

# Impact on Internal Control System According to Committee of Sponsoring Organizations (COSO) to Reduce Illegal Financial Transactions in Commercial Bank Listed in Amman Stock Exchange

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## *Abstract*

*This study aimed to identify the effect of internal control according to committee of sponsoring organization to reduce illegal financial transactions, specially money laundering transactions in commercial banks listen in Amman Stock Exchange. The researchers adopted an analytical descriptive approach. A specially – designed questionnaire was given to a (13) commercial bank. This questionnaire was given especially to (financial manager, internal auditing manager, internal auditing), each bank took only (3) questionnaire collected back (33) questionnaire from bank. Which is a named (85%), the researcher used analytical program which is spss to analyze this data. The study came up with the existence of a positive effect of the independent variable of the study (combined and separated) to reduce money laundering in commercial bank , the most effective was information and communication and low effective was performance monitoring , according to sample population. This study recommended using committee of sponsoring organization (COSO) in most of commercial bank, especially in control environment and improving it as they can.*

**Key Words:** *Internal Control System, Organization, Stock Exchange, Amman.*

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## **Introduction**

The end of the twentieth century and the beginning of the twenty-first witness information and communication revolution accompanied with vast advance of financial transactions, especially in banking services like cash and draft, change services by cheques, money drafts by electronic tools, which is the easiest in its execution and performance at the same time the hardest to know the sources of laundering money.

All of this makes it necessary for all the entities to design control systems to protect its assets and to control its business. Thus, because of the importance of the internal control, particularly after increasing the cases of fraud and manipulation of financial statements which leads to money theft, money laundering and other financial crimes. The committee of sponsoring organizations (COSO) (1992) established an integrated internal control framework, where it is widely accepted about internal control, which consists of five

components: control environment, risk assessment, control activities, information and communication and monitoring (Romny 2010).

One of the main causes for establishing COSO is fighting corruption and money laundering in banks, where money laundering is considered a financial crime as its offenders hide the illegal sources of money to use it later in legal projects which has a negative reverse on country's economy and private sector's organizations (AlAmeri, 2005 p.5).

Therefore, this study examines the impact of internal control systems according to the framework of the committee of sponsoring organizations to reduce illegal financial transactions, specially money laundering transactions in commercial banks listed in Amman Stock Exchange.

### **Significance of the study**

The significance of the study is:

- 1- Paying attention to understanding the work framework of the committee of sponsoring organizations and its articles.
- 2- Paying attention to fighting money laundering crimes before they happen.

### **Study Objectives**

This study aims to recognize the following:

- 1- Assessing internal control systems applied in banks and checking their harmony with the committee of sponsoring organizations (COCO).
- 2- Recognizing the traditional and modern ways of money laundering transactions.
- 3- Defining strong and weak points of internal control systems in bank
- 4- Recognizing bank sector procedures in fighting money laundering transactions.
- 5- Recognizing the impact of internal control system according to the framework of COSO to reduce illegal financial transactions, particularly money laundering transactions in commercial banks listed in Amman Stock Exchange.

### **Study Problem**

Economic units face a number of problems of internal control and its basic elements (accounting and administrative). This matter required building competent internal control systems that are capable of achieving accurate and valid financial reports, especially in banks that face a dangerous challenge lies in money laundering transactions. Thus, COSO with its five fold framework created a method for helping organizations in their internal control of their works. The study problem focused on the following queries:

- 1- What is the extent of applying the framework of COSO for internal control in commercial banks listed in Amman Stock Exchange?
- 2- Does the application of COSO framework of internal control affect on reducing the illegal financial transactions in commercial banks listed in Amman Stock Exchange?  
This question ramifies into the following questions:
  - A- Does the component of control environment in the framework of COSO of internal control affect on reducing illegal financial transactions in commercial banks listed in Amman Stock Exchange?
  - B- Does the component of assessing risks in the framework of COSO of internal control affect on reducing illegal financial transactions in commercial banks listed in Amman Stock Exchange?

- C- Does the component of activities in the framework of COSO of internal control affect on reducing illegal financial transactions in commercial banks listed in Amman Stock Exchange?
- D- Does the component of information and communication in the framework of COSO of internal control affect on reducing illegal financial transactions in commercial banks listed in Amman Stock Exchange?
- E- Does the component of performance control in the framework of COSO of internal control affect on reducing illegal financial transactions in commercial banks listed in Amman Stock Exchange (ASE)

## Study Hypotheses

Depending on study problem and its ramified questions, the following study hypotheses can be formulated:

### Main Hypothesis

There is no statistically significant impact of applying the framework of COSO of internal Control in reducing illegal financial transactions in commercial banks listen in ASE?

And from the above hypothesis, the following hypotheses can be emanated:

### First Hypothesis

There is no statistically significant impact of environment control of the framework of COSO of internal Control in reducing illegal financial transactions in commercial banks listed in ASE.

### Second Branch Hypothesis

There is no statistically significant impact of risks assessment of the framework of COSO of internal Control in reducing illegal financial transactions in commercial banks listed in ASE.

### Third Branch Hypothesis

There is no statistically significant impact of control activities element of the framework of COSO of internal Control in reducing illegal financial transactions in commercial banks listen in ASE.

### Fourth Branch Hypothesis

There is no statistically significant impact of information and communication element of the framework of COSO of internal Control in reducing illegal financial transactions in commercial banks listen in ASE.

### Fifth Branch Hypothesis

There is no statistically significant impact of performance control of the framework of COSO of internal Control in reducing illegal financial transactions in commercial banks listen in ASE.

## Study Limitation

- Human limitation: subjects who are going to respond to the questionnaire, the internal auditors working in Jordanian Commercial Banks.
- Location limitations: population study consists of commercial banks listed in ASE and they are (13) banks.
- This study is restricted on the study sample which consists of internal auditors, auditing managers and financial in Jordanian Commercial Banks.

- Using the questionnaire as a tool for data collecting and this data have to be subject to possible problems for using this tool.

### Study Variables

The study variables are described and restricted and they include two types of variables namely:

Dependant Variable: the dependant variable is money laundering transactions.

Independent Variable: the independent variable of the study is internal control system according to the framework of COSO and it ramifies to the following articles:

- Control environment, risk assessment, control activities, information and communication, control and follow up.

The researcher prepared a model for this study and figure (1) explains the nature of relation among study variables.

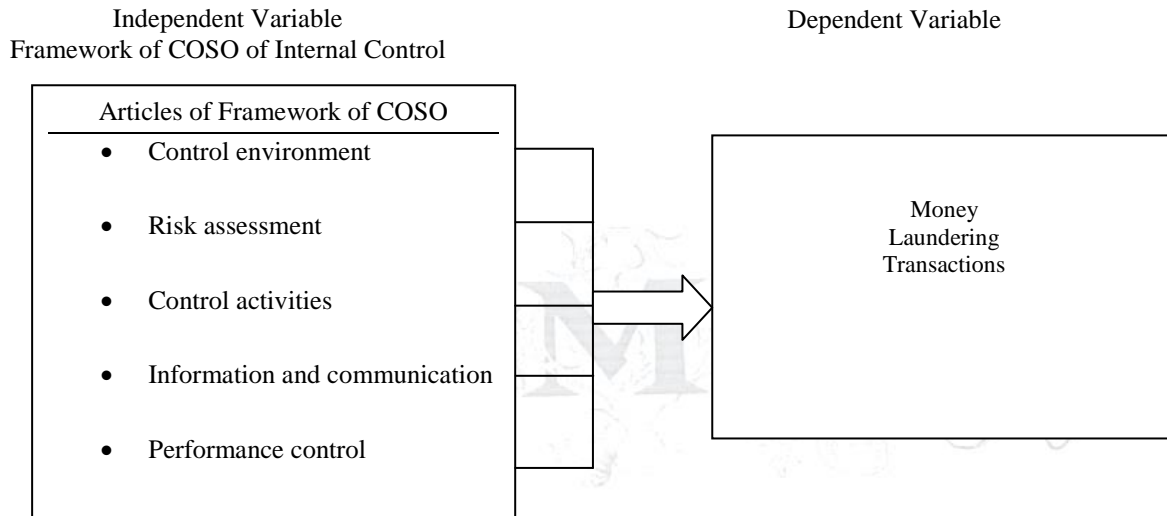


Figure (1) The nature of relations among study variable

### Procedural Definitions

**Internal Control System:** It is a system throughh which we can create procedures, precautions for preserving cash assets and distributing tasks, works and responsibilities among company individuals according to the specialization (Chahill, 2006).

**Concept of the Committee Organization (COSO):** It is an organization consists of five organizations and it means the committee that sponsors the organization. This committee include the five largest professional associations: American Institute of CPA, Financial Executive International, the Association of Accountants and Financial Professionals in Business, the Institute of Internal Auditors, American Accounting Association. The committee's actual task is to concern in internal control system and develop it (COSO, 2012).

**Illegal Transactions (Money Laundering):** it is dirty money gained from trading in illegal weapons, children, white slaves, human organs and other criminal actions and all of this illegal money where gangs transfer money into fixed assets, goods, services and legal money (Safa, 2003).

## Theoretical Framework and Literature Review

### Internal Control

Scientific technological advance in this age lead to an increase in establishments size, increasing its responsibilities in achieving their objectives and administrative problems resulting from the diversity if their activities and the advancement of their business, so this calls in to separate ownership from administration. Thus, so as to make owners feel secure on their money there is a need for a third part to confirm that business results and accounting procedures are in agreement with international accounting standards and this third party is the external auditors.

In order not to have any delay in external auditing, so the internal control system is inevitable required by modern administration (management) to keep the available resources and internal control system characterizes by competence and effectiveness, it can be applied by individuals and management, and it forms a protection for the organization for risk that it may face (AlAydee, 2000, p.82).

Internal control has several concepts and may authors, professional associations handle this concept, most important of these are:

The definition of the International Federation of Accountants: It is that process done by persons in charge of control to provide a reasonable confirmation about achieving the aims of the entity regarding the reliability of providing financial reports, processes efficacy and competence and submission to laws and applied systems.

### Committee of Sponsoring Organization (COSO) and its emergence

Some professional organization s in the United States of America issued several reports that contributed in effective role towards developing interest in internal control system assuring its effectiveness, like the report issued by COSO in September 1992 entitled: Internal Control – Integrated Framework, the law issued by institute of Chartered Accountants in England and Wales in December 1994 and the report issued by CPA Canada in November 1995 and other reports that handled internal control design for organizations to know the weak points in the system and correcting them (Ghali, 2003, p.320).

### Concept of COSO and its emergency

This committee consists of five organizations and it means the committee that sponsors organizations and works to foster the role of control in organizations. The five organizations that work in the United States are: American Institute of CPAs, Financial Executives International, the Association of Accountants and Financial Professionals in Business, the Institute of Internal Auditors and American Accounting Association (COSO, 2005, p.45). This committee works in accounting and financial field, provides a comprehensive conception of the internal control concept and assessing internal control through the report that it issued entitled (Internal Control – Integrated Framework).

- The framework of COSO has passed through several developments until 1985, where the National Committee for Financial Reports was established and its name was Treadway Committee as well as it was named after its first president James C-Treadway and this committee was established by the above five mentioned organizations sponsorship. This framework consists of five articles: risk assessment, control activities, information and communication, control environment and monitoring.

## The Articles of Internal Control System according to the Framework of COSO

### Control environment

Control environment is considered the main element of internal control as it gives a strong indicator that there is an effective internal control system and it represents the surroundings which have the accounting control techniques and others including preparing financial statements. (Arens and Labak, 2005, p.383).

The control environment is affected by the organization culture, its history and it affects on employees' conscious and their behaviors as well as it comprises the following key components (COSO, 2006): honesty and ethical values, commitment to competence – board of directors and auditing committee – management philosophy and operation style – organizational structure – identifying responsibilities and delegation of authority – polices regarding human resources.

### Risk assessment

If the auditor needs to assess the risks he has to assess the extent of the effectiveness of control structure policies and its procedures in preventing errors, detecting and correcting them. The extent of risk assessment differs according to the strength of internal control system design which is found it financial data. In case if that the internal control system design is in a good manner and works as it is planned for, therefore control risks are assessed with low level. While in the case of that the internal control system is not reliable, so he has to ignore internal control and to only depend on detailed auditing.

### Control activities

All of the risk related to control activities have to be assessed and they include traditional activities related to internal control concept, policies and procedures leading to the following:  
Integration with estimating risks-choosing control activities and developing them – working on choosing the activities.

### Information and communication

Information has to be suitable and has to be put and delivered in the right time to help individuals to bear responsibility. Information is needed continuously by all organizational sections in the enterprise to achieve the objective within the plan. In addition, there should be information system in the enterprise that fits the required information, the way of having having it, handling it, extracted reports and providing the management with reports about achieved performance from attaining objectives. Additionally, there should be communication mechanisms inside the enterprise characterized by competence, which enables the employees to deliver important information to senior management in the right time.

### Monitoring performance

Monitoring performance can be achieved by the following ways (Delaney, 2001):

- 1- Continuous monitoring for activities.
- 2- Separate periodical assessments.

### Money laundering

Money laundering is considered one of the most dangerous financial crimes that has negative reflexions on economy and society as it is the common denominator of most crimes and illegal activities, particularly drug crimes, terrorism crimes, arms running and white slave etc.

Banks are considered the main target for money laundering, this is due to the growing role of banks in providing various financial services, especially change transactions and cash transfer by checks and traveler's checks, financial drafts from electronic devices, credit cards and clearing transactions, managing portfolios, currency and stock circulation and others.

These services have great extent and domain in information age as well as it can be changed into more styles easily by performance and has less control by executing mechanism, in particular in electronic banks field or web banks on the Internet. These transactions with their two forms, traditional and electronical are best tools to hide the illegal sources of money. On the other hand, banks themselves are spearhead in fighting money laundering to protect themselves from financial risks first and the legal responsibility resulting from dealing with these risks or for their participating in these actively in international effort for fighting money laundering.

### **Money laundering concept**

There are money definitions that tackled the concept of money laundering, most important of these are:

First definition: It is putting illegal money with the money of the society economy so that it appears with clear legal form and as if it clear legal gain (AlQusous, 2002, p.13).

Second definition: It is any separate action includes hiding, acquiring, acquisition for using, investment or funding wealth prohibited by law or any violate procedure for the law (Hafni, 2006, p.24).

Study of (AlAzemi, 2012) entitled: Role of Board of Directors in Applying standards of Internal Control and their impact on attaining objectives of Kuwaiti Industrial Companies. This study aims to recognize the role of board of directors in applying standards of internal control according to the American Model (COSO) and its impact on attaining the objectives of Kuwaiti Industrial Companies. The findings of this study reached that there is a relation between applying standards of internal control represented in management's understanding and perception of the objectives of internal control, integration of components or parts of internal control, effectiveness of every part of internal control structure's party, competence of managing internal control, extent of using information technology, benefiting from it and attaining objectives related to financial reports, commitment objectives and operational objectives in Kuwaiti Industrial Companies.

- Study of (Badawi, 2011) entitle: Impact of Internal Control System Structure according to the Framework of COSO on Attaining control Objectives.

This study aims to recognize the impact of the components of internal control system structure according to the framework of COSO on attaining control objectives in national organizations working Gaza Strip and the extent of development of building structures of internal control systems in these organizations.

The results of this study show that there is a great interest by these national organizations working in Gaza Strip in internal control systems.

-Study of (Compbell et al, 2006) entitled: Important Added Value to Internal Control Systems (Adding Significant Value with Controls).

This study aims to bring out the basic benefits of keeping effective internal control systems. The study handled a general and brief view about COSO model for internal control, which is used by several organizations as an applied framework and its components are explained that they are considered standards to measure the degree of advancement of control systems in the economical units. The study concludes that

the report of the Institute of Internal Auditors focused on the important benefits added to the control improvements taken from section 404 of SOX Law.

The study recommends the companies that they have to comply with the requirements of SOX law, section 404 regarding internal control, which leads to reducing risk and decreasing the costs of external auditing and interest in COSO model.

- Study of (Scannell& other, 2013) entitled: Supply Chain Risk Management within the Context of COSO's Enterprise Risk Management Framework.

This study aims to explain how enterprise's management identify expected risks from supply chain and the relation of these procedures with enterprise risk management and the framework of COSO in the enterprise. This study comes to that the components of risk management system of the project issued by COSO in the year 2004 has taken a reasonable framework that enables the enterprises to achieve integration between enterprise risk management system and supply chain risk management system.

- Study of (Rittenbedrg: 2006) entitled Internal Control: No Small Matter.

This study seeks to clarify the guidelines of internal control standard to prepare the financial statements for small enterprises issued on 7/11/2006 by COSO as a request from Small and Emerging Companies (SEC) to assist small companies in forming its financial reports on the basis of the requirements of 404 section of SOX Law 2002. The study conclude that good internal control system in an integrated part with successful organizations and that all organizations can perform an effective system for internal control. The study recommends that we should explain the integrated framework of internal control issued by COSO for the year 1992 and this framework should not be extended or replaced as well as the guidelines for this new standard should be principles for management decisions to depend on them.

## Method and Procedures

This chapter deals with the method and procedures used to carry out the objectives of the study. They include the methodology used in the study, population and sample, used tool and way of preparing it and the most important statistical techniques used in manipulating .

### Gathered Data

In view to the fact that of the important topics reported in this study, the researcher used the analytical descriptive method and it was the basis for getting data and information as well as two types of data gathering sources are used: Primary Sources: They are the data that has been taken through designing a questionnaire that suits the study subject, distributing it on the study sample, processing it, analyzing it by using the program SPSS and using the statistical tests.

Secondary sources: it is the data obtained from books and researches, periodicals, and reviewing literature, magazines, electronic sites and special publications or from the sources regarding the subject under discussion.

Second: Study population and its sample

### Study Population

Study population consists of commercial banks listed in ASE amounted (13) banks according to securities Depository Center of ASE in 2014



### Study Sample

The comprehensive counting method of the study population in used, where the study sample includes financial managers, internal auditing managers and internal auditors in banks. Study questionnaire is distributed on banks, three questionnaire for each bank. 33 questionnaires were answered with %85 and all of them were valid for analysis, so 33 questionnaires were analyzed and this represents %100 of the answered questionnaires.

### Validity of the study instrument tool

The researcher prepared the instrument and to make sure of its validity he prepared the questionnaire with the help of the supervisor and under his guidelines. The researcher showed the study instrument for several arbitrators who have specialization and experience of the faculty members of the Jordanian Universities.

#### Fourth: Reliability of the study instrument

In order to verify that the questionnaire measures the targeted factors and to make sure of its validity, the researcher used the test of the external consistency of the questionnaire items by using Cronbach's Alpha as Cronbach's Alpha measurement depends on the consistency of the respondent from one item to another. This measurement indicates to the strong correlation and consistency among the questionnaire items. In addition Cronbach's Alpha provides an estimation of the reliability. The coefficient of reliability of the whole instrument by using Cronbach's Alpha reached %94.9 and this percentage is considered very high for the approval of the results of the current study, whereas the accepted percentage for generalizing the results of the human and social researches is %60 or more.

### Statistical methods used in this study

The researcher used some of the suitable statistical methods in the analytical program SPSS to process the obtained data taken from field study, the researcher used the following statistical methods:

Spearman's rank correlation coefficient: it has been used to verify of study instrument validity through the test of internal consistency of the questionnaire items.

Cronbach's Alpha: it is used to examine the extent of the reliability of the study instrument that has been used to collect the data.

Frequency and percentage: they are used to recognize the characteristics of the respondents of the study sample.

Mean: it is used to know the extent of the high or low of responses of the study sample respondents over each item of the study items.

Standard deviation: it is used to identify the dispersion of the responses of the study sample respondents from the mean value.

One sample kolmogorov-Smirnov test: it is used to check that the data of the study variables comply with the normal distribution or not.

Variance inflation factor: this test is used to check whether there is a problem of multicollinearity among the independent variables or not.

Multiple regression: it is used to measure the impact of applying internal control system according to the Framework ,of COSO to prevent money laundering transactions.

Simple regression: it is used to identify the impact of applying every component of the components of the framework of COSO for internal control to limit money laundering transactions.

## Results and Testing Hypotheses

Table (1) shows a summary of the results of testing study hypotheses like the following:

Hypothesis	Decision	Results
Main	Refusing the null hypothesis	There is a statistically significant impact of applying the framework of COSO of internal control on reducing illegal financial transactions in commercial banks listed in ASE.
First branch	Refusing the null hypothesis	There is a statistically significant impact of the component of control environment of the framework of COSO on internal control on reducing illegal financial transactions in commercial banks listed in ASE.
Second branch	Refusing the null hypothesis	There is a statistically significant impact of the component risk assessment of the framework of COSO of internal control on reducing illegal financial transactions in commercial banks listed in ASE
Third branch	Refusing the null hypothesis	There is a statistically significant impact of the component of control activities of the framework of COSO internal control on reducing illegal financial transactions in commercial banks listed in ASE
Fourth branch	Refusing the null hypothesis	There is a statistically significant impact of the component of information and communication of the framework of COSO internal control on reducing illegal financial transactions in commercial banks listed in ASE
Fifth branch	Refusing the null hypothesis	There is a statistically significant impact of the component of monitoring of the framework of COSO of internal control on reducing illegal financial transactions in commercial banks listed in ASE.

## Results and Recommendations

### Results

The results of the study showed that the commercial banks listed in ASE apply the framework of COSO for internal control in a high degree. The highest degree is for the component of monitoring (performance assessment) then information and communication, control activities and lastly control environment.

- 1- Independent study variables, which are represented by framework of COSO of internal control, have a positive effect in reducing illegal financial transactions in commercial banks listed in ASE from the point view of study sample respondents.
- 2- The current study showed that the component of information and communication is the most important component of the framework of COSO of internal control that has an impact in reducing illegal financial transactions in commercial banks listed in ASE, then risks assessment, control activities, control environment and lastly monitoring (Performance control).
- 3- The results revealed the importance of the integration of the five components of the internal control according to the framework of COSO of the internal control and the need to apply them in an integrated way, which has a positive effect in reducing illegal financial transactions in commercial banks listed in ASE.

## Recommendation

In the light of the results obtained from the current study, the researcher suggests number of the recommendations that participate in reducing illegal financial transactions in commercial banks listed in ASE:

- 1- Commercial banks listed in ASE have to continue applying the framework of COSO of internal control with its five components and working towards developing the methods of applying them to face the threats of many laundering transactions.
- 2-The banks listed in ASE have to attach importance to the component of the environment control, like the other components of the framework of COSO due to it has the fifth rank that is the last one on the scale of the study sample respondents' assessment. This component is important as it creates the mood that enables the employees to bear their control responsibilities, including interest in ethical values, management philosophy, employee's competence and their harmony and motivating bank employees to limit many laundering transactions. All of this is done by informing all employees of their control roles in the right written way as well as establishing the principle of dealing with virtuous morals, honesty with employees and clients as well as interest in the process of training them on these things.
- 3-Establishing clear and specific policies regarding informing employees with the necessary information that enable them to do their duties and providing suitable communication means as well as to be effective in internal and external regions as this has a great effect in reducing illegal financial transactions in commercial banks listed in ASE.
- 4-The researcher recommends doing more future studies and researches regarding the framework of COSO of internal control as this subject is very important.

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