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Internal Control System in Credit Organizations

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***Abstract*—Credit institutions should very carefully manage risks, constantly adapt to the competitive environment, and develop their activities daily. At the same time, they have to comply with certain rules of conduct, which are controlled by both external and internal control bodies. In order to more identify weaknesses or problem areas in their activities, credit institutions use a system of internal and external control. The article describes the features of these types of controls and how they can integrate. The paper considers the modern structure of COSO, which consists of several components: control environment, risk assessment, control activities, information, communication and monitoring. The need for it by Russian credit structures has been identified. It has been determined that credit institutions that use an internal control system quickly respond to change external environment conditions and easily increase their capital. In Russia, 10 large banks use COSO that maintain their leading positions in the domestic credit market.**

Keywords—internal control, banking supervision, auditing, COSO framework.

I. Introduction

Lately, the banking sector exist in a complex competitive environment. Therefore, banks should carefully manage risks, constantly adapt to the competitive environment, developing their activities daily.

Many scientists, such as G.N. Beloglazova, O. V. Vaganova, G.G. Korobova, L.P. Krolivetskaya, O. I. Lavrushin, A.M. Tavasiev, S.D. Yushkov. Research on theoretical issues related to internal audit of commercial banks and businesses was carried out by Edward W. Reed, Kichard V. Cotter, Edward K. Gill, Richard K. Smith and others.

According to the works of scientists, we find that the banking supervision system is constantly updating the legal framework, regulations and rules that control banking operations. The purpose of all these laws and regulations is to protect customers and shareholders from financial losses, as well as neutralize the risks that can arise from weak internal controls. To strengthen internal control in banking structures, an internal audit is carried out.

II. Methodology

The research was carried by using financial methods and principles. Thus, using the method of scientific knowledge method, the systemic and logical-semantic analysis, the quantitative characteristics of credit institutions of the Russian Federation were studied on the basis of a historical approach, internal control abroad was studied, on the basis of the comparison method and the principle of comparison, the components of the COSO internal control system were presented. On the study, the method of statistical data processing, as well as the synthesis of theoretical and practical material were used.

III. Results and Discussion

“Internal control is a set of policies and procedures that are used by management to ensure the safety of the company's assets and confidence in the accuracy and reliability of accounting data” [1]. "The internal control system includes a set of various interrelated methods and procedures that the administration develops and uses to ensure the reduction of unwanted risk in business and financial activities, as well as in accounting and reporting" [2].

At banking sector, the internal control system is an integral part of the audit process activities. In general, the internal control system can be viewed as a system of processes and procedures that ensure the efficient operation of the bank and complies with the legal framework applicable in the banking sector.

The internal control system improves the efficiency of functioning and economic development, representing a way of business expertise [17]. The recommendations of the Basel Committee on Banking Supervision is considered the theoretical basis for organizing internal control at the present that defines internal control as a process carried out on a continuous basis by the Board of Directors, management and employees of the bank at all levels. The bank's internal control system organization provides for the coverage of all areas of the bank's activity by control procedures without exception. Internal control of commercial banks in the Russian Federation is organized in accordance with Bank of Russia Regulation No. 242-P "On the Organization of Internal Control in Credit Institutions and Banking Groups", which reflects the principles of Basel Committee on Banking Supervision and international practice of organizing internal control in credit institutions. The Bank of Russia has developed a methodology to verify the organization of internal control system, which defines uniform approaches to assessing this system. Significant attention is also paid to internal control issues during inspections of banks as part of the implementation of Federal Law No. 177-FZ "On insurance of deposits of individuals in banks of the Russian Federation" and Ordinance of Russian Central Bank No. 1379-U "On assessing the financial stability a banks in order to participate in the deposit insurance system”.

Control system functions must be implemented in relation to the past, present and future periods. Having analyzed the quantitative characteristics of credit institutions of Russian Federation, presented in the diagram (Fig. 1), over a two-year period, we can say that control over the banking sector is exercised not only at the internal level, but also by Russian Central Bank , which prevents the emergence of systemic banking crises and protects the interests of bank customers. [5].

TABLE I. QUANTITATIVE CHARACTERISTICS OF CREDIT INSTITUTIONS IN RUSSIA (UNITS)

Indicator	1.01.19	1.01.20	1.07.20	1.08.20	1.09.20	1.01.19
Existing credit organizations – in total:	484	442	427	420	417	484
Banks:	440	402	388	381	378	440
- with a universal license	291	266	257	255	252	291
- with a basic license	149	136	131	126	126	149
Non-Bank credit organizations	44	40	39	39	39	44
Credit organizations registered by the Bank of Russia, but have not yet paid the authorized capital and have not received a license (within the legally established period)	0	0	0	0	0	0
Credit organizations that have had their licenses revoked (revoked) since the beginning of the year	67	31	6	13	15	67
Credit organizations reorganized since the beginning of the year	10	12	9	9	10	10

The graph shows a slight decrease in the number of commercial banks. This decrease due to the tightening of the supervisory policy of Russian Central Bank, which aims to improve the banking sector.

The activities of banks are controlled not only by the Central Bank, but also by the credit institutions themselves, as a rule, carry out internal control and internal audit of their activities. For a more understanding of the relationship between these concepts, it is necessary to distinguish between these concepts from a scientific point of view.

Internal control aims to create a system of inspections, regulation and assessment of banking risks and making sound strategic decisions, since the effectiveness of internal control system organization is reflected in the quality of transactions performed by the bank, compliance with economic standards and financial performance.

Internal audit is also a control activity that carried out by the internal audit service. Internal audit functions include monitoring the adequacy and effectiveness of the internal control system. Internal audit is viewed as a periodic and independent assessment of control system organization itself. An audit allows to determine the effectiveness of a credit institution, identify risks and assess the internal control system. All audit results allow building effective management of the credit institution, monitoring the adequacy of activities and informing shareholders about the results of activities.

Consequently, there is a fine line between the concepts of "internal audit" and "internal control", which is often erased due to the identity of control procedures, so we should understand these two concepts in more detail.

The internal control system is an indicator of banking reporting process. Internal controls include scheduling administrative functions and preparing a complete and accurate annual report. Since mistakes and fraud can occur in the activities of credit institutions, it is important to establish precautions to ensure adequate performance of the functional duties of employees. In the absence of an established system of effective internal control, employees can misuse assets, so the assets can be distorted and the bank itself can violate laws. Consequently, effective control reduces the risk of assets losing and helps to ensure the completeness and accuracy of information about the plan, the reliability of financial statements in accordance with law and regulations.

By studying the history of banking, it is possible to identify the beginning of internal control concept development, which begins to evolve as the development of financial reporting. The first control procedures appeared in the United States at the beginning of the 20th century. Of course, these procedures have evolved over time in accordance with changes in business processes. So at the beginning of the 20th century, when the Spanish-American War brought significant changes to the US business environment, “selective testing” was introduced and system checks were established, which marked the birth of internal control [3].

Between 1930 and 1940, control becomes mandatory and manifests itself in the form of an audit of financial statements, and the role of the auditor is to check the financial statements for compliance with the law. In 1949, American Institute of Certified Public Accountants (AICPA) published a special report, "Internal Control", which demonstrates the importance of "protecting assets" and "ensuring the reliability and accuracy of financial data." However, this report expands the scope of the auditor's management function and responsibility.

In 1977, internal controls were first made mandatory by the Foreign Corrupt Practices Act (FCPA). The idea of internal control has expanded and considered the main tool of the audit process. In 1980, the AICPA Commission issued a report "Fraudulent Financial Reporting", which emphasizes the importance and necessity of internal control [4].

Finally, in 1992, the COSO (Committee of Sponsoring Organizations of the Treadway Commission) system was created and released its first publication mentioning three objectives of internal control; Business Effectiveness and Effectiveness, Financial Integrity and Compliance with Applicable Laws. The COSO system has expanded the scope and perspective of internal controls. COSO's internal control system has five components; "Control environment", "Risk assessment", "Control activities", "Information and communication" and "Monitoring" (Figure 1).

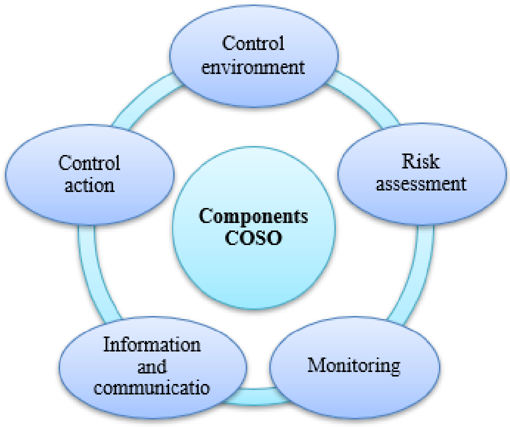

Fig. 1. Components of COSO Internal Control System.

In 2010, due to the changes and improvements in the business environment, COSO updated its first version of PriceWater house Coopers.

Considering the initial nature of internal control, then it was originally a prototype of accounting, which has been expanded and modified. Currently, the internal control system not only prevents and detects fraud and errors, but also creates a management system and procedure to achieve the organization's management objectives.Internal control is initiated by the board of directors, management and other personnel of the organization, designed to provide reasonable assurance about the achievement of objectives related to operations, reporting and compliance with the regulatory framework [5]. COSO's Integrated Internal Control Framework is recognized internationally, and some of its recommendations were used in the Sarbanes-Oxley Act of 2002, which mentions that the primary responsibility for internal control rests with management.

The role of credit institution's internal control is determined by the COSO control structure, which was developed and published in 1992, and was updated in 2013, which provides comprehensive knowledge on this issue. The modern COSO structure has several components consisting of a control environment, risk assessment, control activities, information, communication and monitoring, it is presented in the form of a matrix in Figure 2. The first component, "Control environment" reflects the internal beliefs, ethics and values of the control system, in particular, the behavior of management in relation to the control system.

The second component, Risk Assessment, identifies management's risk assessment efforts and highlights areas where higher risks may exist.

The third component "Control activities" refers to the control system, which consists of division of duties among employees of a banking institution.

The fourth component "Information and Communication" defines the internal and external methods of communication between bank employees and customers, and also organizes information exchanging.

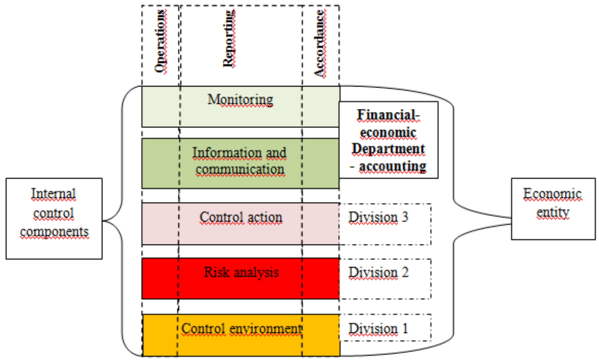

Fig. 2. COSO model in matrix form

The fifth component, “Monitoring,” raises managerial monitoring of the management system and provides problem reporting and solutions.

Considering the internal control system of financial reporting, it should be noted that its function is to proactively influence the activities of employees who correct their work. The main goal of preventive action is to avoid the appearance of distortions in the financial statements, to correct management methods. To correct the methods of management, a credit institution allows detective control that detects distortion in management activities and requires corrective action to correct the situation.

Modern methods of analysis allows each commercial bank to form its own internal control system. Let us formulate the main elements of internal control of activities and present them in Figure 3.

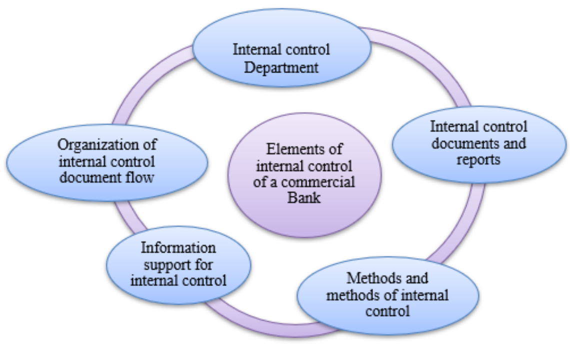

Fig. 3. The main elements of internal control for a credit institution

The reliability of any credit institution largely depends on the correctness and efficiency of the internal control service. Therefore, the main role of internal control is to help the organization achieve specific goals and objectives. It is imperative that the structure of the organization uses components of internal control that adhere to standard procedures, rules and regulations. Only then will the internal control system ensure the safety of assets and promote the development of the credit institution's activities. On the Russian credit market, only a few credit institutions are best prepared to identify various banking risks through internal control and can quickly respond to changing environmental conditions, while increasing their capital (Table 2).

TABLE II. QUANTITATIVE CHARACTERISTICS OF CREDIT INSTITUTIONS IN RUSSIA (UNITS)

№	Bank	08.2020, thousand rubles	08.2019, thousand rubles	The change, %
1	Сбербанк России (Sberbank of Russia)	32038692505	28829391091	11.13
2	ВТБ (VTB)	15812570376	14362664764	10.09
3	Газпромбанк (Gazprombank)	7464298277	6280851891	18.84
4	Национальный Клиринговый Центр (National Clearing Center)	4758431795	3477018146	36.85
5	Альфа-Банк (Alfa-Bank)	4045250732	3352124069	20.68
6	Россельхозбанк (Russian Agricultural Bank)	3669968288	3409211256	7.65
7	Московский Кредитный Банк (Credit Bank of Moscow)	2897123280	2167278996	33.68
8	Банк Открытие (Bank opening)	2860035302	2251015939	27.06
9	Совкомбанк (Sovcombank)	1592289496	1055460722	50.86
10	Росбанк (Rosbank)	1432371007	1217502469	17.65

As a result of the research, current directions for improving the competitiveness of banks in order to strengthen their positions in international financial markets are proposed [15]. Carrying out activities in the internal control system helps to speed up the audit process and helps auditors to prepare and present financial statements for interested parties. Moreover, auditors gain insight into lending institution and its internal environment and perform various audit procedures at a faster pace. For example, auditors use a risk assessment from the internal control system [6].

In summary, we can say that the ideal system of internal control for a credit institution can be developed with a large number of elements that take into account the division of duties between employees. For example, when not one person will process one transaction from start to finish, but several, which will allow achieving an effective internal control system and will help to find problem areas in the work.

IV. CONCLUSIONS

Strict internal control is the key to business success and is essential for maximum profit in any organization, including credit. The external audit process is mainly based on the internal control system and if the credit institution has a clear delegation and division of duties among employees, it is easier for auditors to carry out control activities, form conclusions and conclusions. Auditors perform various types of procedures and try to accumulate information about the activities of a credit institution based on data from the internal control system.

One of the most advanced control systems is the COSO structure, the emergence of which was a major event in the field of audit. It contains guidelines for auditors, spelled out the algorithm for conducting the audit procedure and formed a methodology for assessing various aspects of the business, which contributes to the formation of an opinion about the internal environment of the studied organization.

In Russia, 10 large banks use COSO that maintain their leading positions in the domestic credit market.

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