

# **IMPORTANCE OF INTERNAL CONTROL SYSTEM IN BANKING SECTOR : EVIDENCE FROM TURKEY**

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## **Abstract**

The globalization process, complexity of banking transactions and the increase in fraudulent activities have recently sharpened the ever-increasing attention on internal control systems in banking sector. Banks are the main player in economies, especially in bank-based economies such as Turkey. To sustain a healthy economic environment authorities care internal control system and develop strategies for bank managements through regulations. Establishment of internal control system has become a legal obligation since the new banking law and the BRSA's regulations in Turkey.

In this paper, the importance of internal control system is expressed and also its impacts to the banking system are analyzed. Moreover, the current structure of the internal control system in Turkish Banking sector is explained and evaluated through the annual reports. The method used in this research is evaluating and comparing of selected 15 Turkish banks and 3 main international banks. The data is collected from the 2012 year-end annual report of each bank and analyzed with qualitative research methods.

The research shows that the internal control activities of the banks are adapted to the international standards in Turkey and effective control procedures exist in the banking system. In addition, efficient internal control mechanisms have great impact on the strong and stable outlook of Turkish banking sector.

**Keywords:** Banks, Banking, Internal Control

## **I. Introduction**

Finance sector has become the most important actor with the impact of globalization and technological improvements in last two decades. As a consequence, financial products have increased, operational borders have expanded, and new financial markets have emerged. These developments have increased and diversified the risks that the banking sector has to manage. Poor management and insufficient control of risks originated financial crises in the world. The initial domestic crises spread the world through globalization, in a short period of time.

The global financial crisis highlighted the importance of well-functioning and healthy banking sector for macro stability (Hayali et al. 2012). One of the main reasons of banking failures which results in major financial loss and even bankruptcy is due to high risks taken by the bank management on an excessive scale and inability of controlling them. The lack of an internal control system which duty is to keep the risks under control or major breakdowns within an existing internal control system pose a threat against the success of the banking sector.

Internal control is a system structured within the corporation whose goal is to raise efficiency and effectiveness of activities. The system assures the conformity of activities within the laws and regulations and improve the reliability of financial reporting. Internal control system possesses vital importance for the institution to attain its ultimate objectives. Internal control system allows banks to foresee potential problems which may cause financial losses and thereby prevent or minimize any future losses. Researches on the causes of bank failures mainly concluded that an efficient and effective internal control system might prevent financial cost.

Control; being one of the five main functions of management, is a process of monitoring operations so as to detect whether the operations fulfill their functions as planned or not, and if there is a deviation, the control process determines the reasons of this deviation and takes the necessary steps to eliminate it (Ozten et al. 2012, p.1). The main purpose of control is to raise concern over errors, and detect the points of failure in order to prevent their re-emergence.

Internal control system can be generally defined as a system which has the features of maintaining the assets of a company, ensuring accuracy and reliability of information and reports related to accounting and other operations, and increasing the effectiveness of the operations. Additionally, the system also covers all assessment and methods that are adopted in order to detect the suitability of operations in accordance with policies determined by management, implementing a chart of accounts and reporting system, specifying the duties, authority and responsibilities, and organization plan of the cooperation (Cook et al. 1980, p.198). In other words, internal control system which is created by management and implemented by management and employees is a process which is designed to ensure reasonable assurance to achieve pre-specified objectives (Doyrangöl, 2002).

According to the definition by COSO in 1992, an internal control system is defined as a set of methods, designed and controlled by senior management and board of directors to provide a limited assurance regarding reliability of financial reporting, effectiveness and efficiency of operations and their compliance with laws and regulations (Aksoy, 2007). The COSO definition and the model covering all components of the internal control system is a guidance for other regulations throughout the world and in Turkey.

The main objective of internal control system for banks is to continuously track the compatibility of all banking practices and operations with international auditing standards, banking laws, regulations and rules to solve problems that may arise where necessary. In addition to this, with an effective internal control system, erroneous, fraudulent transactions and irregularities are less likely to happen in banking (Ozten et al. 2012, p. 133).

## **II. Literature Review**

There are many researches which emphasize the necessity and importance of internal control system in the banking system. An insufficient internal control system often causes an inability to detect fraudulent activities and a decrease in the performance of the bank (Adeyemi et al. 2011).

The Basel Committee, (Basel 1998) along with banking supervisors throughout the world, has focused increasingly on the importance of sound internal controls. Internal control is a process affected by the board of directors, senior management and all levels of employees. It is not solely a procedure or policy that is performed at a certain point in time, but rather it is continually operating at all levels within the bank. The board of directors and senior management are responsible for establishing the appropriate culture to facilitate an effective internal control process and for monitoring its effectiveness on an ongoing basis; however, each individual within a corporation must participate in the process.

Socol (Socol 2011) mentioned that the administration board and executive management promotes high standards of ethics and integrity, establish an institutional culture highlighting and demonstrating the importance of internal control on all organizational levels. All employees of the bank must be aware of the role they have in the internal control system and must be actively involved in this process.

Internal control system asserts that the system should be always kept under control and supervision since people tend to think about their interests more rather than the interests of the corporation. If there is a failure in the financial accounting system of a corporation, a decrease in assets and an increase in abuses will inevitably takes place in the absence of an effective internal control system (Yayla 2006, p. 112).

Karagiorgos, Drogalas and Dimou (Karagiorgos et al. 2011) find a number of interactions between components of internal control system and effectiveness of internal auditing within Greek Banks.

Olatunji (Olatunji, 2009) examined the impact of internal control system in banking sector and according to the findings the lack of an effective internal control system is the major cause of bank frauds in Nigeria. It is then concluded that the management of every bank should create and establish a standard internal control system, strong enough to stand against the wiles of fraud in order to promote continuity of operations and to ensure the liquidity, solvency and going concern concept of the bank.

Amudo and Inanga (Amudo et al. 2009) identify the following six essential components of an effective internal control system; control environment, risk assessment, control activities, information and communications, monitoring, and information technology in their study. The findings of the study under evaluation results are that measuring effectiveness of internal control is concerned with the existence and functioning of the six major control components identified by the model.

One of the, perhaps the most prominent one, vital components of a bank's structure in modern banking system is internal control system in developed or developing countries. Because effective and efficient performance of the system indicates that the bank operates as desired. Consequently, investors and other customers in the market will prefer to use the services of that bank since they will have confidence and peace of mind about bank's financial stability (Yavuz, 2002).

### **III. Components of Internal Control System**

In response to widely publicized business failures in the USA in the late 1970s and mid-1980s, the National Commission on Fraudulent Financial Reporting (the Treadway Commission) was inaugurated to identify factors that caused fraudulent corporate financial reports and make recommendations that resolve such issues. The recommendations directly addressed the problems of weakness of internal controls and emphasized the importance of the control environment, codes of ethical conduct, management reports on effectiveness of internal controls and development of a common definition and framework of internal control. The evolutionary process of developing a generally accepted definition and framework of internal control was realized in 1992 with the publication of a landmark report on internal control: *Internal Control - Integrated Framework*, referred to as "COSO".

According to COSO (1992), the main objectives of the internal control process can be categorized as follows:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations.

According to COSO model, which has received international recognition in respect to internal control, it is proposed that internal controls are to be performed based upon five basic components related to operational effectiveness and efficiency, reliable financial reporting and ensuring regularity. Five basic components in question are control environment, risk assessment, control activities, information and communication, and monitoring. Organizational environment and philosophy of management have an impact on the formation of control environment. A strong internal control structure is one of the most significant components in the prevention of fraud. Having a weak internal control process facilitates the occurrence of fraud in operations (Bozkurt 2009).

A direct relationship exists between objectives, which are what an entity strives to achieve, components, which represent what is required to achieve the objectives, and the organizational structure of the entity (COSO, 2013).

Control environment refers to all factors which are effective in determining, increasing or decreasing the effectiveness of policies, procedures, and methods specific to a process. Control environment stands out with the basic understanding adopted by senior management of the corporation to control the organization, its attitude toward problems and approach to solving problems and their perspective of the importance of moral values. Strictly speaking, control environment can be perceived as a consciousness of the senior management of a corporation to control the organization and employees (Kaval 2005).

Risk Assessment is defined as identification of potential errors, and implements control, policies and procedures in order to reveal those errors and prevent them. A corporation basically establishes an early warning system to determine remote risks or risks with low-probability, and take the necessary actions to remove or minimize such risks.

Control operations consist of a range of activities. These are (Frazier et al. 1996, p.40);

- Performance assessment (Comparison between the objectives of a corporate and actual operations)
- Information processing controls
- Physical controls (such as controlling the physical presence or absence of assets, controlling whether necessary measures are taken in order to reach assets and records or not, comparison between periodic inventory and accounting records)
- Segregation of duties (for instance assigning different employees for different tasks such as procurement of assets, registration procedures, and custody of assets)

Another primary element of a good internal control system is to be able to obtain information both vertically and horizontally and ensure communication among employees. This is only possible if the management information system and its information subsystems are arranged in a disciplined and responsive manner. Effective communication should be established including all employees at all levels of the corporate. All employees should be informed regarding their positions within the internal control system (Keskin 2006, p. 40).

A key element of a strong internal control system is realization by each employee of necessity of fulfilling his/her responsibilities in an efficient manner and of communicating to leading management any problem that may have appeared during operations, internal norms or observed illegal actions (Socol 2011, p.402).

Information and communication can reduce the risk of fraud in two ways. First, the possibility of fraud concealment is reduced by means of the integrity and the accuracy of information. To put it differently, a person who commits a fraud can't have the opportunity of hiding it for a long time. Secondly, an open and effective communication fostered in a corporate, helps detecting the possibility of fraud in advance (Cendrowski et al. 2007, p.128).

Compliance of internal controls with corporate policies and procedures and potential back doors that result in new risks have to be determined. In a sense, the quality of internal control performance is measured by monitoring. Monitoring performed on a regular basis, is a process that covers the assessment of internal control quality, the design and operation of controls and actions to be taken. Continuous observation of the internal control system and discovery of deviations is required in order to achieve these mentioned objectives. And this is performed by Internal Audit function/unit in corporations.

The ability to identify new risks that may occur due to some changes among employees and within the corporate, and the ability to provide continuity of internal control need to be monitored in the course of time. Therefore, monitoring internal control also requires a process. This process assesses the quality of internal control in the course of time (Frazier et al. 1996, p. 72). In brief, monitoring is a process designed to provide an independent assurance related to the efficiency of internal control procedures. By monitoring, internal control activities are constantly kept under surveillance and their performance is assessed. This is in fact a message for the whole organization, indicating that fraudulent actions are revealed within the shortest time (Cendrowski et al. 2007, p. 140).

#### **IV. Regulations on the Internal Control System in the Turkish Banking Sector**

After 1994 and 2001 banking crises in Turkey, ownership of a number of banks were transferred to Savings Deposit Insurance Fund (SDIF) which is the legal authority responsible for the protection of saving deposits. These banks share several common characteristics such as insufficient internal control, risk management and inspection mechanism. This situation made banking sector extremely sensitive and fragile against internal and external shocks.

Banking Regulation and Supervision Agency (BRSA) which is the sole authority on banking sector in Turkey was established in accordance with Banking Act No:4389. After being published in the Official Newspaper dated June 23, 1999, aforementioned act became effective and some regulations underlying the internal control system were made as well. (Banking Act No: 4389, 1999: Article 3)

Additionally, as a result of successive crises in the banking sector, "Banking Sector Restructuring Program" aimed at solution of structural problems was implemented on 15 May 2001. Another significant improvement on internal control is "Regulation on Internal Control and Risk Management Systems of Banks" issued by the BRSA in 2001. The purpose of this regulation is to determine the principles and procedures related to risk management systems and internal control systems which are established by the banks in order to monitor and control the potential risks. (Regulation on Internal Control and Risk Management Systems of Banks, 2001: Article 1)

However, this regulation has undergone much criticism such as being too complex and open to different interpretations by practitioners, having vague provisions and job descriptions and not using a plain language (Yurtsever 2008, p. 86).

The act numbered 4389 was replaced by the 5411 Turkish Banking Act in 2005 since the former one was incapable of satisfying the needs after financial crises Turkey experienced. This act is still in force and covers the private financial institutions under the name of participation banks and has a detailed infrastructure in line with international standards. (Banking Act No:5411, 2005: Article 2)

The new Act includes more detailed provisions in contrast to previous Act related to issues on internal control, internal audit, and risk management systems which the banks have to implement. Generally speaking; the term "internal system" is used to cover the operations of internal control, internal audit and risk management. A new Act has been issued to execute internal control operations by internal control unit and employees. (İbis et al. 2012, p. 113).

According to this Act, banks are obliged to establish and operate a qualified and effective internal control, risk management and internal audit unit that cover all branches and associations subject to consolidation. This unit is to monitor and control the risks that banks are exposed to and is to be compatible with the scope and structure of the operations and changing conditions. (Banking Act No.5411, 2005: Article 29)

BRSA issued complementary Regulations in order to eliminate potential loopholes in the implementation. The new regulation dated 2006 concerning internal systems, described procedures and principles regarding internal control, internal audit and risk management systems to be established by the banks and their functioning in detail. (Regulation on Internal Systems of Banks, 2006: Article 1) Furthermore, the board of directors of the banks is held responsible to determine employees to be in charge of the system operation, and the board of directors is also obligated to establish an audit committee including at least two members with no executive function. (Regulation on Internal Systems of Banks, 2006: Article 4)

It is important to note that as well as being more detailed, more clear and less vague compared to previous one, the regulation dated 2006 is also an advanced arrangement in terms of compliance with international standards and practices. After all, the Regulation includes the basic issues stated in especially Basel standards in general.

The roles and responsibilities of especially the board of directors, audit committee and senior management have been described under separate headings in a comprehensive and detailed way considering the operations in the country, the distinction between the internal control system and internal audit system has been clarified, internal control activities have been outlined, internal audit system has been connected to risk-based inspection activities, internal audit system has been regulated in detail to require major changes in practice and the bank management has been rendered flexible in risk management (Yurtsever 2008, p. 256).

Finally, "Regulation on Internal Systems of Banks" issued by BRSA on June 28, 2012 and the previous regulation has been repealed. According to new regulation, the objective of internal control system has been stated as follows: "to maintain the bank's assets, the execution of activities effectively and efficiently in accordance with Law and other relevant laws, the bank's internal policies and

regulations and banking practices, ensuring reliability, integrity of accounting and financial reporting system and obtaining information on time.” (Regulation on Internal Systems of Banks, 2012: Article 9)

All those arrangements demonstrate that since the beginning of 2000’s, Turkish banking system has continuously been changing and progressing related to internal systems. When the provisions of law as well as regulations issued by legitimate authority are taken into account, it is easily noticed that Turkey has shown an effective effort in compliance with filling practice gaps and international standards. The banks operating in Turkey, implement effective internal control practices in the presence of both aforementioned arrangements and their high risk activities.

#### **V. Internal Control System Practices of Turkish Banking Sector**

In this study, internal control system activities of some selected banks that belongs to different banking groups on savings, participation, and investments in the Turkish banking sector have been investigated. All bank groups are subject to the same legal requirements in terms of internal control system practices. In this context, in order to be able to reflect the current situation, annual reports for the year 2012 of selected banks are analyzed. The limitation on the number of selected banks within the scope of research is determined by their quotation in Borsa Istanbul (BIST) and their segments.

The two banks analyzed in this study, AlbarakaTurk and Bank Asya are participation banks and they exercise international Islamic bank operations under the name of participation banking in Turkey. The participation banks are subject to regulations on public disclosure of financial reports of Capital Markets Board (CMB) like every other company whose stocks are listed on BIST. The content of the declared annual reports to the public by the banks was specified by Banking Regulation and Supervision Agency (BRSA) and by separating one of the chapters of the report for internal systems, reveals the importance of the subject given by the controlling institution.

AlbarakaTurk Participation Bank Inc. has established an auditing committee of the board of directors, which is a legal obligation according to internal systems regulations. The committee is responsible for the existence of internal systems and is monitored by the board of directors. The structure of internal systems reports to audit committee within the corporation. In order to monitor and control the risks being exposed to, a structure of the internal systems which is compatible with the scope and structure of the corporation and changing conditions, qualified and effective within the framework of procedures and principles stipulated in the relevant legislation, has been implemented.

Within the scope of internal systems, Internal Audit (Board of Inspectors), Presidency of Risk Management, Presidency of Regulation and Compliance, and Presidency of Internal Control have been established and specialized on these issues. Presidency of Internal Control in the bank performs risk based and interactive controls that allow banking operations in general management units and branches to be performed efficiently and safety.

Findings, opinions and suggestions specified as a result of internal control operations are initially shared and assessed by the people carrying out these operations. In this respect, necessary, complementary, and preventive measures can be taken and implemented rapidly. Moreover, appropriate and practicable solutions to improve process and activities are put into practice, too.

These operations of Presidency of Internal Control are performed by employees independently and impartially. Presidency directly reports to The Audit Committee of The Board of Directors in accordance with the legislation. Activities of Presidency were assessed in 5 Audit Committee meetings in 2012.

The other participation bank analyzed in this research is Asya Participation Bank Inc. It is a quoted company established with domestic capital and preserved this domestic capital structure except for the initial public offering. Internal system organization of Bank Asya, slightly differs from AlbarakaTurk’s. The Audit Committee is named as “Audit Coordinatorship” in Bank Asya. The Coordinatorship is charged with activities and presence of Risk Management, Inspection Board, and Internal Control Center. There is also a Legislation and Compliance Management acting under the board of directors. Unlike AlbarakaTurk the Legislation and Compliance Management reports directly to the Board of Directors for its activities.

Duties and responsibilities of the Internal Control Center have parallels with Internal Control Presidency of AlbarakaTurk. Asya's Audit Coordinatorship functions strictly committed to the internal systems regulations of BRSA.

The Internal Control Center is in charge of designing internal control system, internal control activities and their performance, monitoring designed controls. According to the results achieved after monitoring, it is also charged with taking necessary measures to improve the control system of the Bank and perform internal control activities smoothly.

Bank's internal control system has an organic structure and employees from each level of the corporation are accepted as a part of the internal control system. Thereby, besides the Coordinatorship, holding all employees responsible for safeguarding of the Bank's assets, effectiveness and efficiency of activities, reliability of accounting and financial reporting system, compatibility of activities with internal regulations and current legislation, a sense of ownership has been achieved.

The Bank assesses the compatibility of internal control activities with the legislation and international standards by applying a method named as "Control Self-Assessment Workshops" and tools. The senior managers and unit managers are selected to be participants of this workshop. The activities concerning the subject of internal control are designed with the Unit Managers of the related activities within the scope of workshop. The decisions taken during the workshop are followed by the Internal Control Center by means of "action tracking inventory." The participants held 134 meetings in 2012 and took 275 action decisions. And in addition to routine monitoring, the Center performed 255 monitoring in the branches in 2012.

The Center building query scenarios with ACL program, carried out its controls in this respect. Furthermore it assessed the process of information systems within the scope of COBIT.

The Center employs employees having an internationally valid certificate. The total number of employees employed by Presidency is 40. In 2012, Audit Coordinatorship held 37 meetings in which the activities of the Center were also assessed.

It's been said that the activities of Turkish banking system dissociate by their licenses. There is not any change in terms of both general banking and regulations regarding internal systems. These banks are obliged to ensure the performance of internal systems and establish a responsible audit committee.

On the other hand, besides the Audit Committee related to internal systems, Alternatifbank established the Committee of Early Risk Detection and Management under the board of management. The structure of internal systems includes Inspection Board, Risk Management, Legislation and Compliance Board, and Internal Control Management.

Internal Control Management functions as a coordinating unit from an organizational level perspective. The Management functions under the Audit Committee, is responsible to the Board of Directors, and it fulfills its responsibility to the Board of Directors through the Audit Committee. Headquarter Control Unit, Control Unit of Branches, Basic Controls and Support Unit are included in the Management, which has allocated responsibility to employees who perform activity as a primary component of control mechanism and gained a flexible structure. The Management aims at safeguarding of the bank assets, performing activities effectively and efficiently in accordance with legislation and internal rules, and the reliability, integrity and accessibility of accounting and financial reporting system. The Bank taking banking precedents and code of banking ethics as a reference as well as the legislation, stated the issues related to internal control activities in written form, which is different from other banks analyzed in this study.

Audit Committee came together four times in 2012 and made evaluations on the actions of the Internal Control Management.

On the other hand, Finansbank Audit Committee came together 8 times in 2012 and made evaluations related to internal systems. Finansbank established Risk Committee and Operational Risk Management Committee under the Board of Directors apart from the Audit Committee on internal systems.

While Risk Management Department included in the internal systems of the bank carries out its activities under the Risk Management Committee, it reports to the Audit Committee, too. Inspection Board, and Internal Control Center and Compliance are the other functions of internal systems established and reports directly to the Audit Committee. As well as having a unique structure related to risk management, Finansbank assembles internal control and compliance issues which are the parts of internal systems structure under the same roof in contrast to first three banks which have been initially analyzed.

Internal Control and Compliance Center organized as two separate departments in previous years were assembled in the fourth quarter of 2012. The objective of the Center covers operations to reduce operational, legal and financial risks, and control activities. The structure is divided into 4 categories in the field of internal control. These are branches and shareholders control unit, the head office control unit, control design unit, and information technologies and SOX control unit. Within the department, there are 64 employees for the internal control, 15 for the legislation and compliance, and 1 as the manager, which is a total of 80 employees.

Akbank has also preferred to assemble the departments of Internal Control and Compliance under the same roof. On the other hand the Bank's internal systems function under the Board of Directors with Audit Committee and the Executive Risk Committee. Internal systems inherently function under Audit Committee. In this respect, Inspection Board, Risk Management Department and the Internal Control and Compliance Presidency have been established. Internal Control and Compliance Presidency established previously as separate structures within Akbank were assembled in the fourth quarter of 2012.

The Presidency of Internal Control and Compliance, aims at keeping credit and operational risks at minimum level, fighting money laundering, prevention of terrorism financing, and provide compliance. Operational objectives of the task have been specified as informational systems compatible with activities and products, a communication structure allowing all units and employees to share necessary information and control activities auditing this whole structure and minimum compliance risk, minimum credit and operational risk, effectiveness and efficiency. The Presidency, has been trying to ensure efficiency of the system with centralized and decentralized monitoring conducted by control employees distributed to 35 different points. The Audit Committee evaluated the activities of Presidency in four meetings held in 2012.

In Tekstilbank, the Board of Directors Audit Committee is charged with internal systems as stated in the legislation. Audit Committee held 12 meetings in 2012 with system managers, organized as Inspection Board, Risk Management, and Internal Control Center and Compliance Board, in order to make evaluations on internal systems.

Internal control structure was established in 2001 and after being included in compliance function in 2008; its name was changed as Internal Control Center and Compliance Board. In 2011, the Compliance Unit started to function under the Presidency. The Presidency still conducting centralized and decentralized monitoring with its 13 employees, designs activities with manager/s of the units in the process of determining activity controls.

The Presidency includes 4 units which are Headquarter Control Unit; Branches Control Unit, Compliance Unit, and Legislation Unit. In addition, Branches Control Unit in itself is divided into different geographical regions units determined by cities which include branches. The Presidency aims at an effective and efficient performance of the activities in accordance with internal and external regulations and banking practices and providing the reliability, integrity and accessibility of accounting and financial reporting system. In order to reach these goals, the Presidency, establishing functional task distinctions and division of responsibilities, benefits from the efficiency of informational systems and internal communication channels.

For the realization of new products and projects, taking the opinion of the management has been arranged as a legal requirement. Thus, the management has been given ownership role for the activities that will take the Bank to its strategic goals.

Halk Bank is one of the other state-owned banks analyzed within the scope of this study. The main feature of the bank is to provide financing for craftsmen, artisans and SMEs. Today, 48.90% of the shares of the Bank have been sold through public offering and the shares have been listed in BIST. Halk Bank structured its internal control systems in accordance with provisions of the Regulation on Internal Systems of Banks published by BRSA. Organizational structure of Halk Bank presents a triple characteristic. It includes Inspection Board, Internal Control Department, and Risk Management. Additionally, the structure named as Control Department and indicated in the Bank's organizational chart functions under deputy general manager who is in charge of "Risk Management and Internal Control" group. Aforementioned manager functions directly under Board of Directors. In the previous banks analyzed in this study, responsible member of the board of directors is charged with all internal control practices.

Errors and omissions discovered as a result of internal control and financial control activities are reported under the name of Risk Warning Report (RWR) and Financial Examination Report (FER), and forwarded to the unit conducting control activities. Despite warning, the risks that cannot be solved are reported a higher management level and this process are carried out until the solution of the risk. Another banking practice within risk-based audit approach is to keep internal control working hours different from working conditions in branches discovered to have high risk rates as a result of centralized controls and statistical analyses and credit, assets and track weighted branches as well as branches having rapid increase in the figures considering the impact on assets and equities.

The key feature of the Bank's organization chart is that the employers who perform processing, pricing, and control functions work in different units and work under different members of board of directors. This structure also called as Matrix organizational chart establishes control at every level of process.

Audit activities are carried out with assignments within monthly programs organized in branches. Branches are incorporated into control programs monthly or bi-monthly programs considering the size of assets. Internal control employers are also temporarily charged in branches other than Regional Coordinatorships under which they function. Internal control employees can function in a branch in a maximum of three control period and this rotation allows branches to be controlled by different internal control employees.

Activities under the name of "Compliance Controls" are conducted and these activities aim at controlling all the activities carried out or planned to be carried out, new operations and products in accordance with the Law and other relevant legislation, bank's internal policies and principles and banking conventions. In addition to this, there is a unit regarding these issues.

As one can see, Halkbank operating in large banking segment carries out its activities related to internal systems through a large team, and reposition its employees in different branches.

The other bank to be analyzed within the scope of this research is TSKB which provides service as Turkey's first privately-owned investment bank. In TSKB, a set of regulations called as "Risk Catalogue" has been prepared to review the processes related to measurement, evaluation, and management of banking risks, and organization is structured in this way.

Internal systems are structured as directorship rather than presidency in contrast to Halkbank. Inspection board and Internal Control and Risk Management functions are under Audit Committee and directly responsible to the Board of Directors.

TSKB's Internal Control System has been structured to be able to keep all financial and operational risks identified concerning activities continuously, on a reasonable level and under control. Taking a proactive role in project and product development activities, both process supervisors and Internal Control Management, act as decision makers to identify internal control points. This situation proves that internal control activities have been effective at all levels and absorbed well by the bank. Bank's Audit Committee evaluates the efficiency of internal control system and the results of internal control actions are prepared by Internal Control Management on a periodic basis through activity reports. Audit Committee assembled 34 times in 2012 and made evaluations on internal system components.

Turkish Economy Bank (TEB) operating in commercial banking and being included in medium-sized banks segment in Turkey, signed a partnership deal in 2005 with one of the first global banks, BNP Paribas and the shares were listed in BIST.

TEB internal systems have been established under Inspection Presidency, Risk Management Group Presidency, and Compliance and Internal Control Group Presidency. Internal system structure reports to Audit Committee like the other banks analyzed here. In 2012, Audit Committee made evaluations on the components and activities of internal systems in 51 meetings.

Risk Management, Compliance and Internal Control and Inspection Board reports Board of Directors Audit Committee, works independently but in cooperation, and they are divided into different organizational departments within themselves. For instance the organization of Compliance and Internal Control is structured as; Compliance and Internal Control Group, Internal Control Department, Legislation and Compliance Department, Operational Risk and Information Security Department, Client and Production Security Department and Treasury Front Office Department. It is also notable that internal control and compliance components have been organized separately. In internal control organization, daily, weekly, monthly or quarterly controls related to critical activities in branch or general management departments are conducted by Branches Control Department included in Internal Control Department and General Management Control Department. Moreover, within Legislation and Compliance function, there are Legislation Department and Compliance Department in accordance with Internal Systems Regulations of BRSA.

YapıKredi Bank, the other bank examined in this study, was established in 1944. Today, it is positioned as the fourth largest privately owned bank in Turkey by asset size. Its shares have been listed in BIST since 1987.

During the process of adopting Basel II standards executed under the control of BRSA, a significant substructure has been prepared in terms of capital adequacy and other evaluations made by BRSA on banking sector. The bank also performs follow-up audits, as well as spot audits, and these audits not only include branches but also other partnerships.

Including all branches, units and partnerships subject to consolidation, Internal Control Systems, which are qualified and efficient in accordance with principles and regulations have been established in the bank. They aim at monitoring risks and providing controls. The units of Internal Audit, Internal Control and Risk Management included in internal control systems function under Audit Committee in the organizational structure of the Bank. These units report to Board of Directors quarterly through Internal Systems Supervisor and Audit Committee.

Internal Control activities in YapıKredi Bank are conducted under the management of Audit Committee in different periods and this allows taking necessary actions. In order to increase the efficiency of tracking activities and expedite the implementation of measures for critical audit results in the bank, Internal Audit Monitoring Unit has been established. Being established outside of internal audit, this unit allows internal audit to be monitored and has undertaken an audit function including partnerships at the same time. Furthermore, so as to increase control in branches, a separate monitoring unit that tracks branches has started to operate.

Another unit in the bank, aiming at removing, detecting and taking necessary measures against any external risk, is the Anti-Fraud Unit. The Anti-Fraud Unit has conducted periodic controls throughout the year and in this respect, suspected cases of internet banking, fraud transactions in ATM and call centers, and also credit card losses have been detected and prevented.

Garanti Bank established in 1946, is the second largest private bank in Turkey. Providing services in all business lines including payment systems, retail, commercial, corporate, SME, private and investment banking is an integrated financial services group together with its eight financial subsidiaries.

Audit Committee is charged with the efficiency and competence of internal control, risk management, internal audit systems of Garanti Bank. It is also responsible for the operation of these mentioned systems and reporting systems in accordance with related regulations and protecting the

integrity of generated information. In addition, whether the financial reports reflect the truth or not, and their compatibility with the legislation is under the responsibility of the monitoring committee.

In Garanti Bank, an Anti-Fraud Committee has been established within internal systems unlike other banks. Therefore, another function has been implemented to prevent losses arising from any kind of fraud or deception. Another unique function is Safe Operation Unit. Operational transactions are certainly one of the channels that are open to abuse in banks. Therefore this unit strengthens the control of operational transactions and prevents possible abuses. Anti-Fraud Committee, offers opinions and suggestions to Safe Operation Unit about implemented strategies and measures against attempts and acts of fraud caused by external factors.

Internal controls in Garanti Bank function under the Board of Directors and Risk Management Directorate, Internal Control Center, Compliance Management, Safe Operation Management and Inspection Board work independently from executive units but in cooperation. Aforementioned systems are under the roof of Audit Committee and report directly to the Board of Directors. At this point, Audit Committee is in charge of establishing an internal control system to prevent possible errors in the financial reports of the Bank due to fraud or error.

Internal Control System is a process which allows the activities of Garanti Bank to be carried out within the framework set by the Board of Directors and in accordance with legislation and regulations. Internal Control Center carries out actions aiming at improving control activities and internal control environment on the basis of “operational matrix”. Thus, throughout Garanti Bank, operational risks maintain integrity within information such as effect, probability and current process and they may be monitored by adopting a risk-based approach.

Internal Control Center provides a reliable internal control environment and its coordination and in accordance with management strategy and principles, implementation of banking actions systemically, efficiently and effectively within current legislation and regulations. In this respect, some infrastructures are established to identify exposure risks and monitor them. The role of internal control does not differ from other Turkish banks; however, it also plays an important role in disaster management and business continuity processes. Garanti Bank coordinates responsible units throughout the bank in contrast to other banks in Turkey.

The banks in Turkey demonstrate similarities in terms of internal control practices regarding basic international standards. Concentration areas of internal control have been submitted to banks as a strategy plan by regulators in accordance with internal systems regulations prepared by international standards and accepted. Sub-units and organizations of internal control units show differences among banks.

This study, examining the internal control mechanisms of the Turkish banking sector, has revealed a distinctive feature which is the emphasis given to process controls. It may be assumed that the separation of internal control function and internal audit function has a significant impact on this finding within the implementation of internal systems in Turkey.

## **VI. Internal Control Practices In the World**

Although internal systems in Turkey are adapted in accordance with successful examples throughout the world, related banking literature and international standards, the banks examined in this study demonstrate differences from internal control practices in the world. In Turkey, internal control activities feature a process-oriented structure whereas multi-national bank examples examined here focus on financial reporting.

The Bank of America Corporation (BoA) is an American multinational banking and financial services corporation headquartered in USA. BoA holds audit committee responsible for internal systems, too. Audit Committee is a Board committee. On the other hand, Compliance and Operational Risk Committee, Ethics Oversight, Financial Crimes Governance, Global Compliance Committee, Internal Governance and Control Committee and Operational Risk Leadership Committee function under the Board of Directors. BoA offers a more diverse structure than practices in Turkey regarding board of directors committees within banking internal systems. The units of internal systems function under Audit Committee as in Turkey.

The main responsibility of Audit Committee, acting on behalf of the Board of Directors, is to allow management to dominate banking activities in terms of risk control and management.

Audit Committee informs Board of Directors about the accuracy and compliance of the Bank's financial reporting and efficiency of internal control system. The responsibility of the Committee is the same with Turkish practices and regulation on internal system which outlines internal control, has been prepared with reference to international standards and practices throughout the world.

Bank of America adopts the framework of Internal Control published by Treadway Commission within Committee of Sponsoring Organizations (COSO) for reporting its financial activities. The risk of weakness that might initially emerge in financial reporting through audit by internal control is investigated, and then the success of internal control systems in measuring risk-based activities through independent audit is tried to be discovered.

Not only does internal control framework cover processes in the bank, it also focuses on financial reporting. It is also the same for Deutsche Bank.

Deutsche Bank is a European centered financial institution operating internationally. The bank has established Risk Committee and Audit Committee and monitors internal systems in the charge of the committees. Audit Committee is responsible for financial oversight, internal control, risk management, internal audit and compliance.

Deutsche Bank also has established internal control mechanism and provided control of board of directors over activities. The responsibilities of internal control activities regarding financial reporting have been allocated to a highest level executive such as Co-CEO or CFO, providing reasonable assurance within the framework of IFRS.

Internal control framework is in charge of controls over financial reporting as well as disclosure and presentation of financials, consolidation and control of other periodic reports, process controls of valuation and IPV (independent price verification), safeguarding of bank assets, internal and external reconciliation control, design and practice of accounting rules.

The bank has established a process which is called ICOFR (internal control over financial reporting) regarding financial reporting. The process has been established to prepare consolidated financial reports for external reporting. ICOFR also includes the process of controls on public disclosure of financial reports and accounting error prevention. The design of ICOFR process has been prepared with reference to internal control-integrated framework publication of COSO.

The objectives to be achieved within the process are specified as existence, completeness, valuation, rights and obligations and ownership, presentation and disclosures, safeguarding of assets. ICFOR processes include functions of Finance, Group Technology and Operations, Risk, and Group Tax.

Board of Directors and relevant committees held several meetings in 2012 to assess the effectiveness and efficiency of internal control activities. In addition, relevant auditor reports and regulatory authority reports were also assessed.

Both these globally important financial institutions have established internal systems structure similar to the ones in Turkey. The analysis of internal systems in both global and Turkish banking process has demonstrated that those systems function directly under the board of directors through a committee. In accordance with the principles of corporate governance, the members of audit committee in publicly traded Turkish banks are considered as independent members in contrast to global examples. In addition, they undertake more public interest responsibilities than the other members of the board of directors.

While apex organization of internal control systems differs from global banking process in this respect, basic organization focuses on safeguarding of assets and process controls. Moreover, it is also notable that the major responsibility of internal control is to ensure reliability, integrity and accessibility of financial information. On the other hand, it is also important to note that the focus on financial reporting in global banking process has been analyzed in this study.

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## **VII. Conclusion**

Since financial markets has become more dependent and interactive at present due to globalization, implementation of modern practices and procedures related to internal control systems appears to be an obligation rather than a necessity, considering the objectives set by Turkey in order to participate in European Union, and considering the current regulations raised by international institutions and risks of our developing economy.

Accounting and auditing scandals throughout the world and a number of Turkish banks transferred to SDIF as a result of 1994 and 2001 banking crises demonstrate that poor internal control, risk management and corporate governance approach may result in major losses for both corporate and economies. On the other hand, studies done in this field point out that current internal control system can provide a reasonable assurance to corporations on discovery of errors and risk prevention.

As a result of “Banking Sector Restructuring Program” set out in Turkey in 2001, important reforms were carried out and Turkish banking system has gained a positive structure. The recent financial crisis reinforces this argument. Turkey has become the sole OECD member country which has been able to continue its activities without being supported without an additional funding by the state in this U.S.-based crisis.

Another fundamental change providing banking sector with this significant resistance function, certainly results from the changes on banking internal systems. Internal systems initially enacted by Law no.4389, dated 1999, have gained reliable provisions by the Banking Law number 5411. Furthermore internal systems have established a compulsory, reliable and fundamental presence in banking corporations through regulations renewed by BRSA considering current requirements.

BRSA last renewed related regulation in 2012 and created an advanced implementation area which is extremely close to international standards. We have tried to analyze the internal control systems of some banks in our country and we have reached some conclusions as follows;

- It's been observed that even though the banks share the same general framework related to the Law and regulations, each bank has made some alterations specific to their own structure. This situation allows the banks to provide aforementioned flexibility and an efficient and practical system.
- When both BRSA principles and banking practices are evaluated on an annual basis, it is understood that internal control approach is continuously changing and improving in terms of requirements emerging as a result of economic, political, social and environmental and such changes and developments.
- Internal control activities have been gaining a much more important presence in banking practices as the time passes. Additionally, it is also worth mentioning that modern internal control system approach has started to gain importance instead of traditional approaches and methods. It is also clear that the banks have been trying to improve and put forward distance and central internal control practices through reducing centralized audit and control functions. Establishment of an internal control organization in which the participation of all employees

including top management who uses computer-assisted audit techniques and tools intensively within modern internal control practices, fulfills the requirements of modern, systematic and risk-based proactive audit, establish permanent audit structures and adopt control self-assessment practices, take risks for the bank to achieve its mission and general objectives into internal control process, has been the main priority for each bank in this regard.

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