Internal Controls

USAID-Funded Economic Governance II Project

Objectives of this Module

At the end of this module, participants will be able to:

- Explain why a strong internal control system is important to bank management and bank supervisors – the role of internal controls in risk management
- Describe the key components of a strong internal control system
- Explain the basic elements used in evaluating internal control systems
- Describe how good internal controls promote safety and soundness

Importance of Internal Controls

- Why are internal controls important?
- Are they a legal requirement?
- Is the examiner a part of the internal control mechanism?
- Can all controls be documented as “cost effective”?

Importance of Internal Controls

Important to bankers:

- Integral part of sound corporate governance
- Assist in risk management
- Maintain reliable financial and managerial information
- Facilitate compliance with laws and regulations, and policies and procedures

Importance of Internal Controls

Important to bank supervisors:

- Contribute to industry stability
- Minimize financial impact on the government
- Promote safe and sound banking practice
- Enhance trust in the industry by depositors
- Facilitate risk-focused examinations

Definition: Internal Controls

A Textbook Definition - **Internal Control** comprises the plan of organization and all of the coordinate methods adopted within a business to:

- safeguard its assets;
- check the accuracy and reliability of its accounting data;
- promote operational efficiency; and
- encourage adherence to prescribed managerial policies and procedures, laws and regulations, and supervisory requirements.

Types of Internal Controls

Generally, there are two types:

1. **Preventative Controls –** designed to discourage errors or irregularities from occurring. Example – processing vouchers only after signatures have been obtained from appropriate personnel.

2. **Detective Controls –** designed to find errors or irregularities after they have occurred. Example – Reviewing loan payments to ensure they have been posted to proper accounts.

Internal Control / Internal Audit

Internal Control is NOT Internal Audit

Control – the activity of managing or exerting control over something.

Audit – methodical examination or review of a condition or situation. (It is a function charged in part to assure quality of Internal Control).

Roles & Objectives of Internal Controls

Role:

Internal Controls is a process **continuall**y operating in the bank to safeguard the safety and soundness of all other operating processes.

Roles & Objectives of Internal Controls

Objectives:

Performance – efficiency and effectiveness of activities

Information – reliability, completeness and timeliness of financial and management information

Compliance – compliance with applicable laws and regulations

Basle Core Principles

Basel Core Principle #14 reinforces the importance of a sound internal control system

> **"Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business…"**

Basle Core Principles – Essential Criteria for Principle # 14

Banks must have:

- Clear arrangements for delegating authority and responsibility
- Separation of functions that involve committing the bank, paying funds and accounting for assets and liabilities
- Reconciliation of these processes

Basle Core Principles – Essential Criteria for Principle # 14

- Safeguarding of assets

- Appropriate independent internal or external audit and compliance function to test adherence to controls, laws and regulations

Basel Framework - Elements of a Sound Internal Control Process

- Management Oversight and the Control Culture
- Risk Recognition and Assessment
- Control Activities and Segregation of Duties
- Information and Communication
- Monitoring Activities and Correcting Deficiencies
- Evaluation of Internal Control Systems by Supervisory Authorities

Basel Framework – Assessment Principles of Internal Control Systems

Management Oversight and the Control Culture:

Principle 1 – Board of Directors is ultimately responsible for ensuring that an adequate and effective system of internal controls is established and maintained;

(a**)** approving and reviewing overall business strategies and significant bank policies of the bank;

(b) understanding major risks to the bank, setting acceptable levels for risks, and ensure management takes steps to identify, measure, monitor and control risks;

(c) approving the organizational structure; and,

(d) ensuring senior management is monitoring the effectiveness of the internal control system.

Basel Framework – Assessment Principles of Internal Control Systems

Management Oversight and the Control Culture, (cont.):

Principle 2– Senior Management should have responsibility for:

(a**)** Implementing strategies and policies approved by the board;

(b) Developing processes that identify, measure, monitor and control risks incurred by the bank;

(c) Maintaining an organizational structure that clearly assigns responsibility, authority and reporting relationships;

Basel Framework – Assessment Principles of Internal Control Systems

Management Oversight and the Control Culture, (cont.):

Principle 2 (cont.) – Senior Management should have responsibility for:

(d**)** ensuring that delegated responsibilities are effectively carried out;

(e) setting appropriate internal control policies; and,

(f) monitoring the adequacy and effectiveness of the internal control system.

Basel Framework – Assessment Principles of Internal Control Systems

Management Oversight and the Control Culture, (cont.):

Principle 3 – Board of Directors and Senior Management are responsible for:

(a**)** promoting high ethical and integrity standards;

(b) establishing a culture within the organization that emphasizes and demonstrates to all levels of personnel the importance of internal controls; and,

(c) all personnel at the bank understanding their role and being fully engaged in the internal controls process.

Basel Framework – Assessment Principles of Internal Control Systems

Risk Recognition and Assessment

Principle 4 – an effective **internal control system** requires:

(a**)** that material risks that could adversely affect the achievement of the bank's goals are being recognized and continually assessed;

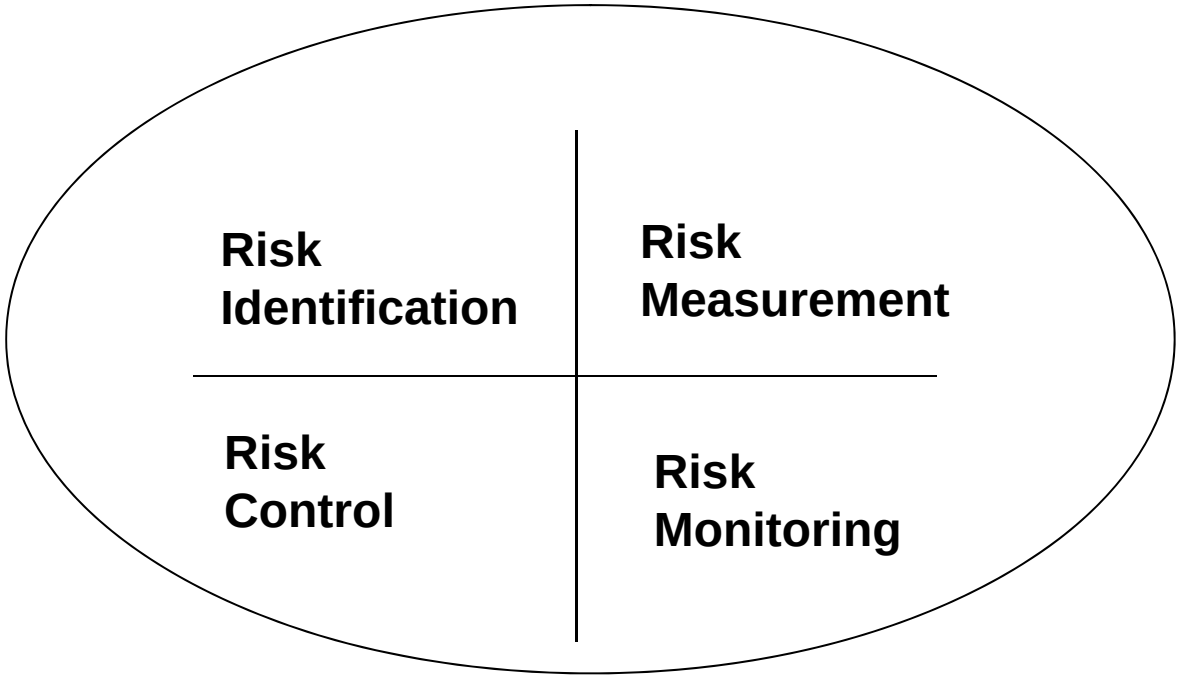
(b) that the assessment cover all risks facing the bank and the consolidated banking organization; and,

(c) That internal controls may need to be revised to address any new or previously uncontrolled risks

Risk Recognition and Assessment

Risks Are Managed in Part by Internal Controls

Internal Controls Facilitate:



Basel Framework – Assessment Principles of Internal Control Systems

Control Activities and Segregation of Duties

Principle 5 – Control Activities should:

(a**)** be an integral part of the daily activities of the bank;

(b) have appropriate control structure with control activities defined at every business level;

(c) include:

- top level reviews;
- activity controls for different departments and divisions;

Basel Framework – Assessment Principles of Internal Control Systems

Control Activities and Segregation of Duties (cont.)

Principle 5 - Control Activities (cont.):

(c) Include (cont.):

- physical controls
- checking for compliance with exposure limits and follow-up on non-compliance,
- system of approvals and authorizations; and,
- a system of verification and reconciliation.

Basel Framework – Assessment Principles of Internal Control Systems

Control Activities and Segregation of Duties (cont.)

Principle 6 - Effective Internal Control System requires:

(a) That there is appropriate segregation of duties and that personnel are not assigned conflicting responsibilities.

(b) Areas of potential conflicts of interest should be identified, minimized, and subject to careful independent monitoring.

Basel Framework – Assessment Principles of Internal Control Systems

Information and Communication – **an effective Internal Control System requires:**

Principle 7 - there are adequate and comprehensive internal financial, operational and compliance data. It should be reliable, timely, accessible and provided in a consistent format.

Principle 8 – there are reliable information systems in place that cover all significant activities of the bank. They must be secure, monitored independently and supported by adequate contingency arrangements.

Principle 9 – effective channels of communication to ensure all staff understand and adhere to policies and procedures affecting their duties and responsibilities.

Basel Framework – Assessment Principles of Internal Control Systems

Monitoring Activities and Correcting Deficiencies

Principle 10 – Internal Control effectiveness should be monitored on an ongoing basis. Monitoring of Key Risks should be part of daily activity as well as periodic evaluations of business lines and internal audit.

Principle 11 – There should be a comprehensive **internal audit system** with trained, competent and operationally independent staff. This function should report directly to the board of directors or its audit committee.

Principle 12 – Internal Control deficiencies should be reported in timely manner to appropriate management level and addressed promptly. **Material deficiencies** should be reported to senior management and the board of directors.

Basel Framework – Assessment Principles of Internal Control Systems

Evaluation of Internal Control Systems by Supervisory Authorities

Principle 13 – Supervisors should require that all banks, regardless of size, have an effective system of internal controls that:

(a) is consistent with the nature, complexity and risk inherent in their on- and off-balance-sheet activities;

(b) responds to changes in the bank's environment and conditions;and,

(c) in cases where Supervisor's determine it is not adequate or effective for that bank's specific risk Profile, appropriate action should be taken.

Types of Control Breakdowns in Problem Banks

Lack of adequate management oversight and accountability;

Failure to develop strong control culture;

Inadequate recognition and assessment of risks on and off balance sheet;

Absence or failure of key control structures;

Inadequate communication;

Inadequate or Ineffective audit programs and monitoring

Examiners Internal Control Evaluation Internal Controls

- Apply industry standards
- Use Internal Control Questionnaires (ICQs)
- Document conclusions
- Weigh all exceptions to form an overall conclusion

Examiners Internal Control Evaluation Internal Controls

- Familiarize yourself with the bank's system and operation in the area under examination.
- Familiarize yourself with the ICQ.
- Review policies and procedures concerning the bank's system of controls.

Examiners Internal Control Evaluation Internal Controls

Use all sources of information:

1. Organizational charts
2. Procedure manuals
3. Operating instructions
4. Job specifications and descriptions
5. Flow charts
6. Internal and external audits

Examiners Internal Control Evaluation Internal Controls

The scope, type and depth of review depends on:

1. Size of the institution
2. Complexity of operations
3. Risk profile

Examiners Internal Control Evaluation
Internal Controls

Identify key positions and ask yourself:

- *Is this a critical position? Can a person in this position make a significant error that will result in the inaccurate recording of transactions? Can the person enter false information or gain control of assets?*

- *Would normal routines promptly disclose the significant error, or are there controls in place to minimize the possibility of concealing error?*

Examiners Internal Control Evaluation Internal Controls

- The ICQs are only a guide in enabling the examiner to determine the adequacy of internal controls established for areas of bank activities.

- The examiner must use ICQs pro-actively:
  - Observe
  - Test
  - Interview the right bank personnel

Examiners Internal Control Evaluation Internal Controls

- Be alert to deviations from established control policies or procedures
- Consider mitigating circumstances
- Consider cost of control procedures and other available control remedies
- Consider the materiality of the exception
- Look for substantive instances of noncompliance rather than isolated incidents of control exceptions

Examiners Internal Control Evaluation Internal Controls

- Exercise care in situations involving new products/services where expertise is centered around one person or a small group

- Be alert to situations involving conflicts of interest:
  - Personal financial interest of bank officer depends on bank operating results;
  - Bank is dominated by a single individual with a strong personality;
  - Managers rely excessively on assistants.

Summary

Internal controls:

- Are a key component of sound corporate governance and assist management in managing risk inherent in the business
- Assist in maintaining reliable financial and managerial information
- Facilitate compliance with laws and regulations, and policies and procedures

Internal Controls

- Contribute to industry stability
- Minimize financial impact on the government
- Promote safe and sound banking practice
- Enhance trust in the industry by depositors
- Facilitate risk-focused examinations