

Assessment of the system of Internal Control and Internal Financial Control



The King Report on Governance for South Africa (King III) recommends that the Board should report on the effectiveness of the system of internal controls in the Integrated Report and also recommends that the Audit Committee should report on the effectiveness of systems of internal financial controls.

In order to do this, the Board is required to holistically consider all information brought to its attention and consider whether the risk of material misstatement and/or significant loss is sufficiently reduced through adequately-designed and effective internal controls. It is critical that the organisation’s combined assurance model is designed to facilitate this assessment of controls that protects the data quality and integrity of both financial and non-financial data. The cost benefit of particular controls should also be considered by the Board.

Management is responsible for ensuring adequate internal controls to safeguard the assets of the company and specific controls relevant to the preparation and fair presentation of an Integrated Report should be in place and operate effectively.

Internal Audit is responsible for providing a written assessment on the effectiveness of the system of internal control to the Board. In order to do this, internal audit procedures should be aligned to standards for the professional practice of internal auditing as prescribed by the Institute of Internal Auditors (IIA). These standards require that Internal Audit comply with ethical requirements and plan and perform audit procedures to obtain reasonable assurance that the system of internal control is operating effectively. The procedures selected depend on the internal auditor’s judgement, including the assessment of risk. In making those assessments, the internal auditor needs to consider the overall control environment relevant to the entity in order to design procedures that are appropriate in the circumstances. Where the Internal Audit function is outsourced to a third party, this assessment needs to be provided by the relevant service provider. It is critical that this is agreed upfront as part of the annual Internal Audit plan.

The Board should critically evaluate the written assessment made by Internal Audit. We recommend that the following be considered in this assessment:

- Internal Audit’s direct and indirect reporting lines;
- The level of access granted to Internal Audit within the organisation;
- The absence of undue budgetary constraints;
- The qualification and experience of the Internal Audit team;
- The Internal Audit methodology applied (including sample size and techniques);
- The scope of the audits executed; and
- The utilisation of Management Control Self-Assessment.

King III does not specify the extent to which the Board needs to report on the system of internal control. In reports published to date, we noted statements that vary between outright positive statements such as “Internal controls are in place to ensure the integrity of the group’s qualitative and quantitative financial information, which is used by a variety of stakeholders” to limited statements such as “Nothing has come to the attention of the directors to indicate that any material breakdown in the functioning of these controls, procedures or systems occurred during the year under review”.

The responsibility of Boards and Audit Committees to report to stakeholders on the effectiveness of the system of internal control (including internal financial control) should not be underestimated. Under the provisions of the current Companies Act, which codifies the standard of director conduct, a control breakdown resulting in significant loss for any of the stakeholders might render the board, or an individual director, liable in law.

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