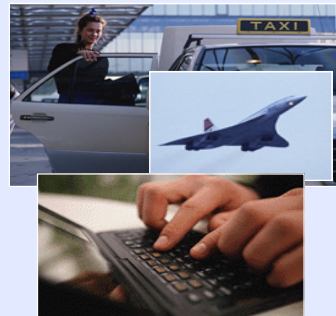


## Internal Control

Deepjee Singhal  
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## Business Environment

- Competition & Survival
- Increased Customer Orientation
- Pressure on bottomlines
- Focus on Risk Management - Need for Control Awareness
- Corporate Governance Practices
- Increased use of 'Information Technology' solutions



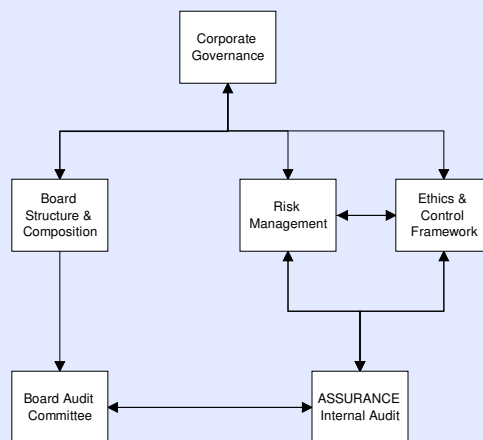
## Change in Emphasis

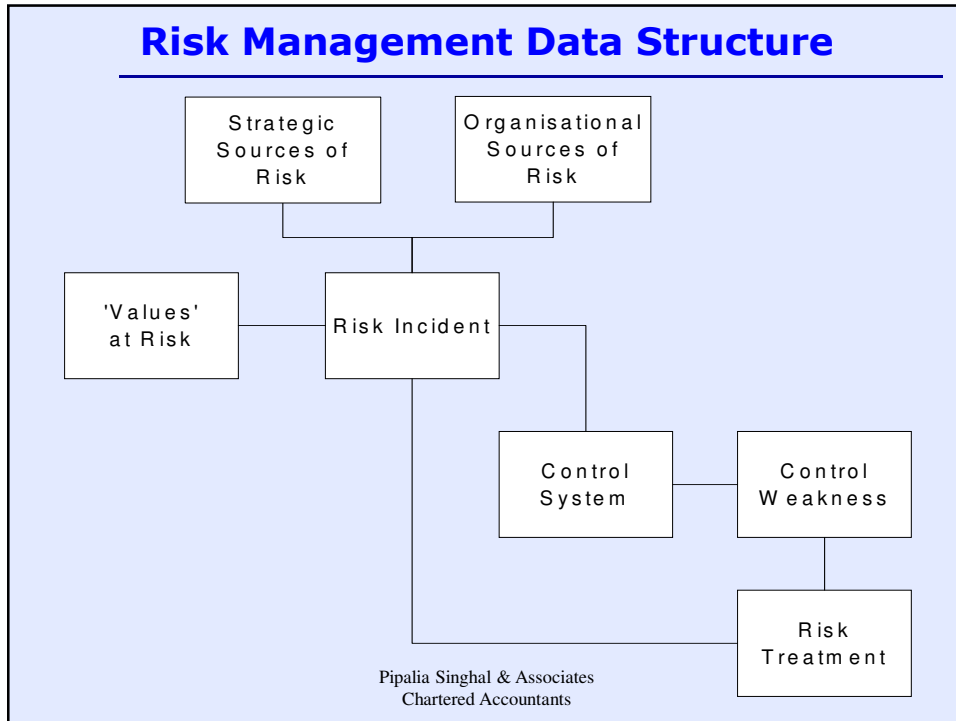
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- | <b>Traditional Role</b>   |  | <b>Business Role</b>  |
|---|--|---|
| <ul style="list-style-type: none"> <li>• Compliance Focus</li> <br/> <li>• Find and Fix</li> <br/> <li>• Labour – intensive</li> <br/> <li>Accounting Controls</li> </ul> |  | <ul style="list-style-type: none"> <li>• Service Focus</li> <br/> <li>• Anticipate &amp; Prevent</li> <br/> <li>• Technology &amp; Knowledge Leveraged</li> <br/> <li>• Business Processes</li> </ul> |

## A Corporate Governance Model

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**Committee of the Sponsoring Organisations  
of the Treadway Commission (COSO)**

**Internal Control –  
Integrated Framework**

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**What is COSO?**

COSO is a voluntary private organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls and corporate governance.

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## Developments in USA

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- Watergate – 1973-76
  - Interest shift from Auditors to Legislators and Regulators
  - Illegal payments to Foreign Government Officials
  
- Foreign Corrupt Practices Act (FCPA), 1977
  - Maintenance of Books, records and accounts
  - Devise and Maintain system of internal accounting control
  - Increased Internal Audit Department sizes
  - Management scrutiny of Internal Control
  - Professional and Regulatory bodies actions

## Developments in USA

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- SEC, Cohen Commission – AICPA – Committee on Auditors Responsibilities, FEI Report on Internal Control
- Minahan Committee – AICPA – 1979
  - Guidance to Management & Boards to comply with Internal Control Provisions of FCPA
- 1985-Congressional Subcommittee
  - Management's conduct
  - Financial Reporting propriety
  - Effectiveness of Independent Audits

## Treadway Commission

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- National Commission on Fraudulent Financial Reporting ( 1985-87) – Treadway Commission - Chairman - James C.Treadway, Jr., Executive Vice President and General Counsel, Paine Webber Inc.
- Sponsoring Organizations –
  - American Accounting Association (AAA)
  - American Institute of Certified Public Accountants ( AICPA)
  - Financial Executives Institute (FEI)
  - Institute of Internal Auditors (IIA)
  - Institute of Management Accountants(IMA)
  - Coopers and Lybrand

## Treadway Commission - Contd

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- Objective
  - Causal Factors for Fraud
  - Recommendations for reducing incidents
- Recommendations
  - Emphasis on Control Environment, Codes of Conduct, Audit Committees – competent and involved, Active and Objective Internal Audit Function
  - Create an Integrated Framework to help Public Companies
    - Improve Internal Controls
    - Evaluate Effectiveness of Internal Controls

## **Why is COSO important to me?**

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- Corporate Governance
- Increased Expectations from Audit – Value Addition
- Risk Management
- Flatter Organisation structures – BPR,etc.
- Structure for identification and assessment of Internal Control

## **Is COSO only for large entities?**

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- COSO is a Framework
  - Component Factors
  - Evaluation Guidelines
- COSO recognizes unique nature of Medium and Small Size entities
- COSO makes the framework factors relevant to MSS entities

## Integrated Framework

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- Control Components integrated with Management Process
- Establish common definition serving the needs of different parties
- Directed towards Management needs
  - Establishing
  - Monitoring
  - Evaluating
  - Reporting
- Provide a benchmark for assessment

## Internal Control

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- “.. A process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of [following] objectives-
  - effectiveness and efficiency of operations
  - reliability of financial reporting
  - compliance with applicable laws and regulations



## Internal Control – Contd.

- Process
  - A means to an end
- Effected by People
  - It's not merely policy manuals and forms, but people at every level of an organization.
- Reasonable Assurance
  - Not absolute assurance, to an entity's management and board.
- Objectives – one or more categories
  - Operations
  - Reporting &
  - Compliance

## THE COSO MODEL



## Internal Control - Components

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- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

## COSO Model: Key Components

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- The Control Environment
  - Individual attributes, including integrity, ethical values, and competence of people in the organisation
    - commitment by directors, management, employees
    - written codes of conduct, formal standards of discipline, and performance appraisal
    - organisation structure that allows planning, implementation and control of business
    - delegation of authority with accountability
    - professional approach to financial reporting

## Control Environment

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- Integrity & Ethical Values
  - Preferences, Value Judgments and Management Styles
  - Beyond Law
  - Differing concerns on stakeholders
- Incentives and Temptations
  - Emphasis on short term results
  - High performance dependent rewards
  - Non-existent or ineffective controls
  - High decentralisation
  - Weak Internal Audit function
  - Ineffective Board
  - Penalties for improper behaviour

## Control Environment – Contd.

---

- Providing and Communicating Moral Guidance
  - By example
  - Code of Corporate Conduct
  - Penalties for non conformance to Code
- Commitment to competence
  - Knowledge and skills
- Board of Directors or Audit Committee
  - Independence, Experience, stature of members, extent of involvement in activities, appropriateness of actions

## Control Environment – Contd.

---

- Management's Philosophy and Operating Style
  - Successful risk taking
  - Formal vs Informal communication
  - Attitude towards reporting
- Organisation Structure
  - Centralised v Decentralised
  - Size and nature of activities
  - Assignment of Authority and Responsibility
- Human Resource Policies and Practices
  - Hiring, Orientation, Training, evaluating, counseling, promoting, compensating and remedial actions

## COSO Model: Key Components (Contd)

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- Risk Assessment
  - Mechanisms to identify, analyse, and manage risks relating to entity's activities
    - timely identifying key business risks
    - considering the likelihood of risks crystallising and the significance of consequent financial impact
    - setting control priorities for allocating available resources and communicating clear objectives

## Risk Assessment

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- Entity wide objectives
  - Operations Objectives
  - Financial Reporting Objectives
  - Compliance Objectives
- Risks
- Managing Change – Mechanisms in place – Forward Looking

## COSO Model: Key Components (Contd)

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- Information and Communication
  - Systems enabling people to capture and exchange information needed to conduct, manage and control its operations
    - performance measures (like budgets, forecasts) that allow monitoring business and financial activities & risks
    - ongoing identification and capture of timely, credible, relevant information (financial reports etc)
    - variance/exceptions-based timely reporting systems that allow prompt problem identification/ remedying
  - Effective Communication



## Information & Communication

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- Information Systems
  - Formal or Informal
  - Automated or Manual
  - Evolving
  - Strategic and Integrated systems
  - Information Quality
    - Content is appropriate
    - Information is timely
    - Information is current
    - Information is accurate
    - Information is accessible

## Communication

---

- Internal
- External
- Means
  - Policy Manuals
  - Memoranda
  - Bulletin Board Notices
  - Meetings
  - Action taken by Management

## **COSO Model: Key Components (Contd)**

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- **Control Activities**
  - Implementing policies & procedures to ensure objectives are achieved
    - complete and accurate accounting of transactions
    - appropriate authority limits that contain entity exposure
    - reliability and validation of information reports generated
    - limiting exposure to assets/records loss / frauds (separation of duties, physical distancing, etc)
    - surprise checks to preempt control violations
    - compliance reports for legal/ regulatory obligations
  - Range
    - Approvals, Authorizations, Verifications, Reconciliation, Reviews, Security, Segregation of duties

## **Control Activities**

---

- Integration with risk Assessment
- Control of Information system
- Types of control could be –
  - Preventive, Detective
  - Segregation of duties
  - Performance indicators
  - Physical controls
  - Audit reviews
- Control implementation

## **COSO Model: Key Components (Contd)**

---

- **Monitoring**
  - Monitoring entire process to be able to react as warranted by changing conditions
    - reasonable assurance that control procedures are in place and are being followed, with breaches being brought up in time
    - tracking environmental changes warranting changes in internal financial control procedures
    - adequate support for the board's public statements on internal control/ internal financial control

## **Monitoring**

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- Ongoing Activities
- Separate Evaluations
  - Scope and Frequency
  - Process appropriateness
  - Evaluation methodology – logical and appropriate
  - Documentation – appropriateness
- Reporting Deficiencies
  - Existence of mechanism
  - Reporting protocols
  - Follow up actions



## Internal Control

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- Helps achieve objectives
- Does not ensure achievement or survival
- Helps ensure reliable financial reporting
- Does not ensure reliable financial reporting
- Errors of judgment, Human errors, Overriding powers, resource constraints
- Not a panacea

## To Have an Effective Internal Control System

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**Managers should focus their attention on controlling RISKS to ensure that :**

- Company's objectives and goals are met.
- The assets of the Company are properly safeguarded.
- Resources (Money, Materials, Assets & Human Resources) are optimally utilised for Company objectives.
- Statutory & Regulatory requirements are complied with.
- Risk of Unethical practices is mitigated.

## **Suggested Approach**

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- Various Organisations world wide have reacted to the need for continuous monitoring of risks & controls
- Self Assessment is the most commonly used method to ensure the adequacy & effectiveness of controls
- IBM, Cummins, Motorola and Daimler Chrysler, Philips, Siemens are known to be using Self Assessment successfully

**WHAT  
IS  
SELF-ASSESSMENT ?**

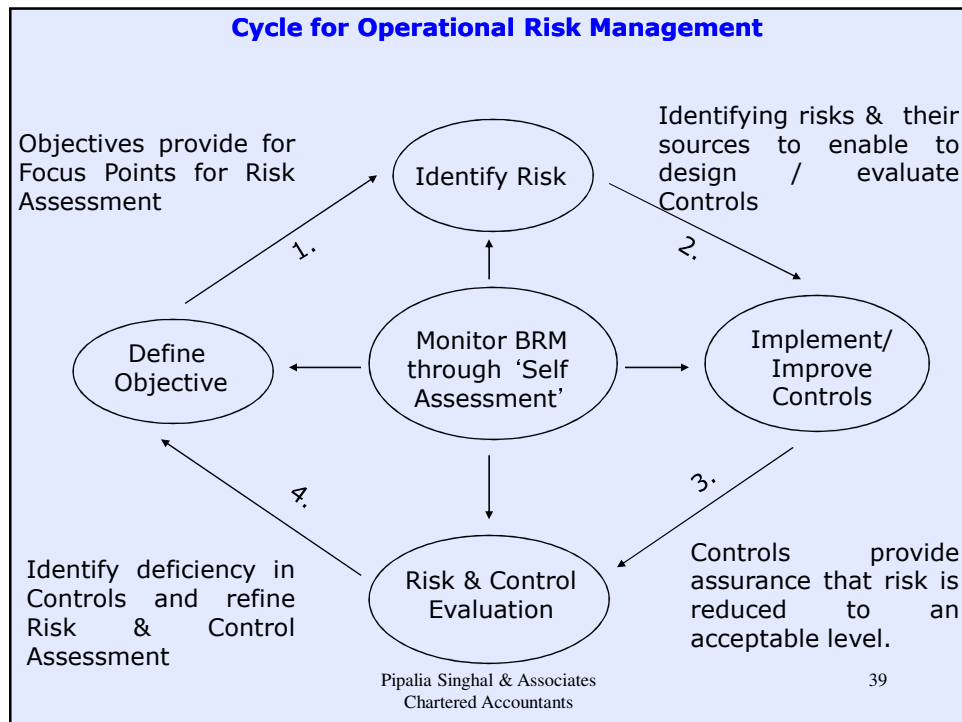
- Self Assessment is a method in which risks & controls are monitored regularly by the Process Owner through a specially designed questionnaire.
- Self Assessment Questionnaires (SAQ) contain questions for evaluating the adequacy & effectiveness of controls for a stated risk.
- e.g. A SAQ for Procurement process can have the following questions:
  - Can a PO be raised at a rate higher than the approved rate? (Y / N)
  - Is deviation from approved SOP authorized & reported ?....(Y / N)
  - Are downward rate revisions promptly updated ? (Y / N)
- Remedial actions can then be taken
- Conduct Self Assessment every six months.

## Benefits

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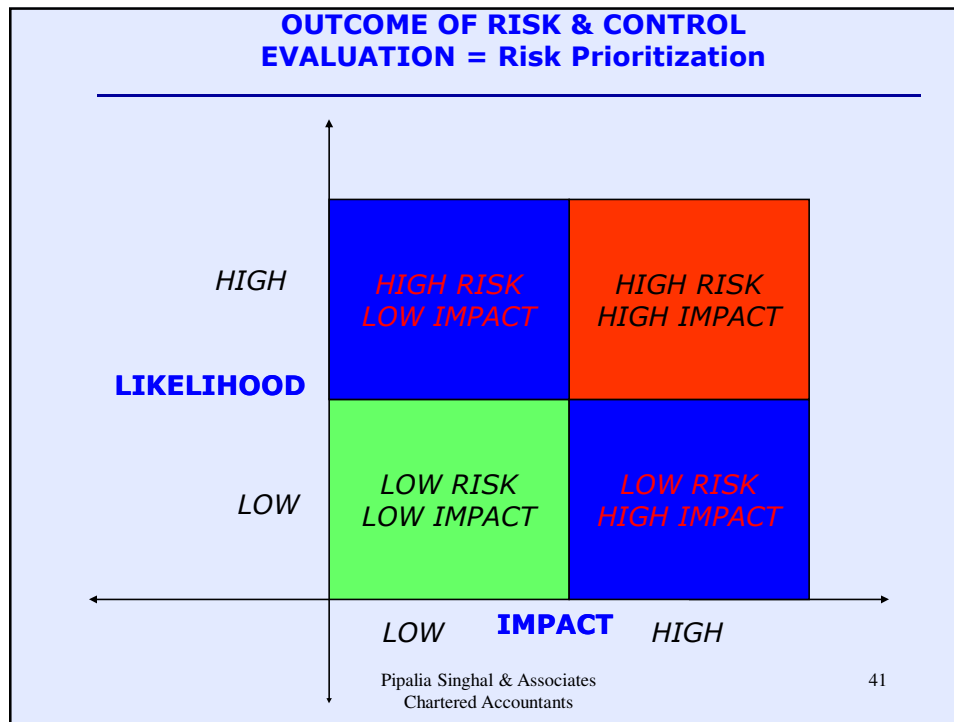
- Help the Company achieve its goals
- Improve effectiveness of the function
- Install an Early Warning System
- Identify wastage, reduce costs
- Give an assurance to the Management on efficacy of internal controls

## GOOD CORPORATE GOVERNANCE



## Risk and Control Evaluation

- Can we totally avoid / eliminate the risk?
- What is the likelihood or probability of occurrence?
- Whether controls are existing?
- Whether controls existing are adequate to cover risks?
- Whether controls are functioning consistently & effectively?
- Whether controls are cost effective?
- Whether controls are preventive or detective?
- Whether controls are manual or automated?
- What is the impact of Risk (financial and / or non-financial )?  
e.g. image of Company, legal penalty, loss of market share
- Prioritise risks based on its severity



### Guidelines for Determining Likelihood of Risk

- High volume of transactions
- Total Value of transactions high
- No segregation of duties
- Liquidity of assets handled
- Manual controls
- Geographically remote
- High regulatory requirements
- Extensive external interface
- Poor monitoring mechanisms
- Excessive Delegation
- Ability to do an act and conceal the same
- High work pressure

## Guidelines For Determining Impact Of Risk

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- ⇒ High monetary loss
- ⇒ High wastage of resources
- ⇒ Serious regulatory repercussions
- ⇒ Affects Company Image adversely
- ⇒ Likely to be recurring
- ⇒ Permanent loss / damage
- ⇒ Has a cascading effect

## Format For Developing Saqs

DIVISION	DEPT	SECTION			
<b>PROCESS :</b>					
<b>PROCESS OWNER :</b>			Risk Champion :		
<b>Srl</b>	<b>Risk</b>	<b>Control</b>	<b>Evaluation</b>	<b>SAQ</b>	<b>Response (Yes / No / NA)</b>
Prepared By			Reviewed By		
Date			Review Date		

## Questions?

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## Universal Case Control Environment

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- Integrity & Ethical Values
  - Preferences, Value Judgments and Management Styles – operating personnel abusing power.
- Incentives and Temptations
  - Emphasis on short term results- Mukund talking about muck getting under the carpet.
  - High performance dependent rewards – Sales manager talking about high pressures to meet and exceed sales targets.
  - Ineffective controls- controls bypassed and not detected.
  - Weak Internal Audit function ??
  - Ineffective Board- did not go into details of good performance in times of recession.

## Control Environment – Contd.

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- Providing and Communicating Moral Guidance
  - Code of Corporate Conduct – no mention
- Board of Directors or Audit Committee
  - Independence, Experience, stature of members, extent of involvement in activities, appropriateness of actions
  - CEO not attending this crucial meeting.

## Control Environment – Contd.

---

- Management's Philosophy and Operating Style
  - Formal vs Informal communication
  - Attitude towards reporting – bypass routine accounting standards and practices.
- Organisation Structure
  - Assignment of Authority and Responsibility – weak accountability – Nimesh talking about having control measures to highlight deviations.
- Human Resource Policies and Practices
  - Hiring, Orientation, Training, evaluating, counseling, promoting, compensating and remedial actions
  - Training processes not geared towards intilling value systems – comment by HR Head – Gopal Karanth.



## Risk Assessment

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- Absence of Risk Assessment activity at Universal.
- Risk –
  - people would be tempted to report better results / misrepresent results
  - inaccurate results being tabled and accepted.

## Control Activities

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Weak Control of Information system – predominance of failure in control environment which would cascade in control activities also being weak.

- Weak controls – (cannot comment that it is weak controls as top management is responsible for failures)
  - Preventive, Detective
  - Segregation of duties
  - Performance indicators
  - Physical controls
  - Audit reviews
- Control implementation will necessarily fail as collusion between two functions like Distribution and Sales – internal control bound to fail.

## Information & Communication

---

- Information Systems
  - Information communication is weak as Board is not aware of the activities in the company.
  - Absence of Information Quality
    - Content is appropriate
    - Information is timely
    - Information is current
    - Information is accurate
    - Information is accessible

## Monitoring

---

- Ongoing Activities not monitored properly.
- Separate Evaluations not carried out -
  - Scope and Frequency
  - Process appropriateness
  - Evaluation methodology – logical and appropriate
  - Documentation – appropriateness
- Reporting Deficiencies
  - Existence of mechanism
  - Reporting protocols
  - Follow up actions

## Action Plan

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- Review of control system suggested by Krishnan that would be based on assessing the control environment in the company and suggesting needed improvements.

## Genesis of SOX...

Rapid eruption of large scale corporate & financial scandals from Year 2000 onwards...

- Enron (USA)
- Worldcom (USA)
- Global Crossing (USA)
- Tyco Bell (USA)
- Many Corporates restated the profits previously reported
- Parmalat (Europe)

- Scandals did happen in past like Barings Bank in 1990s or like Bank of Credit and Commerce during 1980s...
- But the sheer size & number of scandals within a short span and the blatant violations by corporate management teams was overwhelming and shocking
- Investors lost USD \$ 35 Billion since the new millennium..

## What went wrong...

### Fraudulent Manipulation of Financial Statements – a variety of factors

- Erosion in Management Values
- Corporate Compensation Policy - High ESOP holdings required that stock prices remained high
- Fraudulent Financial Reporting
- Inadequate Internal Control Structure & Mechanisms
- Passive Role of Audit Committees
- Passive Role of Independent Directors
- Investment Bank – Research Analyst – conflict of interests
- Auditor Independence – high fees from other services
- Inadequate Regulatory Infrastructure

- Even the well developed Regulatory and Financial Reporting Framework & Standards in the USA could not prevent these downfall of these firms...

## These scams hurt the investor's sentiments...

### Surveys conducted showed the following results:

- 77% of investors opined that CEO greed and corruption has caused US financial meltdown
- 71% of investors felt accounting fraud is rampant
- 82% of investors wanted tough laws
- 81% of fund managers opined that executives place their interest ahead of shareholders
- 70% of corporate frauds from 1987 to 1999 involved the CEO

- These scandals raised issues regarding management values, standards of corporate governance, roles and responsibilities of management regarding accuracy, integrity and reliability of financial statements
- Investor Trust & Confidence was at all-time low
- Tough Times Needed Tough Action...

### Comment from SEC Chairman says it all ...

“Inattention to good corporate governance practices over the past decade or more is at the heart of what has gone so terribly wrong in corporate America in the past few years.

If significant steps are not taken to revisit and remodel corporate governance practices, corporate America will continue to attract the anger and animosity not only of disillusioned shareholders, but also of a much broader cross-section of American society.”

– **SEC Chairman William H. Donaldson**

- Comment from SEC Chairman highlights regulator’s anxiety about the investor mood and sentiments prevailing at that time...

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### Sarbanes Oxley Act, 2002 (SOX)

Sarbanes Oxley Act, 2002 (named for its originators – Senator Paul Sarbanes & Senator Michael Oxley) was enacted in July, 2002, to bolster investor trust and confidence.

#### Some features of the law are;

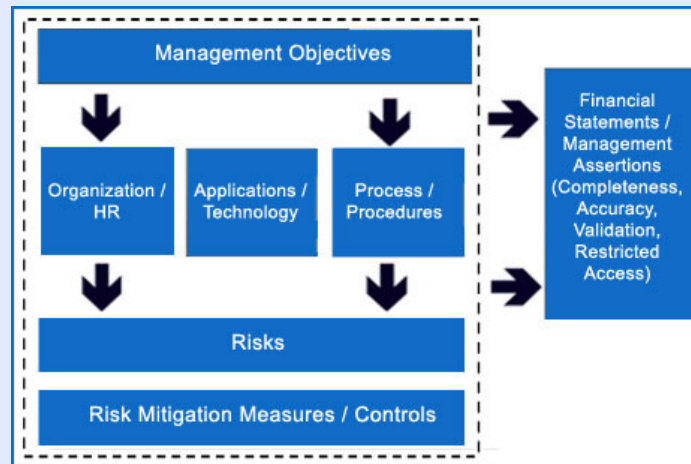
- New/enhanced standards of responsibility & accountability for accuracy, reliability and transparency of financial reporting
- SOX is wider in scope than GAAP – it lays emphasis on transparent disclosures for meaningful analysis and interpretation
- Emphasis on use of recognized Internal Control Framework For Evaluation of Internal Controls
- Stricter penalties for wrongdoing – intentional or otherwise
- Securities and Exchange Commission (SEC) is responsible for implementation guidance or directives
- SOX has 11 sections but Section 302, 404, 409, 802, 806, 906, 1106 are more important

- With more than 300 sections, this is probably the most significant piece of legislation since the Securities Exchange Act in 1934...

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### An organizational perspective of SOX



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### Section 302 and 404 of SOX

Section 302 (Corporate Responsibility for Financial Report) requires

- Quarterly attestation by CEO and CFO about
  - Accuracy, Reliability & Completeness of Financial Statements
  - Establishing and Maintaining Internal Controls
  - Evaluation of effectiveness of such controls 90 days prior to the report
  - Any significant deficiencies in internal controls have been disclosed to Auditors and Audit Committee

Section 404 (Management Assessment of Internal Controls) requires

- Annual Attestation by CEO and CFO about Establishing and Maintaining Internal Control Structure and about Evaluation of Effectiveness of such Internal Controls
- Attestation by the External Auditor on the Management assertion about existence and effectiveness of Internal Controls

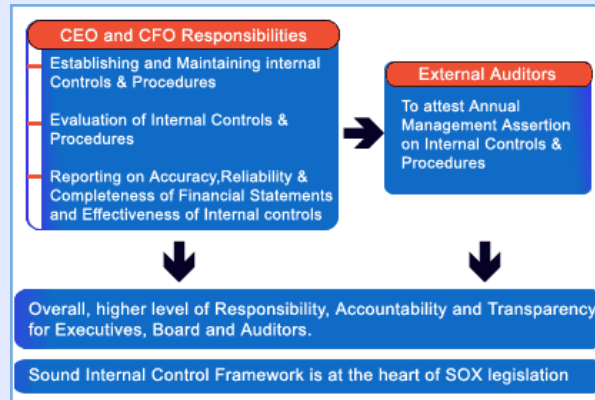
Compliance deadline for Organizations with Market Capitalization > USD 75 M is November, 15, 2004. For Organizations with Market Capitalization < USD 75 M, the deadline is July 15, 2005

- Section 404 with less than 100 words is the most power-packed piece of legislation ever...

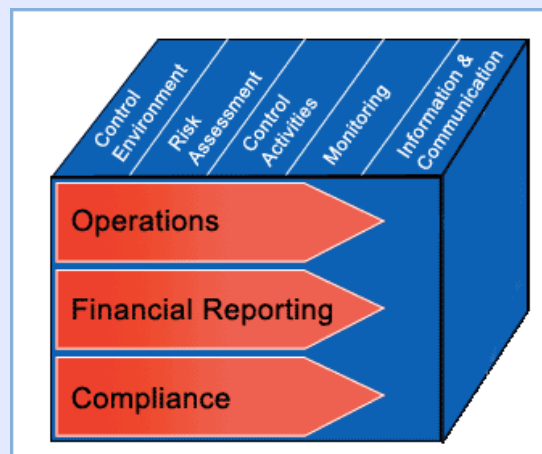
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### Section 404 of SOX



### COSO Framework

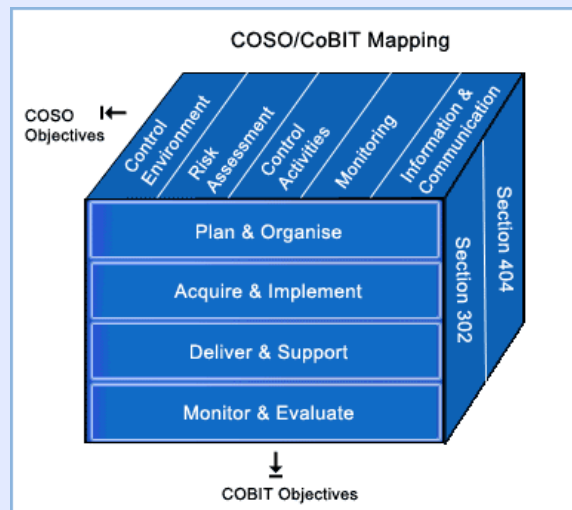


### CoBIT Framework

- CoBIT (Control Objectives for Information and Related Technology) developed by the IT Governance Institute of The Information Security Audit and Control Association (ISACA)
- These standards were also issued in 1992
- CoBIT provides good practices for management of IT processes, defining manageable and logical structure, bridging the gaps among business risks, technology issues, control needs and performance measurement
- 34 High-Level Control Objectives and 318 Detailed-Control Objectives are classified into Four Major Domains –
  - Plan & Organize
  - Acquire & Implement
  - Deliver & Support
  - Monitor & Evaluate

• Several IT Control Frameworks like ISO 17799 exist, but CoBIT, an open IT Governance Framework, aligns well with COSO

### COSO / CoBIT Mapping





### Compliance Challenges...

- Multiple Regulations – SOX, Basel II
- Evolving Regulations - some components are still under review or require implementation in future
- Cost-effective implementation of multiple compliance initiatives while addressing regulatory requirements
- Ability to constantly track the progress of multiple compliance activities and taking corrective action thereon
- Cross functional, multi-department, multi-location involvement across organization for SOX compliance
- Need to control, co-ordinate and communicate across organization
- Continuous improvement in processes and regular review of internal controls
- Disparate IT systems
- Outsourced services
- Selection of technology solution – there is no single solution for full SOX compliance
- Data storage, retention, indexing and future access

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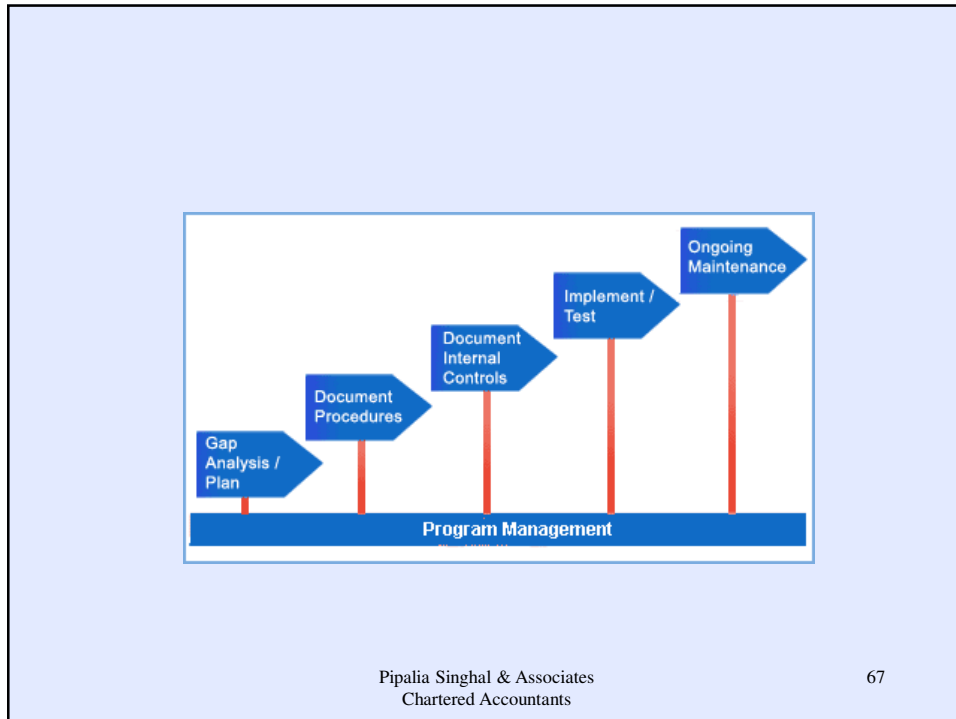
### Compliance Challenges... Suggested Approach

- SOX provides an opportunity for improvement by critical examination of current procedures, risks, controls
- Organizations can turn Compliance into Competitive Advantage...
- Organizations will have to take Unified View for Compliance with various Regulations ...
- SOX Compliance can be part of Enterprise Risk Management Framework
- Even though SOX is not applicable, organizations are voluntarily implementing Internal Controls Framework as Industry Best Practices

- In PWC and META group surveys, more than 50% respondents felt SOX Compliance was a necessary cost of doing business while 40% felt, it will ultimately make them more competitive...

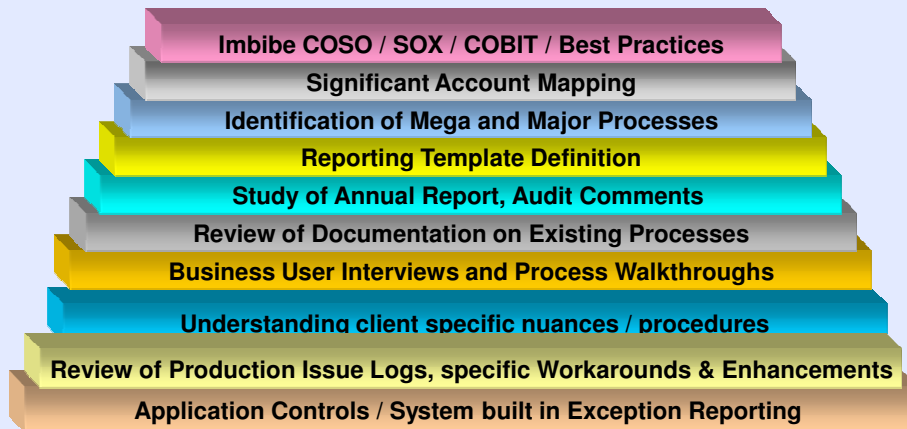
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- Preliminary Assessment of Existing Internal Control Framework
  - Action Plan / Strategy for SOX Section 404 Compliance
  - Documentation of Procedures and Processes
  - Documentation of Internal Control Framework
  - Testing of Internal Controls identified
  - Training
  - Technology Solution / Tools Selection
  - Implementation of Process Improvement Suggestions
  - Rollout & Implementation of Technology Solution
  - Program Management
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Business Control Framework building blocks



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Thank You