PRACTICE NOTES

King III Chapter 7 & 9

Guidance on the Assessment of the System of Internal Control

June 2010

Guidance on the assessment of the system of internal control

Introduction

Principle 7.3 of the Code states that internal audit should provide a written assessment of the effectiveness of the company's system of intern al control and risk management.

It is recommended that the board should report on the effectiveness of the system of internal controls in the integrated report. Paragraph 16 recommends that the assessment regarding internal financial controls should be reported specifically to the audit committee.

The written assessment from internal audit provides the board and audit committee with the assurance to be able to report as recommended.

Target audience

This practice note provides guidance on how internal audit can perform their evaluation of the system of internal controls to satisfy their own reporting requirements to the board and the audit committee and in turn support the board and audit committee with its reporting responsibilities to stakeholders.

This practice note may also be used by the audit committee in understanding the work performed by internal audit regarding the internal financial controls.

In March 2009 the Institute of Internal Auditors released a Practice Guide for formulating and expressing internal audit opinions as part of the International Professional Practice Framework. This Practice Guide will provide an additional source of guidance.

THE INTERNAL CONTROL FRAMEWORK

The board is ultimately responsible for the system of internal control. Management is responsible for implementing and maintaining an internal control framework to address risks relevant to the company to achieve its objectives. One example of an internal control framework is set out by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which addresses the following business objectives:

- Strategic.
- Operational.
- Compliance.
- Financial.

We recommend that a fifth element, namely sustainability, be added to this framework.

In determining its policies in regard to internal control, and ultimately assessing what constitutes a sound system of internal control for an individual company, the board should consider the following factors:

- The nature and extent of the risks facing the company;

- The extent and categories of risk which is considered acceptable to bear i.e. risk tolerance;
- The likelihood of the risks materialising;
- The company's ability to reduce the incidence and impact on the business of risks that do materialise; and
- The cost of particular controls, relative to the benefit thereby obtained in managing the related risks.

It is important to note that internal audit cannot render an assessment statement if there is no framework to objectively support internal audit's conclusions.

MONITORING OF CONTROLS BY MANAGMENT

One of the key elements of any system of internal control should be monitoring. Monitoring should be included as a standard element of any system of internal controls, regardless of the assessment performed by internal audit.

Management should be performing self-assessments of the controls in their functional responsibility to[1]:

- Identify and correct internal control problems on a timely basis;
- Produce more accurate and reliable information for use in decision-making;
- Prepare accurate and timely financial information; and
- Be in a position to provide periodic certifications or assertions on the effectiveness of internal control.

ASSESSMENT PROCESS BY INTERNAL AUDIT

In simplistic terms, a system of internal control has as its main aim the management of risks that threaten the achievement of its strategic, sustainability, operational, compliance and financial objectives.

In determining the effectiveness of the system of internal control, there are three steps that should underlie the process:

1. Identify the business objectives in the five areas before.
2. Assess the risks that prevent the achievement of these objectives .
3. Perform tests and gather evidence relating to the internal controls in place to manage these risks and as to the effectiveness of such internal controls.

1. Identifying the business objectives

To date, many internal audit departments have focused mainly on operational and financial business objectives in determining the internal audit scope. As a result of the recommendations in King III, the scope of internal audit should increase to cover the full spectrum of business objectives as per the framework adopted by the board.

2. Assess the risks that prevent the achievement of business objectives

1 COSO guidance on monitoring internal control systems, January 2009.

Useful methods to be applied to assess the risks that prevent the achievement of business objectives may include PEST analysis, Five Forces analysis or SWOT analysis.

2.1 Identifying the controls

The Chief Audit Executive (CAE) should plan the internal audit activities to ensure that a sufficient evidential base will exist from which to draw a conclusion as to the effectiveness of the system of internal controls.

Internal audit should evaluate whether controls exist to address the risks identified. Controls identified are then evaluated to determine whether they are adequately designed, implemented and are operating effectively.

In providing this written assessment, internal audit may need to establish new methodologies and planning for the following:

- The aggregation and interpretation of findings from several audits, some of which may have been completed months before the assessment date. In such instances follow-up work on remedial work may be required.
- Methodologies for incorporating audit evidence developed through less formal means need to be established. As macro-level assessment statements are generally pervasive in nature and require a greater breadth of coverage, reliance on other types of assurance processes may be required.
- Evidence from the work of others (e.g. quality assurance functions in the business) can be considered provided that the CAE evaluates the risk associated with utilising the work of others and explains this when the assessment statement is expressed.

This will require extensive planning from internal audit and a thorough knowledge of the external audit plans and/or work performed by any other assurance providers as part of the combined assurance model.

Internal financial controls

Specifically for the purpose of the annual documented assessment of internal financial controls and to define the scope of the assessment and testing, internal audit should focus on risks of material misstatement of reported financial information to all stakeholders. Risks of misstatement may arise from internal or external risk factors that impact the business.

Risks may also manifest in the initiation, authorisation, processing and recording of transactions and other adjustments that are reflected in financial information.

It will be useful for internal audit to focus on significant account balances and disclosures in the financial statements when performing this assessment.

Suspense and control accounts should also be considered as often significant volumes of transactions are recorded through these accounts.

2.2 Evaluating the controls

Controls should be evaluated for effectiveness in:

- Design: the controls are effectively designed to detect and/or prevent material misstatement.
- Implementation: the controls have been implemented appropriately and are performed by the correct individual or system at the right time.
- Operation: the control operates as intended and the risk of material misstatement if detected and/or prevented.

In the consideration of the likelihood that a control might fail to operate effectively internal audit should also consider the complexity of the control, the judgement required to operate the control, the risk of management override, the competence of the staff that perform or monitor the control, and changes in key personnel related to the control, amongst other things.

3 Perform tests and gather evidence relating to the effectiveness of internal controls in place

To complete the documentation and testing requirements of the formal assessment, internal audit is expected to evaluate evidence supporting the design, implementation and operation of the controls. The nature of these procedures would be considered to determine whether suitable testing had taken place to evaluate the design and implementation of the controls included in the scope of the annual assessment.

It is internal audit's responsibility to determine the nature and extent of evidence required to support its conclusions on the design, implementation and operating effectiveness of financial controls.

In principle, the evidence gathered to support internal audit's conclusions should be commensurate with the measure of risk to the objectives. Areas that pose a high risk should be extensively tested and documented, while self assessments can be considered acceptable evidence for those areas considered to be low risk.

The form and extent of the documentation will vary depending on the size, nature, and complexity of the company. It can take many forms (for example, paper documents, electronic, or other media). Also, the documentation can be presented in a number of ways (for example, policy manuals, process models, flowcharts, job descriptions, internal memorandums, checklists, etc).

CONCLUSION BY INTERNAL AUDIT

Internal audit should determine the actual and potential impact that control deficiencies have (both in isolation as well as in aggregate) on the objectives.

The following elements will need to be considered in during these conclusions:

- Materiality: the magnitude of the residual risk that one of the objectives will not be achieved.
- Impact: the implication of the audit findings on the various levels within the company.

Consideration should be given to how a control weakness impacts the achievement of the company's objectives.

Internal auditors perform evaluations at certain points in time, but should be alert to actual or potential changes in conditions that affect the ability to provide an assessment from a forward-looking perspective. In those cases, internal auditors should address the risk that performance can deteriorate. It is therefore argued that the process to identify and rectify problems in the control environment is the most important aspect under consideration when the CAE renders his assessment statement.

Since internal control is a process, the internal auditor should focus on whether the control structure has facilitated identification and correction of control problems. The accumulation of numerous separate audit engagements involves attention to preventative, detective, and corrective controls as reflected in the individual areas of the company's operations.

If problems are persistent or pervasive in their effects on the achievement of the objectives, then the internal auditor will report on those aspects of control that are not adequate in the overall assessment statement in the summary report.

In reaching an overall conclusion, the emphasis must be upon the concept of internal control as a process. If the process ensures the identification of undue business risk and effective remedial action is taken, then the temporary presence of an internal control weakness does not necessarily preclude the expression of an assessment statement that overall internal control is adequate. Indeed, the "acceptable risk" concept should be acknowledged which is inherent in designing a cost-effective system of internal control.

Consideration should be given on who detected the control weakness and how it was detected. If the control weakness was for example detected by the company's monitoring controls, then the control environment can still be considered effective.

THE ASSESSMENT STATEMENT

King III requires an assessment from internal audit and does not require internal audit to issue a review and/or audit opinion over the internal financial controls.

This recommendation also implies that the assessment over the system of internal control does not relate to a particular financial year, although the audit committee's obligation to annually report in the integrated report may require an annual review of the internal financial controls.

The supporting audit evidence will be built up over a period of time and based on the results if several periods of testing, work performed by others and informal evidence.

The written assessment of internal financial controls provided by internal audit to the audit committee should include a comprehensive memorandum by internal audit that documents:

- The scope of internal auditing activities, which includes the appropriate level and quality of work based on the company's risks.
- The cycle on which audit plans are based.
- Consideration of the control components and limitations of control.
- The status of follow-up activities.
- An expression on the pervasive effects being considered.
- A discussion of serious problems and possible solutions.
- The overall assessment statement for the year.

Should the assessment statement not agree with the board, audit committee or executive management's assertions, the difference in opinion should be explained in the integrated report.

The assessment of internal financial controls

A similar assessment statement should be furnished specifically to the audit committee relating to internal financial controls.

In terms of the Companies Act, 2008 the audit committee must conclude and report yearly to the stakeholders and the board on the effectiveness of the company's internal financial controls. The audit committee should holistically consider all information brought to its attention from all sources, including the documented assessment of the internal financial controls by internal audit and external audit information, before concluding and reporting annually to the stakeholders and the board on the effectiveness of the company's internal financial controls.

The audit committee should report weaknesses in financial control, whether from design, implementation or operation, that are considered material (individually or in combination with other weaknesses) and that resulted in actual material financial loss, fraud or material errors, to the board and the stakeholders as part of the integrated report.

Internal financial controls can be considered effective by the audit committee if the risk of material error is adequately reduced and, as a result, financial information is reliable. To determine whether weaknesses in financial control, or a combination of control weaknesses, resulted in actual material financial loss, including fraud and/or material errors that should be reported to the board for disclosure, the audit committee should make reference to the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" for guidance as follows:

"*Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.*"

Examples of questions the audit committee should ask relating to the internal financial control framework include[2]:

- Is there a control framework governing financial reporting in the company?
- Have all the risks that pertain to the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework been identified and documented?
- Are the controls (manual and automated) in place to address these risks and they adequately designed to prevent or detect material misstatements in the financial statements and disclosures?
- Do the controls identified operate as they are supposed to and are the appropriately evidenced?

[2] King's Counsel: Internal financial controls, PricewaterhouseCoopers, 2010

- Has internal audit tested the controls identified above and reported the results to the audit committee completely and accurately?
- Is the audit committee's assertion appropriately evidenced (including internal audit's assessment)?
- Is a process in place to ensure that the framework remains relevant over time and is embedded as part of the company's financial reporting procedures?
- Internal audit should use its knowledge of the organisation's structures, operations and processes to identify risks to reliable financial reporting.