

Corporate Governance and Internal Control

A part of Clause 49 pertaining to Indian corporate governance was recently amended in line with international standards to include CEO/CFO certification. The Clause makes the CEO/CFO responsible for not only establishing the internal control system but also to evaluate its effectiveness for adequacy and to inform auditors and Board about any deficiency or gap in the system. This article analyses Clause 49 and details the expectation of the regulators, responsibility of the management, and the guidelines to be followed by the auditors during financial audit.

Efficient and effective corporate governance is the crucial need of the hour for corporate business sector. Past failures and corporate scams like Enron amply prove this fact, and have forced regulators to review the existing regulations.

Amendment of Clause 49 and the Clarification

The listing agreement was amended recently and the following amendment was incorporated in Clause 49, popularly known as corporate governance clause. "The CEO, i.e. the Managing Director or Manager appointed in terms of Companies Act, 1956 and CFO i.e. the whole-time Finance Director or any person heading the finance function discharging the finance function shall certify to the board that:

They accept the responsibility for establishing and maintaining internal controls and that they have evaluated the effectiveness of the internal control systems of the company and they have disclosed to the auditors and audit committee deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or proposes to take to rectify these deficiencies.

They have to indicate to the auditors and Audit Committee:

- i. Significant changes in internal control during the year;

- ii. Significant changes in accounting policies during the year and that the same have been disclosed in the notes of the financial statements; and
- iii. Instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system".

Clarification

Management is responsible for the system of internal control. This is the important clarification, as some managements still believe that the system of internal control is the responsibility of internal audit, external audit or CFO. On the other hand, effective system of internal control is the responsibility of CEO, CFO and the senior executive team as a whole.

It is further clarified that, the Managing Director is considered as the CEO and Finance Director is the CFO for the above purpose. In the absence of Finance Director the Board may designate any other director or senior person for that purpose. The required certificate has to be placed before the Board. The certificate has to certify the matter with relevant documents such as internal audit report, the audited balance sheet and profit and loss account together with schedules and notes there on.



— CA. R. Soundara Rajan

(The author is a member of the Institute working with Engineers India Limited. He can be reached at rs.rajan@eil.co.in)

From the above it is clear that it is the responsibility of CEO and CFO to:

- a. Establish and maintain the internal controls;
- b. Evaluate effectiveness of internal control system. The assessment of internal control system has to be made using recognised framework.
- c. Disclose deficiencies in the design or operation of internal controls they are aware of;
- d. Take steps to rectify the deficiencies in the internal control system;
- e. Inform auditors and Audit Committee of any significant changes in the internal control system and significant fraud if any of which they have become aware.

Framework For Internal Control

There are various definitions of internal control. Many in western world use COSO's internal control- integrated framework. The definition relates to all aspects of internal control.

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private sector initiative which studied the causal factors that can lead to fraudulent financial reporting and developed recommendations for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions.

The National Commission was jointly sponsored by five major professional associations in the United States—the American Accounting Association, the American Institute of Certified Public Accountants, Financial Executives International, The Institute of Internal Auditors, and the National Association of Accountants (now the Institute of Management Accountants). The Commission was wholly independent of each of the sponsoring organisations, and

contained representatives from industry, public accounting, investment firms, and the New York Stock Exchange.

As Information technology is used extensively in application development, record keeping, data base management and information dissemination, internal control relies on the IT controls. Framework such as Control Objectives for Information and related Technology (COBIT) as supplement to COSO is used for internal control assessment.

IT in Business

Information Technology and business are becoming inextricably interwoven. I don't think anybody can talk meaningfully about one without talking about another...

Bill Gates

The external auditor performs independent assessment on the adequacy of internal control and gives his formal opinion on the management report.

Internal Control Definition

Internal Control is broadly defined, as a process effected by 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.

Rule of Technology

Rule 1: Technology used in business is that automation applied to an efficient operation will magnify the efficiency.

Rule 2: Technology used in business is that automation applied to an inefficient operation will magnify the inefficiency.

Bill Gates

While internal control is the process, its effectiveness is a state or condition of the process at one or more points in time.

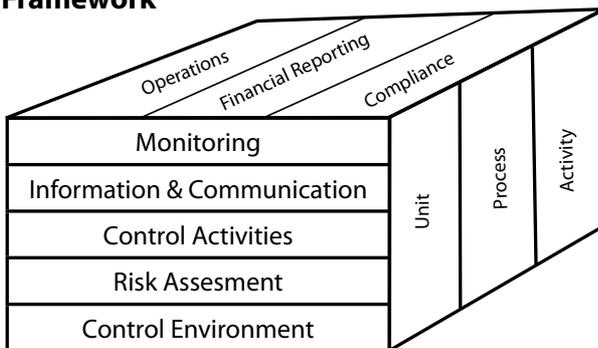
The first category addresses the organisation's objectives related to business, which includes performance and profitability goals and safeguarding assets. Second relates to the preparation of reliable published financial statements and the data derived from such statements such as press releases. The third deals with complying of laws applicable to the organisation.

COSO's Internal Control Framework

Internal control consists of five interrelated components. These are derived from the way management runs a business, and are integrated with the management process. Although the components apply to all entities, small and mid-size companies may implement them differently than large ones. Its controls may be less formal and less structured, yet a small company can still have effective internal control. The components are:

Control Environment
Risk Assessment
Control Activities
Information and Communication
Monitoring

COSOs Internal Control - Integrated Framework



Control Environment

It is the foundation for all other components

of internal control, providing discipline and structure. Control environment factors includes:

- the integrity, ethical values and competence of the people who form the backbone of the organisation;
- management's philosophy and operating style;
- the way management assigns authority and responsibility, and organises and develops its people;
- and the attention and direction provided by the Board of Directors.

Research Findings

Research continues to prove that, organisations perform better and last longer when top management is committed to strong internal control and convey this through their actions.

The following controls are already required as per the clause 49(II) D of listing agreement.

Audit committee has to review

- the financial statements before submission to Board for approval;
- Changes if any in accounting policies and practices and reasons for the same;
- Significant adjustments made in financial statements;
- Disclosure of related party transactions;
- Qualifications in audit report;
- Compliance with listing and other requirements.

In addition to the above listing agreement requires a code of conduct to be laid down for Board and senior management personnel.

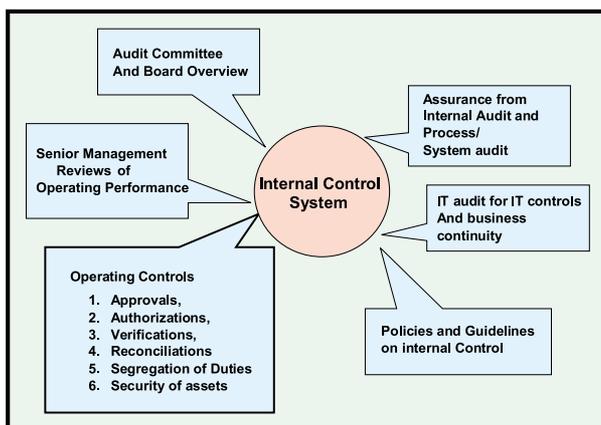
Risk Assessment

Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because operating conditions continue to change, mechanisms are needed to identify and deal with the special risks associated with change. Further as per clause 49 (IV) C of listing agreement every company has to lay down procedure for risk assessment and minimisation.

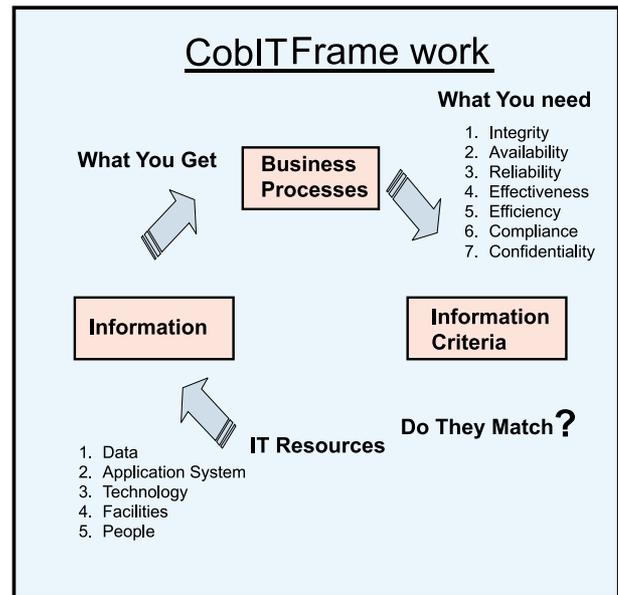
Control Activities

Control activities occur throughout the organisation at all levels. Control activities are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks. Control activities occur throughout the organisation, at all levels and in all functions. They include a range of activities such as:

- approvals,
- authorisations,
- verifications,
- reconciliations,
- reviews of operating performance,
- security of assets and
- segregation of duties.



At higher levels management oversight, reviews of audit committee emphasise the management's commitment towards the internal control.



Information and Communication

Relevant information must be identified, captured and communicated in a form and timeframe that enables people to carry out their responsibilities. Information systems produce reports, which can contain operational, financial and compliance-related information. They deal not only with internally generated data, but also information about external events, activities and conditions necessary for decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organisation.

Nowadays IT is used for communicating significant information upstream and with external parties, such as customers, suppliers, regulators and shareholders. Hence IT controls play a critical role in the internal control system.

Monitoring

Internal control systems need to be monitored. Ongoing monitoring occurs in the course of operations. It includes regular

management and supervisory activities. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the Board. "Built in" controls support quality and empowerment initiatives, avoid unnecessary costs and enable quick response to changing conditions.

The internal control definition—with its underlying fundamental concepts of a process, effected by people, providing reasonable assurance—together with the categorisation of objectives and the components and criteria for effectiveness, and the associated discussions, constitute this internal control framework.

Evaluation of Internal Control System

The management before the financial year-end that is during October to December takes steps to evaluate the control system. The internal audit and process audit team may be used to evaluate internal control system of the company and report the same to audit committee and Board.

Nature Of Errors

- Sometimes the errors may be of a nature that affects the materiality of disclosure.
- The errors may affect the quarterly accounts or the yearly financial statements.
- It may affect a quarter or the full year or multiple years.

The management may alternatively, outsource this activity for independent review. The internal control addresses basically the risk involved and it forms part of risk minimisation. The major steps involved in the activity are as given below:

Identification of risk and key controls for financial statements:

- a. Identify the accounts in general ledger which are considered significant;
- b. Identify the business process that generates the transaction into the account, location, and the operating entity;
- c. Identify the key transaction representing the balance;
- d. Identify the key controls;
- e. Define the material error. Normally it is defined by the management in consultation with statutory auditors. It is based on the value as a percentage of profit, net worth, turnover etc.

Key Control

Control that are not likely to result in material error, should they fail, should not be considered "key"

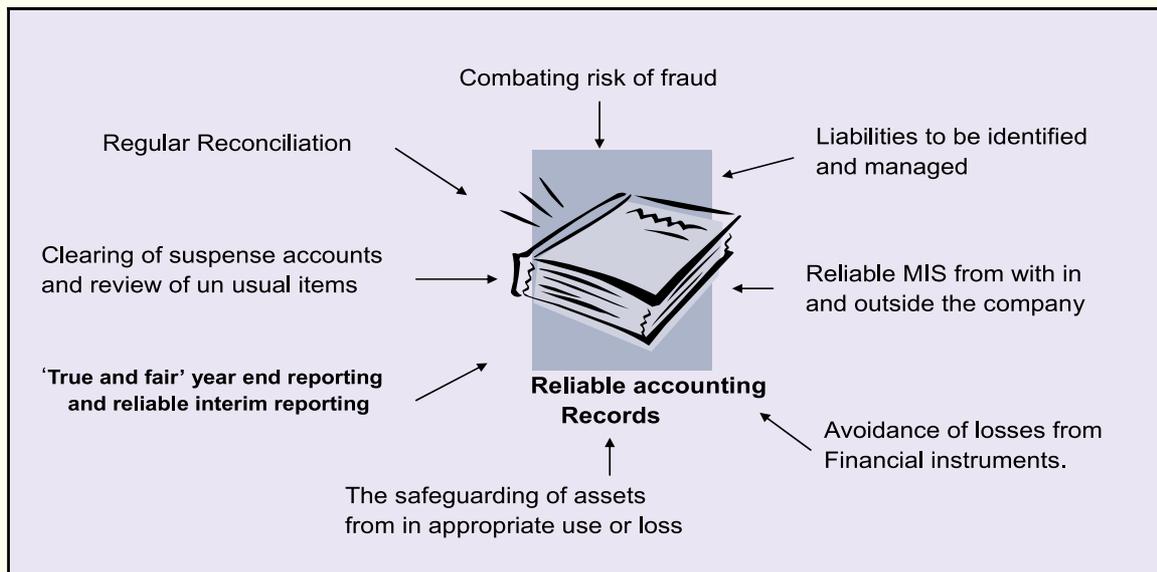
COSO

Definition on Key Control

- f. Identify the probability and level of errors, that is where it affects-
 - Profit and loss or
 - Balance sheet or
 - Disclosures or
 - Statement to press or stock exchanges or investors etc.

The error may only affect P & L, or Balance Sheet or Both.
- g. Find out the control weakness and study whether it is onetime sporadic error or it may recur again and again due to control or system weakness. Sometimes the control weakness may not be visible due to compensation effect.
- h. Take steps to rectify the weakness and gap.
- i. Prepare a report on internal control and

Internal Financial Control



submit to audit committee, Board and further, share it with auditors.

What Can Internal Control Do?

Internal control can help an Organisation to:

- achieve its performance and profitability targets, and prevent loss of resources.
- help ensure reliable financial reporting.
- and help ensure that the enterprise complies with laws and regulations, avoiding damage to its reputation and other consequences.

In sum, it can help an organisation to get to where it wants to go, and avoid pitfalls and surprises along the way.

Key Points COSO wants to emphasise are:

1. Internal control is a continuing process rather than a point-in-time situation.
2. Management has to assess the adequacy

as of year-end even though system operates continuously. Not only in the year of assessment but for multiple years.

3. Internal control provides a reasonable - not absolute assurance. This may be due to the judgments in decision-making being faulty. Breakdown may occur because of simple error, mistake or assumption. This concept of reasonable assurance built into the definition of internal control, is due to the fact that there is a remote likelihood that the material misstatements will not be prevented or detected on a timely basis. Normally external auditors use a range of 5 to 10 percent for remote likelihood. When assessing the adequacy, management needs to find out even if errors occur and cause material errors in financial statement are due to the result of 'simple error or mistake'.
4. Controls can be circumvented by collusion of two or more people.

5. The design of internal control may be limited by resource constraint and relative costs.
6. Responsibility of internal control is a shared responsibility among all the executives with leadership provided by CEO/CFO.

System of internal control provides a reasonable level of assurance when:

- a. The cumulative risk of misstatement due to known control weakness is less than 10% probability. It is based on auditor's use of 5-10% in determining the likelihood of a material error is 'more than remote'. It may not generally be possible to calculate the probability of any error with precision. It may be helpful for management to determine the adequacy of internal control.
- b. The Control weakness that is identified by management and external or internal auditors, to be corrected promptly.
- c. The management team believes the level of control is appropriate to the business, enabling reliable financial reporting.

Roles and Responsibilities

Everyone in an organisation has the responsibility for internal control.

Internal control is, to some degree, the responsibility of everyone in an organisation and therefore should be an explicit or implicit part of everyone's job description.

Management

The chief executive officer is ultimately responsible and should assume "ownership"

of the system. More than any other individual, the chief executive sets the "tone at the top" that affects integrity and ethics and other factors of a positive control environment.

Board of Directors

Management is accountable to the Board of Directors, which provides governance, guidance and oversight. A strong, active Board, particularly when coupled with effective upward communication channels and capable financial, legal and internal audit functions, is often the best-needed framework for internal control effectiveness and adequacy.

Internal Auditors, Process Auditor, Legal Cell

Internal auditors and process auditors play an important role in evaluating the effectiveness of control systems, and contribute to ongoing effectiveness and often play a significant monitoring role.

"In the domain of modern auditing, our methodologies for the control and audit of computer based system are still in their infancy. Further, the rate at which new computer technology is developed and introduced seems to outstrip the rate at which we can develop viable audit methodologies".

Ron Weber
EDP auditing- Conceptual Foundations and Practice

The internal control system is normally judged by the management's commitment to internal audit and process audit function. To be effective the internal audit function should have financial experts, Control experts, IT experts and persons with the knowledge of organisation business.

Recently legal cell has become a vital link in the internal control system architecture. They oversee and periodically check the compliance to be made and educate the organisation on the changes in the legal requirement. A weak legal cell is a potential internal control threat especially due to the complex law requirements.

Other Personnel

Virtually all employees produce information used in the internal control system or take other actions needed to effect control. Also, all personnel should be responsible for communicating upward problems in operations, noncompliance with the code of conduct, or other policy violations or illegal actions.

A number of external parties often contribute to achievement of an organisation's objectives. External auditors, bringing an independent and objective view, contribute

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directly through the financial statement audit and indirectly by providing information useful to management and the Board in carrying out their responsibilities. Others providing information to the entity useful in effecting internal control are legislators and regulators, customers and others transacting business with the enterprise, financial analysts, and the news media. External parties, however, are

not responsible for, nor are they a part of, the organisation's internal control system.

Further documented guidelines are needed on internal control, monitoring with proper responsibilities. Mere compliance is not enough. There must be qualitative compliance. Enron had quantitatively complied with the guidelines and yet failed because it was dishonest and not ethical. Hence ethical compliance and integrity play a vital role in good governance.

Conclusion

Unfortunately, in many cases top managements have greater, and unrealistic, expectations of control systems. They look for absolutes—believing that, internal control can ensure an organisation's success at any cost—that is, it will ensure achievement of basic business objectives. But internal control cannot change an inherently poor manager into a good one or shifts in government policy or programs, competitors' actions or economic conditions, which can go beyond management's control. Internal control can ensure the reliability of financial reporting and compliance with laws and regulations. Thus, while internal control can help an organisation to achieve its objectives, we should understand that it is not a panacea.

To be effective an organisation should have good documentation of internal control system and basic organisation culture supported by commitment from top management. Further the audit and legal cell should be equipped with diversified experienced staff with training in internal control, risk, business system, IT and legal/compliance knowledge.

At least once a year a detailed audit of key processes, controls, and compliances to be done and a report submitted for review and remedial action to audit committee and Board. This will provide confidence to CEO/CFO during the certification process. □