



**IFC**

**International  
Finance Corporation**  
World Bank Group

# Maintaining Internal Control: *Performance vs. Conformance*

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# Important Component of Corporate Governance

1. Reviewing and guiding corporate strategy and risk policy
2. Monitoring effectiveness of the company's governance
3. Selecting and monitoring executives
4. Aligning executive and board remuneration
5. Ensuring transparent board election process
6. Monitoring and managing potential conflicts of interest
7. **Ensuring the integrity of the firm's accounting and financial reporting systems, including the independent audit and *that appropriate controls* are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.**
8. Oversee disclosure and communications

# Many Definitions of Internal Control

- *Internal Control - Integrated Framework (1992)*, Committee of Sponsoring Organizations of the Treadway Commission, US (**COSO**)
- *Guidance on Control (1995)*, Canadian Institute of Chartered Accountants, Canada (**CoCo**)
- *Internal Control: Guidance for Directors on the Combined Code (1999)*, Institute of Chartered Accountants in England and Wales, UK (**Turnbill**)
- Discussion Paper on Risk Management and Internal Control in the EU (2005), (**FEE**)
- Sarbanes Oxley (2002), Sec. 404(b) Internal Control Evaluating and Reporting, US (**SOX**)
- Local legislative definitions
  - Постанова НБУ від 20 березня 1998 р. №114
  - Наказ Держкомфінпослуг від 27 вересня 2005р. № 4660



# Dichotomy of Philosophy

## PERFORMANCE

### COSO, CoCo, Turnbill and FEE

- Primary objective of internal control is to improve the performance of business, NOT to report and disclose.

## CONFORMANCE

### SOX

- Reporting of evaluations related to financial control over disclosure of information and financial reporting



# Broad, Principles Based definition of Internal Control

*...a process, effected by an entity's board of directors, 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 applicable laws and regulations.*

***COSO Internal Control – Integrated Framework (1992)***

# Broad, Market and Risk Based definition of Internal Control

- . . . a system which encompasses the policies, processes, tasks, behaviors and other aspects of a company that, taken together:
  - Facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives;
  - Help ensure the quality of internal and external reporting; and
  - Help ensure compliance with applicable laws and regulations, as well as internal policies with respect to the conduct of business.

***Turnbull Guidance – Internal Control: Guidance for Directors on the Combined Code (1999, 2004)***

# Performance Philosophy in a Nutshell

- Effective internal control is effected by people
- Effective internal control is integral to all of the activities of the company
- Every individual within an entity has some role in effecting internal control.”  
(COSO)



# Differentiating and Defining the Internal Audit Function



“an **independent**, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”

# Internal Control Objectives

Internal control systems encompasses the means by which senior management obtains reasonable assurance that:

1. The entity's accounting and operating reporting is complete and reliable
2. Operations are being conducted in accordance with the entity's prescribed policies and procedures
3. The entity is in compliance with applicable laws and regulations
4. The entity's assets and information are protected from improper use.

# Internal Audit Objectives and Tasks

1. To advise management if the organization has sound systems of internal controls to protect the organization against loss
2. Evaluate system of controls
3. Assess risks / Component of risk management
4. Test operations of systems (including IT)
5. Communication, recommendations for improvement and follow up



# Division of Responsibilities

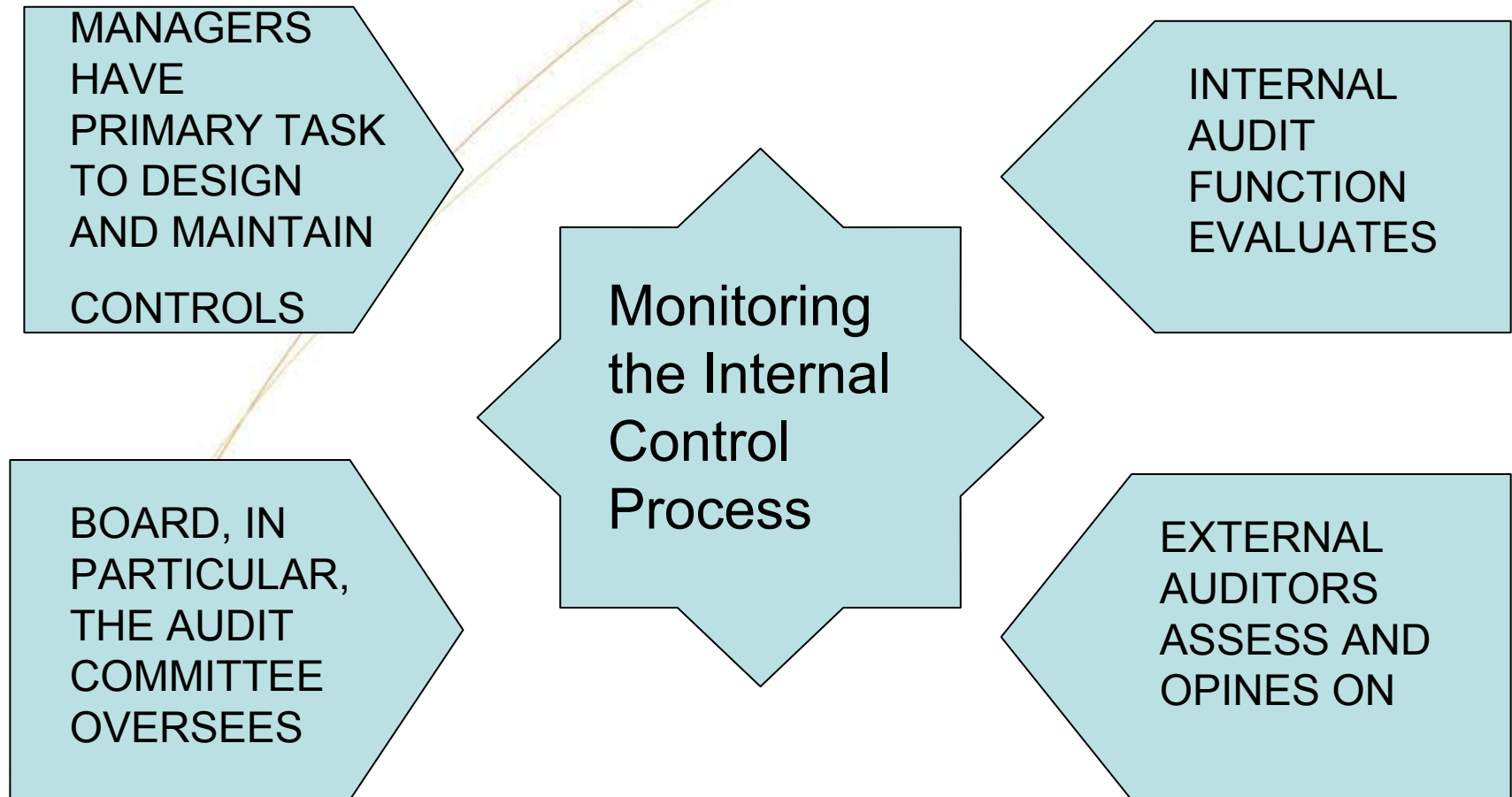
## Management

- **Establish** and **maintain** an adequate and effective system of internal controls
- **Develop** a system to monitor and control risks

## Internal Audit

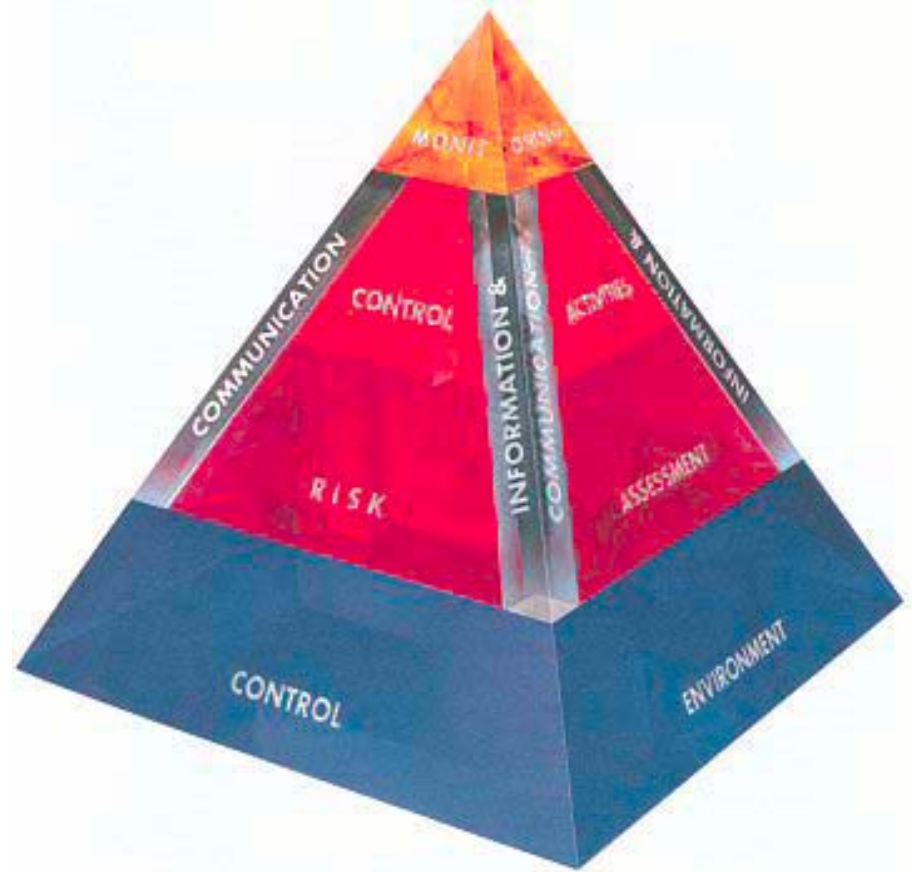
- **Assist** management in the efficient and effective discharge of their responsibilities
- **Advise** and **make recommendations** on internal control and corporate governance

# Internal Audit helps to monitor the Internal Controls



# Internal Control Components

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring



# What Shapes Control Environment?

## Control Environment



# Risk Assessment



“ . . . we just didn't think we faced so much risk.”

# Control Activities

- Control activities are the policies and procedures that help ensure management directives are carried out.
- They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives.

# Information and Communication

- Content is appropriate – Is the needed information there?
- Information is timely – Is it there when required?
- Information is current – Is it the latest available?
- Information is accurate – Is the data correct?
- Information is accessible – Can it be obtained easily by appropriate parties?

# Monitoring

Monitoring ensures that the internal control system is operating as expected.

Monitoring through financial reports

- Comparison of actual to budget
- Comparison of the current month to the previous month
- Comparison of the current month to the previous year's month

# Limitations of Internal Control

- Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's objectives.
- The likelihood of achievement is affected by the realities that human judgment in decision-making can be faulty.
- Another limiting factor is the need to consider controls' relative costs and benefits.

# Benefits of a Strong Internal Control System

- Facilitate a company's effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives;
- Help a company ensure the quality of internal and external reporting; and
- Help ensure compliance with applicable laws and regulations, as well as internal policies with respect to the conduct of business.



# Last Thought on Value/Performance

**An interesting fact emerged from the most recent (2004-2005) Turnbull Review, which stated that:**

*It was felt that those companies that viewed internal control as sound business practice were more likely to have embedded it into their normal business processes, and more likely to feel that they had benefited as a result, than those that viewed it primarily as a compliance exercise.*