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Improving of the organizational structure in the bank's internal control and it's effectiveness

The essence of internal control of the bank and its components are considered. Creation of organizational structure of the internal control that is founded on three directions of controllers' activities and increases its efficiency is offered.

internal control, internal audit, organization structure, effectiveness

A system of effective internal controls is a critical component of bank management and a foundation for the safe and sound operations of banking organizations. Weak or ineffective internal control has caused losses in many banks and has contributed to the failure of others around the world. Some of these cases involved could have been prevented or discovered through effective control mechanisms before the losses actually incurred by the banks. That's why the problem of improving of internal control system nowadays is quite actual.

The question of internal control of the bank in Ukraine has not been sufficiently discussed, but some researchers devoted their publications to this problem: Stelmah V., Moroz O., Shvets N., Pryhod'ko R., Krasnova I. and other.

The aim of this article is to research the components of effective system of control in the bank, including creation of organization system of management.

Banking has a diversified and complex financial activity which is no longer limited within the geographic boundary of a country. Since its activity involves high risk, the issue of effective internal control system, corporate governance, transparency, accountability has become significant issues to ensure smooth performance of the banking industry throughout the world. In many banks internal control is identified with internal audit; the scope of internal control is not limited to audit work. It is an integral part of the daily activity of a bank, which on its own merit identifies the risks associated with the process and adopts a measure to mitigate the same.

Internal Audit on the other hand is a part of Internal Control system which reinforces the control system through regular review [4].

According to an IMF publication Internal Control refers to the mechanism in place on a permanent basis to control the activities in an organization, both at a central and at a department/divisional level. A key component of effective internal control is the operation of a solid accounting and information system.

In scientists view on the performances of the banks has pointed out that an effective internal control system could have contributed significantly in improving the performance of the commercial banks if the control culture is brought in through policy guidelines and structural changes at these banks.

Internal control is the process, effected by a company's board of directors, management and other personnel, designed to provide reasonable assurance regarding the

achievement of objectives in the effectiveness and efficiency of operations, the reliability of financial reporting and compliance with applicable laws, regulations, and internal policies [3].

Internal controls are the policies and procedures established and implemented alone, or in concert with other policies or procedures, to manage and control a particular risk or business activity, or combination of risks or business activities, to which the company is exposed or in which it is engaged.

The internal control environment is the framework under which internal controls are developed, implemented and monitored. It consists of the mechanisms and arrangements that ensure internal and external risks to which the company is exposed are identified; appropriate and effective internal controls are developed and implemented to soundly and prudently manage these risks; reliable and comprehensive systems are to be put in place to appropriately monitor the effectiveness of these controls.

Each company needs to have in place an appropriate and effective internal control environment to ensure that the company is managed and controlled in a sound and prudent manner. The factors which together comprise the control environment are:

- a board of directors that is actively concerned with sound corporate governance and that understands and diligently discharges its responsibilities by ensuring that the company is appropriately and effectively managed and controlled;
- a management that actively manages and operates the company in a sound and prudent manner;
- organizational and procedural controls supported by an effective management information system to soundly and prudently manage the company's exposure to risk;
- an independent audit mechanism to monitor the effectiveness of the organizational and procedural controls.

The primary objective of internal control system in a bank is to help the bank perform better through the use of its resources. Through internal control system bank identifies its weaknesses and takes appropriate measures to overcome the same. The main objectives of internal control are as follows:

- Efficiency and effectiveness of activities (performance objectives).
- Reliability, completeness and timelines of financial and management information (information objectives)
- Compliance with applicable laws and regulations (compliance objectives)

Responsibility of the Board of Directors is lies in the overall responsibility of establishing broad business strategy, significant policies and understanding significant risks of the bank. Through the establishment of 'Audit Committee' the Board of Directors can monitor the effectiveness of internal control system.

The internal as well as external audit reports will be sent to the board without any intervention of the bank management and ensure that the management takes timely and necessary actions as per the recommendations. The Board of Directors have periodic review meetings with the senior management to discuss the effectiveness of the internal control system of the bank and ensure that the management has taken appropriate actions as per the recommendations of the auditors and internal control.

Responsibility of the Senior Management lies in setting out a strong internal control framework within the organization the role of Managing Director. He/she will establish a 'Management Committee' (MANCOM), which will be responsible for the overall management of the Bank. With governance & guidance from the Board of Directors the MANCOM will put in place policies and procedures to identify, measure, monitor and control these risks. The MANCOM will put in place an internal control structure in the banking organization, which will assign clear responsibility, authority and reporting relationship.

Although The MANCOM will monitor the adequacy and effectiveness of the internal control system based on the bank's established policy & procedure and provide a certification the Board of Directors on the effectiveness of Internal Control policy, practice and procedure [10].

An effective internal control system continually recognizes and assesses all of the material risks that could adversely affect the achievement of the bank's goals. Effective risk assessment must identify and consider both internal and external factors. Internal factors include complexity of the organization structure, the nature of the Bank's activities, the quality of personnel, organization changes and also employee turnover. External factors include fluctuating economic conditions, changes in the industry, socio-political realities and technological advances.

Risk assessment by Internal Control System differs from the business risk management process which typically focuses more on the review of business strategies developed to maximize the risk/reward trade-off within the different areas of the bank. The risk assessment by Internal Control focuses more on compliance with regulatory requirements, social, ethical and environmental risks those affect the banking industry.

Effective internal control system requires that there is an effective reporting system of information that is relevant to decision making. The information should be reliable, timely accessible and provided in a consistent format. Information would have to include external market information about events and conditions that are relevant to decision making. Internal information must cover all significant activities of the bank. These systems including those that hold and use data in electronic form must be secure. Most importantly the channels of communication must ensure that all staff fully understand and adhere to policies and procedures effecting their duties and responsibilities and that other relevant information is reaching the appropriate personnel.

Structure for Internal Control System

Organization structure plays a vital role in establishing effective internal control system. The essence of the ideal organizational structure that will facilitate effectiveness of the internal control system is the segregation of duties. The bank should, depending on the structure, size, location of its branches and strength of its manpower try to establish an organizational structure which allow segregation of duties among its key functions such as marketing, operations, credit, financial administration etc [8].

Up to which level this segregation will take place will depend on an individual bank. For instance a bank which has small branch operations at remote places of the country may not find it feasible to have such functional segregation of duties at that branch level. However at the higher level such segregation should exist and where possible this should be extended to the branch levels.

In cases where such segregation is not possible, there must be certain monitoring mechanism which should be independently reviewed to ensure all policies and procedures are followed at the branch level.

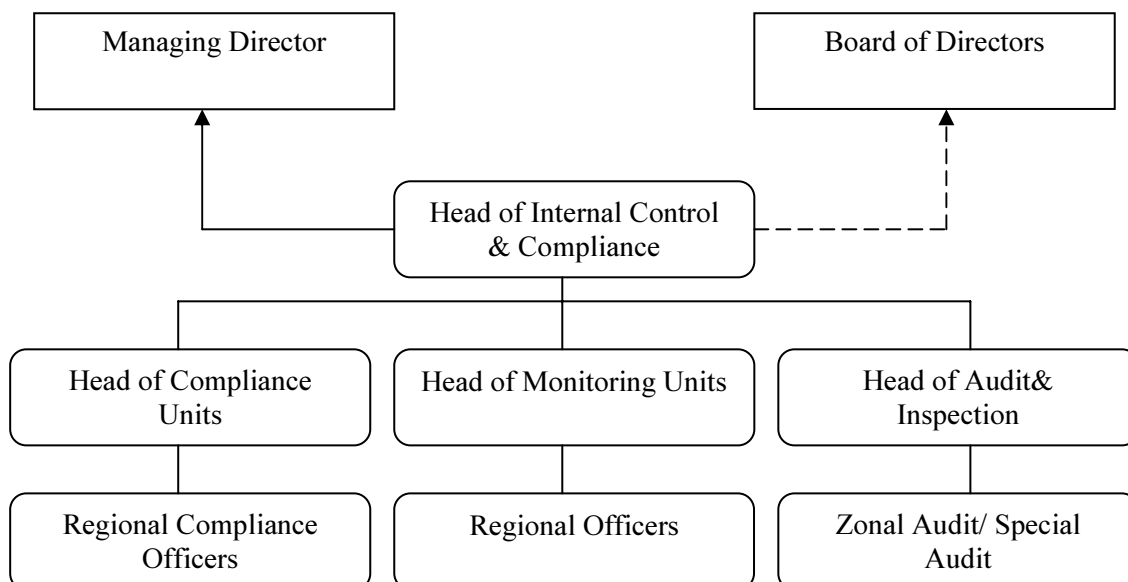
The organizational structure of the internal control will depend on the tasks performed by the unit and the size of the organization. A bank with large branches may have regional level internal control units which will allow regular monitoring and audit at the branch level.

The head of internal control unit should have a reporting line with the bank's board. The audit committee of the board can be the contact point for the internal control unit. This unit must also have a reporting line with the Managing Director of the bank.

The unit should be adequately staffed so that it can perform its duty properly. In order to ensure that availability of efficient people with internal control the banks will make it

mandatory for all middle to senior management staff to spend at least two years with internal control on secondment.

The following organization structure for the internal control unit is based on the basic tasks that are to be performed by this department. Depending on the size of the bank and its requirement this may vary (pic.1).



Picture 1 - Organizational structure of internal control

The head of the internal control will be responsible for the both compliance and control related tasks which include compliance with laws and regulation, audits and inspection, monitoring activities and risk assessment. The head of internal control will report directly to the MD and also have an indirect reporting line to the Audit Committee of the Board

The compliance unit will be responsible to ensure that bank complies with all regulatory requirement while conducting its business. They will maintain liaison with the regulators at all level and notify the other units regarding regulatory changes.

The monitoring will be responsible to monitor the operational performance of various branches. They will collect relevant data and analyze those to assess the risk of individual units. In case they find major deviation they will recommend to the Internal Control Head for sending audit & inspection team for thorough review.

The audit team will perform periodic and special audit. A bank may have different section within this team responsible for carrying out specific tasks. For instance a bank may have a special audit section responsible only for credit inspection.

Thus, the effective system of internal control can minimized losses and risks in banking business. Organizational structure of internal control as one of the main elements of management contributes it. Proposed organizational structure includes: communication of the bank with regulators of the banking system, monitoring of banking transactions in the departments, including regional departments, as well as carrying out special inspections and audits, what provides control at all levels of the bank and in our opinion, is the foundation of an effective system of internal control of the bank.

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Усовершенствование организационной структуры внутреннего контроля и его эффективности

Рассматривается сущность и компоненты внутреннего контроля банка. Предложено создание организационной структуры внутреннего контроля, основанной на трех направлениях деятельности контролеров, способствующей повышению его эффективности.

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Удосконалення організаційної структури внутрішнього контролю та його ефективності

Розглядається сутність та компоненти внутрішнього контролю банку. Запропоновано створення організаційної структури внутрішнього контролю, заснованої на трьох напрямках діяльності контролерів, що сприяє підвищенню його ефективності.

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