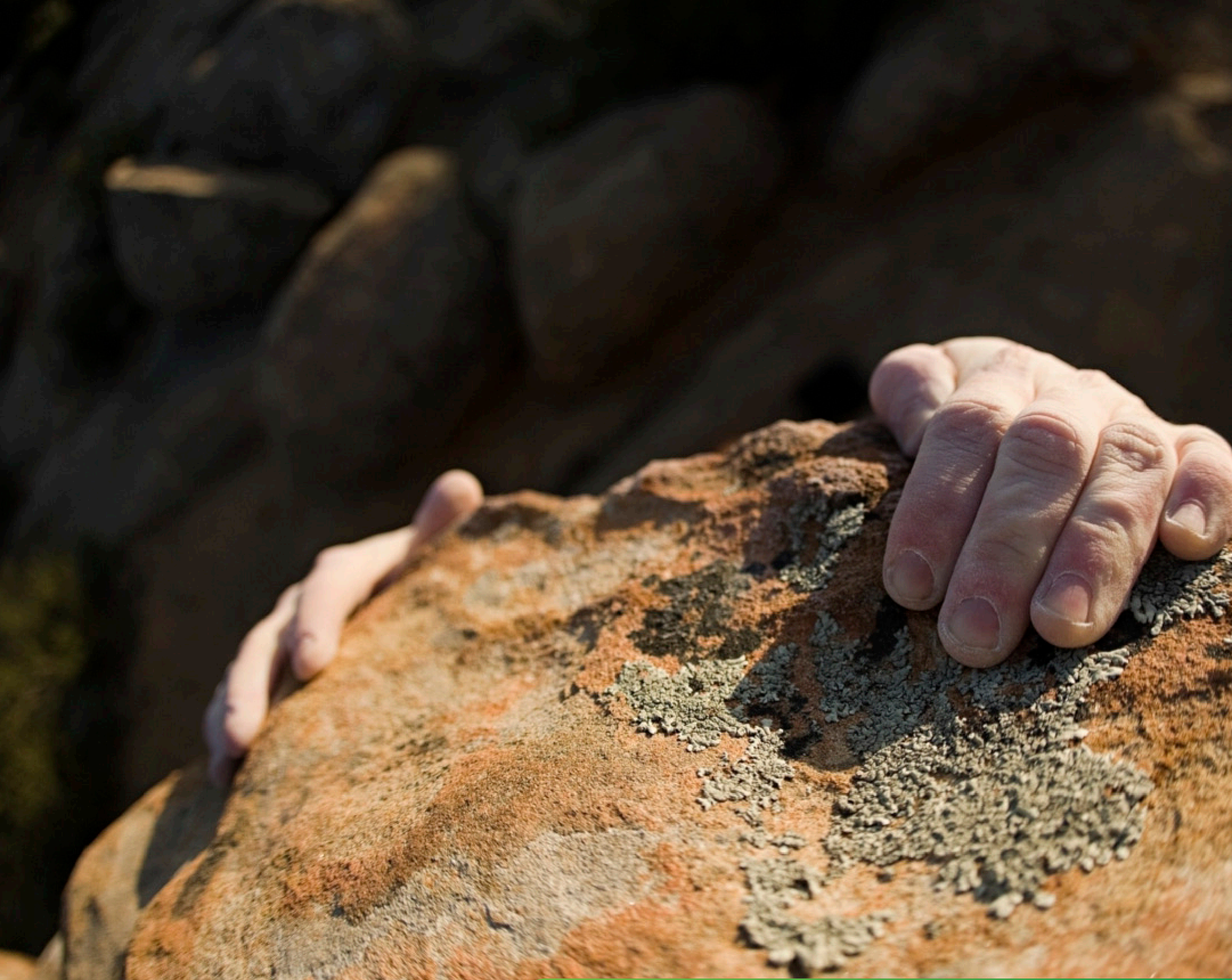

INTERNATIONAL GOOD PRACTICE GUIDANCE

Evaluating and Improving Internal Control in Organizations: Executive Summary

International Federation of Accountants

Evaluating and Improving Internal Control in Organizations

The International Good Practice Guidance *Evaluating and Improving Internal Control in Organizations* highlights areas where the practical application of existing internal control standards and frameworks often fails in many organizations. The guidance is valuable for professional accountants in business who work with their organization to continuously evaluate and improve internal control, and ensure that internal control is an integrated part of the organization's systems of governance and risk management.

The full-length version of Evaluating and Improving Internal Control includes relevant resources from IFAC, its member bodies, and other relevant organizations. It can be downloaded free of charge at www.ifac.org/paib.

The Value of the Guidance

Internal control is a crucial aspect of an organization's governance system and ability to manage risk. It is also fundamental to supporting the achievement of an organization's objectives and creating, enhancing, and protecting stakeholder value.

High-profile organizational failures typically lead to the imposition of additional rules and requirements, as well as to subsequent time-consuming and costly compliance efforts. However, this obscures the fact that the right kind of internal controls—enabling an organization to capitalize on opportunities while offsetting the threats—can actually save time and money and promotes the creation and preservation of value. Effective internal control also creates a competitive advantage, as an organization with effective controls can take on additional risk.

Despite the existence of sound internal control guidelines, it is often the application of such guidelines that fails or could be further improved in many organizations. With the publication, the Professional Accountants in Business (PAIB) Committee aims to provide a practical guide focused on how professional accountants in business can support their organization in evaluating and improving internal control as an integral part of its governance system and risk management. The guidance is complementary to existing internal control guidelines and is based on those internal control matters that often cause difficulties in practice.

The guidance helps to answer many key questions.

- What should the scope of internal control be?
- Who should be responsible for internal control?
- How should controls be selected, implemented, and applied?
- How can internal control be better integrated into the DNA of the organization?
- How should the organization report on internal control performance?

PROFESSIONAL ACCOUNTANTS IN BUSINESS AND INTERNAL CONTROL

Evaluating and improving internal control are among the core competencies of many professional accountants in business. Therefore, professional accountants can play a leading role in ensuring that internal control forms an integral part of an organization's governance and risk management. With an integrated, organization-wide approach to risk management and internal control, professional accountants in business also encourage the practice of viewing and treating risks in a more holistic way—with improved internal control.

Key Principles of Evaluating and Improving Internal Control

The key principles represent good practice for evaluating and improving systems for internal control. These principles are not formulated to design and implement an internal control system, for which other existing guidelines exist (see Appendix B in the full-length guidance). Rather, they are designed to facilitate the evaluation and improvement of existing internal control systems by highlighting areas where the practical application of such guidelines often fails in many organizations.

A. Internal control should be used to support the organization in achieving its objectives by managing its risks, while complying with rules, regulations, and organizational policies. The organization should therefore make internal control part of risk management and integrate both in its overall governance system.

B. The organization should determine the various roles and responsibilities with respect to internal control, including the governing body, management at all levels, employees, and internal and external assurance providers, as well as coordinate the collaboration among participants.

C. The governing body and management should foster an organizational culture that motivates members of the organization to act in line with risk management strategy and policies on internal control set by the governing body to achieve the organization's objectives. The tone and action at the top are critical in this respect.

D. The governing body and management should link achievement of the organization's internal control objectives to individual performance objectives. Each person within the organization should be held accountable for the achievement of assigned internal control objectives.

E. The governing body, management, and other participants in the organization's governance system should be sufficiently competent to fulfill the internal control responsibilities associated with their roles.

F. Controls should always be designed, implemented, and applied as a response to specific risks and their causes and consequences.

G. Management should ensure that regular communication regarding the internal control system, as well as the outcomes, takes place at all levels within the organization to make sure that the internal control principles are fully understood and correctly applied by all.

H. Both individual controls as well as the internal control system as a whole should be regularly monitored and evaluated. Identification of unacceptably high levels of risk, control failures, or events that are outside the limits for risk taking could be a sign that an individual control or the internal control system is ineffective and needs to be improved.

I. The governing body, together with management, should periodically report to stakeholders the organization's risk profile as well as the structure and factual performance of the organization's internal control system.

The Significance of the Principles

When applied effectively in organizations, these principles help avoid many common pitfalls.

- **From compliance to performance enabler**

Internal control is often perceived and treated as a compliance requirement rather than as an enabler of improved organizational performance. Effective internal control can help organizations improve their performance by enabling them to take on additional opportunities and challenges in a more controlled way. Therefore, organizations need to have a better understanding of how organizational performance relates to effective risk management and the role and effectiveness of internal control.

- **Responsibility of line management instead of being sidelined**

Responsibility for internal control should reside with those who have the highest level of authority for achieving the organization's objectives instead of being delegated to staff who lack executive powers. This helps reiterate the importance—at the highest levels—of internal control.

- **Turning a poor "tone at the top" into a motivational culture**

Poor "tone at the top" is a significant factor in organizational failures; conversely, recognizing positive performance can have a significant impact on strengthening internal control.

- **Rewarding risk taking *and* internal control**

In order to get the appropriate attention of executive and line management, as well as of all other employees, internal control objectives should not only be linked to the organization's objectives but also to individual performance objectives.

- **Insufficient internal control competence is also a risk**

There is a risk that people with assigned internal control responsibilities might not have sufficient knowledge, experience, skills, or time to adequately fulfill those responsibilities. This can seriously weaken and even jeopardize the effectiveness of the internal control system, which can in turn damage an organization. To counter this, sufficient internal control competence needs to be ensured throughout the organization.

- **From being in control to achieving one's objectives**

Controls are a means to an end—the effective management of risks, enabling the organization to achieve its objectives. Prior to designing, implementing, applying, or assessing each specific control, organizations first need to know what risks, or combinations of risks, the control is supposed to modify.

- **Embedding internal control: from the shelf to the minds of employees**

Internal controls can only work effectively when they, together with the risks they are supposed to modify, are clearly understood by those involved. Controls should not be documented and communicated in isolation but integrated, through formal and informal channels, into the elements of the management system in which they are intended to operate, including the related objectives, activities, processes, systems, risks, and responsibilities.

- **From "out of date" to "up to date"**

If a problem with an individual control or the internal control system occurs, the organization needs to be made aware as soon as possible, so that further damage can be prevented or contained and the issue rectified. In many cases, however, not enough attention is given to defining what, exactly, should be monitored and evaluated with respect to internal control, how this should be done, and by whom.

- **Reporting on structure *and* performance**

Organizations should transparently report on the structure and performance of their governance, risk management, and internal control system in their various reports to internal and external stakeholders, such as through their periodic accountability reports or on the organization's website.

International Good Practice Guidance

IFAC's purpose in issuing principles-based International Good Practice Guidance (IGPG) is to foster a common and consistent approach to those aspects of the work of professional accountants in business and public services not directly covered by international standards. IGPGs focus on key areas of strategic importance to professional accountants in business, with the aim of guiding their thought processes and decision making and, thus, supporting the exercise of professional judgment, which is critical in their roles. IGPGs address governance, evaluation, improvement, and implementation of strategic decisions for which professional accountants in business are responsible or to which they can contribute their expertise as trusted colleagues and advisors.

The Professional Accountants in Business (PAIB) Committee has applied the extensive expertise, experience, and diversity of its members and IFAC member organizations to draw out a set of internationally accepted principles that professional accountants can apply in organizations where they work, regardless of jurisdiction, size, economic sector, or form of ownership. The principles provide a common frame of reference when deciding how to address issues and challenges, and helping organizations to achieve sustainable success.

IGPGs also help accountants to identify additional available resources by including links to the relevant work and resources of IFAC member organizations and other colleagues.

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