Briefing Papers

Briefing Papers are intended by the Auditing Practices Board (APB) to be a means of raising issues relating to the provision of audit and related services. They both communicate its current views concerning such issues and also encourage debate amongst users, auditors and preparers of financial and other reports.

Briefing Papers do not set out mandatory requirements. Mandatory requirements are set out in Statements of Auditing Standards (SASs) and Statements of Investment Circular Reporting Standards (SIRs).

As *Briefing Papers* are intended to deal with issues that require continuing debate and development, readers may wish to communicate their views on these issues to the APB. Such comments will assist the APB in keeping the subject matters of all such papers under review, and are welcome at any time. If the APB concludes that mandatory requirements or guidance should be issued at a future date, it will do so following its normal due process.

Briefing Paper - Providing Assurance on the Effectiveness of Internal Control

Contents

Section

1. **Introduction**

2. **Concepts underlying the provision of assurance on internal control**

Background

The interrelationship between business objectives, risk identification, control design and control operation

The elements of providing assurance on internal control

Inherent limitations of internal control

3. **Illustration of a narrative report providing assurance on the effectiveness of internal control**

Appendix I *Conclusions of the APB's 1998 consultation*

Appendix II *Internal control requirements of the Combined Code, the Listing Rules and associated APB guidance*

1 Introduction

During the 1990's there was much debate surrounding the desirability of public statements by directors of listed companies concerning the effectiveness of internal control, and the extent to which auditors should express assurance on such statements. Publication of the report of the Turnbull Committee '*Internal Control: Guidance for Directors on the Combined Code*' (Turnbull report) and associated APB Bulletins [1] has brought that debate to a conclusion.

The Turnbull report provides guidance for directors on the implementation of the internal control provisions of the Combined Code [2]. Its guidance is intended to reflect sound business practice whereby internal controls are embedded in the business processes by which an entity pursues its objectives.

Under the Listing Rules and the associated APB Bulletins the auditors review whether the company's published summary of the process it has adopted in reviewing the effectiveness of its system of internal control is both supported by the documentation prepared by, or for, the directors and appropriately reflects that process. The auditors are not required to provide assurance on internal control.

The procedures to support the review required by the Listing Rules are considerably narrower in scope than those that would be required for an engagement to provide assurance on internal control. This paper does not deal with the narrow requirements of auditors under the Listing Rules but with the much broader concepts of providing assurance on the effectiveness of internal control.

Interest in the effectiveness of internal control has not been restricted to the capital markets. Regulators in the financial services sector have shown considerable interest in the internal control of the entities they regulate. In the public sector there are specific requirements for auditors to consider aspects of the internal control of many bodies.

The APB has issued two discussion papers on the subject of providing assurance on internal control [3] . These papers explained the issues associated with providing assurance on internal control, especially in reports that are made public, and explored different approaches. Responses to these discussion papers indicate that there is still some way to go before a consensus is reached on how engagements to provide assurance on internal control should be performed and how conclusions should be reported.

If a demand for either external or internal auditors to provide assurance on internal control develops, then the conceptual and practical difficulties that have been identified will need to be overcome.

The APB hopes this Briefing Paper will contribute to developing a model of how practitioners might be able to express assurance on the reliability of systems of internal control. This paper will also assist directors, regulators and others, better appreciate the challenges associated with reporting on the effectiveness of internal control and, in particular, the advantages of providing assurance through a narrative, rather than a standardised, report.

Following the concepts described in this Briefing Paper will, almost invariably, give rise to a lengthy narrative report. A lengthy narrative report is necessary in order to communicate the various judgments made by the practitioners, the reasoning underpinning those judgments, and the context in which the opinion is given. Owing to the lack of generally accepted suitable criteria available to practitioners in carrying out such engagements, and the difficulties of communicating conclusions relating to internal control, a standardised short-form report is likely to lead to misunderstandings and unfulfilled expectations.

The illustrative narrative report set out in Section 3 of the paper is nine pages long and relates to only the revenue of the subject entity. Furthermore, it does not include a full description of the design of the system of internal control for revenue. It is not difficult to imagine, therefore, that a narrative report dealing with all aspects of an entity's system of internal control, and including a full description of the system, could be a substantial document.

It is likely to be impractical to circulate widely reports of such length and, therefore, it seems most likely that reports providing assurance on the effectiveness of internal control will usually be provided by practitioners to those who have instructed them, and not be published.

Footnotes

1. Guidance for auditors in meeting the requirements of the Listing Rules are dealt with in APB Bulletins 1999/5 (United Kingdom) and 2000/1 (Republic of Ireland). See Appendix 2 of this paper.

2. See Appendix 2 of this paper

3. *'Internal financial control effectiveness'* in April 1995, and *'Providing assurance on internal control'* in March 1998.

2 Concepts underlying the provision of assurance on internal control

Background

1. In 1998 the APB published a consultation paper entitled '*Providing Assurance on Internal Control*'. It set out preliminary proposals for a Framework of Principles applicable to engagements intended to provide assurance on internal control.

2. The proposed Framework of Principles drew heavily on the exposure draft 'Reporting on the credibility of information' which had been published by the International Auditing Practices Committee (IAPC) in August 1997.

3. Thirty eight detailed and helpful responses to the consultation paper were received. A summary of the conclusions that the APB has drawn from the comment letters is set out as Appendix I to this paper.

4. The adoption of a common reporting framework will be in the public interest if it results in more consistent practice, and avoids the development of expectation gaps between practitioners and the users of their reports. If the demand for either external or internal auditors to provide assurance reports on internal control increases, the accountancy profession will need to overcome the conceptual and practical difficulties that currently exist.

Publication of Turnbull Report

5. In September 1999 the Institute of Chartered Accountants in England & Wales, with the support of the UK Listing Authority, published *'Internal Control: Guidance for Directors on the Combined Code'* (the Turnbull report). The Turnbull report places a much greater emphasis on objective setting, risk identification and risk assessment than earlier guidance for directors. It requires, for example, the board's deliberations to 'include consideration of the following factors:

- the nature and extent of the risks facing the company;
- the extent and categories of risk which it regards as acceptable for the company to bear;
- the likelihood of the risks concerned materialising;

- the company's ability to reduce the incidence and impact on the business risks that do materialise; and

- the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks'.

6. Although the Turnbull report is directed at the boards of listed companies it has been adopted in many other sectors. As can be seen from Appendix I a number of commentators considered that the APB's 1998 proposals should have placed a greater emphasis on risk identification and assessment.

Finalisation of IAPC Assurance Framework

7. In July 2000 the IAPC published an International Standard on Assurance Engagements (ISAE) that describes the objectives and elements of assurance engagements intended to provide either a high or moderate level of assurance. The ISAE has evolved from the IAPC's proposal *'Reporting on the credibility of information'* which is referred to above.

8. One of the more significant differences between the original proposal of the

IAPC and the ISAE is that the ISAE does not require a standardised format for reporting on assurance engagements but rather identifies the minimum information required to be included in the report. The ISAE envisages that, for certain assurance engagements, practitioners may choose to adopt a flexible approach using a narrative, long-form, style of reporting, rather than a standardised short-form format.

9. This more flexible approach to reporting accommodates the views of many commentators on our 1998 proposals, that reports intended to provide assurance on internal control should be narrative rather than standardised.

10. The ISAE explains the importance in assurance engagements of 'criteria' that establish and inform the intended user of the basis against which the subject matter has been evaluated or measured in forming the conclusion. An evaluation of internal controls is however very judgmental - generally accepted criteria do not exist. In this briefing paper the APB seeks to explore how to compensate, through narrative reporting, for the absence of generally accepted criteria.

Further development of APB's thinking

11. In considering the comments received on the 1998 paper and in light of the developments since 1998, described above, the APB has developed its thinking regarding the interrelationship between business objectives, risk identification and assessment, internal control design, and the operation of internal controls.

12. This has reconfirmed the importance of clearly distinguishing between:

a. providing assurance on internal control design; and

b. providing assurance on the operation of a system of internal controls in accordance with its design.

The scope of each of these engagements would be quite different.

13. As established suitable criteria are typically not available to practitioners the

APB has further concluded that practitioners need to explain their conclusions in the context of:

a. the significant 'applicable risks' identified by the client;

b. how these risks were identified by the client;

c. the aspects of the system design that are intended to mitigate these risks; and

d. a description of the system of internal control [4].

Consequently reports intended to provide assurance on internal control will typically be narrative rather than standardised..

14. All systems of internal control have inherent limitations. It is important that any assurance report should draw attention to those limitations and the consequence that performance of the engagement may not detect that unintended events or results could have occurred.

15. These further developments in APB's thinking are explained more fully in the text that follows and are illustrated by the illustration of an assurance report on the effectiveness of a system of internal control set out in Section 3.

16. The narrative report in Section 3 is included for the sole purpose of illustrating the application of the concepts described in this section of the paper. The illustration is not intended to be used as an authoritative model of how such reports ought to be presented.

The interrelationship between business objectives, risk identification, control design and control operation

17. Internal controls exist to mitigate the risks that threaten the achievement of an entity's business objectives. In order to have effective internal control, the entity needs, once its business objectives have been established, to:

a. have identified and assessed the risks that threaten achievement of those objectives;

b. have designed internal controls that will manage those risks; and

c. operate the internal controls in accordance with their design specification.

18. The framework depicted on page 10 shows the interrelationship between these activities together with illustrative considerations that apply to the judgments involved in reaching an overall conclusion about the effectiveness of internal control.

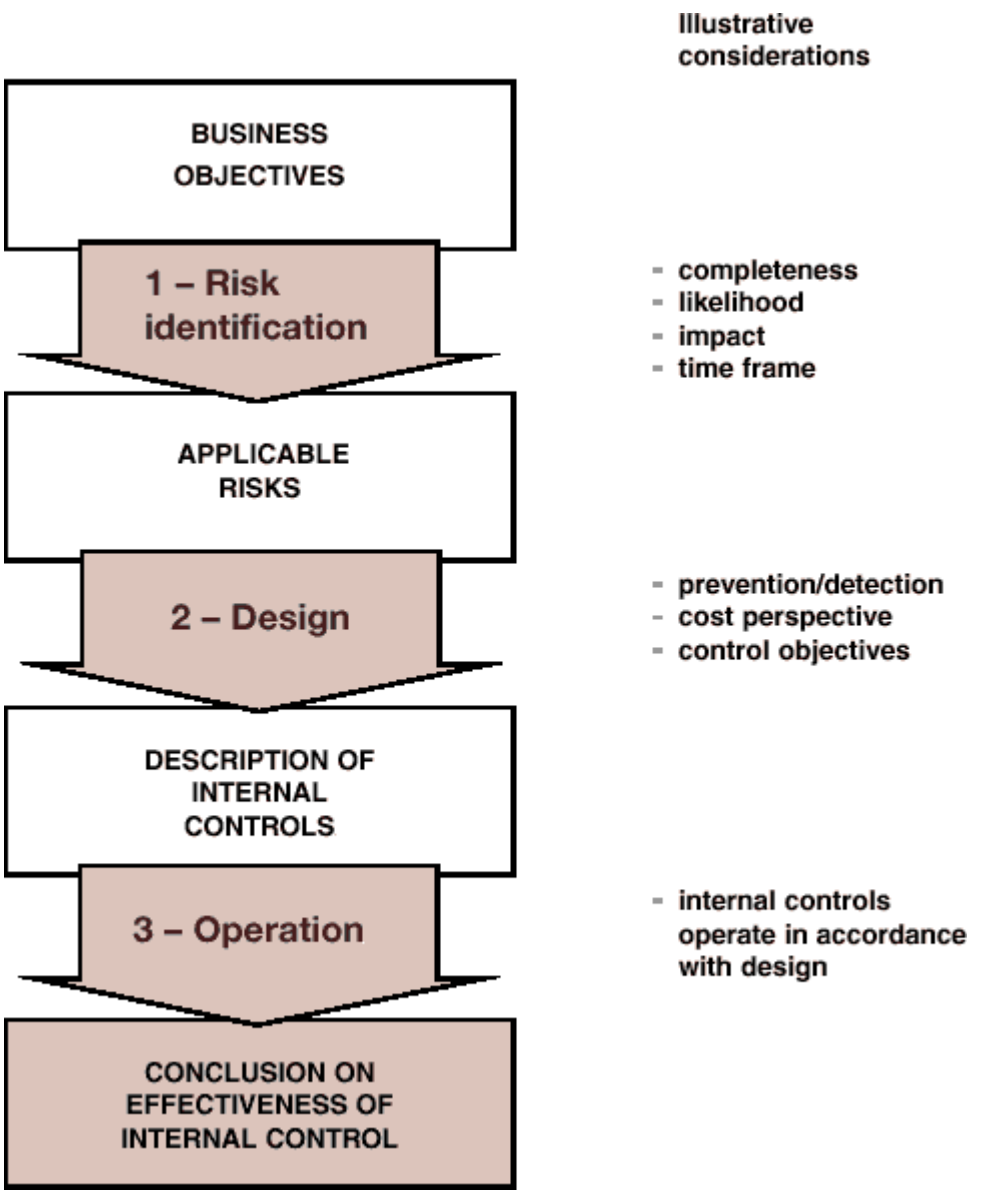
19. The framework depicts three of the processes that management will typically undertake when reviewing the effectiveness of internal control.

20. The first process is risk identification and assessment which is based on understanding the entity's business objectives. The output of the process is an understanding of the 'applicable risks' that need to be addressed in the design of the system of internal control.

21. The second process is designing the system of internal control, based on a knowledge of the applicable risks. The output of this process would be a record of the system of internal control, typically in the form of a systems manual.

22. The third process is evaluating whether the system actually operates in accordance with the system description. The output of all of the processes taken together would be a conclusion on internal control effectiveness.

Framework for forming an opinion on the effectiveness of internal control



23. For each process there are a number of important and quite different considerations that management will take into account. On the diagram illustrative examples of these considerations are listed against each process.

24. Although the diagram is intended to illustrate management's processes it will be these processes that practitioners will need to assess when engaged to provide assurance on the effectiveness of internal control.

25. The diagram, therefore, serves to illustrate:

a. the separate elements of an engagement to provide assurance on internal control;

b. that practitioners could be engaged to provide assurance on individual processes or on a combination of the three processes;

c. the range of 'considerations' that apply to each process; and consequently

d. the inherent complexity of an engagement to provide assurance about the effectiveness of internal control.

Business objectives

26. All entities have business objectives; they are the goals that an entity sets for itself. At an overall level business objectives may be general statements, (such as a mission or vision statement) but will usually be specified in more detail as they are incorporated into business plans.

27. Clear business objectives need to be identified before an effective system of control can be established. Without clear objectives, management will be unable to identify and evaluate the risks that threaten the achievement of their objectives and design and operate a system of internal control to manage those risks.

28. Many internal control frameworks such as COCO [5], COSO [6] and that of the Basel Committee on Banking Supervision divide business objectives into three categories. The Turnbull report uses the same three categories to describe what an internal control system encompasses:

a. **Effectiveness and efficiency of operations** includes objectives related to an entity's goals, such as customer service, the safeguarding and efficient use of resources, profitability and meeting social obligations.

b. **Reliability of internal and external reporting** (sometimes referred to as internal financial control).

c. **Compliance with applicable laws and regulations and internal policies with respect to the conduct of the business.**

29. Objective setting is the responsibility of the directors and senior management. Although practitioners engaged to provide assurance on internal control need to be aware of the entity's objectives, it is not appropriate for them, as part of an assurance engagement on the effectiveness of internal control, to be involved in the entity's objective setting processes.

Applicable risks

30. A risk is a threat that circumstances, events or actions will adversely affect an entity's ability to achieve its business objectives. Risks, therefore, affect an entity's ability to survive, successfully compete within its industry and maintain the overall quality of its products, services and people. An

entity's objectives, its internal organisation and the environment in which it operates are continually changing. An effective system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of the risks to which the entity is exposed.

31. Risk identification involves identifying the risks that may potentially threaten achievement of an entity's business objectives. Completeness is the key consideration; all significant risks need to be considered.

32. Once identified, risks can then be assessed in terms of their likelihood (probability), imminence (timing) and potential impact (materiality). Risk assessment is the process of prioritising the 'potential risks' into those 'applicable risks' that need to be actively managed.

33. There is no single process through which management identifies and assesses risks. Although a number of useful mechanisms have been developed none of them eliminates the need for a great deal of judgment, not least in assessing the likelihood and potential impact of risks.

34. The following discussion is provided purely as an example of one possible mechanism:

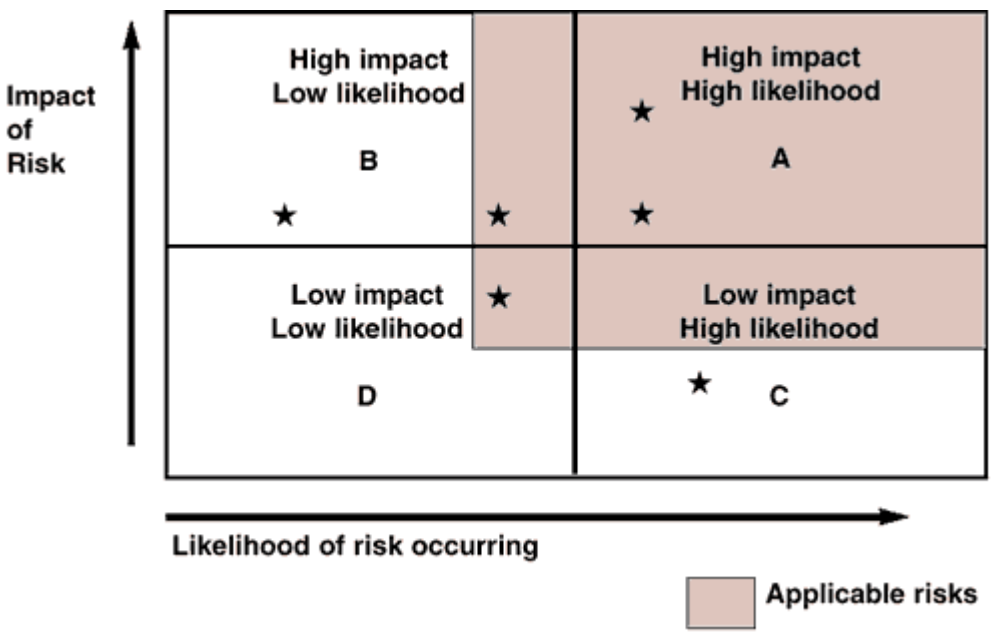
Illustration of a process of risk identification and assessment

A typical risk identification and assessment exercise, when carried out for the first time, is likely to consist of brainstorming sessions involving directors, management and employees [7]. Such sessions may be facilitated by those with an expertise in risk management.

To maximise the effectiveness of brainstorming sessions the entity should have defined its business objectives in detail in advance. However, such brainstorming is likely to generate more detailed business objectives as well as a more comprehensive understanding of potential risks.

The perceptions of individual directors and managers as to what constitutes a risk, its likelihood and potential impact may differ. Consequently, the more directors and managers that are involved the more useful the exercise is likely to be.

Potential risks are then evaluated through a 'risk screening' process that involves locating each identified risk on a map such as that depicted overleaf [8]:



Management will designate an area on the map within which risks are deemed to be 'applicable risks'. This is depicted by the shaded area in the diagram above. The identification of the risks and the

determination of the shaded area is likely to be an iterative process during which particular attention will be paid to those risks that initially fall either just outside or just inside the area of the risk map designated to contain the applicable risks.

Risks falling outside the shaded area are not disregarded by management and internal controls may be developed to control these risks. The significance of the risks within the shaded area is that these are the risks that management has determined need to be addressed in order for them to be satisfied that internal control is effective.

Internal control design.

35. Active management of 'applicable risks' may involve:

a. acceptance of the risk (with appropriate monitoring);

b. transfer of the risk (eg through insurance);

c. terminating the risk generating activity; or

d. mitigating the risk through internal control.

36. With respect to 35 (d), the Turnbull report states that a system of internal control should:

- 'be embedded in the operations of the company and form part of its culture;
- be capable of responding quickly to evolving risks to the business arising from factors within the company and to changes in the business environment; and
- include procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified together with details of corrective action being undertaken'.

37. In designing internal controls to manage 'applicable risks', management consider:

a. **The desired balance between prevention and detection controls**. Prevention controls are controls designed to avoid an unintended event or result from occurring (for example a control built into a computer system to raise purchase orders once stock levels become so low that there is a risk to an entity's production activities). Detection controls, by contrast, are designed to discover an unintended event or result that has occurred (for example analysing the effluent from a chemical plant to measure whether the pollution controls within the plant have been effective). While most systems will involve both prevention and detection controls the nature and extent of each will be influenced by factors such as:

   - the degree of risk;
   - the quality of staff, especially those that undertake prevention controls; and
   - the reliability of information processing systems.

b. **The cost perspective of the entity**. The extent and nature of internal control will be influenced by cost considerations. These considerations may not always lead to the lowest cost solution being implemented. For example, an oil and gas refiner may be required to control the amount of sulphur emitted into the atmosphere from its refinery. Operational

management may initially recommend that state of the art monitoring equipment (that is integrated into the production processes of the refinery) should not be installed on the basis that the cost per barrel is too high in the context of the then prevailing world oil price. The directors may, however, overrule a recommendation based on short term considerations in circumstances where they have made the minimisation of sulphur emissions as one of their primary business objectives regardless of short term fluctuations in world oil prices.

c. **Specific control objectives**. 'Applicable risks' may need further analysis to focus the design of discrete actions. For example the risk that cash is not collected from credit sales may need to be split into control objectives involving:

- ensuring a customer's credit rating is checked before shipments are made;
- preparing monthly ageing analysis of receivables; and
- sending follow up notices to overdue debtors.

Internal control operation

38. An entity's objectives, policies and procedures with respect to internal control are usually embedded into the operations of the entity by being documented in its systems manuals or software. Such manuals provide criteria for management, and practitioners, to measure whether internal control has operated in accordance with its design.

39. However, even with a well-documented system design, judgment will be required in determining whether controls have operated as designed. A key consideration is likely to be the extent to which deficiencies in the operation of controls are tolerated before the achievement of objectives is considered to be threatened.

The elements of providing assurance on internal control

40. The framework depicted on page 10 illustrates that providing assurance on the effectiveness of internal control consists (at least conceptually) of up to three areas of judgment. These being consideration of:

a. risk identification and assessment;

b. the design of the internal controls; and

c. whether the internal controls operated in accordance with the design.

41. Practitioners will need to have a knowledge of the business of the entity that is sufficient to enable them to identify and understand the events, transactions and practices that may, or ought to, have a significant effect on the entity's system of internal control. The extent of knowledge required will depend on the scope of each individual engagement.

42. Depending on the needs of the engaging party, the starting point (other than the requisite knowledge of the business) of a particular internal control assurance engagement may be:

a. the description of the system of internal control (in which case consideration of management's risk identification process and internal control design is not within the scope of the engagement);

b. the 'applicable risks' (in which case management's risk identification process is not within the scope of the engagement); or

c. the entity's business objectives.

Providing assurance that a system operated in accordance with the description of internal control

43. In undertaking an engagement to provide assurance on the operation of internal control practitioners will wish to clarify, when agreeing the terms of engagement, whether the assurance relates to a point of time or to a period. The date (or period covered) will be set out in the narrative assurance report.

44. Provided that the entity's description of its system of internal control is sufficiently detailed practitioners are likely to be able to gather sufficient appropriate evidence to express a high level of assurance that internal controls have operated as designed.

45. If the engagement involves providing assurance on the operation of a known system of internal controls practitioners may be able to issue a relatively concise report. This is because it will be unnecessary to include in the report a detailed description of the design of the system of internal control. The report is, nevertheless, likely to be narrative in nature as there may be a number of issues that practitioners wish to describe including, for example:

- isolated control failures;
- observations concerning the abilities of staff involved, and
- potential weaknesses identified by the practitioners not contemplated within the systems description

46. Responses to the APB's 1998 consultation paper suggest that an engagement to provide assurance that a system operated in accordance with the description of internal controls may be of limited value. Many believe that practitioners should address the more judgmental areas of systems design and risk identification and assessment.

Providing assurance on the effectiveness of the design and operation of the system of internal control.

47. In such an engagement the practitioners seek to provide assurance concerning both the design of the system of controls to address a defined set of 'applicable risks' and the operation of those controls. (Assurance concerning the operation of controls is dealt with in paragraphs 43-46 above). The practitioner does not consider whether the applicable risks are complete.

48. In undertaking such an engagement the practitioner will need to obtain and evaluate management's views on various important considerations concerning the design of the internal controls including, for example:

- the desired balance between prevention and detection controls;
- the balance between cost and benefits; and
- the importance of specific control objectives.

49. As the practitioners' judgment regarding the effectiveness of the systems design will be based on their evaluation of the considerations identified by management they will need to describe management's considerations in their narrative report in order to provide an adequate context for their conclusions.

50. The narrative report will also set out:

- the applicable risks;
- any framework for design or benchmarking exercise used by either the directors or the practitioners; and
- a description of the design of the system of internal control.

51. Such narrative reports will be much longer than the auditors' report on annual financial statements. It will, however, be appreciated that the context for the auditors' report on financial statements is provided by the financial statements themselves which include the balance sheet, profit and loss account, the accounting policies and a reference to the accounting framework. Without these 'criteria' the auditors' report would have little meaning. In a narrative report on internal control the applicable risks and the systems description can be likened to the primary financial statements and the key considerations to the accounting policies.

52. If sufficient contextual information is provided in the report regarding the systems design and the key considerations, then practitioners may determine that they are able to express a high level of assurance that the design of the internal controls is effective to mitigate specified applicable risks. However, as the design of any system of internal control is highly judgmental practitioners may take the view that they are unable to express a high level of assurance on the effectiveness of the design of the system.

53. The level of assurance provided by practitioners will be a function of many factors, including:

- the nature of the entity
- the extent of the practitioners' knowledge; and
- the scope of the engagement.

Providing assurance on the applicable risks, effectiveness of the design and operation of the system of internal control.

54. In such an engagement the practitioners seek to provide assurance concerning the identification and evaluation of 'applicable risks' as well as the design of the system of controls and the operation of those controls. In other words all three processes depicted in the framework on page 10.

55. The APB is not aware of the existence of any universally accepted criteria suitable for evaluating the effectiveness of an entity's risk identification and assessment activities. A great deal of judgment

is needed, not least in assessing likelihood and potential impact. In most circumstances it is likely to be impossible for practitioners to determine, with any degree of certainty, that all potentially significant risks that threaten the achievement of business objectives have, in fact, been identified and have been properly evaluated.

56. As the risk identification and assessment process is highly judgmental, practitioners are unlikely to be able to obtain sufficient evidence to be able to express a high level of assurance regarding the completeness of an entity's 'applicable risks' or the effectiveness of the process that was used to determine them. However, practitioners may be able to obtain sufficient evidence to provide moderate assurance and conclude that nothing has come to their attention indicating that there are any other risks, apart from the identified applicable risks, that should have been assessed as both likely to arise and having high impact.

57. When determining what constitutes sufficient appropriate evidence of the effectiveness of the entity's risk identification and assessment processes, practitioners will need to consider whether they need to observe some or all of the meetings at which management and directors carry out the risk identification and assessment processes. Attending such meetings is likely to provide the most persuasive evidence regarding the risk identification and assessment processes.

58. In an engagement that involves providing assurance on the applicable risks, the practitioners' starting point is the entity's business objectives. The key considerations relating to the risk identification and assessment process include:

- the completeness of the applicable identified risks;
- the probability of an applicable risk actually crystallising;
- the materiality of the likely impact of the risk; and
- the time period over which the risk is expected to materialise.

59. There are no established criteria for risk identification. As the risks facing each entity are unique to it, the process is inherently judgmental. Consequently, the practitioners need to set out in their report:

- the business objectives;
- a description of the risk identification and assessment process, including the key considerations; and
- the applicable risks.

Narrative reports

60. It can be seen, therefore, that the more extensive the scope of a controls assurance engagement, the more information needs to be included in the practitioners' report. Only if this information is provided to the user, can the user understand the judgments that support the practitioners' conclusions.

61. A formalised short-form opinion to the effect that internal control is 'effective' or 'adequate' would be insufficient as it would not enable users to understand the context in which the opinion is

given or the judgments that have had to be made in reaching the conclusion, and the reasoning underpinning those judgments. Consequently, short-form reports expressing assurance regarding internal controls are likely to lead to misunderstandings and unfulfilled expectations.

62. Section 3 of this paper provides an illustration of a narrative assurance report. It is based on an imaginary engagement to provide assurance on the effectiveness of the system of internal control relating to the recording of advertising revenue by a newspaper publishing company. The example is included for the sole purpose of illustrating the concepts described above. It is not intended to be used as an authoritative model of how such reports ought to be presented.

Inherent limitations of internal control

63. Those who commission reports on internal control from practitioners may be looking for absolute assurance and, as a consequence, have unrealistic expectations. They may, for example, believe that internal control:

a. can ensure an entity's success, that is will ensure achievement of basic business objectives, or at least the entity's survival; and

b. can ensure the reliability of financial reporting and compliance with laws and regulations.

64. Decisions made in designing internal control inevitably involve the acceptance of some degree of risk. As the outcome of the operation of internal control cannot be predicted with absolute assurance any assessment of internal control is very judgmental.

65. Consequently, when accepting an engagement to provide assurance on internal control it will be necessary for practitioners to explain what internal control cannot do. The Turnbull report provides the following useful summary:

'A sound system of internal control reduces, but cannot eliminate, the possibility of poor judgment in decision-making, human error, control processes being deliberately circumvented by employees and others, management overriding controls and the occurrence of unforeseeable circumstances.
A sound system of internal control therefore provides reasonable, but not absolute assurance that a company will not be hindered in achieving its business objectives, or in the orderly and legitimate conduct of its business, by circumstances which may reasonably be foreseen. A system of internal control cannot, however, provide protection with certainty against a company failing to meet its business objectives or all material errors, losses, fraud or breaches of laws and regulations.'

66. Entities and their internal control needs differ by industry, size, culture and management philosophy. When designing a system of internal control there are many options as to the nature and extent of controls that may be implemented. Internal controls, for example, may be preventive or detective in nature and may be performed by people or by information technology systems. There is a balance to be achieved between the cost of implementation of controls and the identified benefits derived from the controls. Consequently one entity's internal control system may be very different from another's in relation to similar business processes.

67. To avoid the development of an unnecessary expectation gap, narrative assurance reports should caution the reader that any projection of the evaluation of the risks and control procedures to future periods is subject to risk. For example, the business risks facing the entity may change and

the control procedures may become inadequate because of changes in conditions. In addition the degree of compliance with the control procedures may deteriorate.

Footnotes

4. Inclusion of a description of the system of internal control may not be necessary in those circumstances where the practitioner is aware that the user of the report is fully conversant with the system in place. For example, a regulator may mandate many aspects of the system design and consequently not need to have the design description included in the practitioners' report.

5. Criteria of Control Board of the Canadian Institute of Chartered Accountants

6. Committee of Sponsoring Organizations of the Treadway Commission (a USA organisation)

7. Each director and manager in an entity is likely to have a different viewpoint regarding the risks an entity faces and consequently the most comprehensive identification of potential risks is likely to be the result of a risk identification process that involves directors and managers from all departments within an entity. Informed outsiders such as auditors, actuaries, suppliers and bankers are also likely to provide useful input in identifying potential risks.

8. Techniques, often using information technology tools, have been developed that enable participants' assessments, both individually and in aggregate, to be depicted on a risk map. The same techniques may enable a group of managers or directors to analyse their individual and collective views on specific risks and facilitate discussion among participants with differing views on a particular risk.

3. Illustration of a narrative report providing assurance on the effectiveness of internal control

Cautionary note: This example has been developed for the sole purpose of illustrating what a narrative report on the effectiveness of internal control might look like following the concepts described in Section 2 of this Briefing Paper. As such reports could be presented in many ways, and will usually be tailored to reflect the requirements of the engaging party, it is not intended to be authoritative. Consequently, the example is not intended to provide a model of how such reports ought to be presented or to reflect the APB's views as to the ideal content of such reports.

15 April 2001

The Audit Committee PQR Group Limited

Dear Sirs

Effectiveness of internal controls relating to the advertising revenues of PQR Limited

In accordance with the arrangements set out in our letter dated 3 March 2000, we are writing to summarise the outcome of our work in assessing the effectiveness of the internal controls relating to the advertising revenues of PQR Limited during the period 30 September 2000 to 28 February 2001.

A separate report submitted to senior management contains a full description of the design of the system of internal control which, in the interests of brevity, has been excluded from this report.

Scope of Engagement

Included in the scope of our engagement were the processes relating to:

- maintaining PQR's competitiveness by keeping current with the advertisement presentation styles of its competitors;
- the booking in and recording of advertisements;
- the accuracy and timeliness of the inclusion of advertisement in the newspapers published by PQR Limited;
- adherence of the advertisements to PQR's 'Code of publication values';
- the processing of the related advertising revenues to the general ledger and the management accounts; and
- the collection and banking of cash and the recording of cash receipts.

As agreed we have not assessed the systems that control bank payments or the onward reporting and summarisation of general ledger information into either the management or statutory accounts.

Inherent Limitations of the Engagement

There are inherent limitations as to what can be achieved by internal control and consequently limitations to the conclusions that can be drawn from this engagement. These limitations include the possibility of faulty judgment in decision making, of breakdowns because of human error, of control activities being circumvented by the collusion of two or more people and of management overriding controls. Also there is no certainty that internal controls will continue to operate effectively in future periods or that the controls will be adequate to mitigate all significant risks which may arise in future. Accordingly we express no opinion about the adequacy of the system of internal control to mitigate future risk.

Companies and their internal control needs differ by industry, size, culture and management philosophy. When designing a system of internal control there are many options as to the nature and extent of controls that may be implemented. Internal controls, for example, may be preventive or detective in nature and may be performed by people or by information technology systems. There is a balance to be achieved between the cost of implementation of controls and the identified benefits derived from the controls. Consequently one company's internal control system may be very different from another's in relation to similar business processes.

Decisions made in designing internal controls inevitably involve the acceptance of some degree of risk. As the outcome of the operation of internal controls cannot be predicted with absolute assurance any assessment of internal control is very judgmental.

Business Objectives

We discussed the business and control objectives of PQR Limited relating to advertising revenues with the executive directors and senior management and understand them to be:

- To maximise revenues from advertisements placed in PQR Limited newspapers by ensuring that the presentation of advertisements keeps pace with developments at its competitors but without incurring the expense of being the brand leader.
- To ensure that all advertisements booked by customers are published accurately in accordance with each advertiser's requirements.
- To ensure that all advertisements placed in newspapers are invoiced in accordance with the appropriate rate card.
- To accept that a proportion of revenues may not be collectible as a result of credit risk, but given the low marginal cost of advertisements being published, to accept a level of uncollectible revenue of up to 2.5% of total revenue as a feature of the business.
- To ensure that the textual and pictorial content of advertisements adhere to PQR's 'Code of publication values'.
- To ensure that PQR Limited is able to receive and process advertisements even when its computer systems are unavailable.

Work Performed

We performed our work during the period from 15 June 2000 to 31 March 2001.

Our assessment of the effectiveness of internal controls was divided into four phases:

- Understanding the business and management's business objectives in controlling advertising revenues.
- Reviewing management's embedded risk identification processes and observing management's risk screening process that is intended to identify
- those risks (the 'applicable risks') that represent both a significant and likely risk to the business.
- Assessing the effectiveness of the design of controls intended to control the applicable risks.
- Testing the effectiveness of the operation of those controls during the period 30 September 2000 to 28 February 2001.

Understanding the business

To provide the necessary background information to carry out the engagement we obtained an understanding of the following:

- The trends in the financial results of the business, and the key performance measures used by management, together with comparisons to similar businesses.
- The systems used to process transactions and produce management information.

We also obtained an understanding of the background to the business, including its people, customers, suppliers and competitors, the key business processes and the current business environment.

Risk Identification

We assessed both the effectiveness and results of management's on-going processes for identifying and managing risks. This included obtaining an understanding of the overall control environment, the key performance measures used by management and management's processes designed to identify emerging risks.

Using these assessments and this background information about the business we reviewed the adequacy of the listing of potential risks identified by management. The potential risks identified are set out in the annexe to this letter.

Risk Screening

Risk screening is a process whereby all of the potential risks are evaluated by management, based on their assessment of the likelihood of the risk occurring and the potential impact of the risk. Risks meeting certain criteria are deemed to be applicable risks. The screening process was organised and facilitated by consultants skilled in this field from LMN. We observed and participated in risk screening meetings held at each division.

The process of risk screening involves a significant degree of judgment and the culmination of the process was the final screening meeting with the executive directors, which the audit committee also attended, on 15 July 2000. This meeting considered:

- the potential risks previously identified by line management and the executive directors;
- whether there were other risks requiring consideration; and
- the likelihood and significance of each potential risk.

Risks were screened out from further consideration if they met one of the following three criteria:

- If the effect of the risk is capable of being quantified and its direct financial effect was less than a materiality level of £5,000.
- If an appropriate risk management strategy such as insurance effectively mitigates the risk.
- Based on judgmental assessments of the likelihood and possible significance of the risk, if it was judged to be either unlikely to occur or not of high significance.

The detailed results of this screening process are set out in the annexe to this letter. This shows the risks identified, the results of the screening process and the reasons why risks were screened out from further consideration.

This resulted in the following list of applicable risks.

- The risk that advertising revenue may not be maximised because of a failure to monitor developments by competitors in the presentation of advertisements.

- The risk that advertisements may be published that do not meet PQR's 'Code of publication values'.
- The risk of inaccurate transfer of data between the editorial and billing system, and hence of incomplete billings.
- The risk that cheque receipts are not properly banked or are misappropriated.
- The risk that cash received at the front desk is not passed to the cashiers or is misappropriated.
- The risk that the editorial and billing systems are not available.

The risk screening processes were initially undertaken in June and July 2000. During the period to 28 February 2001 we updated our understanding of the business and its processes for any indications that there may be changes which would indicate that risks previously screened required more consideration, or for indications of new risks.

We have not considered the impact on the risks to the business arising from the changes in sales ledger and general ledger systems implemented in March 2001 and the associated personnel changes.

Controls designed to mitigate applicable risks

We assessed the design of the internal controls relating to each applicable risk. These controls comprise:

- specific controls - relating to the processing of individual transactions,
- pervasive controls - relating to the processing environment, access to systems, quality and training of personnel, physical safeguards etc,
- monitoring controls - relating to performance of key reconciliations of account balances, management oversight of the key performance measures and other monitoring procedures.

For each individual applicable risk we assessed the effectiveness of the design of the specific, pervasive and monitoring controls. Apart from the exception described below, in all cases, we concluded that the controls were effectively designed. Details of the design of the internal controls relating to the applicable risks are set out in the report that we have previously sent to senior management.

Operation of controls

We tested whether the controls operated in accordance with their design during the period 30 September 2000 to 28 February 2001. These tests consisted of reviewing evidence of the application of the controls, discussion with key personnel and evaluating the integrity of the information used to perform the controls. We did not test those specific controls where we found that both the related pervasive and monitoring controls to be operating effectively

Exceptions Arising

Our work indicated that there were adequate controls over five of the six applicable risks. In the case of the risk relating to the availability of the editorial and billing systems we found that PQR Limited does not have an appropriate plan in place to enable it to continue operating if these systems are not available. Whilst there have been no incidences of any problems arising in the period 30 September 2000 to 28 February 2001, we strongly recommend that management should develop and test a detailed plan for continuing operations in the event of a failure of these computer systems.

Conclusions

Our conclusions in relation to the internal controls over advertising revenue processing at PQR Limited in the period 30 September 2000 to 28 February 2001 are as follows:

During the course of our work, as described above, nothing came to our attention to indicate that there are any risks, other than the applicable risks detailed in the section on risk screening above, that we consider should have been assessed as both likely to arise and having high impact.

In our opinion:

1. Except for the risk of non-availability of the editorial and billing systems, the design of the controls related to the applicable risks was in all cases effective to mitigate the applicable risks to an acceptable level.

2. The monitoring and pervasive controls identified which related to the applicable risks (and which are described in the detailed report sent to management) were in all cases operating effectively during the period 30 September 2000 to 28 February 2001.

Limitation of use

This report is for the internal use of PQR Limited only. It should not be made available to any third party without our prior written consent. We accept no responsibility to any other party who may gain access to this report.

Yours faithfully

ANNEXE

Risk Description	**Risk screened from further consideration**	**Reasons**
Risk of loss of revenue through one or all of: • Failure of the business to invest in its titles and keep its product up to date. • New media products developed by competitors. • Attractiveness of competitor	No	PQR has adopted a strategy of following developments at its competitors rather than setting the pace for the industry. It is, therefore, crucial for its business success to have controls to ensure that it is fully aware of the activities of its competitors on a timely basis. Failure to respond to competitor innovation is the major business threat to revenue.

publications.		
Risk that advertisements may be published that do not meet PQR's 'Code of publication values'.	No	Although the company maintains comprehensive insurance cover which effectively mitigates the financial cost of the company being sued for advertising illegal services such as prostitution, the risk to the company's reputation is regarded as high. There is a high turnover of staff who process advertisements and consequently a need for strong controls over their work to ensure that the company's guidelines in this area are adhered to.
Risk that not all advertisements published are invoiced. This risk can be focussed more specifically to the risk that the transfer of data between the editorial system and the billing system is incomplete or inaccurate.	No	Judged to be likely and potentially significant.
Inaccurate production of the advertisement in the newspaper	Yes	Individual advertisements are not significant to the business and there is no evidence of any systemic problems in this area.
The charges for advertisements placed, are not in line with the approved rates - either in error or as a result of deliberate collusion with advertisers.	Yes	Individual advertisements are not significant to the business. Actual yields achieved are very closely monitored and there is no evidence of yields being out of line with expectations.
Cheques received are not deposited at the bank on a timely basis or are misappropriated.	No	Judged to be likely and potentially significant.
Inappropriate credit limits are set resulting in acceptance of business from uncreditworthy customers.	Yes	The business objectives recognise that a proportion of revenue will not prove collectible but this is accepted given the low cost of publishing an advertisement. Monitoring of bad debts expense is ongoing and is a relatively static proportion of turnover. Given the large number of customers, management accept this ongoing cost and do not believe that additional controls in this area would be cost effective.
Cash receipts at the front desk are not passed to the cashiers or are misappropriated.	No	Cash receipts are significant and this is judged to be a likely and potentially significant risk.

Transfer of accounting information to the nominal ledger from the billing system is not complete or accurate.	Yes	Although potentially significant to the reported results failure of the transfer system is not judged to be likely as this process is computerised and there are strong integrity controls over the computer system.
The risk of unauthorised access to the editorial and billing systems.	Yes	The potential for either deliberate or unintentional error arising from unrestricted or unauthorised access to these systems was not judged to be a significant and likely risk.
The risk that the editorial and billing systems are not available.	No	Systems unavailability were judged both significant and likely.

Appendix I

Conclusions of the APB's 1998 consultation

Purpose of the 1998 consultation

1. In 1998 the APB published a consultation paper entitled *'Providing Assurance on Internal Control'*. It set out the APB's preliminary proposals for a Framework of Principles applicable to engagements intended to provide assurance on internal control. In the paper the APB expressed the view that a Framework of Principles would avoid expectation gaps developing between practitioners and users of their reports and result in more consistent practices. In publishing the consultation paper, therefore, the APB had hoped to stimulate debate and develop further the role of reporting accountants in providing assurance about the operation of internal controls.

Comments received

2. Thirty eight responses to the consultation paper were received [9]. In addition to answering the specific questions posed, a number of additional issues were raised. The comment letters were thought provoking and have been of considerable assistance to the APB in progressing its thinking.

Overview of the comments

3. The conclusions that the APB has drawn from the consultation, are set out below under the following headings:

- Framework of principles
- More emphasis on risk assessment
- Narrative reporting
- Difficulties with `suitable criteria'
- Scope of the proposals

- Private or public reporting
- Scepticism
- Application to internal auditors

Framework of principles

4. There was strong support among commentators for the development of a Framework of Principles. Twenty one commentators stated that such a Framework would be worthwhile.

5. The thirteen proposed 'Principles' were generally supported although many found the proposed distinction between 'basic' and 'additional' Principles confusing. Some commentators suggested other Principles that are applicable to such engagements.

More emphasis on risk assessment

6. A number of commentators considered that a greater emphasis should have been placed on risk identification and assessment. In many models of internal control, business objective setting and risk identification and assessment are considered to be pre-requisites for designing a system of internal control.

7. In response to this concern the content of this Briefing Paper addresses risk identification and assessment and business objective setting. This has the benefit of more closely aligning the APB's thinking with the Turnbull report.

Narrative reporting

8. The consultation paper set out specimen reports for a number of example engagements. Many commentators thought that these reports were:

a. overly formalised (boiler plate);

b. unnecessarily caveated;

c. defensive; and

d. unhelpful.

9. These commentators suggested that reports on internal control should be 'discursive' but acknowledged the difficulties that could exist in publishing 'discursive' reports.

10. Arising from these comments, the APB has developed an illustration of a narrative report. It is included as Section 3 of this Briefing Paper.

Difficulties with 'suitable criteria'

11. The consultation paper emphasised the importance of 'suitable criteria', and suggested that before being in a position to express an opinion on the adequacy or effectiveness of internal controls the reporting accountant would need either generally accepted criteria or a detailed list of control objectives.

12. Commentators expressed many reservations on the need for suitable criteria. As such criteria are typically not available to assurance providers, the proposals were seen, in effect, to require detailed control objectives to be provided to practitioners before they would be in a position to provide assurance on internal control.

13. This was interpreted, by some commentators, as reducing the practitioners' role to one of 'certificate provider' rather than 'useful adviser'. Many commentators, including regulators, thought this was unhelpful and expressed the view that the value that they were seeking from practitioners might involve the reporting accountants contributing to the identification and assessment of risks or providing advice on the design of the system of internal control.

14. In the absence of generally accepted criteria commentators recognised that the reporting accountants' report would need to provide sufficient information to allow users to put the reporting accountants' judgments into an appropriate context. This seems to provide further support for narrative, rather than standardised short-form, reporting.

Scope of the proposals

15. A number of commentators seemed to misinterpret what the APB meant by the expression 'assurance engagement'. As a result they were concerned that the APB was trying to prohibit both reporting accountants and internal auditors from undertaking a wide range of engagements that they have traditionally, and quite properly, performed. This was not the intent of the APB.

16. The objective of an assurance engagement is for a professional accountant to evaluate a subject matter that is the responsibility of another party against identified suitable criteria and to express a conclusion that provides the intended user with a level of assurance about that subject matter.

17. It follows that an assurance engagement does not encompass engagements such as 'agreed-upon procedures' compilation of financial or other information, management consulting or other advisory services such as comparing or benchmarking internal control systems. This is not to say that practitioners or others should not undertake such engagements only that such engagements are not assurance engagements.

Private or public reporting

18. Commentators were uncertain whether the Framework proposed in the consultation paper was intended to support public or private reporting. Many commentators thought that private reporting should be encouraged but thought that the proposed reporting style was more appropriate for public reporting.

19. In order for the reader to fully appreciate the context in which the reporting accountants have drawn their conclusions the illustrative report in this Briefing Paper sets out, in some detail, key considerations concerning an entity's business objectives, applicable risks and design characteristics of the internal control system. The illustrative narrative report developed for this Briefing Paper is quite lengthy and, consequently, APB envisages that such reports will have a limited circulation.

Scepticism

20. Concern was expressed by a number of commentators with respect to the proposed Principle that reporting accountants should plan and conduct an engagement to provide assurance on internal

control with an attitude of professional scepticism. Some commentators interpreted 'scepticism' as meaning 'disbelieving' and thought that the concept of 'objectivity' would be preferable to scepticism.

21. The APB remains strongly of the view that practitioners should be sceptical in the sense that they should neither assume that the responsible party is dishonest nor assume unquestioned honesty. In this regard the APB is entirely consistent with the International Standard on Assurance Engagements.

Application to internal auditors

22. Many internal auditors interpreted the proposals as restricting the scope of work that they should undertake and consequently objected to the notion that the proposals should apply to them.

Footnotes

9. Copies of the comment letters have been placed on public record in the libraries of the six accountancy bodies that constitute the CCAB

Appendix II

Internal control requirements of the Combined Code, the Listing Rules and associated APB guidance

Internal control requirements of the Combined Code

Principle D.2 of the Code states that 'The Board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets'.
Provision D.2.1 states that 'The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management'.
Provision D.2.2 states that 'Companies which do not have an internal audit function should from time to time review the need for one'.

Requirements of the Listing Rules

Paragraph 12.43A of the Listing Rules of both the UK and Irish Listing Authorities require the following to be included in a company's annual report and accounts:

a. a narrative statement of how it has applied the principles set out in Section 1 of the Combined Code, providing explanation which enables its shareholders to evaluate how the principles have been applied;

b. a statement as to whether or not it has complied throughout the accounting period with the Code provisions set out in section 1 of the Combined Code. A company that has not complied with the Code provisions, or complied with only some of the Code provisions or (in the case of provisions whose requirements are of a continuing nature) complied for only part of an accounting period, must specify the Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non compliance.

Requirements of auditors

A company's statement under 12.43A(b) must be reviewed by the auditors before publication only insofar as it relates to Code provisions A.1.2, A.1.3, A.6.1, A.6.2, D.1.1, D.2.1, and D.3.1 of the Combined Code.

Extracts from APB Bulletin 1999/5 'The Combined Code: Requirements of Auditors under the Listing Rules of the London Stock Exchange".

17 In relation to all elements of the corporate governance disclosures relating to the Code provisions that are within the scope of their review, the auditors obtain appropriate evidence to support the compliance statement made by the company. Appropriate evidence will usually be obtained by performing the following procedures:

a. reviewing the minutes of the meetings of the board of directors, and of relevant board committees (for example audit, nomination and risk management committees);

b. reviewing supporting documents prepared for the board of directors or board committees that are relevant to those matters specified for review by the auditors;

c. making enquiries of certain directors (such as the chairman of the board of directors and the chairmen of relevant board committees) and the company secretary, regarding procedure and its implementation, to satisfy themselves on matters relevant to those Code provisions specified for review by the auditors; and

d. attending meetings of the audit committee (or the full board if there is no audit committee) at which the annual report and accounts, including the statement of compliance, are considered and approved for submission to the board of directors.

Auditors review of compliance with Code provision D.2.1

32 Although the Turnbull guidance addresses all of the internal control requirements of the Combined Code, Listing Rule 12.43A requires the auditors to review only the disclosures made with respect to Code provision D.2.1.

35 The objective of the auditors' review is to assess whether the company's summary of the process the board (and where applicable its committees) has adopted in reviewing the effectiveness of the system of internal control, is both supported by the documentation prepared by or for the directors and appropriately reflects that process.

36 To achieve this objective the auditors, in addition to the procedures outlined in paragraph 17:

a. through enquiry of the directors obtain an understanding of the process defined by the board for its review of the effectiveness of internal control and compare their understanding to the statement made by the board in the annual report and accounts;

b. review the documentation prepared by or for the directors to support their statement made in connection with Code provision D.2.1 and assess whether or not it provides sound support for that statement; and

c. relate the statement made by the directors to the auditors' knowledge of the company obtained during the audit of the financial statements. As explained in paragraph 39, the scope of the directors review will be considerably broader in its scope than the knowledge the auditors can be expected to have based on their audit.

The Stock Exchange considers this approach to be consistent with its Listing Rules' requirement.

40 Auditors, therefore, are not expected to assess whether all risks and controls have been addressed by the directors or that risks are satisfactorily addressed by internal controls. In order to communicate this fact to users of the annual report the following sentence is included in the auditors' report on the financial statements.

We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the company's corporate governance procedures or its risk and control procedures.

NOTICE TO READERS