

# Risk Management and Internal Control Guidelines

## What is internal control?

**T**here is a renewed focus on internal control around the world because of numerous recent and public breakdowns in internal controls affecting a variety of organisations. These breakdowns have resulted in financial losses as well as enormous loss of reputation and customers.

Internal control has been re-defined to become more compatible with the current business environment. Internal control is defined as:

*“a process, effected by an organisation's Board of Directors, Chief Executive Officer, senior management and other employees, designed to provide reasonable assurance regarding the achievement of the organisation's objectives.”*

In effect, this means that by effectively implementing internal control, an organisation can be reasonably assured of meeting its objectives and managing its many operational, financial, legal and regulatory risks.

This is a much broader definition of internal control than the traditional one of focusing on financial controls and legal compliance, as it incorporates the efficiency and effectiveness of all of an organisation's operations and the associated

risks and processes that impact on the achievement of its objectives

The role of internal audit is also broader, to become more of a facilitator to improve the organisation's efficiency and effectiveness in achieving its objectives, rather than focusing on financial and compliance objectives.

## Why do I need to be concerned about internal control?

Internal control applies to the public sector as much as the private sector. Public sector executive management are held accountable for the resources under their control and the results that are achieved.

Internal control is the responsibility of everyone in the organisation and is an integral part of all the management processes, techniques and tools used by an organisation to achieve its strategic objectives.

Having recognised the importance of internal control within the public sector, NSW Treasury has produced:

- ◆ the "blue book": Statement of Best Practice Internal Control and Internal Audit, June 1995 ("the BPS"); and
- ◆ the "white book": Internal Control Assessment, July 1995

to enable agencies to understand the broader view of internal control and assist them in the implementation of an effective system of internal control.

Treasury intends these to be living documents. Ongoing research overseas is continually indicating improvements to internal control best practices. The documents will therefore be revised and updated as new information becomes available.

# What is the Risk Management and Internal Control Assessment process?

The first enhancement of the BPS is the Risk Management and Internal Control Assessment process, as spelt out in these guidelines. The purpose of the process is to equip agencies to:

- ◆ assess their agency's current internal control practices against defined best practice;
- ◆ determine where they want to be in terms of their agency's internal control practices compared to best practice;
- ◆ develop a plan for improving their agency's internal control practices, focussing on known key success factors;
- ◆ implement their plan so as to achieve real improvement in their agency's internal control practices.

**The process utilises three key self-assessment tools:** namely

- ◆ the matrix (Volume 2);
- ◆ status report and response sheets (Volume 3); and
- ◆ the strategies for improvement (Volume 1).

## 1. The Self-Assessment Matrix

The matrix provides definitions of the actions and behaviour covered in each of the elements of control identified in the BPS, as well as some additional elements derived from the ongoing research (see next section for details). It has been developed with active input from practising managers in the public sector and is designed specifically to suit public sector situations.

The matrix is divided into 3 major segments, that are designed for use by:

- ◆ CEO's, senior management/executive teams, covering the "Tone at the top" of the organisation;
- ◆ line managers covering internal control framework, control environment, analysis of risks, establishment of controls, information and communication and monitoring;
- ◆ internal audit groups.

The matrix allows you to determine how effective your operations are from a control perspective by:

- ◆ comparing yourself against best practice;
- ◆ identifying areas for improvement.

## Status Report and Response Sheets

In addition to the matrix, you will find a set of planning tools which include response sheets (in both individual and aggregate form) for each section of the matrix and a blank Internal Control System Status Report ("wheel"). These tools allow you to:

- ◆ score your agency's performance against the best practice matrix definitions;
- ◆ record your desired position on the matrix status report ("wheel");
- ◆ compare your current with your desired position;
- ◆ identify your priority areas for improvement.

## 2. The Strategies for Improvement Tool

The Strategies for Improvement tool contains a series of generic strategies based upon best practice internal control, as well as the risks associated with a lack of appropriate control. The generic strategies are summarised into the following four main areas:

- ◆ internal control leadership;
- ◆ HR mechanisms used to reinforce internal control;
- ◆ accountability for internal control;
- ◆ business and control process supports.

The generic strategies may be adapted to allow you to develop strategies specific to your organisation, to assist you to move towards best practice.

## How can risk management and internal control assessment help me?

This process will assist you in evaluating the current effectiveness of your operations from a control perspective, allow you to compare yourself against best practice and/or the organisation's desired position, and enable you to develop specific strategies for improvement to attain these targets.

The rationale behind improving internal control practices is clearly spelt out in the BPS "blue book", which presents the business case for agencies.

Internal control, by definition, is a comprehensive, fully integrated approach to assessing, limiting, monitoring and controlling any risks that impact on an agency's capacity to perform against its corporate objectives.

In today's environment of increasing accountability and responsibility, non performance cannot be justified by the occurrence of risks that could have been reasonably predicted.

## Why self-assessment?

For it to work, internal control has to be owned by the organisation. For this reason, the guidelines have been designed purely for organisation use as a self-assessment process.

There will be no central control or reporting over the information; it is therefore in each organisation's own best interests as to how, and how honestly, they choose to use the matrix.

Responsibility for an organisation's self assessment process can be delegated to an internal project manager, or alternatively consultants can be used to provide additional objectivity.

Whether handled by an internal project manager, or external consultant, there are certain competencies required:

- ◆ in depth knowledge of the Committee of Sponsoring Organisations of Treadway Commission (COSO) framework, Treasury Guidelines, with internal audit being placed in context
- ◆ credibility and standing with the senior management group, to be able to challenge the status quo of present operations
- ◆ facilitation skills in resolution of divergent opinions, project management, and influencing participation
- ◆ general business orientation is preferable to internal audit in the project management role in order to ensure a breadth of thinking.

In terms of sharing information and learning from each other, plans are being explored to establish a network through which people could exchange experience and success stories across the sector. As an extension of this, there could be opportunities to aggregate data from a number of agencies and provide comparisons of one organisation to the composite.

## What are the elements covered in the Risk Management and Internal Control Assessment process?

The assessment process can examine the entire range of control elements, or address only a subset of these. The full set of elements and the individual components within those elements is listed below.

| Description  | Control component/element   |
|--|---|
| <p><b>Tone at the Top</b></p> <ul style="list-style-type: none"> <li>◆ General understanding of senior management's culture and approach to internal control</li> </ul>                                    | <ul style="list-style-type: none"> <li>◆ Attitude to internal control</li> <li>◆ Responsibility for internal control</li> <li>◆ Linkage with strategic objectives</li> <li>◆ Timely and relevant information</li> <li>◆ Integrity and ethics</li> <li>◆ Internal and external audit</li> <li>◆ Audit committees</li> <li>◆ Management monitoring</li> </ul> |
| <p><b>Internal Control Framework</b></p> <ul style="list-style-type: none"> <li>◆ Understanding of and responsibility for internal control within the organisation</li> </ul>                              | <ul style="list-style-type: none"> <li>◆ Definition of internal control</li> <li>◆ Responsibility</li> <li>◆ Management processes</li> <li>◆ Perception of internal audit</li> </ul>  |
| <p><b>Control Environment</b></p> <ul style="list-style-type: none"> <li>◆ Management and staff internal control practices that safeguard the achievement of organisation objectives.</li> </ul>           | <ul style="list-style-type: none"> <li>◆ Skills and experience</li> <li>◆ Management information</li> <li>◆ Integrity and ethics</li> <li>◆ Perception of internal control</li> <li>◆ Reporting of significant deficiencies</li> </ul>  |
| <p><b>Analyse Risks</b></p> <ul style="list-style-type: none"> <li>◆ Assessment and management of risks that could jeopardise the achievement of organisation objectives</li> </ul>                        | <ul style="list-style-type: none"> <li>◆ Functions and tasks</li> <li>◆ Assess risks</li> <li>◆ Manage risks</li> </ul>   |
| <p><b>Establish Controls</b></p> <ul style="list-style-type: none"> <li>◆ Incorporation of internal control principles and practices into all other organisation systems</li> </ul>                        | <ul style="list-style-type: none"> <li>◆ Control procedures</li> </ul>  |
| <p><b>Information and Communication</b></p> <ul style="list-style-type: none"> <li>◆ Adequacy of information and communication channels for transmitting and collecting business - related data</li> </ul> | <ul style="list-style-type: none"> <li>◆ Information</li> <li>◆ Communication</li> </ul>  |
| <p><b>Monitoring</b></p> <ul style="list-style-type: none"> <li>◆ Management's procedures for reviewing the effectiveness of the internal control system</li> </ul>  | <ul style="list-style-type: none"> <li>◆ Monitoring</li> </ul>  |
| <p><b>Internal Audit</b></p> <ul style="list-style-type: none"> <li>◆ The role and responsibilities of internal audit in enforcing compliance with internal control within the organisation</li> </ul>     | <ul style="list-style-type: none"> <li>◆ Roles, responsibilities and strategies</li> <li>◆ Competency and performance measurement</li> <li>◆ Co-ordination with other review functions</li> </ul>   |

## Using the self-assessment matrix

The **self-assessment matrix** can be used at various levels and areas within the organisation; for example, with:

- ◆ the CEO and senior executive group (covering Tone at the Top);
- ◆ line management / operational staff (covering the control framework and practices, including perceptions of internal audit and senior management's approach to internal control);
- ◆ internal audit staff (covering Internal Audit).

### *Project management*

If your self-assessment process is extensive, covering many groups and levels, you will need to identify a special project manager to co-ordinate the process and consolidate the information. To provide appropriate leadership and to ensure that an overall agency perspective is maintained, project management responsibility should be assigned to senior management. Either way they will be acting as the agent for the CEO, who must be seen to drive the overall assessment. They could be involved in selecting candidates for participation in the self-assessment, facilitating this process, establishing a steering committee to oversee the project, and co-ordinating and managing the project on a day – to – day basis.

### *Gathering the self-assessment data*

There are various techniques you can use to gather the self-assessment data, namely:

- ◆ **interviews**
  - involving collaboration between interviewer and interviewee to discuss each question and record the appropriate response
- ◆ **workshops**
  - with the added benefit of achieving consistent understanding across all assesseses, and allow different group techniques to be applied

### ◆ **surveys**

- covering the practice of internal control as experienced by staff;
- recording attitudes of different groups within the organisation to internal control.

For each technique, you can use the matrix as it stands or adapt and simplify it for your purposes. You may decide to cover all elements of the matrix, or only selected elements.

### *Recording your assessment*

There are two response tools:

- ◆ the individual response sheet; and
- ◆ the aggregate response sheet, which is then transferred onto the organisation's internal control system status report (the "wheel").

The individual response sheet allows for each person to assess the organisation on the relevant factors of the matrix, recording that assessment on the 1 (basic) to 4 (best practice) continuum.

The aggregate response sheet enables individual responses to be collated to provide an assessment for the organisation as a whole. This overall assessment can then be charted on the "wheel" (see page 15).

### *The key factors for a successful self-assessment are:*

- ◆ active CEO commitment and involvement in the process
- ◆ clearly assigned responsibility to CEO's agent to carry out the project
- ◆ adequate briefing/education of assesseees in the principles and content of internal control
- ◆ non-punitive approach to self-assessment outcomes within the organisation; this applies particularly to differing views that may be expressed by senior management and operational staff.

**Internal audit has a role to play** in terms of assessing its own role and functions; being independently assessed and receiving feedback from other assessors on its operations and contribution to the business; and possibly in co-ordinating the organisation's planning for future improvement.

Alternatively, if such resources are not available within the organisation, specialist consultants may be engaged to assist in the conduct and management of the project.

There is, of course, no hard and fast rule as to who in the organisation, and how many, should complete the matrix. The selection of candidates for self-assessment will vary on the circumstances of the individual organisation, depending on a number of factors, including the size of the organisation, number of business units, and the existing level of awareness of internal control in relation to best practice. Assessments can be carried out across the whole organisation or in business units; and at senior management, middle management and operational staff levels.

A step - by - step approach to using the self-assessment matrix and tools

The recommended approach for conducting the control self-assessment is shown in the diagram on page 16. Each phase of the approach is described below.

## ***Step 1 - Plan and prepare***

This step predominantly deals with deciding how, where and with whom you want to apply the self assessment process. Understanding the rationale for individual involvement and responsibility in the internal control self-assessment is a critical success factor in identifying actions that will add value and contribute to the organisation performance. The people responsible for internal control also need to set indicative goals for this process in the organisation - these will vary from organisation to organisation, depending on the nature of the environment and the risks faced plus the resources available.

In addition to defining and agreeing the objectives and scope of the work to be performed, it will be necessary to gather key statistics, background information and performance indicators.

## ***Step 2 - Conduct self-assessment***

This is where the bulk of the work is done. Interviews, workshops and surveys can be used to gather the data on organisation performance against the matrix. This is then aggregated to form an overall picture of your organisation.

Depending on the extent of differences in the self assessment, this process of aggregating responses may require a workshop to air differences and reach some form of consensus wherever possible.

Differences of opinion between different groups and levels are important and need to be noted, questioned, justified and resolved. These differences may be based on different experiences of the internal control process or on different interpretations of the wording. Discussion of differences is a healthy practice and one that raises consciousness of the importance and value of internal control. Documentation or other corroborating evidence, both in terms of policy and practice, will be important in resolving these differences.

Use the matrix, the response sheets and the wheel to record your self-assessments.

## ***Optional Step - Compare to other agencies/benchmarks***

In the event that a database is established, your organisation record could be added to the database and the comparative profiles mapped. In comparing organisations it is important to define the key organisational attributes: any comparison should be with like organisations.

Comparing your organisation with other like organisations or with broad benchmark data is a useful, though not a necessary, step in the process. This can take the form of a comparative diagram using the Internal Control System Status Report (or "wheel\*").

### ***Step 3 - Refine internal control goals***

The indicative goals set in Step 1 now need to be refined. Goals will vary for the different elements of internal control, depending on the existing levels of performance, risk profile and key processes applying in your organisation. For example, you may want to be at "Best Practice" for the Control Environment element, though you are prepared to accept a lower level in terms of the Information and Communication element.

Use the -wheel- for recording goals.

### ***Step 4 - Analyse performance gaps***

The gaps between performance and agreed organisation goals for internal control have to be established so that priorities can be set for action planning consistent with the organisation's overall strategic objectives.

Use the "wheel" to highlight gaps and indicate priorities.

### ***Step 5 - Develop action plans for change***

Using the Strategies for Improvement tool provided, you need to adapt these generic strategies to your organisation's purpose and situation, based on the action priorities identified in Step 4.

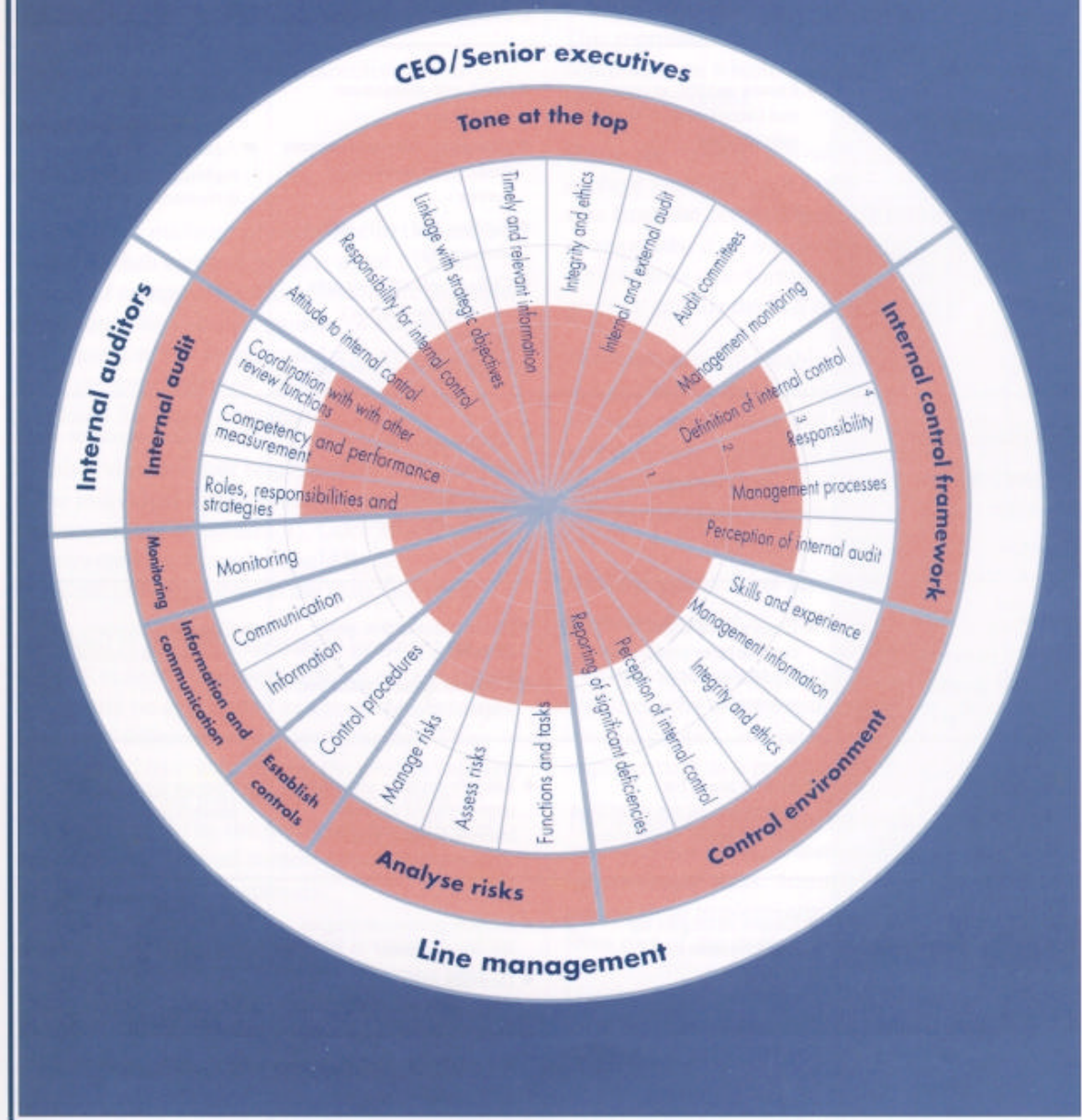
Action plans should be simple and focused on improving internal control performance in line with organisation strategic objectives. Reporting should cover:

- ◆ confirmed organisation internal control objectives
- ◆ priority action areas for improvement
- ◆ organisation- specific pragmatic actions and strategies
- ◆ an implementation plan including responsibilities and timetable.

This will show the key strengths and areas for improvement for internal control within your organisation.

*Scores are  
indicative only*

# Risk Management and Internal Control Self-Assessment Matrix



# Approach to Risk Management and Control Assessment

|  | Review points   | Key activities   | Key outputs  |
|--|---|--|--|
| <b>Step 1</b><br><i>Plan and prepare</i>                 | <ul style="list-style-type: none"> <li>◆ Ensure objectives, scope and approach for the self-assessment are agreed</li> </ul>      | <ul style="list-style-type: none"> <li>◆ Define objectives</li> <li>◆ Select candidates for self-assessment</li> <li>◆ Agree scope and approach (interview/ workshop/ survey)</li> <li>◆ Identify indicative internal control goals</li> <li>◆ Complete key statistics</li> </ul>                          | <ul style="list-style-type: none"> <li>◆ Documented and agreed objectives, scope and approach for self-assessment</li> <li>◆ Key statistics</li> <li>◆ Indicative goals</li> </ul>                           |
| <b>Step 2</b><br><i>Conduct self-assessment</i>          | <ul style="list-style-type: none"> <li>◆ Ensure quality, accuracy and completeness of self-assessments</li> </ul>                 | <ul style="list-style-type: none"> <li>◆ Brief self-assessment candidates</li> <li>◆ Complete self-assessments (interview/ workshop/ survey)</li> <li>◆ Review and verify self-assessments</li> <li>◆ Collate self-assessments and calculate agency profile</li> <li>◆ Prepare profile graphics</li> </ul> | <ul style="list-style-type: none"> <li>◆ Completed self-assessments</li> <li>◆ Agency profile highlighting group differences</li> </ul>  |
| <b>Optional Step</b><br><i>Compare to other agencies</i> |   | <ul style="list-style-type: none"> <li>◆ Input agency profile into database</li> <li>◆ Calculate comparative profile and generate graphic</li> </ul>   | <ul style="list-style-type: none"> <li>◆ Comparative profile</li> </ul>  |
| <b>Step 3</b><br><i>Refine internal control goals</i>    | <ul style="list-style-type: none"> <li>◆ Ensure profile and comparative profile are representative of self-assessments</li> </ul> | <ul style="list-style-type: none"> <li>◆ Review indicative goals from Step 1</li> <li>◆ Confirm agency goals for internal control</li> </ul>   | <ul style="list-style-type: none"> <li>◆ Confirmed agency goals for internal control</li> </ul>  |
| <b>Step 4</b><br><i>Analyse performance groups</i>       | <ul style="list-style-type: none"> <li>◆ Ensure areas for improvement are identified and strengths highlighted</li> </ul>         | <ul style="list-style-type: none"> <li>◆ Identify priority areas for improvement against internal control goals</li> </ul>   | <ul style="list-style-type: none"> <li>◆ Priority areas for internal control improvement</li> </ul>  |
| <b>Step 5</b><br><i>Develop action plans</i>             | <ul style="list-style-type: none"> <li>◆ Ensure strategies for improvement are determined</li> </ul>                              | <ul style="list-style-type: none"> <li>◆ Review generic strategies for improvement</li> <li>◆ Develop agency strategies for improvement</li> <li>◆ Identify barriers to implementation</li> <li>◆ Prepare action plans</li> </ul>  | <ul style="list-style-type: none"> <li>◆ Report covering: <ul style="list-style-type: none"> <li>- strategies for improvement</li> <li>- implementation issues</li> <li>- action plan</li> </ul> </li> </ul> |