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INTERNAL CONTROL SYSTEM: STRUCTURE, SELF-DEVELOPMENT AND SELF-CONTROL

Abstract. Without a coordinated, limited control risk resources cannot be effectively used, and significant risks cannot be identified and properly managed. Internal control is clearly structured and has a vertical hierarchy. The system of internal control consists of three levels and each of them inherent function of improvement of the previous one. The lowest level of control is the control of managers departments as well as primary control during operations with production department.

The second level of internal control is the specialized control departments, such as: financial control, security, compliance, risk management, quality management of service or manufactured products, and so on. The functions of these divisions are the development of activities methods in their working area and control implementation of this methods, or compliance with external / legal regulations. Within the limits of their authority, the subjects of control at this level of internal control also develop / propose changes to the control methods (within their competences) which are applied to the first level. The third level is the level of internal audit. The function of internal audit is directed at two main lines: control of operations and settlements; assessment and improvement of the internal control system. Therefore, internal audit, has one of the main tasks, it is the improvement and control of the subjects of the first and second levels of the internal control system. Improvement and development of internal audit is carried out through self-assessment and external evaluation of internal audit (commissioned by the Supervisory Board).

Keywords: internal control, internal audit, risk, compliance, risk management

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JEL Classification: M42, M14

Introduction. The changes that take place both in the internal and external environment of the corporate sector determine the needs to constantly adjust their behavior on the market and create a flexible, adaptive management system to implement its strategy, which is one of the decisive factors of profitability and competitiveness.

Modern complex business conditions make needs of relevant research in the area of business management information effective use. This is due to the need for stable development, and to increase their financial and economic performance. An effective and most accessible tool for such a search and, accordingly, one of the competitive advantages of modern subscription, is internal control, the effective functioning of which will significantly accelerate the reactivity of management and provide an opportunity for timely detection and elimination of problems in its activities.

In the twenty-first century business isn't uncommon cross functional teams of internal auditors, risk management specialists, specialists responsible for controlling employees, internal control or quality inspectors, fraud investigators and other risk management and

control professionals working together to help their organization managing risks. It is not enough that there are different risk and control functions, the challenge is to assign certain roles of control groups, effective and efficient coordination between these groups, that way there are no gaps in control or unnecessary duplication. Without a coherent, coordinated approach limited risk and control resources cannot be effectively organized, and significant risks cannot be identified and properly managed.

Literature review and the problem statement. Researches in the field of internal control, studying its essence and structure were the following scientists: O. Y. Redko [Kamenska, Redko 2015], A. M. Liubenko [Liubenko 2017], E. Akwaa-Sekyi, G.J. Moreno [Akwaa-Sekyi, Moreno 2017], J.B. Duncan, D.L. Flesher, M.H. Stocks [Duncan, Flesher, Stocks 1999], F. Hanim Fadzil, H. Haron, M. Jantan [Hanim Fadzil, Haron, Jantan 2005], M.J. Jones [Jones 2008], F. Kabuye [Kabuye, Nkundabanyanga, Opiso, Nakabuye 2017], J. Krishnan [Krishnan 2005], L. Li, G. Tian B. Qi [Li, Tian, Qi 2012], J.-Y. Liu [Liu 2018], G. Michelon [Michelon, Bozzolan, Beretta 2015] and others. Also are important investigations of M. Namazi [Namazi 2013], J. Pathak [Pathak 2005], G. Sarens, J. Christopher [Sarens, Christopher 2010] and others. These scholars have systematized knowledge in this direction, defined the concepts of internal audit, compliance, controlling, and determined their place in the system of internal control. The purpose of this article is to study the structure of the internal control system, the definition of the role and ways of its components interaction, the characteristics of the method of its self-development.

Research results. In today's society, the role of control is constantly rising and acquires new shades of its essence. Control as a management function should be considered through the system of monitoring and checking the process of functioning of the object, comparing the planned and actual values of the given parameters, detecting deviations in the parameters and factors that caused them. Therefore, control performs a two-way communication function between the object of management and the control system. Internal control is a component of the management system. Effective internal control is a factor that affects the credibility of creditors, investors, depositors and helps to understand the main risk areas in the organization. Practitioners and academics dealing with internal control have developed several concepts, among which the main ones are formulated in the documents INTOSAI, COBIT, IIA. Organization INTOSAI (the Internal Control Standards Committee of the International Organization of Supreme Audit Institutions) was established in 1953 to promote cooperation and information exchange between Supreme Audit Institutions and the unification of standards in the field of financial control. In June 1992, the members of the organization developed the "Guidelines for Internal Control Standards"

According to the recommendations of INTOSAI, internal control is divided into: management control, objects of which are plans, policies, procedures, methods for achieving goals; administrative control - aimed at achieving the economic use of resources, ensuring maximum efficiency and implementation of management's instructions; accounting control - procedures and documents for the preservation of assets and the reliability of financial reporting. Another core concept of internal control was developed by the Committee of Sponsoring Organizations (COSO), which was formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting. COSO is an independent private sector initiative that studies factors that may lead to inaccurate financial reporting and develops recommendations for open joint stock companies and their independent auditors for SEC (US Securities and Exchange Commission) and other regulators for educational institutions. COSO was created

to improve the quality of financial reporting by improving business ethics, using effective systems of internal control and corporate governance.

One of COSO's key documents is the «Internal Control: Integrated Framework» (1992) and «Organizational Risk Management: Integrated Model» (September 2004). The COSO model is recommended for implementation by the Basel Committee. Internal control, in accordance with the COSO document, is considered as a process carried out by the management of the organization, designed to provide assurance of the achievement of goals according to the following criteria: efficiency and effectiveness of activities; reliability of financial reporting, compliance with certain requirements. The internal control system is part of the risk management process, which transforms it into a more effective, risk-oriented. Considering theory of the system of internal control (IC), we want to draw attention to the opinion of Kamenska T. O. and Redko O. Y., who divide it into the following parts: financial control, including control over completeness and reliability of accounting records and financial reporting, is an important element of the IC; operational control - control over the production and other business activities of the enterprise, control of individual business processes of the enterprise; compliance-control - verification of compliance with legislation, requirements of regulatory and supervisory bodies, as well as internal documents of the enterprise, which determine the internal policy, rules, procedures, the purpose of which is to assess the quality and compliance of established systems to ensure compliance with the requirements of legislation and other legal acts and internal documents, as well as developing proposals for improving these systems [Kamenska, Redko 2015]. Similar opinion is shared by other researchers in this direction.

The disadvantage of this division is its one-sidedness, and consideration only in a horizontal way, without application of the IC parts hierarchy. Here we see the problem of development and control for IC system (its components). Often, academics are focused on the main tasks of internal audit (IA), as a part of the IC, include control over it, and here comes a dilemma, how IA being an equal subject of IC may to take control and improve it? We believe to give answer for this question we should start looking to review the structure of the IC in a vertical way. This approach was described by the experts of the Institute of Internal Auditors (IIA) in their practical guidance [IIA 2013]. IIA experts suggest model "Three Line of Defense". In their view, this is a simple and effective way to strengthen communication between risk management and control, explaining important roles and responsibilities (fig. 1) [IIA 2013].

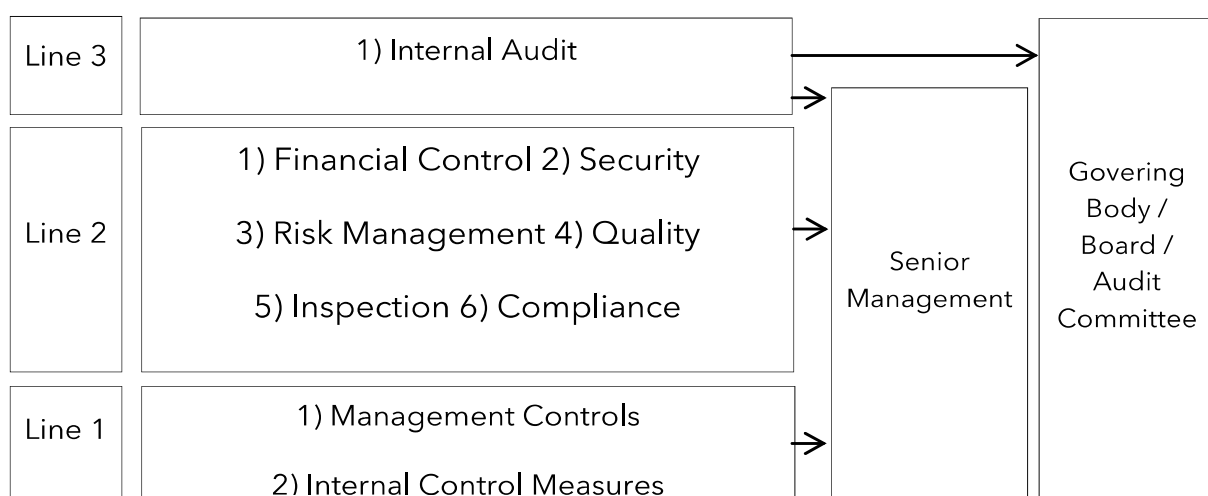


Figure 1 – Model of IC system

Source: [IIA 2013]

In the "Three Line of Defense" model, managerial control is the first line of defense in risk management, the various risk control and supervision functions established by management are the second line of defense, and an independent guarantee is the third one. Each of these three "lines" has a special role within the framework of an extensive organization management system [IIA 2013]. Senior management and governing bodies are responsible for defining the goals of the organization, defining strategies for achieving these goals, and establishing management structures and processes for best risk management to achieve these goals. The "Three Line of Defense" model is best realized with the active support of leadership and top management of the organization [IIA 2013].

Relevance of this model is confirmed by its implementation by large international organizations and holdings (table 1). In this article, we want to describe the case of the UniCredit Group (Table 1), which we consider to be obvious for this study. First level control there is designed to ensure the correctness of transactions. Such control is carried out by specialized units, fixed in the procedures or the back office of the organization [Unicreditgroup 2018]. In our opinion, this should be supplemented with the control of the heads of units in their work area.

Table 1 – Comparative table of IC systems in international corporations

	UniCredit	Snam	Eni SpA	Italgas
Level 1	The first control level or line is intended to ensure the correctness of the transactions. The control is carried out by the profile unit, fixed in the procedures or carried out by the back office.	Definition, assessment and monitoring the risks inherent in individual group processes. At this level there are departments that have individual risks. They are responsible for detecting, measuring and managing them, as well as taking the necessary control measures.	The first level of control: defines, assesses, manages and controls the risks for which it is responsible, for which it defines and implements specific management actions. (ICIRE - Internal Control and Risk Management System)	The first level: the identification, evaluation and monitoring of the risks inherent in individual group processes. The units that are the owners of individual risks are responsible for identifying, measuring and managing them, and taking the necessary control measures.
Level 2	The second control level or risk management is the responsibility of the unit that is separated from other profile units, and they are separate structural units responsible for verifications. The compliance function ensures: proper application / compliance with the regulatory framework, its consistent interpretation at the group level; identification, assessment, warning and monitoring of general risks related to the compliance of the group or relevant legal entities.	1) Monitoring of the main risks for ensuring their effective management and processing; 2) Monitor the adequacy and functioning of the control to prevent these major risks; 3) Support of the first level in the definition and implementation of adequate management systems for major risks and related control; 4) This level implies the presence of the personnel responsible for the coordination and management of the main management systems, including the fight against corruption, antitrust laws, corporate administrative responsibility, disclosure.	The second control level: monitors the main risks to ensure the efficiency and effectiveness of their management; is responsible for monitoring the compliance and functioning of control performed for major risks. It also provides first-level support for the identification and implementation of adequate systems for managing key risks and related control elements;	The second control level: monitoring of the main risks to ensure their effective and efficient management; monitoring of adequacy and functioning of control; support for the first level in the definition and implementation of adequate management systems for key risks and related control. Activity within the second level is the personnel functions involved in the coordination and management of the main management systems.

	UniCredit	Snam	Eni SpA	Italgas
Level 2	The Group of Risk Management (GRM) monitors and manages the Group's risks by defining policies and methods, aimed at measuring and controlling these risks and optimizing the cost of risk by defining guidelines, policies on material credit risks in accordance with internal and external rules and norms.		The structure of the first and second control levels corresponds to the size, complexity, profile of the specific risk, and the regulatory environment in which each company operates.	
Level 3	The third control level is carried out by an internal audit. IA evaluates and regularly checks the completeness, functionality and adequacy of the internal control system. Internal audit is independent of the production (level 1) and the second control level.	Independent and objective verification of the effectiveness and adequacy of levels 1 and 2 and all methods of risk management in general. An internal audit performs this activity in accordance with management and guidance. The system of internal control and risk management is regularly subject to verification and updating in order to continuously ensure its suitability and protect the main business areas of risk.	Third control level: provides independent, objective assurance on the feasibility and effectiveness of the first and second control levels and, in general, of the ICIRE Eni system as a whole. The third control level is carried out by the Eni SpA Internal Audit Group, which monitors the use of a risk-based approach based on a centralized model.	Third level: Independent and objective check of efficiency and adequacy of activity of the First and Second levels and general risk management methods. This activity is performed by the function of internal audit.

Source: Consolidated by the author on the basis of [IIA 2013; Unicreditgroup 2018; Internal control and compliance, Snam 2018; Italgas 2018]

UniCredit Group's risk management (GRM) function (hereinafter referred to as the «Group») belongs to the second level of IC and is to control and manage the Group's risks [Unicreditgroup 2018]: management and optimization of the Group's asset quality and cost of risk; definition (in conjunction with the function of the CFO) and monitoring the Group's risk appetite and its capital adequacy; definitions according to regulatory requirements, Group rules, methodologies, types of risks, policies and risk management strategies; determination and application of assessment, management, measurement, monitoring and reporting of risk criteria to ensure consistency and transparency in the Group; verification of the adequacy of risk measurement systems adopted throughout the Group; quantitative assessment of the impact of changes in the economic cycle or stressful events on the financial structure of the Group; creating a risk culture in a group. Thanks to a well-established risk management process, GRM actively manages the Group's risk in the following areas [Unicreditgroup 2018]: credit risk; market risk; liquidity risk; operational and reputational risk. The compliance function is also embedded in the second level of internal control system, it is aimed at preventing and managing the risk of non-compliance with regulatory requirements and conflicts of interest in order to preserve the reputation of the Bank, trusting consumers and promoting resilience of the group (creating a corporate values / consolidation) through strategic direction (politics and thoughts) and support and monitoring (mapping of risk matching, preventive assessment) in all activities of the Group [Unicreditgroup 2018].

The purpose of Unicredit's internal audit is to help protect the organization's ability to achieve its goals effectively [Unicreditgroup 2018]: control ensures that the transactions are

appropriate and are executed in accordance with laws and regulations; estimation of work processes efficiency; assessment of the proper functioning of the overall system of internal control (linear or operational control and control of risk management). IA of UniCredit verifies compliance of the companies in the Group with the parent company's guidelines and the effectiveness of the IC systems, establishes guidelines, coordinates and oversees the internal auditing activities carried out by the IA units in the group. In this sense, the IA of the Group performs third-level control functions. IA Groups and local IA structures, including in cases where legal entities act as affiliated companies, are part of the IA's competence. [Unicreditgroup 2018].

Consequently, the IC is clearly structured and has a vertical hierarchy. The IC system consists of three levels and each of them has a function of improvement of the previous one. Based on the data presented in Table 1 and the case implemented in UniCredit, we can say that the lowest level of control is the control of unit managers, as well as the primary control during the operations of the production (or specialized) unit. An example of such control can be the units (individual employees) in banks who verify the adequacy and quality of the data package in the process of signing the loan agreement. The third level is the level of IA. Concluding from the data obtained during the study, we can say that the function of IA is directed into two main channels: control of operations, calculations, etc.; assessment / improvement of the IC system. Therefore, IA, as one of the main tasks, has the improvement and control of the subjects of the first and second levels of IC. In connection with this statement, the last question arises - "And who controls IA?". The only correct option, in our opinion, is the self-assessment of the IA and the external assessment of IA (commissioned by the Supervisory Board) (more detail is discussed in [Kiiko 2018]).

Conclusions. Having analyzed theoretical bases and practical experience in the field of internal control, we can say that it is a complex and multilevel system. A system that consists of three main levels, on which from the lowest to the highest is carried out cross-control of all spheres and areas of the organization activity. Where the first level it is the level of control within the production departments; the second level is the control of the specialized created units of the organization, the role of which is carried out special control within the limits of the powers granted to them in the organizational structure; the third level is the level of internal audit, independent evaluation, which is directly directed to the supervisory board (top management), its role of evaluating the internal control system, and providing a qualified opinion regarding the organization's activities (assessment of operational, financial and other activities). This method of organizing the system of internal control allows to provide qualitative current functional control over the main activity, there is also working a separate special control, such as compliance, controlling, financial monitoring, security, etc., at the highest level, an assessment is made of the adequacy and quality of the previous two levels, which leads to the self-development and self-organization of the internal control system.

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