

## ROLES AND RESPONSIBILITIES IN THE PROPER IMPLEMENTATION AND FUNCTIONING OF INTERNAL CONTROL OF PUBLIC ENTITIES

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### Abstract

*The notion of performance is associated with an ideology of progress, of always doing better. As far as the performance of public entities is concerned, this is harder to quantify than for example, the performance of a company. However, in order for the public sector not to face a budget deficit with inappropriate management or inappropriate resource use, internal control can help with solutions for improving its activities, solutions to reduce inefficient spending and ways to use resources as efficiently as possible.*

*This paper attempts to capture the links and interfaces between the best known and current models that can help organizations to define, design, implement, and develop risk management and the internal control system. This is "The COSO Cube" model presented in 2013 in the COSO Framework & SOX Compliance paper and the "THREE LINES OF DEFENSE IN EFFECTIVE RISK MANAGEMENT AND CONTROL" presented by The Institute of Internal Auditors in January 2013.*

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**JEL classification:** H11; H83; H89; M42

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### 1. Introduction

Each organization has a well-established basic mission and objectives that it strives to achieve. In obtaining these goals, the organization will meet events and circumstances that may threaten said goals. These potential events and circumstances create risks that an organization needs to identify, analyze, define and address. Some risks may be accepted (integral or in part) and others may be

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alleviated in whole or in part to a point where they are at an acceptable level for the organization.

There are a number of ways to identify and mitigate risks; all merged into one key instrument, namely, an effective internal control system. Basically, the internal control model set up in the COSO cube and the three lines of defence model will be presented. These models, though developed by different organizations, are not foreign to one another, but complement each other and have the same purpose, which is performance.

The COSO's Internal Control Model (Integrated Framework) outlines the components, principles, and factors needed by an organization to manage its risks effectively by implementing an internal control system. However, it does not provide much detail in determining who is responsible for carrying out the specific duties. Clear responsibilities must be defined so that each organization and individual understands its role in addressing risks and control. It is also necessary to establish the issues for which the structures are responsible and to establish ways in which they can coordinate their efforts between them so that there are no "loopholes" and no unnecessary or unintended duplication of efforts.

The model of the three defence lines addresses how specific risk-related and internal control tasks are applied and how they can be assigned and implemented within an organization, regardless of size or complexity. Management has to understand the differences between roles, responsibilities and specific tasks and determine how they can best be allocated to the organization in order for the organization to achieve its goals.

## **2. Sections**

International legislation in the field of internal control is supported by general principles of good practice, accepted and promoted by the IIA (International Institute of Internal Auditors) and INTOSAI (International Organization of Supreme Audit Institutions), organizations which provide members with opportunities for professional and technical cooperation.

Thus, according to the general principles of good practice promoted internationally, the concept of internal control is associated with a broader meaning, being regarded as a managerial function and not as a verification operation. With the help of the control function, management notes the deviations of the results from the established objectives, analyzes the causes and provides corrective or preventive measures. The way to implement the general

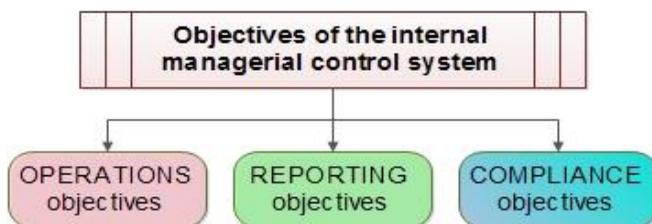
principles of good practice in internal control systems is specific to each country.

In Romania, the necessity and the obligation to organize the internal control in the public entities is regulated by the Government Ordinance no. 119/1999 on internal / managerial control and preventive financial control. Through this ordinance, internal / managerial control is defined as all the forms of control exercised at the level of the public entity, including internal audit, established by management in accordance with its objectives and legal regulations, in order to ensure the management of public funds in an economic, efficient and effective manner. Internal control also includes organizational structures, methods and used procedures.

Even though the definitions of internal control are numerous on the international and national level, they are not contrary, they all point to the fact that it is not a single function, but a set of management principles, appropriated by all those responsible at all levels of the entity to ensure that the entity's objectives are achieved.

The organization of the managerial internal control system within the public entities should consider the pursuit and realization of three categories of general objectives, as follows (Fig. 1):

**Figure 1. The objectives of the internal managerial control system**



Source: own projection based on the Managerial Internal Control System implementation manual

These categories of general objectives are:

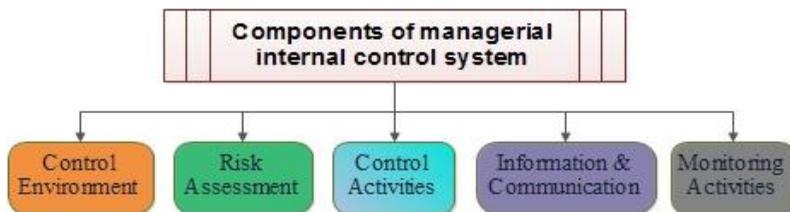
• **operational objectives:**

- target the goals of the public entity, in terms of the effectiveness and efficiency of the entity's operation;
- follow the use in conditions of economy, efficiency and effectiveness of resources;

- oversee the protection of the entity's resources, inappropriate use or loss;
- **reporting objectives:**
  - ensure the reliability of external and internal information;
  - keep track of proper accounting;
  - track the quality of information used in the public entity or broadcast to third parties;
  - aim to protect documents against: dissimulation of fraud and distortion of results;
- **compliance objectives:**
  - monitor and ensure compliance with internal laws, regulations and policies;

The entity defines its own strategy by setting the general objectives, which then results from the specific objectives. In carrying out the activities necessary to accomplish the objectives of the entity, the staff must take into account the components of internal managerial control, namely its standards according to the general requirements. The specialized literature divides the 16 managerial internal control standards on 5 major components of the managerial internal control system, thus (Fig. 2).

**Figure 2. Components of the management internal control system.**



Source: own projection based on *the Managerial Internal Control System implementation manual*

The relationship between the objectives of the managerial internal control, its components and the organizational structure of the public entity is nuanced in COSO's specifications in the revised 2013 Internal Control Framework. Through this schematization, it is desired to show a three-dimensional link between the objectives of the internal control system, its components and the organizational structure of the public entity. Thus, through the COSO Cube (Figure 3), it is observed that the three categories of objectives of the internal managerial control system apply to the five components at

all organizational levels of the public entity: by departments, directions, services, offices, including work stations.

**Figure 3. The COSO Cube**



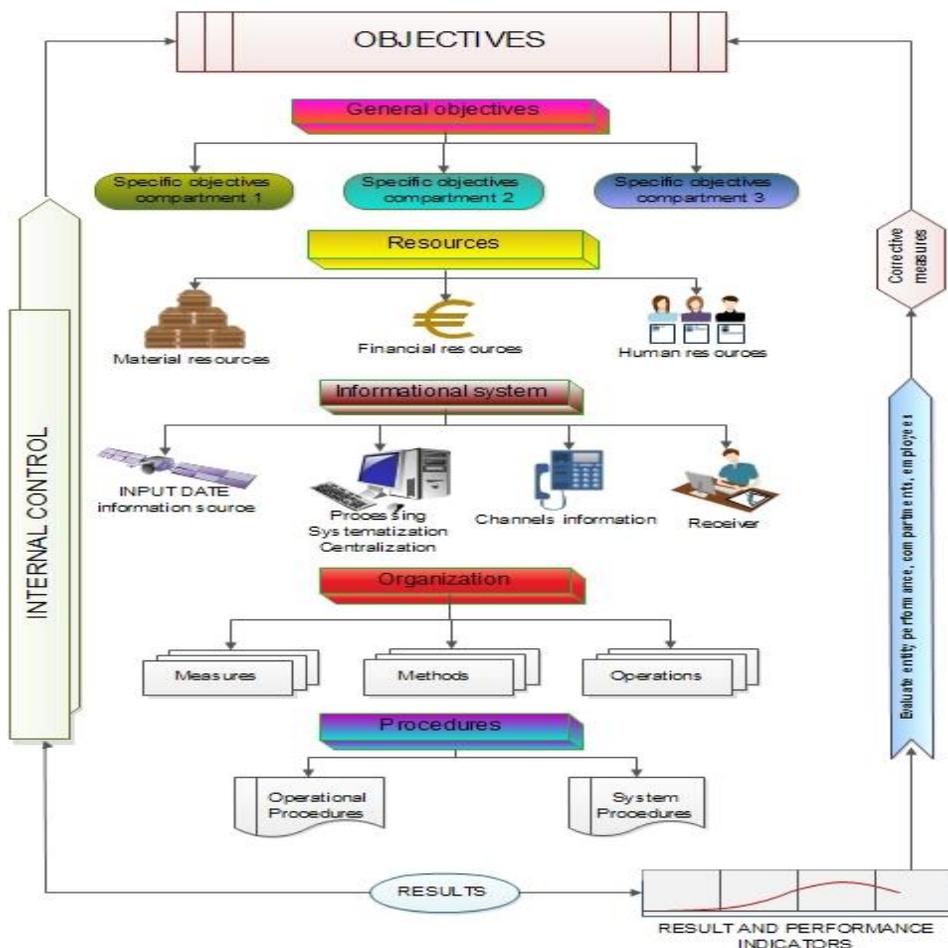
Source: The 2013 COSO Framework & SOX Compliance

In order to have a good control over the operation of the entity as a whole, as well as of each activity / operation, the management of the entity, through the internal managerial control system, establishes, implements and operates through a variety of procedures, means, actions and provisions. This set of elements forms the specific managerial internal control instrumentation that can be classified into six large groups as follows:

- objectives;
- means (resources);
- informational system;
- organization;
- procedures;
- control.

Therefore, by using the specific managerial internal control tools, the public entity can analyze the obtained results. The comparison of the results achieved in accordance with the established objectives is based on a set of control forms exercised at the level of the public entity in order to ensure the management of the public funds in an economical, effective and efficient manner.

Figure 4. Scheme of the specific managerial internal control instrumentation



Source: own projection based on the Managerial Internal Control System Implementation Manual, <https://sgg.gov.ro/new/metodologie-scim>

Building a solid managerial internal control system is a lengthy process that requires significant efforts and responsibility from the entire staff of the entity, in particular, from senior management. The implementation and development of the managerial internal control system in any public entity involves a series of processes, activities and actions that require responsibility,

appointment of the responsible personnel and, last but not least, the setting of the deadlines for carrying out the activities.

Performing internal control is an activity that primarily targets the entity's responsible internal parts, such as management, internal auditors, and all staff. However, there are also external stakeholders interested in the impact, proper functioning and efficiency of the internal control system.

At internal level of the public entity:

#### Managers

All staff members of the organization play an important role in carrying out internal control work. However, management has overall responsibility for the design, implementation, and supervision of proper operation, maintenance and documentation of the internal control system.

The management structure may include councils, committees or responsible persons who have different roles, tasks, duties, business objectives, entity objectives, legislation and regulations.

In Romania, according to the regulations in the field <sup>1</sup>, the persons responsible for the implementation and development of the managerial internal control system as well as the distribution of the main responsibilities within the public entity's internal framework are:

- Leader of the public entity
- Chairman of the Monitoring Committee
- The Technical Secretariat of the Monitoring Committee
- Members of the Monitoring Committee
- The compartment manager
- The risk responsible
- The person who identifies the risk
- Those responsible for designing system and operational procedures

#### Internal Auditors

Leadership often creates a distinct internal audit unit as part of the internal control system and uses it to help monitor the effectiveness of the internal control system. Internal auditors regularly provide information on the operation of internal control, paying particular attention to the assessment of its design and operation. They communicate through audit reports, information on strengths, weaknesses and recommendations for improving internal control. However, their independence and objectivity must be guaranteed.

Therefore, internal audit offers independent and objective assurance, a consulting activity that adds value and improves the operations and activities of

an organization. It helps an organization achieve its goals, using a systematic approach to assessing and improving the efficiency of all processes.

Although internal auditors are a valuable asset in internal control, internal audit does not replace internal control. In order for an internal audit function to be effective, it is essential that the internal audit staff be independent of management, work in an impartial manner, be fair and honest, and subordinate them to the highest level authority within the organization. This allows internal auditors to submit impartial opinions on their internal control assessments and objectively submit proposals to remedy the found deficiencies.

In addition to the monitoring role of an entity's internal control, adequate and well-trained staff from internal audit structures can contribute to the efficiency of external audit efforts by providing direct assistance to the external auditor. The nature, field of application, duration of projects, or planning of external audit missions can be streamlined if the external auditor can rely on the work of the internal auditor.

Therefore, internal auditors examine and contribute to the continued effectiveness of the internal control system through their assessments and recommendations, therefore, play a significant role in the efficiency of internal control. However, internal audit does not have primary management responsibility for the design, implementation, maintenance and development of internal control.

#### Staff members

Staff members also contribute to internal control. Internal control is an explicit or implicit part of each person's attribution. All staff members play a role in the proper conduct of the audit and must be responsible for reporting issues related to operations, non-compliance or compliance with the Code of Conduct. Staff responsible of execution often applies the internal control measures, verify the correctness of the operations performed, correct incorrect operations, and identify issues that can best be addressed by known measures in performing daily tasks.

#### External parties

The second major group of stakeholders in the entity's internal control are external parties such as external auditors, legislators and regulators in the field. They can also help by regulating internal control regulations. They can contribute to the organization's goals or provide useful information for internal control. However, the external parties are not responsible for the design, implementation, smooth operation, maintenance or development of the organization's internal control system.

## The Court of Auditors and external auditors

Tasks of Court of Auditors and external auditors include assessing the functioning of the internal control system and informing management of the findings. However, the consideration of the internal control system by the external parties is determined by the mandate and the mission.

The external auditors' assessment of internal control implies:

- determining the importance and sensitivity of the risk for which control is assessed;
- evaluating the misuse of resources;
- failure to achieve ethical, economic, efficiency and effectiveness objectives;
- non-fulfilment of liability and non-observance of laws and regulations;
- assessing the suitability of the design of the internal control system;
- testing the effectiveness of controls;
- reporting internal control assessment and discussing necessary corrective actions.

The external audit institutions are interested in ensuring the existence of strong internal audit units. These internal audit units are an important element of internal control by providing a continuous means of improving the operations of an organization. Where it is found that internal audit units have failed to ensure independence, have poor efficiency or are non-existent, external audit institutions should, whenever possible, provide assistance and guidance for the establishment and development of these unit's internal audit and support the assurance of the independence of internal audit activities. Such assistance could include the posting of specialists, the conduct of courses, the exchange of training materials and the development of common methodologies and work programs.

Also, external audit institutions need to develop a good working relationship with internal audit units, so that shared experience and knowledge can be shared and complement each other. Including internal audit reports and recognizing their contributions to external audit work, as appropriate, may also favour this relationship. Internal audit could reduce external audit work and avoid unnecessary duplication of work. External audit institutions should ensure that they have access to reports, work papers, and information on internal audit work.

Both external audit institutions and external auditors play an important role in contributing to and achieving internal control objectives. In particular, they pay attention to "fulfilling liability" and "keeping resources safe".

## Legislators and regulators

Legislation must provide a common understanding of both the definitions of internal control and the objectives to be met. Also, legislation can adjust and improve the policies that both internal and external stakeholders have to follow in fulfilling their roles and responsibilities to ensure effective internal control.

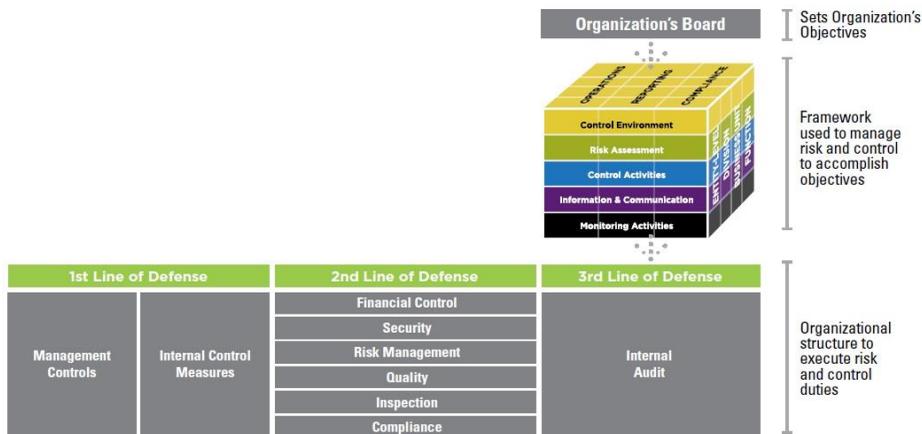
In July 2015, the Institute of Internal Auditors releases the paper **LEVERAGING COSO ACROSS THE THREE LINES OF DEFENSE** to help organizations strengthen their governance structures by providing guidance on how to designate and assign roles and responsibilities specific to internal control. This paper aims at correlating the internal control model proposed by COSO<sup>2</sup> with the Model of the three lines of defence.

The internal control model promoted by the COSO (Integrated Framework) (Fig. 2) outlines the components, principles and factors needed by an organization to manage its risks effectively by implementing an internal control system. However, this model does not provide much detail in determining who is responsible for the performance of specific duties. Clear responsibilities must be defined in such a way that each structure and individual of the organization understands its role in addressing risks and implementing controls. It is also inappropriate to establish ways in which groups can coordinate their efforts with each other so that there are no "loopholes" or unnecessary or unintended duplication of efforts.

The model of the three defence lines addresses how specific risk-related and internal control tasks are applied and how they can be assigned and implemented within an organization, regardless of size or complexity. Leadership needs to understand the differences between roles, responsibilities, and specific tasks, and determine how best they can best be attributed to the organization for the organization to achieve its goals.

The model helps to understand and clarify the roles and responsibilities of the organization's groups, structures or individuals. Its fundamental premise is that, under the supervision and directives of senior management and the board of directors, three large separate groups (or lines of defence) must be formed within the organization to achieve an effective management of risks and to achieve adequate internal control. Schematically, these relationships are shown in the figure below (fig. 5).

**Figure 5. Relationship Among Objectives, The Framework and the Model**



Source: LEVERAGING COSO ACROSS THE THREE LINES OF DEFENSE, July 2015

The basic responsibilities of the three groups (or "lines of defence") are:

- **1st.** To know, hold and manage risks and internal control;
- **2nd.** Monitoring risk and internal risks control in support of management;
- **3rd.** Provide independent assurance for senior management and senior management with regard to the effectiveness and efficiency of risk management and internal control;

Each of the three lines of defence plays a distinct role throughout the organization's governance process. When each group performs their assigned role effectively, the organization is more likely to be successful in achieving its goals. At the same time, when the organization is structured, according to the three lines of defence, it works more efficiently, as risk management and internal control are more likely to be managed effectively.

The roles of the senior management and the board of directors in the model of the three lines of defence

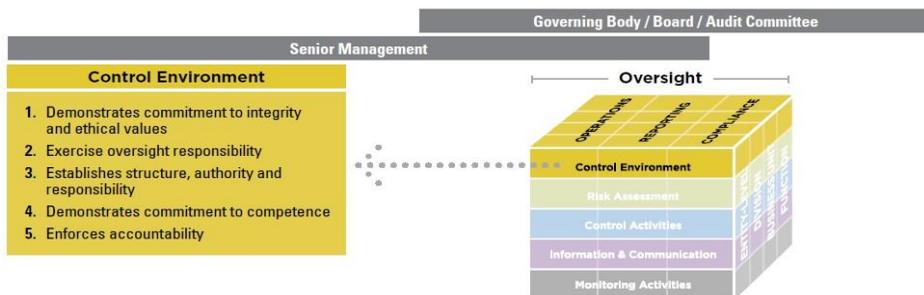
Top management and board of directors have an integrating role in this model. The senior management is responsible for selecting, developing and evaluating the internal control system under the supervision of the board of directors.

Although neither the senior management nor the board of directors is considered to be part of one of the three lines of defence, these parties have the responsibility to collectively and fully set the organization's objectives. It is their

responsibility to define high-level strategies, setting general objectives and the task of establishing optimal organizational structures. In addition, they have ultimate responsibility for the activities of the first and second line of defence.

As shown in the figure below, senior management and board of directors have primary responsibility for an organization's control environment by applying the top five managerial internal control standards.

**Figure 6. Oversight Responsibilities for the Control Environment**



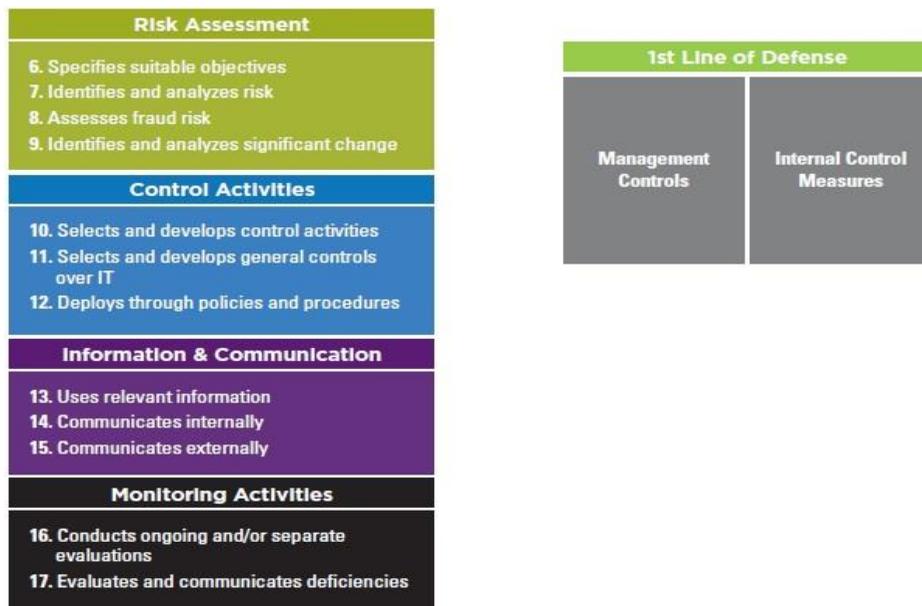
Source: LEVERAGING COSO ACROSS THE THREE LINES OF DEFENSE, July 2015

### Roles of the first line of defence: Operational management

The first line of defence in the model is made up of first line and middle line managers who have the task of knowing and managing risk management and internal control. Operational managers develop and implement the organization's risk control and management processes. These include processes designed to identify and assess significant risks, perform the activities as planned, highlight inappropriate processes, identify control deficiencies, and communicate superior performance to business leadership.

Operational managers must be sufficiently qualified to carry out these tasks. They have significant responsibilities for 4 major components of the managerial internal control system that aggregate 12 internal control standards, as shown in the figure below.

Figure 7. COSO and the 1st Line of Defense



Source: LEVERAGING COSO ACROSS THE THREE LINES OF DEFENSE, July 2015

The responsibilities of the second line of defence: Internal monitoring and surveillance functions

The second line of defence includes the management of various areas with associated risks and compliance functions set by management to ensure that first-line risk management and risk management processes are properly designed and function as planned.

This is where management functions are separated from front-line management, but they also fall under the control and guidance of senior management. Second-line functions are typically responsible for ongoing monitoring of risks and risks. The second line often works closely with Operational Management to help define the implementation strategy, provide expertise with risks, implement policies and procedures, gather information, and help create an overview picture.

Under management supervision, the second-line staff monitors specific controls to determine whether they are working properly. The monitoring

activities carried out by the second line cover all three categories of objectives: operational, reporting and compliance.

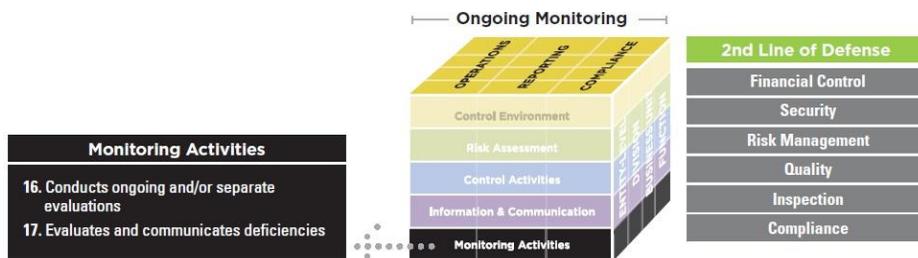
The responsibilities of people in line 2 vary greatly depending on the nature of the organization but include at least:

- Assisting management in the design and development of risk management and control processes.
- Define monitoring and measurement of success compared to managerial expectations.
- Monitoring the adequacy and effectiveness of internal activities and control activities.
- Escalating critical issues, emerging risks and exceptional values
- Identification and monitoring of known and emerging issues affecting the organization's risks and controls.
- Identification of changes in the organization's implicit appetite risk and tolerance to risk.
- Provide guidance and training on the risks of management and control processes.

Each function in the second line has a certain degree of independence from the activities of the first line of defence, but they are, by their nature, still management functions. Secondary management functions can directly develop, implement, and / or modify the organization's internal and risk control processes. They can also act as decision-makers for certain operational activities to the extent that they need to be directly involved in a front-line activity. This function may not be fully independent of the first line of defence.

To be effective as a line of defence, it must have an appropriate stature, with well-trained leaders. Stature derives from authority and direct reporting lines that respect the command. The second line of defence is schematized in the figure below.

**Figure 8. COSO and the 2nd Line of Defense**



Source: LEVERAGING COSO ACROSS THE THREE LINES OF DEFENSE, July 2015

### Third line of defence: Internal Audit

Internal auditors serve as the third line of defence of the organization. Among other roles, internal audit provides assurance on the efficiency and effectiveness of governance, risk management and internal control. The scope of internal audit work may include all aspects of the range of activities and operations of an organization.

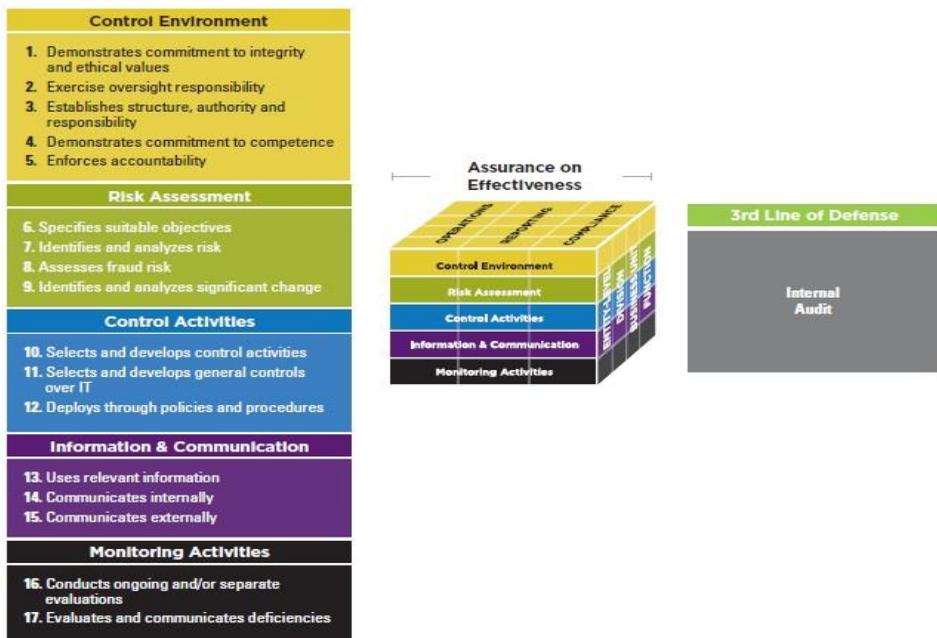
What distinguishes internal audit from the other two lines of defence is its high level of organizational independence and objectivity. Internal auditors are not responsible for the operations of the organization.

In most organizations, the independence of internal audit is further strengthened through a direct reporting relationship between the audit director and the board of directors. Because of this high level of organizational independence, internal auditors are positioned optimally to provide reliable and objective assurance.

Internal auditing actively contributes to effective organizational governance, ensuring that certain goals are met while independence and professionalism are guaranteed. Establishing professional audit work should therefore be a priority for all organizations.

So the internal audit has significant overall organization responsibilities, analyzed through the entire spectrum of components of the internal management system that totals the 17 internal control standards, as shown in the figure below.

Figure 9. COSO and the 2nd Line of Defense



Source: LEVERAGING COSO ACROSS THE THREE LINES OF DEFENSE, July 2015

### 3. Conclusions

Each organization has to define very clearly its responsibilities in terms of organization, risk management and internal control. This reduces the unnecessary gaps or duplications of assigned tasks related to risk management and internal control.

This paper attempts to capture the links and interfaces between the best known and current models that can help organizations define, design, implement, maintain and develop risk management and internal control system, with the help of the "COSO Cube" model presented in 2013 in the COSO Framework & SOX Compliance paper and "The Three Lines of Defence in Effective Risk Management and Control" presented by The Institute of Internal Auditors in January 2013.

However, in order for a system of internal managerial control to function properly within an organization, it is very important that it be fully assimilated into the organizational culture of public entities so that all staff become aware

of both their own responsibilities and the benefits it brings. As long as the implementation of the managerial internal control system is perceived as an additional activity to the job specific duties, the chances of success are greatly diminished. It is not enough that it exists only in documents, with existing standards and methodologies.

The managerial internal control system must be designed as a living body, depending on the size and complexity of the public entity's activity, to which all the staff are involved in the implementation and development process, and it is absolutely necessary for them to understand clearly and in detail their responsibilities.

A real problem at the level of entities may be the lack of qualified human resources and their fluctuation, a problem that creates deficiencies in the process of implementation and development of the managerial internal control system. It is therefore very important to carry out training courses in the field of managerial internal control and risk management for both management and executives.

My conclusion indicates that the organization itself, its structures and staff, and organizational culture have the greatest influence on the effective functionality of all processes, activities, and goals. A leadership-based entity with an emphasis on human development by engaging, consulting, participating, guiding and involving all staff actively seems to be the best condition for achieving success.

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