



INTERNAL AUDIT

PRINCIPLES OF AN INTERNAL CONTROL SYSTEM IN BANKS

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This article aims to outline the basic principles of functioning of the internal control system in banks, to characterize the position of an auditor in Slovak banks, and to compare the situation in Slovak banks with trends in developed economies.

Internal Control System

A set of effective mechanisms of an internal control system in banks is one of the fundamental conditions of their healthy functioning. In simple words, an internal control system can be defined as a set of mutually integrated instruments and measures in internal controls. Internal control is an inseparable element of corporate management, it includes methods and procedures that are applied within controlling of the way a bank is managed so as to achieve the goals set out by the bank's management. Effectiveness of the system of internal controls is not dependent on the number of control departments or the number of their employees, but on the position of internal control at all levels of management. Its introduction into practice means that control becomes an element of everyday work of all employees of the bank. Often the system of internal controls is identified with the supervision department of the bank or the internal audit department. However, these departments only represent one of the constituents of a well functioning system of internal controls.

In Slovakia, we come across the term „internal control system“ in the Act on Banks, which in Article 9 establishes for banks the duty to specify in their statutes the system of internal controls, and in Article 23, in the sense of which a bank is obliged to submit to the National Bank of Slovakia a report on the results of the system of internal controls, adopted measures to correct shortcomings in the work of the bank found by internal controls, and an approved plan of control activities for a calendar year. No legal norm in relationship to banks defines the term „internal control system“ and no legal norm specifies duties of banks in this respect. Perhaps this is one of the reasons why the level of internal control and its effectiveness in banks varies.

The Basle Committee for Bank Supervision issued framework principles of systems of internal controls in banking organizations. According to these principles, a sys-

tem of effective mechanisms of internal controls is a decisive constituent of bank management and the basis of their safe and sound functioning. A consistent system of internal controls can help safeguard achieving the bank's goals as well as assist in adherence to laws, directives, internal guidelines, and procedures, thereby reducing risks of unexpected losses or damage to good reputation of a bank. The Basle Committee recommended to supervision organs all over the world to use principles set out within the system of internal controls for evaluation of the internal controls system.

The adopted principles can be divided to six elementary evaluation spheres that incorporate 13 principles:

- management supervision and control culture,
- finding and evaluating risks,
- control activities and division of duties,
- information and communication,
- activities of monitoring and correction of shortcomings,
- evaluation of internal control systems by supervision authorities.

Increased interest of the Basle Committee in the system of internal controls in banks is not accidental; analyses of losses of large banks in the world indicate that these could have been avoided had the banks implemented effective systems of internal controls. (Well-publicized is the example of the collapse of Barings Bank).

Banking supervision in Slovakia has not established principles for internal controls in banks, however, if it wants to maintain a healthy banking sector, it will have to at least outline a framework for this area. Evaluation of effectiveness of the internal controls system is the basis for every on-site inspection that banking supervision conducts in banks. With regard to insufficient legal backing and blurry terminology, it can only compare the existing situation in banks with principles of the Basle Committee and point out the shortcomings in the internal controls system or its ineffectiveness. In particular the ineffective systems of internal controls, which banking supervision pointed out within its on-site supervision reports are sub-



jected to sharp criticism by banks, but eventually they were one of the main causes of problems and losses in large banks.

An example of France can be given for a comparison, where a separate directive has been issued of internal controls of credit institutions.

Introductory provisions of this directive outline internal controls primarily as:

- a system of control of internal operations and procedures
- organization of accounting and processing of information
- system of measuring risk and results
- system of control and management of risk
- documentation and information system.

According to this directive, a credit institution must introduce a set of mechanisms adapted to the character and volume of operations, its size, and risks of various character to which they are exposed. They must also introduce similar mechanisms on a consolidated basis. Credit institutions are obligated to organize their system of controls so as to ensure mechanisms that:

- ensure regular control with a set of instruments constantly functioning at the level of operating units that would guarantee regularity, safety, and validation of adopted measures and observing other tasks associated with control of risks of whatever character linked with performed operations,
- examine based on adapted periodicity the regularity and compliance of operations, observing procedures, and effectiveness of mechanisms, above all their suitability with regard to the character of the set of risks associated with the operations.

The structure of credit institutions and specifically mentioned mechanisms must be compiled in a way to ensure unambiguous independence between units charged with carrying out operations and units charged with their verification, as well as monitoring of tasks linked with monitoring of risks.

Every constituent of an internal control system is further specified in the directive, whereby the principle is emphasized of ensuring the functions of internal control on a consolidated basis. The directive is very extensive and it is not possible in this article to describe in detail all its parts. My intention is to demonstrate that also the area of internal controls can be defined and put into a legal framework, which can contribute to the elimination of a formal approach to controls and to strengthen its position in banks.

Internal Audit

Control and audit do not differ by their goals; however, internal control is not an audit and an audit does not replace internal control.

The main principles of internal control which it would be appropriate to introduce in all banks:

- a clear statement of control objectives,
- a guidebook of operational procedures,
- strict separation of duties,
- constant documentation of accounts,
- effective internal audit,
- efficient information and control system of management,
- quality personnel.

For comparison, we shall mention the objectives of an internal audit:

- protection of safety of operations, valuables, assets, and persons,
- increasing the effectiveness and quality of services,
- ensuring the protection and widening of reliable and rapidly available information,
- ensuring adherence to goals set put by management of the institution.

Integration of mechanisms of internal controls with procedures of processing operations meant delegating control to the level of operational departments. The objective of an audit is above all to ensure that the introduced mechanisms function properly, which means that audit has evolved from straightforward supervision to supervision over control.

The profession of an internal auditor is one of the newest professions; internal audit has systematically been implemented only from the 40's of this century. From its beginning, internal audit and the position of an internal auditor underwent several changes. Initially the main objective of internal audit was financial and bookkeeping supervision. Gradually its activity shifted towards auditing operations, whereby it related to all types of operations in order to ensure internal control and effective management, and this independently of the management staff.

Contemporary opinions about an internal audit perceive this domain as an independent, advisory organ of bank management, established with the objective of examining and evaluating activities of the bank. The activity of internal audit has shifted from reviewing of other controls in the bank to advising the management of the bank with the objective to assist in perfecting the used methods, systems, and procedures of the bank in order to achieve the highest possible effectiveness of operations of the bank.

The position of internal auditors in the processes and in management of banks is specific; based on principles of the Basle Committee it is important for internal auditors to be subordinated directly to the most senior management level of the bank — the supervisory board or the bank's senior management. It is decisive for the internal audit department to be independent of the every-day functioning of the bank, to have access to all activities, including branch offices and subsidiaries. Internal audit staff must have the possibility to provide information directly to the supervisory board or the bank's senior management,



and this information must not be in any way distorted by management levels to which this information pertains. Independence of internal audit staff can be enhanced by giving powers to decide about their salaries to the supervisory board, i.e. not the managers who are effected by the work of internal auditors.

In Slovakia, in the sense of Article 8 of the Act on Banks, overseers of the internal audit department can be appointed, dismissed, and their salary is decided by the statutory organ following approval or at the recommendation of the supervisory board. At the same time, the jurisdiction is enacted for the supervisory board to effectively influence through the internal control department the supervisory activities in a bank. It may be concluded from what had been stated above that foundations for independence and impartiality of internal auditors have been laid. It depends on the approach of senior managers and members of supervisory boards how these provisions are applied in favor of effective operations of banks and the work of internal auditors.

Experience from banks in Slovakia shows that banks uphold applicable laws towards internal auditors, however, the position of internal auditors in individual banks greatly differs. The position of internal auditors in our circumstances cannot be identified with the function of effective advisors for the senior management of the bank, but their contribution to the effectiveness of banks is visible. Internal auditors must by their own professionalism and competence prove that they are capable of providing added value to the senior management of the bank, that they are offering to the management of the bank a specific product that differs from other participants in the management process.

Internal auditors should by timely and correct information contribute to management's proper decisions; if they cannot do so, they are co-responsible for the bank's failure. If internal auditors want to develop as an advisory organ for bank managers, they must meet demanding professional criteria, whereby they must constantly work on improving their qualification. A system of education should

be introduced for internal auditors, which for example already exists in the Czech Republic. The Czech institute for internal auditors provides systematic education for internal auditors in the form of courses dedicated to individual problems in auditor work and also in the form of post-graduate study completed by a final examination and an awarded diploma of a CIA (Certified Internal Auditor). High professionalism of internal auditors may greatly contribute to their independence, which is closely linked with responsibility for results of a bank.

And finally, the question must be asked as to who oversees the internal auditors. A situation where internal auditors would not be overseen by anyone is unacceptable; they should be under the control of owners, external auditors, as well as regulatory authorities. Also here the requirement is justified of an institutional outline for their position, a constituent of which could be to formulate certain ethical principles. Formulating ethical principles could help resolve ethical and professional requirements which auditors are confronted with and at the same time it would help employees understand better their role and position in a bank. The position of internal auditors in management processes of a bank is irreplaceable, their gradual development, strengthening of confidence and independence can contribute to improving the effectiveness of their activity also in banks in Slovakia.

References:

1. Bank Institute, a. s., Praha: Organization of Bank Management.
2. Jozef Tyll: Can Business Administration and Management Cope without Internal Audit?
3. Basle Committee for Banking Supervision: Framework for Systems of Internal Controls in Banking Organizations.
4. France: Directive 97-02 of February 21, 1997 on internal controls in credit institutions.

IMF AND WORLD BANK DELEGATES AT THE PRAGUE CASTLE

Following an invitation of Mr Vaclav Havel, President of the Czech Republic, about 250 delegates to the IMF and the World Bank as well as their critics will be discussing consequences of the globalisation at the Dance Hall of the Prague Castle.

The debate is to be held shortly before the Annual Meeting of these international financial institutions sche-

duled for 26-27 September 2000. His invitation was aimed at removal of strains between the conflicting parties.

According to DPA, Horst Köhler, Director general of the IMF, has welcomed Havel's initiative during his visit to Prague last week.

(TASR)