

**BEST PRACTICES FOR INTERNAL  
CONTROL ROLES AND AUDIT  
EFFICIENCY**

*being a paper delivered by*

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## PROTOCOLS

### Introduction

1. I consider it an honour to have been invited to make a presentation at this Annual Retreat of the Internal Control and Audit Division of one of Nigeria's most reliable banking brands, the Fidelity Bank PLC. The outstanding accomplishments of this bank, which are not surprising, can rightly be attributed to the quality of its leadership headed by a chartered accountant. I associate with and warmly congratulate the Board and Management of Fidelity Bank PLC.
2. The topic of my discourse, *Best practices in Internal Control and Audit Efficiency*, is as timely as it is strategic for many respects. In spite of its usefulness to the efficiency of management and security of corporate assets, the Internal Audit is not only derided, but it also owes its existence to the whims and caprices of the Board of Directors (BoD). Many corporate managers see the average internal auditor, as an uncompromising adversary in the scheme of things, more like a necessary evil. This is hardly surprising.
3. Unlike financial reporting, internal auditing is not about the expression of *opinions* on corporate financial statements read at Annual General Meetings. It is about the provision of information to all strata of the organization, at *irregular* intervals, to enhance the value of decisions thereby promoting efficiency and effectiveness in resource utilisation.
4. The seeming obscurity of the internal audit is reinforced by the fact that the form its reports should take, is not expressly provided for in the Companies and Allied Matters Act 1990. Even Sections 63-65 of the Investment and Securities Act (ISA) 2007 which require external auditors to provide assurance on the internal control system of corporate entities did not also specify the format of reporting. Yet these pieces of legislation strictly confer on the Board of Directors the responsibility for evolving internal control measures that will guarantee the security of corporate assets, which is one of the main duties of the internal audit department. In spite of these legal

inadequacies, the role of internal audit in value creation deserves to be acknowledged. Thus efforts by your organization to seek and adopt best practices in internal control and audit efficiency is most commendable

5. Although I have been requested to speak on best practices in internal control activities, I will therefore commence this presentation by highlighting the crucial roles of internal audit in value creation such that other professionals (accounting and non-accounting) they work with would appreciate them as good team players rather than just as *corporate policemen*. In order to achieve this objective the paper is segmented into four sections: section one discusses the nature and usefulness of internal audit; section two gives an insight into the new roles of internal audit in an information-driven business environment; the third section discusses best practices in Internal Control and Audit while the last section contains the recommendations and concluding remarks.

## **THE NATURE OF THE INTERNAL AUDIT FUNCTION**

### *The Internal Audit Function*

6. Corporate entities usually take strategic decisions germane to the realisation of their set goals, prime of which, is prompt delivery of value to all stakeholders. Irrespective of the nature of the business decisions taken, their effectiveness and efficiency are contingent on the existence of appropriate internal control measures.
7. These control measures refer to “a system within an organization which prescribes the division of authority, the responsibilities for all activities and their direction and recording; for the purpose of creating a smooth operating procedure in an efficient and progressive manner, so ordered that a degree of check and restraint exists, resulting in the accomplishment of the organization’s purposes with a minimum of waste and a maximum of production or gain”<sup>1</sup>.

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1 T. Reginald Cloake, “Internal Check and Control as distinguished from Internal Audit”, *New York Certified Public Accountant*, xii ( September, 1942) p.617

8. Except these internal control measures are evolved and enforced, wastes associated with quackery, collusion, theft, fraud, loss of man-hours, regulatory breaches, etc, may arise which will vitiate the attainment of set goals at least cost. Thus, internal auditing can be perceived as the independent appraisal activity performed within an organization for the review of the accounting, financial and other operations as a basis for protective and constructive service to management.

9. The key concepts of the COSO<sup>2</sup> Framework include:

- Internal control is a process, a means to an end, rather than an end itself
- Internal control is affected by people. Its not merely policy, manuals, and forms, but people at every level of the organization
- Internal control can be expected to provide only reasonable assurance, not absolute assurance, to an entity's management and board
- Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.

10. In effect, internal control is a type of control which functions by measuring and evaluating the effectiveness of other types of control. However, since internal control activities involve human actions, there is the possibility of errors in processing or judgement. Operational rules or policies can, for instance, be overridden by top management through coercion or by collusion among employees thereby impairing the effectiveness of internal controls. Therefore, it is the fear or uncertainty surrounding the effectiveness of internal control measures that makes prompt, periodic and effective checks of operations by internal audit staff inevitable in progressive and well-managed organizations.

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<sup>2</sup> COSO means Committee of Sponsoring Organisations of the Treadway Commission. It issued its first internal audit framework in 1992. This was later reviewed in 2004.

### *Usefulness of Internal Audit*

11. The prime objective of internal auditing, according to the Institute of Internal Auditors, Inc., is to assist management in achieving the most efficient administration of the operations of the organization. This objective has two main control phases:

- protection of the interests of the organization including the pointing out of deficiencies in subsisting practices to provide a basis for corrective action; and
- furtherance of the interests of the organization including the recommendation of changes for the improvement of the various stages of the operations.

12. Pursuant to these, the mandate of a well functioning Internal Audit department includes to:

- ◆ ascertain the *degree of reliability* of accounting and statistical data generated within the organization that usually form the basis of the financial statements or stewardship reports of the board of directors;
- ◆ ascertain whether the policies put in place to secure corporate assets are *effectual and adequate* and in fact, review and appraise the policies, plans, the internal records and procedures of the organization with a view to determining their adequacy and effectiveness, in the light of emerging evidence and data;
- ◆ ascertain the *extent of compliance* by corporate managers to established policies, plans and procedures and indeed, guide against any possible breach of agreed policies by verifying all payment and receipt vouchers, stock movements, receivables and notes payable, cash balances, banking records and reconciliation statements, short and long term loans granted, investments, extent of exercise of authority by staff, etc;
- ◆ assist external auditors and audit committees of companies to *facilitate* their work;
- ◆ ensure that *internal controls are working properly* so that the external auditors can have faith in the accounts produced by the organization. In other words, the internal audit must ensure that accounting records are devoid of errors of all kinds and deliberate misrepresentation or fraud;

- ◆ reassure management of the *integrity of its operations*- provides assurance that control and governance processes are operating effectively and efficiently;
- ◆ ascertain whether *set targets are being achieved* and if not propose remedial measures; and
- ◆ ascertain and *align the risk appetite* of the organization with strategy

13. From the above, it is obvious that internal audit is a key function in the efforts of resource managers to create value as it provides professional services that enhance the productivity of other investment centres. The usefulness of internal audit lies not in the fact that it encompasses "...all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies"<sup>3</sup>, but that it ensures that these systems of control *actually work as intended*.

#### **NEW ROLES FOR INTERNAL AUDIT**

14. The traditional internal audit functions reviewed above have become inadequate in the light of the emerging complexities in today's business environment. The rapid advancement in information technology increasingly pose severe challenge to the productive activities of business entities so much so that their output become obsolete even before they leave the factories. This law of obsolescence has raised the stakes in environmental scanning implying that competitive leadership is to be won not by size of profit and market but by knack for minute market details by business innovators.

#### ***Environmental Scanning***

**15.** It follows therefore that the scope of activities of Internal Auditing must necessarily go beyond the presentation and review of internally generated financial information, the efficiency and effectiveness of business operations *to include generation of non-financial information and a detailed review of the external*

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<sup>3</sup> American Institute of Certified Public Accountants, *Internal Control*, a Special Report by the Committee on Auditing Procedure (New York, 1949) p.6

*environment of the business.* The shorter the review period, the better for the organisation particularly because of the lag effects between the taking of decisions, implementation and results. Indeed, according to the Balanced Scorecard philosophy developed by Kaplan and Norton (1992)<sup>4</sup> performance measurement will yield better results if done within a shorter period, say, weekly, monthly and quarterly.

### ***Involvement in Information Technology Initiatives***

**16.** In the deployment of information technology facilities to enhance operational processes, the internal audit must be involved from beginning to the end of the project. In other words, the internal audit must be part of the team charged with the responsibility of building IT architecture in an organization from the outset for the initiative to be effectual. Given the pervasive impact of IT in business today, great care must be taken in the selection and deployment of hardware and software based on well thought out user specifications. Yet, these are areas in which the internal auditor has increasingly shown so much dexterity. To relegate the internal audit to the background is therefore to court corporate disaster.

### ***Enterprise Risk management***

17. Although, the environment in which business is done has become increasingly uncertain, success in business, defined in terms of ability to deliver value at a profit, depends on the risk management capabilities of resource managers. The underlying premise of Enterprise Risk Management (ERM) is that every entity exists to provide value for its stakeholders. All entities face uncertainty and the challenge for management is to determine how much uncertainty to accept as it strives to grow stakeholder value. Uncertainty presents both risk and opportunity, with the potential to erode or enhance value. According to the COSO Framework, Enterprise risk management enables management to effectively deal with uncertainty and associated risk and opportunity, enhancing the capacity to build value. It is instructive to note that value is maximized when management sets strategy and objectives to strike an

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<sup>4</sup>Kaplan, R & Norton, D.(1992), “The Balanced Scorecard: Measures that Drive Performance”. Harvard Business Review, Jan-Feb, pp71-79.

optimal balance between growth and return goals and related risks, and efficiently and effectively deploys resources in pursuit of the entity's objectives.

18. The thrust of risk management today is not only about preventing business decline but also about managing business success. In fact, it is important that resource managers get out of the mentality that risk management is crucial to avoid business decline. It is also important to staying ahead of competition because the next business surprise might just be lurking in the corner. This is where the information generated by the internal audit from both the internal and external environments finds great relevance. Thus, efficient internal control and risk management techniques have become inevitable strategic tools for organisations desirous of sustained success in today's business.

19. According to the Turnbull Report in UK, good risk management philosophy has the potential to re-orient the whole organisation around performance improvement if resource managers deliberately focus on:

- putting in place a framework for considering risk and reward which will help facilitate the achievement of the company's main business objectives;
- open and appropriate disclosure to enable all stakeholders understand why and how risks are being taken and managed;
- constructive opportunity management as well as disaster prevention strategies;
- the introduction of an ongoing process which builds on the existing control system and helps the establishment to review, create awareness and reinforce business objectives, critical success factors, succinct reporting and key performance and risks indicators;
- the increasing level of external and internal changes to which companies are subjected. As change increases, so too does the need for risk management

20. Thus, in the new dispensation, internal auditors need to assess the adequacy of techniques used to manage the various risks associated with the firm's operations

with a view to advising management on appropriate measures. Therefore, beyond its perceived role as corporate policeman, the internal auditor should be seen as key partner in investment activities particularly because today's business environment has changed from one focused on cost competitiveness to one with emphasis on value creation.

## **21. BEST PRACTICES IN INTERNAL CONTROL AND AUDIT EFFECTIVENESS**

### **21.1 Established by Board**

The internal audit activity must be a deliberate creation of the Board of Directors as required by legislation. Its responsibilities must be defined by the Board as part of its oversight functions. Its mandate must be clearly defined.

### **21.2 Control Environment**

The control environment sets the tone of an organization influencing the control consciousness of its people. Control factors include the integrity, ethical values, management operating styles, delegation of authority, segregation of duties as well as the processes for managing and developing people in the organization. Persons charged with governance responsibility must lead by example by walking their talk. Executive overrides must be rare. This is the foundation for the efficiency of internal control.

### **21.3 Adequate Authority**

It must have full authority and unrestricted access to any and all records and physical properties of the corporate entity including staff carrying out various assignments. It must also have unrestricted access to the Board.

### **21.4 Right Organisational Structure**

The head of Internal Control and Audit department should rightly be the same rank as the chief finance officer and be accountable to the Board. While he may report on day to day operations to the Chief Executive Officer, he should report

functionally to the Board which approved the internal audit charter and internal audit risk-based plan

### **21.5 Operating Procedures Manual**

The relevant policies and procedures must be documented in a standard manual which should be circulated to all employees. Adequate awareness of these operational guidelines must be done to ensure voluntary compliance. Changes to them must also be circularized.

### **21.6 Independence and Objectivity**

To ensure the independence and efficiency of internal audit, the appointment of the head of department, his performance evaluation, remunerations or removal should be the responsibility of the Board. Indeed, the internal audit activity must remain free from interference by any staff in the organization on all matters including audit selection, scope, procedures, frequency, timing or content of reports. Accordingly, internal auditors must exhibit the highest level of professional objectivity in gathering, evaluating and communicating information about activity or process being examined. They must make a balanced assessment of all the relevant circumstances and not be unduly influenced by their own interests or others in forming judgements.

### **21.7 Existence of an Internal Audit Plan**

Annually, the head of internal audit must submit to the Board and senior management an internal audit plan for review and approval. This plan will consist of work to be done, budget and resource requirements for the year. The plan should be developed based on prioritization of the audit universe using risk-based methodology. Any deviations from the plan will be periodically reported to senior management team and the Board.

### **21.8 Adequate funding**

The internal audit department must be adequately resourced in terms of personnel, equipment, office space, etc, through budgetary allocations. The head of department must bring to the knowledge of the board and senior management the implications of resource limitations on the achievement of the agreed internal audit plan.

### **21.9 Periodic Assessment and Reporting**

The head of internal audit must periodically report on the activity of his department with emphasis on comparison between plan and performance. The report should also include significant risk exposures and control issues including fraud risks, governance issues and other related matters as well as recommendations to mitigate observed lapses or risks.

## **22. The Internal Audit Function is well managed when**

- The results of the internal audit activity's work achieve the purpose and responsibility included in the internal audit charter
- The internal audit activity conforms with the definition of internal auditing and the standards; and
- The individuals are part of the internal audit activity demonstrate conformance with the code of ethics and the standards.
- The internal audit activity adds value to the organization and its stakeholders when it provides objective and relevant assurance and contributions to the effectiveness and efficiency of governance, risk management and control processes

## **CONCLUSION**

23. Internal auditing, as an objective activity, is part of the organisation's plan for managing risk, evaluating controls, ensuring compliance with control policies, laws and regulations such that set objectives are achieved. Its functions therefore include evaluating the adequacy of techniques used to manage these risks as well as providing

assurance that control and governance processes are operating effectively and efficiently and if need be, identify and recommend changes that would add value. In other words, it is within the professional competence of the internal auditor to provide advice on how to design a proper control system and conduct an independent appraisal on how effective the controls are. To succeed in this regard, the internal auditors must continually re-engineer themselves and imbibe the virtues of learning to learn as well as persuasive communication in order to build bridges of understanding with other responsibility centres. As Sharma (1999) noted, “the internal Audit Department cannot operate in an adversarial role and still be able to create value. The department will operate at the optimum level for value creation when its services, advice and counsel are being sought by operation’s management”<sup>5</sup>

Thank you for listening.

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<sup>5</sup> Robert Sharma (1999), Ibid. P. 102