

**HALIFAX**

# **Internal Controls**

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# Background

- The Audit Committee is responsible for ensuring “the adequacy and effectiveness of HRM’s systems of internal control in relation to financial controls and risk management as established by Administration”<sup>1</sup>

# Definition of Internal Control <sup>1</sup>

- Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance

<sup>1</sup> Internal Control – Integrated Framework, COSO (Committee of Sponsoring Organizations of the Treadway Commission)

# Definition of Internal Control

- This definition reflects certain fundamental concepts. Internal control is:
  - Geared to the **achievement of objectives** in one or more categories – operations, reporting and compliance
    - E.g. Audited financial statements, issued with a clean audit opinion, are presented to Council within 2 months of year end
  - A **process** consisting of ongoing tasks and activities – a means to an end, not an end in itself
  - **Effected by people** – not merely about policy and procedure manuals, systems, and forms, but about people and the actions they take at every level of an organization to affect internal control
  - Able to **provide reasonable assurance** – but not absolute assurance, to HRM's senior management and Council

# Examples of Control Activities

- Segregation of incompatible duties
  - Instances where a single individual is able to commit an irregularity and then conceal it
- Authorization of transactions in accordance with management's policies
  - Procurement maintains Spending Authority listing – list of individuals who can approve transactions
  - Journal entry authorization
- Periodic reconciliations
  - Balance sheet accounts are reconciled each month, reviewed quarterly
  - Vendor reconciliations
- Analytical review
  - Projections, variance analysis financial statements
- IT controls – access to programs and data

# Limitations of Internal Controls

- Internal controls provide **reasonable** assurance of achieving the entity's objectives
- Limitations do exist and may result from:
  - Simple errors
  - Reality that human judgment in decision making can be faulty
  - Ability of management to override internal control
  - Ability of individuals to circumvent controls through collusion
- In addition, “more” is not “better” in the case of internal controls
  - Cost of excessive or redundant controls may exceed benefits
  - Perception of excessiveness or redundancy may have a serious negative effect on how employees view controls in general, thus adversely affecting the overall control environment

# Responsibility for Internal Control

- Management is primarily responsible for the effectiveness of internal controls
- Management's performance is subject to oversight by HRM's Audit and Finance Committee. The Audit and Finance Committee is ultimately responsible for ensuring that management fulfills this duty.

# Evaluating Internal Controls

- In most organizations, public and private, there is normally an existing awareness of internal controls and their importance
- Formal documentation and evaluation exercise can be viewed as mechanism to provide more structure, rigour and evidence of management's framework of internal controls
  - Opportunity to improve the design of controls through more efficient practices
  - Opportunity to identify and eliminate redundant controls
  - Documentation can assist in training of new personnel

# Internal Control Developments in Private Sector

- In response to the financial failures of several large US companies, Sarbanes-Oxley Act (SOX) passed in 2002
- Similar requirements established in Canada for registrants on Canadian exchanges (NI 52-109)
  - Requires management to explicitly acknowledge responsibility for establishing, maintaining and assessing internal control effectiveness
  - Requires CFO / CEO personally certify that they have reviewed and tested their internal controls over financial reporting and assert that the internal controls are operating effectively
- Penalties may include fines, jail time, civil liability

# Internal Control Developments in Public Sector

- In public sector similar examples of internal control certification are beginning to surface
- Canadian Federal Government issued Policy on Internal Control effective April 1, 2009 (rolled into Policy on Financial Management April 1, 2017)
  - Deputy Head and CFO of each department are required to sign an annual Statement of Management Responsibility Including Control Over Financial Reporting
  - Summary of the required annual assessment of their system of ICFR as well as action plan must be appended to Statement of Management Responsibility

# Roadmap to Effective Internal Control Over Financial Reporting

