THE INTERNAL CONTROL SYSTEM OF THE CREDIT INSTITUTIONS

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Abstract:
Effective internal controls are the foundation of safe and sound banking. A properly designed and consistently enforced system of operational and financial internal control helps a bank's board of directors and management safeguard the bank's resources, produce reliable financial reports, and comply with laws and regulations. Effective internal control also reduces the possibility of significant errors and irregularities and assists in their timely detection when they do occur. A bank's board of directors and senior management cannot delegate their responsibilities for establishing, maintaining, and operating an effective system of internal control. The board must ensure that senior management regularly verifies the integrity of the bank's internal control. Although internal control and internal audit are closely related, they are distinct from each other.

Keywords: internal control system, internal banking control, credit institutions, types of internal controls.

JEL Classification: M10, G21, G24, G32

INTRODUCTION

In order to define the internal control term and respectively the notion of internal banking control we started with the control concept.

As a result of the analysis of the control concept we are observing that this concept is „an attribute of the management, a function of management, an instrument of knowing the reality and a mean of correcting the errors" (Ghiță şi Pereş, 2009). The control is most widely used signifying verification, frequently associated with a "permanent or periodical analysis of an activity, of a situation in order to follow its progress and to take improvement measures" (Morariu, Suciu, Stoian, 2008). From the perspective of the control exercising we can discern: internal control including the whole range of controls from within the entity and external control which include the ensemble of the controls addressing the entities from the exterior of the entity. If the control is a management's function, the internal control "is not a function, but an ensemble of instructions", "which one can identify in the structure of every function and every activity of the management and falls within the responsibility of every employee".(Morariu, Suciu, Stoian, 2008) Due to this cause one cannot affirm the existence of an internal control service. Nevertheless, if we would try to define the notion of internal control we are observing that it was intensely modified in order to manage the changes intervening in the life of an enterprise (the continuously increasing complexity of the enterprises, the dispersion of the activity centers, fraud occurrence) by "establishing essential rules which have to be obeyed in order to reasonably conduct an activity".(Morariu, Suciu, Stoian, 2008)

Jacques Renard, defines the internal control in the following way: "The internal control represents the ensemble of security measures which are contributing to holding the control over the enterprise. Its goal is on one hand to ensure protection and patrimony and information quality and on the other hand to apply the instructions coming from the direction and facilitates the improvement of the performances. It manifests itself through organization, the methods and the procedures of each activity of the enterprise in order to maintain the perenniality." (Renard, 2003)

Another definition is given by KMPG company: „An internal control system encompasses the policies, processes, tasks, behaviors and other aspects of a company that, taken together (KMPG, 2000):facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives This includes the safeguarding of assets from inappropriate use or from loss and fraud, and ensuring that liabilities are identified and managed;

- help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organization;
- help ensure compliance with applicable laws and regulations, and also internal policies with respect to the conduct of business.

We can affirm that „the internal control is a whole system of controls, financial and otherwise, established by the management for the smooth running of business; it includes internal cheek, internal audit and other forms of controls." (Hamed, 2009)

The internal control is defined by the actual regulatory framework(BNR, 2009) as „a continuous process, intended to provide a reasonable assurance to achieve the performance goals – efficiency and effectiveness of the activities, information goals – reliability, integrity and on time financial information purveyance and conformity goals - compliance with the laws and regulations applicable and also with the policies and internal procedures. In order to be expedient, the internal control needs the implementation of the following functions: the function of risk control, the compliance function and the internal audit function. The internal control also includes the organization of the accountancy, the information processing, risk assessment and risk measurement systems."

From the definition one can observe that the central bank, as supervising authority and at the same regulatory authority described the internal control in the prospective of a internal control global system at credit institution level. The fact that the internal audit is a function of the internal control system does not imply that the internal audit overlaps with the internal control. They are tightly linked but distinct on each other. As stipulated by the law, the credit institutions must have an independent internal audit function which has to be permanent and effective whose goal is: (i) to ensure the fact that the policies and the processes of the credit institutions are respected inside all the structures and activities, (ii) to review the policies, processes and control mechanisms in such a way as to remain sufficient and adequate to the activities performed. Therefore we define the internal banking control as „the systems, policies, procedures, and processes effected by the board of directors, management, and other personnel to safeguard bank assets, limit or control risks, and achieve a bank's objectives" (*Internal Control Comptroller's Handbook*, 2000).

Following that the internal audit to be that department included in the internal control system whose main task is o ensure permanently that the control system is effective and otherwise to be able to detect and correct the errors.

TYPES OF INTERNAL CONTROLS IN THE CREDIT INSTITUTIONS

In the case of credit institutions, the internal control is a combination of both financial and other controls.

Financial controls are carried on by both the competent departments and by the internal audit department within the credit institution, acting to increase the efficiency, to preserve the patrimony, to know the legal aspect of the financial operations, to establish the liabilities in case of fraud. The financial controls can be typed in (Tulvinschi, 2008):

- *Preventive financial controls:* are carried on prior to the operation, by checking the documents concerning the rights and obligations referring to expenses and income registration. These documents are processed within the central work departments or within the administrative units by the staff authorized or by the president order.
- Concurrent financial controls: are carried on by the employees at their level, on the documents processed in the moment of banking operations entailing patrimonial employment of the bank according to the working procedures (effecting an external payment on behalf of a bank's client) and by automated data processing special programs in order to detect the fraud coming both from within the bank and from

outside the bank (access codes for employees who are effecting and authorizes payments, the security system of the software processing the cards, etc.).

- *Subsequent financial controls*: driven by the chief accountant and the staff responsible from a branch, by authorized departments and mostly by the internal audit department. This type of control endorses the branches and by specialized department from the central which are performing and registering operations engaging bank's patrimony. As a result of this control, there are detected shortcomings and losses, causes or responsible are identified and measures for similar subsequent infringement are submitted.

Irrespective of the moment of exertion of a financial control the types of controls mentioned above are endorsing mainly (Hamed, 2009) the following aspects: controls for recording accounting transactions properly, controls for proper safe guarding company assets like cash stock bank debtor etc, early detection and prevention of errors and frauds, properly and timely preparation of financial records the balance sheet and profit and loss account, to maximize profit and minimize cost.

Other controls exerted within the credit institutions are: quality controls, supply control, marketing control, etc.

THE ELEMENTS OF THE CREDIT INSTITUTION'S INTERNAL CONTROL SYSTEM

Any control systems rely mainly on the dimension of the credit institution, on its complexity and risk profile. Each effective control system must include (BNR, 2009): (i) the role and the liabilities of the management concerning the internal control; (ii) the identification and assessment of the significant risks; (iii) control activities and the separations of the liabilities; information and communication; (v) supervising and error corrections activities.

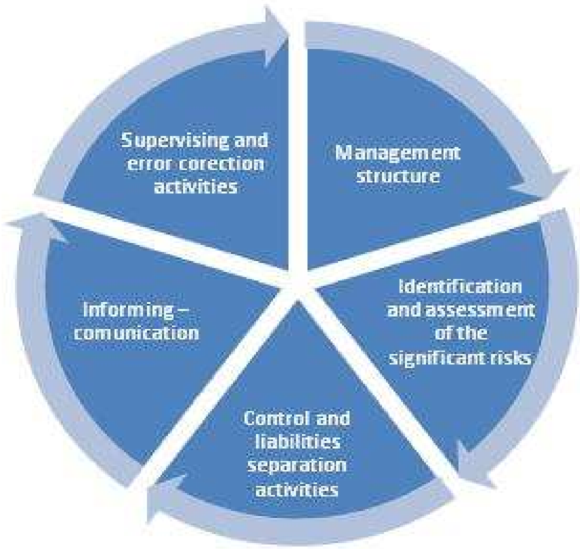

Figure 1. Internal control system components.

The role and the liabilities referring to the internal control is named in the literature as „control environment" that is „composed of actions, policies and procedures that are reflecting the overall attitude of the manager of the Boards of Directors and of the owner of the entity towards the internal control and its importance for the entity."(Loebbecke, 2003) This environment establishes the discipline and the structure of the control system and must comprise: (*Internal Control Comptroller's Handbook*, 2000)

- The organizational structure of the institution. (Is the bank's organization centralized or decentralized? Are authorities and responsibilities clear? Are reporting relationships well designed?)

- Management's philosophy and operating style. (Are the bank's business strategies formal or informal? Is its philosophy and operating style conservative or aggressive? Have its risk strategies been successful?)
- The integrity, ethics, and competence of personnel.
- The external influences that affect the bank's operations and risk management practices (e.g., independent audits).
- The attention and direction provided by the board of directors and its committees, especially the audit or risk management committees.
- The effectiveness of human resources policies and procedures.

The identification and assessment of the significant risks implies the use of the ensemble of the measures adopted in order to determine and to assess the phenomena, the factors and the events having a negative influence on the activity using rules, methods, procedures and specific tools. The assessment must take into consideration all levels of the credit institution, all its organizer levels, must cover all the activities and to consider the occurrence of new activities, having in sight both the internal and external parameters (Figure 2).

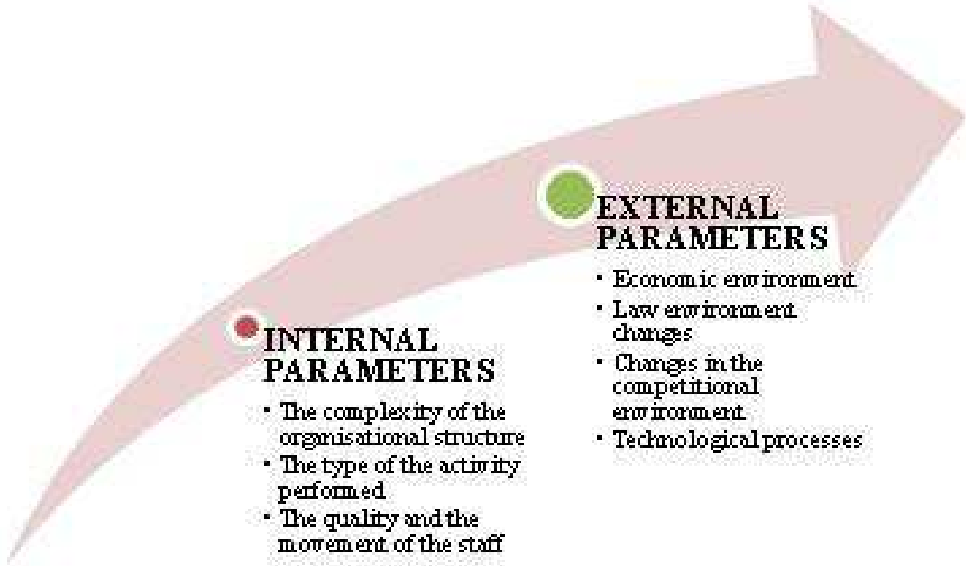

Figure 2. The parameters influencing the identification and the assessment of the significant risks.

The process of risk assessment must comprise the identification of both the risks that can be controlled by the credit institutions and the uncontrollable risks. In case of the controllable risks, credit institutions must decide whether to undertake totally the risks or the extent of reducing using control procedures. In case of uncontrollable risks, credit institutions must decide if accepts, denies or reduces the activities affected by the risks. The decision must be taken by specialists of the credit institution that are not responsible for the achievement of the commercial and financial performance. Therefore, an effective evaluation of the risks helps the entities to determine the risks, the controls needed and the manner of managing them.

The control activities and the separation of the liabilities. The control activities are the policies, procedures and the practices elaborated to follow on one hand, if the bank's staff respects the attributions and the liabilities and on the other hand the manner of operation of the directives of the management regarding the business level in the bank. The control activities ensures the manager that the risks blocking the bank to achieve its goals. As a consequence, these control activities have to be defined for each organizational level of the credit institution in two steps: setting up the policies and control procedures and the verification of the compliance of the policies and procedures. The policies are a part of the daily routine of the credit institution and implies at least the following stages (BNR, 2009):

- Analysis at the management structure level;

- Operative analysis at the structural level of the credit institution;
- Verification that are intending to restrict the access to the assets, for instance : debts, cash, restricting the access to the client's accounts etc.;
- The analysis of the abidance by the limits imposed to the risk exposure and observing the manner of how the non-compliance situations are solved;;
- approvals and authorizations, in case of transactions above certain amounts;
- the checking – the four eyes principles: task separation, cross verification, the double checking of the assets, double signature;
- verification and reconciliation of transactions, particularly where there are differences between the methodologies or evaluation systems used by the structures responsible for initiating transactions - front office - and by the structures responsible for recording and monitoring of transactions initiated - back office.

Internal control system provides a proper separation of powers, aimed at preventing conflicts of interest. For example: (i) a person's dual responsibilities in areas such as acting in front office and back office, (ii) approving disbursement of funds and actual drawing, (iii) credit documentation evaluation and monitoring customer credit after contracting. Areas that may be affected by potential conflicts of interest must be identified and subject to independent monitoring carried out by persons not directly involved in those activities whose information is based on the established reporting lines properly. This division of tasks can reduce a person opportunity to commit and conceal fraud or error.

To ensure safety and quality objectives of the operations, credit institutions have guided by the principle of division of four criteria (Nițu, 2002): the authorization, execution, control and supervision tasks to three people or structures.

The approval requires that a person to be empowered by management to authorize a transaction or just certain transactions. To exercise this activity, lists have to be drowned up containing the operations that will be allowed and list of persons authorized by the Board of Directors. Given that the vast majority of banking transactions are automated, enabling the system in such a paperless environment is based on "confidential code assigned to certain persons or certain computer terminals, codes by which those people can perform a particular operation."(Nițu, 2002)

The execution of banking operations includes on one hand its effective implementation of and on the other hand the recording. In the case of credit institutions two steps are automated, which means that "the transaction is entered at a terminal in the computer system and it runs the technical operation, generate records and issue confirmation enforcement operation."(Nițu, 2002)

The banking operations control is designed to ensure that transactions are authorized by a person empowered to do so and that they were properly treated. In the banks' computer systems this step is made easier because, in general, information systems provide a series of security guarantees, based on secret access codes, known only by persons empowered to carry out a transaction. In addition, any operation of "introduction" of a transaction is followed by a validation transaction (the principle that any operation is temporary and becomes final only after a code validation by an authorized person) and a control operation (any operation should be listed and made subject to approval by a responsible person, and will validate the transaction.)

Supervision. Bank is built on a pyramidal basis, there is decentralization and delegation of powers, which involves both a duty to control, and the one to supervise. Supervision can take the following forms: (i) to make sure permanently about the level of training and qualification of staff, (ii) to make sure that regular checks are carried out under the procedures, (iii) to make spot checks, (iv) periodically evaluate the statistics on activities, development plans and budgets, (v) maintain control regarding important decisions.

Internal control information and communication systems allows all personnel to understand their role in the control system, how their roles relate to others and their responsibilities. In terms of information credit institutions must have reliable information systems covering all their activities and organize information management in compliance with the legal incidents. It should also ensure the existence of financial data, operational and compliance, adequate and complete, to conduct business and to have information on market events and conditions that are relevant for decision making. Information must be credible, relevant, complete, timely, accessible and provided in a consistent format. These systems produce reports information on bank operations, the financing arrangements, and on how it complied with the Board, as managed by the management activity. Information systems are transmitting information inside the bank and to external parties, such as regulators, shareholders, etc.. .

Monitoring activities and correcting deficiencies. Internal control systems must be monitored in order to assess the quality of performance over time. Monitoring the effectiveness of internal control system must be part of the daily activities of credit institutions and should include separate assessments of internal control system in general, being made by both the staff responsible for each structure of the credit institution and by the internal audit. The deficiencies identified in the internal control system must be immediately notified to the persons responsible for environmental managers, who must take measures to remedy them promptly. Those that are classified as major deficiencies must be reported for the management level and to the supervisory boards of credit institutions. To establish a detection system of internal control deficiencies and take steps to address these deficiencies is responsible for the management sectors.

DISCUSSION

The general structure of an internal control system being previously described the problem that rises is to establish when an internal control system is effective and when is not. We must emphasize that inside an organization, the managers are the main responsible for a normal functioning of the internal controls, but an efficient functioning of a control system is not only depending on the managers, the executive staff having its crucial role. Therefore the individual on each level of an organization are influencing the internal control, being in some extend in everyone’s responsibility. Nevertheless, the internal control, no matter how well designed and operated, can provide only reasonable assurance of achieving an entity's control objectives. The likelihood of achievement is affected by limitations inherent to internal control. O A limitation inherent in any system is the element of human error (misunderstandings, fatigue, and stress). Errors also may occur in the use of information produced by IT. Additionally, controls, whether manual or automated, can be circumvented by the collusion of two or more people or inappropriate management override of internal control. Custom, culture, and the corporate governance system may inhibit fraud, but they are not absolute deterrents. An effective control environment, too, may help reduce the risk of fraud.” (Hamed, 2009)

CONCLUSIONS

The main ideas from this paper are:

Firstly *that an effective internal control helps an organization achieve its operations, financial reporting, and compliance objectives.* Effective internal control is a built-in part of the management process (i.e., plan, organize, direct, and control). Internal control keeps an organization on course toward its objectives and the achievement of its mission, and minimizes surprises along the way. Internal control promotes effectiveness and efficiency of operations, reduces the risk of asset loss, and helps to ensure compliance with laws and regulations. Internal control also ensures the reliability of financial reporting (i.e., all transactions are recorded and that all recorded transactions are real, properly valued, recorded on a timely basis, properly classified, and correctly summarized and posted).

Secondly *that the internal control can provide only reasonable assurance – not absolute assurance - regarding the achievement of an organization's objectives.* Effective internal control helps an organization achieve its objectives; it does not ensure success. There are several reasons why internal control cannot provide absolute assurance that objectives will be achieved: cost/benefit realities, collusion among employees, and external events beyond an organization's control.

As a conclusion we can notice that the managers are using the control system to check if the units are functioning as planned, i.e.:

- if the banking operations are effective and efficient;
- if the trading are correctly registered;
- if the financial statements are balanced;
- if the management risk systems are effective;
- if the credit institution is compliant with the laws and regulations and with the policies and internal procedures.

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