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Internal control

Corporate governance, internal audit and strategic renewal

In the early 1990s, as the result of a series of eventful organisational malpractices in Europe in both the private and public sector, ranging from financial disasters to operational catastrophes, there was mounting criticism of the quality and scope of financial reporting and the effectiveness of independent accounting. This article discusses the background to corporate governance in the UK. It then covers the development of corporate governance in the Central Bank of Iceland and explains how international currents have affected the Bank.

The main elements of internal control are listed and discussed, followed by how internal control and internal audit can be used to stimulate and promote changes and strategic renewal.

The conclusion is that internal control is a very important element of corporate governance. Internal audit adds value to the organisation by assessing the control systems and reporting that assessment to the board and management, which in turn use it as a measure of the "health" of the organisational system.

The audit function thus becomes the enabler of change by providing knowledge about the true state of the organisation and the rate of the change taking place through an assessment of internal control systems.

1. Introduction

This article addresses the interplay between good corporate governance, internal control, internal audit and strategic renewal.

The case of the Central Bank of Iceland is interwoven into this discussion, to explain how international changes in central banking have affected the organisation and procedures of the Bank.

Firstly, the background and evaluation of corporate governance is covered fairly thoroughly. The main emphasis is on the Anglo-Saxon methodology, as this seems to have more relevance for Europeans than the US approach. Developments regarding corporate governance in the Central Bank of Iceland will be touched upon.

The main elements of internal control are listed and discussed, followed by how internal control and internal audit can be used to stimulate and promote changes and strategic renewal.

Lastly, a short overview is given of the development of the Central Bank of Iceland in the past few years, and how its internal control system and internal audit have evolved.

2. Corporate Governance

Governance is the structure used by management to oversee the activities of the organisation. "Good corporate governance should provide proper

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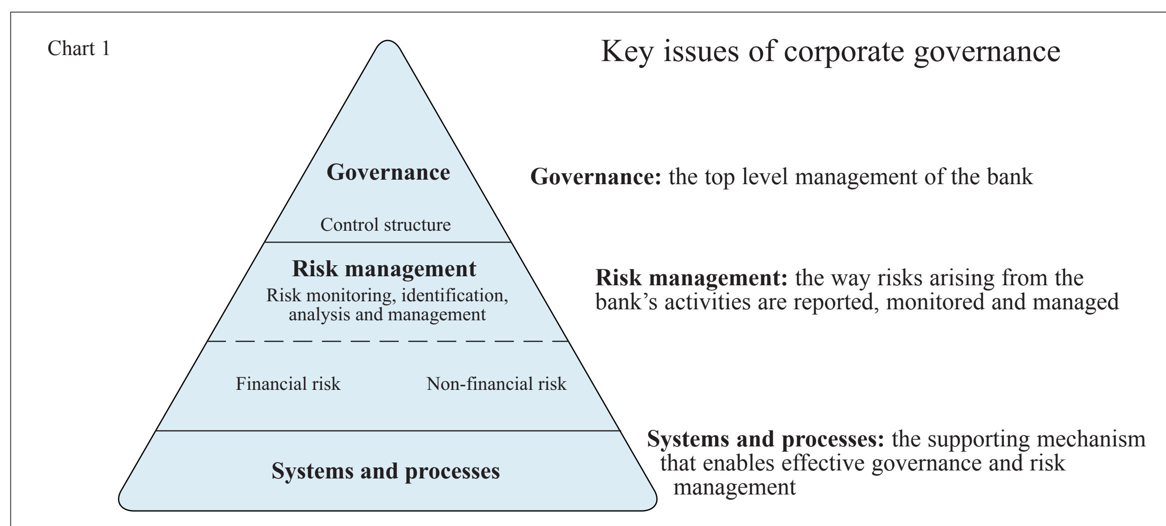


incentives for the board and management to pursue objectives that are in the interest of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently".[2]

The board of directors thus should provide governance, guidance and oversight to senior management. It is ultimately responsible for ensuring that an appropriate internal control system is in place, including risk assessment.

Corporate governance activities are represented as four principal components:

- direction
- executive action
- supervision
- accountability

Organisations such as the IMF and the BIS have promoted increased central bank transparency and central banks are increasingly expected to follow the same control and accounting guidelines as commercial banks and organisations in general.

Significant responsibilities imposed on the board of directors of a bank by the BIS principles for effective internal control culture include:

- Responsibility for approving and periodically reviewing the overall business strategies of the bank
- Understanding the major risks run by the bank, and setting acceptable levels for them
- Approving the organisational structure
- Ensuring that senior management monitor the effectiveness of the internal control system

To summarise: In times of accountability and transparency central bankers need to address three critical areas, as shown in Chart 1.

Background to corporate governance

In the early 1990s, as the result of a series of eventful organisational malpractices in Europe both in the private and public sector, ranging from financial disasters such as Maxwell Communications and BCCI to operational catastrophes like the Zeebrugge ferry and British Airways' "dirty tricks" campaign, there was mounting criticism of the quality and scope of financial reporting and the effectiveness of independent accounting. This also raised serious questions from government, institutional and private investors, employees and the general public, about the role of managers, directors, internal and external auditors and audit committees.

In the UK this led to the establishment of the Cadbury Committee, which reported in late 1992 and again in 1996. The Cadbury Report (1992), which had the backing of the Bank of England, the

2. See "OECD Principles of Corporate Governance", published June 21, 1999.

London Stock Exchange and accounting bodies, sought to establish a Code of Best Practice on disclosure and audit arrangements for stock exchange-listed companies. The Cadbury Report (1992) was widely regarded as groundbreaking, as it set the agenda for best practice. The Report embraced issues of ethics, fairness and openness, and developed a definition of governance that contained openness, integrity and accountability, stating that "governance is the system by which companies are directed and controlled".

Of particular relevance to the issue today is one important point in the *Code of Best Practice:*

- The directors should report on the effectiveness of the company's system of internal control

Most major European companies have established audit committees as recommended by Cadbury and others. Audit committees assume the important responsibility of representing boards of directors on oversight matters related to financial reporting, auditing and overall corporate governance. As a corporate governance mechanism, audit committees monitor management, the external auditor and the internal auditor in an effort to protect stakeholders' interests.

Cadbury (1992) suggested that it would be a good practice for companies to establish internal audit to undertake regular monitoring of key controls and procedures, and where an internal audit function existed, the audit committee should ensure that it was adequately resourced and had appropriate standing within the organisation. The internal audit function and programme should be reviewed by the audit committee.

The closing chapters of the Cadbury Report called for a further group to be formed, with the aim of judging how its recommendations had been applied and whether they had worked. This led to further development in corporate governance in Europe and elsewhere.

In 1999 the Cadbury Report was updated in the UK and the Combined Code went into effect. The Combined Code emphases all controls, requiring listed companies to review their controls annually and states that this review should *"cover all controls, including financial, operational, compliance and risk management"*. The Combined Code is now followed in the UK as best practice by companies listed on London Stock Exchange. Companies are not bound by law to comply with the guidance, but they have to explain any deviations from it.

In considering the effectiveness of internal financial control and reporting on it, directors should consider:

1. Control environment
2. Identification and evaluation of risks and control objectives
3. Information and communication
4. Control procedures
5. Monitoring and corrective action

The UK situation can more or less be extrapolated to the general situation in corporate governance in Europe.

In the USA the Sarbanes-Oxley Act of 2002 is the most sweeping legislation affecting corporate governance and is an attempt to put corporate America on track again by imposing strict rules on companies, accountants and auditors. The legislation is regarded as a necessary evil to protect stakeholders after a series of corporate scandals.

According to the literature on corporate governance it is expected that the principle-based approach will continue to thrive in Europe, while strict rules (the prescriptive approach) will remain the norm in the United States.

OECD published its principles of corporate governance in 1999 and organisations such as the IMF and BIS are putting increased pressure on central banks to enhance the transparency of their actions, and central banks are more often expected to follow the same control and accounting guidelines as other organisations.

This has among other things been done by providing technical assistance to member countries in order to help them to increase the transparency and accountability of their administration.

Background to corporate governance in the Central Bank of Iceland

The Central Bank of Iceland was established by an Act of Parliament in 1961. From the outset, it has performed traditional central banking functions. Its mandate, role and activities were always shaped by

the general circumstances of the day and political realities. In the early period, interest rates were regulated, there was wide-ranging foreign exchange control, the Treasury had liberal access to Central Bank financing and the Bank was charged with the supervision of institutions permitted to accept deposits from the public. Although formally independent, the Bank was required by law to support the economic policy of the Government, even if it disagreed with it.

The Central Bank Act was revised in 1986 and again in 2001. The most important change in 1986 was the confirmation of liberalisation of interest rates. The 2001 revision of the Central Bank Act entailed changes very much along the lines of those which had been implemented in central bank legislation in many industrial and developing countries over the past decade or so. The objectives of the Bank were redefined and simplified. The main objective of monetary policy became the promotion of price stability, in practice within the framework of an inflation target. The Bank was also to concern itself with issues relating to financial stability. The Bank was granted independence to use its instruments to pursue the objective of price stability, Treasury access to Central Bank financing was formally closed, clear transparency and accountability provisions were built into the law, and provisions on the transfer of Central Bank profits to the Treasury were modified so as to permit the build-up and maintenance of sufficient capital in the Central Bank. The Act also called for greater emphasis on good corporate governance and internal rules and controls to implement the mandate given in the Act.

Thus, following the 2001 revision, the Act on the Central Bank of Iceland compares favourably with those of central banks in other industrial countries. Prior to the 2001 revision, an international study found the Central Bank of Iceland to be one of the least independent of a large group of central banks. The new Act put the Bank in the forefront of modern central banking functions and activities.

In practice, it may be maintained that the Central Bank of Iceland has moved rapidly forward in the area of corporate governance even if there is no formal code in Iceland which could provide guidance.

3. Internal Control

A system of effective internal control is a critical component of an organisation's management and a foundation for its safe and sound operation. A system of strong internal controls can help to ensure that the goals and objectives of an organisation will be met, that it will achieve long-term targets and maintain reliable financial and managerial reporting. Such a system can also help to ensure that the organisation will comply with laws and regulations as well as policies, plans, internal rules and procedures, and reduce the risk of unexpected losses and damage to the organisation's reputation.

The following presentations of internal control in essence cover the same ground.

1. In USA, the Committee of Sponsoring Organisations of the Treadway Commission (COSO) issued *Internal Control – Integrated Framework* in 1992, which defined internal control as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
   - Effectiveness and efficiency of operations
   - Reliability of financial reporting
   - Compliance with applicable laws and regulations
2. The Rutteman Report (1994) in UK defined internal control as the whole system of controls, financial and otherwise, established in order to provide reasonable assurance of:
   - Effective and efficient operations
   - Internal financial control
   - Compliance with laws and regulations
3. In Canada it was the Canadian Institute of Chartered Accountants (CoCo, 1995) that issued *Guidance of Control* along the same lines as Cadbury and COSO.

In CoCo's *Guidance of Control,* control is put into context with how a task is performed. It says, "A person performs a task, guided by an understanding of its *purpose* (the objective to be achieved) and supported by *capability* (information, resources,

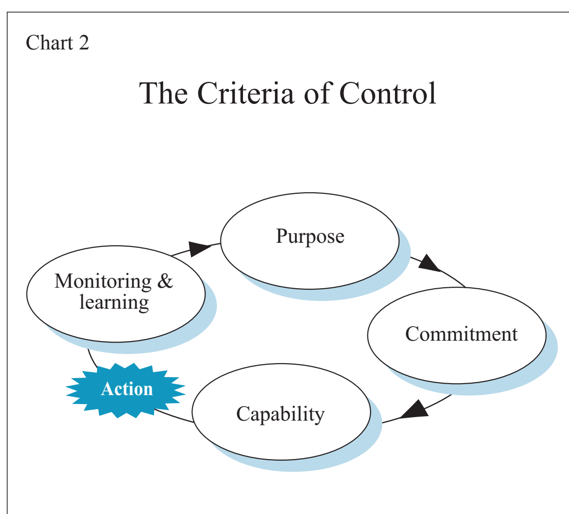
supplies and skills). The person will need a sense of *commitment* to perform the task well over time. The person will *monitor* his or her performance and the external environment to *learn* about how to do the task better and about changes to be made. The same is true of any team or work group. In any organization of people the essence of control is purpose, commitment, capability, and monitoring and learning".

The above criteria create the basis for understanding control in an organisation and for making judgements about the effectiveness of control.

It is important here to make a distinction between control and management. Control can never constitute everything involved in managing an organisation. Control supports but does not tell what objectives to set for the organisation. Control cannot prevent incorrect strategic and operational decisions.

Chart 2

The Criteria of Control



Purpose groups criteria that provide a sense of the organisation's direction:

- objectives (including mission, vision and strategy)
- risks (and opportunities)
- policies
- planning
- performance targets and indicators

Commitment groups criteria that provide a sense of the organisation's identity and values:

- ethical values, including integrity
- human resource policies
- authority, responsibility and accounting
- mutual trust

Capability groups criteria that provide a sense of the organisation's competence:

- knowledge, skills and tools
- communications processes
- information
- coordination
- control activities

Monitoring and Learning groups criteria that provide a sense of the organisation's evolution:

- monitoring internal and external environment
- monitoring performance
- challenging assumptions
- reassessing information needs and information systems
- following-up procedures
- assessing the effectiveness of control

To summarise, internal control consists of five interrelated elements:

- Management oversight and control culture
- Risk assessment
- Control activities
- Information and communication
- Monitoring activities

Effective governance, risk management and the control culture can only be achieved if the right information gets to the right people at the right time. Significant gains can be made by adopting appropriate, robust and properly controlled information technology. However, technology alone is not enough; the surrounding procedures and processes need to be clearly defined and quality staff recruited, retained and trained so the organisation can establish and maintain the highest standards.

The task of senior management is, as above, to ensure that the internal and external factors that could

adversely affect the achievement of the organisation's objectives are identified and evaluated. They should also ensure that the risks affecting the achievement of the bank's strategies and objectives are continually being evaluated.

Internal audit

Internal control provides some degree of assurance for the achievement of corporate objectives, and an important part of every internal audit function is how control and governance integrate in the audit environment. Current thinking on corporate governance dictates that the effectiveness of internal auditing depends on its place in the organisation and the use of professional staff together with the use of recognised internal auditing standards. Historically, due to the growing complexity and expansion of organisations, management needed to control business processes. The consequence was that internal auditors needed to concentrate on the way business controls were managed, moving from the traditional financial audits, which were transferred to some extent to line managers and external auditors.

In the IIA's *Professional Practices Framework* internal audit is defined as follows:

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes".

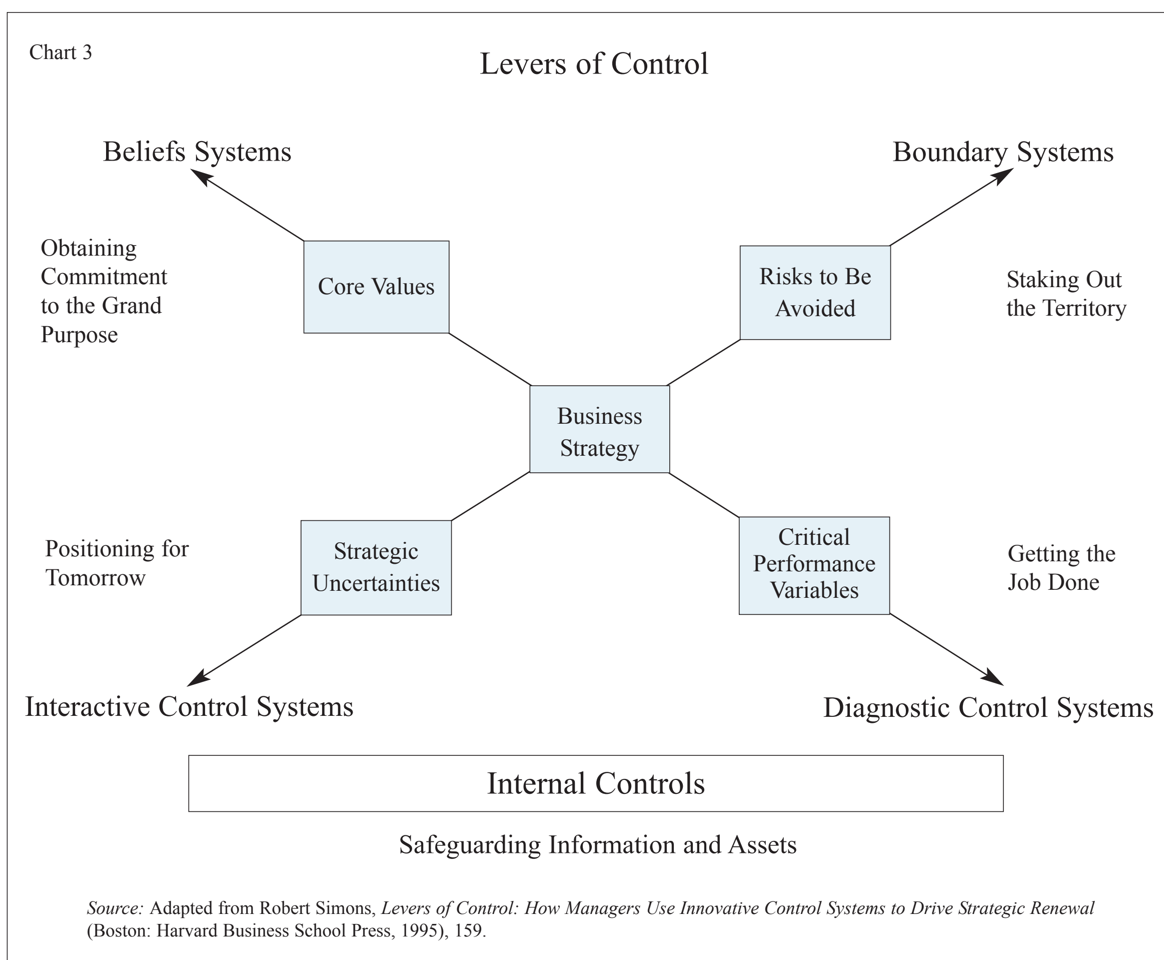
Internal audit is a valuable service to the board of directors and management as it appraises independently the effectiveness of internal control. The board of directors need constant monitoring of the internal controls so that they may be informed in a timely manner of any irregularities or weaknesses that occur, to allow immediate action to be taken to rectify them. The need for constant monitoring suggests that this is a role for the internal auditors rather than the external auditors as proposed in *The Audit Agenda* published in December 1994 by the Auditing Practices Board (APB, 1994). This is also the view taken in *Auditing into the Twenty-first Century* by the Research Committee of the Institute of Chartered Accountants of Scotland (ICAS, 1993).

The board thus delegates in practice, at least in part, the oversight over the detailed design and operation of the control system and some of the monitoring procedures to the internal audit, which in turn reports to the board or audit committee and thereby assists the directors in fulfilling their corporate governance duties to report on their organisation's internal controls and risk management.

The internal audit function also provides managers with support in monitoring and implementing internal control frameworks, codes of conduct and other aspects of governance. Internal audit is of assistance in ensuring compliance with governance requirements and is considered by managers of organisations to add value to the business by helping to achieve control objectives in the following areas:

- Achievement of established objectives and goals
- Compliance with policies, plans, procedures and regulations
- Safeguarding of assets
- Accuracy of information
- Economic and efficient use of resources

As an organisation's internal control assessment has become more risk-based, the role of internal audit has changed from a focus on compliance to a risk-based coverage of efficiency and effectiveness. This is only one area where the internal audit function has been changing. In the rapidly changing environment in which organisations are operating today, the internal audit function faces unique challenges. Value-for-money auditing with its triple objectives of economy, efficiency and effectiveness has assumed the primary position in many internal auditing functions. It is no longer confined to the traditional role of evaluating internal controls and protecting assets, but is increasingly becoming involved in process design. As a consequence the range of activities has broadened to include, for example, advisory and consulting tasks at the expense of compliance work. Recently there has been a trend away from the advisory and consulting role as a result of various malpractices in organisations.



Source: Adapted from Robert Simons, *Levers of Control: How Managers Use Innovative Control Systems to Drive Strategic Renewal* (Boston: Harvard Business School Press, 1995), 159.

4. Strategic Renewal – Changes

Moving from the background and the basics of corporate governance, internal control and internal audit, and on to how internal control and internal audit can help embrace changes and strategic renewal, it is relevant to discuss the underlying philosophy behind the existence of internal audit. This can be approached in different ways. One way is to connect it with organisational strategy and examine how the internal audit, through its various functions and responsibilities, can serve as the knowledge base for organisational changes.

Although perhaps not of the same relevance as in private companies, this is still also an issue in central banks. Central banks have to be able to adapt to changes in the environment, changes in legislation and changes in the way they do their business in a similar way to profit-oriented organisations. This led to the conclusion that an internal audit function in a central bank, besides looking at the compliance side of things, has to be dynamic, staffed by highly qualified people, and value-adding to the organisation.

Organisational strategy and the internal audit function

As a general introduction to the issue it is useful to consider organisational strategy and link it to the internal audit function. One important theme that arises is the importance of internal audit's role in supporting organisational strategy.

Strategy can be defined in the following way: "Strategy is the *direction* and *scope* of an organisation over the *long term*: which achieves *advantage*

Table 1 Relating the four control levers to strategy			
Control system	*Purpose*	*Communicates*	*Control of Strategy as:*
Beliefs systems	Empower and expand search activity	Vision	Perspective
Boundary systems	Provide limits of freedom	Strategic domain	Competitive position
Diagnostic Control Systems	Coordinate and monitor the implementation of intended strategies	Plans and goals	Plan
Interactive Control Systems	Stimulate and guide emergent strategies	Strategic uncertainties	Pattern of actions

Source: Levers of Control: How Managers Use Innovative Control Systems to Drive Strategic Renewal.

for the organisation through its configuration of *resources* within a changing *environment*, to meet the needs of *markets* and to *fulfil stakeholder* expectations."[3]

Organisations are restructuring, reinventing and reengineering themselves to change their goals and their processes in pace with the changing business environment. The need for strategy is driven by internal and external factors. Internal drivers can be process time cycles and resource acquisition time. External drivers can be changes in the environment, such as technology, customers, suppliers, regulations, etc. (McNamee, 1995). Change is ongoing in the environment and therefore in the organisation. Wrong strategy results in delivering the wrong thing at the wrong time. The right strategy and its implementation, on the other hand, creates value for the organisation and is fundamental for its continuing survival. Internal audit can have an important role in ensuring the implementation of the strategy because of its general overview of the business. The management of the organisation are the overseers of change through their strategic direction.

Robert Simons (1994) has articulated a framework for viewing control systems used by management to implement business strategy. This framework explains the interaction between management controls, internal controls and organisational strategy. He divides controls into four levers, positive and negative, plus the fifth, internal control. These four positive and negative forces complement each other when used together. The control of business strategy is achieved by integrating the forces of beliefs systems, boundary systems, diagnostic control systems and interactive control systems.

The beliefs systems embrace the core values of the organisation. They define and explain the values and direction that senior management want subordinates to follow.

The second level of control is the boundary systems which establish limits, based on defined business risks. Beliefs and boundary systems are the formal information-based rules and procedures to control the patterns of behaviour of the staff.

Diagnostic control systems are the formal information systems that managers use to monitor organisational outcome and to correct deviations from a preset standard of performance. Profit plans and budgets are a good example of diagnostic control systems.

Interactive control systems focus attention and force dialogue throughout the organisation. Managers use the systems to activate the search for the

3. Johnson, G. & K. Scholes, *Exploring Corporate strategy, text and cases*, 4th edition, Prentice Hall, 1997, p. 10.

future position of the organisation. They serve as a catalyst for change.

Internal control systems are there to safeguard critical assets and adherence to rules and to report on the "health" of the organisation.

So how does the internal audit fit into this system of controls? The audit function in an organisation becomes the enabler of change by providing knowledge of the true state of the organisation and the rate of the change taking place in it with an assessment of internal control systems (McNamee, 1995). Managers will practise different strategies at different stages of the organisation's life cycle and according to how the environment is supposed to be changing. They will therefore need different information at different stages in the life cycle and as the process changes. Thus the role and focus of internal audit will have to change over time. What was important information some years ago may have less relevance to the organisation today. In order to be a value-adding function in the organisation, internal audit will therefore have to ensure that it does the right things by collecting the right information and reporting it to management in an effective manner.

Let us now move to the case of the Central Bank of Iceland and look at how these recent trends and theories have affected its organisation.

5. The Case of the Central Bank of Iceland

As mentioned before, significant changes have been made in the legal framework of the Central Bank of Iceland over the last few years. The general trend in the direction of accountability and transparency for central banks has definitely affected the Bank. Major changes have been made to the framework within which the Bank operates. It has developed its procedures and organisation. Some functions performed before have been discontinued or moved elsewhere. Functions are still slowly but surely being trimmed down to core objectives of the Central Bank. The staff is more qualified than ever, with 50% holding a university degree at the end of 2002. The number of staff has fallen by well over a fifth since 1990.

The Central Bank of Iceland has thus been heavily influenced by international developments in central banking.

How has this affected the internal control system and the use of internal audit?

Increased management awareness of the Bank's core objectives and public demand for increased transparency and accountability have resulted in a reformed internal control system. Management responsibility for internal control has been emphasised, which has an effect on staff performance. It has been stressed that the main objectives of the internal control processes are:

- The performance objective – i.e. the efficiency and effectiveness of activities of the Bank
- The information objective – i.e. the reliability, completeness and timeliness of financial and management information
- The compliance objective – i.e. compliance with applicable laws and regulations

The trend towards a more open and transparent institution has resulted in a revision of the control system in the Bank. Some elements of it have already been finished and put into effect; others are still under revision and development.

Elements relating to corporate governance and control in the Bank that have recently been updated:

- Laws and regulations governing the Bank
- Relevant and up-to-date internal rules and descriptions of procedures
- Continuity plan
- Description of working processes
- Handbook on information security
- Handbook on physical security
- Adequate information and communication systems
- Risk management system
- Separation of duties

The above elements among many others are necessary components of good corporate governance.

The internal audit function underwent significant changes in 1999, when a new head of the department was appointed. This was in accordance with the general development in the Bank and the general trends in internal auditing practices. Some of the staff were new and functions were moved from internal audit to the accounting department where they

belonged. Staff numbers fell from seven to three. A new strategy for internal audit was formed, based on new thinking and approaches.

The internal audit now provides support to the Supervisory Board and senior management by helping to ensure that the Bank achieves its objectives.

In doing so, the emphasis is on the value-adding part. How are the Bank's core functions supported? The internal audit has been proactive in all its work and encourages management and the Board, in regular and special reports and on a daily basis, to embrace changes in the organisation in accordance with the central banking environment in general.

The internal auditor is appointed by the Supervisory Board of the Bank which is in turn elected by Parliament. The internal auditor is thus accountable to the Supervisory Board and not to the Board of Governors who, according the Central Bank Act, are responsible for formulating and implementing monetary policy as well as managing the Bank in general. Nevertheless, the internal auditor works closely with the Board of Governors in ensuring adequate internal procedures for assessing and managing risks.

In order to assess the internal audit, the Central Bank Act provides for an annual external audit under the auspices of the State Auditor General.

6. Closing comments

The conclusions to draw from all the above are that control is a very important element of corporate governance. Management use control systems to help ensure that business objectives are achieved.

Internal audit adds value to the organisation by assessing the control systems and reporting that assessment to the board and management, which in turn use it as a measure of the "health" of the organisational system.

The audit function thus becomes the enabler of change by providing knowledge about the true state of the organisation and the rate of the change taking place through an assessment of internal control systems.

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