

## THE DEVELOPMENT OF THE ORGANIZATIONAL FORMS OF INTERNAL CONTROL IN THE CONTEXT OF THE JOINT STOCK COMPANY EVOLUTION

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Development of organizational forms of internal control in the conditions of joint-stock company evolution is presented. It is shown that joint-stock company evolution is the precondition of formation of a modern corporation in Russia. In the article the author considered the purposes and functions of organizational forms of internal control, the problems and the prospects of their development.

The present paper observes the development of the organizational forms of internal control under the conditions of joint-stock company evolution. Joint stock company evolution is proved to be a prerequisite for the formation of an actual corporation in Russia. The purposes of the organizational forms of the internal control functions, as well as problems and perspectives of their development are considered in the context of this paper.

Under the conditions of economic reforms in this country, the market environment is rapidly changing towards aggravation of competition and its transition into the form of hyper-competition; increase of external environment uncertainty; increase of quick-change risks set; aggravation of business sensitivity for external and internal environment changes; increase in the volume of business and its diversification; companies reorganization through merger or takeover; domestic business integration into multinational corporations<sup>1</sup>.

In consequence these factors affect the complexity of business processes and company process management is increasing, therefore, increasing is the role of control. Control as a function of management implies estimation and analysis of company performance. Control allows to estimate the degree of the company's pursuing its objectives and the necessary adjustment of the target actions. Control binds all management functions together.

Control (from French *conrole* - check) is the process ensuring the system's achievement of its objectives that consists of three basic elements:

- ◆ establishment of system performance standards being subjects to control;
- ◆ measurement of the results obtained and their comparison with the results expected;

◆ updating of the administrative processes: should the achieved results differ essentially from the established standards 2.

We shall define the concept of "internal control". Till now there hasn't been introduced a unified view of the organization "internal control" concept content. The references contain various definitions of internal control, such as: a means, a function, a factor, a form, a kind of activity, a condition, a method, a phenomenon.

We use the definition established by the Treadway Committee technique (The Committee of Sponsoring Organizations of the Treadway - a U.S. private-sector initiative, formed to provide higher degree of reliability and integrity of information provided by the security markets issuers):

"*Internal control* is a process, executed by the Board of directors, the management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- ◆ Effectiveness and efficiency of operations;
- ◆ Reliability of financial reporting;
- ◆ Compliance with existing laws and regulations".

The gist of internal control of a company is revealed through its functions. *The key functions* of internal control of the organization are:

- ◆ *operative* - uncovering undesirable deviations, provision of the duly, authentic information for the urgent decision-making. Allows instant reacting to the negative external and internal factors;
- ◆ *protective* - guaranteeing economic security in terms of resource integrity;
- ◆ *informational* - ensuring information flow to all organization departments in order to make the appropriate administrative decisions, which ensure normal functioning of the controlled object;

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◆ *regulatory* - developing the proposals on the revealed deviations elimination. Facilitates actions, and administrative decisions improvement, as well as “bottlenecks” extension;

◆ *preventive* - preventing undesirable deviations and undesirable consequences of any actions. Internal control is called not only to reveal drawbacks (evidence of swindling, theft, abuse), but also to promote their elimination and exclusion at a later time;

◆ *educational* - ensuring that corporate culture (strict observance of legality, precise officiating, etc.) is shared across the organization.

The interrelated system of independent (external) audit and managerial (internal) control and audit acts in the developing market-oriented economy.

In terms of subordination (supervisory and supervised entities mutual relations) control falls into the following types: structure functional control and internal control and audit.

*The structure functional form* of control provides the development of a regulatory documents package by the organization experts, generally together with external auditors or advisers, regulating the order of the organization structural units and management interaction in implementation of measures of control, result-based drafting, as well as setting actions on elimination of the revealed drawbacks and their implementation control<sup>3</sup>.

This type of control allows continuous system monitoring of safety and effective utilization of all kinds of physical, financial and labor resources based on the management instructions and arrangements, as well as the checks resulting in making managerial decisions concerning particular business lines of separate divisions and their experts.

Internal control and audit is stipulated by hierarchical relations (control impact on the part of a linear or a functional leader). The latter control type exists in the following organizational forms:

- 1) supervision and auditing service (management);
- 2) an auditing committee;
- 3) internal control service;
- 4) internal audit service;
- 5) Board of directors audit committee.

An organization may have some other control and audit services, with the object of their interest being beyond financial matters. Thus

we can mention, for instance, the IT department of control and audit, the Department of ecological audit, the Department of quality audit, etc. The subject of our research is financial control (hereafter control).

Apart from the organizational forms listed above, the control function is also implemented by economic security service, both by the Accounting and the Legal department, and the Service of organizational development.

The presence of one form of control does not signify uselessness of the others. For example, the company may practice the following variant: the auditing committee and the internal control service, with the internal control service performing functions of the control-auditing service and the internal audit service.

Within the framework of the theory of organization development we shall determine the stages of the corporate management system formation in Russia and we shall define how the organizational forms of control correspond to these stages.

The history of joint-stock companies in the form of syndicates and trusts in the Soviet time (1921 - 1923) dates back to the New Economic Policy, which, in turn, caused organization of control within them. The introduction of the 1923 Civil Code fixed legislatively the initiation of an auditing committee as the internal control body.

With joint-stock companies liquidation, auditing committees in organizations remained. In addition to those the bodies of public inspection functioned. Internal control in the Soviet period was effective enough: massive abuse was nipped.

Economic and political changes in Russian Federation in the beginning of the 1990s resulted in essential reorganization of the control bodies system. Particularly, the public inspection bodies were abolished in 1990<sup>2</sup>.

The precondition for a modern corporation formation in Russia was joint stock company evolution. Privatization and corporization of the state ownership marked the beginning of this process.

Joint stock company evolution resulted in the development and improvement of a corporation as a form of the organization of entrepreneurship activity. We assume there are five stages of joint-stock company transformation in Russia in the post-perestroika period.

Stage 1 (the beginning of 1990s - approx. 1995). The implemented privatization and Pay-SOP of the state enterprises promoted restora-

tion of joint-stock companies, thus the structure of the proprietors of joint-stock companies arose spontaneously. The enterprises property belonged to the large set of the shareholders (minority shareholders). As the functions of possession and management were combined in one person, the control service full-function activity was not required, i.e. the internal control in its organizational form was practically absent. Yet the structure functional control left from the planned economy continued its existence, though it was not so effective.

Stage 2 (approx. 1995 - the end of the 1990s). The middle of the 1990s saw the beginning of the intensive process of the joint-stock property redistribution to the advantage of the majority shareholders who tried to intercept and/or take control over the organization. The Federal law "On joint-stock companies" of 26.12.95 № 208-F3 formalized in legislation the obligatory election of an auditing committee in Russian joint-stock companies. The task of these committees involves annual auditing of the organization's financing and operating activities and preparation of the corresponding report for the General Shareholders' Meeting.

The auditing committee is accountable to the supreme management body - the General Shareholders' Meeting.

Along with auditing committees, organizations establish supervision and auditing services, which are aimed at prevention of inefficient use of resources, revealing and prohibition of abuse.

The controllers' basic functions are control and informational ones.

Supervision and auditing service principally assesses the fulfillment of the planned performance, occurred events and their consequences.

When estimating management behavior, auditing of legality and correctness of the officials' actions at realization of operations in accordance to their functional duties is carried out.

The types of audit applied: documentary and complex audit, selective inspections of assets security and accuracy of reporting based on the results of the accounting periods.

The supervision and auditing service is subordinated to top executive management.

Stage 3 (approx. the end of the 1990s - the beginning of 21 century). At the end of 1990s, the concentration of the joint-stock property reached such a level that it resulted in appearance

of some groups of the proprietors or a single proprietor holding the controlling block of stock (the majority proprietors). Joint-stock companies were joining financial markets and gaining strategic partners while attracting investments.

The process of dividing the functions of possession and management began. Enterprises (both private and new established) reached significant scales. This resulted in the first corporations' establishment.

By the turn of 20<sup>th</sup> and 21<sup>st</sup> century, considerable experience of management abuse and the company performance inefficiency had been accumulated, which was the evidence of control crisis meaning the decrease of its reliability. Consequently, there was a necessity to organize such forms of control, which allowed to minimize the risks and raise company performance efficiency. This served as the initiating of the internal control service, whose basic task was business process analysis in order to construct and maintain an effective system of internal control.

The internal control service submits to the linear (operational) management.

Stage 4 (the beginning of 21<sup>st</sup> century - approximately 2005). The major part of medium and large joint-stock companies was transformed into corporations. As a rule, external investors representing large, medium business and foreign companies became a dominant proprietor. The capital was divided into the capital - property and capital - function, hence, there was a need for the company's Board of directors, competent and trustworthy.

To perform its functions the Board of directors requires unprejudiced source of information about the state of play in the company. The board of directors must be confident that managers discharge duties on provision of the reporting reliability, make an effort to minimize risks, organize and support effective internal control and management systems. To do this, audit committees are established within the Board of directors.

Russian legislation does not govern the issues of these committees creation and functioning. The information on the audit committee performance can be found in the Corporate Code of Conduct drawn up by Federal Commission on the Securities Market (FCSM) in 2000.

In the general case, the auditing committee key functions are as follows:

- ◆ control of financial data reporting preparation processes and procedures;
- ◆ control of reliability and efficiency of the internal control and risk management systems;
- ◆ working up recommendations to the Board of directors on a choice of an external auditor;
- ◆ provision of conditions necessary for internal audit effective functioning.

Since the audit committee does not perform any checks, there is a need for creating an internal audit service.

Here is the definition of internal auditing given by the Institute of Internal Auditors: "Internal audit is an activity on granting independent and objective guarantees and consultations aimed at improvement of organization performance. Internal auditing helps organizations achieve their stated objectives by applying systematic methodology to analyzing and improving business processes, risk management, control and corporate governance".

This definition covers the basic characteristics of internal auditing: independence, objectivity, company activities improvement, granting of guarantees and consultations.

Thus, the aim of internal audit creation is the increase of the company performance efficiency.

The key functions of the internal audit system are: supervising, informational and analytical, methodological and consulting.

Supervising function:

- 1) studying, analyzing and monitoring the internal control system (ICS) adequacy and efficiency;
- 2) compliance with the legislation, including regulatory order of sanctioning of business transactions implementation;
- 3) compliance with the internal regulations, including in terms of non-misuse of powers;
- 4) compliance with the legislative and statutory requirements for accounting records maintenance and financial statements forming;
- 5) compliance with the legislative and statutory requirements for tax accounting and recording;
- 6) expediency consideration of managerial decisions made by managers;
- 7) assets availability and preservation auditing;
- 8) finding additional reserves of increasing efficiency;
- 9) interaction with external independent audit and external regulatory bodies.

Information and analytical function:

- 1) informing the management on the revealed circumstances and tendencies;
- 2) consultation on the developing of managerial decisions;
- 3) real assets internal flows analysis;
- 4) blue prints and budget implementation analysis.

Methodological and consultation functions:

- 1) contribution (analysis) towards accounting techniques applied;
- 2) contribution (analysis) towards tax accounting techniques applied;
- 3) contribution (analysis) towards overall performance of the managerial accounting system;
- 4) analysis and contribution towards tariff setting rules;
- 5) units of business consulting on the issues which fall under competence of the internal audit system (IAS).

Stage 5 (approximately since 2005 till the present time). The present stage of corporation development. It is characterized by the following features:

- ◆ corporations strictly toe the line of the global share market;
- ◆ implemented Corporate Code of Conduct, obligations to pay out well-defined dividend, introduced independent chief executives, etc.;
- ◆ internalization of the executive management;
- ◆ corporation is open for investment for anyone wishing to become its co-owner on certain conditions appreciated in advance and guaranteed by the law;
- ◆ advancement of the corporate affairs quality, increase in corporate performance transparency, structure of its proprietors, introduction of international standards of the financial reporting.

Audit committees interacting with all participants of the process start their functioning within the corporation: periodic meetings, coordination of tasks and responsibility of the participants, discussion of vital issues of the financial reporting and questions of the company control.

Companies may comprise various organizational forms of internal control and audit. The decision on the number of control authorities and the forms of control, and internal audit services, in particular, is made by the proprietors or top executive management of the company providing deputation of the appropriate powers on the part of the proprietors. When mak-

ing a decision the following factors for the company are taken into account:

- ◆ possession and management tasks sharing;
- ◆ sizes and structural branching;
- ◆ risk level common to the operation of a company;
- ◆ maturity of control environment.

Intensive development of corporations is currently observed. In Russia, internal audit becomes an important tool of the corporate management efficiency. Internal audit is perspective-oriented, i.e. it implements assessment and analysis of the future events, which may adversely affect business-units and the entire corporation activity.

The following conclusions can be made from the said above. Joint stock company evolution has manifested itself as the precondition of the

modern corporation formation in Russia. With joint-stock company evolution, the organizational forms of control develop and improve. Each stage of joint stock company development is characterized by increase in management complexity and, therefore, by decrease of reliability of the old organizational form of control causing the need for its reorganization.

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