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# Role Of Internal Auditors In Internal Control Over Financial Reporting (ICFR)

MAKING AN IMPACT THAT MATTERS since 1845

# Background to the Investment and Securities Act (ISA) of 2007

1962

1979

1999

2007

2021

### Capital Issues Committee

Operated within the CBN

Mandate was to examine applications from companies seeking to raise capital from the capital market and recommend the timing of such issues to prevent issues clustering which could overstretch the market's capacity

### Securities and Exchange Commission (SEC) Decree No. 71 of 1979

Capital Issues Committee metamorphosed into SEC with the promulgation of SEC Decree No. 71 of 1979

### Investments and Securities Act (ISA) No 45 of 1999

Successive reviews of this earlier enactment led to the introduction of a new legislation

### Investments and Securities Act (ISA) No 45 of 2007

Enlarged powers and functions of the Commission over the capital market

As part of the efforts to reform corporate financial reporting in Nigeria, provided specific requirements in S. 60 – 63 to be met by companies with respect to Internal Controls Over Financial Reporting (ICFR)

### Guidance on Implementation of Sections 60 – 63 of Investments and Securities Act 2007

The SEC issued the framework for implementation of S. 60 to 63 of the ISA, 2007, including the specific requirements on ICFR

# Why the ICFR Guidelines – Practices in other Jurisdictions

*"Sustaining reliable financial reporting is dependent upon effective ICFR".*

In the aftermath of the Enron era, several countries have enacted legislation around evaluating financial reporting controls, which require Management to assess internal controls, **but not the company's external auditor**. Some countries have adopted a "comply-or-explain" approach to management assessment, while others have issued corporate governance codes that recommend having a management assessment.

## Why the focus on ICFR now?

- A commitment to internal controls which permeates across the organization – operations, compliance with laws and regulations in financial reporting.
- While ICFR is not new… the complexity of financial reporting and business models continue to evolve.
- Regulators are continuing to push to enhance the reliability of financial reporting for investors.
- As a result, in the past few years, the SEC is now placing emphasis on effectiveness of ICFR to reduce company failure.

## Similar legislations in other jurisdictions

**U.S.A**

The U.S. enacted the Public Company Accounting Reform and Investor Protection Act to improve public and financial reporting, commonly referred to as the Sarbanes-Oxley Act of 2002 or "SOX . Of the numerous provisions of US-SOX, Sections 302, 404 and 906 require certification of financial statements and other financial information as well as an assertion of the effectiveness of internal control over financial reporting (ICFR) by a company's management.

**Japan**

The Financial Instruments and Exchange (FIE) of 2006 incorporates Japan's ICFR requirements. In applying this law, the Subcommittee on Internal Controls of the Business Accounting Council issued its "Evaluation and Auditing Standards for Internal Control for Financial Reports" and "Implementation Standards," both of which were finalized in 2007. The Law and Standards are collectively referred to as **Japanese SOX or J-SOX,**

**China**

Basic Standard for Enterprise Internal Control (the Standard) was passed in 2008 and the related series of supplemental guidelines (the Guidelines) in 2010 to improve the feasibility of the stock exchanges' requirements regarding internal control self-assessment through providing generally accepted rules for the assessment of internal control effectiveness. Together, the Standards and Guidelines are sometimes referred to as Chinese-SOX (C-SOX)

# Dissecting the SEC’s Guidelines for Implementation of S. 60 to 63

“Sections 60 to 63 of the ISA of 2007 require public companies to include in their annual reports **a report of management on the company’s internal control system**”

### Certification in annual or periodic reports

The CEO and CFO or officers or persons performing similar functions in a public company filing periodic or annual reports under S.60(1), shall certify in each annual or periodic report filed, that -

- They are responsible for establishing and maintaining internal controls
- They have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known
- They have evaluated the effectiveness of the company's internal controls as of a date within 90 days prior to the report
- They have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation and also disclosed to their external auditors and audit committee, significant deficiencies noted
- They have identified in the report whether or not there were significant changes in internal controls or other factors that could significantly affect internal controls, including any corrective actions.

### Duty of directors on internal controls

S. 61(3) requires that a public company shall establish a system of internal controls over its financial reporting and security of its assets and it shall be the responsibility of the board of directors to ensure the integrity of the company's financial controls and reporting

# Dissecting the SEC’s Guidelines for Implementation of S. 60 to 63

## Management's Annual Assessment of, and Report on, the Company's Internal Control over Financial Reporting

The board of directors of a public company shall report on the effectiveness of the company's internal control system in its annual report (Sec. 61(2)). The company’s annual report should include an internal control report of management that contains:

A statement of management's responsibility for establishing and maintaining adequate ICFR for the company

A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company’s ICFR

Management's assessment of the effectiveness of the company’s ICFR as of the end of the company's most recent fiscal year, including a statement as to whether or not the company’s ICFR is effective

A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued **an attestation report on management's assessment** of the registrant’s ICFR

## Duty of auditor to report on internal controls of public companies

A company is required to file, as part of the company’s annual report, the attestation report of the external auditors that audited the company’s financial statements in addition to the report of the internal control system

An auditor of a public company shall, in his audit report to the company, issue a statement (Attestation statement) as to the existence, adequacy and effectiveness or otherwise of the internal control system of the public company (Sec. 63)1

# Dissecting the SEC's Guidelines for Implementation of S. 60 to 63

### Auditor Independence Issues

The auditor is required to attest to management's assessment of internal control over financial reporting. Companies and their auditors should be mindful of regulations on auditor independence that prohibit an auditor from providing certain non-audit services to an audit client

### Material Weaknesses in Internal Control over Financial Reporting

Management of a company is precluded from determining that a company's internal control over financial reporting is effective if it identifies one or more material weaknesses in the company's internal control over financial reporting

# Dissecting the SEC's Guidelines for Implementation of S. 60 to 63

## Method of Evaluating

The methods of evaluating ICFR will vary from company to company, however, a company must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the company's ICFR

The assessment of a company's ICFR must be based on procedures sufficient both to evaluate the design, implementation and to test the operating effectiveness.

## Location of the report in annual financial statements

The report should be close to the corresponding attestation report (opinion page) issued by the company's independent audit firm, or in a portion of the document immediately preceding the companies' financial statement.

# Framework For Implementation of Internal Control over Financial Reporting

The SEC guideline provides that management must base its evaluation of the effectiveness of the company's ICFR on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. It also added that the COSO framework satisfies the criteria however, it is not mandatory to be used. See key frameworks below;

COSO Integrated Internal Control Framework
**Committee of Sponsoring Organisations**

Criterial of Control (CoCo) Framework
**Institute of Chartered Accountants of Canada**

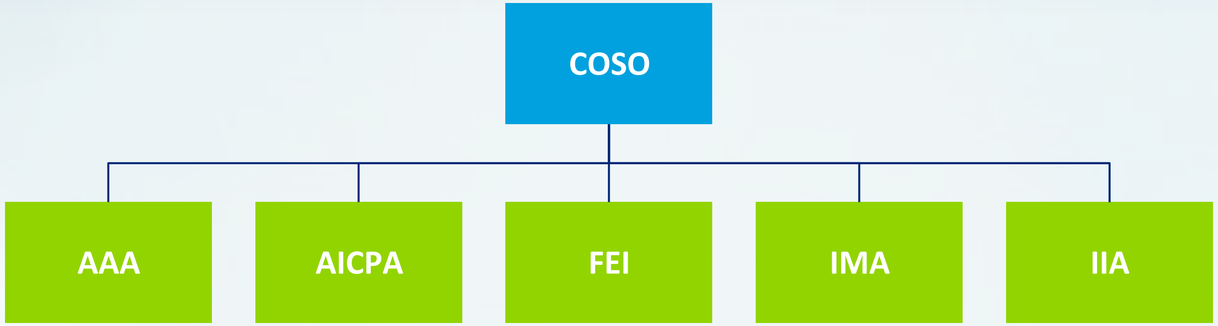
Guidance for Directors on the Combined Code (Turnbull Report)
**Institute of Chartered Accountants in England & Wales**

> "An assessment of the effectiveness of internal control over financial reporting must be supported by evidential matter, including documentation, regarding both the design of internal controls and the testing processes"

# The COSO Framework

# Background

## COSO's structure and mission




- COSO is a joint initiative of five sponsoring organizations
  - American Accounting Association (AAA)
  - American Institute of Certified Public Accountants (AICPA)
  - Financial Executives International (FEI)
  - Institute of Management Accountants (IMA)
  - Institute of Internal Auditors (IIA)

**COSO's mission is…**

*"…to provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations."*

**www.coso.org/aboutus.htm**

# Internal control

Internal Control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of the following objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

The definition of Internal Control highlights three (3) concepts peculiar to it which are:

- Internal Control is a process;
- Internal Control is effected by people;
- Internal Control is only designed to provide reasonable assurance and not absolute assurance.

# Framework

Effective system of internal control

**Per COSO, an effective system of internal control requires:**

- **Each of the five components of internal control and relevant principles to be present and functioning**

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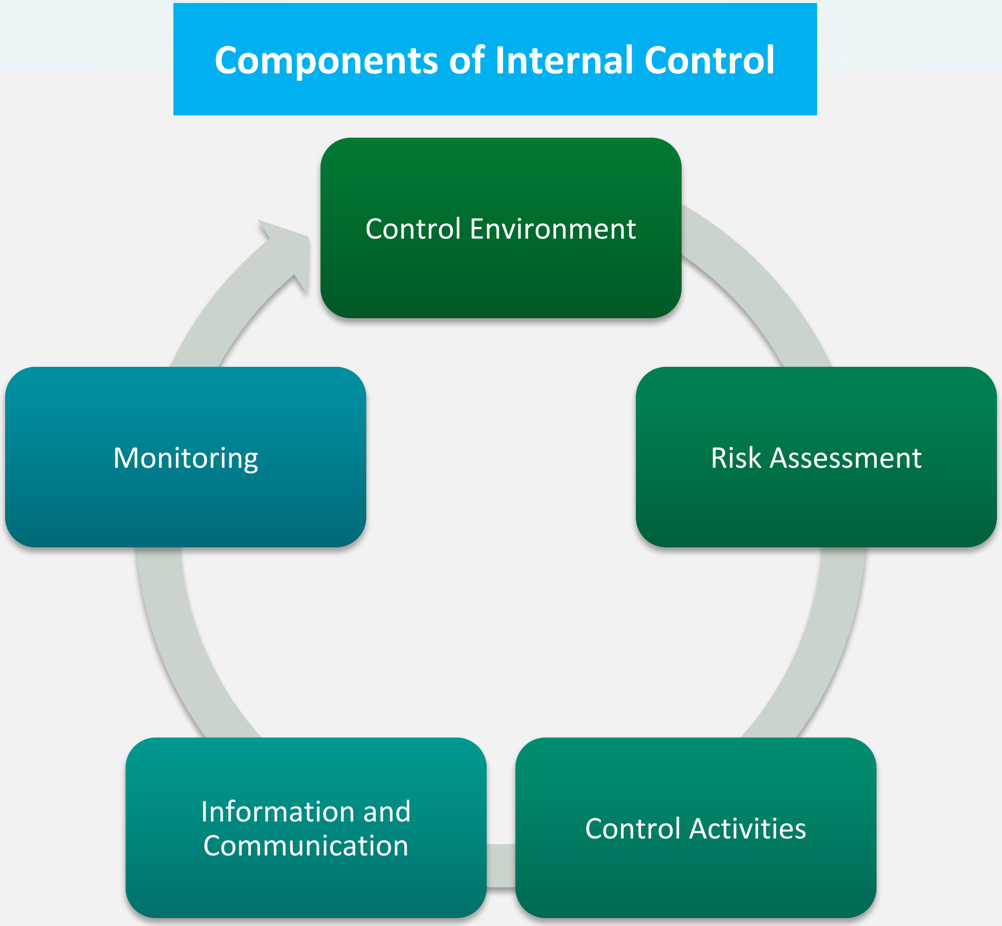
- **The five components to be operating together in an integrated manner**



# Relationship of Objectives, Components and the Entity

**Definitions**

- **Objectives: Are what an entity desires to achieve.**
- **Components: Represent what is required to achieve objectives.**
- **Entity Structure: Represent the operating units, legal entities and other structures**

- A direct relationship exists between objectives, components, and the entity structure which can be depicted in the form of a cube.

The objectives are represented by the columns.

The components are represented by the rows.

The entity structure is represented by the third dimension of the cube

# Objectives

*"Internal control is a process effected by an entities board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to **operations, reporting and compliance.**"*

**Operations** – Pertain to the effectiveness and efficiency of the entity's operations, including operational and financial performance goals and safeguarding of assets against loss.

- Objectives are dependent on operating model

-improvement on financial performance, productivity, quality

-When objectives are not well defined, its resources may be misdirected.

**Reporting** – Pertain to internal and external financial and non-financial reporting. Encompasses reliability, timeliness, transparency and other characteristics defined by regulators, standard setters or the entity's policy.

**Compliance** – Pertain to the adherence to laws and regulations to which the entity is subject.

# Objectives – Operations (Cont'd)

*"Laws, rules, regulations, and external standards have created an expectation that management reporting on internal control includes controls relating to preventing and detecting unauthorized acquisition, use, or disposition of entity assets."*

The operations objective includes safeguarding of assets

*Entities may set objectives relating to;*

Prevention of loss

Timely detection of loss

Reporting of loss

These objectives form the basis of assessing risk relating to the safeguarding of assets and selecting and developing controls needed to mitigate such risk

Some entities consider safeguarding of assets a separate category of objective

# Objectives – Reporting

Pertains to the preparation of reports for use by organizations and stakeholders and may relate to financial or non-financial reporting and to internal or external reporting.

External

**External Financial Reporting Objectives**

- Annual Financial Statements
- Interim Financial Statements
- Earning Releases

**External Non- Financial Objectives**

- Internal Control Reports
- Sustainability Reports
- Supply Chain / Custody of Assets

Internal

**Internal Financial Reporting Objectives**

- Divisional Financial Reports
- Customer Profitability Analysis
- Bank Covenant Calculations

**Internal Non-Financial Objectives**

- Staff / Asset Utilization
- Customer Satisfaction Measures
- Health and Safety Measures

Financial

Non-Financial

# Objectives - Compliance

*The compliance objective pertains to the adherence to applicable laws and regulations that apply across the entity.*

**Laws, Rules and Regulations**

Establish minimum standards of conduct expected of the entity.

Some entities will set objectives utilizing a higher level of performance and management can exercise discretion in this regard.

For example, while a law may limit minors working more than 18 hours in a school week, an organization may set an objective that limits its minor-age staff to working 15 hours per week.

# Framework and guidance

| Components | Summarized Principles |
| --- | --- |
| **Control Environment** | 1. Demonstrates commitment to integrity and ethical values<br>2. Exercises oversight responsibility<br>3. Establishes structure, authority and responsibility<br>4. Demonstrates commitment to competence<br>5. Enforces accountability |
| **Risk Assessment** | 1. Specifies relevant objectives<br>2. Identifies and analyzes risk<br>3. Assesses fraud risk<br>4. Identifies and analyzes significant change |
| **Control Activities** | 1. Selects and develops control activities<br>2. Selects and develops general controls over technology<br>3. Deploys through policies and procedures |
| **Information & Communication** | 1. Uses relevant information<br>2. Communicates internally<br>3. Communicates externally |
| **Monitoring Activities** | 1. Conducts ongoing and/or separate evaluations<br>2. Evaluates and communicates deficiencies |

# Roles and responsibilities

# Roles and responsibilities

**Board/Audit Committee**

**Senior Management**

**RESPONSIBILITIES**

### Management
### (1st Line of Defense)

*Own and manage risk and control*

- Owns the risk, and the design and execution of controls to respond to risks

### Risk and Compliance Functions – including ICFR team
### (2nd Line of Defense)

*Monitor risk and control in support of management*

- Provide management with expertise, process excellence, and work with 1st line to monitor effectiveness of risk assessment and control activities impacting Internal Controls over Financial Reporting and Disclosure Controls and Procedures

### Internal Audit
### (3rd Line of Defense)

*Provide independent assurance to the board and senior management*

- Assess effectiveness of both the 1st and 2nd line's efforts consistent with the expectations of the Board and senior management

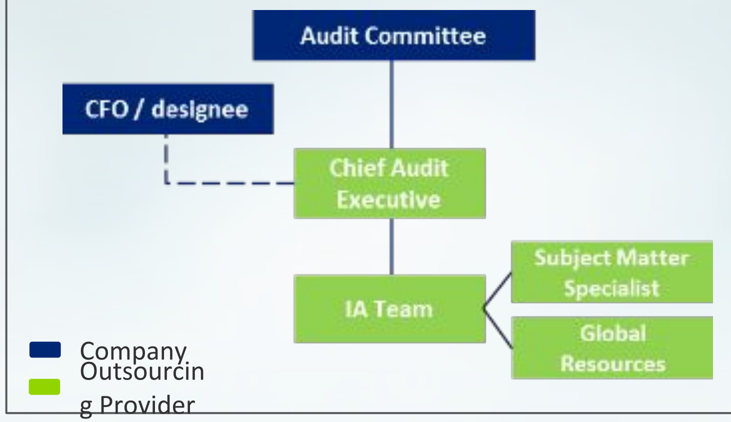
**External Auditors**

**Regulators**

- The existence of an Internal Audit function is strongly recommended for all organizations and is **mandated** by some global exchanges, such as the NYSE.
- Typically, a higher line of defence can define and place **some reliance** on a lower line of defence; not the other way around. This is one reason why **management cannot consolidate full ownership of ICFR** to the third line (Internal Audit).

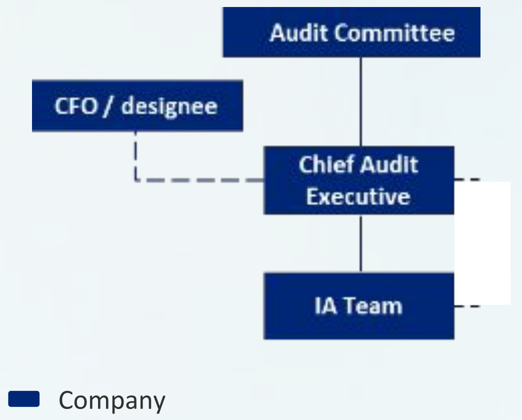
# Internal Audit function delivery models

### Outsourced Model




### Cosourced Model


### In-house Model




**Outsourced model Differences**

- Effective in quickly jumpstarting a new function
- Helps minimize or eliminate cost of hiring and retaining an internal team

**Outsourced/Cosourced models Benefits**

- Flexibility and scalability of resources
- Cost effective
- Access to subject matter specialists and global teams
- Access to industry leaders and practices

**Cosourced model Differences**

- Effective in augmenting and quickly maturing a small function
- Helps develop future leaders

**In-house model Differences**

- Retains institutional information within entity
- Slower velocity to stand up
- Less upward movement within capability
- Challenging to staff with skill to cover all geographies and subject areas.

**Why Outsource or Cosource?**

As an alternative to an in-house only function, many companies choose to outsource or co-source with a service provider primarily to have access to industry leaders and practices, subject matter specialists and global teams. The following are just some of the benefits:

- Managed cost
- Higher staffing flexibility
- Minimal talent management
- Extensive and current industry knowledge and experience
- Minimal training impact
- Fewer international challenges (language, local laws, travel time and costs)
- Significant and current leveraging technology

# *The Internal Control Roles and Responsibilities as Defined by COSO*

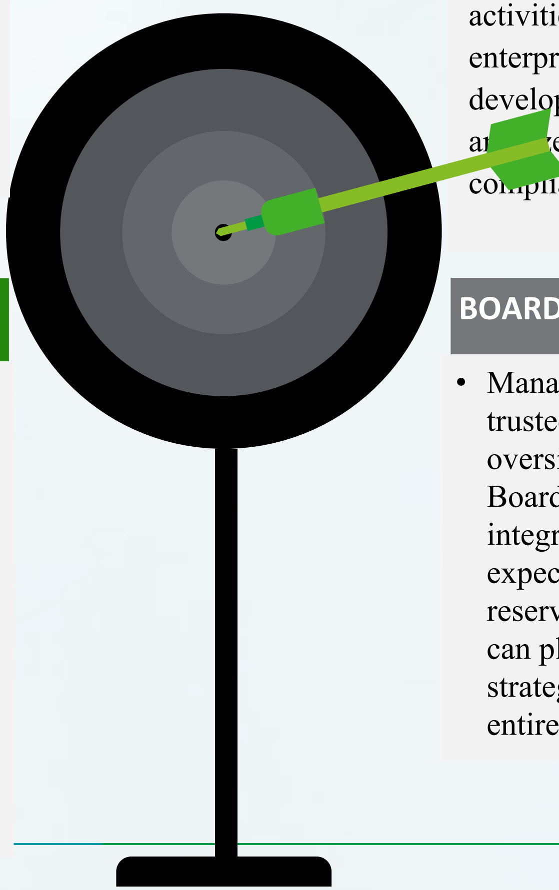
Every individual within an entity has a role in effecting internal control. A person's role varies in the level of responsibility and involvement.

## MANAGEMENT

- Management is directly responsible for all activities of an entity, including its internal control system. Naturally, management at different levels in an entity will have different internal control responsibilities. These will differ, often considerably, depending on the entity's characteristics.

## FINANCIAL OFFICER

They are of particular significance to monitoring are finance and controllership officers and their staffs, whose activities cut across, up and down the operating units of an enterprise. These financial executives often are involved in developing entity-wide budgets and plans. They track and analyze performance, often from an operations and compliance perspectives, as well as a financial one.



## CHIEF EXECUTIVES

- Providing leadership and direction to senior managers. Together with them, the CEO shapes the values, principles and major operating policies that form the foundation of the entity's internal control system.
- Meeting periodically with senior managers responsible for the major functional areas – sales, marketing, production, procurement, finance, human resources, etc. – to review their responsibilities, including how they are controlling the business.

## BOARD OF DIRECTORS

- Management is accountable to the Board of Directors or trustees, who provides governance, guidance and oversight. By selecting and monitoring management, the Board has a major role in defining what it expects in integrity and ethical values and can confirm its expectations through its oversight activities. Similarly, by reserving authority in certain key decisions, the Board can play a role in high-level objective setting and strategic planning. The Board provides oversight over the entire system of internal control

# *The Internal Control Roles and Responsibilities as Defined by COSO*

## AUDIT COMMITTEE

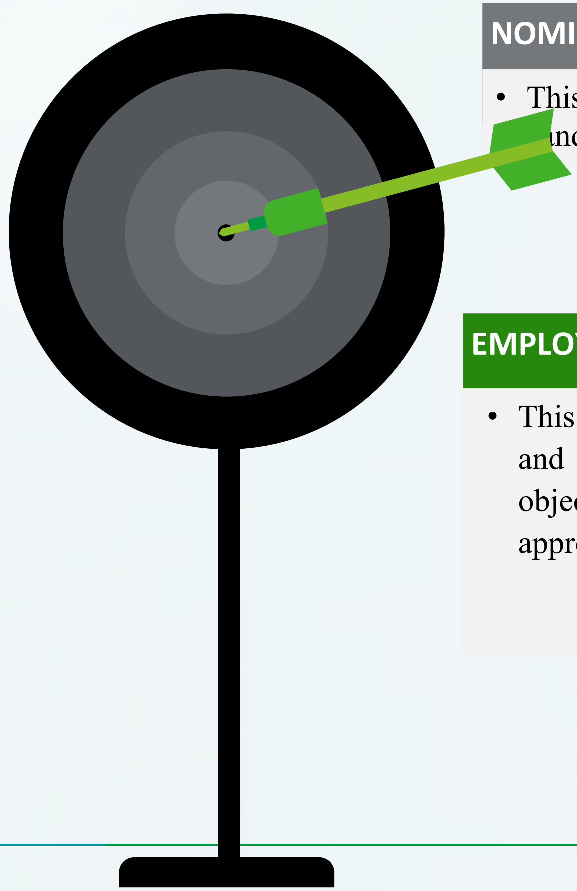
- The audit committee is in a unique position. It normally has the authority to question top management regarding how it is carrying out its financial reporting responsibilities, and it also has authority to ensure that corrective action is taken. The audit committee, in conjunction with or in addition to a strong internal audit function, is often in the best position within an entity to identify and act in instances where top management overrides internal controls or otherwise seeks to misrepresent reported financial results. Thus, there are instances where an audit committee, or Board, must carry its oversight role to the point of directly addressing serious events or conditions.

## FINANCE COMMITTE

- This committee is useful in controlling major commitments of funds and ensuring that capital expenditure budgets are consistent with operating plans.

## NOMINATING COMMITTEE

- This committee provides control over the selection of ndidates for directors and top management.



## EMPLOYEE BENEFIT COMMITTEE

- This committee oversees employee benefit programs and sees that they are consistent with the entity's objectives and that fiduciary responsibilities are being appropriately discharged.

## COMPESATION COMMITTEE

- This committee can see that emphasis is placed on compensation arrangements that help the entity's objectives and that do not unduly emphasize short-term results at the expense of long- term performance.

## *The Internal Control Roles and Responsibilities as Defined by COSO*

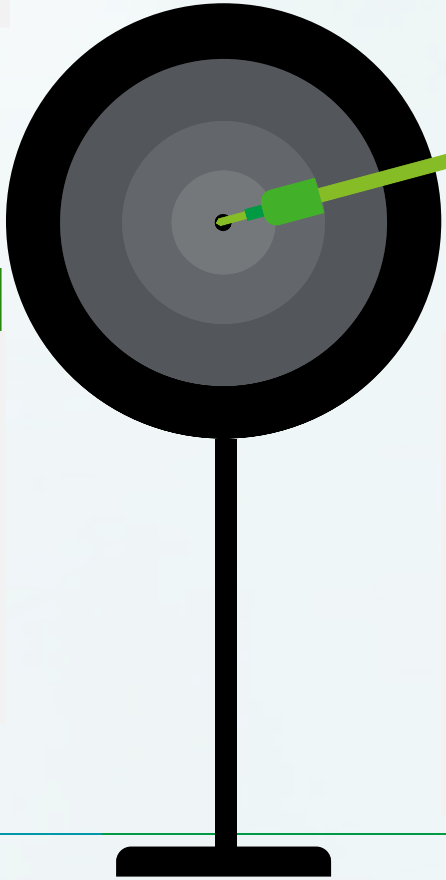
Every individual within an entity has a role in effecting internal control. A person's role varies in the level of responsibility and involvement.

### INTERNAL AUDITORS

- Internal auditors directly examine internal controls and recommend improvements.

### LEGISLATOR AND REGULATORS

- They affect the internal control systems of many entities, either through requirements to establish internal controls or through examinations of particular entities. Many of the relevant laws and regulations deal only with internal controls over financial reporting, though some, particularly those that apply to government organizations, can deal with operations and compliance objectives, as well.



### EXTERNAL AUDITING

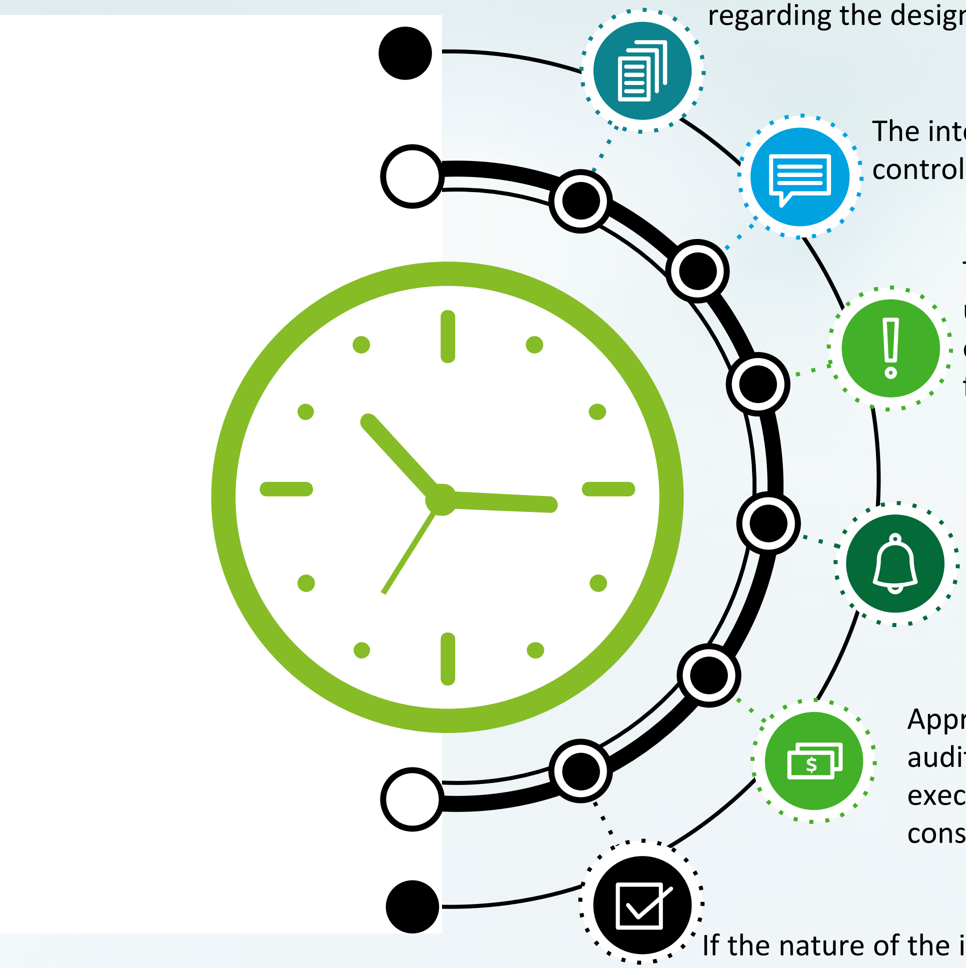
- Perhaps no other external party plays as important a role in contributing to achievement of the entity's financial reporting objectives as the independent certified public accountants. They bring to management and the Board of Directors a unique independence and objective view and can contribute to an entity's achievement of its financial reporting responsibilities.

### Legal Counsel

- Counsel from legal professionals is key to defining effective controls for compliance with regulations and managing the possibility of lawsuits. The chief legal/compliance officer is responsible for ensuring that legal, regulatory, and other requirements are understood and communicated to those responsible for effecting compliance Outsourced Service Providers
- Many organizations outsource business functions to outside service providers, including administrative, finance, human resources, technology, legal, and others. The objective is to obtain access to enhanced capabilities at a lower cost.

# ISA 315 –EXTERNAL AUDITORS VS INTERNAL AUDITORS

# Responsibilities Of An Internal Audit Function In ICFR



Performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, the entity's system of internal control and governance processes.

The internal audit function plays an important role in the entity's process to monitor the entity's system of internal control.

The internal audit function can provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels.

In accordance with ISA 240, the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.

Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals

If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence.

# Thank You