

Concepts of internal audit and internal control

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Glossary

Internal Audit	<p>The Institute of Internal Auditors definition is:</p> <p>Internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.</p> <p>More concretely, it is the functional means by which the managers of an entity receive an assurance from internal sources (including internally subcontracted sources) that the internal controls are achieving their internal control objectives. It will cover, inter alia, Financial Audits, System Based Audits, Performance Audits and IT Audits. It has most of the characteristics of external audit except that it finally reports to the management and therefore can never have the same level of independence as external audit.</p>
Ex ante financial control (EAFC)	<p>Ex ante financial control (EAFC) is the set of control activities prior to carrying out financial decisions relating to appropriations, commitments, tender procedures, contracts (secondary commitments), and related disbursements and recovery of unduly paid amounts. Such decisions can only be taken after the explicit approval of the ex ante financial controller.</p> <p>EAFC is sometimes also called "preventive control". This is the narrower meaning of financial control. If described as EAFC there can be no ambiguity.</p>
Internal Control	<p>The whole system of financial and other controls, including the organisational structure, methods, procedures and internal audit, established by management within its corporate goals, to assist in conducting the business of the audited entity in a regular, economic, efficient and effective manner.</p> <p>Internal control relate to the following categories: Control environment; Risk assessment; Information and Communication; Control activities and Monitoring of controls</p>
Economy	<p>Minimising the cost of resources used to achieve given planned outputs or outcomes of an activity (including having regard to the appropriate quality of such outputs or outcomes).</p>
Efficiency	<p>Maximising the outputs or outcomes of an activity relative to the given inputs.</p>
Effectiveness	<p>The extent to which objectives of an activity are achieved i.e. the relationship between the planned impact and the actual impact of an activity.</p>
Public Internal Financial Control (PIFC)	<p>PIFC is the overall financial control system performed internally by a Government or by its delegated organisations, aiming to ensure that the financial management and control of its national budget spending</p>

	centres (including foreign funds) complies with the relevant legislation, budget descriptions, the principles of sound financial management, transparency, efficiency, effectiveness and economy. PIFC comprises all measures to control all government income, expenditure, assets and liabilities. It represents the wide sense of internal control. It includes but is not limited to ex ante financial control (EAFC) and ex-post internal audit (EPIA)
Public entity	Public authority, public institution, company, national society that uses/manages public funds
Public funds	Amounts allocated from the state budget, NMIC and NSIH, special funds, local budgets, external financial assistance provided to the Republic of A country or to Public Institutions, foreign debts (credits) guaranteed by the State or by the Local Public Administration Authorities, as well as internal debts contracted by the Local Public Administration Authorities

Abbreviations

EU	European Union
FMC	Financial Management and Control
FMIS	Financial Management Information System
IA	Internal Audit
IASB	International Accounting Standards Board
IC	Internal Control
IFAC	International Federation of Accountants
IIA	Institute of Internal Auditors
INTOSAI	International Organization of Supreme Audit Institutions
ISA	International Standards on Auditing
ISPPIA	International Standards on the Professional Practice of Internal Auditing
IT	Information Technology
OECD	Organization for Economic Cooperation and Development
PIFC	Public Internal Financial Control
SAI	Supreme Audit Institution
SIGMA	Support for Improvement of Governance and Management

1. CONCEPTS OF FINANCIAL CONTROL AND RISK MANAGEMENT

Overview

- 1.1. Public Internal Financial Control (PIFC) is an exercise in risk management. All transactions involving the use of other people's money involve an element of risk that the resources will be lost, used improperly, not used for the purpose intended, or used properly but inefficiently. PIFC seeks to balance the risks of such events against the costs of their prevention.
- 1.2. Over a decade ago, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued *Internal Control – Integrated Framework*¹ that has helped businesses and other entities assess and enhance their internal control systems. That framework has since been incorporated into policy, rule, and regulation, and used by thousands of enterprises to better control their activities in moving toward achievement of their established objectives.
- 1.3. As a result of many high-profile business scandals and increased awareness of the level of corruption in many countries as noted by the Corruption Perception Index published by Transparency International, calls were made for enhanced corporate governance and risk management, with new law, regulation, and listing standards. The need for an overall risk management framework for the entity as a whole, providing key principles and concepts, a common language, and clear direction and guidance, became even more compelling. Thus, COSO published *Enterprise Risk Management – Integrated Framework* in 2001 that fills this need. This framework expands on internal control, providing a more robust and extensive focus on the broader subject of enterprise risk management. While it is not intended to and does not replace the internal control framework, but rather incorporates the internal control framework within it, entities may decide to look to this framework both to satisfy their internal control needs and to move toward a fuller risk management process.
- 1.4. Among the most critical challenges for managements is determining how much risk the entity is prepared to and does accept as it strives to create value. Using these integrated frameworks, legislation has been enacted or is being considered by many countries to extend the long-standing requirement for governments to maintain systems of internal control as well as require management to certify and the independent auditor to attest to the effectiveness of those systems. The Government of A country is encouraged to adopt similar legislation based on these frameworks to provide a fuller risk management and internal control process.

¹ Executive Summary of *Enterprise Risk Management – Integrated Framework* (September 2004) published by the Committee of Sponsoring Organizations of the Treadway Commission

- 1.5. To assist in achieving the goal of improving their risk management processes, many countries are establishing or enhancing an internal audit function within their governmental units. The professional practice of internal audit is supported by a framework published by the Institute of Internal Auditors. This framework provides for a code of ethics, internal auditing standards, development and practice aids, and practice advisories. The Government of A country is further encouraged to enhance their internal audit function and to adopt this Professional Practices Framework for Internal Auditors.
- 1.6. The underlying premise of risk management is that every entity exists to provide value for its stakeholders. All entities face uncertainty, and the challenge for management is to determine how much uncertainty to accept as it strives to grow stakeholder value. Uncertainty presents both risk and opportunity, with the potential to erode or enhance value. Risk management enables management to effectively deal with uncertainty and associated risk and opportunity, enhancing the capacity to build value.
- 1.7. Value is maximized when management sets strategy and objectives to strike an optimal balance between growth and return goals and related risks, and efficiently and effectively deploys resources in pursuit of the entity's objectives. Risk management encompasses:
 1. *Aligning risk appetite and strategy* – Management considers the entity's risk appetite in evaluating strategic alternatives, setting related objectives, and developing mechanisms to manage related risks.
 2. *Enhancing risk response decisions* – Risk management provides the rigour to identify and select among alternative risk responses—risk avoidance, reduction, sharing, and acceptance.
 3. *Reducing operational surprises and losses* – Entities gain enhanced capability to identify potential events and establish responses, reducing surprises and associated costs or losses.
 4. *Identifying and managing multiple and cross-entity risks* – Every entity faces a myriad of risks affecting different parts of the organization, and risk management facilitates effective response to the interrelated impacts, and integrated responses to multiple risks.
 5. *Seizing opportunities* – By considering a full range of potential events, management is positioned to identify and proactively realize opportunities.
 6. *Improving deployment of capital* – Obtaining robust risk information allows management to effectively assess overall capital needs and enhance capital allocation.
- 1.8. These capabilities inherent in risk management help management achieve the entity's performance and prevent loss of resources. Risk management helps ensure effective reporting and compliance with laws and regulations, and helps avoid damage to the entity's reputation and associated consequences. In sum, risk management helps an entity get to where it wants to go and avoid pitfalls and surprises along the way.

Risk Management Defined

- 1.9. Risk management deals with risks and opportunities affecting value creation or preservation and is defined as follows:

Risk management is a process, effected by an entity's legislative body, management and other personnel, applied in strategy setting and across the entity, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

- 1.10. This definition is purposefully broad. It captures key concepts fundamental to how organizations manage risk, providing a basis for application across all sectors. It focuses directly on achievement of objectives established by a particular entity and provides a basis for defining risk management effectiveness.

Achievement of Objectives

- 1.11. Within the context of an entity's established mission or vision, management establishes strategic objectives, selects strategy, and sets aligned objectives cascading through the entity. The risk management framework is geared to achieving an entity's objectives, set forth in the following categories:
- *Strategic* – high-level goals, aligned with and supporting its mission
 - *Operations* – effective and efficient use of its resources
 - *Reporting* – reliability of reporting
 - *Compliance* – compliance with applicable laws and regulations
- 1.12. This categorization of entity objectives allows a focus on separate aspects of risk management. These distinct but overlapping categories – a particular objective can fall into more than one category – address different entity needs and may be the direct responsibility of different executives. This categorization also allows distinctions between what can be expected from each category of objectives. Another category, safeguarding of resources, used by some entities, also is described.
- 1.13. Because objectives relating to reliability of reporting and compliance with laws and regulations are within the entity's control, risk management can be expected to provide reasonable assurance of achieving those objectives. Achievement of strategic objectives and operations objectives, however, is subject to external events not always within the entity's control; accordingly, for these objectives, risk management can provide reasonable assurance that management, and the legislative body in its oversight role, are made aware, in a timely manner, of the extent to which the entity is moving toward achievement of the objectives.

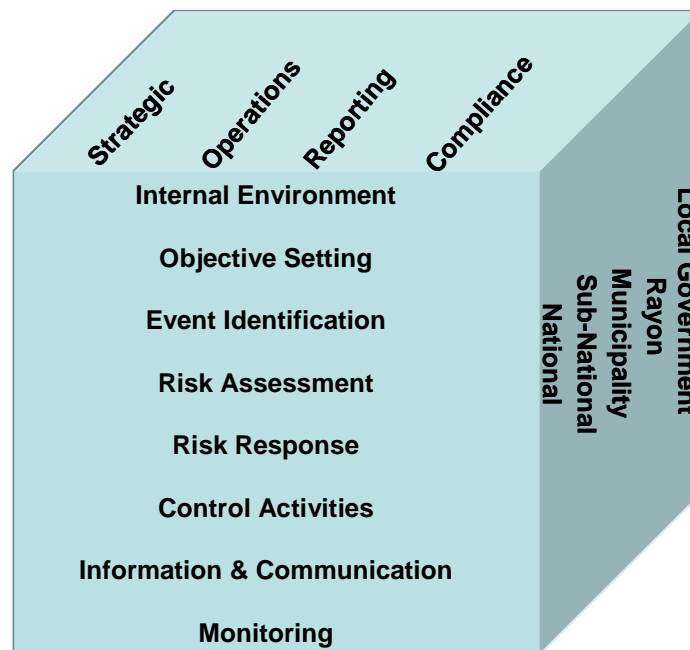
Components of Risk Management

- 1.14. Risk management consists of eight interrelated components. These are derived from the way management runs an enterprise and are integrated with the management process. These components are:
1. *Internal Environment* – The internal environment encompasses the tone of an organization, and sets the basis for how risk is viewed and addressed by an entity’s people, including risk management philosophy and risk appetite, integrity and ethical values, and the environment in which they operate.
 2. *Objective Setting* – Objectives must exist before management can identify potential events affecting their achievement. Risk management ensures that management has in place a process to set objectives and that the chosen objectives support and align with the entity’s mission and are consistent with its risk appetite.
 3. *Event Identification* – Internal and external events affecting achievement of an entity’s objectives must be identified, distinguishing between risks and opportunities. Opportunities are channelled back to management’s strategy or objective-setting processes.
 4. *Risk Assessment* – Risks are analyzed, considering likelihood and impact, as a basis for determining how they should be managed. Risks are assessed on an inherent and a residual basis.
 5. *Risk Response* – Management selects risk responses—avoiding, accepting, reducing, or sharing risk—developing a set of actions to align risks with the entity’s risk tolerances and risk appetite.
 6. *Control Activities* – Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out.
 7. *Information and Communication* – Relevant information is identified, captured, and communicated in a form and timeframe that enable people to carry out their responsibilities. Effective communication also occurs in a broader sense, flowing down, across, and up the entity.
 8. *Monitoring* – The entirety of risk management is monitored and modifications made as necessary. Monitoring is accomplished through ongoing management activities, separate evaluations or both.
- 1.15. Risk management is not strictly a serial process, where one component affects only the next. It is a multidirectional, iterative process in which almost any component can and does influence another.

Relationship of Objectives and Components

- 1.16. There is a direct relationship between objectives, which are what an entity strives to achieve, and risk management components, which represent what is needed to achieve them. The relationship is depicted in a three-dimensional matrix as follows:

Figure 1: Risk Management Model



- 1.17. This depiction portrays the ability to focus on the entirety of an entity’s risk management, or by objectives category, component, entity unit, or any subset thereof.

Effectiveness

- 1.18. Determining whether an entity’s enterprise risk management is “effective” is a judgment resulting from an assessment of whether the eight components are present and functioning effectively. Thus, the components are also criteria for effective risk management. For the components to be present and functioning properly there can be no material weaknesses, and risk needs to have been brought within the entity’s risk appetite.
- 1.19. When risk management is determined to be effective in each of the four categories of objectives, respectively, the legislative body and management have reasonable assurance that they understand the extent to which the entity’s strategic and operations objectives are being achieved. Further, they are assured that the entity’s reporting is reliable and that applicable laws and regulations are being followed.
- 1.20. The eight components will not function identically in every entity. Application in small and mid-size entities, for example, may be less formal and less structured. Nonetheless, small entities still can have effective risk management, as long as each of the components is present and functional properly.

Limitations

- 1.21. While risk management provides important benefits, limitations exist. In addition to factors discussed above, limitations result from the realities that human

judgment in decision making can be faulty, decisions on responding to risk and establishing controls need to consider the relative costs and benefits, breakdowns can occur because of human failures such as simple errors or mistakes, controls can be circumvented by collusion of two or more people, and management has the ability to override risk management decisions. These limitations preclude a legislative body and management from having absolute assurance as to achievement of the entity's objectives.

Encompasses Internal Control

- 1.22. Internal control is an integral part of risk management. The risk management framework encompasses internal control, forming a more robust conceptualization and tool for management. Internal control is defined and described in Internal Control – Integrated Framework. Because that framework has stood the test of time and is the basis for existing rules, regulations and laws; that document remains in place as the definition of and framework for internal control. Consequently, the entirety of that framework is incorporated by reference into this one.

Roles and Responsibilities

- 1.23. Everyone in an entity has some responsibility for risk management. The chief executive officer is ultimately responsible and should assume ownership. Other managers support the entity's risk management philosophy, promote compliance with its risk appetite, and manage risks within their spheres of responsibility consistent with risk tolerances. A risk officer, financial officer, internal auditor, and others usually have key support responsibilities. Other entity personnel are responsible for executing risk management in accordance with established directive and protocols. The legislative body provides important oversight to risk management, and is aware of and concurs with the entity's risk appetite. A number of external parties often provide information useful in effecting risk management, but they are not responsible for the effectiveness of, nor are they a part of, the entity's risk management.

2. THE ELEMENTS OF INTERNAL CONTROL

- 2.1. All personnel within the Government of A country are responsible for assessing risk in their area of responsibility and establishing those internal control procedures necessary to minimize risk. An Integrated Framework for Risk Management has been developed by the Committee of Sponsoring Organizations (COSO) of the Treadway Committee and is summarized below on page ?? The basic components of this framework are as follows:
1. Internal Environment
 2. Objective Setting
 3. Event Identification
 4. Risk Assessment
 5. Risk Response
 6. Control Activities
 7. Information and Communication
 8. Monitoring
- 2.2. COSO had previously developed an Integrated Framework for Internal Control and it is summarized in Section 5. This integrated framework has been incorporated into the Integrated Framework for Risk Management above and is still in effect. Basically, internal controls can help an entity achieve its performance goals and prevent loss of resources. It can help ensure reliable financial reporting. And it can help ensure that the entity complies with laws and regulations, avoiding damage to its reputation and other consequences. In sum, it can help an entity get to where it wants to go, and avoid pitfalls and surprises along the way. COSO indicated that an internal auditing function is often established within an entity to assist in monitoring the effectiveness and efficiency of internal control systems.
- 2.3. A Working Group on Audit Manuals from the European Court of Auditors (ECA) and select Supreme Audit Institutions (SAIs) from Central and Eastern European Countries, Cyprus, Malta, and Turkey was assigned the task to address audits of Internal Control Systems. They adopted the frameworks developed by COSO and identified the following key components of an ideal public internal financial control system in their report²:
- Management awareness and responsibility to establish sound and efficient financial control systems.

² Internal Control Systems in Candidate Countries, Vol. 1, Report to Supreme Audit Institutions of Central and Eastern European Countries, Cyprus, Malta, Turkey and European Court of Auditors prepared by the Working Group on Audit Manuals (November 2004).

- A strong central institution/organization (preferably Ministry responsible for finance) responsible for the direction and co-ordination of public finances.
- Centrally established standards (preferably by the same institution/organization as stated above) for accounting, financial statements and reporting and controls including internal audit.
- Clear procedures and transparent lines of responsibility and accountability in internal and external control environment.
- Risk assessment based systems and procedures of preventive, detective and directive controls, such as public procurement, countering of fraud and corruption, programming and selection of projects, etc.
- Clear and transparent rules for financial and performance reporting by the government and other public sector entities.
- An effective internal audit function.
- Strong and continuing external oversight (by parliament and supreme audit institutions) and sound professional relationship between internal and external audit.

2.4. INTOSAI had also provided a framework for establishing and maintaining internal control as well as a checklist (see paragraph 0) that could be used to determine if the concepts for risk management, internal control and internal audit had been fully implemented. The Working Group further identified the following key internal and external audit functions:

1. Management is responsible to establish and organize internal audit as a “supervisory function” within the organization’s internal control system and connection between management, stakeholders and external audit. Internal audit also has a role in risk management, and can help in realization of the basis goals of an organization. In effect, internal audit is independent and objective, and provides assurance and consulting activity designed to add value and improve effectiveness of risk management, control and governance processes.
2. The role of the external auditor will be to assess the work undertaken by internal audit and where possible rely on it. The external auditor may gain audit assurance from an effective internal control system, but to do so will need to ensure that it has operated correctly during the financial period. The external auditor will make a judgment on this following an assessment on the effectiveness of the internal control system, and also an assessment of the reliance that can be placed in the work of internal audit.

3. (Internal audit) is an important aspect of an internal control structure. The management of public entities should be clearly responsible for defining the role of internal audit and ensuring that it has an appropriate level of authority and independence, including the right to report to the highest level of management. A crucial instrument in developing and providing effective internal audit services should be the Central Harmonization Unit (CHU) - as a centre of excellence and experience. They should be responsible for developing and harmonizing of control and audit methodologies based on EU and international best practice, coordinating the further development of sound financial management by promoting best PIFC practice and quality assessment/compliance testing including internal control system and internal audit throughout the public sector.
 4. In evaluating the effectiveness of internal control, the external auditor can use the work of their internal audit colleagues, who form one part of the internal control structure, and are well placed to provide the external auditor with guidance as to the effectiveness of the systems that are in place. The external auditor must always remember however, that responsibility for the overall conclusion drawn is ultimately that of the external auditor based on an examination of the systems in place, the quality of the internal audit unit, and the attitudes towards internal control and risk management of the entity under review. To allow the work of internal audit to be effectively assessed, the external auditor has to understand purpose (role), procedures and methods of internal audit's work, as well as considering the quality of staff and the independence and objectivity that they bring to their work.
- 2.5. SIGMA³ had earlier identified the following need for internal and external auditors in their six baselines for public sector financial control:
1. A functionally independent internal audit/inspectorate mechanism with relevant remit and scope has to be in place. Could have the form of one or several organization entities, but should meet the following criteria: be functionally independent, have an adequate audit mandate (in terms of scope and types of audit), use internationally recognized auditing standards.
 2. It should also be considered if there is in place appropriate co-ordination and supervision of the applied audit standards and methodologies.
 3. One of the six baselines applies to external audit. It states that the general financial control standards for the management of EU-funds and own resources in the candidate countries as well as in the member states require an effective external audit of all public sector resources and assets, and that this should be carried out in a continuous and harmonized manner. The external audit could also have a crucial role in the evaluation of and reporting on how the financial control systems are implemented and function.

³ Public Sector Financial Control Baseline, Support for Improvement of Governance and Management (SIGMA), Organization for Economic Cooperation and Development (OECD) Baselines (October 1999)

3. INTERNAL CONTROL

Introduction

- 3.1. Senior executives have long sought ways to better control the entities they run. Internal controls are put in place to keep the entity on course toward their goals and achievement of its mission, and to minimize surprises along the way⁴. They enable management to deal with rapidly changing economic and competitive environments, shifting demands and priorities, and restructuring for future growth. Internal controls promote efficiency, reduce risk of asset loss, and help ensure the reliability of financial statements and compliance with laws and regulations.
- 3.2. Because internal control serves many important purposes, there are increasing calls for better internal control systems and report cards on them. Internal control is looked upon more and more as a solution to a variety of potential problems.

Definition of Internal Control

- 3.3. Internal control means different things to different people. This causes confusion among legislators, regulators and others. Resulting miscommunication and different expectations cause problems within an entity. Problems are compounded when the term, if not clearly defined, is written into law, regulation or rule.
- 3.4. This concept deals with the needs and expectations of legislators, management and others. While internal control can help an entity achieve its objectives, it is not a panacea. It defines and describes internal control to:
 1. Establish a common definition serving the needs of different parties.

Provide a standard against which governmental bodies, business, and other entities—large or small, in the public or private sector - can assess their control systems and determine how to improve them.
- 3.5. Internal control is broadly defined as a process, affected by an entity's legislative body, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
 1. Effectiveness and efficiency of operations
 2. Reliability of financial reporting
 3. Compliance with applicable laws and regulations

⁴ Executive Summary of Internal Control – Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission on their website (www.coso.org)

- 3.6. The first category addresses an entity's basic objectives, including performance goals and safeguarding of resources. The second relates to the preparation of reliable published financial statements, including interim and condensed financial statements and selected financial data derived from such statements, such as budgetary control releases, reported publicly. The third deals with complying with those laws and regulations to which the entity is subject. These distinct but overlapping categories address different needs and allow a directed focus to meet the separate needs.
- 3.7. While internal control is a process, the effectiveness is a state or condition of the process at one or more points in time. Internal control systems operate at different levels of effectiveness. Internal control can be judged effective in each of the three categories, respectively, if the legislative body and management have reasonable assurance that:
1. They understand the extent to which the entity's operational objectives are being achieved.
 2. Published financial statements are being prepared reliably.
 3. Applicable laws and regulations are being followed.

What Internal Control Can Do

- 3.8. Internal control can help an entity achieve its performance goals and prevent loss of resources. It can help ensure reliable financial reporting. And it can help ensure that the entity complies with laws and regulations, avoiding damage to its reputation and other consequences. In sum, it can help an entity get to where it wants to go, and avoid pitfalls and surprises along the way.

What Internal Control Cannot Do

- 3.9. Unfortunately, some people have greater, and unrealistic, expectations. They look for absolutes, believing that internal control can ensure an entity's success - that is, it will ensure achievement of basic objectives or will, at the least, ensure survival. Even effective internal control can only help an entity achieve these objectives. It can provide management information about the entity's progress, or lack of it, toward their achievement. But internal control cannot change an inherently poor manager into a good one. And, through shifts in government policy or programs, economic conditions can be beyond management's control. Internal control cannot ensure success or even survival.
- 3.10. An internal control system, no matter how well conceived and operated, can provide only reasonable - not absolute - assurance to management and the legislative body regarding achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the collusion of two or more people, and management has the ability to override the system. Another limiting factor is that

the design of an internal control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

Components of Internal Control

- 3.11. Internal control consists of five interrelated components. These are derived from the way management runs its activities, and are integrated with the management process. Although the components apply to all entities, small and mid-size entities 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:
1. *Control Environment* – The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people, management's philosophy and operating style, the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the legislative body.
 2. *Risk Assessment* – Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. 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 economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with the change.
 3. *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. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

4. *Information and Communication* – Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to informed decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as suppliers and shareholders.
5. *Monitoring* – Internal control systems need to be monitored—a process that assesses the quality of the system’s performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. 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 legislative body. An internal auditing function is often established within an entity to assist in monitoring the effectiveness and efficiency of internal control systems.

Integrated Framework

- 3.12. There is synergy and linkage among these components, forming an integrated system that reacts dynamically to changing conditions. The internal control system is intertwined with the entity’s operating activities and exists for fundamental business reasons. Internal control is most effective when controls are built into the entity’s infrastructure and are a part of the essence of the enterprise. “Built in” controls support quality and empowerment initiatives, avoid unnecessary costs and enable quick response to changing conditions.
- 3.13. There is a direct relationship between the three categories of objectives, which are what an entity strives to achieve, and components, which represent what is needed to achieve the objectives. All components are relevant to each objectives category. When looking at any one category—the effectiveness and efficiency of operations, for instance—all five components must be present and functioning effectively to conclude that internal control over operations is effective. The internal control definition—with its underlying fundamental concepts of a process, effected by people, providing reasonable assurance—together with the categorization of objectives and the components and criteria for effectiveness, and the associated discussions, constitute this internal control framework.

Roles and Responsibilities

3.14. Everyone in an organization has responsibility for internal control.

1. 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. In a large entity, the chief executive fulfils this duty by providing leadership and direction to senior managers and reviewing the way they are controlling the operation. Senior managers, in turn, assign responsibility for establishment of more specific internal control policies and procedures to personnel responsible for the unit’s functions. In a small entity, the influence of the chief executive is usually more direct. In any event, in a cascading responsibility, a manager is effectively a chief executive of his or her sphere of responsibility. Of particular significance are finance officers and their staffs, whose control activities cut across, as well as up and down, the operating and other units of an entity.
2. Legislative Body – Management is accountable to the legislative body, which provides governance, guidance and oversight. Effective members of the legislative body are objective, capable and inquisitive. They also have knowledge of the entity’s activities and environment, and commit the time necessary to fulfil their responsibilities. Management may be in a position to override controls and ignore or stifle communications from subordinates, enabling a dishonest management which intentionally misrepresents results to cover its tracks. A strong, active legislative body, particularly when coupled with effective upward communications channels and capable financial, legal, and internal audit functions, is often best able to identify and correct such a problem.
3. Internal Auditors – Internal auditors play an important role in evaluating the effectiveness of control systems, and contribute to ongoing effectiveness. Because of organizational position and authority in an entity, an internal audit function often plays a significant monitoring role.
4. Other Personnel – Internal control is, to some degree, the responsibility of everyone in an organization and therefore should be an explicit or implicit part of everyone’s job description. 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, non-compliance with the code of conduct, or other policy violations or illegal actions.
5. External Parties – A number of external parties often contribute to achievement of an entity’s objectives. External auditors, bringing an independent and objective view, contribute directly through the financial statement audit and indirectly by providing information useful to management and the legislative body in carrying out their responsibilities. Others providing information to the entity useful in effecting internal control are those transacting business with the entity, financial analysts, bond raters, and the news media. External parties, however, are not responsible for, nor are they a part of, the entity’s internal control system.

ANNEX: FRAMEWORK FOR ESTABLISHING AND MAINTAINING EFFECTIVE INTERNAL CONTROL⁵

Managers' Internal Control Roles and Responsibilities

Create a positive control environment by

- Setting a positive ethical tone,
- Providing guidance for proper behaviour,
- Removing temptations for unethical behaviour,
- Providing discipline when appropriate,
- Preparing a written code of conduct for employees.
- Ensure that personnel have and maintain a level of competence to perform their duties.
- Clearly define key areas of authority and responsibility.
- Establish appropriate lines of reporting.
- Establish management control policies and procedures that are based on management's analysis of risk.
- Use training, management communications, and day-to-day actions of managers at all levels to reinforce the importance of management control.
- Monitor the organization's control operations through annual assessments and reports to top management.

Auditors' Roles and Responsibilities

- Maintain independence in fact and appearance.
- Ensure professional competence of audit staff.
- Advise management on areas at risk.
- Establish auditing strategic plans and goals.
- Perform audits of operations.
- Evaluate information technology systems.
- Recommend ways to improve operations and strengthen controls.

⁵ Extracted from Annex 13, Vol. II, Internal Control Systems in Candidate Countries, Working Group on Audit Manuals, INTOSAI (November 2004).

- Follow up to ensure recommendations are fully and effectively implemented.
- Coordinate audit activities with external auditors.
- Implement an audit quality assurance system.
- Periodically evaluate effectiveness of internal control practices
- Continually monitor operation of internal control practices throughout the organization and modify them as appropriate

Checklist for Managers⁶

In establishing your framework, have you

- Assessed the risks the organization faces?
- Identified control objectives to manage the risks?
- Established control policies and procedures to achieve the control objectives?
- Created a positive control environment?
- Maintained and demonstrated personal and professional integrity and ethical values?
- Maintained and demonstrated a level of skill necessary to help ensure effective and efficient performance?
- Maintained and demonstrated an understanding of internal controls sufficient to effectively discharge responsibilities?

For implementing internal control, have you

- Adopted effective internal control throughout the organization?
- Based the organization's internal control on sound internal control standards?
- Included in the organization's internal control structure appropriate and cost-effective control practices?
- Prescribed control practices through management directives, plans and policies?
- Established a means of continually monitoring the operation of the organization's internal control practices?

Concerning the audit function, have you:

⁶ Taken from Internal Control: Providing a Foundation for Accountability in Government--An introduction to internal control for managers in governmental organizations, http://www.intosai.org/Level3/Guidelines/3_InternalContrStand/3_INT_Ae.pdf

- Shown an understanding of the difference between internal control and audit?
- Recognized that an audit function is integral to your organization's internal control?
- Established an audit function?
- Ensured the audit organization's independence?
- Given the audit organization responsibility for evaluating the effectiveness of the audited organization's internal control practices?
- Established a system to monitor the organization's progress in implementing internal and external auditor recommendations?