Internal Controls Over Financial Reporting (ICOFR)

From compliance to competitive advantage

Issue 1

Setting the context to ICOFR

Internal Controls Over Financial Reporting (ICOFR) is now viewed by many organisations as an opportunity to improve the efficacy and efficiency of their operating model. This presents an opportunity for an organisation to proactively strive for value addition in comparison to industry benchmarks, as opposed to viewing it solely as a compliance obligation. ICOFR highlights the procedures put in place by an organisation to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements.

The objective of ICOFR is to assist management in evaluating and testing the effectiveness of controls that are in place to mitigate the risks faced by an organisation. Through the effectiveness of ICOFR, an organisation can reduce the risks of material misstatement, improve financial statement quality, including disclosures, and attain adequate data security.

The foundational principles of ICOFR

The principles and best practices in relation to internal control and, specifically, ICOFR, are based on internationally recognised integrated control frameworks. These principles are fundamental elements necessary for an effective internal control system and are derived from the widely recognised COSO (Committee of Sponsoring Organizations) Framework. The five principles of COSO, which form the foundation of ICOFR, are as follows:

Control Environment

The control environment sets the tone of an organisation, influencing the control consciousness of its people.

Risk Assessment

Every entity faces a variety of risks from external and internal sources that must be assessed both at the entity and the activity level.

Control Activities

These are policies and procedures that ensure management directives are carried out.

Information & Communication

Pertinent information must be identified, captured and communicated in a form and timeframe that supports all other control components.

Monitoring

Internal control systems need to be monitored – a process that assesses the quality of the system's performance over time.

The three categories of controls within the ICOFR framework

The ICOFR framework consists of three categories of controls that are typically included in an organisation's overall internal control structure. All three categories operate together in an integrated manner to collectively reduce, to an acceptable level, the risk of not achieving the intended objectives. These controls are not necessarily defined within the COSO Framework but are commonly recognised and implemented in practice. They are as follows:

1. **Entity level controls**

   Controls applied across the entire organisation and relate to the control environment. They include tone at the top, accountability, management's philosophy and operating style, the integrity and ethical values of the organisation, the board of directors' oversight, etc.

2. **Process level controls**

   Controls applied to specific business processes within an organisation. They include controls such as segregation of duties, documentation and record keeping, approvals and verifications, performance reviews, and physical controls.

3. **IT and fraud controls**

   Controls related to IT systems and designed to prevent/detect fraudulent activity. They include controls such as background checks, monitoring, and investigation procedures, data backup and recovery, system change management, etc.

Key drivers fuelling the need for ICOFR

With everchanging regulatory and reporting requirements, Internal Controls Over Financial Reporting play a key role to ensure the integrity, accuracy and reliability of financial information. Over the years, various factors and incidences have spurred the adoption of robust Internal Controls Over Financial Reporting, and these include:

- **Regulatory compliance:** One of the major factors influencing Internal Controls Over Financial Reporting has been regulatory compliance. Particularly, this has been the case within highly regulated industries such as the financial services industry. Regulatory bodies, such as the Securities and Exchange Commission in the United States, the Financial Conduct Authority (FCA) in the UK and the Securities Exchange Commission in Nigeria, have imposed requirements for organisations to establish and maintain effective Internal Controls Over Financial Reporting. This has been done in part to reform corporate financial reporting, safeguard the integrity of capital markets and restore investor confidence.

In the US, Internal Controls Over Financial Reporting are primarily governed by the Sarbanes-Oxley Act (SOX) of 2002. SOX requires public companies to establish and maintain adequate internal controls to ensure the reliability of financial reporting.

The SEC in Nigeria requires listed companies to issue a certification on ICOFR, effective December 2023. Companies are thus required to engage consultants or auditors to perform an independent review and issue a statement on its existence, adequacy and effectiveness or otherwise.

Section 14 (1)(c) of the Corporate Governance Disclosure Directive, introduced by the Bank of Ghana (BoG), mandates Boards to disclose the status of Internal Controls Over Financial Reporting (ICOFR) in the Audited Financial Statements. This requirement aims to enhance transparency and accountability in financial reporting practices within the Ghanaian corporate sector.

- **Investor confidence and stakeholder trust:** Increased investor confidence and preserving stakeholder trust are positively correlated with effective Internal Controls Over Financial Reporting. Investors are more inclined to offer funding and make wise investment selections when there are strong policies, processes, and controls in place. Furthermore, organisations that have strong internal controls in place are likely to attract and retain stakeholders for business transactions.

- **Corporate governance:** Over the past two decades, corporate governance has garnered significant attention as a result of notable occurrences such as the Enron scandal, the introduction of the Sarbanes-Oxley Act, and the Global Financial Crisis. Internal controls have played a pivotal role in the growth of mechanisms for oversight and accountability that enhance accountability, transparency, and ethical behaviour in decision-making. The most recent Corporate Governance Disclosure Directive from the Bank of Ghana is another piece of local legislation that supports internal controls. According to this directive, the board of financial institutions must include information about the internal control framework effectiveness of their institutions within their audited financial statements.

- **Fraud awareness:** Every industry is vulnerable to fraud of some kind during the normal course of business; financial statement fraud is one such fraud. Internal controls serve as a system to identify and prevent fraudulent acts from occurring. Effective job separation, rigorous approval procedures, and monitoring activities are used to achieve this Without adequate Internal Controls Over Financial Reporting, it can be costly to conduct business when fraudulent activity goes undetected.

The seven pillars of a healthy ICOFR Programme

For an ICOFR programme to meet its potential of driving value, reducing cost and mitigating risk within an organisation, resources must be invested towards attaining maturity across seven (7) key pillars. Maturity in these pillars provide support in maintaining a "healthy" and value-driven ICOFR programme. The seven (7) pillars and their corresponding features are as follows:

Pillar 1: Strategy

- The foundation of every good ICOFR programme is a well-defined strategy that aligns with organisational priorities. A mature ICOFR strategy surpasses mere compliance; it becomes an enabler of corporate values and strategies. Recognising ICOFR as an inherently strategic initiative, it must be strategically positioned to garner support from the Board and C-level individuals.

Pillar 2: Risk assessment

- An effective ICOFR risk assessment connects key risks with audit assertions and supports the overall strategy, control selection, and testing approach. A more mature ICOFR risk assessment isn't static. It's technology enabled, aligned with the enterprise risk assessment and includes qualitative risk factors so that it's more than just a financial scoping exercise.

Pillar 3: Entity-level controls

- ELCs that operate at the right level of precision can act as an "insurance policy" to help mitigate other control failures if they occur. Management tends to shy away from ELCs due to external auditor concerns about precision levels and due to the requirements associated with management review controls. But, in practice, management often rely on direct ELCs to gain confidence in the overall financial results. It's wise to consider them in evaluating controls.

Pillar 4: Control selection

- Control selection should stay up to date with current business processes and focus on non-routine areas that require judgment. A common problem is too many key controls, many of which don't clearly link back to the overall assessment of financial reporting risk. The control inventory should include different kinds of controls (automated versus manual and preventative versus detective), contribute to improving control design and automation, and keep down the total cost of control.

Pillar 5:Testing strategy

- A healthy ICOFR testing strategy adjusts the testing approach based on risk, incorporates continuous monitoring, and leverages management's knowledge and expertise

Pillar 6: Evaluating results

- When ICOFR runs smoothly, the results would not show many deficiencies. When deficiencies do occur, a mature programme sets the right priorities: remediation efforts that implement sustainable solutions and also help improve operations and the broader organisation. Without such robust remediation, which correctly identifies and completely addresses a deficiency's root cause, the deficiency may return in subsequent years—an all-too-common occurrence in many companies

Pillar 7: Governance

- Good ICOFR governance means the right tone at the top, frequent training for process owners and control testers, adequate resources, and the right reporting structures. A mature ICOFR programme sets clear responsibilities and facilitates communication between who owns the overall programme, who designs the controls, who performs the controls, and who tests the controls.

Benefits of ICOFR

Internal Controls Over Financial Reporting (ICOFR) are crucial for ensuring the accuracy and reliability of financial information reported by organisations. The key benefits of implementing robust ICOFR systems to organisations are as follows:

- Provides a framework for internal controls that help prevent material misstatements in financial reporting
- Presents a structured methodology for recognising and assessing prospects for enhancing operational efficiency, lowering expenses, and elevating the quality of financial reports
- Enhances investor and stakeholder trust in the organisation's internal controls, thereby increasing the likelihood of attracting investments, securing financing, and facilitating business transactions
- Provides a systematic approach to compliance that can help organisations avoid penalties and other legal consequences associated with non-compliance of financial reporting frameworks such as SOX, IFRS, ISA, etc.
- Facilitates the identification and elimination of inefficiencies and redundancies in processes, ensuring that controls are suitably designed and operating effectively
- Facilitates risk mitigation in financial reporting and operational processes, thereby enabling organisations to make well-informed decisions and navigate uncertainties more effectively.

Case Study – Silicon Valley Bank's (SVB) Collapse:

- SVB, a once-prominent player in its industry, experienced a devastating collapse attributed to a combination of factors, including the absence of robust ICOFR measures. Without proper controls in place, financial irregularities went undetected, leading to substantial financial misstatements and misleading reports. Warning signs, such as unusual transactions and inconsistent financial data were overlooked, exacerbating the company's downward spiral.

The role of ICOFR in prevention:

- Had SVB implemented effective ICOFR measures, the collapse could have been prevented. A thorough assessment of control weaknesses would have highlighted specific issues, notably unusual transactions and inconsistent financial data. This awareness would have facilitated timely corrective actions, mitigating the risks that ultimately led to the company's devastating collapse. ICOFR's detection and prevention mechanisms would have identified and deterred fraudulent activities, safeguarding the company's financial integrity. Consequently, this strengthened financial control framework would have laid the groundwork for reliable financial reporting, increased transparency, and fostered stakeholder trust, enabling more informed decision-making.
- This case study underscores the importance of implementing strong ICOFR measures. It also lends credence to the notion that management and board of directors must prioritise ICOFR as a strategic imperative, actively promoting a culture of compliance, ethics, and accountability.

How can KPMG help?

KPMG helps its clients through planning, scoping, risk assessment, documentation of controls, test of control design & operating effectiveness, training and establishment of a sound ICOFR program. We are organising our people and networks around these service propositions.

ICOFR Advisory Services

Supporting clients in optimising their ICOFR framework, by providing comprehensive support in system design, seamless implementation, and targeted enhancements. This may include:

- Design of ICOFR systems
- Implementation of ICOFR systems
- Improvement of ICOFR systems
- Technology enablement

ICOFR Assessments

The assessment process encompasses a range of activities aimed at strengthening your control environment and ensuring compliance with industry regulations. This may include:

- Risk assessment and gap analysis
- Process documentation and evaluation
- Control testing and assurance
- Reporting

ICOFR Compliance

Our ICOFR compliance services support organisations in achieving and maintaining compliance with the Sarbanes-Oxley Act (SOX). This may include:

- Assessment of SOX compliance
- Implementation of SOX compliance controls
- Training on SOX Compliance

ICOFR Training Services

Provide several training services to help organisations improve their financial reporting processes and comply with regulatory requirements. This may include:

- ICOFR fundamentals
- Regulatory compliance
- Control design and documentation
- Control testing and evaluation
- Role-specific training (Board and executives)

Contact us

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