A C T A U N I V E R S I T A T I S L O D Z I E N S I S
FOLIA OECONOMICA 242, 2010

Michał Wydrych[*]

INTERNAL CONTROL OVER FINANCIAL REPORTING – REVIEW OF DIFFERENT AMERICAN AND EUROPEAN APPROACHES AND LEGISLATIONS

Abstract. Transparency of public company's operations, performance and strategic orientation for the future, as well as the characteristics of their governance structures are becoming increasingly important elements of corporate governance. These requirements not only apply to companies and their information policy, but also relate to particular countries or regions and their efforts to build strong institutional and regulatory system which ensures the reliability of disclosed information.

The challenges posed to companies by the stock investors today are very high. Surveys conducted among the investors take into account not only the area of operation, strategy and plans for future, but also the degree of openness to investors and information policies. Talking about the transparency and company's openness to stakeholders we have to consider the most important aspect – it's the reliability of the information published by the entity. This is a crucial thing of the reporting standards, code of conduct and business practices.

All companies, which depend on the reliability of the data presented possess or should implement risk management process and strong, coherent system of internal control.

This article is about internal control system. It's trying to answer what is exactly strong and coherent internal control system over financial reporting, how should be organized in the company, who are the people responsible for such a system and how the internal control system was and is defined by different countries and their legislations.

That's why it says about COSO model, Sarbanes-Oxley in US and different European legislation like for instance British or Swedish approaches.

Internal control over financial reporting-it's just an overview of the system that's still gaining in value and is a very important aspect of today's complicated business life.

Keywords: internal control over financial reporting, corporate governance, disclosed information, code of conduct, control environment, Risk Assessment, Control Activities, board's responsibilities, effectiveness of internal control

1. INTRODUCTION AND GENERAL INFORMATION

Transparency of public company's operations, performance and strategic orientation for the future, as well as the characteristics of their governance structures are becoming increasingly important elements of corporate governance.

[*] MSc., ABB sp. z o.o.

These requirements not only apply to companies and their information policy, but also relate to particular countries or regions and their efforts to build strong institutional and regulatory system which ensures the reliability of disclosed information.

The challenges posed to companies by the stock investors today are very high. Surveys conducted among the investors take into account not only the area of operation, strategy and plans for future, but also the degree of openness to investors and information policies. Talking about the transparency and company's openness to stakeholders we have to consider the most important aspect – it's the reliability of the information published by the entity. This is a crucial thing of the reporting standards, code of conduct and business practices.

All companies, which depend on the reliability of the data presented possess or should implement risk management process and strong, coherent system of internal control.

2. INTERNAL CONTROL OVER FINANCIAL REPORTING – DEFINITION AND GENERAL APPROACH

There are many definitions of internal control, as it affects the various constituencies (stakeholders) of an organization in various ways and at different levels of aggregation.

Under the COSO[1] Internal Control-Integrated Framework, a widely-used framework in the United States, internal control is broadly defined as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

a) Effectiveness and efficiency of operations;

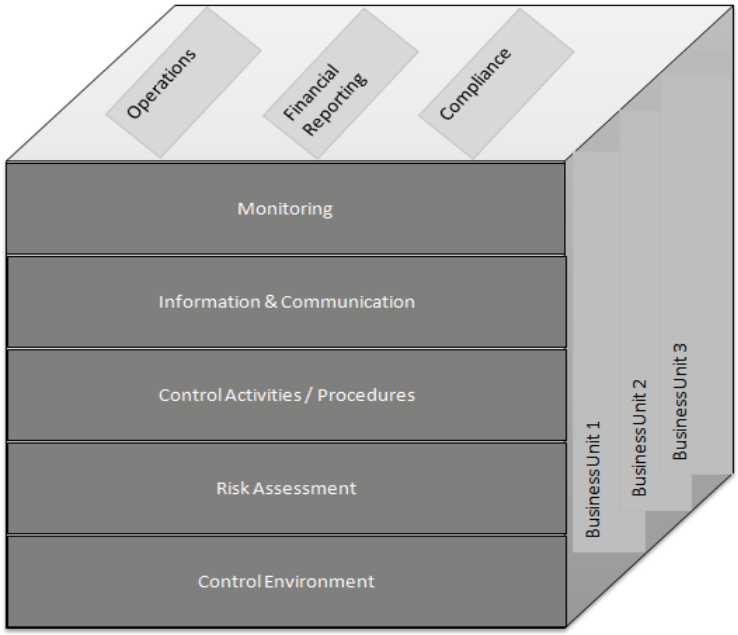
b) Reliability of financial reporting;

c) Compliance with laws and regulations.

[1] Committee of Sponsoring Organizations of the Treadway Commission (COSO), is a U.S. private-sector initiative, formed in 1985. Its major objective is to identify the factors that cause fraudulent financial reporting and to make recommendations to reduce its incidence. COSO has established a common definition of internal controls, standards, and criteria against which companies and organizations can assess their control systems.

COSO is sponsored and funded by 5 main professional accounting associations and institutes; American Institute of Certified Public Accountants (AICPA), American Accounting Association (AAA), Financial Executives International (FEI), The Institute of Internal Auditors (IIA) and The Institute of Management Accountants (IMA).

The original COSO Cube



COSO defines internal control as having five components:

1. **Control Environment**-sets the tone for the organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control.

The control environment element is also a view of internal controls from the entity's perspective, including both the environment it creates for business processes and controls internally, and the influences of its environment on its ability to establish and/or maintain an effective system of internal controls. Some of the ways the control environment can be evaluated regarding the risks associated with the control environment include:

- communication and enforcement of integrity and ethical values,
- organizational structure,
- human resource policies and practices,
- commitment to competence,
- participation of those charged with governance,
- management's philosophy and style,
- assignment of authority and responsibility,
- industry factors.

2. **Risk Assessment**-the identification and analysis of relevant risks to the achievement of objectives, forming a basis for how the risks should be managed.

The risk assessment aspect of COSO, in general, refers to the entity's ability to properly assess risks and, for major ("significant") risks, mitigate them to an acceptable level using controls. Some of the various ways in which risks could be introduced to the entity and, therefore, areas where controls and/or procedures should be developed to affect the entity's system of controls positively include:

- changes in operating environment,
- new personnel,
- new or revamped information systems,
- rapid growth,
- new information technology employed,
- new business models, products or activities,
- corporate restructurings,
- expanded foreign operations,
- new accounting pronouncements.

If the entity's management and/or board are not active in

assessing and mitigating risks, this aspect of the control system would be defective to some degree.

3. **Control Activities**-the policies and procedures that help ensure management directives are carried out. Control activities can be divided into three categories, based on the nature of the Company's objectives to which they relate, i.e., operations, financial reporting, or compliance. The control activities components are:

3.1 Policies and Procedures- control activities usually involve two elements: a policy establishing what should be done and procedures to affect/implement the policy.

3.2 Control Activities in Place- control activities serve as mechanisms for managing and mitigating risk, identify errors and unacceptable behaviors and correcting them, thereby enabling the achievement of objectives. Control is built directly into processes and always relates back to the risk it was designed to mitigate.

4. **Information and Communication**-systems or processes that support the identification, capture,

and exchange of information in a form and time frame that enable people to carry out their responsibilities. The financial reporting information not only should have reliability, but should also be communicated in a timely manner and accurately to managers and decision makers.

Therefore, in general, this aspect of controls deals with effective communication and relay of information from the financial reporting systems, and the controls that make those activities effective. Some of the various ways in which

information and communication can be evaluated regarding the risks associated with those activities include:

- systems to support the identification, capture and exchange of information in a form and time frame that enable personnel to carry out their responsibilities,
- financial reporting information,
- internal control information,
- internal communication,
- external communication.

5. **Monitoring**-processes used to assess the quality of internal control performance over time. It refers to the entity's ability to monitor the effectiveness of controls as they operate daily, individually and in cooperation with other controls.

Some of the various ways in which controls over monitoring of control effectiveness could be evaluated regarding the risks associated with those activities include:

- analyzing control objectives and their related control activities,
- ongoing and separate evaluations on internal controls over financial reporting,
- identifying and reporting deficiencies,
- assessing the quality of internal control performance over time,
- putting procedures in place to modify the control system as needed (add, change, delete),
- ensuring effective management review of control system status,
- checking for the absence of monitoring systems, which tends to allow people to reduce vigilance on controls,
- utilizing relevant external information or independent monitors,
- reviewing changes to controls since the date of the last report.

The COSO definition relates to the aggregate control system of the organization, which is composed of many individual control procedures.

Discrete control procedures, or controls are defined by the SEC as: "...a specific set of policies, procedures, and activities designed to meet an objective. A control may exist within a designated function or activity in a process. A control's impact...may be entity-wide or specific to an account balance, class of transactions or application. Controls have unique characteristics – for example, they can be: automated, IT- dependent or manual; reconciliations; segregation of duties; review and approval authorizations; safeguarding and accountability of assets; preventing or detecting error or fraud. Controls within a process may consist of financial reporting controls.

Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of key processes. Integrity and ethical behaviour are often driven from the company's "Mission

and Values" and "Business Ethics" and other behavioural standards, how these are communicated, and how they are monitored and enforced in the business activities is of utmost importance. These include management's actions to remove incentives and temptations that might prompt personnel to engage in less than honest, illegal, or unethical acts. These policies should be effectively communicated to all levels of management, and the executives should set examples of high standards for ethical values.

In most cases the control environment "tone at the top" is set by the Board of Directors and Finance & Audit committee. Factors include the Board or Finance & Audit committee's independence from management, experience and stature of its members, extent of its involvement and scrutiny of activities, and appropriateness of its actions.

3. THE NEW REQUIREMENTS IN THE AREA OF COMPANY FINANCIAL REPORTING AND CORPORATE GOVERNANCE – DIFFERENT APPROACHES AND LEGISLATIONS

3.1. Sarbanes-oxley act of 2002 (sox)

The most famous and well known regulation it the area of internal control framework is of course the Sarbanes-Oxley Act of 2002.

Sarbanes-Oxley Act passed by U.S. Congress in July 2002. The main reasons of enacting the law Sarbanes-Oxley were business scandals in the United States in the years 2000–2001– particularly the Enron and WorldCom affairs. These scandals unprecedented resulted in a dramatic fall in investor confidence in the financial markets and key players operating on them like for instance investment advisers, auditors and companies listed on stock exchange.SOX greatly strengthens the independence requirements of the key players in the financial market and relies on a very high level of requirements for the effectiveness of internal control of entities registered in the U.S. Securities Exchange Commission (SEC). Sarbanes-Oxley Act includes eleven chapters. Requires additional disclosures made by the Board on the effectiveness of internal control system. Imposes an obligation to control the quality of audit services, the additional penalties (financial and criminal) for the company in case of detection of misstatements in the financial statements and introduces an absolute requirement for auditor independence.

This brings about the appointment of accounting oversight board called PCAOB (Public Company Accounting Oversight Board – PCAOB).

Law is aimed at restoring investor confidence by improving the quality and reliability of financial reporting.

Sarbanes and Oxley Act was not the first and only such a regulation in the business world. There were some European acts, directives or best practice policies that has covered this special topic.

3.2. The combined code on corporate governance and internal control framework

There is for instance the Combined Code on Corporate Governance in Great Britain.

The Combined Code[2] was essentially a consolidation and refinement of a number of different reports and codes concerning opinions on good corporate governance. The first step on the road to the initial iteration of the code was the publishment of the Cadbury Report (1992). The Cadbury Report was a response to major corporate scandals associated with governance failures in the UK (such as Robert Maxwell's executive abuses). The result of this was the accompanying Cadbury Code- the first explicit guidelines on corporate governance in the UK.

In 1995, the Greenbury committee was set up, intended as a 'study group' on executive compensation and the result of which was the Greenbury Report of 1995. Following this the Hampel report drew upon both Cadbury and Greenbury as well as elaborating on their recommendations and others that it considered to be relevant (including the roles of executive directors, non-executive directors and institutional investors). It is the Hampel Report, that the first iteration of The Combined Code is based upon.

The Code is a set of principles of good corporate governance and provided a code of best practice aimed at companies listed on the London Stock Exchange. It is overseen by the Financial Reporting Council and its importance derived from the Financial Services Authority's Listing Rules.

In the section 1.C- "Accountability and Audit" it's written that the main principal of the board with regards to financial reporting is internal control.

The board of directors is responsible for the company's system of internal control. It should set appropriate policies on internal control and seek regular assurance that will enable it to satisfy itself that the system is functioning effectively. The board must further ensure that the system of internal control is effective in managing risks in the manner which it has approved.

In determining its policies with regard to internal control, and thereby assessing what constitutes a sound system of internal control in the particular circumstances of the company, the board's deliberations should include consideration of the following factors:

[2] Internet: http://en.wikipedia.org/wiki/Combined_code [2009]

– 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 materializing;
– the company's ability to reduce the incidence and impact on the business of risks that do materialize, and
– the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.

It is the role of management to implement board policies on risk and control.

In fulfilling its responsibilities, management should identify and evaluate the risks faced by the company for consideration by the board and design, operate and monitor a suitable system of internal control which implements the policies adopted by the board.

All employees have some responsibility for internal control as part of their accountability for achieving objectives. They, collectively, should have the necessary knowledge, skills, information and authority to establish, operate and monitor the system of internal control. This will require an understanding of the company, its objectives, the industries and markets in which it operates, and the risks it faces.

An internal control system encompasses the policies, processes, tasks, behaviors and other aspects of a company that, taken together:
– facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud, and ensuring that liabilities are identified and managed;
– help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organization;
– help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.

A company's system of internal control shall reflect its control environment which encompasses its organizational structure. The system shall include:
– control activities,
– information and communications processes and
– processes for monitoring the continuing effectiveness of the system of internal control.

The system of internal control should:
– be embedded in the operations of the company and exists as a 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.

A 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.

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 or regulations.

Reviewing the effectiveness of internal control is an essential part of the board's responsibilities. The board needs to form its own view on effectiveness after due and careful enquiry based on the information and assurances provided to it. Management is accountable to the board for monitoring the system of internal control and for providing assurance to the board that it has done so.

The role of board committees in the review process, including that of the audit committee, is for the board to decide and will depend upon factors such as the size and composition of the board, the scale, diversity and complexity of the company's operations and the nature of the significant risks that the company faces. To the extent that designated board committees carry out, on behalf of the board, tasks that are attributed in this guidance document to the board, the results of the relevant committees' work should be reported to, and considered by, the board.

The board takes responsibility for the disclosures on internal control in the annual report and accounts.

Effective monitoring on a continuous basis is an essential component of a system of internal control. The board cannot, however, rely solely on the embedded monitoring processes within the company to discharge its responsibilities. It should regularly receive and review reports on internal control. In addition, the board should undertake an annual assessment for the purposes of making its public statement on internal control to ensure that it has considered all significant aspects of internal control for the company for the year under review and up to the date of approval of the annual report and accounts.

The board should define the process to be adopted for its review of the effectiveness of internal control. This should encompass both the scope and frequency of the reports it receives and reviews during the year, and also the process for its annual assessment, such that it would be provided with sound, appro-

priately documented, support for its statement on internal control in the company's annual report and accounts.

The reports from management to the board should, in relation to the areas covered by them, provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in managing those risks. Any significant control failings or weaknesses identified should be discussed in the reports, including the impact that they have had, could have had, or may have, on the company and the actions being taken to rectify them. It is essential that there be openness of communication by management with the board on matters relating to risk and control.

When reviewing reports during the year, the board should:

– consider what are the significant risks and assess how they have been identified, evaluated and managed,

– assess the effectiveness of the related system of internal control in managing the significant risks, having regard, in particular, to any significant failings or weaknesses in internal control that have been reported,

– consider whether necessary actions are being taken promptly to remedy any significant failings or weaknesses and consider whether the findings indicate a need for more extensive monitoring of the system of internal control.

Additionally, the board should undertake an annual assessment for the purpose of making its public statement on internal control. The assessment should consider issues dealt with in reports reviewed by it during the year together with any additional information necessary to ensure that the board has taken account of all significant aspects of internal control for the company for the year under review and up to the date of approval of the annual report and accounts.

The board's annual assessment should, in particular, consider:

− the changes since the last annual assessment in the nature and extent of significant risks, and the company's ability to respond to changes in its business and the external environment,

− the scope and quality of management's ongoing monitoring of risks and of the system of internal control, and, where applicable, the work of its internal audit function and other providers of assurance,

− the extent and frequency of the communication of the results of the monitoring to the board (or board committee(s)) which enables it to build up a cumulative assessment of the state of control in the company and the effectiveness with which risk is being managed,

− the incidence of significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have, a material impact on the company's financial performance or condition and

− the effectiveness of the company's public reporting processes.

Should the board become aware at any time of a significant failing or weakness in internal control, it should determine how the failing or weakness arose and re-assess the effectiveness of management's ongoing processes for designing, operating and monitoring the system of internal control.

The board should, as a minimum, disclose that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company, that it has been in place for the year under review

and up to the date of approval of the annual report and accounts, that it is regularly reviewed by the board and accords with the guidance in this document.

The board may wish to provide additional information in the annual report and accounts to assist understanding of the company's risk management processes and system of internal control.

The disclosures should include an acknowledgement by the board that it is responsible for the company's system of internal control and for reviewing its effectiveness. It should also explain that such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material misstatement or loss.

3.3. Swedish code of corporate governance

Writing about internal control regulations in European countries we can not forget about Sweden's approach. There is an act called "Swedish Code of Corporate Governance".

The mission of The Swedish Corporate Governance Board was to manage and administrate the Swedish Code of Corporate Governance to promote good governance of listed companies in Sweden.

This Code is a set of guidelines for good corporate governance that all stock exchange listed companies are obliged to apply. The work of the Board is an integral part of the self-regulation system on the Swedish securities market

As of 1 July 2008, The Swedish Code of Corporate Governance is applicable to all Swedish companies whose shares are traded on a regulated market in Sweden. At present, these markets are OMX Nordic Exchange Stockholm and NGM Equity.

In the part III of this act "Rules for Corporate Governance" there is point 3.7 which says about the internal control environment and the special role of the Board of Directors.

It's written that the board of directors is responsible for ensuring that the company has good internal controls and formalized routines that ensure that established principles for financial reporting and internal controls are followed. The board is also responsible for ensuring that the company's financial reports

are prepared in accordance with the law, relevant accounting standards and other requirements for listed companies.

The board is to establish also an audit committee consisting of at least three directors. The majority of the audit committee members are to be independent of the company and its executive management. At least one member of the committee is to be independent of the company's major shareholders. No board member who holds an executive management position is to be a member of the audit committee. If the board of directors feels it is appropriate, the entire board may perform the audit committee's tasks, providing that no director who is a member of the executive management participates in this work.

The audit committee is to be responsible for the preparation of the board's work to ensure the quality of the company's financial statements, meet the company's auditor regularly to remain updated on the aims and scope of the audit, as well as to discuss co-ordination between external and internal audits and views on the company's risks, establish guidelines on services other than auditing that the company may procure from the company's auditor, evaluate the auditing work and inform the company's nomination committee of the results of this evaluation, and assist the company's nomination committee in preparing nominations for the post of auditor and recommendations on fees for auditing services.

At least once a year, the board is to meet the company's auditor without the chief executive officer or any other member of the executive management present.

The board of directors is to ensure that the company's six- or nine-month report is reviewed by the auditor.

The board have to submit an annual report on the key aspects of the company's systems for internal controls and risk management regarding financial reports.

For companies that do not have a separate internal audit function, the board of directors is to evaluate the need for such a function annually and to justify its decision in its report on internal controls.

Other European country that poses the standards and regulations with regards to internal controls are for instance:

- **Netherlands**- "The Deutch Corporate Governance Code"

– the company is required to have a system of internal control and risk management. The Board should declare an annual report on the adequacy and effectiveness of risk management and control,

- **France**- "Loi de Securite Financiere"

– imposes an obligation to prepare by the Chairman of the Supervisory Board report on internal control procedures, to the company's annual report.

Nowadays different projects of the European Parliament and the Council are going to regulate this topic systematically for all public companies listed on stock exchanges in the EU

When it comes about Poland- Polish Accounting Standards has been changed this year. These laws also affect the responsibility of all board members of the company. A big change was the introduction of accountability of members of supervisory boards. According to this change on accounting- the fulfillment of the obligations imposed on the unit correspond to all the members of their governing bodies.

Unit to meet the financial requirements must apply the overarching accounting principles.

In order to ensure true and fair, reliable and clear picture of the financial reports the board of a unit has to establish a sound system of internal control. That is of course entity and process level controls within a mechanism of financial risks management.

Therefore, the responsibility of management to the design and operational phase of the internal control framework is very important. The more efficient is the system of internal control- the company operates more efficiently, better respond to threats and in the longer term is more profitable.

4. CONCLUSIONS

In conclusion, I would like to stress that system of internal control is nothing new. It is a very important aspect of today's complicated business life. It's still gaining in value because we are struggling with different dusty information form everywhere.

Financial scandals, economic bankruptcy of many companies, their global business range, scope and free flow of capital are the main reasons that cause the need for changes in corporate governance.

Transparency in business, globalization and high- level standards required from stakeholders are also simultaneous evolution in management system of this aspect.

As we can easily observe- nothing is constant. All these new or existing requirements not only apply to companies and their information policy, but also relate to particular countries or regions and their efforts to build strong institutional and regulatory system which ensures the reliability of disclosed information.

The main challenge of internal control nowadays should be maintenance of a sound system of internal control in order to safeguard shareholders' investment and the company's assets.

The boards should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational ,compliance controls and risk management systems.

This is a crucial thing of the reporting standards, code of conduct and business practices.

REFERENCES

The Sarbanes-Oxley Act of 2002, July 2002
The Combined Code on Corporate Governance, July 2003
M. Wydrych, SOX 404- New requirements on financial reporting & Corporate Governance, April 2006, "FLASH"– internal ABB magazine,
Some of the paragraph 2nd was taken from the COSO web site, ww.coso.org and www. wikipedia.com

This article is dedicated to the memory of my deceased father Szczepan Wydrych

Michał Wydrych

SYSTEM KONTROLI WEWNĘTRZNEJ PRZEZ PRYZMAT SPRAWOZDAWCZOŚCI FINANSOWEJ – PRZEGLĄD WYBRANEGO AMERYKAŃSKIEGO I EUROPEJSKIEGO USTAWODAWSTWA

Przejrzystość funkcjonowania spółek publicznych, działalność operacyjna, strategiczna jak również charakterystyka struktur zarządczych stają się dzisiaj coraz ważniejszymi elementami ładu korporacyjnego na świecie.

Wymagania te odnoszą się nie tylko do poszczególnych spółek publicznych czy ich polityki informacyjnej ale również zależą od ustawodawstwa danego kraju, regionu, wzmacniając budowę i znaczenie silnego, zinstytucjonalizowanego systemu zapewniającego rzetelność ujawnianych danych i publikowanych informacji.

Dzisiejsze wyzwania postawione podmiotom publicznym przez inwestorów są bardzo wysokie.

Ankiety przeprowadzone wśród tej grupy stakeholderów ujawniły, że w procesie inwestowania ważna jest dla inwestorów nie tylko sama w sobie działalność operacyjne czy też strategiczna. Znaczenia nabiera transparentność działania, stopień otwartości podmiotu „na rynek" oraz spójna polityka informacyjna.

Mówiąc o przejrzystości działań podmiotów publicznych, ich otwartości dla wszelakich stakeholderów, musimy dostrzec najważniejszy aspekt tego tematu tj. rzetelność informacji publikowanej przez spółkę. Rzetelne i prawidłowo zaprezentowane dane podmiotów publicznych to kredo jeśli chodzi o raportowanie finansowe czy szerokorozumiany kodeks postępowania i praktyk biznesowych.

Wszystkie spółki, którym zależy na przejrzystości działań i ujawnianiu rzetelnych i sprawdzonych informacji powinny zaimplementować system zarządzania ryzykiem oraz kontrolę wewnętrzną.

Ten właśnie artykuł tyczy się tematu kontroli wewnętrznej w spółce za który odpowiedzialne są organy zarządcze.

Autor podejmuje próbę odpowiedzenia na następujące pytania: