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Assessing the system of internal control

Audit Committee Questions
Audit Committee Institute

Audit committees play an important role in overseeing an organization's internal control processes. Effective audit committees perform their oversight by demanding relevant, timely and accurate information from management, the internal auditor and the external auditor, and by asking direct and challenging questions.

Financial reporting risk | **Reasonable assurance** | **Monitoring activities** | **Internal control reporting** | **Annual review exercise**

Audit committee oversight essentials …

Management is responsible to establish and maintain an effective system of internal control. The audit committee is to oversee these controls and to review the effectiveness of the system as a whole. An effective internal control system provides reasonable assurance that policies, processes, tasks, behaviours and other aspects of an organisation, taken together, facilitate its effective and efficient operation, help to ensure the quality of internal and external reporting, and help to ensure compliance with applicable laws and regulations.

Internal controls should be used to maintain the risks facing the company within the defined risk tolerance levels set by the board, bearing cost-benefit considerations in mind. The audit committee should be satisfied that proper control policies, procedures and activities have been established and are operating as intended. An effective system of internal controls hinges on the right tone set at the top of the company – the board and audit committee should send out a clear message that internal control responsibilities must be taken seriously.

The performance of the system of internal control should be assessed through ongoing monitoring activities, separate evaluations such as internal audit, or a combination of the two. Procedures for monitoring the appropriateness and effectiveness of the identified controls should be embedded within the normal operations of the organisation. Although monitoring procedures are part of the overall system of control, such procedures are largely independent of the elements they are checking. While effective monitoring throughout the organisation is an essential component of a sound system of internal control, the board cannot rely solely on embedded monitoring processes to discharge its responsibilities. The board, with the assistance of the audit committee, should regularly receive and review reports on internal control and be informed about how the reviews giving rise to the reports have been undertaken.

The reports from management should provide a balanced assessment of the effectiveness of the system of internal control in the areas covered. Any significant control failings or weaknesses identified should be discussed in the reports, including the impact they have had, could have had, or may have on the organisation, and the actions being taken to rectify them. It is essential to have a frank, open dialogue between management and the audit committee on matters of risk and controls.

The audit committee should define the process to be adopted for its (annual) review of the effectiveness of internal control and risk management systems. The annual review exercise should consider the issues dealt with in the reports reviewed during the year, together with additional information necessary to ensure that the board has taken account of all significant aspects of internal control.

Indications that internal control isn't working as intended …

Executive and business teams are not engaged in the risk and control processes	- Formal risk and control discussions are regularly postponed - Risk and control processes are disconnected from 'business as usual'
Development of the system of internal control is seen as the ultimate goal	- Overly complex process and business teams are slow to adopt - Little enhanced debate or further quantification
Oversight and challenge is not robust	- Reporting focuses on risk coverage, rather than action - Risk and control assessments, reports / processes rarely change - Business owners are not challenged, and receive little feedback
The role of the risk function is confused, at best misunderstood – at worst ignored	- Little remit to challenge strategy and related risks - Seen as consolidators of information
Unclear accountability for risk and control	- Risks are not addressed in a timely manner, and struggle to find a home - Internal audit "owns" the process
Assurance is patchy – strong for traditional risks; weak on emerging risks	- No clear assurance map - Internal audit plans rotate around the same topics - Executive teams rely heavily on management self-assurance

Key questions for audit committees to consider:

Identification and monitoring of controls

- Does management have clear strategies for dealing with the significant risks identified? Are internal control actions defined for all significant risks that have been identified?
- How are processes/controls adjusted to reflect new or changing risks, or operational deficiencies?
- Are the company's resources sufficient to adequately perform all internal control activities? What specialists will be involved in evaluating controls over complex, judgmental and IT-dependent processes?
- Does the organisation's culture, code of conduct, human resource policies and performance reward systems support its objectives and the internal control system?
- Through their actions and policies, does management demonstrate the necessary commitment to competence and integrity within the organisation?
- Is authority and responsibility clearly defined and segregated? Are the decisions and actions of different parts of the organisation appropriately coordinated? Are there adequate controls over the approval and monitoring of special non-recurring transactions?
- Do management and the board receive timely, relevant, reliable reports on risk and internal control? Are key risk indicators set up to monitor significant risks and mitigating actions?
- Are there areas of the organisation's operations that are not fully understood by internal audit or other assurance providers?
- Is management's self-assessment process adequately managed, formalized and tested by internal audit? Is the right amount of independent challenge built into the process?
- Are internal audit visits on a cyclical basis and/or special reviews by external auditors used to the fullest extent in the monitoring process?

Reviewing and assessing internal control

- Are there ongoing review processes embedded within the organisation's operations, that monitor the effective application of the policies, processes and activities related to internal control and risk management?
- Do these processes monitor the organisation's ability to re-evaluate risks and adjust controls effectively in response to changes in its objectives, business, external environment and other changes in risk and control assessments?
- Is there appropriate communication to the board (and committees) on the effectiveness of the ongoing monitoring processes for risk and internal control matters, including reporting on any significant failings or weaknesses on a timely basis?
- Do any internal control findings or weaknesses indicate a need for more extensive monitoring of the internal control system?
- Is inconsistent risk or internal control information received from a number of competing functions and, if so, are steps needed to ensure management gives a single view of risk and internal control?

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