

# Private Client Services

Are your internal controls supporting your business strategy?\*

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\*connectedthinking

PRICEWATERHOUSECOOPERS 

“We know you want more than just another consultant that delivers recommendations and reports.”

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Are your internal controls supporting your business strategy?

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Welcome to the inaugural issue of PricewaterhouseCoopers' (PwC) Featured Article Series by Private Client Services (PCS).

PCS was conceived on 1 October 2007 as a network of professionals with deep industry experience and dedicated resources that focuses on the needs of entrepreneurs, owner-managed and family businesses. We know you want more than just another consultant that delivers recommendations and reports. Our PCS team wants to be your trusted business advisor to deliver practical business advice, and we want to grow alongside you and your business.

Through this sharing of some of the topics and issues that are pertinent to you, business owners, we hope to offer you valuable insights and solutions in addition to showcasing the capabilities of our local experts and global network/knowledgebase.

We hope that this issue will be an interesting and useful read, and we look forward to sharing further instalments with you.

**Ng Siew Quan**  
Private Client Services Leader  
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## Are your internal controls supporting your business strategy?

In years past, the term 'internal controls' was rarely mentioned in the business section of newspapers or in business magazines. Today, however, thanks to recent headlined scandals, frauds, and business failures, you are almost as likely to see internal controls mentioned on the front page of the newspaper as in the business section.

More often than not, the name Sarbanes-Oxley will appear in the same story. This, of course, refers to the 2002 US legislation requiring US public companies to meet strict requirements for implementing, documenting, and testing internal controls. Its enactment was a response to widely-publicised control failures and their sometimes catastrophic consequences.

The law was enacted as a corrective measure. What has emerged as companies work to bring them into compliance, however, is the significant business benefits that flow from the strengthened internal controls it mandates.

In answering this primary question of whether you have adequate internal controls to support your business strategy, perhaps you may begin by addressing these other questions.

### Where are the greatest risks to a private company?

#### **Weak controls**

First, there is the control environment. If the critical 'tone at the top' is unclear and poorly communicated, a concrete focus on promoting ethical behavior may be lacking: no written code of conduct; no ethics hot line; and no advisory board in an oversight role. Controls may also be detective rather than preventive – designed to uncover problems after they occur, rather than prevent them from occurring. In such an environment, the company may not even have a process for reviewing significant non-routine transactions involving management.

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Or, a company may simply lack controls to prevent incidents such as:

- Inappropriate revenue recording
- Unauthorised revenue transactions (pricing changes, credit limit authorisations, weak customer acceptance policies)
- Excess inventory purchases
- Purchases of products and services at higher-than-expected costs
- Unapproved payroll changes, risking unauthorised salary increases, employee salaries in excess of authorised levels, and the potential for fictitious or 'no-show' employees
- Unauthorised wire transfers
- Inappropriate investment of excess funds
- Unnecessary fixed-asset purchases
- Theft

Smaller companies often struggle to segregate duties effectively without hiring significantly more administrative personnel. However, appropriate segregation of duties can be achieved, even in smaller companies, by the involvement of senior management in the review and approval process.

#### **Poor information**

Another risk is that the information used to monitor operations may be flawed or inappropriate. Shortcomings may include a lack of sufficient detail, inattention to the details provided, or over-reliance on reports containing source data that is not periodically checked.

In some cases, employees may not understand the rationale behind procedures they have to perform or even the specific procedures that they should perform to ensure compliance with internal controls processes. Staff turnover, a significant issue in today's business environment, exacerbates this problem as does failure to document policies and procedures. Documentation is critical because as people change roles and responsibilities, there needs to be a process to ensure that controls assumed to be in place and operating are in fact continuing when a new employee takes on that responsibility. This safeguard will prevent the control process from going away with the former employee.

#### **Inadequate security**

The failure to secure financial and physical assets is a serious control risk. Likewise, access to information technology assets, both hardware and software is also important. Often omitted from this is intellectual property, such as formulas and customer information.

#### **Regulatory non-compliance**

Finally, regulatory non-compliance is a significant control risk that demands the focused attention of private companies. Agencies such as the Monetary Authority of Singapore (MAS), Inland Revenue Authority of Singapore (IRAS), and the Accounting and Corporate Regulatory Authority (ACRA) issue and enforce regulations that apply to both private and public companies. If employees do not follow the relevant company policies and procedures, or do not know what they are, problems are likely to ensue.

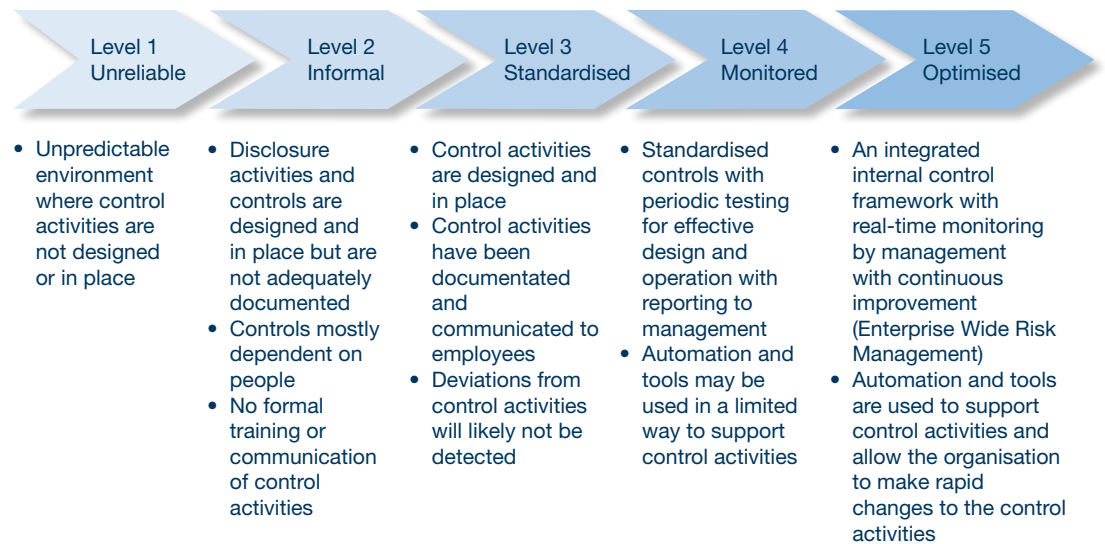
“In many, if not most private companies, controls are informal. As a consequence, controls may not be known or adhered to, or may not be accomplishing their objectives. While management may believe controls are in place, they may not be functioning as intended, may not be fully implemented, or may not have been initially implemented at all.”

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## Where is your company on the internal controls maturity framework?

The following illustration identifies the stages of maturity in private companies' control programmes.





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## Initial questions when evaluating internal controls

The following questions have been provided as guidance in evaluating the basic principles representing the fundamental concepts associated with the five components of internal control.

### Control environment

- Has management developed and clearly articulated a statement of integrity and ethical values that is understood by all employees?
- Are processes in place to monitor adherence to and remedy deviations from these values?
- Does the company have a board of directors/advisors, consisting primarily of individuals outside of management, with defined roles and authority, to evaluate the risk of management override of internal controls?
- Do its members meet with the auditors, oversee the quality of financial reporting, and evaluate business decisions?
- Do management's philosophy and operating style set the tone for the organisation with both internal staff and external parties?
- Is the company's organisational structure formalised and documented with an organisation chart that sets forth roles, job descriptions, authority, and reporting line responsibilities for all employees?
- Are key employee roles aligned with operating and financial reporting processes?
- Does the company have competent individuals in financial reporting and oversight roles?
- Do the company's human resource practices demonstrate its commitment to integrity, ethical behavior, and competency in the recruiting, training, development, and evaluation of employees?

### Risk assessment

- Does management specify financial reporting objectives with sufficient clarity to enable the identification of risks that might affect the reliability of such information? Such risk assessment should include business processes, information technology and both internal and external factors.
- Does management consider the potential for fraud in its financial reporting risk assessment – including incentives and pressures to commit fraud, the likelihood of fraud, and the impact of fraud on financial reporting?
- Does the company implement anti-fraud programmes and controls?

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### **Control activities**

- Does the company design control activities to mitigate financial reporting risks, considering all points of entry into the company's general ledger?
- Do the control activities, where appropriate, use information technology tools to identify and manage fraud risk?
- Do the designed control activities encompass a full range of activities, including approvals, authorisations, reconciliations, verification, reviews of operating performance, security of assets and segregation of duties?
- Do these activities balance preventive and detective controls?
- Have policies and procedures been established, documented and communicated throughout the company?
- Are they performed on a timely basis and built into the company's regular business processes, enabling management's directives to be carried out?
- Have information technology controls been designed to ensure the completeness and accuracy of valid and authorised transactions?
- Are critical general computer controls in place to ensure the integrity of the system and of the data processed?

### **Information and communication**

- Is the pertinent information captured being provided on a current and accurate basis and used to help achieve financial reporting objectives?
- Is such information being distributed and used to execute the appropriate control components of financial reporting, permitting prompt resolution of exceptions and maintaining the quality of the information produced?
- Does the company's communication enable all personnel to understand internal control objectives and processes, their responsibilities in achieving internal control objectives, and the importance attached to those responsibilities?
- Are communication channels available to outside parties to facilitate their input on information affecting the achievement of financial reporting objectives?

### **Monitoring**

- Does the company continuously monitor its internal controls over financial reporting, use knowledgeable personnel to evaluate the results of such monitoring, and adjust the scope and frequency of evaluations to determine whether controls are functioning as designed?
- Are internal control deficiencies identified and communicated in a timely manner to parties responsible for taking corrective action, and to management and the board/ advisors as appropriate?
- Is timely corrective action in fact taken?



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## Benefits for private companies

Appropriate and properly functioning internal controls offer powerful benefits to private companies in a number of key areas. If the owners of a private company are considering the sale of all or part of the entity, or are seeking private equity financing, effective controls can increase prospective buyers' willingness to pay a premium for the acquisition. Controls enhancements can also lower borrowing costs and help attract new business partners.

Many potential private-equity investors and venture-backed companies are also seeking to invest in companies with strong and well-documented internal controls. Should these companies eventually go public, the road to compliance will be an easier process.

Private companies which actively seek to enhance their internal controls, ensure the credibility of financial information, and receive the operating benefits that a strong system of internal controls can provide such as:

### Financial reporting benefits

- Heightened credibility provided to all stakeholders, whether they be owners, employees, customers, lenders, or vendors
- Better information to manage the business
- Reduced risk of errors or irregularities

### Operational benefits

- Clarity on the roles and responsibilities of both management and employees
- Greater controls over the management of business growth
- Reduced costs obtained from greater operating efficiency
- Maximised operating performance

### Regulatory benefits

- Decreased risk of litigation or business disruption, thanks to the focus on compliance
- Lowered risk of employee or customer litigation
- Increased credibility with MAS, IRAS and other regulators
- More credibility in contractual relationships with vendors and customers

The bottom line for business owners – increased focus on internal controls maximises the value of a business.

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## **The time to act is now**

For public and private companies alike, the emphasis is on, and need for, effective internal controls will increase as business becomes more complex. Companies should strive to achieve these effective internal controls and derive the significant business benefits that flows from their implementation.

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