Evaluation of Internal Control Structure: Evidence from Six Listed Banks in Bangladesh

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Abstract

A critical evaluation of internal control structures in organizations is necessary to determine their capacity to ensure that the organization’s activities are carried out in accordance with established goals procedures. This study is on six listed private banks of Bangladesh. The paper develops a conceptual model in evaluating the internal control structure. The result is that almost all the banks in our sample achieved most of components of control objectives in a greater extent and the deviation regarding achievement of these is minimum. Only one or few banks have lacking regarding some of the control components. This indicates that more or less the current internal control structure is effective for all the sample banks used in the study. The study ends with some recommendations about those components of control variable found ineffective in the study.

Key Words: Private local bank, internal control, control objectives, evaluation etc.

1. Introduction

Private banking sector is getting increasing attention due to its significant stands in the financial system of Bangladesh. It plays a crucial role for the development and growth of the economy. For achievement of proper operational goals and providing reliable and relevant information, compliance with laws and regulations, Internal Control Structure is highly important. Considering this importance, we have made an attempt to evaluate the Internal Control Structure in the listed local private banks and the extent of achievement of corporate goal by applying different Internal Control techniques. This study mainly focuses on the evaluation of the internal control structure in local listed private banks. The present study covers the extent of implementation of internal control structure techniques. Committee of Sponsoring Organizations of the Tread way Commission (COSCO)’s landmark study titled Internal Control- Integrated Framework is widely used and accepted by the major U.S Accounting Bodies as the authority on internal controls. The Study defined internal control structure as a system, structure, or process, implemented by a firms board of directors, management and other personnel, intended to provide reasonable assurance about achieving control objectives in the following categories: 1. Effectiveness and efficiency of operations, 2. Reliability of financial reporting, and 3. Compliance with applicable laws and regulations.

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At the organization level, internal control objectives relate to the reliability of financial reporting, timely feedback on the achievement of operational or strategic goals and compliance with laws and regulations. At the specific transactions level, internal control refers to the actions taken to achieve a specific objective (e.g., how to ensure organizations payments to third parties are for valid services rendered).

Internal control procedures reduce process variation, leading to more predictable outcomes. ICS is important for all types of organization to achieve its objectives. Because, if a proper ICS is implemented, all of the operations, physical resources, and data will be monitored and under control, objectives will be achieved, risks will be minimized, and information output will be trustworthy. On the other hand, if the ICS is weak and unsound, the firm’s resources may be vulnerable to loss through theft, negligence, carelessness, and other risks. As a result, the AIS will likely generate information that is vulnerable, untimely, and perhaps unrelated to the firm’s objectives. Especially in a banking sector it is the key element to sustain in a modern competitive market. Incase of banks the degree of risk exposure is very high because it deals with the most vulnerable assets particularly cash and the frequency of dealing with cash is greater than any other organizations. In addition every transaction in banks is of higher amount. So the magnitude of potential loss is greater. In fact banks are subject to all the three factors that affect the degree of risk exposure. Whether a bank achieves operational and strategic objectives may depend on factors outside the organization, such as competition or technological innovation. Thus ICS is highly important for banks to achieve the control objectives.

1.1 Problem Statement

Each company needs to have in place an appropriate and effective internal control environment to ensure that the company is managed and controlled in a sound and prudent manner. The problem statement is that whether or not the established internal control systems in banking sector are effective. This raises the following inter-related questions:

- What internal control systems are currently in use? Do they include all the expected elements of internal control systems?
- Are internal control systems in the projects adequately documented and regularly updated as changes occur?
- Do the Banks that comply with recommended internal control systems realize their goals more often than those that do not?

1.2 Objectives of the study

This study investigates to know about the practices of Internal Control systems by the private banking sector in Bangladesh and the extent to which a particular Internal control structure technique helps in achieving the control objectives in the sector.
2. Literature Review

A breakdown in the internal control system is identified as the main cause of the business. The existence of smooth internal control is necessary for well achieving the business objectives. According to O'Leary et al. (2006), an adequate system of internal control is considered as critical to good corporate governance. The necessity of research on internal control is due to the inherently complex nature of the internal control process and this research spreads itself across a broad range of auditing, accounting and general business areas (Kinney Jr., 2000). Among earlier empirical research, Gadh et al. (1993) developed a prototype model for evaluating internal control systems. In reviewing this work, Houghton (1993) argues the Gadh et al. (1993) model does not deal adequately with the control environment element of the entity's internal control structure. Similarly, Chang et al. (1993) developed what they termed an assumption-based truth maintenance system (ATM) to model auditor decision-making on internal control environments. Again, this model mentioned but did not evaluate the control environment and the accounting information system elements and was deemed too narrow in focus.

Ouchi (1979) argues that design of organizational control mechanisms focuses on achieving cooperation among individuals having divergent objectives. Goal congruity is a central mechanism of control in an organization (Ouchi, 1980)

Research in informal controls targeted at the business process level of the organization include informal responsibility and accountability expectations (Pierce et al, 2001; Dhillon, 2001), power and politics issues in security decision making.

Anderson and Dekker(2005), Anderson et al. (2000); Chirst et al. (2005); Coletti et al. (2005) attempted to provide initial evidence on the relationship between transaction characteristics, the design of inter-organizational control practices and the performance achieved under alternative control design choices. They found that all the components have the impact on the pervasiveness and magnitude of the risk management and control problems in a large cross section of firms.

2.1 Findings from Earlier Studies

Bangladesh is an emerging economy. Internal control and its impact on the corporate governance systems here are arguably less evolved than those in developed countries such as the Anglo-American countries, Germany, or Japan. Emerging markets as a whole differ substantially from developed countries in their institutional, regulatory and legal environments (Prowse,1999). In Bangladesh analysis on the performances of the banks has pointed out that an effective internal control system could have contributed significantly in improving the performance of the commercial banks if the control culture is brought in through policy guidelines and structural changes at these banks.

Empirical work from China’s banking systems found that commitment to competence, organization structure, management behavior, information systems, and assignment of authority
and responsibility proved to be the most significant internal control variables. (Cockburn and Lee, 1984).

A sample of 210 listed firm of Taiwan by Jung-Hua-Hung and Hui-Lin-Han(1997) revealed that management attitudes, training and professional abilities of auditors are the significant control variables in achieving the efficient internal control structure of the firms. Very few studies of internal control were done related to the developing countries and especially in context of Bangladesh. One study can be found from Ali, Khan, Fatima and Masud (2008) that made attempt on the various aspects of internal control variables on Bangladeshi firms. They analyzed the responses of 25 corporate firms and found that only very few of them discloses and comply with the systematic control variables and the corporate governance aspects on a voluntary basis and little efforts are made by them in order to have a sound internal control system.

Another study conducted by Fowzia,(2009) investigated into the sound effects of diverse factors on co-operation between internal and external auditors of listed banks in Bangladesh. Findings revealed that co-operation promoted through management and the audit committee is the most important factor for assessing co-operation between internal and external auditors followed by professional confidence, co-operation and consultation, reliance on internal audit and communication. This results found consistent with our study in the sense that external audit committee is the important control environment variables of the banks.

3. Conceptual Framework and Methodology

The Figure shows the conceptual framework components of dependent and independent variables. The effectiveness of internal control is the dependent variable. This is achieved by the presence and proper functioning of all the predefined independent variables in relation to each category of the organization’s objectives. Proper functioning of independent variables provides reasonable assurance of proper functioning of dependent variable. Then the organization realizes preset objectives of efficient and effective operations, generation of accurate, reliable and informative financial reports that comply with relevant legal and regulatory requirements.
The study involves investigation of whether internal control systems are followed in the private banking sector of Bangladesh. All the local private banks listed with Dhaka stock exchange will fall under the population of the study. A total of 6(six) private banks whose stocks are traded on the Dhaka stock exchange were selected as a sample. The following banks were selected to investigate the internal control structure: Dhaka Bank Ltd., Islami Bank Bangladesh Ltd., Standard Bank Ltd., IFIC Bank Ltd., ICB Islamic Bank Ltd., and Dutch Bangla Bank Ltd. The study uses the details of variables of different components of internal control techniques using

**Figure 1: The Conceptual Framework of Internal Control**

Objectives of the organization are achieved when interferences on the variables caused by the working relationships are taken into account.
the primary data collection method, particularly by questionnaire, observations and face-to-face communication and document analysis.

We have used SUMMATED (Likert) Scale in the measurement of degree of achievement of control objectives and implementation of several Internal Control Techniques. It is a scale, usually of approval or agreement, used in questionnaires. As per Likert’s Model we have given highest score (5) for “Always” and least score (1) for “Never” except management philosophy and operating style. In case of management philosophy and operating style, as all questions imply negative attitude we have reversed the above scale.

4. Components of Internal Control

Firms need five interrelated components of (ICS) to ensure strong control over their activities. These are: control environment, risk assessment, control activities, Information and communication, and monitoring components. The extent to which each component is implemented is influenced by the size and complexity of the firm, type of industry, management philosophy, and corporate culture.

4.1 Control Environment Component

Every organization, regardless of size, should devise a strong internal control environment. A weak control environment often indicates weakness in the other components of the ICS. Management philosophy and operating style, the first sub component of the control environment, require certain positive actions. These actions include setting an example of ethical behavior by following a personal code of ethics establishing a formal corporate code of conduct, stressing the importance of internal controls and treating personnel fairly and with respect. Integrity and ethical values represent a second subcomponent of the control environment. The ethical and unethical behaviors of managers and employees can have a pervasive impact on the entire ICS, creating an atmosphere that can significantly influence the validity of the financial reporting process. Every public and non- public firm should prepare a written code of corporate conduct that establishes the appropriate tone for management, subordinates and employees.

Commitment to competence is the third subcomponent of the control environment. Firms must recruit competent and trustworthy employees to encourage initiative and creativity and to react quickly to changing conditions. The board of directors or audit committee is a fourth sub component of the control environment. A properly functioning board of directors should appoint an audit committee of outside directors.

Organizational Structure is the fifth subcomponent of the control environment. It identifies the framework of formal relationships for achieving firm objectives. Another subcomponent of the control environment is assignment of authority and responsibility. Authority is the right to command subordinates. Responsibility is ones obligation to perform assigned duties and to be held accountable for the results attained. Human Resource policies and practice, the seventh and final subcomponent of the control environment, involve a consideration of policies regarding the recruitment, orientation, training and motivation, evaluation, promotion, compensation, counseling, discharge and protection of employees.
4.2 Risk Assessment Component

All firms regardless of size, structure, or industry, face significant external and internal risks. The Risk assessment component of the ICS consists of the identification and analysis of relevant risks that may prevent the attainment of company-wide objectives and objectives of organizational units and the formation of a plan to determine how to manage the risks.

4.3 Control Activities Component

A firm should develop specific control activities—policies, practices, and procedures—to help ensure that employees properly carry out management directives. To fulfill objectives, control activities are implemented to address specific risks identified during risk assessment. One subcomponent of control activities relates to the achievement of financial reporting objectives. Another category of control activities relevant to achieving financial reporting objectives is performance reviews, which includes: comparing budget to actual values, relating different sets of data—operating or financial—to one another, together with analysis of the relationships and investigative and corrective actions, and reviewing functional performance. A third subcomponent of control activities consists of General and application controls, helps ensure the reliability and integrity of information systems that process financial and non-financial information.

4.4 Information and Communication Component

Information must be identified, processes, are communicated so that appropriate personnel may carry out their responsibilities. The following subobjectives ensure those AIS’s methods and records result in reliable financial reporting— all transactions entered for processing are valid and authorized, all valid transactions are captured and entered for processing on a timely basis and in sufficient detail to permit the proper classification of transaction, the input data of all entered transactions are accurate and complete, with the transactions being expressed in proper monetary terms, all entered transactions are processed properly to update all affected records of master files or other types of data sets, all required outputs are prepared according to appropriate roles to provide accurate and reliable information, and all transactions are recorded in the proper accounting period.

4.5 Monitoring component

The purpose of monitoring, the final component of the ICS is to assess the quality of the ICS over time by conducting ongoing activities and separate evaluations. Ongoing monitoring activities, such as supervision of employees, are conducted daily. Separate monitoring activities, such as audits of the internal control structure and accounting records, are performed periodically.

5. Interpretation of Survey Results for Each of the Components of Control Structure

The survey results regarding the effectiveness and efficiency of operations, reliability of financial statements, compliance with applicable laws and regulations is given in the appendices.

As in Table 1, out of 6 banks, IBBL, IFIC, and IIB highly achieved effectiveness and efficiency of operation 19.99% better than average performance of local listed private banks. DBL and
DBBL are ineffective and inefficient relating to average performance, 4.00% worse than average performer. Within our sample SBL is the most ineffective and inefficient which deviates from average performance by 52.00%. IBBL, SBL, IIB, and DBBL provide highly reliable financial statements, 7.14% higher than the average. DBL and IFIC provide less reliable financial statements, 14.29% lower than average reliability.

Almost all the banks highly comply with applicable laws and regulation, 3.45% more than average compliance. Only ICB Islamic Bank Ltd. moderately complies, 17.24% less than the average compliance.

**Control Environment Component:** The estimated results of different variables of control environment component are presented in table 2 of appendices. The results indicate that IBBL, SBL, and IFIC banks highly emphasizes on long-term profit and operating goals, whereas DBL and DBBL moderately emphasize. Management group is not dominated by one or few individual in case of IBBL, IFIC and DBBL but for DBL, SBL, and IIB management group is moderately dominated by one or few individual. The results suggest that IBBL, SBL, and IFIC management takes less business risk to achieve their objectives but DBL and DBBL management take a little bit business risk in their decision making. Only THE ICB Islamic Bank Ltd.’s management takes moderate business risk to achieve their objectives. Out of 6 banks, IBBL, IFIC & IIB management is conservative toward selecting accounting policies, SBL & DBBL banks’ management is less aggressive, and the remaining one bank DBL’s, management is highly aggressive toward selecting accounting policies.

Management behavior is mostly restricted by corporate code of conduct in case of IBBL & IFIC but for SBL, IIB & DBBL management behavior is less restricted by corporate code of conduct. Only the DBL’s management behavior is least restricted by corporate code of conduct. Out of 6 banks, DBL, IBBL, and SBL recruit competent and trustworthy employees, DBBL recruits less competent and trustworthy employees, IFIC and IIB recruit least competent and trustworthy employees. Through appointment of audit committee composed entirely of outside directors is not practiced in Bangladesh. We have found some positive responses. It is found that DBL & IBBL always appoint audit committee, DBBL very frequently appoints audit committee, whereas SBL, IFIC & IIB banks do not appoint audit committee. Out of six banks, IBBL, SBL & DBBL banks audit committee always work closely with BOD, external and internal auditors, one bank i.e. DBL whose audit committee frequently works closely with BOD, external and internal auditors, and in case of IFIC & IIB they have no audit committee. So there is no question of working closely with BOD, external and internal auditors. The results show that DBL, IBBL & DBBL banks audit committee always review the actions of the managers independently but in case of SBL audit committee very frequently reviews the actions of the managers independently. Most of the banks management always implement the recommendation provided in the audit report, the rest of 2 banks have no audit committee for providing recommendation. As shown in Table 5.2, except DBL all banks always prepared an up-to-date organization chart. Information system function is totally separated from incompatible function in case of DBL, IBBL & DBBL.
but for IIB information system function is frequently separated; SBL’s information system function is seldom separated. Information system function is not separated in case of IFIC. We have found that bank’s team members are always empowered to make decisions by not seeking multiple layers of approval in IBBL, team members are very frequently in DBL’s, bank’s team members are frequently in SBL, IIB & DBBL.IFIC team members are seldom empowered to do so. Most of the banks always prepare written employee job description, only IIB very frequently prepare. We have found that most of the banks always properly delegate authority to employees and departments, only SBL frequently properly delegates. As shown by Table 2, DBL, IBBL & SBL have written recruitment policy and they always comply with it, the rest 3 banks have written recruitment policy and they frequently comply with it. Most of the banks always provide training program to new employees, only IIB very frequently perform this function. We have found that most of the banks always provide instructions to new employees with respect to internal control ethics and corporate code of conduct, SBL very frequently provides and IIB frequently provides those instructions. Table 2 shows that IBBL always conducts periodic rotation of duties among key employees, SBL & DBBL conduct very frequently and DBL, IFIC & IIB conduct frequently.

Risk Assessment Component: The result of component of risk assessment variables as presented in table 3 of appendices found that most of the banks always conduct risk assessment to identify, analyze and prevent credit risk, only DBBL frequently conducts.

Control Activities Component: This table 4 demonstrates the different variables to assess the control activities of internal control structure. The outcome is that all the banks in our sample except DBBL, properly segregated authorized their authorization function. We have found that most of the banks always kept the formats and contents of all documents in simple, only DBL & DBBL kept very frequently. The result shows that IBBL, IFIC & IIB always use pre numbered documents, but DBL, SBL, & DBBL very frequently use those documents. Most of the banks always restrict access to computer rooms, computer files and information by authorized users, but is in case of DBL, their access is very frequent and DBBL’s access is frequent.

Monitoring Component: It can be observed from table 5 of appendices that out of 6 banks, most of the banks always have ongoing monitoring activities, but DBL very frequently has and IIB frequently has ongoing monitoring activities. IBBL, IFIC & DBBL have always separate monitoring activities, but DBL & IIB frequently have and SBL seldom has separate monitoring activities.

6.1 Conclusion

The study tries to analyze the components of different control variables used for assessing the internal control systems of banks considered here. The study found that all the banks considered for the paper achieved the control objectives in a greater extent and the deviation regarding achievement of control objectives is minimum. Based on average the local listed private banking
sector frequently emphasizes on short-term profits and operating goals and they differ among themselves in a greater extent regarding the extent of emphasis. One or few individuals seldom dominate management group. The deviation among them is negligible. It implies that the risk aversive ness of managements grouping local listed private banking sector. Management is seldom aggressive toward selecting alternative accounting principles.

Out of 6 banks, all the banks have written corporate code of conduct. Management behavior is frequently restricted by written corporate code of conduct. All the banks frequently recruit competent and trustworthy employees to encourage initiative and creativity and to react quickly to changing condition. Appointment of audit committee is not practiced in our country. But the respondents interchangeably use the internal audit committee with the outside audit committee. Thus the data presented in the report is not reflecting the underlying reality.

All the banks very frequently prepared an up to date organization chart. Information systems function frequently separated from incompatible functions but they deviate to a great extent regarding the magnitude of separation. Team members are very frequently empowered to make decision by not seeking multiple layers of approval. But they deviate in a greater extent. Internal audit function is always separate from accounting.

All the banks very frequently prepared written employee job description, required written approval for changes made to information systems and properly delegate authority to employees. All the banks very frequently have written recruitment policy and complied with it, have training program, have given instructions to new employees and have periodic rotation of duties. Based on average it is found that all the banks very frequently conduct credit risk assessment. Banks differ among them to a minimum extent regarding credit risk assessment.

All the banks always properly authorized all the transaction and activities and there is no deviation among them regarding authorization. All the banks very frequently segregate authorization functions but they always segregate recording and custodian function. All the banks very frequently design simple and pre numbered documents.

All the banks always maintain accurate records of assets including information restrict physical access to assets by unauthorized users and protect records and documents. All the banks always make reconciliation between two independently maintained records. All the banks very frequently have on going and separate monitoring activities and the deviation regarding these points is minimum. The conclusion can be made that more or less existing internal control structure is effective for all the private banks considered in the study.

6.2 Recommendations

The most vital components of internal control environment is audit committee composed entirely of external directors but this component is not practiced in local listed private banking sector of our country. We think that the implementation of the above technique will improve the extent of
achievement of control objectives. In case of some banks due to implementation of automated AIS, there is no reconciliation between subsidiary and general ledger. The automated information system should be redesigned in such a way that reconciliation should be performed. Because we think it will improve the reliability of their financial statements.

In some banks computer resources are not restricted for unauthorized users. As a result, employees sometimes may use the computer resources for personal purposes. As it increases the cost of operation, it should be prohibited. We think it will increase the profitability of those particular banks.

Information system function should be totally separated from incompatible functions for those banks in which information system functions are not totally separated from incompatible functions. Authorization function should be segregated as much as possible. All source documents should pre-numbered. All banks should implement ongoing and separate monitoring activities.

References


## Appendices

### Table 1: Effectiveness and Efficiency

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<tr>
<th>Control Objectives</th>
<th>DBL</th>
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<th>IFIC</th>
<th>IIB</th>
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<td>Deviation</td>
<td>%</td>
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1* Effectiveness and efficiency of Operations  
2* Reliability of Financial Statements  
3* Compliance with Applicable Laws and Regulations

### Table 2: Control Environment Component

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<th>Control Objectives</th>
<th>DBL</th>
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<th>DBBL</th>
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<tr>
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1* Emphasis on Short-term Profit and Operating goals, 2* Management group dominated by few individuals 3* Management take undue business risk 4* Management aggressiveness towards accounting principles, 5* Management behavior is restricted by code of conduct, 6* Commitment to competence, 7* Appointment of audit committee composed of outside directors, 8* Audit committee work closely with board of directors: external and internal, 9* Audit committee provide an independent review, 10* Management take proper actions recommended in the audit, 11* Preparation of an up to date organization chart, 12* Information system is separated from incompatible functions, 13* Members empower to decisions not seeking multiple layers, 14* Preparation of written employee job description, 15* Proper delegation of authority to employees and departments, 16* Written recruitment policy and extent of compliance with it, 17* Training program for new employees, 18*
New personnel are given instructions with respect to internal control ethics and corporate code of conduct, 19 Periodic rotation of duties among key employees

Table 3: Risk Assessment Component

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Table 4: Control Activities Component

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Table 5 Monitoring Component

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1 Authorization functions are segregated, 2 Formats and contents of all documents are kept simple, 3 Sources documents are pre-numbered, 4 Restriction on access to computer rooms, computer files and information by unauthorized users

1* on going monitoring activities, 2* Separate monitoring activities