

## EFFECTIVE GOVERNANCE, RISK MANAGEMENT, AND INTERNAL CONTROL

### IFAC:

- considers it is in the public interest that organizations have integrated and effective governance, risk management, and internal control;
- recognizes that professional accountants have the requisite skills to play critical leadership and support roles in planning, implementing, executing, evaluating, and improving governance, risk management, and internal control;
- encourages greater global consistency in principles and guidelines that assist all organizations to implement governance, risk management, and internal control as integrated parts of their management system; and
- is actively engaged in these topics, helping to promote relevant knowledge, experience, and learning.

### Introduction

IFAC believes that establishing an integrated and effective system of governance, risk management, and internal control is desirable for all types of organizations and can make an invaluable contribution to achieving sustained organizational success. When organizations fail, the costs to society can be considerable.<sup>1</sup> This was illustrated during the global financial and sovereign debt crises, when the failure of organizations—irrespective of size or structure, or whether in the private sector or public sector—led to a variety of adverse consequences. These included loss of social, financial/economic, or environmental value; reduced services; deprived stakeholders; the need for government bailouts and subsidies; increased unemployment; and, in extreme circumstances, civil unrest.

In acknowledging the importance of governance, risk management, and internal control to successful and sustainable organizations, IFAC:

- considers it is in the public interest that organizations should strive for integrated and effective governance, risk management, and internal control, embracing both conformance<sup>2</sup> and performance<sup>3</sup> aspects;
- recognizes that professional accountants, both those within organizations and those advising organizations, have the requisite skills to play critical support and leadership roles in planning, implementing, executing, evaluating, and improving governance, risk management, and internal

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<sup>1</sup> Refer IFAC letter dated June 5, 2012, [Global Sustainability and Growth: Recommendations for the G-20 Leaders' Summit – June 18-19, 2012](#)

<sup>2</sup> Conformance is viewed as compliance with laws and regulations, best practice governance codes, accountability, and the provision of assurances to stakeholders in general. The term can refer to internal factors defined by the officers, shareholders, or constitution of an organization, as well as external forces, such as consumer groups, clients, and regulators.

<sup>3</sup> Performance is viewed as policies and procedures that focus on opportunities and threats, strengths and weaknesses, strategy, value creation, and resource utilization, and guide an organization's decision making.

control. In many cases, they are in positions of strategic or functional leadership, or are otherwise well placed to partner with other disciplines. In addition, professional accountants have a responsibility to provide objective, accurate, and timely information and analyses to support these activities;

- encourages greater global consistency in principles and guidelines<sup>4</sup> that assist all organizations, their governing bodies, and management to implement governance, risk management, and internal control as integrated parts of their management system. This leads to enhanced, better-informed decision making, more effective control, and sustainable organizational performance; and
- is actively engaged in these topics, helping to promote relevant knowledge, experience, and learning, in particular through its Professional Accountants in Business (PAIB) Committee. Among its objectives, the PAIB Committee provides leadership and guidance on a range of issues, including governance, risk management, and internal control.

IFAC recognizes that there are considerable differences between the stages of development and level of maturity of principles and guidelines for governance, risk management, and internal control, especially at the global level.

Furthermore, it recognizes that awareness and implementation of effective governance arrangements are important for all organizations. However, they will differ between organizations of different sizes. While larger organizations may have robust arrangements centered on a governing board and board sub-committees, effective arrangements for smaller organizations might be structured around individual owner-managers and external service providers.

### **Public Interest**

IFAC is of the view that it is in the public interest for organizations to be well managed, act ethically, consider long-term sustainable organizational performance, be transparent, and be responsive to a broad range of stakeholders. These objectives can best be achieved when organizations effectively integrate governance, risk management, and internal control within their organization.

### **Ethical Behavior**

A central feature of most organizations that effectively integrate governance, risk management, and internal control in their overall management system is a robust ethical culture. The systems, processes, and practices of these organizations typically embody and reflect strong ethical behavior, emphasizing the importance of ensuring not only that well-designed and effective arrangements are in place, but also that ethical behavior is expected, required, recognized, and rewarded.. In this regard it is critical for organizations to adhere to certain fundamental principles, such as transparency, trust, and integrity.

IFAC recognizes that governing bodies, management, and other employees are at times presented with ethical dilemmas and conflicts. It is therefore important for organizations to have in place arrangements and processes to enable these dilemmas and conflicts to be addressed and to ensure that appropriate behavior ensues. At an organizational level, it is common for codes of conduct to be established, promoted, and enforced. Typically, these codes should provide a means or process by which those confronted by an ethical dilemma or conflict can address them. At a personal level, board directors, managers, and other employees who are members of professional organizations are typically obliged to comply with codes of ethical behavior for their profession. For example, professional accountants are

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<sup>4</sup> "Guidelines" is a collective term for the various frameworks, standards, or guidance documents.

obliged to comply with requirements of the International Ethics Standards Board for Accountants (IESBA) *Code of Ethics for Professional Accountants*.<sup>5</sup>

## **Transparency and Reporting**

IFAC believes that organizations should be transparent in reporting on the structure and performance of their governance, risk management, and internal control arrangements in their various reports to internal and external stakeholders. This can be achieved through periodic accountability reports or a description on the organization's website. Organizations should report not only on the existence of an integrated management system, but also on major risks the organization faces, the controls it has established, how internal control is monitored and evaluated, how the system works, and what has been done to remediate any control failures or weaknesses. A better understanding of how an organization manages its risks creates trust and provides reassurance to its stakeholders.

## **Effective Governance, Risk Management, and Internal Control**

### *Governance*

Governance involves the set of responsibilities and practices exercised by the governing body and management of an organization with the goal of:

- providing strategic direction;
- establishing accountability for achieving objectives;
- ascertaining that risks are managed appropriately; and
- verifying that the organization's resources are used responsibly.

Successful organizations adhere to governance principles, and periodically evaluate results to ensure the continuing effectiveness of their governance arrangements. As organizations and their environments change, their governance must adapt to opportunities and threats by reviewing and revising objectives and improving processes and practices.<sup>6</sup>

### *Risk Management and Internal Control*

Risk is faced by all types of organizations and is not inherently negative. Successful organizations identify and manage risk when considering and choosing among appropriate opportunities. Risk management and internal control are significant parts of effective governance and fundamental to supporting the achievement of an organization's objectives and to creating, enhancing, and protecting stakeholder value.

IFAC considers that, together, risk management and internal control, as integrated parts of an organization's overall governance system, is:

- effected and understood by an organization's governing body, management, and other personnel;
- applied in strategic settings, both across an organization's operations and in its stakeholder communications; and

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<sup>5</sup> The IESBA *Code of Ethics for Professional Accountants* includes a conceptual framework that uses a "threats and safeguards" approach to addressing ethical dilemmas and conflicts. In applying the code, professional accountants need to determine the threats to compliance with the principles and requirements described in the code; and then apply safeguards that eliminate the threats, or reduce them to an acceptable level.

<sup>6</sup> Refer [International Good Practice Guidance: Evaluating and Improving Governance in Organizations, 2009](#).

- designed to help its users identify, analyze, mitigate, and manage risks in line with the organization's risk appetite and risk management strategies.

The overall governance system should provide a reasonable level of confidence regarding the achievement of organizational objectives. It should also provide for proper disclosure regarding the effectiveness of the risk-management and internal control systems.

Successful organizations take advantage of opportunities—and, in many instances, counter threats—through effective application of risk management and internal control, and therefore improve their performance.

### **Contribution of Professional Accountants**

IFAC estimates that there are over one million professional accountants worldwide working to support organizations in commerce, industry, financial services, education, and the public and not-for-profit sectors, and to make those organizations more successful and sustainable. Those professional accountants form a very diverse constituency, and can be found working as employees, advisors, consultants, and self-employed owner-managers.

Evaluating and improving governance, risk management, and internal control are among the core competences/capabilities of professional accountants. Therefore, organizations can be confident that professional accountants are able to contribute strongly to meeting organizational objectives in these areas.

Professional accountants play a leading role in ensuring that governance, risk management, and internal control form an integral part of an organization's overall management system.<sup>7</sup> In addition to those professional accountants working to support organizations directly, there are others—such as external auditors, assurance providers, and business advisors—who provide professional services that aim to promote more robust governance arrangements.

Whether providing direct support or professional services, professional accountants are obliged to act in accordance with a code of ethics. This requires the ethical behavior necessary to ensure that governance arrangements operate effectively.

### **Global Consistency**

IFAC believes that, from an international perspective, governance, risk management, and internal control guidelines should be principles-based as opposed to prescriptive—what works in one environment may not work, or might work differently, in another. In striving for global consistency, it is important to note that there are differences between people, structures, places, and views on what governance, risk management, and internal control mean. There are also differences in legislation—and the maturity of legislation—governing the operation of organizations in different jurisdictions.

IFAC acknowledges that global consistency should provide sufficient flexibility to accommodate the environmental context of individual companies and the different governance problems that arise in different jurisdictions, as well as the specifics of individual organizations.

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<sup>7</sup> Refer [Evaluating and Improving Internal Control in Organizations](#) (2012) and [Eleven Principles for Effective Business Reporting Processes](#) (Exposure Draft, 2012) - Professional accountants in business are involved in the design, planning, execution, audit, evaluation, and improvement (or, in short, the implementation) of their organizations' reporting processes.

When promoting effective governance at a global level, IFAC believes that the Organisation for Economic Co-operation and Development OECD *Principles of Corporate Governance*<sup>8,9</sup> provide international guidelines to effectively govern the relationship between the managers and owners of organizations, as well as other stakeholders. The OECD Principles are one of the 12 key standards for international financial stability recognized by the Financial Stability Board, and form the basis for the corporate governance component of the Report on the Observance of Standards and Codes (ROSC) of the World Bank Group.

### **The Role and Work of IFAC**

IFAC promotes enhanced, globally consistent governance, risk management, and internal control arrangements in a number of ways. Among many things, it:

- actively engages on these topics, in particular through its PAIB Committee, which:
  - provides leadership and guidance on a range of relevant issues, including governance, risk management, and internal control;
  - seeks to achieve global recognition of professional accountants in business as organizational leaders and strategic partners in building long-term sustainable organizational success; and
  - promotes awareness of the important roles professional accountants in business play in creating, enabling, preserving, and reporting value for organizations and their stakeholders
- makes regular submissions to G-20 governments detailing recommendations consistent with the positions identified in this paper;
- issues a range of publications and international good practice guidance;<sup>10</sup>
- convenes meetings, roundtables, and conferences of experts and key stakeholders to discuss and debate governance and risk management issues; and
- collaborates on these topics to develop views and promote the value of robust and effective integrated systems of governance, risk management, and internal control, with a number of international organizations.

### **Implications for IFAC Members and Associates**

IFAC encourages members and associates to contribute to advancing IFAC's positions presented in this paper by:

- promoting awareness of these matters, especially within their own jurisdictions;<sup>11</sup>
- developing professional education and continuing professional development (CPD) offerings that address topics pertaining to governance, risk management, and internal control; and

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<sup>8</sup> IFAC's guidance on governance is designed to complement the OECD Principles by encouraging organizations to achieve a balance between conformance with rules and regulations and driving organizational performance in terms of opportunities and risks, strategy, value creation, and resource utilization.

<sup>9</sup> Refer [OECD Principles of Corporate Governance](#).

<sup>10</sup> Refer [Publications & Resources](#) of the PAIB Committee.

<sup>11</sup> Publications in the areas of governance, risk management, and internal control—together with the various international guidelines to which IFAC contributes—form a good base for promoting awareness, developing CPD, and promoting the need for enhanced arrangements.

- utilizing their relationships, where appropriate, with governments and regulators to promote the need, and provide the guidelines, for enhanced governance, risk management, and internal control arrangements.

This Policy Position has been prepared by IFAC. The approved text of this Policy Position is published in the English language. For further information, please email: [publicpolicy@ifac.org](mailto:publicpolicy@ifac.org)

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#### **IFAC'S MISSION**

IFAC's mission is to serve the public interest by:

- Contributing to the development of high-quality standards and guidance
- Facilitating the adoption and implementation of high-quality standards and guidance
- Contributing to the development of strong professional accountancy organizations and accounting firms and to high-quality practices by professional accountants, and promoting the value of professional accountants worldwide
- Speaking out on public interest issues