2011 ) .

Markowitz ( 1952 ) reported that 'a scientific discipline has evolved around pull offing market and fiscal hazard under the general rubric of modern portfolio theory ' . He besides pointed that 'in modern portfolio theory, the discrepancy of a portfolio is used as the definition of hazard ( ibid ) . There are chiefly three elaborate hazards as follows:

Recognition hazard is most merely defined as the potency that a bank borrower or counterparty will neglect to run into its duties in conformity with in agreement footings ( Basel Committee, 1999 ) . A

Investing hazard refers to the possible failure in the undertakings investing. It may destruct a whole corporation due to an inaccurate computation of the expected return of undertakings.

Assets impairment hazard refers to the loss of touchable or intangible assets due to unsure factors. For illustration, a replacing trade good possibly a strong challenge for the original manufacturers. Besides, new engineering and merchandise life rhythm would be a menace for entrepreneurs.

### **Management of hazard**

There are some manners for corporations to cover with the above hazards: Hedging, Reduction, insurance and acceptation.

Hedging refers to avoiding hazards by utilizing compensatory actions, for case, do non publish securities in states that have terrible rising prices ; shut the subordinates in political relations unstable states ( ibf ) .

Decrease agencies take actions to take down the hazard, for case, utilizing fudging contract to avoid foreign exchange hazard.

Insurance is a manner to reassign the hazard by buying suited insurance merchandises. In this state of affairs, the hazard of a house will reassign to others.

Acceptation refers to to the full accept the hazard of operating activities. It requires a house has a strong capital modesty. In general, a house seldom chooses to accept hazards.

### **Institutional Economics**

Institutional economic sciences accents learning, development, and restricted reason. It initial occurred on the twentieth century, and the

representative economic experts are Thorstein Veblen, John R. Commons, and Wesley Mitchell ( Rutherford, 2008 ) .

Hamilton ( 1987 ) pointed that 'old institutionalism rejects the decrease of establishments to merely gustatory sensations, engineering, and nature. Tastes and outlooks of the hereafter, wants and motives, are non merely determined by the nature of establishments, but besides limited and shaped by them ' . When people live and work in establishments on a regular footing, it shapes their universe positions. Basically says that traditional institutionalism focal point on the lawful foundations of an economic system and the evolutionary, used, and calculated procedure. The fluctuations of the establishments are surely a effect of the very inducements shaped by such establishments, and are hence endogenous ( ibid ) . Categorically, institutionalism is a traditional manner to response the current economic orthodoxy.

## **LLSV theory**

In 1997, four celebrated jurisprudence andfinancebookmans, La Porta, Lopez-de-Silanes, and Shleifer are fromHarvardUniversity, and Vishny is from the University of Chicago, issued the article 'Legal Determinants of External Finance ' . LLSV ( 1997: 1149 ) reported that states with poorer investor protections, measured by both the character of legal regulations and the quality of jurisprudence enforcement, have the smaller and narrower capital markets. In peculiar, Gallic civil jurisprudence states have both the weakest investor protections and least developed capital markets, particularly as compared to common jurisprudence states. LLSV ( ibid ) further discussed



the relationship of jurisprudence and external finance, they pointed out that the legal environment has a immense consequence in the size of capital markets over states.

LLSV ( 1998: 1151 ) examines legal regulations covering the protection of corporate stockholders and creditors, the beginning of these regulations, and the quality of their execution in 49 states. The consequences display that common-law states normally have the strongest, and Gallic civil-law states the weakest, legal protections of investors, with German and Norse civil jurisprudence states located in the center. They besides notice that concentration of ownership of portions in the largest public companies is negatively related to investor protections, while consistent with the hypothesis that little, diversified stockholders are unlikely to be of import in states that fail to guard their rights.

## **Balanced scorecard**

The thought of Balanced Scorecard was proposed ab initio in 1992 by Kaplan & A ; Norton. They claimed that traditional fiscal accounting steps such as return-on-investment ratio and earnings-per-share rate might offer confusing signals for companies` uninterrupted betterment and invention ( Kaplan and Norton, 1996 ) . 'The traditional fiscal public presentation steps worked good in the industrial epoch, but they are out of measure with the accomplishments and competences companies are seeking to get the hang today ' ( Kaplan and Norton, 1992: 71 ) . It means that the traditional financial accounting techniques focus on recording and gauging the past economic activities of corporations while it can non supply a wholly advice

about companies ' current and future funding and putting events.

Furthermore, in the current society of concern information, companies should take several factors such as clients, providers, employees, invention into consideration ( ibid ) . Therefore, balanced scorecard was offered from four chief positions to measure houses ' public presentation: the fiscal, client, internal concern procedure, invention and acquisition ( ibid ) . The purpose of balanced scored card is to take houses ' visions into actions ( Kaplan and Norton, 1996 ) .

Balanced mark card requires persons inside the group set up their ain scorecards, and on occasion look into the public presentation of scored cards. This result is related to their personal fillip. Mark cards are normally built based on four facets: fiscal, client, internal concern procedure, invention and acquisition. First, to recite non-financial informations, 'What you step is what you get ' ( Kaplan and Norton, 1992: 71 ) . It means to construe groups ' objects and thoughts into a series of aims, steps, ends and enterprises, which makes non-financial elements seeable and assessable ( Kaplan and Norton, 1996 ) .

### **The above theories ' practical deductions for internal control**

In order to observe how internal control is generate, and why corporations should set up a sound internal control system for maintaining a good concern operation, the above portion introduces theories including bureau job, fiscal hazard and portfolio theory, Institutional Economics, LLSV theory and balanced scorecard. From a comprehensive position, following are some practical deductions of the theories for internal control.

In the first topographic point, bureau job requires an internal control to protect the company owner`s benefits. In other words, bureau job is the root of internal control. Economists assume that resources can be divided into the undermentioned three: land, capital and engineering, and presume that what people pursue is to maximize their ain public-service corporation. With the uninterrupted development of productive forces, the graduated table of production of endeavors continuously expand, the proprietors of the company, though they have the economic resources such as land and capital, but non need fully hold the ability to pull off a concern ; However, directors occupy proficient resources, but no capital. In order to apportion resources expeditiously, the proprietors hire directors who have the ability to stand for them to take responsible for the operation of the endeavor. This action produces a separation of ownership and direction. But, the end of operators is non consistent with concern proprietors.

The proprietor intend to maximize the value and make wealth for themselves, while the end of corporate directors are higher incomes, benefits and repute, which is consistent with the premise of economic adult male in the economic sciences, that is chase of their ain public-service corporation maximization. Furthermore, because of directors take responsible for day-to-day concern activities, they are able to make and hold on more concern fiscal information than the corporate proprietor, this is an information dissymmetry. Asymmetrical information can easy allow directors to do inauspicious choice and moral jeopardy, besides say that concern directors use private information to prosecute single public-service

corporation maximization, the consequences of that may damage the endeavor 's value. Thus, bureau theories provide academic support for the reason of internal control. Besides, internal control as a powerful tool has utilised by the endeavor proprietors for a better proctor.

Second, fiscal hazard and portfolio theories propose to what widen internal control activities should accomplish. The bureau jobs lead to an happening of bureau cost, the being of bureau cost brings the hazard for proprietors. Thus the proprietors set up internal control system for modulating directors.

Based on the comparative investing theory, in the same return rate, people prefer to take a undertaking with smaller hazard. Although there exists hazard of internal control costs, sing the world that investors normally can non to the full invest portfolios efficaciously to cut down a hazard, internal control hazard is still to be considered when judging an endeavor.

Furthermore, institutional economic sciences makes internal control good organised. In order to cut down the bureau job caused by the hazard, proprietors would automatically supervise and control directors, inquire them to vouch and be responsible for the concern consequences. Some fiscal dirts show that the voluntary established internal control system does non run into the demands of the proprietors on the hazard control. Gradually, internal control system is developing to legal commissariats inside corporations. The institutionalisation of internal control is the consequence of concern enlargement. In bend, the institutionalisation of internal control strengthens the protection of the proprietor.

Furthermore, LLSV theory of investor protection points out that when the capital market develops to a certain extent, the demand of protecting investors in capital markets in different states and different economic system is the same. The significance of setting up internal control is to protect investors efficaciously. Harmonizing to the theory of LLSV, mature capital markets require the mature internal control system, and internal control system criteria in developing capital market will bit by bit go rigorous as the mature market.

Finally, balanced score card is a good practical manner of internal control. Balanced Scorecard ( BSC ) is a nucleus strategic direction and execution tool. It divides information into 4 dimensions, and makes it easy to be measured. The chief intent of BSC is to change over the endeavor scheme into elaborate actions, to foreground the comparable advantage. Inside the balanced scorecard, the factor of 'financial ' and 'internal procedure ' require endeavors set up sound internal control system, in order to vouch the accomplishment of endeavor scheme.

## **Internal control towards Group companies**

With the progressively incorporate planetary economic system, the competition between states is really a competition between large companies and groups. In recent old ages, the group company has become an of import force and indisputably occupies a important place in the whole economic system, no affair in its size, efficiency or impact.

However, after the lessons of Enron, Barings Bank and other serious incidents, it is concluded that: the success of internal control of a corporation is straight related to the company 's destiny. Corporations should rapidly set up a sensible system of internal control. The building of corporations ' internal control system should foremost guarantee the subordinate operating as a self-financing independent individuality. Second, prosecute the group 's overall involvements. However, the solution to the job of the effectivity of internal controls of the whole corporation is non simple, due to the many beds of direction inside the corporation, directors in the headquarter could merely through the indirect bid and control to restraint and proctor subordinates.

The constitution of the group 's effectual internal control system is a cardinal to continuously better the overall value of a corporation and heighten the nucleus fight of the group. In this chapter, foremost introduce the definition and features of a group company. Additionally, the relevant survey provides a theoretical footing for farther researching the internal control manner. Then, in the last subdivision of this chapter we focus on a strategic way which uniting with characteristics of a corporation to transport out internal control`s relevant frame survey.

## **Definition of group company**

Soderquist ( 2000 ) believes that a corporation is a configuration of relationships holding a varied and changing hierarchal construction. There is an ununderstandably big figure of relationships that can take topographic

point in corporations, furthermore, many of these relationships will continuously change.

A group is an gathering of parent and subordinate companies that function as a solo economic topic via a common beginning of control ( ibid ) . The impression of a group is frequently used in the revenue enhancement jurisprudence, accounting and house jurisprudence to clear up the rights and duties between companies. If a company involves in wholly different concerns, it is normally named a pudding stone.

## **Features of group company**

When it comes to group companies, people normally wonder what advanced a little and individual administration to go a multiple and complex group administration. Chandler ( 1992 ) points out that the thought of the group company is an account of alternate relationships between market and houses. In other words, the modern multiple endeavors ( groups ) will replace the traditional little companies when the direction and addendum inside a house could supply higher productiveness and net incomes, lower costs than the coordination of the outside market mechanism. Besides, it is a transmutation from the market behavior into corporations` internal buying behavior. For illustration, antecedently commercial activities are performed by several concern units, now through the restructuring or even amalgamation of corporations to make a trading internalization. Such internal dealing brings the undermentioned benefits for the expanded endeavor groups: First, minutess between inside units as a everyday work, which cut down the dealing costs. Second, for the production and selling 's

integrating, information costs bead significantly. Finally, the coordination of integrating makes a steadfast to the full uses societal resources, hence heightening its efficiency.

In this procedure, the types of parent and subordinate companies are the undermentioned three: First of wholly, concern enlargement. Corporations form a new subordinate driven by merchandise invention and industrial upgrading, to make a horizontal or perpendicular strategic integrating of subordinates. Second, capital driven. In order to accomplish the mark of strategic development, corporations use the methods of keeping, acquisition, amalgamation and equity engagement to command subordinates ( Soderquist, 2000 ) . Third, regional enlargement. The parent company develops specific regional markets, domestic markets or international markets based on the scheme demands of internal resources sharing, decrease of internal dealing costs and location advantage of market. All in all, no affair what sort of enlargement corporations are using, the indispensable features of a group company is that there is a parent-subsidary based perpendicular organizational construction.

In decision, the group does hold an independent legal position. More specifically, groups are consisted by a parent company with several subordinates, in other words, the group as the parent company includes a figure of subordinate companies. Subordinates are controlled by a parent company through keeping securities. Furthermore, equity and belongings rights are the nexus between a parent company and its subordinates.

Furthermore, from the position of internal organizational relationships, on



the one hand, the parent company and subordinates both have the independent legal position ; on the other hand, the parent company vertically controls low-level endeavors by buying equity or belongings rights.

## **Fiscal Risks of a group company**

Due to the big figure of subordinates, it is hard to fully incorporate the resources inside a group. In addition, the characteristics of fiscal hazards of a group are besides different from traditional endeavors and harder to work out.

The first hazard of a group is possible debt default. Because of the so many directions inside parent company and subordinates, the hazard of debt default would be magnified ( Diana, 2005 ) . For case, each subordinate could be a guarantee topic, besides, could be an adoption organic structure. Some kinds of catastrophes such as inappropriate guarantee and big scale debt default would happen, doing a bad influence of the whole group 's repute. Even though, consequence in a prostration of a group.

The 2nd is a hazard of investing failure. Inside a group, the central offices can not acquire all the information of each subordinate, therefore it is hard to expeditiously supervise and measure each subordinate 's investing undertakings ( Buehler and Shetty, 1975 ) . Once a failure occurs, the loss of investing would be immense, to boot result in a big figure of non-performing assets and bad debts, thereby diminishing the net incomes of parent company.

Furthermore, the benefit struggle between parent and subordinate company increases the fiscal hazard of a group. Harmonizing to the rational adult male theory, both parent and subordinate company are prosecuting their aim benefits maximal, therefore doing a batch of struggles in day-to-day concern operating. At the same clip, such many beds of direction consequence in a high direction cost and low efficiency. All of the above features increase the possibility of a group 's fiscal loss.

Finally, a large group 's fiscal hazard would act upon the prosperity of regional economic system. More specifically, the parent company non merely impact the determination of subordinates but besides affect the steady of regional economic system. A prostration of a group would do a terrible societal and economic effect ; infinite failures of groups in the universe have confirmed this position.

### **Specifications for a group 's internal control**

It is normally believed that an internal control system is designed for a peculiar administration. However, when speaking about a group company 's internal control system, things become complicated. It is stupid to utilize the same internal control contents between a group company and a common endeavor, because they are different in the facet of organizational construction, fiscal system and ability of bearing hazards. The nucleus of a group 's internal control is to use conjunct ends or schemes to aline and compress inside subordinates. Furthermore, strengthen the preparation of forces of internal control system, and finish the mechanism of incentive

direction. Aiming to make a consensus of that the group is belong to the full participant includes investors, direction and employees.

Because of the big figure of subordinates of a group, internal control for a group company may hold several particular characteristics and specific demands. First of all, unlike the little simple endeavor, in a group company internal control must cover the whole entity, which including both top-down and down-top control. For case, the parent company needs to supervise subordinates ' fiscal position, frailty versa ; subordinates should besides execute control activities towards the determination ordered by the parent company for avoiding an unsuitable order. Second, the control powers of different subordinates are non same ( Spira and Page, 2003 ) . For illustration, the types of subordinates include wholly-owned subordinates, joint stock company and keeping company. The parent company could merely execute a rigorous control to those close subordinates such as whole-owned houses, nevertheless, to those weak-linked companies, internal control activities are no demand and non possible to be perfect.

Furthermore, unlike the common simple endeavor views the accounting and concern operation as the nucleus of internal control, a group tends to set 'capital control activities ' as its cardinal procedure. In other words, the aim of a group 's internal control is to vouch a safe transmutation of hard currency flows from subordinates to the parent company. Therefore this kind of internal control is concentrating on the control of capital base on ballss in and out inside subordinates. Finally, manners of the parent company performs internal control in subordinates are assorted and different, because

the control power is different. For case, for the wholly-owned subordinate, the parent company could straight delegate CEOs to take the direction, in add-on, scrutinizing and supervising the fiscal studies and budgets in order to command the capital flow. However, for the joint stock company or keeping company, the parent company could utilize their rights of vote in the general meeting of stockholders, to near an influence on the determination of targeted subordinate 's concern activities.

### **Research Methodology - a instance survey of BP group**

After presenting the specifications for a group company, now a celebrated and typical group company is necessary to be analysed for back uping the points this thesis proposed. BP group as the sample of this instance survey is typical and constructive.

In this chapter, we will present BP group 's internal control construction, and so carry on some informations analysis to verify the effectivity of BP 's internal control.

### **BP group 's system of internal control**

In chapter 3 we have briefly introduced the COSO model and Turnbull study, they are celebrated instructions to endeavors for set uping an internal control system. However, when using those instructions into a group company, some revisions should be proposed. One of the most of import 'revisions ' is to unclutter a long-run 'strategic end ' of a group. The board of BP group takes duty for directing and oversing the whole company. The board has proposed a planetary end for BP group, which is to maximize long-

run stockholder value through the allotment of its resources to activities in the oil, natural gas, petrochemicals and energy concerns ( BP PLC, 2010: 32 )

BP group keeps a wide system of internal control, which includes the general set of direction systems, procedures, organizational constructions, behaviors and criterions that are employed to carry on their concern and deliver returns for stockholders ( ibid ) . This internal control system is considered to run into the demands of internal control of the Corporate Governance Code in the UK and of COSO ( Committee of Sponsoring Organizations of the Treadway Commission ) in the US ( ibid ) . It solves hazards and how we can respond to them every bit good as the whole control environment. Core constituents of the system of internal control are: 'the control environment ; the direction of hazard and operational public presentation ( including in relation to fiscal coverage ) ; and the direction of people and single public presentation ' ( ibid ) . The undermentioned image shows a comprehensive debut of BP group 's internal control system.

The item contents of the control system are showed in the graph. Among the dynamic pie graph the hazard direction and operational public presentation should be viewed as a important portion. It includes concerns place, prioritize, manage, proctor and better the direction of hazards on a daily footing to fit them to cover with jeopardies and uncertainty ( BP PLC, 2011: 123 ) . This enables the most of of import hazards can be identified.

Mentioning to the facet of proctor, it is of import for BP to carry on a centrally control and proctor. BP`s centrally controlled procedure as a portion of internal control system, it consists of the undermentioned constituents:

Accountabilities of forces of the group, to corroborate that there are reappraisal and mandate of proven militias engagements independent from the working concern and that there are effectual controls in the blessing procedure and verification that the proven militias estimations and the related fiscal influences are reported in clip ( ibid: 90 ) .

Capital allotment procedure, the proxy authorization is trained to prosecute in capital undertakings that are compatible with the bringing of the group 's concern program ( ibid ) . An official reappraisal procedure proposes to guarantee that both proficient and concern criterions are met old to the committednes of capital undertakings.

Internal audit is to analyze whether the group 's internal control system is good designed and running efficaciously to satisfactorily respond to put on the line that are of import to BP ( ibid ) .

### **A confirmation of the effectivity of BP 's internal control**

On April 20th 2010 that was a catastrophe for BP group, due to the leak oil of Mexico gulf. This incident brought a black consequence of which BP had to pay 1000000s lbs to reconstruct the environment of Mexico gulf. However, from the chance of this thesis, it is a good opportunity to verify and analyze the effectivity of internal control system of the mark company after experienced such a hazard.

## **Liquidity analysis**

This portion aims to prove the ability of cashing of BP. Due to an incident of leak oil, BP must apportion immense figure of money to pay the Restoration work. Thus a information analysis towards BP 's liquidness could be a opinion for BP 's periodical internal control public presentation. Current ratios are viewed a swayer of a company 's liquidness. Following are graph of current ratio of BP Group.

Form the image above, it is clear that in the 2nd one-fourth of 2010 the current ratio dropped evidently from 1. 13 to 0. 96, chiefly because of a immense hard currency outgo of environment Restoration work. While, from the 3rd one-fourth of 2010 the ratio had a steady addition from 1. 01 to 1. 25 ( till one-fourth 2 of 2011 ) . It is showed that BP group usage about 1 twelvemonth to increase their liquidness for the possible payment for the Restoration work. After the one-fourth 3 of 2011, the current ratio restored to the normal value ( around 1. 15, above 1 ) as shows before the incident. To reason, from the chance of liquidness informations, BP 's internal control system was effectual and showed a speedy reaction to the incident in seting their liquidness.

## **Profitability and stock value analysis**

In this portion, return on plus rate and stock monetary value would be used to analyze BP 's profitableness and stockholders ' assurance.

It is clear that in 2010 the return on assets was minus ( -1. 22 ) due to a big figure of compensation payments decrease the return rate. However, merely

1 twelvemonth yesteryear in 2011 BP kept their return on assets rate to be 8.98%. It is incredible for a company to hold such strong recovery ability but BP did it. It besides shows the hazard direction work of BP is first-class.

However, the stockholders seemed non to be that confident with BP.

Harmonizing to the stock monetary value graph, it is easy to be concluded that before the Mexico incident, the stock public presentation of BP were ever better than the whole stock market, nevertheless, after the oil leak incident the stock performed worse than the FTSE all portions. Therefore, it shows that investors' are non that confident with BP group. Due to stockholders' subdued reaction to the stock, it shows that the internal control of BP has a job in communicating with public. Therefore, BP needs a more comprehensive sweetening in communicating with stockholders, investors and citizens.

## **Restrictions**

There are chiefly two restrictions about this instance survey. First of wholly, the informations collected from the one-year study would non stand for the existent concern fortunes. It is normally believed that before a listed company releases its study they would use accounting houses to fancify their fiscal studies, thereby doing an mistake between written and true public presentation. Therefore, the analysis based on this would non accomplish a complete carnival.

In add-on, the stock market public presentation can non 100% shows the true rating of a company. From the position of psychological science,



investors have a 'Herd behavior', which means people tend to carry on the same actions as most of market participants conduct. Take BP for an illustration, after the leak oil incident all the people plans to sell the stocks, therefore doing an unreasonable uninterrupted low monetary value of stock.

Furthermore, a hapless public presentation of BP's stocks is non merely due to the Mexico incident, but besides the planetary economic recession. Thus it would act upon the equity of the researching consequence.

Although a sound internal control system has been established inside BP group, it is still hard to easy cover with the black incident. Furthermore, the protecting map of internal control it is still limited because hazard can non be wholly eliminated. However, the substance of internal control is a variegation of hazards, non turning away. Therefore, via the fiscal information analysis, the effectivity of BP group's internal control is fundamentally satisfied.

## **Decision**

This thesis foremost reviews the construct of internal control, and so introduces relative back uping theories of internal control. In add-on, research the construction of a group company, and its issue of how to set up an inside internal control system. Furthermore, a instance survey of BP group is showed to intensify the points proposed in the former portion.

After the instance survey of BP group, some valuable positions and inventions about how to hone a group's internal control are concluded as the decision portion.

In chapter 3 we have introduced the COSO model and Turnbull study, they are elaborate instructions to houses for set uping an internal control system. Here, we will discourse a group company 's internal control constituents by uniting the COSO and Turnbull instructions.

When speaking about a groups ' internal control, we must foremost find the aims of internal control. COSO ( 1992 ) defined the aims of internal controls from three facets: economic system and efficiency of operations, dependability of fiscal and direction studies and conformity with Torahs and ordinances. Although the diverseness ends set by the COSO study can be more orientated to the internal control, but triggered a pandemonium of ends in coordination. COSO ( 2004 ) studies amended 'reliability of fiscal and direction studies ' into 'reliability of studies ' , this new definition of 'reports ' screens endeavors ' all studies, including fiscal studies. In add-on, the COSO.