Internal Control

**Turnbull Report** 1999 provided guidance for creating strong internal control system and later incorporated into Combined code, it was last revised in 2005 and still present as a standalone document.

**Sarbanes-Oxley** Act (SOX) has very detailed Internal Control requirements.

**COSO** (committee of sponsoring organizations) an American volunteer organization with aim to help executive management to implement effective internal control.

**Combined code principles on IC**

**Financial reporting** the board should present a balanced and understandable assessment of company’s position and prospects.

**Internal control** the board should maintain a sound system of internal control to safeguard shareholder’s investment and the company’s assets.

**Audit committee and Auditors** the board should establish formal and transparent arrangement for considering how they should apply the financial reporting and internal control principles and for maintain an appropriate relationship with the company’s auditors

**Combined Code, Principles C1, C2 and C3**

**Internal Control Management** by definition

Refers to the procedures and policies in place to ensure that company objectives are achieved

Internal Control System has two parts

**Control environment** is the overall philosophy of the company to internal controls

**Control Procedures** provides the detailed controls implemented in an organization.

- Are devised to ensure the orderly and efficient conduct
- Must be enabling to respond to both internal and external risks.
- Key risk oriented and provide response to the challenges

**Internal Control and Risk Management in Corporate Governance**

According to Turnbull Report effective IC Improves organizational effectiveness and efficiency, financial controls are key elements of internal control as they ensure mitigation of fraud risks.

Muhammad Aleem Arif
As company’s environment is always changing so internal controls must also be changed to reduce risks faced by the organization but risk can’t be eliminated totally.

**Risk Management and Corporate Governance.**

<table>
<thead>
<tr>
<th>Combined Code Requirements</th>
<th>Management of Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The directors are responsible for investor’s and business assets protection</td>
<td>• The company should protect itself from all risks of accidents and their “damages”</td>
</tr>
<tr>
<td>• Protection spans losses of error, omission and fraud</td>
<td>• Board should ensure the risk monitoring system is there</td>
</tr>
<tr>
<td>• Must take such steps so such events do not occur</td>
<td>• The system will guide management to take account of risks</td>
</tr>
<tr>
<td>• In short the Board should implement such system which give shareholders interests a total protection</td>
<td>• The board will ensure assessment of risk and returns of their decisions</td>
</tr>
</tbody>
</table>

**Internal Controls As Defined By COSO**

“A process affected by board and management’s decisions this process is designed to provide reasonable assurance regarding the achievement of objectives in effectiveness and efficiency of operations reliability of financial reporting, and compliance with applicable laws and regulations”

**Internal controls and COSO**

IC seems to apply to three categories of the business

1. Effectiveness and Efficiency of Operations
2. Reliability of financial reporting
3. Compliance to the legislation

**Objectives of IC**

A good IC system means better Risk Management Strategy of the Company

According to Turnbull Guidance, an internal control system encompasses the policies, process, tasks behaviors and other aspects of the company so that

- To facilitate it to enable to respond to significant risks
- Safeguard companies assets from misuse and losses, and liabilities are managed
- Ensure quality of internal and external reporting to its financial performance
- Helps to deal with legal issues

**Controls can be Achieved by Different Methods**

- A system of reward and discipline
- Feedback and feed forward
- Making contractual relationships, to clarify duties
- A clear organizational command structure
Elements of Internal Controls

Control Environment
It describes Ethics and values of the company and includes the following elements

- Management’s philosophy
- Organizational structure
- Authorities and responsibilities
- Policies related to Human Resource
- Management should back their implemented controls
- There must be controls related training
- Recruitment process must support the future control environment requirements
- Internal audit will verify internal controls
- Duties must be segregated

Control activities
These are policies and procedures that ensure that decisions are taken and instructions are carried out, they occur at all levels of organizations.

Types of control activities

- Comparison
- Authorization
- Reconciliation
- Computer controls
- Arithmetical
- Physical

Are the activities to protect assets and enhance the reliability of internal control mechanism.

Risk Assessment
Risks are of two types

- **Controllable** can be handled by control procedures, and
- **Uncontrollable** are tried to minimize rather than just leaving spare these are because of external environment of the organization.
Monitoring and information and communication

The company might have developed a good internal control mechanism but it must be examined that they are being used and what is their valuation, and for evaluation monitoring is necessary, because things behave different in real world as planned in theories,

The company must also provide its management with Timely, Accurate, Understandable and Relevant to the demand of the management, as to enable managers to operate in an effective internal control system there must be a good information system

Features of a “Sound” Internal Control System

- Principles of IC must be embedded with organization structures and must demonstrate it with its own action of biding controls
- Internal Control System must be capable to quickly respond to emerging risks
- Must include the procedures for reporting bugs and failures to the appropriate management level, along with a corrective proposal,

Limitations of Internal Control

- Human Error
- Poor judgment of management
- Control system being deliberately circumvented by employees e.g. collusion
- Management itself overriding the controls
- Unforeseeable and unpredicted events
- Cost VS benefit in sight of employees

Typical reasons of Internal Control Failure

(Above mentioned limitations are typical reasons for internal controls failures)

Executive Management’s Role in Risk Management

It’s not only executive management’s responsibility to develop internal control system, in fact it’s the duty of each employee to monitor and sustain maintain internal control mechanism.
The Combined Code and Turnbull Guidance make it clear the Board’s duty for system of internal control implementation, the BOD should seek a regular assurance on internal control system’s effectiveness.

Turnbull Report guides that in determining the IC policies of a company following should be considered:

- The nature and the risk face by the company
- The extant and category of the acceptable level of risk
- The likelihood of the risks materializing
- The company’s ability to reduce the incidence, and the impact of risk that do materialize
- Cost and benefits from the implementation of specified controls and take that risks

**Turnbull Report**

Internal Controls should be established using a risk based approach (Establish objectives > identify risks > decide controls > implement Controls > monitor Controls).

Board should:

- Set appropriate internal control policies
- Seek regular assurance that the system is functioning.
- Review the effectiveness of the IC System
- Provide Disclosure in Annual Reports

Management should:

- Implement board policies
- Seek regular assurance on proper working of system

<table>
<thead>
<tr>
<th>Role</th>
<th>Responsible</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ensuring adequacy and effectiveness of internal control management</td>
<td>Board of Directors</td>
</tr>
<tr>
<td>• Setting normal control policies</td>
<td>Senior Executive Management</td>
</tr>
<tr>
<td>• Monitoring effectiveness of internal control system.</td>
<td></td>
</tr>
<tr>
<td>Establishing specific internal control policies and procedures</td>
<td>Heads of Business Units</td>
</tr>
<tr>
<td>Operating and adhering to internal controls</td>
<td>All Employees</td>
</tr>
</tbody>
</table>

**Sarbanes-Oxley Act-summery of responsibilities**

The Sarbanes act (SOX) also sets out responsibilities regarding risk management. However, in direct contrast to other corporate governance systems, remember that these responsibilities are statutory.

Muhammad Aleem Arif
rather than guidance. The comments below relate specially to the s404 requirements of SOX, i.e. the audit and reporting of internal control systems within a company.

In SOX terms, management refers to the board, with specific emphasis on the CEO and CFO.

**Management**

Learn about the system of internal control in place.

Evaluate the effectiveness of both the design and effectiveness of that system. Prepare a written assessment, at the year end, on the effectiveness of internal control which must be included in the company’s annual return.

**Independent Auditor**

Express an opinion on management’s assessment of the effectiveness of internal controls in the company.

Verify that management’s assessment is correct by independent testing of the controls system.

Express an opinion on the financial statements of the company.

**Embedding Internal Control**

All employees have responsibility for internal control and this tone needs to be set by management, who must be seen to be abiding by the controls they have to put in place.

**Internal Audit & Audit Committee**

**Internal auditing** is a profession and activity involved in helping organizations achieve their stated objectives. It does this by using a systematic methodology for analyzing business processes, procedures and activities with the goal of highlighting organizational problems and recommending solutions.

**Role of Internal Audit Department**

- Reviewing Accounting and internal control system.
- Assisting with the identification of significant risks.
- Reviewing Economy Efficiency and effectiveness of operations.
ACCA P1 Internal Control

- Examining Financial and Operating information.
- Special Investigation e.g. into suspected fraud
- Reviewing compliance with laws and other external regulations

Factors Considered while determining the need of Internal Audit
- The scale, diversity and complexity of the company’s activities
- The size of the organization with respect to number of employees
- Cost and Benefit Analysis
- Changes made to the structure of the organization will enhance the internal audit requirement
- PESTEL and competitive environment might change the need of internal audit
- Any problems in existing internal control system will give rise to internal audit requirement
- Any indication in weakness of internal control system will require internal audit

Types of Audit Work

Value for money audit
The 3 Es

1. Economy
2. Efficiency
3. Effectiveness

Social and environmental audit
An environmental audit is defined as

“a management tool comprising systematic, documented, periodic and objective evaluation of how well organization, management, equipment is working, with the aim of safeguarding the environment by facilitating management control of environmental practices and assessing compliance with company policy and regulatory requirements”

Environmental reports
It is a report often included in annual reports by many companies sometimes accompanied by ‘auditors’ statement.

It contains following information

- Sustainability
- Targets that are achieved so far
- Compliance with regulations
- Emissions
- Obtaining environmental management system ISO 14001

Muhammad Aleem Arif
Social auditing
Directors can include a social report describing company’s contributions to the society and community like Donations, Sponsorships, Health and Education,

Management audit
An objective and independent appraisal of the effectiveness of managers and corporate structure in the achievements of entities’ objectives and policies, With aim to identify existing and potential weaknesses in management and along with rectification recommendations. Also known as operational audit this type of audit requires specialized skills and experience and professionals

Independence of internal audit function
A key issue is the independence of internal audit function

As internal auditors issue an opinion on the effectiveness on internal controls so there is independence is also important for the shareholders trust. Practically they can never be 100% independent because of following reasons

- Relationship to their colleagues might hinder them to report fraud
- They might not try to upset their ultimate bosses (directors)
- Might not report problems in protecting business’ image and ultimately their jobs protection can be a problem
- As dependents on the company they can be perused to keep quiet or they can be intimidated
- Directors might ignore report which criticize them

Threats to Independence of Internal Audit Function
Independence is the freedom to carry out work in an unbiased manner with access to all information and freedom of drafting an opinion

There are number of threats to the internal audit function, the following are identified by ACCA code of Ethics and Conduct.

Self-Interest--- This arises when personal stake is involved.

Self-review--- This occurs while review self designed controls.

Advocacy---This is where the auditor promotes the client to the point that their subjectivity may be compromised.

Familiarity---When a close personal relationship with an officer in the company is developed.

Intermediation---This occurs when the auditor is deterred from acting objectively.

When these threats arise auditor should try to eliminate or reduce them to an acceptable level by
1. Either withdrawal from engagement team or terminating financial or business relationship

2. Discussing issues with top management of firm or client.

**Reporting Structure**
- The internal audit functions should report to the audit committee, mainly made up of independent NED’s
- The chief internal auditor should have access to chairman
- The internal auditor team are bin house employees.
  - These shouldn’t have operation duties neither have performed them accordingly to avoid self review.
  - Ideally there must be family or personal no ties to operational staff.
- When it is outsourced.
  - Firm should be rotated after reasonable intervals.
  - The outsourced firm should not perform too many services to the client.
  - Fee levels should be monitored to avoid dependence.

**Standard of Work**
Internal audit function would be expected to carry out their work to a high professional standard.

They should be well managed and have clear and appropriate procedures and audit plan should be revised annually.

For conducting good Internal Audit
- Planning should be performed.
- Objectives should be set for the engagement.
- The work should be documented, supervised and revised
- Results should be communicated to management.
- Recommendations for action should be made.

Audit committee is committee at the BOP consisting mainly of independent NED’s (at least three in large companies) for one must have recent and relevant financial experience.

The key role of A.C is oversight “assessment” and review of the other functions and systems in the company.
**Role of Audit Committee**

**Financial Statements**
Monitoring integrity of the FS, check the clarity and completeness of disclosures in financial statements regarding financial performance

**Review controls**
Internal controls, risk management and internal financial controls

**Internal Audit**
- Monitor effectiveness,
- ensure accountability to the audit committee,
- ensure CIA has access to chairman,
- meet CIA at least once without management presence,
- ensure management recommendation action
- Review and assess the internal audit plan,
- Approve appointment,
- Termination of CIA pressure independence
- Monitor and assess the role and effectiveness of the internal audit function in the overall context of the company’s risk management system.

**External Auditors**
The audit committee is responsible for oversight of the company’s relations with its external auditors

- Recommendations for appointment
- Re-appointment and approval
- Recommendations for remuneration and terms of engagement.

Remember the approval of the above has to be given by the shareholder at the AGMI.

- Review and monitor independence
- Develop and implement policy on EA providing non-audit service
- Review qualification and expertise of the EA
- Review the scope of the audit with the auditor and satisfy with itself that this is sufficient
ACCA P1 Internal Control

- Make sure that appropriate plans are in place for the audit at the start of each annual audit and carry out a post-completion audit review.

The audit committee should also review the procedure in place for whistle-blowing within the company. There should be agreement in place for improprieties at the organization and for these concerns to be independently investigated and action-taken if necessary.

If the company doesn’t have an internal audit functions

- The committee should consider annually whether there is a need for an internal audit function
- Make a recommendation to the board and the reasons for the absence of an internal audit functions should be explained in the relevant section of the annual report.

The audit committee strengthens the independence of the internal and external audit functions by

- Taking appointments and fee-setting out of the hands of executive directors
- Ensuring that the company, as well as the audit firms, is considering independence.

An audit committee can raise the profile and importance of the audit, internal control and risk management in an organization.

Note: These notes are skimmed reading for the session to be held on Tuesday, 28th Oct as an epitome of the covering topic; we recommend full reading from book and relevant material for complete and enhanced understanding.