

# Analysis of the Internal Control System on the Revenue Cycle of Lending at Rural Bank

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**Abstract.** This research aim to determine whether internal control system of Rural Banks "X" is aligned with the elements of the COSO internal control structure. Data was collected by means interviewing and observing. The analysis was carried out by comparing the results of interviews and observations over the credit distribution income cycle to internal control framework according to COSO and the Otoritas Jasa Keuangan (OJK) Framework. Results of this study indicate that the internal control structure framework and OJK Framework has been implemented in the most of procedure of lending. This article proposes to identify lending risks periodically to ensure that controls are in place to address the identified risks.

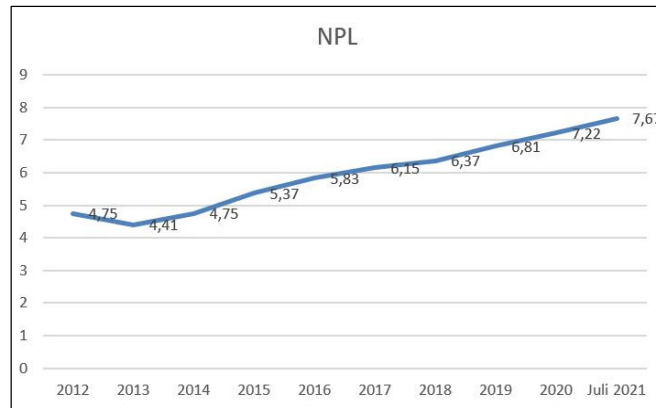
**Keywords:** COSO; Internal Control Structure; Lending system

## 1 Introduction

Currently, the Government of Indonesia is very aggressive in building the economy through the development of micro and small businesses because this sector has leverage in improving the community economy and multiple effects in lowering the unemployment rate. The government's efforts are proven through various actions, including creating a conducive business climate, providing capital assistance, business protection, developing partnerships, training, forming associations, promotions, developing cooperation, developing facilities and. To support economic development, especially micro and small businesses and medium-sized enterprises, banks has an important role in providing funding to pioneer or develop businesses. This can occur because of the function of banks as intermediary institutions where banks collect funds from the community in the form of deposits and channeling it to the community in the form of lending and or other forms. The government's instruments to provide capital support to MSMEs is BPR (Rural Bank).

Bank Perkreditan Rakyat (BPR) or rural bank have a role in driving the progress of economic equality and micro-economic growth. This role is carried out by providing loans that have the potential to increase credit risk. Credit risk is crucial for bank management because of its relationship with other risks such as operational, market, and liquidity risks [1]. The problem that arises if credit risk is not prevented is bad credit. Bad credit brings a threat to the continuity of BPR such as: cash turnover slows down because cash availability decreases, profits decline, liquidity ratio, solvency and profitability are directly or indirectly affected.

Bad credit will reduce the reputation of rural banks and can reduce public confidence in rural banks. PT. BPR X Tembung also experienced a classic problem faced by BPRs in general, namely non-performing loans. The level of non-performing loans or bad loans has always increased by almost 2% from 2014 to 2016. Even in 2016 the NPL level shows that the NPL has exceeded the prescribed limit. Bank Indonesia sets a limit for BPR NPLs of 5% [2]. Credit activities have always been a matter of great concern because credit activities are the main activities of BPRs in running their business. Based on data from Indonesian banking statistics (SPI)[3], the NPL graph for Rural Banks from 2012 to July 2021 can be seen in figure 1 below:

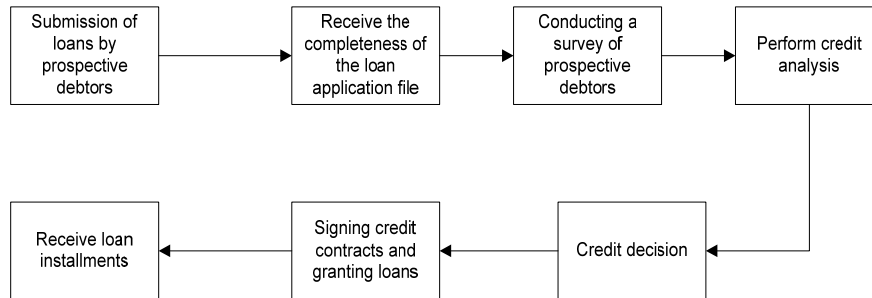


**Fig.1.** NPL of rural bank in Indonesia

Non-performing loans are used as a proxy for credit risk [4]. From figure 1 it can be seen that non-performing loans have increased significantly every year so that there is poor credit quality because they have a number of non-performing loans. It can also be concluded that credit risk increases every year on average at Rural Banks. Credit risks can be avoided or minimized by implementing the internal control structure consistently. If the internal control structure is sufficient in lending activities, it can prevent the occurrence of errors that can harm the bank. This study aims to determine whether the internal control of the revenue cycle on lending system at PT. X Tembung is in accordance with the elements of internal control according to COSO and provides input or improvements that may be applied related to the internal control system.

## 2 Literature review

The revenue cycle is related to providing products or services to customers and subsequently collecting cash from customers [5]. The main source of revenue for rural banks (BPR) is interest income derived from lending. The revenue cycle for lending at Rural Banks, in general, can be described in figure 2:



**Fig.2.** Lending Procedure in Rural Bank

Rural banks face credit risk when carrying out lending procedures and if controls are not designed and implemented, it can increase NPL. The factors that cause non performing loans are as follows[6]:

- a) External factors of the bank
  - 1) There is doubtful intentions from debtors who are in doubt.
  - 2) There are difficulties or failures in the liquidity process of the credit agreement that has been agreed between the debtor and the bank.
  - 3) Conditions of the management and business environment of the debtor.
  - 4) Disasters (for example: fire, natural disasters) or business failures.
- b) Internal bank factors
  - 1) Lack of knowledge and skills of credit managers.
  - 2) There is no credit policy at the bank concerned.
  - 3) Provision and supervision of credit carried out by banks deviates from established procedures.

If credit is not managed properly, there will be many non-performing loans (Non-Performing Loans) which results in a decrease in interest income and a decrease in loan principal which in turn will suffer losses and it is not impossible to experience bankruptcy [7]. An effective internal control system is an important component in bank management and is the basis for healthy and safe financial operations. Research conducted on banking in Spain shows a significant effect of internal control on credit risk[1]. Internal control is a supervisory mechanism established by management on an ongoing basis, with a purpose [8]:

- a) Maintain and secure bank assets.
- b) Ensure the availability of more accurate reports.
- c) Improve compliance with applicable regulations.
- d) Reducing financial / loss, the impact of irregularities including fraud / fraud, and violation of aspects of prudence.
- e) Increasing organizational effectiveness and increasing cost efficiency.

Elements of the Internal Control System The COSO (Committee of Sponsoring Organizations of the Treadway Commission) introduces five internal control components that are interconnected with each other, consist of [9]:

- a) Control Environment
- b) Risk Assessment
- c) Control Activities
- d) Informasi dan Komunikasi
- e) Monitoring

Weak internal control systems in banking institutions can have an impact on the operation of a bank [8], supervisory mechanisms become weak and bank management accountability mechanisms become unclear which can result in a culture of internal control at all levels becoming non-occurring. Weak internal controls also result in the process of identifying and risk assessment of banking operations becomes inadequate. Banking institutions that have weak internal control will lose control of the bank's operational activities due to lack of separation of functions, improper authorization, inadequate verification process of risk exposure and bank performance. Communication and information between levels in organizations are also affected, especially communication and information on the quality of risk exposure and the implementation of corrective actions. Weak internal control systems, especially monitoring activities, can result from weaknesses in internal audit functions that fail to perform consulting functions on risk management and fail to design effective internal audit programs. It is the object of an internal audit. Finally, the lack of commitment by the Bank's management to conduct internal control processes and enforce strict sanctions as evidence of the internal control environment at banking institutions needs attention.

A sound internal control system must be designed and implemented by banks so that banking risks can be properly mitigated. The lending process must also be mitigated by designing and implementing an internal control system so that BPR can maintain credit quality. If the BPR is not able to maintain credit quality properly, it will affect the performance of the BPR, especially financial performance, which can result in the ability of the BPR to fulfill its obligations to depositors. Therefore, in order for the implementation of prudential principles and sound credit principles to be carried out consistently, Rural Bank must have a Rural Bank Credit Policy (KPB) which contains [10]:

- a) Prudence in credit, The principle of prudence in credit includes policies in lending, assessing credit quality (collateral), as well as professionalism and integrity of BPR officials in the field of credit.
- b) Credit Organization and Management, where rural banks have credit units or work units where there is a separation of functions that analyze credit, disburse loans and administer loans.
- c) The credit approval policy shall at least cover the concept of the total relationship of credit applicants, determination of credit approval authority limits, responsibilities of credit severing officers, credit approval processes, credit agreements, and credit disbursement approvals.
- d) Credit Documentation and Administration.
- e) Credit monitoring which covers all aspects of credit, namely the conformity of the process of granting and collecting credit with applicable policies, procedures, and provisions, so that the amount of credit granted does not violate or exceed the LLL in accordance with the Financial Services Authority Regulation which regulates the maximum limit for granting credit to rural banks. Monitoring must also be followed by internal auditing.
- f) Non-performing loan handling. BPR must detect the presence of non performing loan or potentially become a non performing loan and deal with it as soon as possible. All BPR employees, especially those related to credit, must have the same understanding in dealing with NPL.

### **3 Methodology**

The research was carried out in September 2020 where the object of the research was a BPR in Tembung, Deli Serdang Regency. The research object asked for the identity of them not to be disclosed. The type of data used in this study is qualitative data. Primary data, obtained directly from the object of research in the form of data relating to the procedure of lending and control. Secondary data, obtained from the company in the form of data and documents at PT. BPR X Tembung and from other sources such as books, journals, financial service authority regulations (OJK) and Bank Indonesia. Data collection is carried out by conducting interviews with organizational elements in the credit department and the Director of BPR. In the credit department, the researcher interviewed the head of the credit department, the party who carried out the credit analysis and the one who carried out the credit survey. Directors were interviewed to find out about the control environment related to policies and management philosophy on lending. After obtaining primary data from the interviews, the researchers also carried out observations on each stage of the loan procedure while confirming the results of the interviews. The results are evaluated by comparing with COSO and OJK regulations.

### **4 Result and Discussion**

Analysis of the internal control system of PT. BPR X can be described as follows according to COSO and OJK Regulation:

#### **a) Control Environment**

PT. BPR X Tembung has an organizational structure, job description and decree that clearly explains the division of tasks, responsibilities and work relationships. However, there is no personnel or employee that has job to monitor or supervise billing to debtor. In this condition, we can conclude that is not in accordance with the organizational structure, because the existence of vacant positions (bill monitoring section). In terms of integrity and ethical values, PT. BPR X does not have a code of ethics guideline that directs the ethical behavior of every employee, especially employees in lending. Ethics and integrity are carried out only based on Bank Indonesia guidelines. In human resource policies, PT. BPR X Tembung has procedures for the acceptance of new employees, training, promotions, compensation. PT. BPR X also has training activities & other motivational activities.

#### **b) Risk assessment**

PT. BPR X Tembung has not carried out a comprehensive risk assessment and has no risk universe and risk register. In credit distribution, only 5 C debtors are assessed. Important risk assessment is carried out to design and implement internal controls in credit providing.

#### **c) Control Activities**

There are performance reviews conducted by top management in terms of achieving credit targets every month, against the target bills that must be achieved every month and debtor payment reports from month to month. PT. BPR X Tembung also has and runs credit policies

and procedures contained in the Guidelines for BPR (PKPB), and BPR X Tembung Credit Guidelines (PP). Segregation of duties in the procedure of lending is carried out by several related functions but survey and analysis financial condition of prospecting debtor performed by the same person from AO Lending. This can cause fraud if analysis is not carried out based on the actual condition of debtor. We find that there are certain controls to check the accuracy, completeness and feasibility of authorizing all of credit's procedure. The department that performs these functions is the internal control department. We find this department only looking at the completeness of signatures in credit documents to ensure credit procedures are administratively in place but do not analyze the risks of credit procedures that should not be performed by the same function.

#### **d) Information and Communication**

The entity has an accounting information system that includes methods and records for processing transaction data into information needed in decision making, especially credit decisions and other decisions, such as non-performing loan problems, contained in PKPB &PP. Communication on information is also done well to internal and external parties (e.g.: customers, OJK, BI and taxation).

#### **e) Monitoring**

Monitoring should be carried out continuously through the implementation of internal audits or annual external audits. Even though it has an SPI function, based on the results of the study, information is obtained that audit has not been performed periodically to the process of lending. Monitoring of lending procedures are only carried out by one employee and performed by checking the completeness of loan documents and credit authorization, Installment payments are monitored by reviewing the list of installment payments of debtors who are managed by computerized information systems and delinquent debtors will be contacted by phone and if they have been in arrears exceeding 3 times will be visited for billing directly. The internal control of PT. BPR X must be addressed immediately to reduce the risk of non-performing loans. Some recommendations from the results of the analysis of the Internal Control Structure of PT. BPR X Tembung is:

- 1) Improve organizational structure with clear job descriptions and performance targets primarily in credit function. Every position in the organizational structure must be filled by employees with integrity and have appropriate competencies.
- 2) Implement comprehensive risk management and risk assessment in the function of lending. Extensive risk assessment on the function of lending must be followed by self assessment (CSA) so that the risks of lending can be immediately anticipated with adequate internal controls.
- 3) The segregation of duties in lending is carried out by separating the functions of the survey and analysis so that the giving credit more leverage and prevent fraud.
- 4) In terms of monitoring bills, it is recommended that a special unit be assigned to carry out the task of monitoring bills so that there is no duplication of tasks that can cause fraud and hinder other work.
- 5) Add personnel to the Internal Control department and further develop the Internal Control program or establish a special work unit for active monitoring of the overall implementation of lending (Audit Committee). Internal Audit / Audit Committee will usually carry out analysis, assessment and submission of suggestions. Audit helps

implement systematic, disciplined evaluations & enhances the effectiveness of risk management, control & regulatory processes, and organizational management. This internal audit is an added value that enhances BPR operations.

- 6) Monitoring debtor's economic and business developments as well as providing technical assistance for business development to debtors may reduce credit risk because the relationship between debtors and banks is becoming closer and not just a debtor-creditor relationship.

## 5 Conclusion

The results of this study successfully concluded that in general, the entity has implemented an internal control system in accordance with the COSO framework and tried to follow OJK regulations by making PKPB and PP documents in accordance with the recommendations of OJK to avoid increasing non-performing loans. But we also found some things that require improvements so that the internal control system of the entity, especially in the field of credit can run more optimally. Some of the things we propose in improving the internal control system are as follows:

- a) Entity does not have personnel to monitor the collection of loans. To supervise collection, management needs to determine the personnel responsible for monitoring the collection of loans.
- b) Risk management must be done for business processes, especially in the lending stage. To ensure that internal controls have been designed to lower credit risk, risk identification needs to be done on a regular basis, so that the entity can design and operationalize adequate internal controls.
- c) Perform the segregation of duties for personnel that conducting surveys and carrying out credit analysis, the entity must place separate personnel so that it can be assured the process is going well so that there is no fraud.
- d) In terms of monitoring bills there is a duplicate of tasks (the task of monitoring bills is done by other parts randomly, no special unit is set to run) which can cause fraud and inhibit other work. BPR X should reassign the bill monitoring function unit, so that there is no duplication of duties.
- e) BPR X only monitor the completeness of documents and administration related to the implementation of lending by internal control by 1 person only and there is no stipulation or establishment of a special work unit to actively monitor the overall implementation of lending. BPR X should add personnel to the Internal Control section and further develop the internal control program or establish an Audit Unit or Audit Committee to actively monitor the overall implementation of lending (monitoring objectives, achievement strategies, financial reporting, compliance with regulations, internal controls, and recruitment and supervision).

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