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The Institute of  
**Internal Auditors**  
*Australia*

**Whitepaper**

# The System of Internal Control

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# The System of Internal Control

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## Background

### Purpose

As internal control experts, internal auditors may be called upon to provide advice on an organisation's system of internal control to management, the audit committee, or both. In particular, audit committees in Australian Government agencies subject to the 'Public Governance, Performance and Accountability (PGPA) Act'<sup>1</sup> are required to review "the appropriateness of the...system of internal control".

This White Paper is intended to provide guidance to internal auditors on:

- › what a system of internal control is.
- › what constitutes an 'appropriate' system of internal control.
- › how to assess a system of internal control.

## Background

There are differing interpretations of what a 'system' of internal control is. Furthermore, determining whether a system of internal control is 'appropriate' and assessing that system of internal control are subjective exercises, the results of which are open to challenge.

## Discussion

### Issue

What is a system of internal control, what is an 'appropriate' system of internal control, and how is the effectiveness of a system of internal control assessed?

### History

Internal control practices have existed since ancient times. It has been said that Hellenistic Egypt had a dual system of internal controls in place for tax collecting, with one set of bureaucrats collecting taxes while another oversaw them.

In more recent times, there has been a trend in the evolution of management control concepts towards recognising a broader range of influences on the control of organisations, and this has been reflected in the development of internal control 'models' that incorporate the human element involved in internal control, including management's philosophy and operating style.

The COSO<sup>2</sup> internal control framework is a widely-recognised model for internal control and it explains that 'an effective system of internal control reduces, to an acceptable level, the risk of not achieving' objectives.

The 'International Standards for the Professional Practice of Internal Auditing' (Internal Audit Standards) go a step further and consider control as being 'adequate' if it has been designed in a manner that provides 'reasonable assurance the organisation's risks have been managed effectively and that the organisation's goals and objectives will be achieved efficiently and economically'.

<sup>1</sup> 'Public Governance, Performance and Accountability Rule 2014' Section 17(2).

<sup>2</sup> Committee of Sponsoring Organizations of the Treadway Commission.

# The System of Internal Control

## What is a System of Internal Control?

According to COSO, an internal control system encompasses the policies, processes, tasks, behaviours and other aspects of an organisation that, taken together:

- › Facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving objectives. This includes safeguarding of assets from inappropriate use or from loss and fraud, and ensuring liabilities are identified and managed.

- › Help ensure the quality of internal and external reporting – this requires maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation.
- › Help ensure compliance with applicable laws and regulations, and also internal policies with respect to the conduct of business.

A system of internal control is not just about policies and procedures – it is used by people and requires the use of judgement. The five components and seventeen principles of a system of internal control based on the COSO internal control framework are listed in Figure 1.

Figure 1: A system of internal control

### Control Environment

1. The entity demonstrates a commitment to integrity and ethical values.
2. The oversight body oversees the entity's internal control system.
3. Management establishes an organisational structure, assigns responsibility, and delegates authority to achieve the entity's objectives.
4. Management demonstrates a commitment to recruit, develop, and retain competent individuals.
5. Management evaluates performance and holds individuals accountable for their internal control responsibilities.

### Risk Assessment

6. Management specifies objectives with sufficient clarity to enable the identification and assessment of risk relating to objectives.
7. Management identifies risks to the achievement of objectives across the entity and analyses risks as a basis for determining how the risks should be responded to.
8. Management considers the potential for fraud in assessing the risks to the achievement of objectives.
9. Management identifies and assesses changes that could significantly impact the system of internal control.

### Control Activities

10. The entity selects and develops control activities that contribute to the achievement of objectives and respond to risks.
11. The entity selects and develops general control activities over technology to support the achievement of objectives.
12. The entity deploys control activities through policies that establish what is expected and procedures that put policies into action.

### Information and Communication

13. The entity obtains or generates and uses relevant, quality information to support the functioning of internal control.
14. The entity internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.
15. The entity communicates with external parties regarding matters affecting the functioning of internal control.

### Monitoring Activities

16. The entity selects, develops, and performs ongoing and / or separate evaluations to ascertain whether the components of internal control are present and functioning.
17. The entity evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board, as appropriate.

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It is management's responsibility to establish and maintain an appropriate system of internal control, and it is generally the audit committee's role to oversee that system of internal control.

## What is an 'Appropriate' System of Internal Control?

An appropriate system of internal control is one that is designed to promote achievement of objectives and help ensure risks to these objectives are maintained within organisational risk tolerance levels, bearing cost-benefit considerations in mind. It is adaptable and able to accommodate changes in the organisation's priorities and operating environment.

Internal auditors can assess whether a system

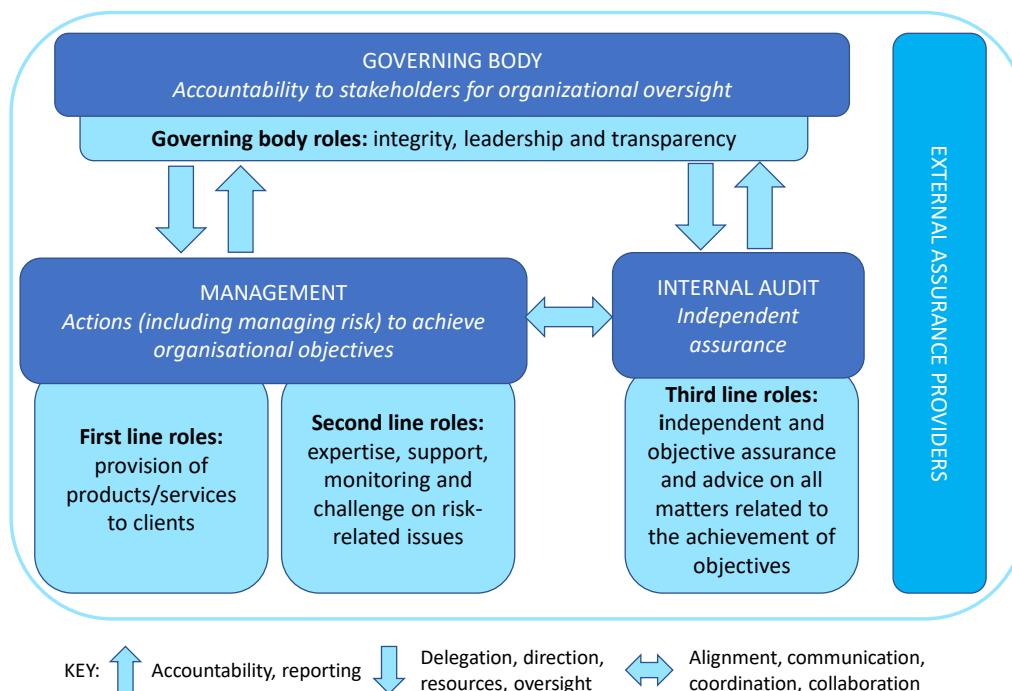
of internal control is appropriate by mapping its components against a recognised model such as COSO.

## How do you Assess Effectiveness of the System of Internal Control?

A system of internal control is a process to help ensure an organisation achieves its objectives and, like any process, requires review to ensure it remains fit-for-purpose.

The effectiveness of the system of internal control can be assessed through ongoing monitoring, and / or separate evaluations. The Institute of Internal Auditors' (IIA) 'Three Lines Model' can be used to define these roles. An example is provided in Figure 2.

Figure 2: Using the IIA's 'Three Lines Model' to define roles



In performing separate evaluations, internal auditors may be able to leverage the work of Line 1 and Line 2. Internal auditors should only place reliance on other assurance providers after undertaking an assessment of their competency, objectivity and independence. Guidance on making these assessments can be found in the IIA 'International Professional Practices Framework' (IPPF) Practice Guides 'Formulating and Expressing Internal Audit

Opinions' and 'Reliance by Internal Audit on Other Assurance Providers'. The IIA-Australia has also issued a Factsheet on 'Coordination and Reliance'.

For a system of internal control to be assessed, all five components and 17 principles must be assessed. For the overall system to be effective, all principles and components must be effective and operating in an integrated manner.

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‘Operating in an integrated manner’ refers to the determination that all five components collectively respond to the risks associated with an objective to ensure these risks remain within tolerance, therefore all five components must be operating together.

It’s important to note that these assessments are subjective, and involve the application of the internal auditor’s professional judgement. Internal audit quality assurance processes are therefore essential.

Furthermore, as explained by COSO, while an effective system of internal control provides assurance of achieving objectives, inherent limitations do exist. Failures can occur, even in an effective system. Per COSO, limitations can result from the:

- › Suitability of objectives established as a precondition to internal control.
- › Reality that human judgement in decision-making can be faulty and subject to bias.
- › Breakdowns can occur because of human failures such as error.
- › Ability of management to override internal control.
- › Ability of management, other personnel and third parties to circumvent controls through collusion.
- › External events beyond the organisation’s control.

## Summary

An ‘appropriate’ system of internal control is one designed in such a way that it increases the likelihood the organisation will achieve its objectives.

An assessment of the system of internal control can be undertaken at a process-level, business unit level, or enterprise-level. If undertaken at a process or business unit level, results can be aggregated to inform an overall assessment.

As per assessment of any internal control, assessment of the system of internal control should consider both its design and its operating effectiveness.

To determine whether an internal control system is effective, the design and operating effectiveness of all five components and 17 principles of the COSO internal control framework must be assessed. If a principle or component is not effective, or if the components are not operating in an integrated manner, then the internal control system is not

effective. However, even if the system is assessed as effective, there are limitations and the system can experience failures.

## Conclusion

A system of internal control can be described as the policies, processes, tasks, behaviours and other aspects of an organisation, that, taken together help organisations achieve their objectives and sustain and improve performance. It should be designed to be adaptable to changing business and operating environments, enable risks to be managed to acceptable levels, and support sound decision-making and governance of the organisation.

Designing and documenting an organisation’s system of internal control using a recognised framework such as COSO will help ensure the system is appropriate and will promote a shared understanding of internal control and the system of internal control.

Further, it will provide a solid basis for assessing effectiveness of the system of internal control. Assessments can be undertaken at different levels throughout the organisation, including at the process-level, business unit level, and enterprise-level.

Internal auditors may wish to include standard tests that cover each component of the system of internal control in their engagement work programs. Results can then be periodically aggregated to provide a report on the system of internal control, based on the work performed. Alternatively, internal auditors can perform a discrete assessment of an overall system of internal control.



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### Purpose of White Papers

A White Paper is a report authored and peer reviewed by experienced practitioners to provide guidance on a particular subject related to governance, risk management or control. It seeks to inform readers about an issue and present ideas and options on how it might be managed. It does not necessarily represent the position or philosophy of the Institute of Internal Auditors–Global and the Institute of Internal Auditors–Australia.

### Author's Biography

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Narelle is a management consultant and audit committee member. She has more than 25 years of experience spanning both the private and public sectors. Narelle has held various internal audit roles including at the Australian Taxation Office, Department of Defence, and the former Department of Industry, Innovation and Science where

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Narelle has been a member of the Institute of Internal Auditors (IIA) since 2007 and is a Director of the IIA-Australia. Narelle has been a member of the IIA-Australia Audit and Risk Committee since 2018 and was a member of the Finance Committee for the IIA 2017 International Conference. Narelle served on the IIA-Australia ACT Chapter Council for six years, including a term as Chapter Chair.

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### About the Institute of Internal Auditors–Australia

The Institute of Internal Auditors (IIA) is the global professional association for Internal Auditors, with global headquarters in the USA and affiliated Institutes and Chapters throughout the world including Australia.

As the chief advocate of the Internal Audit profession, the IIA serves as the profession's international standard-setter, sole provider of globally accepted internal auditing certifications, and principal researcher and educator.

The IIA sets the bar for Internal Audit integrity and professionalism around the world with its 'International Professional Practices Framework' (IPPF), a collection of guidance that includes the 'International Standards for the Professional Practice of Internal Auditing' and the 'Code of Ethics'.

The IIA-Australia ensures its members and the profession as a whole are well-represented with decision-makers and influencers, and is extensively represented on a number of global committees and prominent working groups in Australia and internationally.

The IIA was established in 1941 and now has more than 200,000 members from 190 countries with hundreds of local area Chapters. Generally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security.



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