

CONTROL ENVIRONMENT

A survey carried out by HLB International on Frauds in Corporate Organisations revealed that 50% of frauds were committed as a result of failure to observe controls, while another 25% of frauds were committed as result of absence of controls. Based on this survey, we can conclude that if an organisation had strong controls which were followed, it could eliminate incidences of fraud by 75%.

What is Internal Control?

There are varied definitions, but I find the definition in the International Standards on Auditing as the most comprehensive. It defines **Internal Control** as “The process designed and effected by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations”. Internal control consists of five components namely:

- ✓ The control environment;
- ✓ The entity’s risk assessment process;
- ✓ The information systems, including the related business processes relevant to financial reporting, and communication;
- ✓ Control activities; and
- ✓ Monitoring of controls.

We can de-mystify the jargon and simply look at what each component entails.

Control environment refers to the attitudes, awareness, and actions of those charged with governance and management concerning the entity’s internal control and its importance in the entity. The control environment is the foundation for effective internal control, providing discipline and structure by setting the tone at the top thereby influencing the control consciousness of the entity’s personnel. The control environment, however, in itself does not prevent or detect fraud and has to be supported by other internal control components.

The entity’s risk assessment process is the process by which risks relevant to the business are identified and formulation of an action plan on how to address those risks.

Information systems relate to the financial reporting objectives, which includes the accounting system and consists of the procedures and records established to initiate, record, process, and report entity transactions and to maintain accountability for the related assets, liabilities and equity.

Control activities are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks that threaten the achievement of the entity’s objectives.

Monitoring of controls is a process to assess the effectiveness of internal control performance over time, and involves assessing the design and operations of controls on a timely basis and taking necessary corrective actions.

What does the above mean in simple terms? In the complex business world in which our businesses operate, the only way to build strong controls is firstly to get the management to appreciate that these are required in an organisation and setting the standards for compliance. The management then needs to identify the key risks facing the organisation and develop policies and procedures to mitigate the risks, and systems to monitor and report on these risks. The last step is to constantly monitor the risks and ensure that the policies and procedures to mitigate risks are current. This means that every organisation must dedicate resources to strengthen the controls which in turn increases the efficiency and effectiveness by which the organisation operates.

In the next edition we will review the practical means by which an effective organisation structure can aid in the creation of a strong control environment.

An Article by Ashif Kassam, Managing Partner HLB Ashvir, Appearing in the Windsor News January - March 2007 Edition (A Quarterly Newsletter of The Windsor Golf Hotel & Country Club).