KPMG

Corporate Trends

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INTERNAL CONTROL AGENDA: THE BOARD FOCUS

Company boards are responsible for overseeing the adequacy and integrity of internal control systems as part of their corporate governance duties. As the issues of corporate governance made great leaps over the last few years, it is hardly surprising that boards now look to internal control as a tool for the governance of the corporation's operations as well as in managing directors' liabilities.

In the current charged environment, phrases such as "heightened scrutiny", "lapse controls", "poor accountability" and "responsible but not accountable" are used liberally and seen regularly across many internal control stories. As directors are increasingly pressured to become more accountable, transparent and responsive to stakeholder and community interests, there is a renewed focus on controls in a variety of areas from operational to financial control.

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Internal control requirements: Summary of key differences

The table below provides a summary of the key areas of difference between Malaysia's, the US's, the UK's and Australia's response to the issue of management and oversight of internal controls.

	Malaysia **Malaysian Code on Corporate Governance (MCCG)*** ***Listing Requirements****	**US** **Sarbanes-Oxley Act (Section 404)**	**UK** **Turnbull Report**	**Australia** **ASX Corporate Governance Council's Principle 7**
Control assertion	Boards of listed company must disclose in their annual reports the state of internal control in the form of a statement on internal control (SIC).	Management must assess and the CEO and CFO must report to the market on the effectiveness of the internal controls over financial reporting.	Management must confirm to the market it has reviewed the effectiveness of the internal controls throughout the financial reporting period, but not report on the results.	CEO and CFO must state in writing to the board that risk management, internal compliance and control systems are operating efficiently and effectively.
Documentation of controls	Encouraged but not mandatory.	Mandatory documentation of all significant controls is required.	Encouraged but not mandatory.	Encouraged but not mandatory.
External auditor attestation	The external auditor is required to review the SIC and report the results thereof to the boards of the public listed company.	The external auditor must attest to management's control assessment.	No external auditor attestation required.	No external auditor attestation required.
Risks of non-compliance	Material inconsistency arising from the external auditor's review of the SIC could lead to a qualified or adverse audit opinion on the financial statements (FS) if a required amendment is not made in the FS. Appropriate action against the public listed company, directors or officers (e.g. fines/ penalties, public/ private reprimand). Adverse impact on share price, corporate reputation and stakeholder relationships.	Qualified audit opinion on internal controls. Legal action against the CEO and CFO. Adverse impact on share price, corporate reputation and stakeholder relationships.	Adverse impact on share price, corporate reputation and stakeholder relationships.	Damage to CEO and CFO reputation. Adverse impact on share price, corporate reputation and stakeholder relationships.

*Note *: Set out under Principle DII and Best Practice AAI of the Malaysian Code of Corporate Governance.*
***: Set out under paragraph 15.27(b) of the Malaysia Securities Exchange Berhad's (MSEB) Listing Requirements.*

The Sarbanes-Oxley Act raises a direct compliance issue for all companies issuing securities in the US. Due to the significant influence of the US legislative and regulatory environment on the rest of the world, Sarbanes-Oxley will likely be used as a benchmark for assessing internal control over financial reporting.

So where does all this leave boards in Malaysia?

Implications for the board

For a public listed company in Malaysia, the board is ultimately responsible for internal control issues. Boards can delegate the internal control responsibility to the management but cannot abdicate from being ultimately responsible and answerable for questions relating to internal controls. For this reason, boards must take steps to assure themselves that internal controls, both financial and operational, are properly designed and operating effectively.

The *Statement on Internal Control: Guidance for Directors of Public Listed Companies ("ICG")* issued by the Task Force on Internal Control in February 2001 provides broad guidance on the key areas that directors should pay attention to in order to make a statement about the state of the company's internal control. The ICG requires the Board of the listed company to at least disclose *whether*:

- there is an an ongoing process for identifying, evaluating and managing the significant risks faced by the company;
- the process has been in place during the period under review;
- the process has been regularly review by the Board; and
- the process accords with the guidance set out under the ICG.

The explanatory foreword in the ICG suggests that references be made from other sources such as the report of the Committee of Sponsoring Organisations of the Treadway Commission ("COSO") Internal Control – Integrated Framework, for a more comprehensive definition on internal control. Indeed, under the new US regulatory regime, management is expected to identify, document and evaluate significant controls against "suitable control criteria". For this purpose, it appears that the COSO control model will be almost universally adopted and is expected to provide the basis for the external audit attestation of management's control assessment under Section 404 of Sarbanes-Oxley Act.

While the principle and best practice provision under the Malaysian Code on Corporate Governance relating to internal control are not as rigorous as Sarbanes-Oxley, boards of public listed companies on the MSEB should not underestimate the importance of the task and the resources required to fully assess internal controls to a reasonable level using an acceptable control model such as COSO. This is demanding agenda, particularly in establishing the appropriate internal control framework for the group of companies as a whole.

As an example, a bold public statement by the board that sound internal controls are in place when in fact there were material internal control weaknesses could put the board in an embarrassing situation when material errors, omissions or misstatements are later revealed. Apart from credibility issues, the board will likely be held accountable by the regulatory authorities and the court of public opinion.

Key action steps

Boards need to consider the adequacy and effectiveness of the process in place for them to gain a reasonable level of assurance that there is a sound system of internal control within the group of companies.

In considering what to do (if not already done), boards should consider asking their CEOs and CFOs a range of questions such as:

- What established risk management and internal control frameworks were used to support management's control assessment? If the CEO and CFO did not use a framework, what was the reason provided?

- If the board has embarked on a process to establish and implement a structured risk management system in the organisation, how ***effective*** has the implementation been? Are the quality and timing of the process and content of information (e.g. rigour in risk profiling) provided across the layers of management and finally to the board acceptable?

- Which key business processes (including financial reporting processes) and controls have been assessed and tested? More importantly, which ones have not and why not?

- Have significant processes been documented and evaluated? If not, how can management provide adequate assurance that all key controls have been identified for validation?

- What resources are being devoted to assessing the adequacy and integrity of internal control, and does management have the expertise to perform the assessment? If control gaps exist, how will they be addressed?

- Given existing budgets for internal audit, how is management going to ensure comprehensive coverage of the controls?

- How effective is the internal control oversight in the organisation? Does internal audit play a key role to validate the effectiveness of the governance, risk management and internal control in the organisation?

- What programmes are, or will be put in place to assess, test, and continuously improve controls?

- What key performance indicators ("KPIs") are in place to monitor and motivate managers to take responsibility and accountability for their controls?

- What type of training will be provided to employees performing internal control related tasks to create a risk and control awareness environment and to help ensure they understand the importance and the impact of these activities?

It has been four years since the MCCG was released in its final form in March 2000 to provide listed companies with an opportunity to self regulate. Commentators have argued that some companies have treated the MCCG as a compliance issue, but yet our experience indicates that the MCCG has been used as a platform by many boards to initiate performance-enhancing change right through the organisation.

But perhaps - as history will tell of the experience in the US when the COSO guidelines were released in the 1990s - should our companies fail to properly self regulate, then they may find themselves facing a very tough legislative environment requiring a costly response as illustrated by the Sarbanes-Oxley example.

Boards will be looking to their audit committees to support its role in ensuring strong corporate governance. In recognising the changing roles of audit committees to address internal control and other issues, KPMG has released its Audit Committee Guide on 11 March 2004. For more information on the KPMG Audit Committee Guide, please contact Ms Valerie Lourdes at 03 2095 3388 ext 1903.

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