Alternative approaches and techniques to enhance internal controls

28 November 2005

PRICEWATERHOUSECOOPERS

Agenda

- Introduction
- COSO internal control framework
- Approaches adopted by leading organisations to enhance internal controls
  - Control Self Assessment
  - Integrated linkage of business risks to process documentation and testing
  - Compliance frameworks
- Q&A

Introduction

What is Internal Control?

Internal Control is a process, effected by an organisation's board of directors, management and other personnel, to provide reasonable assurance regarding achievement of objectives in the following categories:

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

- COSO –

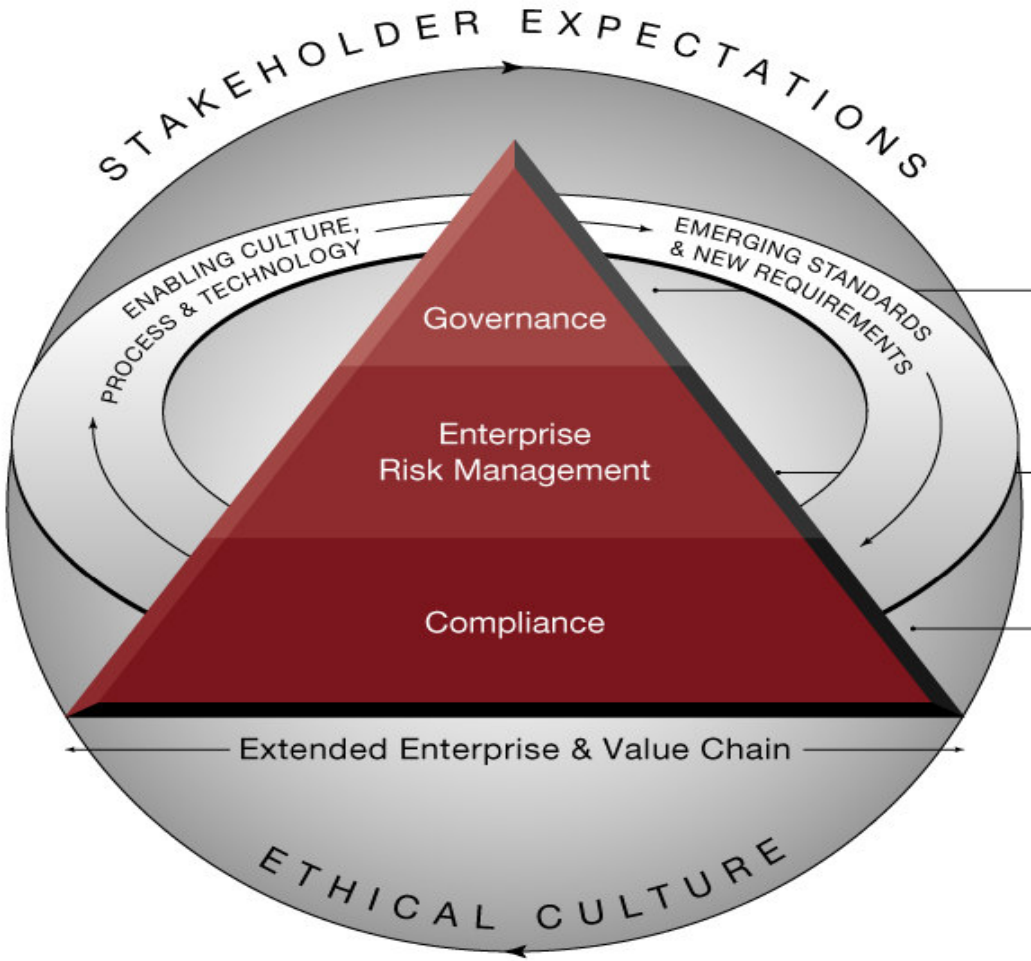
Objectives fall into three categories:

1. Operations – relating to effective and efficient use of the entity's resources
2. Financial reporting – relating to preparation of reliable published financial statements
3. Compliance – relating to the entity's compliance with applicable laws and regulations

What are the key concepts of Internal Control?

- Internal controls are most effective when “built into” operating activities
- People at every level in the organisation have responsibility for internal controls
- Internal controls cannot provide absolute assurance
- Internal control is a major component of an effective corporate governance framework
- An integrated internal control system will not be effective without an entity-wide approach to corporate governance, risk management and compliance.

An integrated view of governance, risk management and compliance



Setting objectives, tone, policies, risk appetite and accountabilities. Monitoring performance.

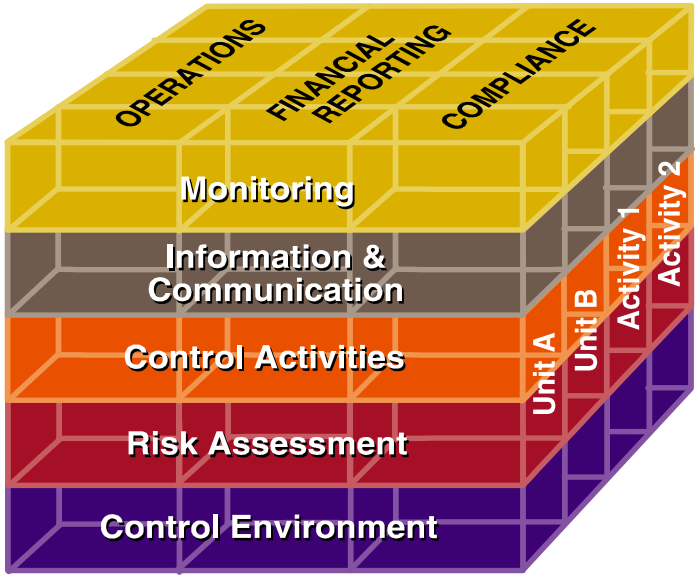
Identifying and assessing risks that may affect the ability to achieve objectives and determining risk response strategies and control activities.

Operating in accordance with objectives and ensuring adherence with laws and regulations, internal policies and procedures, and stakeholder commitments.

COSO Internal control framework

COSO internal control framework

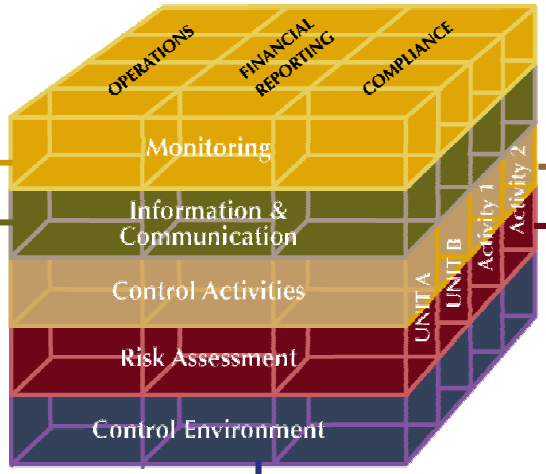
COSO identifies five components of internal control that need to be in place and integrated to ensure the achievement of each of the objectives.



Components of the COSO framework

Monitoring

- Assessment of a control system's performance over time.
- Combination of ongoing and separate evaluation.
- Management and supervisory activities.
- Internal audit activities.



Control Activities

- Policies/procedures that ensure management directives are carried out.
- Range of activities including approvals, authorizations, verifications, recommendations, performance reviews, asset security and segregation of duties.

Information and Communication

- Pertinent information identified, captured and communicated in a timely manner.
- Access to internal and externally generated information.
- Flow of information that allows for successful control actions from instructions on responsibilities to summary of findings for management action.

Control Environment

- Sets tone of organization-influencing control consciousness of its people.
- Factors include integrity, ethical values, competence, authority, and responsibility.
- Foundation for all other components of control.

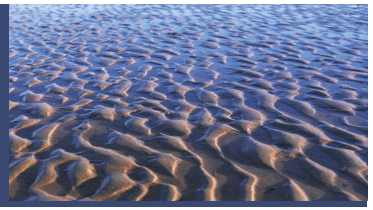
Risk Assessment

- Risk assessment is the identification and analysis of relevant risks to achieving the entity's objectives-forming the basis for determining control activities.

Approaches adopted by leading organisations to enhance internal controls

Control Self Assessment (CSA)

Overview



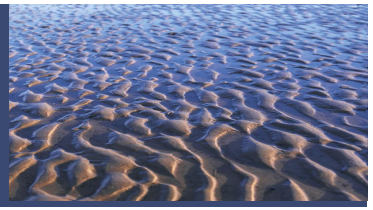
What is CSA?

It is a process whereby work groups, comprising people responsible for particular business units or areas, identify and assess business risks and controls relevant to their areas of responsibility.

What are the key features of CSA?

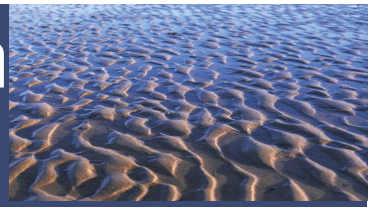
- Particularly appropriate as a technique to implement an integrated internal control framework
- Enables a wide range of people to participate in the development and enhancement of organisational governance
- Can be linked to other quality initiatives for the sustainable implementation of a risk and control culture

How does CSA differ from traditional auditing?



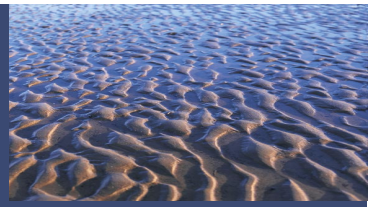
- Line employees (rather than internal auditors) evaluate internal controls
- CSA can be done within an organisation without the involvement of internal auditing
- CSA utilizes tools that may be new to some auditors, such as group facilitation skills, surveys, anonymous voting or projection units
- CSA is a better way to evaluate information or “soft” controls, which require cooperation and participation of the audited party, than traditional audits
- Often, work teams or “clients” issue the CSA report rather than internal audit
- Workshops may be used to teach risk assessment and internal control design to work teams
- The internal auditor’s role is that of a facilitator and an educator of risk and control concepts and ideas. Clients are the content experts.
- A majority of clients appear to like CSA better than they do the traditional audit process.
- Management is more involved than in an audit

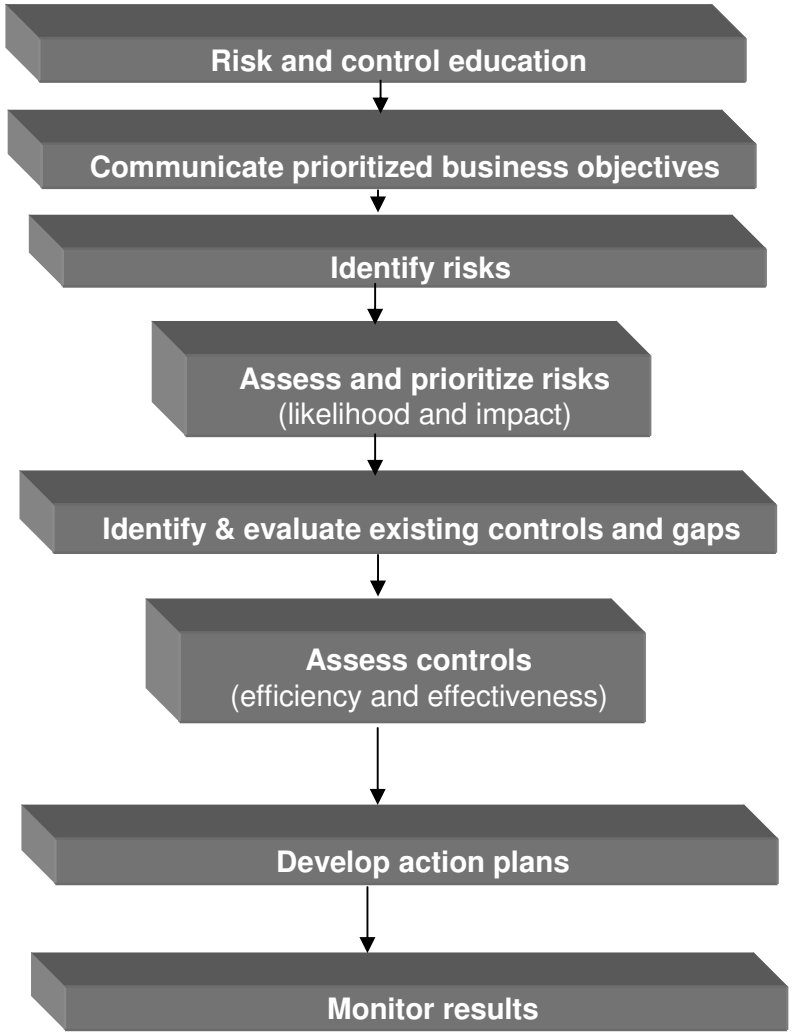
CSA roles and responsibilities in relation to internal controls



Responsibilities	Traditional Approach	CSA Approach
Setting business objectives	Management	Management
Assessing risks	Management	Management
Adequacy of internal controls	Management	Management
Evaluating risks and controls	Auditors	Work teams
Reporting	Auditors	Work teams
Validate evaluation of risks and controls	Auditors	Auditors
Objectives used	Audit's	Management's

Overview of a CSA framework





What does the business unit want to accomplish?

What could prevent the achievement of the business objectives?

What is the likelihood of occurrence and potential impact of these risks?
On which risks should the business unit focus?

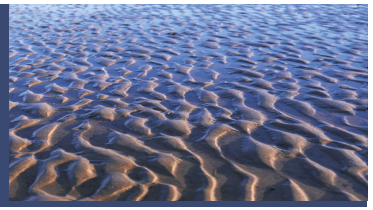
What activities exist today to proactively manage these risks?

Will the objectives be met based on the control activities in place over risks?
Are these activities efficient and effective?
What other control activities could enhance the business unit's risk management?

How will the business unit capitalize on risks while ensuring controls are sufficient, but not excessively restrictive?
Have the opportunities for improvement and the related steps been identified?

How is the business unit doing in the execution of its action plan?
Is the business unit continually identifying new objectives and risks arising in its business?

CSA Formats



There are three primary approaches to CSA

1. Facilitated workshops

   - Objective based

   - Risk based

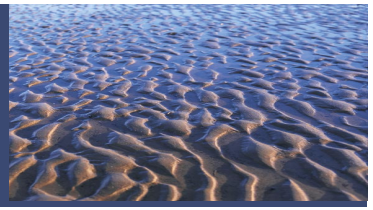
   - Control based

   - Process based

2. Questionnaires (also known as surveys)

3. Management produced analysis

Advantages and critical success factors



Why do organisations adopt CSA?

- To create a stable foundation of internal control upon which to build improved risk management
- Identify cost savings which can be result in competitive advantage
- Define accountability for internal control with the employees
- Develop internal capability to react promptly to changes in market conditions and associated risks, and demonstrate leadership in risk management
- Increase shareholder value through effective risk management

What are the critical success factors for successful implementation?

✓ Executive sponsorship and commitment

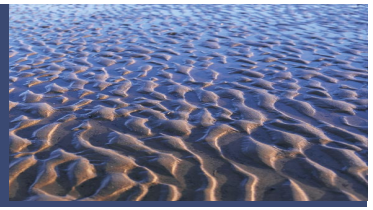
✓ Business line responsibility and accountability

✓ Common language and process across organisation

✓ Dedication of appropriate resources

✓ Monitoring for quality and consistency

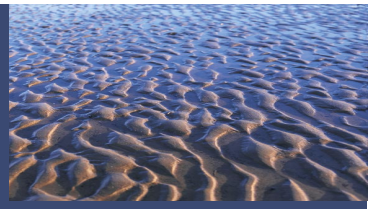
When is CSA not appropriate? Examples



- When employees do not have the required expertise in a particular area
- When fraud is suspected.
- There is repaid corporate change
- The organisation culture does not support or value communication, openness and trust, and therefore management may ignore the results of the workshop
- Tangible management support for employee involvement in the identification of risks and controls is not available
- The audit shop mandate is restricted to compliance and/or regulatory auditing and this is the only expectation of management
- The audit director does not believe that there are sufficient resources or skills within the staff to attempt CSA.

Integrated linkage of business risks to process documentation and testing

Overview

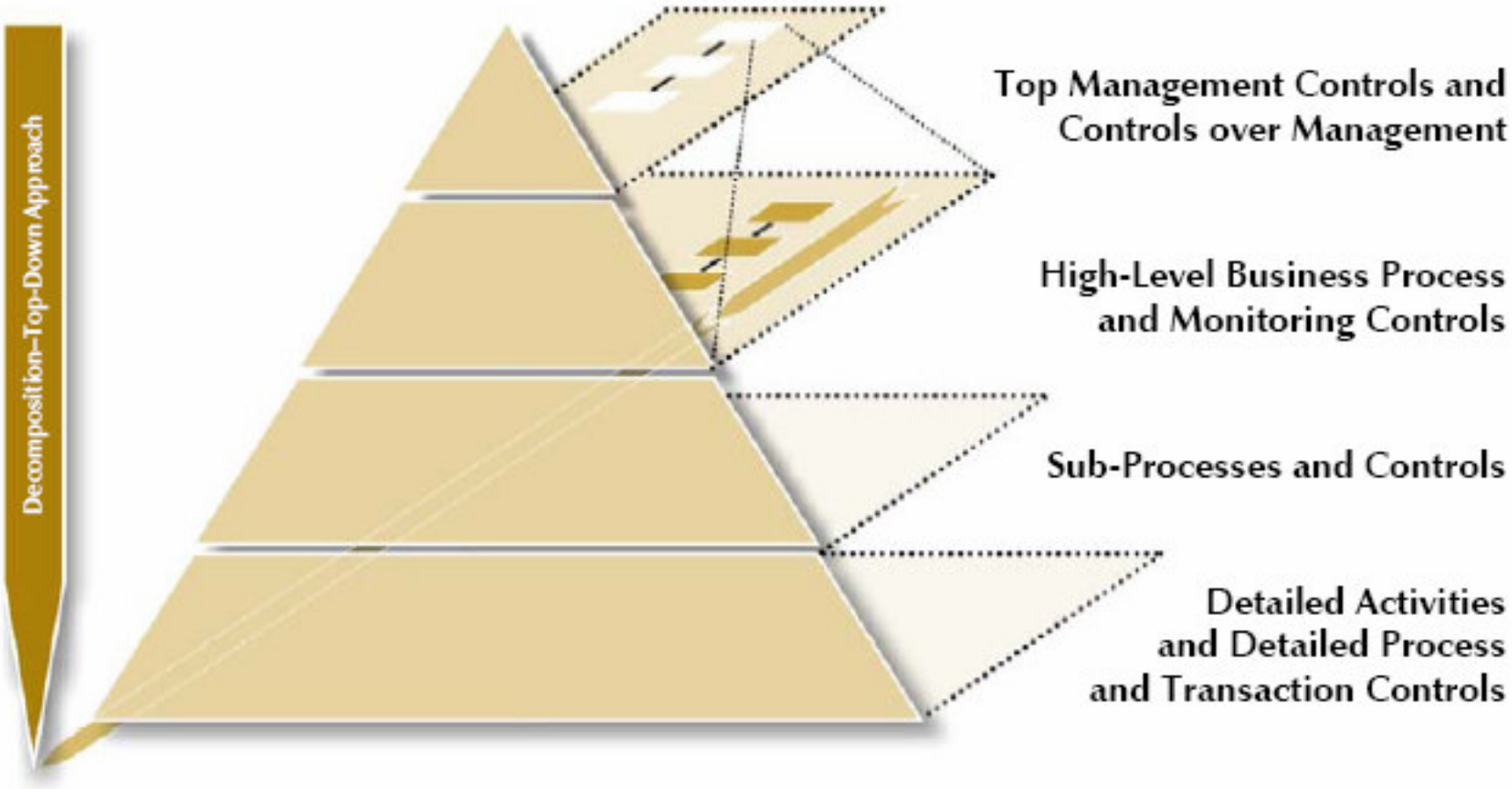


What are the key features of this technique?

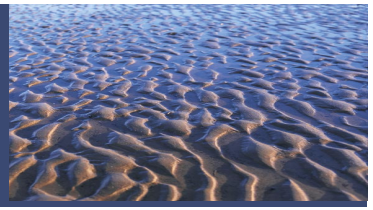
- Commonly adopted for financial statement assertions
- Helps educate personnel on procedures and controls
- Identifies control weaknesses and recommendations to be approved by management
- Reduces risk of performance errors and supports operational efficiency
- Supports management assertions
- Enables ongoing assessment of operating effectiveness
- Enables certification and attestation of work to be performed

Approach for documenting and analysing the system of internal control

Top-Down risk-based Approach



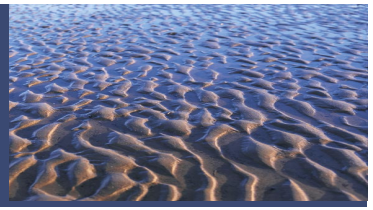
Requirements for process documentation



Process documentation needs to address:

WHO	**performs the control?**
WHAT	**do they do (inputs/process/outputs)?**
WHEN	**does the control operate?**
WHERE	**is the control executed?**
HOW	**are exceptions resolved?**
WHAT	**evidences the control occurred?**

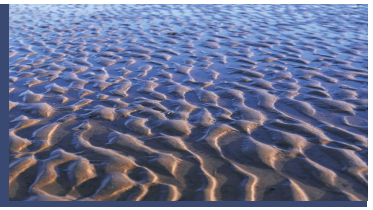
Advantages of this approach



- Clear articulation of accounting policies
- Clear documentation of Internal Control structure and procedures
- Effective process for acknowledgement of responsibility
- Effective roll-up process for periodic reporting certification
- Defensible program to demonstrate effort and approval for meeting requirements
- Documented basis for all assertions / certifications made by CEO / CFO
- Systemized process for early warning / whistle blowing / incident management
- Systemized approach to dealing with change (i.e. transactions, personnel, accounting principles, internal controls and operating procedures)
- A foundation that supports a consistent approach to control which will increase the CEO / CFO confidence in the effectiveness of their control structure

Compliance frameworks

Overview



What is compliance risk?

The risk of impairment to an organisation's business model, reputation and financial condition (resulting) from failure to meet laws, regulations, internal standards and policies, and expectations of key stakeholders such as customers, employees and society as a whole.

- Economic Intelligence Unit and PwC-

What are the cornerstones of a sound compliance framework?

- **Identifying**, addressing and resolving compliance risks
- **Demonstrating** compliance with relevant regulations
- **Embedding** compliance controls within the organisation
- **Managing** costs of compliance

Good practices for an effective compliance framework

1. **Policies and procedures**: develop policies and procedures to institutionalize and encourage appropriate behavior.

2. **High-level oversight**: create role specifically responsible for compliance management and performance.

3. **Decentralized administration and proper delegation**: designate appropriate accountabilities and exhibit due care in delegating discretionary administrative authority.

4. **Establish communication channels**: provide effective communication between all levels of employees.

5. **Audit, Monitor, and Reporting**: compliance efforts must be monitored and audited to ensure the programs are effective.

6. **Uniform enforcement**: policies and procedures must be enforced and when exceptions are discovered, consistent corrective action must be applied.

7. **Prevent further offenses**: use performance information to prevent further similar offenses once a violation has been detected.

Q&A