INTERNAL CONTROLS MATURITY AND SME CORPORATE GOVERNANCE

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Abstract

Good Corporate governance is a key factor in ensuring sound financial reporting and deterring misappropriations of capital and resources. Internal control and corporate governance go hand in hand. Many SME have an ambitious goal of reaching a reliable, continuous and integrated internal control state. However, many SME's are still grappling to build a comprehensive control process. In this paper, we present an internal maturity framework that SME can use to benchmark and know how they can discourage frauds, improve compliance and adoption of standards.

Introduction

Numerous corporate scandals have brought in more awareness and significant attention from regulators, whistle-blowers and the public on internal controls and corporate governance. While corporate governance sets the standards and recommends procedures; internal controls make sure those procedures are being followed. The Financial reporting review board (FRRB) of the Institute of the Chartered Accounts of India (ICAI, 2018) cites lack of significant disclosures in accounting policies covering revenue recognition, borrowing costs, inventories, impairment of assets, goodwill subsidies granted by the government. Many companies were found to be inadequate in reporting gain on outstanding derivative contracts being recognised in the profit and loss which is against the principle of prudence as given under accounting standard 1. The Institute of Cost and Works Accountants of India (ICWAI, 2009) has released a guidance note to help organizations accomplish systematic and objective approach to operations, evaluation and monitoring of risk management, reporting and control practices. Misappropriation of Assets, corruption, and financial statement are common woes SME face due to weak internal controls. Companies with a focus on effective governance have an ambitious goal of reaching a credible, continuous risk assessment and integrated audit process. For many senior management and internal control teams the goal is to attain a repeatable, reliable and data-driven process (Omalayeand Jacob, 2018). Many companies are still grappling to build a comprehensive audit process and many of their existing activities are in "rudimentary" stage (Sohand Martinov-Bennie, 2011). We believe, the use of a maturity model can provide a clear direction to achieve a reliable and evolved assessment and assurance process. In this paper, we present an internal maturity framework that SME can use to benchmark and know how they can discourage frauds, improve compliance and adoption of standards.

Internal controls maturity Model

Broadly speaking there are three types of controls namely *preventive, detective and corrective* (IIA, 2015). Preventive controls are mostly process and role based that adopt a checker and approve approach. Separation of making purchases and approving payments; receiving bills and approving payments; and authorizing returns and issuing refunds are some good examples of preventive controls. Detective controls are internal controls designed to identify problems that already exist. Audits including statutory audits can be seen as form of a detective control. Timely reconciliation and verification of bank accounts, review and verification of refunds/payments, reconciliation of petty cash accounts, audits of payroll disbursements, conducting physical inventory checks etc are some examples of detective controls. Corrective controls are internal controls that are taken to mend any impairment or bring back resources and capabilities to their earlier state that was due to an unapproved activity.

Maturity of internal controls depends on formal mechanisms used for preventive, detective and corrective actions, but also the responsiveness of the management to the outcomes of assessment and quality of follow up actions. Based on COSO's ERM framework (COSO, 2017), we identify nine fundamental parameters of internal controls. Methodology is what is core to auditing. It reflects the approach to assessment, quality assurance and improvement program based on accounting standards. Data capture refers to the quality and depth of data collected for auditing and improvement. Documentation refers to information storage and retrieval for audit trial and follow ups. Planning refers to defining the operational, financial and strategic aspects of audit process and outcomes including scope, time and quality of resources. People refers to the extent to which the audit staff are trained as appropriate, are aware of their responsibilities related to assurance and endowed with enough expertise and experience to conduct the required activities. System refers to extent of standardized information flows and reliability of captured document for assessment process. Risk refers to the depth of risk assessments (operational and strategic) and mitigation plans. Review covers the depth of financial and non-financial areas the quality assurance and assessment will address. Ownership and responsibility indicate whether audit is silo function with little control and ownership across the company or a process led activity owned by process leaders and owners. Table 1 presents the elements that make up key areas of internal audit and their maturity and phases at each level.

Table 1 Internal controls Maturity stages

	Level 1	Level 2	Level 3	Level 4	Level 5
Methodology	Limited to mandatory guidance, informal audit engagement plan, largely top-down, focus on meeting management and regulatory requirements, annual audit plan with basic reports	Mandated and recommended guidance, limited annual audit plan focusing on reports, and monitoring of recommendation.	Focus on mandated, recommended and supplementary guidance, plan with periodic reporting, risk reporting and monitoring of recommendation.	All factors in level three along with implementation guidance, reports, risk assessment, and detailed review of recommendations	All factors in level four along with code of ethics, standards, extensive audit engagement plans, top-down and bottom-down integration, extensive reporting, risk assessment and continuous monitoring of recommendations
Data Capture	Descriptive data, longitudinal data not captured for analysis; lack of indications	Descriptive data along with some analytical data for trend analysis, extensive lag of indicators	All of level two along with somewhat predictive data and some lead indicators	All of level three along with some prescriptive data and reasonable lead indicators	Extensive prescriptive data and predictive analysis along with extensive lead indicators

Documentation	Ad hoc, not clearly documented	Manual documents, not monitored regularly	Well documented but not monitored	Good documentation and monitoring of reports	Extensively documented along with detailed monitoring procedure
Planning	No planning involved.	Plans are based on standard operating procedures for an audit and are executed by mid-senior level members with financial knowledge.	Plans are made recognising cost and revenue drivers, supported with data captured through tools.	Increase in depth and extent of planning where along with revenue drivers, industry benchmarks and possible leakages are sought out before delving into the audit. Plans are over seen by the top management before being	Plans supports corporate Strategies terms of customer growth, profits and business fulfilment. Overseen, revised and monitored by top management.
People	Limited to Audit staff with traditional auditing skills and no industry knowledge	Audit staff with limited business knowledge and resources	Reasonable mix of traditional auditing and business expertise	Experienced auditors with reasonable experience of business and industry expertise	Great mix of traditional auditing skills, and industry expertise complemented by overall business knowledge, and critical thinking
System	Only Manual systems	Use of basic technology and system to capture record and store data.	Reasonable systems to data capture and sharing, with some real time auditing	Real time systems for data capture and auditing	Leading technology (data mining, analytics, etc) and real-time auditing accessible from anywhere
Risk management	Limited risk assessment, no formal identification, mitigation plans	Focused risk assessment, one at a time approach, limited plans	Broader risk assessment (both micro and macro levels), formal identification and mitigation methods	Comprehensive, holistic risk assessment (both micro and macro levels)	Extensive, and Comprehensive, holistic risk assessment (both micro and macro levels), extensive risk management
Review	Focus is mainly on financial transactions and ad hoc review process	Focus is mainly on financial and compliance transactions, it is reasonably formal, with limited follow up reporting	Focus is mainly on financial, compliance and operational transactions with formal and periodic follow up reporting	Focus is mainly on financial, compliance, operational transactions and IT systems with formal and periodic follow up reporting	Extensive review of financial, compliance, operational transactions and IT systems, trailed by a formal and continuous follow up reporting
Ownership and responsibility	Limited to a department, few resources, mostly post-hoc analysis, prone to execution risks	Broadly defined responsibilities at business level, and ownership at Business leader level	All of level two along with minor proactive responses at field level	Well defined Ownership and responsibility at levels of process owners, process leader, management and board	Integration at all levels right from process owner, leader, management and board, along with detailed risk controls

At level 1, the firm's reviews of activities are informal and disordered. Therefore, success of the reviews and audits depends on the expertise and ability of the people conducting the reviews & audits. It is highly likely that the audit and checks are done by the same person manually, with a lack of planning and is highly prone to errors and manipulation. At level 2 is where basic standards of procedures are adhered to, data is captured and used for trend analysis; plans and basic risk assessments have been recognized; At this level, reviews and the audit undertakings are much more controlled than at level, mainly focusing on financial and compliance transactions with limited follow up reporting. At level 3 of maturity, audit activities are automated and completely standardized, plans are made recognising financial, operational and business risks. At level 4 the focus of audits shifts to proactive risk identification to ensure quality and maturity. Data captured consist of good lead indicators and are analysed. This is followed by measuring performance and along with efficient documentation and consistent monitoring. Level 5 is an optimised state with evolved code of ethics, standards, extensive audit engagement plans, extensive reporting, risk assessment and continuous monitoring of recommendations.

Conclusion

The maturity model detailed here guide companies from traditional siloed process towards more mature continuous data-driven reliable organizational wide process. The first step in transformation of internal controls involves conducting a comprehensive "as-is" audit. This helps to identify the current processes, gaps and areas to improve quality assurance and improvements. Please note, not every SME requires the same level of maturity in their internal controls. SME must choose the "to-be" maturity stage based on the needs and goals of the company, nature of its business, regulatory requirements and regimen of audit teams. In the second stage, define standardized process, create and configure appropriate process changes based on the proposed internal controls framework. People capability gaps need to be addressed through extensive training and on the job learning. Focus on process flows and technology adoption. In the 3rd stage, deploy company-wide process and system changes with common objectives across different units and measures. The end goal would be to continuously assess and refine at all levels. The proposed internal control maturity matrix serves as comparison tools to help SME identify the desired maturity level that is right for it. Moreover, the maturity matrix serves as a mechanism to measure progress along the way as this is a continuous journey. MA

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