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An Analysis of Internal Control Systems and Their Influnce on Financial Sustainability of Selected Institutions of Higher Learning in Tanzania

Dr Arthur Sunday , Dr Mabonga Eric , Tumwebaze Lydia , Dr Kirabo Kyeyune B. Joseph
College of Economics and Management Kampala International University-Uganda

Email: arthursun2001@gmail.com

Abstact

The study investigated and sought to establish the relationship between internal control systems and financial sustainability in an Institution of higher learning in Tanzania. Internal controls were looked at from the perspective of Control Environment, Internal Audit and Control Activities whereas Financial sustainability focused on Liquidity, Accountability and Reporting as the measures of Financial sustainability. The Researcher set out to establish the causes of persistent poor financial sustainability from the perspective of internal controls.

The research was conducted using both quantitative and qualitative approaches using Survey,

Correlation and Case study as Research Designs. Data was collected using Questionnaires and

Interview guide as well as review of availablefinancial reports, documents and records of the selected institutions .The study found that management of most institutions is committed to the control systems, actively participates in monitoring and supervision of the activities of the Institutions of higher leraning , all the activities of the Institution's activities are initiated by the top level management, that the internal audit conduct regular audit activities and doesn't produce regular audit reports although the few reports produced by the internal audit department address weaknesses in the system. It was further revealed that there is a clear separation of roles, weaknesses in the system are addressed, and there is a training program for capacity building in most of the institution. However, the study also found out that there is lack of information sharing and inadequate security measures to safeguard the assets of the Institutions of higher leraning . It was however, revealed that all revenues and expenditures are properly classified, and that assets of the Institutions of higher leraning have generally increased. The study established a significant relationship between internal control system and financial sustainability. The investigation recommends competence profiling in the Internal Audit department which should be based on what the Institutions of higher leraning expect the internal audit to do and what appropriate number staff would be required to do this job. It also recommends that the institution

establishes and manages knowledge/information management system to enable all parties within the institutions to freely access and utilize the official information. There should be a strategy to improve the generation of additional finances for the Institutions of higher leraning .
The Study therefore concludes that internal control systems do function although with hiccups
and that there is a significant relationship between internal control systems and financial
sustainability in an Institution of higher learning.

Key Words : Internal Control System, Financial Sustainability,Institutios of Higher Learning.

Introduction

Financial sustainability is one area that is given a lot of prominence all over the world, it has been widely researched. A lot of literature has been written on financial sustainability, and External auditors normally place a lot of emphasis on Internal controls as a measure to ensure sustainable and improved financial sustainability, however, it is the perception of the researcher that there are still gaps in the research so far done. This study will therefore, try to establish the linkage between internal controls and improved financial sustainability as measured by liquidity, accountability and financial reporting.There is a general perception that institution and enforcement of proper internal control systems will always lead to improved financial sustainability. It is also a general belief that properly instituted systems of internal control improve the reporting process and also give rise to reliable reports which enhances the accountability function of management of an entity.

Nevertheless, available Literature still alludes out that in spite of elaborate system of controls in organizations, financial sustainability has been elusive in most of these organizations (OAG, 2010). This study will be guided by “The Agency Theory” as initially put across by Jensen & Meckling, (1976) and later expounded on by Gerrit Sarens & Mohammad J. Abdolmohammadi, (2010). Gerrit & Mohammad theory also has connotations with the Theory of firm articulated by Nicolai J. Foss *et al.* According to the agency theory a company consists of a nexus of contracts between the owners of economic resources who are charged with using and controlling those resources (Jensen & Meckling, 1976). In as much as Internal control Systems are wide and numerous, for the sake of this study, Internal control systems were limited to; the Control Environment, Internal Audit, and Control activities whereas Financial sustainability was looked at basically from the three perspectives of Liquidity, Accountability and Reporting. In nstitutions of higher learning, financial sustainability is one aspect that has not been given the attention it deserves.Accountability needs to be accurate and timely so as to aid decision

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making. It should be noted that International Financial Reporting Standards (IFRSs) emphasize timely production of financial reports. Ideally end of year financial statements should be produced within three months following the end of the period to which the financial statements relate.

Joseph Rujumba (2013) realised that in Institutions of Higher Learning ,there is a financial mismanagement interms of Liquidity shortfalls,accountability inadquaties of an unclear reporting sytem.This is supported by Mulumba 2013,Sekajjugo 2012,Authr 2010, and Asiimwe 1996). It has been greatly argued by different authors eg Bonn et al(2004)that proper internal controls sytems will effectively reduce on poor financial performance. Despite effort to institute proper internal control sytems the tendency of financial management controls reflected interms of unbudgeted expenditure,undisclosed revenue sources and poor accountability has confirmed to manifest itself.Therfore this has created a gap which this study would investigate to establish the relationship between Internal Controls sytems and Financial Sustability

Review of related Literature

According to Hayes *et al.*, 2005 internal control comprises five components; the control
environment, the entity's risk assessment process, the information and communication systems, control activities and the monitoring of controls. However, for purposes of this study, the research will narrow down to only three components of the internal control system. Control environment, internal audit and control activities. The other components of the internal control systems will be held constant. Gupta (2001) drawing from Statements of Standard Auditing.

Strategic controls entail the use of long-term and strategically relevant criteria for the evaluation of business-level managers' actions and performance. Strategic controls emphasize largely subjective and sometimes intuitive criteria for evaluation (Gupta, 1987). The use of strategic controls requires that corporate managers have a deep understanding of business-level operations and markets. Such controls also require a rich information exchange between corporate and divisional managers.
(Hoskisson, Hitt, & Ireland, 1994). On the other hand, financial controls entail objective criteria such as return on investment (ROI) in the evaluation of business-level managers' performance. They are similar to what Ouchi (1980) and Eisenhardt (1985) referred to as outcome controls. Thus, top-level managers establish financial targets for each business and measure the business-level managers' performance against those targets. Such an approach can be problematic when the degree of interdependence among business units is high.

Thus, emphasis on financial controls requires each division's performance to be largely independent. As a firm grows especially through acquisition, it also grows in complexity and the number of units that corporate executives must oversee and manage (thereby increasing their spans of

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control). Clearly, each acquisition increases corporate managers' need for information processing, sometimes dramatically so.

These changes make it difficult for corporate managers to use strategic controls. To reduce information-processing demands, they may change their emphasis from strategic to financial controls. (Michael A. Hitt, et al**)** The three major categories of management objectives comprise; effective operations, financial reporting and compliance (Hayes et al., 2005). Effective operations are about safeguarding the assets of the organization.

The physical assets like cash, non physical assets like receivables, important documents and records of the company can be stolen, misused or accidentally destroyed unless they are protected by adequate controls.

The goal of financial control requires accurate information for internal decision because management has a legal and professional responsibility to ensure that information is prepared fairly in accordance with applicable accounting standards. Organizations are equally required to comply with many laws and regulations including company laws, tax laws and environment protection laws. The authoritative 1994 *Principles of Corporate Governance* of the American Law Institute recommends that “every large publicly held corporation should have an audit committee that would review on a periodic basis . . . the corporation’s internal controls . . .”

Whittington and Pany (2001) note that the control environment sets the tone of the organization by influencing the control consciousness of people. They further assert that control environment is viewed as the foundation for all the other components of internal control. Control environment factors include; integrity and ethical values of personnel responsible for creating, administering, and monitoring the controls, commitment and competence of persons performing assigned duties, board of directors or audit committees (especially the extent of their independence from management, experience & stature), management philosophy and operating style (in terms of their aggressiveness or conservativeness which may determine the level of risk they may take on), and Organizational structure (which may be a well organized structure that provides for proper planning, directing and controlling operations or a disorganized structure that may only se (DeZoort *et al*., 2002; Spira, 2002). Recent case studies on internal auditing in Belgium illustrate the importance of the control environment when studying internal auditing practices. Sarens & De Beelde (2006a, 2006b) found that certain control environment characteristics (e.g., tone-at-the-top, level of risk and control awareness, extent to which responsibilities related to risk management and internal controls are clearly defined and communicated) are significantly related to the role of the internal audit function within anorganization.
et al., 2009). Therefore, management is more likely to invest in a relatively larger internal audit

Whittington & Pany (2001) suggest that internal auditing is performed as part of the monitoring activity of an organization. It involves investigating and appraising internal controls and the efficiency with which the various units of the organization are performing their assigned functions. An

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Internal Auditor is normally interested in determining whether a department has a clear understanding of its assignment, is adequately staffed, maintains good records, properly safeguarding cash, inventory & other assets and cooperates harmoniously with other departments. The internal auditor normally reports to the top management.

Gupta (2001) on the other hand asserts that "Internal audit is an independent appraisal function established within an Organization to examine and evaluate its activities as a service to the organization". The objective of internal audit is to assist members of the organization in the effective discharge of their responsibilities. According to Gupta "the scope of internal audit isdetermined by management". Sebbowa, 2009 also defines "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management control and governance processes". He further mentions the principles of Internal audit to include; Integrity, Objectivity, Confidentiality and Competency.

Bhatia (2003), Internal Auditing is the review of operations and records sometimes undertaken within the business by especially assigned staff. It's also an independent appraisal function established within an organization to examine and evaluate the effectiveness, efficiency and economy of managements control system (Subramaniam, 2006). Its objective is to provide management with re-assurance that their internal control systems are adequate for the need of the organization and are operating satisfactorily (Reid & Ashelby, 2002). It is a component of the internal control system set-up by management of an enterprise to examine, evaluate and report operations of accounting and other controls.

The quality and effectiveness of internal audit procedures in practice are necessary since internal auditors cover a wide variety of assignments, not all of which will relate to accounting areas in which the external auditor is interested. For example, it's common these days for internal audit to undertake the extensive and continuous task of setting management goals and monitoring its performance (Woolf, 1996). Emasu (2010) notes that "The effectiveness of internal audit function partly depends on; legal and regulatory framework, placement of the function and its independence, existence of audit committees, resources allocated to the function and professionalism of internal audit staff". It is however a bitter reality that internal audit departments are rarely adequately facilitated. Regarding the size and facilitation of the Internal Audit Function,

Gerrit and Mohammad (2010), found evidence in support of the monitoring role of the Internal Audit Function. They specifically, found evidence that management ownership is positively related to the relative size of the Internal Audit Function, which is inconsistent with traditional agency theory arguments that predict a negative relationship, but more in line with recent studies on earnings management. This finding suggests that increased management ownership may influence the board of directors to support larger Internal Audit Functions to allow them to closely monitor managers' performance. It is also plausible that management with higher share ownership is

motivated to invest in larger Internal Audit Function for better monitoring of earnings and for signalling to the board of directors that, despite their high stake in earnings, they are convinced that appropriate use of resources has to be assessed on a regular basis.

Gerrit and Mohammad also believe that the proportion of independent board members to have a negative effect on Internal Audit Function size. This finding may indicate a substitution effect, which means that independent board members may be considered as an alternative monitoring mechanism to the Internal Audit Function. They further assert that the control environment has a significant effect on the relative size of the Internal Audit Function. Specifically, a supportive control environment characterized by formalized integrity and clear ethical values, a high level of risk and control awareness, the perception that risk management is important and the fact that responsibilities with respect to risk management and internal control are clearly defined is associated with a relatively larger Internal Audit Function. Using a US sample, Wallace & Kreutzfeldt (1991) found that companies with internal audit departments are observed to be significantly larger, more highly regulated, more competitive, more profitable, more liquid, more conservative in their accounting policies, more competent in their management and accounting personnel, and subject to better management controls. Carey *et al*. (2000) found that agency variables do not explain the voluntary use of internal audit by Australian family firms. More recently, a study by Goodwin-Stewart & Kent (2006), using a sample of Australian listed companies, shows that the existence of an Internal Audit Function is positively associated with firm size and commitment to risk management.

Sarens & De Beelde (2006) also show that the risk and control awareness have an influence on the scope of the Internal Audit Function. These results suggest that when management is aware of risks and control activities, they are more likely to understand the role of the Internal Audit Function in monitoring risk and control activities, thus it is more likely that they will support a relatively larger Internal Audit Function (Sarens & De Beelde, 2006a; Selim & McNamee, 1999). Meigs et al (1988) holds that there must be a strong internal control system and the internal auditor must verify the operations of the system in much the same way, as the external auditor. It involves the investigation, recording, identification and review of compliance tests of control, they also argued that effective internal audit procedures provide sufficient relevant and reliable evidence in order to detect and prevent fraud.

Kochan (1993), considers auditing procedures in one company and describes steps taken in implementing a quality assurance system, she discusses the use of internal audits as an essential part of ISO 9000 certification process. Boakye-Bonsu (1999) asserts that internal audit procedures are seen as ends in themselves rather than a means towards a specific objective, with such an approach our rambler would undoubtedly get lost. Internal audit procedure is a form and content manual that includes audits notes and responsibilities, documentation standards, local reporting standards and targets, training requirements and expectations and performance measures and indicators (Watts, 1999).

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Effectiveness is the achievement of goals and objectives using factor measures provided for in determining such achievement. However, it has been traditional in internal auditing that determination of internal auditing effectiveness can be accomplished by evaluating the quality and effectiveness of internal auditing procedures that result in determination by the internal auditors of the character and the quality of effectiveness of the auditee's control operations and if the auditing procedures are effectively carried out, then the evaluative results are positive (Dittenhofer, 2001). Maitin (1994) says efficiency and effectiveness of internal audit procedures is not a simple task, successful operation is governed by the extent to which the element of internal audit procedures receive attention which include; expertise, independence, objectivity and totality. Effectiveness of internal audit procedures is a measure of the ability of the programme to produce a desired effect or a result that can be qualitatively measured (Harvey, 2004). Zabihollah (2001) argues that, there should be effective internal audit procedures to ensure reliability of financial statements, operational reports, safeguarding corporate assets and effective organizational controls.

Benston (2003) further supplements that perception and ownership, organization and governance framework, legislation, improved professionalism and resources were identified as functions in the public sector derived from the effectiveness of the internal audit procedures. How far internal audit procedures succeed in their effort of effectiveness is mainly judged by three factors that include; frequency of irregularities committed by the staff in the organization in form of errors or fraud, the promptness with which such irregularities are detected by the authorities and the planning which makes possible repetition of such irregularities in future more difficult (Reid & Ashelby, 2002).

Earnest and Young (1995), the work of the internal auditor should appear to be properly planned, controlled, recorded and reviewed. Examples of the due professional care by the internal auditor are the existence of an adequate audit manual, general internal audit plans, procedures for controlling individual assignments and satisfactory arrangements for reporting and following up.

Ray and Pany (2001) also mention Control activities as another component of Internal controls. They note that control activities are policies and procedures that help ensure that management directives are carried out. Controls activities in an organization basically comprise; performance reviews (comparing actual performance with budgets, forecasts and prior period performance), information processing (necessary to check accuracy, completeness and authorization of transactions), physical controls (necessary to provide security over both records and other assets), and segregation of duties (where no one person should handle all aspects of a transaction from the beginning to the end). The last component of internal control according to Ray and Pany is monitoring. This is aimed at ensuring that the internal controls continue to operate as intended. This can be achieved through ongoing monitoring or separate evaluations. Separate evaluations are non routine monitoring activities such as period audits by the internal auditors.

According to Stoner (2003), performance refers to the ability to operate efficiently,

profitability, survive grow and react to the environmental opportunities and threats. In agreement with this, Sollenberg & Anderson (1995) asserts that, performance is measured by how efficient the enterprise is in use of resources in achieving its objectives. It is the measure of attainment achieved by an individual, team, organization or process (EFQM, 1999). Hitt, *et al* (1996) believes that many firms' low performance is the result of poorly performing assets (businesses). Low performance from poorly performing assets is often related to strategic errors made in the acquisition process in earlier years. For example, some firms acquire businesses with unrealistic expectations of achieving synergy between the acquired assets and their current sets of assets. A common reason for such errors is managerial hubris (Roll, 1986) or overvaluation of managerial capability in the acquisition process.

According to Dixon *et al* (1990), appropriate performance measures are those which enable
organizations to direct their actions towards achieving their strategic objectives. Kotey & Meredith (1997) contends that, performance is measured by either subjective or objective criteria, arguments for subjective measures include difficulties with collecting qualitative
performance data from small firms and with reliability of such data arising from differences in
accounting methods used by firms. Kent (1994) found out that, objective performance measures include indicators such as profit growth, revenue growth, return on capital employed. Financial consultants Stern Stewart & Co. created Market Value Added (MVA), a measure of the excess value a company has provided to its shareholders over the total amount of their investments. This ranking is based on eight more traditional aspects of financial sustainability including: total return for one and three years, sales growth for one and three years, profit growth for one and three years, net margin, and return on equity. Verschoor however, mentions other financial measures to include value of long-term investment, financial soundness, and use of corporate assets. He also talks of non financial sustainabilitys measures to include; innovation, ability to attract, develop, and keep talented people, quality of management, quality of products or services, and community and environmental responsibility. Hitt, et al., (1996) mention accounting- based performance using three indicators: return on assets (ROA), return on equity (ROE), and return on sales (ROS). Each measure was calculated by dividing net income by total assets, total common equity, and total net sales, respectively.

According to Kotler (1992), strong performer firms are those that can stay in business for a good number of years. Dwivedi (2002) also found out that, the ability of a firm to survive in business in an indicator of good financial sustainability. Richardson, Sonny & Suzan (1994) found out that, 38 active British businesses went into liquidation in the third quarter of 1992 and in 1991 a total of 21,827 businesses failed compared to 15,051 in 1990.

Hitt, *et al* (1996) mention current ratio (current assets/current liabilities) as a standard measure of liquidity in organisations. Baysinger, (1989) also emphasized the importance of current ratio as a measure of an organisation's liquidity. Other measures of Liquidity according to ACCA and Panday (1996) are; Acid test

ratio (i.e. Current Assets less Inventory/Current Liabilities).

According to Hayes, et al., 2005, Managers need regular financial reports so as to make informed decisions. Reporting (particularly financial reports) is one way through which managers make accountability for the resources entrusted to them. Emasu (2010) asserts that Accountability can be political, social or financial accountability.

Whittington & Pany (2001), talk about the comprehensiveness of internal controls in addressing the achievement of objectives in the areas of financial reporting, operations and compliance with laws and regulations. They further note that "Internal control also includes the program for preparing, verifying and distributing to the various levels of management those current reports and analyses that enable executives to maintain control over the variety of activities and functions that are performed in a large organization" They mention internal control devices to include; use of budgetary techniques, production standards, inspection laboratories, employee training and time & motion studies among others.

According Bakibinga 2001, corporate law requires a divorce between ownership and management of an entity. Owners normally entrust their resources in the hands of managers. Managers are required to use the resources entrusted to them in the furtherance of the entity's objectives. Managers normally report to the owners on the results of their stewardship for the resources entrusted to them through a medium called financial statements. It is these financial statements that reveal the financial sustainability of an entity. John J. Morris (2011) believes that Enterprise Resource Planning systems provide a mechanism to deliver fast, accurate financial reporting with built-in controls that are designed to ensure the accuracy and reliability of the financial information being reported to shareholders.

Methodology

The study population consisted of 05 selected nstitutions of higher Learning where the sample size of 105 were determined of primary data respondents. Primary and secondary data sources were used in the study. Structural Equations Modeling with Analysis of Moment Structures were also used to for statistical modeling.

Cronbach's alpha was used to test the reliability of the instruments and the instruments were found to be reliable at 0.78. Content validity of the two instruments was ensured through use of valid concepts which measure the study variables . Content validity was used to ensure that the questionnaire was content valid. The content validity results were obtained and for all the constructs were above 0.7 as recommended by Sakaran (2000). The study used Means and standard deviations in order to summarize the results. The means were used because they show a summary of data and standard deviation clearly shows how well the means represent the data (Field, 2009). Hierarchical regression was used to estimate the predictive power of the predictor variable on the criterion variable in the model fit.Data was collected using both primary and secondary data collection techniques. Primary data was gathered basically through structured questionnaires and interviews with "Key informant

members" of the 5 selected institutions with 105 respondents.

Findings

Findings on correlation of study variables(ICS and Financial Sustainability)

	1	2	3	4	5
CONTROL ENVIRONMENT(1)	1				
RISK ASESSMENT (2)	.204*	1			
INFORMATION AND COMUNICATION(3)	.112	.441**	1		
MONITORING(4)	.123	.486**	.157	1	.
FINANCIAL SUSTAINABILITY(5)	.283**	.383**	.043	.220*	1

*. Correlation is significant at the 0.05 level (2-tailed).

**. Correlation is significant at the 0.01 level (2-tailed).

Source**: **Primary data

The correlation table presents the relationship between dimensions of Internal Controls measured by control environment, risk asessment,monitoring and information and comunication against Financial sustainability, measured by liquidity, accountability and Reporting. The results show that all the dimensions relate positively. Specifically, control environment relates positively with liquidity, accountability and reporting ($r = 0.283^{**}$, $p < 0.01$; $r = 0.383^{**}$, $p < 0.01$; $r = 0.043$, $p > 0.01$) $r = 0.220^{*}$ $p < 0.01$ respectively.

Multiple Regressions

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	F	
1	.302[a]	.091	.082	.20417	10.212	.002[a]
2	.444[b]	.197	.181	.19282	12.405	.000[b]

3	.465[c]	.216	.192	.19150	9.182	.000[c]
4	.465[d]	.217	.185	.19240	6.840	.000[d]

a. Predictors: (Constant), CONTROL ENVIROMENT

b. Predictors: (Constant), CONTROL ENVIROMENT, RISK ASSESSMENT

c. Predictors: (Constant), CONTROL ENVIROMENT, RISK ASSESSMENT, INFORMATION AND COMUNICATION

d. Predictors: (Constant), CONTROL ENVIROMENT, RISK ASSESSMENT, INFORMATION AND COMUNICATION, MONITORING

Coefficients of the model summary

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	2.479	.187		13.263	.000
	CONTROLE	.188	.059	.302	3.196	.002
2	(Constant)	1.786	.259		6.893	.000
	CONTROLE	.144	.057	.232	2.540	.013
	RISKA	.268	.073	.333	3.655	.000
3	(Constant)	1.927	.273		7.060	.000
	CONTROLE	.145	.056	.233	2.575	.011
	RISKA	.323	.081	.401	3.987	.000
	INFORCOMN	-.099	.064	-.153	-1.548	.125
4	(Constant)	1.926	.274		7.024	.000
	CONTROLE	.145	.057	.233	2.556	.012
	RISKA	.312	.092	.387	3.400	.001
	INFORCOMN	-.098	.064	-.151	-1.516	.133
	MONITRING	.002	.009	.027	.264	.792

a. Dependent Variable: FINANCIAL PERFORMANCE

***Source**: Primary data*

The findings above illustrates that, the independent variable (Internal Control Systems), through its dimensions; control environment, risk asessment, monitoring and information and comunication) explains the variation in the dependent variable up to 21.7 % as denoted by adjusted R2 value in the table. Similarly, considering the dimensions of internal control systems in this study, risk asessment seems to provide better explanation in the variation in the dependent variable

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