ACCA Think Ahead

Internal Audit FOUNDATION

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Internal Control and the Transformation of Entities – a UK and Ireland perspective

Effective internal control is one of the essential enablers for entities to grow with confidence and integrity in a multi-stakeholder world filled with volatility, uncertainty, disruption, and complexity. Internal control goes beyond statutory compliance requirements; it helps entities build trust, confidence, and a positive reputation in achieving strategic business outcomes. Entities operating models are being challenged. The need to be responsive to customer needs in shorter timescales and the advances in technology and data have given rise to innovative cultures and transformation initiatives. What has been the impact on internal control?

Role of internal control

The over 250 UK and Ireland respondents of the 1,950 globally to an ACCA, Internal Audit Foundation and Institute of Management Accountants (IMA) survey placed the prevention of fraud (86%, 84% globally) and the minimisation of risk (85%, 88% globally) as the main factors that described the purpose of internal control. Enhanced data quality was rated lowest at 48% (54% globally) from the options available. This perspective supports the definition of internal control offered in frameworks such as that developed by the Committee of Sponsoring Organizations (COSO).

Areas of opportunity and challenge

The respondents were asked how they rated several challenges in relation to their entity. 40% (50% globally) indicated a shortage of appropriately skilled staff whilst 40% (41% globally) also selected technology advances impacting internal control as the two most significant factors. Both themes are central to this research and are areas of action that both individuals and entities need to focus upon.

Many of the interviewees and roundtable participants who contributed to the research indicated that a traditional view of internal control prevailed. It was easier to retain manual controls rather than embrace the drivers of change, even if this approach did not improve process efficiency or control integrity. Ignoring the 'computer' cannot be a response, as some still felt was preferable.

A roundtable participant from the UK and Ireland commented that entities were developing a 'technology backbone that has consistent data or consistent data structure capable of providing measurement of consistent outcomes. What Boards and Audit Committees wish to know is where are we on that journey to delivering those outcomes? What is getting in the way of this goal? What sort of control environment is appropriate to manage and mitigate the risks in the most economical, efficient and effective way for the organisation'.

Another added, 'think if we keep that word risk in our heads, I think we'll keep a focus'.

Drivers for change

There are several drivers of change in internal control that entities are facing.

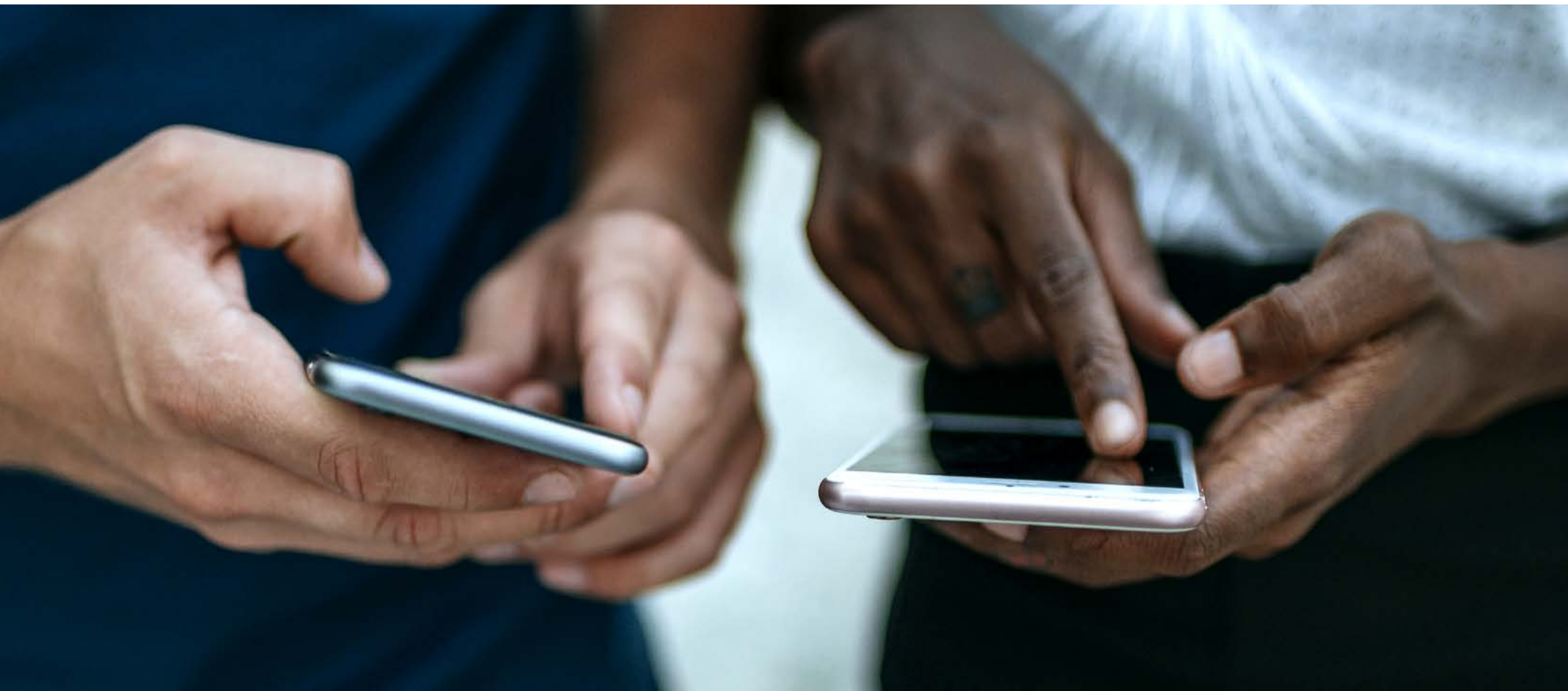
Operating models in entities are **transforming**. Before the pandemic many entities were investing in digitalising their processes, implementing more flexible models and Cloud-based solutions. Many entities have accelerated these initiatives during the pandemic as they needed to understand changing customer behaviours and accommodate different ways of working. Whilst the nature of the transactional boundary might have physically changed as a result, the use of technology has secured that boundary. Understanding this changing nature has reinforced the shift between manual and automated controls and testing how informality can be evidenced. These fundamental shifts in ways of working are an essential first step.

A roundtable participant reflected upon the impact of transformed business models on internal control by commenting that the challenge is in 'understanding the impact of the change on the end-to-end processes and where the controls now reside, who is responsible and how they then fit together. From an internal audit perspective, it is the logistics of auditing those controls to provide assurance in a way that the audit committee can understand.

A participant noted that they had 'observed in several different organisations that if you have the commercial conversation over here and you have the control conversation over there then there is a perception that they are driving in different directions. Actually, the real opportunity is when your controls drive your commercial processes'.

Another roundtable participant reflected upon the impact on the audit universe, commenting that, from their perspective, 'it used to be quite function based. Now it is transitioning to a more process-based audit universe. But it is quite difficult because the processes are either centralised or fragmented, and no matter what way you slice and dice the audit universe, you are missing something, or you are having to deviate from the rules that you have set yourself to come up with the audit universe. It is increasingly challenging to make sure that you have adequate coverage'.

A further participant reflected upon the automation of controls and the reluctance to incorporate these into internal controls. They noted that they 'are auditing the new automated process and we also feel that we probably should be auditing the existing non-automated process as well'.



Transactional cycles are becoming **shorter**. With Cloud-based solutions data capture occurs on mobile devices and through automated processes. Feedback is expected in an instant. The balance of internal control has moved from traditional cycles of review and approval to authorisation at the point of data capture. This changes the emphasis of internal control to a proactive rather than a reactive activity.

A roundtable participant explained that from their perspective that 'to remap the control points [in this new environment] we need to find a mechanism that enables us to do that efficiently and quickly as things change at a quicker rate. As internal auditors, we need to be able to keep up with that'.

Entities are increasingly focusing on a **broader definition of performance**. Whilst financial objectives are as relevant as they always have been, regulators and stakeholders are increasingly looking to disclosures of non-financial information, especially in relation to the sustainability agenda. These are not just external drivers but the need to embrace these in internal decision making is also fundamental. Implementing internal control over such processes is not an insubstantial task. Firstly, much of the data is less structured and comes from a variety of sources. Secondly, many of the processes remain heavily reliant upon manual intervention and end-user solutions which can be challenging to provide assurance over. Finally, interpreting this data requires a broader skill set than the traditional financial one, so implementing internal controls is challenging. Yet over 74% (80% globally) of the survey respondents felt that internal control should be expanded to cover ESG data flows.

A roundtable participant sounded a note of caution, 'where we go into non-financial data as people underestimate the number of resources that you need to put in to make sure that the quality is what you want it to be'.

The development and implementation of technology solutions is increasingly **agile**. End-user developments based upon lo-code and no-code development tools are increasingly used. The lifetime of a solution can often be short term, supporting a particular initiative or customer need, rather than a longer scale one. Machine learning plays an increasing role in analysis and prediction yet understanding this is a gap for many. Only 25% (23% globally) of the respondents indicated that they felt that internal control was included in the considerations of transformation initiatives, with the increasing move to agile developments this may well increase. The confidence level in the understanding of the current technologies which are used in transformation was felt to be low, indicating a skill gap which was reinforced by other survey results.

A roundtable participant reflected on the implications of this agility for internal control. They noted that, 'because of technology evolving so fast, once you create a control all over sudden, that control is no longer relevant and in some cases the controls are not commercially viable'.

Real time insights are essential to entities as they continue to face operational challenges. The expansion of data is a fundamental part of this. Moving towards a more continuous and automated approach to internal control was seen as an important step by 51% (64% globally) of the respondents. Being able to identify transactions which require investigation on a timelier basis is essential. Management reviews are no longer monthly, they are daily in many cases. Internal control needs to recognise this.

Transforming internal control

The activities to transform internal control can be grouped into six areas.

Firstly, embrace technology and data. No longer is auditing around the computer an effective excuse for a lack of skill or understanding. As machine learning and lo-code environments increasingly become embedded in processes and decision making so understanding the box is ever more important.

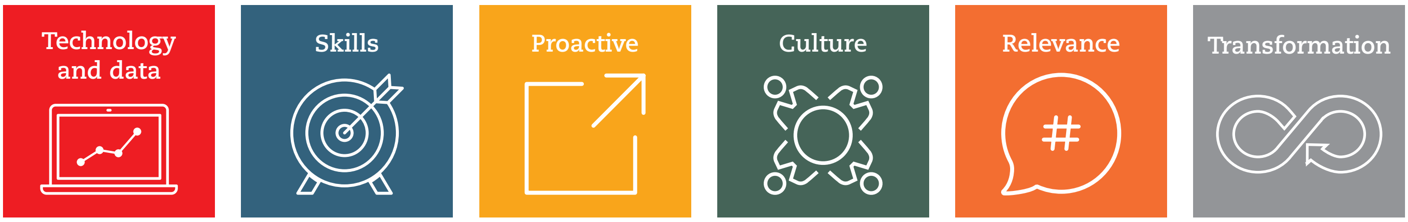
To do this there needs to be a development in the skills of those responsible for the second and third lines on The Institute of Internal Auditors model, at least. These skills need to embrace both technology and data advances, but also reflect that the scope of internal control is increasing. The provision of relevant guidance across the professions as well as investment by both individuals and entities are essential.

The emphasis, especially with the ever-increasing data volumes, must be on proactivity rather than historic reporting. The dynamics of constantly transforming entities mean that lessons learned too late are ever more painful – protecting against fraud is a real time activity.

This engenders relevance for internal control – not just a compliance cost. It needs to add value by being relevant and responsive.

Finally, change is now constant and internal control cannot be an afterthought. The culture of control is ongoing. Internal control needs to be an integral part of transformation, not a side line or implemented after the event. This requires a more proactive stance, but also having the skills and knowledge to play a relevant role.

FIGURE: The activities to transform internal control can be grouped into six areas:



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