

Covid-19 – Paycuts Weaken Internal Controls

Covid-19 pandemic is causing firms to resort to pay cuts and lay-offs. This helps to save costs, but weakens internal control procedures (ICPs). Using the psychological contract theory, this article demonstrates that pay cuts cause adverse attitudinal changes in employees like lower commitment, diligence and effort. Many internal control procedures rely on people for effective implementation. If their attitudes are adversely impacted by pay cuts, then ICPs also weaken. Organisations should recognise this risk. In such a situation, internal audit function can play a very important role in re-enforcing the existing ICPs so that the firm does not suffer. Read more...



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The ongoing pandemic has not only affected the financial performance of firms but has also impacted internal controls. Covid has triggered a series of responses by firms who are grappling with managing their costs. One key cost element that is being targeted is employee cost. Inadvertently, this has an impact on internal control procedures (ICPs).

According to the latest results of MyHiringClub.com and Sarkari-Naukri.info Layoff Survey 2020, 68 per cent of the employers surveyed have either started the layoff process or are planning to. The online survey covered 1,124 companies across 11 industry

sectors in 25 major cities. The survey was conducted between May 1 to May 10, 2020. Among the surveyed organisations, 73 per cent said they have plans to decrease the salary of employees, 57 per cent said this layoff is temporary, while 21 per cent said they are doing permanent layoffs for at least 2 years.

Pay cuts affect employee behaviour in multiple ways. Many ICPs are reliant on people charged with implementing them. If their behaviours are adversely impacted by pay cuts, then ICPs will also suffer. Organisations should recognise this risk. In such a situation, internal audit function can play



a very important role in re-enforcing the existing ICPs so that the firm does not suffer.

Concept of Psychological Contracts and Its Violation

The effect of pay cut on employee behaviour can be best explained by a concept from the disciplines of psychology and employee relations, that has gained attention of academics and practitioners in the recent past. This is the concept of psychological contract developed by organisational scholar Denise Rousseau of Carnegie Mellon University in 1995. Psychological contract represents mutual beliefs, perceptions and informal obligations between an employer and an employee. It is distinguishable from the formal written contract of employment which, for the most part, only identifies mutual duties and responsibilities in a generalised form.

Psychological contract implies long term job security in return for hard work and loyalty. Employees believe that a promise has been made and consideration offered in exchange for it. But in uncertain times, like what the pandemic has created, it often makes it unclear as to what both the parties, the employer and employee owe each other, thus making fulfilling obligations more difficult. As a result there is increased likelihood of misinterpretation and psychological contract violation (PCV).

Psychological Contract Violation and Internal Controls

The existence and effectiveness of internal control is often dependent on the supervisory managers. This brings about a certain dependency on people. When psychological contract is violated or perceived to be violated, behaviour of the supervisory manager may also change.

To illustrate this, let us consider an HR manager of a manufacturing firm. He would normally review the monthly payroll sheet prepared by his subordinates, in great detail but may do so with less care once he perceives a psychological contract breach. This has internal control and financial implications. Perhaps, an absent worker who should have had a loss of pay may get missed out. Even though the maker-checker mechanism exists, its effective functioning depends on the individual's diligence.

There are numerous instances that audit professionals can enumerate where the efficacy of the control is person dependent even though the process itself may be housed within an ERP. For example, a purchase manager till recently would scrutinise every purchase order to ensure that it has the best price and quantity in it. The substantiveness of his checks is personal to him. An ERP may ensure that POs go from the initiator to the purchase manager for approval, but it cannot ensure consistency in

his personal diligence. This subjectivity gets challenged when the psychological contract is breached. He may choose to check less, resulting in weaker controls.

Diligence is Neither Absolute Nor Permanent

One could argue that diligence and care are part of the express contract of employment. Though it is, it is so in a generalised form. Both diligence and care is person dependent. The same employment contract offered to 2 appointees for identical roles may result in different outputs simply due to varying degree of personal application.

Hence, organisations that wish to implement pay cuts must make an assessment of the psychological contract violation and its effect on controls.

The table illustrates the common type of PCVs and likely employee reactions.

Organisational Justice Triggers	Attitudinal Outcomes
Distributive justice issues	Lower job satisfaction
Procedural justice issues	Lower organisational commitment
Interactional justice issues	Increased cynicism
	Behavioural Outcomes
	Lower organisational citizenship
	Lower effort

Distributive justice issues arise when outcomes are perceived to be unfairly distributed, such as financial rewards or paycuts. **Procedural issues** relate to perception of unfair application of procedures, such as promotions. **Interactional**

issues relate to employees perception of trust by superiors and the organisation when they feel they have been treated badly.

These changes in attitudes and behaviours may have implications for employee and organisational controls and performance.

Psychological Contract Violation Leading to Incidence of Fraud

Several studies have indicated that perception of organisational justice and occurrence of fraud are significantly correlated. It was found that justice issues (perceived or real) were often used to rationalise fraudulent behaviour. Researchers found that fraud occurs when there is an incentive to commit it, rationalisation for justifying fraudulent behaviour and available opportunity.

These three situational factors are collectively known as the “fraud triangle”. The factor termed **pressure** (also



referred as incentive) relates to employee’s motivation to commit fraud as a result of greed or personal financial pressure amongst a variety of reasons, while **rationalisation** denotes justification of fraudulent behaviour as a consequence of an employee’s

lack of personal integrity, or other moral reasoning. The third factor, + refers to a weakness in the system where the employee has the power or ability to exploit, making fraud possible.

By applying this triangle framework, we could say PCV provides the rationalisation for a motivated employee to exploit a weakness in the internal controls to commit the fraud. The situation is amplified if the internal controls are further weakened as a result of PCV. Pay cuts, like other underpayment inequities are potent triggers for the triangle to complete making organizations more vulnerable.

Though, frauds are extreme cases, firms must guard themselves against it. An understanding of PCV helps in this direction.

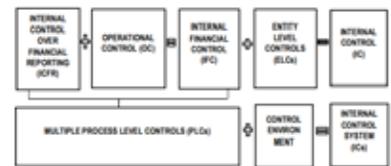
Stronger Internal Control Procedures Mitigate Effect of Psychological Contract Violation

Be it a mundane outcome of lower effort or a serious fraud, organisations should be prepared for a variety of reactions when they trigger organisational justice issues. Reinforcing the internal controls should therefore accompany decisions that can be perceived as psychological contract violations. Not doing so, could make the internal controls less effective.

Internal controls could broadly be categorised as Process Level

Control (PLCs) and Control environment.

SIA 120 (Standards on Internal Audit on Internal Controls) explains that the Control Environment includes the overall culture, attitude, awareness and actions of Board of Directors and management regarding the internal controls and their importance to the organisation. As can be seen from the diagram below, the control environment has an influence on the effectiveness of the overall Internal Control System since it provides the basis for establishing and operating process level controls (such as IFC and OCs) in the organisation.



In a PCV situation, the PLCs and the control environment suffer as discussed earlier. Deliberate effort should be made to strengthen their quality. Such re-enforcement could take the form of re-designing existing PLCs, placing additional controls and deepening the involvement of internal audit. Control environment could especially benefit from risk management training and focusing on corporate ethical environment.

It is widely accepted, that strong internal control procedures across all units

or areas of a firm improve the chances for errors and fraud to be detected and prevented. In particular, employee adherence to the set ICP (e.g. policies on approvals, authorisations, verifications and reconciliations) and segregation of duties need to be both well designed and to be strictly followed by employees.

In a recent study conducted in Australia, it was found that the relationship between employee perceptions of organisational justice and incidence of employee fraud to be moderated by quality of ICP. In other words, where the quality of ICP is high, perceptions of organisational injustice led to lower occurrence of frauds.

Quality of Internal Control Procedures and Increased Importance of Internal Audit

Traditionally, Internal audit (IA) functions to assess the effectiveness of the organization's internal controls, and to report to management about where and how internal controls could be strengthened. Besides, auditing financial transactions, IA activities may also cover non-financial areas such as business unit processes, geographical areas and compliance with laws and regulations. Studies have shown that the IA plays a crucial role in the prevention and detection of fraud within an organisation by ensuring that the audit is well planned and that a proper

IA programme exists. Having a broad scope of audit operations and activities in particular is seen as vital for identifying areas where the controls are not fully functioning and procedures are unclear.

In recent past IA has become a primary agent for transformational change in helping users of systems improve the design of their controls. Studies have revealed that IA recommendations for improving ICP are critical for not only preventing control breakdowns but also in improving the overall quality of ICPs.

During uncertain times, like the current pandemic, firms will do well in expanding the scope of internal audit. The more extensive the scope of internal audit, the better it is. With an extensive IA function (i.e. the larger the number of audit activities), the likelihood of identifying the weaknesses in ICP are greater. Consequently, through better identification of ICP weaknesses, appropriate remedial measures may then be undertaken, leading to a higher quality ICP.

Adverse Attitudinal Changes Impact Firms Differently

When PCV is anticipated, firms should actively seek to establish controls with lower person dependencies. Firms should first assess their type. The below matrix shows how

adverse attitudinal changes impact internal controls in different firms:

STANDARD PRODUCTS	TYPE 3 FIRMS- AVERAGE	TYPE 4 FIRMS- LEAST	SUPERVISOR RETENTION
	IMPACT	IMPACT	
Low tech enabled controls	Low tech enabled controls	Hi tech enabled controls	
More Standard products	More Standard products	More Standard products	
High/Low Supervisor retention	High/Low Supervisor retention	High/Low Supervisor retention	
TYPE 1 FIRMS- WORST	TYPE 2 FIRMS- AVERAGE		
	IMPACT	IMPACT	
Low tech enabled controls	Hi tech enabled controls	Hi tech enabled controls	
More non-Standard products	More non-Standard	More non-Standard	
Low/Hi Supervisor retention	Low/Hi Supervisor retention	Low/Hi Supervisor retention	
	TECHNOLOGY ENABLED CONTROLS		

The above diagram illustrates that firms with low tech enabled controls, who make non-standardised products are more at risk from weakening internal controls. The situation gets aggravated if there is increased attrition in the supervisory cadre. Low tech enabled controls, results in heavy reliance on people dependent controls, which weaken as a result of pay cut induced attitudinal changes.

On a scale of riskiest to least risky, Type 1 firms would be rated riskiest, followed by Type 2, 3 and then Type 4.

Type 4 firms have several things going in their favour. Even when psychological contract violation triggers attitudinal changes, internal controls do not suffer. Significant technology adoption in controls means that processes are well developed and less people dependent, hence less subject to changes in people attitudes. Standard products and existence of seasoned supervisors help in making the internal controls even more resilient.

Re-designing Internal Control Procedures by the Firm

A firm cannot alter the Standard/non-standard nature of the business beyond limited modification of its product mix. Neither can it address supervisor retention matters beyond a point, as it involves human expectations. Of the three parameters used in the above matrix, the one that the firm can very meaningfully alter is the technology adoption in controls. Focusing on this will yield results. In other words, Type 1 and 3 firms must endeavour to move to Type 2 and 4 respectively to effectively deal with PCV.

Key questions the firm must ask itself:

Will their attitudes impact any ICPs?

Can internal audit mitigate risks arising from not systemising?

Have we determined people to be impacted by payouts?
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Can the ICPs be systemised?

Type 1 firms that face the worst impact on their ICPs due to payout caused attitudinal changes, benefit the most from higher quality internal audit.

Internal Audit Improves ICP Quality during Adverse Attitudinal Changes

When employees display adverse changes in attitudes, internal audit can have a moderating effect not only in financial areas, but also

non-financial areas. Reduced diligence by a HR manager, while processing monthly attendance, can be compensated by internal audit. Or an internal audit of POs can make good the lack of attention of the purchase manager. This results in an improvement in the quality of existing ICPs.

Type 1 firms benefit the most because ICPs are less systemised than a Type 4 firm. Special improvement can be seen in relation to approval frameworks, authorisations of financial and non-financial activities, verifications and reconciliations.

Pink Slips Add to ICP Weakness

In their attempt to curtail costs in light of a slowdown, firms not only have resorted to pay cuts, but also lay-offs. Though this serves a commercial purpose, its effect on internal controls should not be underestimated. Redundancies can affect internal controls in three ways:

- i. Elimination of a role that wholly or partly was a part of the internal control procedure
- ii. Moving the ICP as an “additional” activity to a continuing employee
- iii. Improper handover at the time of laying off employees

i. Elimination of a role that wholly or partly was a part of the internal control procedure:

Individual employees often perform multiple tasks some

of which relate to internal control procedures. When such an employee is made redundant without moving the ICP to someone else, then it may weaken the control environment. Decision makers may look at the monetary cost saved by the role elimination without adequately assessing the benefits foregone by someone effectively managing the ICP. This aspect is more poignant in Type 1 firms where the tech enabled controls are not fully operational, or firms who are producing non-standard products.

ii. Moving the ICP as an “additional” activity to a continuing employee:

This pertains to the decision makers recognising the ICP as an essential activity that should not be eliminated, but move it to someone as an added responsibility. This may cause a reduction in importance of the control. Though the control continues to exist, its quality may deteriorate due to reduced importance. Attention should be given not only to existence of controls, but also its quality.

iii. Improper handover at the time of laying off:

Rushed lay-offs, many of them carried out at very short notice, means low quality handover. The leaving employee should explain what work is in his hand, to ensure that smooth transition takes place. The importance of this activity is often not understood. For example, an admin manager,

who had held up certain bills of a service provider, had good reason to do so. It is quite likely that request for payment of such old bills will now be made to the replacing manager who might end up passing it, if the handover was not done properly.

In the current pandemic, firms will do well to assess the impact lay-offs can have on ICPs.

Work from home and ICPs

Firms have never tried work from home (WFH), the way they are trying it now. WFH is also having its effect on internal controls. For example, activities requiring more physical engagement like that of purchases will see their ICPs weaken. Especially so in firms that make non-standard products where the manager is constantly evaluating materials for the very first time.

Industries or activities that already have a high level of technology adoption could see their controls less impacted. But there is no room for complacency. It is premature to conclude that diligence and care is independent of the location of work. Sporadic examples come to light which suggest that, in Type 4 firms mere higher adoption of technology enabled controls does not ensure adequate diligence.

Conclusion

Covid-19 pandemic has brought to us several unprecedented scenarios in various activities including internal controls. Be

it pay cuts, pink-slips or work from home, all have control implications for firms and their governance custodians. It is essential that firms recognise these implications.

The concept of psychological contract violation offers an excellent explanation linking pay cuts and its effect on employee attitudes. Understanding this concept is essential to taking steps to manage ICPs better.

Internal audit is emerging as an efficient tool in the hands of managements to mitigate impact of their decisions related to pay cuts, pink-slips and WFH. Internal audit can effectively identify the control weaknesses that have crept in due to such decisions and re-enforce ICP quality.

Auditors, on their part, now need to pay attention not only to traditional factors such as ICP quality but also to other organisational factors such as employee perceptions of organisational justice. Auditor may further advise their clients to undertake few positive things like encourage virtual bonding, provide better healthcare and insurance facilities, etc. to boost morale of their employees and promote a positive employee experience among employees instead of pay cuts and layoffs.

Maintaining high employee morale is certainly challenging during a global crisis, but it is not unachievable. The little things like strong communication, increased flexibility, and good access to resources – show that the company cares. Additionally,

when the crisis concludes, the company will be in a strong position to retain talent and hire new employees quickly. Having a reputation for supporting workers and keeping spirits high during a crisis will certainly boost the employer brand and support long-term success and keep all the Internal Controls intact. ■■■

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