

# **RISK, GOVERNANCE AND AUDIT**

## **CORPORATE LEVEL**

### **TUTE 06.1**

## **(INTRODUCTION TO INTERNAL CONTROLS)**

### **GENERAL OVERVIEW**



by

**Jeewantha Perera**

**(FCA, ACCA, MBA, B.Sc Accountancy (sp))**

# INTRODUCTION TO INTERNAL CONTROLS

## Internal Control System of an Organization

An internal control system refers to processes introduced by management to help the organizations to accomplish its objectives and goals. Internal controls specify how organizations resources should be directed, controlled and measured. As a result, it plays an important role in preventing and detecting frauds and protecting the organizations resources.

Any entity, irrespective of their size and nature of the operations, requires internal controls. When the organization's operations are complicated, a more sophisticated internal control system is required.

## What is the definition of Internal Control System?

**"Internal control is broadly defined as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to effectiveness & efficiency of operations, financial reporting, and compliance with applicable laws & regulations"**

**"The process designed, implemented and maintained by those charged with governance, Management and other personnel to provide reasonable assurance about the achievement of an entities objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations."**

## Objectives of Internal Control System

### A) Reliability of Financial Reporting

It is the responsibility of the Management to prepare the Financial Statements to meet the common use of the intended users of the Financial Statements. Also, Management has a responsibility to ensure that the Financial Statements are prepared in accordance with the Sri Lanka Accounting Standards and applicable reporting framework including Generally Accepted Accounting Principles.

Reliability of the Financial Information/Financial Statements is one of the key aspects which all the intended users are focusing when taking the respective economic decisions. Therefore, the above requires the business organizations to have a sound internal control within the business organization to maintain the Reliability of the Financial Information to the highest standards.

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## B) Effectiveness and Efficiency of Operations

Internal Controls implemented within the business organization also meant to encourage the efficient and effective use of limited resources including personnel, to optimize the goals of the business organization. An important part of these controls is accurate information for internal decision making. A wide variety of information is used for making critical business decisions. For eg: Price to be charged for a product is based on the information about the cost of making products

Another important part of effectiveness and efficiency is safeguarding the Assets and Records. The physical assets and documents can be stolen, misused or accidentally destroyed unless they are protected by adequate controls.

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## C) Compliance with Applicable Laws and Regulations

There are many laws and regulations that the organizations are required to follow which are directly or indirectly related to various aspects of the business operations. Compliance with these laws and regulations are critical for the functions of the organization and non-compliance of certain laws may affect the Going Concern ability of the business organization. Therefore, the business organizations should have proper Internal Control Systems in place to make sure that the organization is complied with the applicable laws and regulations.

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## SUMMARY.

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### 3) Risk Assessment

This refers to the identification, analysis and management of uncertainty facing the organization. Risk Assessment focus on uncertainties in meeting the organization's financial, compliance and operational objectives. The risk assessment process forms the basis of how management determines the business risk to be managed.

Under the Risk Identification, the business organization should identify each and every risk and to segregate in between Internal and External risks

Upon the identification of the risks, those risk should be analysis in detail depending on the Impact of the Risk and the Possible Occurrence of the Risk, which is referred as the Risk Analysis. The main objective of the Risk Analysis is to establish the potential impact to the organization and the achievement of the organization objectives.

Upon Identification and Analysis of the Risk, the Business Organization should decide which risk is more important than others and identify those which should be treated or managed. This is referred as Risk Evaluation.

#### **Practical Example of how the Business Organizations are performing Risk Assessment**

ABC Company is a Company which operates in the apparel industry and the Managing Director (MD) of ABC, devoted the attention for the following key points in the recent Board Meeting.

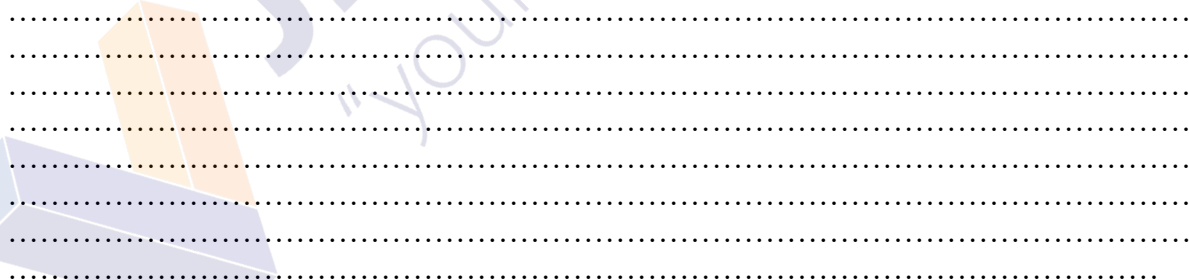
- a) As a result of the economical policy which as been taken by the government, the prices of the apparel which the Company currently exporting to the European Market is increased significantly and further MD stated that, at present the Company prices are much higher than the its competitors which is located at India and China. Further MD stated that, as a result of the prices increase, the Company is experiencing a significant decrease in the current export quantities, compared to previous quarters.
- b) Company IT system faced several breakdowns during the last three months and the system has been repaired by the system vendor and they have provided a warranty period of 2 months.
- c) A local competitor is trying to attract Company's most senior and experience employees while providing a higher salary and MD further stated that, the replacement of these vacancies are much more difficult in the current business context
- d) A minor supplier who supplies material to the Company has requested a price increase and the Company is having the ability to accept the price increase. Further, MD stated the Company is in the position to find new suppliers as well, if it wanted.
- e) Few of the Minor Employees are already resigned from the Company and several employees are going to resign as well in the near future. However, as per MD, the Company is having the ability to recruit new staff under that capacity if the situation demands.

Assume, you are the Finance Manager of ABC Company and based on the above mentioned scenarios, you are expected to carry out the Risk Identification and Risk Response from the Risk Management perspective.

Learning Partners

#### 4) Information and Communication

Information and communication are the process of capturing and exchanging the information needed to conduct, manage, and control the company's operations. Therefore, the information and communication component of internal control is a necessary prerequisite for achieving reliable and relevant information.



## 5) Monitoring

This refers to the assessment of the quality of internal control. Monitoring activities provide information about potential and actual breakdowns in control system that could make it difficult for an organization to accomplish its goals. Responsibility of monitoring internal controls rests with the board of directors of the company.

Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions.

Eg: Management's review of whether bank reconciliations are being prepared on timely basis

Internal Auditors' evaluating the Internal Controls at regular intervals.

Legal department oversight of compliance with the entity's ethical or business practice policies

## **Inherent Limitations of Internal Control Systems**

### **1) Cost Focus/ Cost over Benefits**

Since the end objective is to make profits, all the time, management is really considering about the cost which the business organization incur for internal controls. Always, Management is believing that the benefit derived from the Internal Controls should be higher than the Cost incurred to implement those controls.

### **2) Management override of controls**

Because of the authority and responsibility of officials high up in the organizational structure, the risk infuses that they can easily override the internal control system.

### **3) Collusion**

Lack of integrity and dishonesty of employees and officials can lead to collusion amongst two or more people to circumvent the internal control system.

### **4) People mistakes/Human Errors can be occurred**

The effectiveness of the internal control system depends on the competence, reliability and due care of the people responsible for its operation. Mistakes/errors threaten the effectiveness of any internal control system.

### **5) Controls are mainly focusing on the day-to-day transactions**

Most of the Internal Controls are focusing on the day-to-day transactions. However, there are transactions which is not happening on daily basis. However, controls should be there for those transactions as well.

