Auditing The Efficiency of Internal Control System

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Collapses of such multinationals as Enron and Worldcom in the early 2000s and recent bankruptcies of such financial groups as Lehman Brothers and Washington Mutual damaged investors' confidence in the management system and gave birth to a need to rate reliability of the management system and efficiency of the internal control system in listed companies.

1. Necessity for reports on internal control system

The internal control, an indispensable part of the business management, has become one of worries for investors after a series of financial scandals that led to bankruptcies all over the world.

Many experts and analysts maintain that the main cause of such corporate collapses is weaknesses of the internal control. This argument was supported by a report released in 2004 by the International Federation of Accountants' PAIB (Professional Accountants in Business) committee that aimed at analyzing main causes of collapses of multinationals. The report pointed out the following factors:

- CEO's failure to uphold high ethical standards, allowing a culture to flourish in which secrecy, rule-breaking and fraudulent behavior became acceptable; and allowing high degree of risk (cases of Enron and Worldcom in the U.S. and France Telecom in France).

- Dominant chief executives are able to wield unchallenged influence and authority over the other senior executives and board directors (cases of HIH in Australia and Ahold in the Netherlands).

- Board of directors fails to challenge the chief executive or adopt a generally questioning and independent approach to all the material presented by management (cases of Viviendi in France, Worldcom in the U.S. and HIH in Australia).

- Excessive rewards package based on profit (cases of Enron in the U.S. and HIH in Australia).

- Ineffective internal control system and risk estimating process (cases of Enron and Xerox in the U.S., and Cable & Wireless in the UK).

Facing such a situation, many legal regulations have been introduced in countries to enhance the reliability of the internal control system relating to the financial statements. One of these regulations is the Sarbanes – Oxley Act 2002 in the U.S. that requires all listed companies to make reports on the internal control system. Section 404 of the Sarbanes – Oxley Act stipulates that issuers should include in their annual report a management assessment of effectiveness of internal controls and procedures for financial reporting, and auditors should attest to and report on the management assessment on the effectiveness of the internal control structure.

This Act is considered by many countries as an international standard of management responsibility and compliance with the law pertaining to the internal control. This effort shows that the US government and many others have set stricter requirements on corporate reports and legal assurance of the internal control of public companies.

The demand for a report on credibility of the internal control system is not only a legal requirement that aims at ensuring a transparent environment of business but also a legitimate demand of investors to evaluate the management responsibilities for corporate governance, namely, for building of an effective internal control system. In addition, this can serve as a basis for investors to assess the management competence and encourage them to maintain the effective internal control system.

To ensure that the management assessment of the internal controls is reliable, auditors' attestation of the effectiveness of the internal control system is really necessary. The Sarbanes-Oxley act requires auditors to attest to and report on the management assessment on the internal control system. This is attestation service that is inseparable from the auditing service for the financial reports. In some other countries, such as the UK and Australia, although regulations about assessment on the internal control are not legally compulsory, the attestation service has been one of concerns for their legislative bodies and encouraged to be implemented separately or simultaneously with the audit of financial reports.

2. Criteria for assessing the internal control system

The problem with attestation of effectiveness of the internal control is what criteria are used for auditors to assess design and maintenance the internal control system. Criteria that are suitable for international standards of attestation service are the one set by law or the one designed by managers; suppliers of service; or users with special purposes.

Various models of internal control systems have been developed in the past few years, such as "Internal control - Integrated Framework" introduced by COSO (Committee of Sponsoring Organization) in 1992; "Guidance on Assessing Control" or Criteria on Control (CoCo) Framework by the Canadian Institute of Chartered Accountants (CICA) in 1995; and "Internal Control: Guidance for Directors on the Combined Code" (or Turnbull Report) by the Institute of Chartered Accountants in England and Wales, etc.

Up till now, although no standard model of the internal control system can apply to all assurance engagements pertaining to the internal control system, the suitable standard commonly used for contracts to assure the internal control system is the COSO 1992 model.

a. The Integrated Framework model is publicized in 1992 by the COSO under the National Commission on Fraudulent Financial Reporting (NCFFR) and has been adopted by many American companies to carry out assessment as required by the Section 404 of the Sarbanes – Oxley Act.

According to COSO 1992, 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 in the following categories:

- Effectiveness and efficiency of operations;

- Reliability of financial reporting;

- Compliance with laws and regulations.

The COSO 1992 model of internal control system consists of five interrelated components:

- The control environment is the foundation for all other components of internal control, providing discipline and structure and including the whole personnel and working environment. 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 board of directors.

- Risk assessment is the act of establishing instruments for identifying, analyzing and managing risks relevant to achievement of assigned objectives.

- Control activities: They are the policies and procedures as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties established and realized to ensure management directives are carried out. Control activities aim at addressing risks to achievement of the entity's objectives.

- Information and communication: Information systems produce reports, including operational, financial and compliance-related information. Communication is realized in the whole organization and necessary to both the internal bodies and external parties, such as customers, suppliers, regulators and shareholders. Information and communication help all personnel gather and exchange information needed for realizing, managing and controlling operations of the organization.

- Monitoring: It is a process that assesses the quality of the system's performance over time. Monitoring is accomplished through ongoing management activities, separate evaluations, or both.

According to the COSO 1992, the internal control is a process while effectiveness is a state or condition of the process that is valid at a time. Assessing whether an internal control system is effective or not is a subjective judgment based on assessment of effectiveness of the said five components. Thus, these components constitute criteria for assessing the effectiveness of the internal control system.

It's worth noting that, however, the demand that the effectiveness of all five components is satisfactory doesn't mean that each component should operate separately or reach the same degree of assurance in the organization. Just because the control activities could serve different purposes, the control activity in one division can help achieve control objectives in other divisions. Moreover, a control procedure may be different in terms of degree when it is incorporated into other additional procedures in order to address some specific risk.

In the COSO 1992, each content of every component includes an "assessment" used for presenting factors to be considered of the five components of the internal control system. However, factors used for the assessment according to COSO criteria are only suggestions and they are not appropriate to all cases. In reality, it's necessary to design an assessment program suitable for each case.

b. COSO Enterprise Risk Management 2004

In September 2004, the COSO introduced the Enterprise Risk Management as an extended model of internal control COSO 1992. The model expands on internal control, providing a more robust and extensive focus on the broader subject of enterprise risk management. It is not intended to and does not replace the internal control framework, but rather incorporates the internal control framework within it in order to support the risk management process.

According to the COSO 2004, enterprise risk management is a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, 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.

This enterprise risk management framework is geared to achieving an entity's objectives, set forth in four 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.

The enterprise risk management 2004 consists of eight interrelated components.

+ 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.

+ Objective Setting – Objectives must exist before management can identify potential events affecting their achievement. Enterprise 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.

+ Event Identification – Internal and external events affecting achievement of an entity's objectives must be identified, distinguishing between risks and opportunities. Opportunities are channeled back to management's strategy or objective-setting processes.

+ 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.

+ 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.

+ Control Activities – Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out.

+ Information and Communication – Relevant information is identified, captured, and communicated in a form and time frame that enable people to carry out their responsibilities. Effective communication also occurs in a broader sense, flowing down, across, and up the entity.

+ Monitoring – The entirety of enterprise risk management is monitored and modifications made as necessary. Monitoring is accomplished through ongoing management activities, separate evaluations, or both.

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Determining whether an entity's enterprise risk management is "effective," according to the COSO 2004, 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 enterprise risk management.

3. Level of assurance of auditing service

The International Framework for Assurance Engagement identifies two classes of assurance engagement that could be performed by practitioners as reasonable assurance engagement and limited assurance engagement. The reasonable assurance engagement aims at a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement, as the basis for a positive form of expression of the practitioner's conclusion. However, the reasonable assurance provides a high, but not absolute, level of assurance about effectiveness of control procedures. And the limited assurance engagement: A reduction in reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

The present problem is what level of assurance is appropriate to assurance engagement of effectiveness of the internal control system. Results of studies of levels of assurance of reliability of the internal control have been included in legal regulations and professional standards in some countries in recent years.

- In Australia, the Australian Auditing Standards 810 "Special Purpose Reports on the Effectiveness of Control Procedures" (AUS108 for short) promulgated in 1999 provides guidance pertaining to reports on the effectiveness of control procedures. The AUS considers the assurance engagement as audit (reasonable assurance), review (limited assurance), or agreed-upon procedure (non assurance).

In the UK, in 2001, the Audit Practices Board (APB) issued a document titled Providing Assurance on the Effectiveness of Internal Control (APB 2001) to present elements of providing assurance on internal control. This document distinguishes providing assurance on design of internal controls and providing of assurance on operation of internal controls in accordance with the design. According to the document, the reasonable assurance can only be offered for operation of the internal control system, not for the design of the system.

- The Sarbanes – Oxley Act 2002 requires that auditors should attest to and report on the management assessment on the effectiveness of the internal control structure. Section 404 (b) of the Act reads, "an attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board [PCAOB]. Any such attestation shall not be the subject of a separate engagement." To carry out this requirement, Public Company Accounting Oversight Board (PCAOB) issued Auditing Standard Number 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* in June 2004. The Standard requires that procedures used by auditors must provide reasonable assurance that the customer's internal control system is sufficient and appropriate.

In spite of some differences in levels of assurance of audit service on the internal control system, standards of auditing service and assurance engagement consider potential limitations as reasons why auditors can not provide absolute assurance on reliability of the internal control system. The main potential limitation is the fact that effectiveness of control procedures is only a state at a time. Any anticipation about the effectiveness of control procedures in future may lead to risks when the procedures become inappropriate due to changes in operating conditions or reduction in compliance with control procedures.

4. Opinions of auditors about effectiveness of the internal control system

The International Framework for Assurance Engagement requires suppliers of assurance engagement to provide a written report containing a conclusion that conveys the assurance obtained about the internal control system. This report depends on reasonable or limited level of assurance. Practitioners can express their conclusion in positive or negative form, or give adverse conclusion or a disclaimer of conclusion about both kinds of assurance engagement on a case-by-case basis.

The Framework suggests:

- In a reasonable assurance engagement, the practitioner expresses the conclusion in the positive form, for example: "In our opinion internal control is effective, in all material respects, based on XYZ criteria."

- In a limited assurance engagement, the practitioner expresses the conclusion in the negative form, for example, "Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on XYZ criteria."

5. Necessity for auditors' report on effectiveness of internal control system in Vietnam

Vietnamese economy is developing and integrating into the world market. Its stock market is in its first stage of development and defects in the internal controls of listed companies become a worrying problem. Besides insufficient and inappropriate internal controls, many public companies are facing such problems as abuse of power by directorate, dependent and incompetent board of directors, poor risk assessing process, and lack of control procedures.

Lessons from collapses of major groups in the world and situation of public companies in Vietnam today lead to the need for the service of attesting to effectiveness of internal controls in order to protect investors and further the development of a transparent and healthy finance market. The need for audit of effectiveness of internal controls has become urgent and must be made compulsory. In addition, Ministry of Finance should set standards for the audit of internal controls including regulations pertaining to the supply of assurance engagement, such as accepted criteria for assessment, assessing methods, reporting of effectiveness of internal control, and levels of assurance of auditing service.

In public companies, the management should make reports on responsibility for designing and operating internal controls needed for providing reasonable assurance on achievement of corporate objectives. In addition, demand for auditors' attestation of effectiveness of internal controls should be made into law with a view to assess ability and responsibility of the management for maintaining an effective system of internal controls. Auditors' reasonable assurance will serve as a basis for conclusion that possibility of violating control procedures and policies without being prevented and discovered is very rare.

It's worth noting that an internal control system considered as effective is not a miraculous remedy for all problems of the companies. An effective system of internal controls can assure reasonably that it can help achieve corporate objectives. It can't certainly prevent absolutely all mistakes, wrong judgments or intentional fraud by members of the company. The potential limitations of the internal controls can only be solved by enhancing quality of the human resource. ■

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