INTERNAL CONTROL PRINCIPLES THAT MUST BE PROMOTED IN PUBLIC SECTOR ORGANISATIONS

Ph.D., Mariana JOIȚA (LEAFU)
”Valahia” University of Târgoviște, Romania
E-mail: marianajoita123@yahoo.com
Nicoleta Aura DRAGNEA (ALECSANDRESCU)
”Valahia” University of Târgoviște, Romania
E-mail: nikollare@yahoo.com

Abstract: *Management controls are a set of practices now recognized as one of the essential components of effective management in organizations of all sizes, both in the public and private sectors, around the world. Management controls can be succinctly defined as rules and procedures designed to ensure that government programs achieve their intended results, that the resources used to carry out these programs are consistent with the stated goals and objectives of the organizations concerned, that these programs are protected against waste, fraud and mismanagement, and that decision making is based on the timely collection, recording, communication and use of reliable information. Clearly, the existence of effective management controls is essential to the success and proper functioning of public administrations. They are both a safeguard against waste, abuse and fraud and a means of ensuring that the rules set by managers are correctly applied at all levels of the organisation.*

Keywords*: internal control, management, organisation, manager.*
JEL Classification*: M10, M12.*

1. Introduction

Management controls are the backbone of the organization: all the plans, policies, procedures, and practices required by agents to achieve the entity's objectives.

One of the main objectives and one of the main strengths of an effective management control system should be to enhance the capabilities of managers to lead, to perform their leadership potential and to be a driving force to more easily achieve the goals and objectives of the organization. Such controls should hold each leader accountable, but should not be seen as limiting their freedom of decision in areas for which they have been delegated authority. Management controls do not guarantee the effectiveness of public programmes or the absence of waste, fraud or mismanagement. They are, however, a means of managing the risks associated with programmes and the functioning of public administrations. These controls must be adequate, cost-effective and supported by proper risk analysis and assessment. Management controls can be considered to have two aspects: - management information systems, which are needed by management to direct the work of the organization, to monitor the progress and quality of activities, and to evaluate the results and performance of the organization; - rules, systems, procedures, delegations of authority, and other factors built into the organization's processes to provide reasonable assurance that management's objectives are being met.

2. Literature Review

There is no definition of internal audit in any international standard.

In the UK, for example, internal audit is defined by the Institute of Internal Auditors in the UK as an independent research function established within an organisation to examine and “evaluate its activities on its own behalf”. The approach and standards adopted by the British National Audit Office for internal audit in government departments and agencies mirror those in the private sector.

In the United States, the US Institute of Internal Auditors defines internal audit in the same way as its British equivalent, namely: an independent assessment activity within an entity and in the service of that entity. It is a control exercised by management, consisting of measuring and evaluating the effectiveness of other controls. The complexity of the structure and diversity of functions of the US government has led to internal control practices that differ in many respects from those prevalent in the private sector.

While it is true that in most countries internal audit is part of an organisation's management control system, this is not the case in Germany: in Germany internal audit is a component of external audit. Although internal audit is an integral part of the activities of public administrations, internal auditors report only to the Federal Court of Audit. They report only to this federal court and are not empowered to follow other orders in the exercise of their profession. This is why in Germany internal audit is called 'preliminary audit', not because it is an a priori audit, but because this type of audit is carried out before those who report to the Federal Court of Audit.

In France and Italy, internal audit is considered to cover certain aspects of internal control. This is the case in France with public accountants and financial inspectors, who perform key functions in controlling expenditure, while in other countries, Poland for example, internal audit is considered to encompass certain [public] regulatory and supervisory bodies.

Elsewhere, in Romania, for example, internal audit extends to bodies operating within companies, [reflecting] the possibility that the supreme audit institution is accountable not only to public authorities but also to these organisations.

The concept and scope of management controls

Management controls can be succinctly defined as the organisation, rules and procedures used to help ensure that public programmes achieve their desired results, that the resources used to deliver these programmes are consistent with the stated aims and objectives of the organisations concerned, that these programmes are protected against waste, fraud and mismanagement, and that decision making is based on the collection, recording, accounting delivery and use of reliable information, and that these operations are carried out in a timely manner. It is important that these management controls are seen, not as systems in themselves, operating separately from the rest of the organisation, but as control mechanisms that need to be integrated into the systems serving the whole cycle from planning, audit, budgeting, management and accounting. These systems must contribute to the efficiency and integrity of each stage of this cycle and provide continuous feedback to leaders.

3. Research Methodology

For this article we considered international publications in the field, E-books available through the university library, PDF documents with authors and versions of government or similar publications that are free of charge, articles published in print journals, articles published in e-journals, journal articles available through the university library or in various databases, articles in online newspapers, government and institutional publications, standards, reports of organisations, European documents, course materials and notes, publications available on websites. For the writing of this scientific paper it was not sufficient that the author only knew the subject. The knowledge and material accumulated was intended to be passed on in a form that would achieve its purpose: communication, correct and objective information. As a result, a redaction of the scientific material was required. The selection of the material was done through a thorough documentation, in order to present the most relevant information on the chosen subject.

4. Results

Internal control is an integrated process implemented by an organization's managers and staff designed to address risks and provide reasonable assurance that the following overall objectives are being achieved within the organization's mission:

- execution of orderly, ethical, economical, efficient operations;
- compliance with accountability obligations;
- compliance with applicable laws and regulations;
- protection of resources against loss, misuse and damage.

Internal control is an integrated and dynamic process that constantly adapts to the changes an organisation faces. Management and staff, at all levels, must be involved in this process to address risks and provide reasonable assurance that the overall missions and objectives of the organisation are being met.

Internal control is not an isolated event or a single circumstance, but a set of actions that influence all activities of an organisation. These actions are continuously present in all operations of an organisation. They are perceptible at all levels and inherent in the way the organisation is managed.

The internal control system is an integral part of an organisation and is most effective when embedded in its infrastructure and culture. Internal control must be integrated and not overlapping. In doing so, it becomes an integral part of core management processes in planning, execution and verification. The integration of internal control also has a significant impact on cost control. Adding new control procedures to existing ones generates additional costs.

Internal control does not exist without the people who make it work. It comes from the people who make up the organisation, by what they do and what they say. They need to know their roles and responsibilities and the limits of their authority.

When we talk about the people who make up the organisation, we mean both managers and other staff. Although management primarily exercises a supervisory role, it also sets the organisation's objectives and takes overall responsibility for the internal control system. As this contributes, through the mechanisms it entails, to a better understanding of the risks that threaten the achievement of the organisation's objectives, it is up to management to establish internal control activities and to monitor and evaluate them. Implementing internal control requires managers to give a decisive impetus and make an intensive effort to communicate with other staff. In this sense, internal control is a management tool, directly oriented towards achieving the organisation's objectives. As such, management is an important link in internal control.

Any organisation aims first and foremost to achieve its mission. Every entity has a purpose - the public sector generally aims to provide a service and an outcome that benefits the general interest.

Whatever the organisation's mission, achieving it will mean that the organisation faces all sorts of risks. The task of management will be to identify and control these risks to maximise the likelihood of achieving the mission. If internal control can help to address these risks, assurance on the achievement of the mission and overall objectives can only be reasonable.

Internal control, no matter how well designed and applied, cannot provide management with absolute assurance that the overall objectives will be achieved. Reasonable assurance reflects the idea that uncertainty and risk are linked to the future, which no one can predict with certainty. Achievement of objectives may also be compromised by external factors beyond the control or influence of the organisation: human judgement exercised to make certain decisions may be flawed, malfunctions may occur due to simple failures or errors, controls may be bypassed, management may override the internal control system. Controls have a cost. These limitations prevent management from having absolute assurance that objectives will be achieved.

Decisions taken to manage risks and implement controls must take into account the costs and benefits. Evaluation of this cost includes both financial evaluation of the resources consumed to achieve a specific objective and economic evaluation of the opportunity costs resulting from delayed operations, decreased quality of service or productivity, or a loss of employee morale. Benefit is measured by assessing the extent to which the risk of failure to achieve a stated objective is reduced due to internal control.

Designing internal controls to provide value for money while reducing risks to an acceptable level requires that management has a clear understanding of the overall objectives to be achieved.

Internal control is designed to achieve a number of distinct but interrelated organisational objectives. These overall objectives are achieved through numerous specific sub-objectives, functions, processes and activities.

The overall objectives are as follows:

- Execute orderly, ethical, economical, efficient operations
- Fulfilling accountability obligations
- Compliance with applicable laws and regulations
- Protection of resources against loss, misuse and damage caused by waste, abuse, mismanagement, error, fraud and irregularities

Components of internal control

Internal control is made up of five interdependent components:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Management

Internal control is designed to provide reasonable assurance on the achievement of the organisation's overall objectives. Therefore, setting clear objectives is a prerequisite for designing an effective internal control process. The control environment forms the foundation of the entire internal control system. It provides the discipline and structure as well as the environment that influences the overall quality of internal control. In turn, it greatly influences how strategy and objectives are determined and how control activities are structured. Once clear objectives have been set and an effective control environment has been created, an assessment of the risks the organisation faces in achieving its mission and objectives needs to be made in order to define an appropriate response to them. The main strategy to minimise risks is to implement internal control activities. These control activities can be prevention and/or detection oriented. Corrective measures are a necessary complement to internal control activities to achieve objectives. The cost of control activities and corrective actions must be matched and create value. In other words, their cost must not exceed the benefit obtained (cost-effectiveness). Effective information and communication is essential for an organisation to manage and control its operations. Organisational leaders must have timely access to relevant, comprehensive and reliable communication about internal and external events. In general, the organisation needs information at all levels to achieve its objectives. Finally, since internal control is a dynamic process that must constantly be adapted to take into account the risks and changes an organization faces, it is essential that the internal control system be subject to monitoring and management to ensure that internal control remains in line with objectives, an environment, resources and risks that may have changed.

Connection between objectives and components of internal control There is a direct link between the overall objectives, which are what an organisation strives to achieve, and the components of internal control, which are the tools needed to achieve them.

Internal control applies both to the organisation as a whole and to its individual departments. This link is represented by the third dimension, which represents the whole organisation, entities and departments. It is thus possible to focus on any particular cell of the matrix. While the internal control system thus defined is relevant and applicable to all organisations, the way in which management implements it varies greatly according to the nature of the organisation and depends on a number of factors specific to it. These factors include, but are not limited to, organisational structure, risk profile, operating environment, size, complexity, activities and degree of regulation. Given the specific situation of the organisation, managers will make a number of choices about the complexity of the processes and methodologies implemented to apply the components of the internal control system. The following pages concisely outline each of the components mentioned above, along with commentary.

Personal and professional integrity and ethical values of managers and staff

The personal and professional integrity and ethical values of managers and staff determine their priorities and value judgements, which are reflected in a code of conduct. These qualities must be reflected in an attitude of adherence to internal control at all times and throughout the organisation. All those active in the organisation - both managers and staff - must demonstrate their personal and professional integrity and respect for ethics; all must comply at all times with the codes of conduct in force, for example by declaring any personal financial interests they may have, any positions they may hold outside the organisation or any donations they receive (if they come, for example, from elected or senior public officials) and by reporting any conflicts of interest.

Managers and staff should ensure that they maintain a level of competence that enables them to understand the importance of developing, implementing and maintaining good internal control and fulfilling their responsibilities to achieve the overall objectives of internal control and the mission of the organisation. Managers and their staff should demonstrate an understanding of internal controls sufficient to enable them to perform their duties effectively.

Management style (i.e., managers' philosophies and operating procedures) reflects the following elements:

- a permanent attitude of adherence to internal control, independence, competence and a willingness to lead by example;
- a code of conduct defined by the managers, as well as support and performance reviews that take into account the objectives of internal control and, in particular, that of conducting ethical operations.

It is of paramount importance that management demonstrates and insists on ethical conduct to achieve the objectives of internal control and in particular the objective of 'ethical operations'. In carrying out its function, management must set an example by its own actions and its conduct must be a model of what is the right thing to do rather than an image of what is merely acceptable or merely convenient. In particular, management policies, procedures and practices must promote ways of doing things that meet all the criteria listed: order, ethics, economy, efficiency and effectiveness.

Roles and responsibilities

All staff in an organisation have some responsibility for internal control. Management is directly responsible for all activities of the organisation, including the design, implementation, proper functioning, maintenance and documentation of the internal control system. Everyone's responsibilities within management vary depending on their position in the organisation and the characteristics of the organisation itself. Internal auditors review and contribute to the ongoing effectiveness of the internal control system through their assessments and recommendations and therefore play an important role in the effectiveness of internal control. However, they do not have management's primary responsibility for designing, implementing, maintaining and documenting internal control. Staff members also contribute to internal control. Internal control is, explicitly or implicitly, everyone's responsibility. All staff members play a role in the implementation of internal control and are required to report any problems they observe in the conduct of operations, as well as any violations of the code of conduct or the organisation's internal policy. Certain external parties also play an important role in the internal control process. They may contribute to the achievement of the organisation's objectives or provide useful information for internal control. However, they are not responsible for the design, implementation, proper functioning, maintenance or documentation of the organisation's internal control system.

Internal control is primarily the work of the organisation's internal stakeholders, which includes managers, internal auditors and other staff. However, the actions of external stakeholders can also influence the internal control system.

Managers All staff of the organisation play an important role in implementing the internal control system. However, management has overall responsibility for the design, implementation, operation and maintenance of the internal control system and its documentation. What we call "management" here may include the board of directors and the audit committee, whose roles and composition vary from country to country and which, from country to country, are subject to different laws.

Internal auditors It is not uncommon for management to establish an internal audit unit which it considers an integral part of its internal control system and which it uses in the context of monitoring and managing the effectiveness of the internal control system. Internal auditors regularly provide information on the operation of internal control, paying particular attention to evaluating the design and operations of internal control. They communicate information on the strengths and weaknesses of internal control and make recommendations for improvement. However, their independence and objectivity must be guaranteed. Therefore, internal audit should be an independent and objective activity that provides an organisation with assurance on the degree of control over its operations, provides advice for improvement and contributes to the creation of added value. It helps an organisation to achieve its objectives by assessing, through a systematic and methodical approach, its risk management, control and corporate governance processes and making proposals to strengthen their effectiveness. For the internal audit function to be effective, it is essential that the internal audit team is independent of management, works impartially, fairly and honestly and reports directly to the highest level of management. In this way, internal auditors can provide unbiased opinions on the assessment of the internal control system and objectively present proposals to correct the weaknesses they have discovered. In addition to its role in monitoring an organisation's internal controls, a qualified internal audit team can contribute to the effectiveness of external audit activities by providing direct assistance to the external auditor. The nature, scope or duration of external audit procedures may thus be subject to adjustment if the external auditor can rely on the work of the internal auditor.

Members of staff The rest of the staff, regardless of their level, also influence internal control. It is often those on the front line who implement and monitor certain controls, review them and take corrective action if controls are poorly implemented; in addition, they are in a good position to identify issues in the course of their day-to-day activities that require internal control responses.

External parties: external auditors, legislative and regulatory authorities, and other third parties, all of whom can contribute to the achievement of the organisation's objectives or provide useful information for the implementation of internal control. However, they have no responsibility for the design, implementation, proper functioning, maintenance or documentation of the organisation's internal control system.

5. Conclusions

For several years, a large number of researchers have focused on the links between management systems, more or less sophisticated, and organisational performance. Although the topic of internal control is the subject of much debate and research, it is rare in terms of measuring its effectiveness in the organisation. It is for this reason that the main objective of this article is to contribute to complementing the research on this subject by explaining the role played by the internal control system in improving the performance of organisations. The literature review shows that the internal control system through its five components makes it possible to improve company performance, because this system establishes a favorable control environment, a good risk assessment, a sophisticated information system, a set of procedures and policies and an effective management system. On a practical level, this study aims to enrich previous work belonging to the fields of study of management systems and more specifically the internal control system. It also provides managers and leaders with opportunities to situate and assess how they could improve the performance of their organisations.

Acknowledgment: This work is supported by project POCU 153770, entitled " Accessibility of advanced research for sustainable economic development - ACADEMIKA ", co-financed by the European Social Fund under the Human Capital Operational Program 2014-2020

References:

1. Arens, A.A., Elder, R.J. and Beasley, M.S., 2003. *Auditing and Assurance Services, an Integrated Approach.* Prentice Hall international edition, neuvième édition.
2. COSO, 2003. *Projet d'exposé du COSO Enterprise Risk Management Framework*.
3. COSO, 1992. *Internal Control – Integrated Framework*.
4. Costello, A. and Wittenberg-Moerman, R., 2011. The impact of financial reporting quality on debt contracting: evidence from internal control weakness reports. *Journal of Accounting Research*, 49.
5. Drucker, P., 1957. *La Pratique de direction des entreprises*. Éditions d'Organisation.
6. Everard, P. And Wolter, D., 1989. *Glossaire*. Office des publications officielles des Communautés européennes.
7. Hong, S. and Lee, J., 2015. Internal Control Weakness and Stock Price Crash Risk. *The Journal of Applied Business Research*, 31.
8. IFAC, 2003. *Handbook Of International Auditing, Assurance, and Ethics Pronouncements*.
9. INTOSAI, 2001. *Code de déontologie et normes de contrôle (Normes de contrôle de l'INTOSAI)*.

10. Maesschalck, J., 2004. The Impact of New Public Management Reforms on Public Servants Ethics: Towards a Theory. *Public Administration*, 82(2), pp. 465-466.
11. Mills, R., 1997. Internal control practices within large UK companies. In: K. Keasey & M. Wright (Eds.), *Corporate, governance, responsibilities, risks and remuneration*. Chichester: Wiley.