ОБЩЕСТВЕНИ КОМУНИКАЦИИ И ИНФОРМАЦИОННИ НАУКИ
PUBLIC COMMUNICATIONS AND INFORMATION SCIENCES

THE THEORETICAL MODEL OF INTERNAL CONTROL

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Abstract: *Internal control is a process designed to ensure that the corporate objectives defined by top management are achieved. The main objectives are to increase the effectiveness and efficiency of business processes, ensure the reliability of internal and external financial and non-financial reporting, and comply with applicable laws and regulations. Internal control can also be analysed theoretically, in addition to its practical application. The purpose of this article is to analyse the theoretical model of internal control. According to studies, this model consists of three levels: functional, institutional, and instrumental level, which are substantiated by internal control frameworks such as the COSO Internal Control Framework. This article elaborates on these three levels and their relation to internal control. Future work should follow on from this and, for example, extend the theoretical foundation of the construction model of internal control with macro-theories or analyse the model against the background of current internal control legislation.*
Keywords: *Internal Control, management control, risk management, Levers of Control Framework, Three Lines of Defence, COSO Internal Control Framework*

INTRODUCTION

"Internal Control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance" (COSO 2013, 3). This is the definition of internal control according to the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Internal control refers to the principles, procedures, and measures introduced by management in a company to ensure the organizational implementation of management decisions (cf. Bungartz 2020, 23). The objective is to enhance the efficiency and effectiveness of business processes, ensure the reliability of internal and external financial and non-financial reporting, and comply with applicable laws and regulations (cf. COSO 2013, 3). The term and concept of internal control originated from a strongly focused perspective on accounting. Since the early 1990s, internal control has developed towards a broader governance perspective that encompasses the entire organization, rather than solely focusing on accounting (cf. Maijoor 2000, 105). Internal control can be understood as a conceptual model in terms of model theory, which includes the relevant basic thematic concepts and their interrelationships (cf. Hunziker 2015, 29; Amshoff 1993, 77f; Harbert 1982, 140f). The basic concept of internal control is a theoretical construct with corresponding boundaries and delimitations, based on interrelationships (cf. Hunziker 2015, 29; Hahn/Hungenberg 2001, 266). This article analyses the conceptual levels of internal control from a theoretical perspective, using a theoretical model. Subsequently, this article will categorise tasks and functions as internal control from a theoretical model perspective and differentiate them from other aspects. The conclusion will summarise the key findings and provide an outlook for future research.

RESEARCH METHODOLOGY

When establishing concepts in business administration, it is recommended to use a multidimensional subdivision of the scientific construction model. This includes a functional, institutional, and instrumental level (cf. Winter 2008, 7f; Becker 1990, 300, 313). The following figure illustrates the three model-theoretical levels in a sequential order and provides definitions for each level of the model (adapted from Hunziker 2015, 29; Ossadnik et al. 2010, 18ff; Wall 1999, 18f):

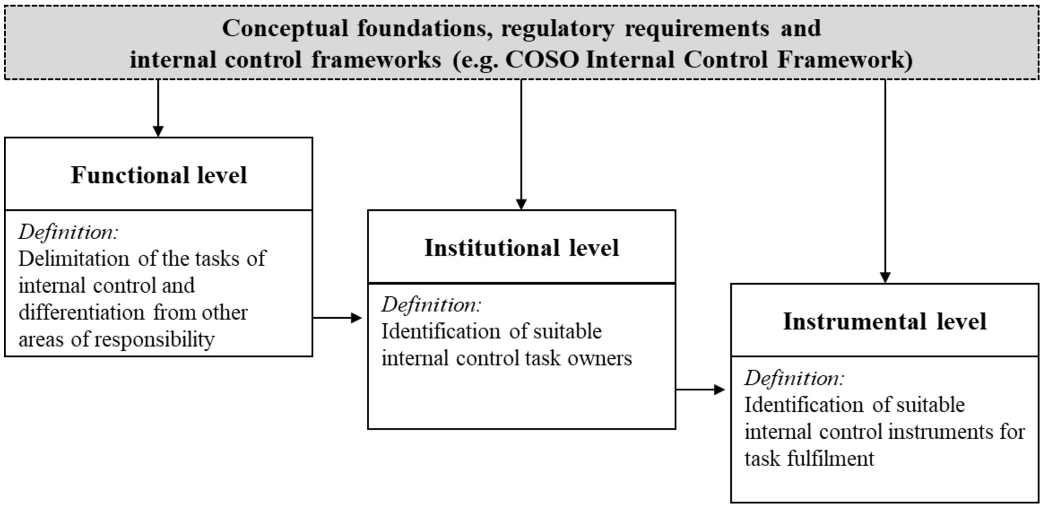

Fig. 1. The theoretical model of internal control

The following section analyses the three model-theoretical levels of internal control and provides a comprehensive scientific-theoretical view of internal control.

RESULTS

The internal control's functional level comprises the tasks of internal control. To fully comprehend these tasks, it is recommended to briefly examine the history of internal control. In both research and practice, internal control has traditionally been closely linked to accounting, resulting in a focus on this area for an extended period. Since the early 2000s, the importance of internal control has been steadily increasing (cf. Hunziker 2015, 50). This is due to the fact that internal control is now part of the audit subject matter for auditors, leading to an increase in audits (cf. Hunziker 2015, 50; Holm/Laursen 2007, 323; Power 1997, 67, 83). This led to the so-called "audit explosion" (Maijoor 2000, 101). However, internal control has evolved from a narrow focus on accounting to a more comprehensive approach (cf. Maijoor 2000, 105). This process is driven by dynamic technological developments and competitive pressures in a networked business world (cf. Stringer/Carey 2002, 62f). The construct of internal control has been expanded by modern management approaches. Frameworks for internal control, such as the COSO Internal Control Framework, have been published and some have become a quasi-standard in the corporate world (cf. Hunziker 2015, 50f). Furthermore, the significance of internal control has grown due to regulatory concretisation and tightening (cf. Hunziker 2015, 51). The responsibilities of internal control are described similarly in academic literature, although slight differences between the narrower, more traditional perspective and the broader organizational theory perspective can still be observed (cf. Hunziker 2015, 51; Sommer 2010, 20f). The tasks of internal control are essentially based on the definition provided by the COSO Internal Control Framework (cf. Hunziker 2015, 52). The following figure shows the organisational theory tasks of internal control (adapted from Hunziker 2015, 52; COSO 2013, 3):

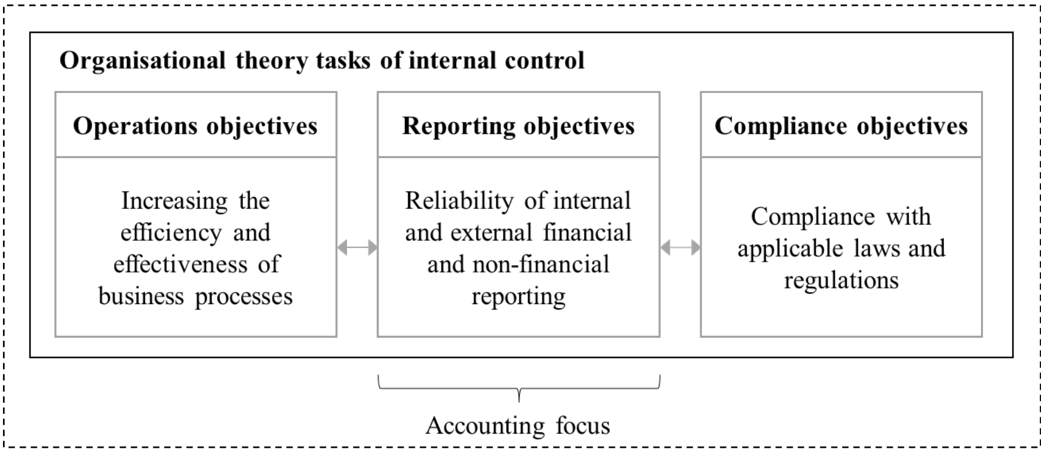

Fig. 2. The tasks of internal control

Corporate governance, management control and risk management are terms that are often mentioned in the context of internal control, but they are thematically and definitionally distinct from it (cf. Hunziker 2015, 66).

There is no generally recognised and uniform definition of corporate governance (cf. Lentfer 2005, 27). The question of a definition can be answered by looking at the core elements of corporate governance: Corporate management and monitoring that is orientated towards the value of the company, exercised by the administrative bodies (internal corporate governance) and by the markets, especially the (equity) capital market, on the basis of reliable corporate reporting (cf. Weber 2011, 29). When examining the various definitions of corporate governance, it is essential to consider the two terms ‘corporate management’ and ‘corporate monitoring’ (cf. Weber 2011, 23). Corporate governance represents a system for managing and monitoring companies (cf. Committee on the Financial Aspects of Corporate Governance 1992, numeral 2.5), which enables the recognition of the relationship to internal control (cf. Hunziker 2015, 67). In the context of corporate governance, internal control is considered as central mechanism for monitoring companies (cf. Rae/Subramaniam 2008, 106; Erfurt 2004, 53ff).

Management control is a term that lacks a clear and universal definition, too (cf. Hunziker 2015, 71). Instead, there are various definitions and concepts of management control that are relatively similar and coexist (cf. Strauß/Zecher 2013, 234; Berry et al. 2009, 2f). Many authors conclude that the two concepts are very similar in terms of content and definition, as they are both mechanisms for allocating resources and achieving objectives (cf. Fadzil et al. 2005, 846; Merchant/Otley 2007, 787). Other authors define internal control as either a concept (cf. Rikhardsson et al. 2005, 13f) or an element of management control (cf. Soltani 2007, 302f). Hunziker compares and contrasts these perspectives, concluding that they are interdependent due to their shared aim of directing employee behaviour in line with the company’s objectives. Furthermore, while they are not involved in the management decision-making process, they do monitor the achievement of objectives and therefore have an indirect influence (cf. Hunziker 2015, 76). However, there are differences between them, as management control is more focused on influencing decision-making, while internal control tends to support it. Management control is more oriented towards strategy, while internal control is more transaction-oriented. Finally, it is worth noting that management control tends to focus on behaviour, while internal control is more mechanistic (cf. Hunziker 2015, 76f; Vaassen et al. 2009, 70).

According to the modern view, risk management is understood as a holistic approach with a strategic focus. This is known as enterprise risk management (cf. Hoyt/Liebenberg 2011, 795). Risks typically arise from a company’s objectives, management processes, and business processes. Risk management aims to control all resulting risks (cf. Hahn 1987, 137ff). This involves identifying, assessing, and controlling individual risks, as well as understanding the interdependencies and effects of these risks on each other. It also includes controlling the overall aggregated risk of the company (cf. Gleißner 2004, 350f, 357f; Romeike/Hager 2020, 87f, 121f, 130; Gleißner 2001, 111, 125f). Additionally, the holistic approach to risk management takes into account non-quantifiable risks (cf. Mikes 2009, 25) and the risk/reward ratio (cf. Farny 1979, 17, 19ff). It guides the company's risk policy and promotes a healthy risk awareness among employees (cf. Rogler 2002, 19ff; Hahn 1987, 139ff). The comparison between risk management and internal control reveals both differences and similarities. Risk management is more strongly oriented towards the company's strategy: it defines the risk policy with risk preferences, examines risk potential, evaluates and manages risks within the framework of the company's individual risk portfolio, and aggregates individual risks at the overall company level. These tasks are not typically included in internal control as strategic risks are generally not managed at the operational business process level. Instead, they usually arise from the corporate environment, which can be complex and difficult to capture through control mechanisms (cf. Hunziker 2015, 84). Internal control primarily manages individual operational risks (cf. Arwinge 2013, 85f; Schartmann/Lindner 2006, 43), while assisting risk management in managing individual operational risks (cf. Schmid/Stebler 2007, 643f). Risk management focuses on both internal and external strategic risks, while internal control focuses on internal risks with a strong process orientation (cf. Hunziker 2015, 85; Arwinge 2013, 88f; Reichert 2009, 28; Ruud/Jenal 2005, 459).

It is difficult to distinguish internal control from management control and risk management due to the absence of universally accepted definitions. In addition to the demarcation, there are overlaps, conditional and complementary connections between the three disciplines (cf. Arwinge 2013, 80f; Power 2007, 60ff; Spira/Page 2003, 651f; Kinney 2000, 83). These connections merge into what is known as the 'control mix' of the company (cf. Hunziker 2015, 87, based on Mikes 2009, 23). Winter (2008, 9) and Chmielewicz (1994, 18ff) recommend that authors choose their approach depending on the research purpose and objective of their studies and publications when engaging in a scientific-theoretical examination of the three subject areas.

The distribution of tasks to internal control task owners constitutes the institutional level of internal control (cf. Hampel et al. 2012, 204). The Three Lines of Defence model (TLoD model) is considered a comprehensive and widely applicable institutional framework and best practice approach for organizing a company's control (cf. Hunziker 2015, 52; Ruud/Kyburz 2014, 761; Eulerich 2012, 55). Particularly in the financial and banking sector (cf. Welge/Eulerich 2014, 60). The TLoD model includes duty bearers and bodies within the internal control and monitoring system, as well as their interfaces (cf. Eulerich 2012, 55ff). It describes the competences and responsibilities of task owners in monitoring for effective and efficient internal control and risk management within the company context (cf. Hampel et al. 2012, 204). The TLoD model is presented below (adapted from Bungartz 2020, 572; Wullenkord/Rapp 2019, 179; Welge/Eulerich 2014, 61; Hunziker 2015, 53):

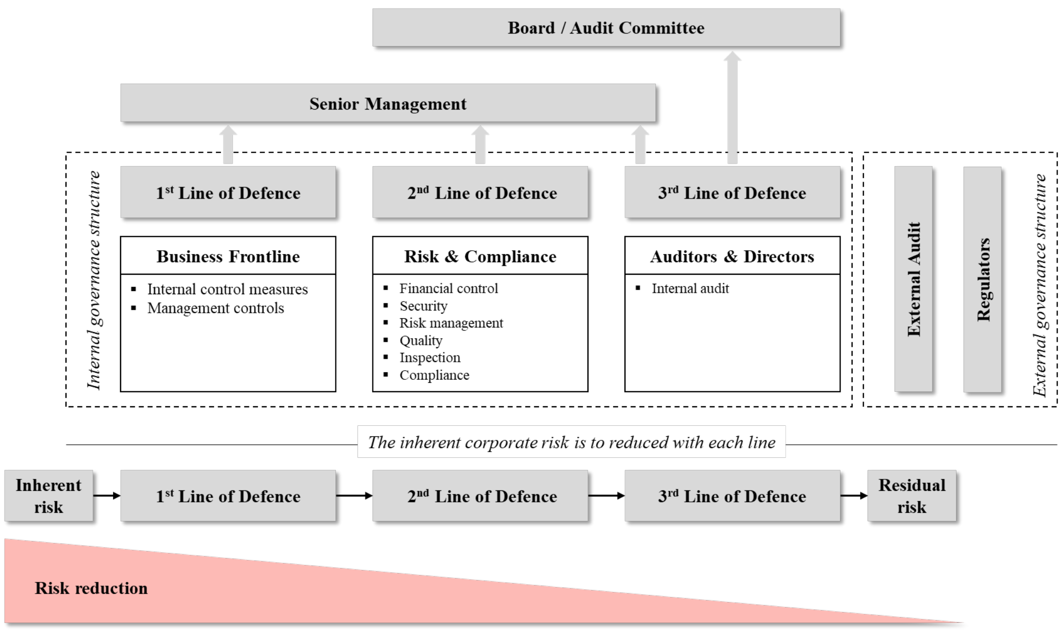

Fig. 3. The Three Lines of Defence model

The first line of defence in the TLoD model consists of conventional controls that are implemented in the operating units. These controls are the responsibility of middle management or the respective specialist departments as risk owners. Their purpose is to mitigate the company's risks at the first level (cf. Wullenkord/Rapp 2019, 179; Schiel 2014, 130; Welge/Eulerich 2014, 61). Regarding internal control, middle management is responsible for the processes and tasks of the operating units. It creates the conditions for effective risk management in the respective units (cf. Wullenkord/Rapp 2019, 179). Middle management identifies, assesses, manages, and monitors these risks on an ongoing basis, contributing to the quality of internal control (cf. Schiel 2014, 130; Lück 1991, 23ff). Therefore, the first line of defence is the foundation of internal control (cf. Eulerich 2012, 56).

The second line of defence regulates and monitors operational controls. This is carried out by various functional units within the company: controlling, risk management, compliance unit, quality management and IT security, but also by human resources and plant security (cf. Welge/Eulerich 2014, 62). The second line of defence units assist middle management or risk owners in implementing effective and efficient risk control structures. They shape the company's risk strategy and policy, create guidelines and directives for risk management, aggregate the control results from the first line of defence, prepare reports for top management and other supervisory bodies, and initiate risk reduction measures if necessary (cf. Wullenkord/Rapp 2019, 179; Schiel 2014, 130; Welge/Eulerich 2014, 62). Here, we can see an interlocking of the two levels (cf. Kreipl 2020, 91; Ruud/Kyburz 2014, 762), which reduces the overall risks of the company once again (cf. Kreipl 2020, 89).

The third line of defence consists of internal audit. It assesses the effectiveness and efficiency of the first two lines of defence (cf. Kreipl 2020, 91). It specifically assesses the suitability, regularity, efficiency, and expediency of the organizational and operational structures of the first and second lines of defence (cf. Wullenkord/Rapp 2019, 179f). Internal audit plays a crucial role in identifying weaknesses in the control system, creating benchmarks, and promoting good corporate practices overall (cf. Kreipl 2020, 91). It serves as an essential interface between the units and bodies of the TLoD (cf. Eulerich 2012, 57f) and occupies a significant position within the TLoD model (cf. Welge/Eulerich 2014, 60). Its role in supporting the achievement of corporate objectives is to systematically analyse and evaluate the effectiveness of internal control within the company (cf. Palazzesi/Pfyffer 2004, 7ff; Meyer et al. 2005, 31f). Internal audit serves as the third line of defence, reducing any remaining risk and detecting any previously undetected risks by the first two lines of defence (cf. Welge/Eulerich 2014, 62).

The internal control's instrumental level includes the mechanisms that a company employs to ensure that its employees implement the strategy defined by top management and achieve the company's objectives (cf. Merchant/van der Stede 2017, 9, 11). This level is linked to internal control, which should also contribute to achieving the overarching objectives (cf. Hunziker 2015, 62; Bungartz 2020, 56; CoCo 1995, 4). As with the two model-theoretical levels of internal control mentioned earlier, there is no universally accepted definition of the control mechanisms and their content (cf. Morris et al. 2006, 474). Instead, there is a wide range of definitions, designs, and attempts at categorization: Direct controls, e.g. budget controls (cf. Morris et al. 2006, 482; Bisbe/Otley 2004, 717) and flexible controls, e.g. principle of self-control and social control (cf. Hunziker 2015, 64; Morris et al. 2006, 472f) or formal control mechanisms that reward desired behaviour, e.g. bonus payments, formal control mechanisms that sanction undesired behaviour, e.g. access controls, and informal control mechanisms, e.g. corporate culture (cf. Feichter/Grabner 2020, 151) or results control (incentive and bonus systems), action control (time targets), cultural control (group rewards), and personnel control (recruitment process) (cf. Merchant/van der Stede 2017, 33ff, 86ff, 95ff, 97ff) or directive, preventive, detective, and corrective controls (cf. Ruud/Jenal 2005, 456) are some examples of non-exhaustive measures. Robert Simons' Levers of Control framework is a widely recognised approach to categorising control mechanisms (cf. Reichert 2009, 37). He identifies four control levers: the value system, which includes fundamental norms and goals; boundary systems, which consist of social and technical restrictions; diagnostic systems, which incorporate feedback systems and business plans; and interaction systems, which involve feedback and measurement systems (cf. Eisele/Steinmann 2015, 182f; Tessier/Otley 2012, 178; Mundy 2010, 505; Henri 2006, 533ff; Simons 1995, 33ff, 95f). The Levers of Control framework, with its four control levers, is intended to serve managers as an instrument for carrying out management and control tasks. To ensure the framework's effectiveness, the four control levers should be used in a balanced and combined manner (cf. Mundy 2010, 502). The diversity and complexity of the control mechanisms can be recognised. The objective is to integrate various control mechanisms within the company, as they are interdependent. For instance, while detective controls identify errors and undesirable events, they alone are insufficient at a holistic level without corrective controls to rectify the situation (cf. Hunziker 2015, 65f; Moeller 2005, 72f).

CONCLUSION

The internal control construction model attempts to theoretically model and depict internal control through its functional, institutional, and instrumental levels. The functional level includes the tasks of internal control, which align with the objectives of the COSO Internal Control Framework: ensuring the effectiveness and efficiency of operational activities, the reliability of reporting, and compliance with laws and standards (cf. Hunziker 2015, 52). Internal control is also delineated at this level: corporate governance is a comprehensive system for managing and monitoring companies. Internal control is a central component of this system. Management control attempts to influence decision-making within the company, while internal control supports the implementation of decisions. Risk management focuses on both internal and external strategic risks, while internal control focuses on internal risks and has a strong process orientation. These two components complement each other. The institutional level of internal control includes the internal control function. The three lines of defence model is particularly important here. The instrumental level of internal control comprises the various control mechanisms in the company that are intended to ensure the implementation of the strategy defined by top management at employee level and the achievement of corporate goals. Future research should utilise macro-theories to expand the theoretical foundation of this internal control construction model for its specific application. Additionally, this scientific-theoretical model should be evaluated in the context of current regulatory requirements for internal control or recognised internal control frameworks used in practice, as both can impact this model. Above all, the empirical validity of this approach is a fundamental consideration.

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ТЕОРЕТИЧЕН МОДЕЛ НА ВЪТРЕШНИЯ КОНТРОЛ

Резюме: *Вътрешният контрол е процес, предназначен да гарантира постигането на корпоративните цели, определени от висшето ръководство. Основните цели са повишаване на ефективността и ефикасността на бизнес процесите, гарантиране на надеждността на вътрешната и външната финансова и нефинансова отчетност и спазване на приложимите закони и разпоредби. Вътрешният контрол може да бъде анализиран и теоретично, в допълнение към практическото му приложение. Целта на настоящата статия е да се анализира теоретичният модел на вътрешния контрол. Според проучванията този модел се състои от три нива: функционално, институционално и инструментално ниво, които се обосновават* *от рамките на вътрешния контрол, като например Рамката за вътрешен контрол на COSO. В настоящата статия се разглеждат тези три нива и тяхната връзка с вътрешния контрол. Бъдещата работа следва да продължи на тази основа и например да разшири теоретичната основа на модела за изграждане на вътрешен контрол с макро теории или да анализира модела на фона на действащото законодателство в областта на вътрешния контрол.*

Ключови думи: *вътрешен контрол, управленски контрол, управление на риска, рамка за контрол, три линии на защита, рамка за вътрешен контрол COSO*

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