

Case Study on CoSO I Framework

Merger & Acquisitions

The preliminary due diligence of Internal Control System (ICS) of Target Company

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Disclaimer

Even if based on praxis and real experiences, the case study does not refer to any specific operating company. It should be intended as representative teaching material, provided to the attending students for discussion, analysis and insights.

Therefore, any evaluations are merely indicative, with the purposes of illustrating and understanding the proposed methodology

Target Company – Highlights

Context (Internal / External)

- **Main sectors / markets:** The Target Company (ABC) is the main subsidiary utilized by an International Group for commercial and bidding activities in Australia. The Target Company has the sole control over another Australian Construction Company (KYX) and with its head office structure located in Sydney ensures direction and coordination on all initiatives in Australia. Current activities are focalized on Business Development, with a focus on complex and larger infrastructure projects, including DBF and concession projects. Main market are Social Infrastructure, Power/Environment, Transport, Private Sector.
- **Ongoing Projects:** One mega project is directly performed by ABC, with a special purpose vehicle (SPV). Several little projects are executed through KYX
- **Main Clients:** LPP Energy (a provincial crown corporation under the Government of Queensland) is the owner of the Mega project and main client of ABC.
- **New Acquisitions:** Future Outlooks will be formalized with the approval of 2018 Business Plan. ABC is currently developing several initiatives in New Galles regarding transports' sector.

Scope of the Audit

- **Control Governance:** Assessment of existence and effective functioning of main interrelated components of the Internal Control - Integrated Framework (Entity Level Controls), as stated by COSO 2013*:
 - Control environment
 - Risk Assessment
 - Control Activities
 - Information and Communication
 - Monitoring Activities

Executive Summary

Introduction

Internal Audit Department of AAA performed an internal audit engagement on ABC, which has included analysis on head office's main processes with a focus on entity level controls. Engagement purpose has been a general assessment of the Internal Control System (ICS) which ABC is developing and formalizing, after the finalization of the new corporate structure that has been initiated in January 2017.

This engagement is advisory in nature and is a part of a preliminary due diligence AAA is performing on ABC, before any decisions regarding the acquisition

Audit Objective & Criteria

The assessment of adequacy and effectiveness of internal control system (ICS) is aimed at evaluating the five Complementary Elements of a proper and functioning ICS as described by Internal Control - Integrated Framework (CoSO 2013): control environment, risk assessment, information and communication, control activities, monitoring. For our evaluation, the criteria used are the principles and main points of focus provided by CoSO Framework, making considerations in terms of existence, effective functionality and integration of the main company controls and taking into account existing practices and drafted procedures.

The subsidiary doesn't adopt an Integrated Management System (IMS), but is developing its own system ensuring consistency and interface with the Group one. At the audit date, this process was in progress and there were not any formalized policies or procedures.

Executive Summary

Evaluation Criteria



Compliant

- The point of focus exists and is properly working
- All the points of focus related to a single principle exist and are properly working
- Most of the principles related to a single component exist and are properly working and are integrated



Partially Compliant

- The point of focus exists but should be improved in order to meet the standard
- Most of the points of focus related to a single principle exist or should be improved in order to meet the standard
- Some principles related to a single component do not exist or should be improved in order to meet the standard



Not Compliant

- The point of focus does not exist
- Most of the points of focus related to a single principle do not exist
- Most principles related to a single component do not exist, should be improved in order to meet the standard or are not integrated

Internal Control Questionnaire and Assessment

Control activities

Control activities are the actions established by policies and procedures to help ensure that management directives to mitigate risks related to the achievement of objectives are carried out. Control activities are performed at all levels of the entity and at various stages within business processes, and throughout the technology environment

| # | Principle | Point of Focus | Assessment | Evaluation | Recommendation |
|----|---|--|--|------------|--|
| 10 | The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels | Addresses segregation of duties | SoD principles are embedded into current practices and transaction control activities, mainly for main sensitive processes (es. purchase-to-pay, personnel administration, treasury and finance, accounting, business development / tenders / equity investments). However, the lack of a formalize organizational structure (in term of not codified roles, reporting lines and responsibilities / signing authorities matrix) could result in situation of excessive discretionary power, confusion and duties' overlapping | M | To finalize as soon as possible the IMS definition and implementation, following general principles provided by Group Guidelines, in order to avoid incompatible functions and to map identified risks to control activities (matrices, inventory of control activities, traceability requirements) |
| 11 | The organization selects and develops general control activities over technology to support the achievement of objectives | --- | IT Governance is based on COBIT standards and has been certified | H | --- |
| 12 | The organization deploys control activities through policies that establish what is expected and procedures that put policies into action | Establishes Policies and Procedures to Support Deployment of Management's Directives | The manager of Quality Assurance Dept has been appointed, with a functional reporting line to Area Sustainability And Integrated Management Department and Group's Sustainability and Integrated Management Department. The new department has the aim to lead the implementation of a management model that should be consistent with the Group's one, by developing the Integrated Management System. At the date of the audit, all IMS Documentation (including: Policy, QHSE Manual, OrgChart, JD Handbook, Management Procedures, etc) were or in draft version or not yet elaborated. A plan of issuance for all main MP, OP & Policies has been defined and should be finalized by the end of 2018. | M | (See principle 10). We specify that to be consistent with Group Guidelines on 231 Compliance Program, the ACEi IMS shall ensure: 1. Existence of formal procedures; 2. Traceability; 3. Segregation of Duties, 4. formal Delegation of Authorities. "Existence of formal procedures" requires compliance with Guideline XXXXXXXXXXXXXXXXXXXX, relating to the setting, definition and development of business management system for the entities belonging to the Group |
| | | Establishes Responsibility and Accountability for Executing Policies and Procedures | Lack of defined JDs and IMS Resp. Matrix could cause deficiencies in term of communication of control objectives and reporting lines, considering also several organizational change and new not-codified roles. | M | To finalize the IMS Resp. Matrix To incorporate Responsibility Matrixes in all future Management Procedures (MP) and Operative Procedures (OP) |
| | | Reassesses Policies and Procedures | Once issued the IMS, there should be periodical management review and system performance monitoring tools | N/A | --- |

Example

Internal Control Questionnaire and Assessment

Control environment

The control environment is the set of standards, processes and structures that provide the basis for carrying out internal control across the organization. The board of directors and senior management establish the tone at the top regarding the importance of internal control and expected standards of conduct

| # | Principle | Point of Focus | Assessment | Evaluation | Recommendation |
|---|---|---|--|------------|----------------|
| 1 | The organization demonstrates a commitment to integrity and ethical values: | Sets the tone at the top | The organization structure is still unofficial and this could affect negatively in term of: - Leadership - Pursuing common values, missions, objectives | | |
| | | Establishes standards of conduct | ABC adopted a Code of Ethics and effectively communicated it to all staff and outsourced service providers (OSPs). ABC website includes information on mission and values which are not exactly consistent with Group's ones. ABC policies (Quality, Health & Safety and Environment Project Policies) should be aligned with Group's Sustainability Model and Policy | | |
| | | Evaluates adherence to standards of conduct and Addresses deviations in a timely manner | An Ethic Officer with the duty of evaluating adherence to expected standards has been formally nominated by the BoD. There are needs of improvement in order to effectively implement ethical standards (See principle 5) | | |
| 2 | The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control | Establishes oversight responsibilities | Bod meets with senior management every month with a detailed agenda and MoMs | | |
| | | Applies relevant expertise | There are internal and external members with multidisciplinary expertise | | |
| | | Operates independently | There are not independent and not-executive directors, but this is reasonable considering: current capital structure, company by-law and the aim to protect sole shareholder's interests. Regarding conflict of interest management, principles are provided only by the Code of ethic | | |
| | | Provides oversight for the system of internal control | BoD retain authority over significant decisions, review management's assignments, approves the budget, reviews financial statement estimates and interacts with external auditors. Organization structure should be formally approved by the BoD, including powers and limitations of authorities | | |

Internal Control Questionnaire and Assessment

Control environment

| # | Principle | Point of Focus | Assessment | Evaluation | Recommendation |
|---|--|---|---|------------|----------------|
| 3 | Management establishes, with broad oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives | Considers all structures of the entity | Company organization chart has not been formally issued, either at enterprise or at departmental level. We analyzed the draft of the Organizational Chart REV, not yet approved: this draft doesn't indicate the managers of each department. Moreover doesn't include the organization under Finance & Concessions | | |
| | | Establishes reporting lines | Company Job Descriptions Handbook has not been formally issued, as well as the other document of the IMS: as a consequence, current reporting lines, even if known, are unofficial. In order to defining authorities at different levels of management, RACI Matrix and Delegation of authority signing Matrix are needed | | |
| | | Defines, assigns, and limits authorities and responsibilities | According to the Corporate Structure as of November 2017, ABC Boards consists of 5 Directors (including the Chairman and Interim CEO), which can represent the Company. The Company has also 7 officers (non directors): for some of these (in particular for recently appointed VPs) we don't have evidence the BoD resolutions or POAs which are needed to define delegation of signing authorities and limitations | | |
| 4 | The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with Objectives | Establishes policies and practices | HR Policies and Practices are consistent with Relevant general Principles | | |
| | | Evaluates competence and addresses shortcomings | Some ABC employees have been involved in Group Academy Training Program, which is managed directly by Parent Company HR Dept. At country level, there is not any specific and structured training program for ABC corporate staff. The onboarding process of new hired employees (including officers / VPs) doesn't encompass an induction on management systems, procedures, practices, requirements, etc.. | | |
| | | Attracts, develops, and retains individuals / Plans and prepares for succession | Several organizational changes are ongoing, starting from the decision to transfer the HeadOffice. These changes could affect organization integration if the objectives are not clearly communicated | | |

Internal Control Questionnaire and Assessment

Control environment

| # | Principle | Point of Focus | Assessment | Evaluation | Recommendation |
|---|---|---|--|------------|----------------|
| 5 | The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives | Enforces accountability through structures, authorities, and responsibilities / Evaluates performance measures, incentives, and rewards for ongoing relevance / Considers excessive pressures | Performance measures, incentives, and rewards are based on predefined standards and centrally monitored. A performance evaluation process is initiated annually and it's managed in order to link compensation and other rewards to performance. Among other, performance evaluation criteria include internal control responsibilities, in order to align incentives with ethics and values | | |
| | | Evaluates performance and rewards or disciplines individuals | <p>The disciplinary system has been implemented but there are area of improvement:</p> <ul style="list-style-type: none"> - In order to implement the Code of Ethic, any misconduct should be reported through an hotline (even anonymous) directly connected to the Ethic Officer e-mail address; - All the employees should be informed regarding the possibility to communicate through this hotline. | | |

Internal Control Questionnaire and Assessment

Risk assessment

Risk assessment involves a dynamic and iterative process for identifying and analyzing risks to achieving the entity's objectives, forming a basis for determining how risks should be managed. Management considers possible changes in the external environment and within its own business model that may impede the ability to achieve its objectives.

| # | Principle | Point of Focus | Assessment | Evaluation | Recommendation |
|---|--|---|--|------------|----------------|
| 6 | The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to Objectives | Exercises judgment in areas such as specifying suitable objectives and sub-objectives and assessing risks to achieving these objectives | Objectives (with a focus on Business & Area Development) are clearly defined into the ABC Business Plan and included into the Industrial Plan. Performance is monitored on a on-going basis, with monthly updating. Strategic Planning and Management Control is based on Group procedure and systems | | |
| | | Considers risk appetite and risk tolerance in defining strategies and objectives | There is a risk appetite framework and relevant statements | | |
| | | Defines Compliance Objective in order to reflects external laws and regulations | There are several compliance bases risk assessment | | |
| 7 | The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed | Includes entity, subsidiary, division, operating unit, and functional levels / Analyzes internal and external factors; Involves appropriate levels of management; Estimates significance of risks identified / Determines how to respond to risks | Risks are identified : - For New BD Opportunities / Acquisitions / Projects Selection (as documented into the Business Plan, Acquisition Plan, and Tender Forms for each bid) - At project level (i.e. Mega Project planning, budgeting and monitoring process, Project risk Management Plan (PGR) and Risk Registers). At country level, a Risk Manger has not been appointed; with the exceptions of mentioned areas, Risk Management is managed with a unformal and scattered silo based approach (in term of risk identification, analysis, and response) | | |
| 8 | The organization considers the potential for fraud in assessing risks to the achievement of objectives | Considers various types of fraud / Assesses incentive and pressures / Assesses opportunities / Assesses attitudes and rationalizations | Fraud Risk Assessment / Auditing are performed at Group Level by the Parent Company, with the assistance of external advisors. ABC has not adopted and implemented corporate procedures on Anti- frauds and Anti - corruption | | |
| 9 | The organization identifies and assesses changes that could significantly impact the system of internal control | Assesses change in the external environment / business model / leadership | As already reported (see principles 1, 2, 4) change management is a current critical factor for ABC, considering that: 1. The new Corporate Structure has been just finalized; 2. The BP is re - focalizing on major civil projects with a preference of DBF Contract Type; 3. The organization structure of the Finance and Concessions team is not clearly defined; 4. Integration with KYX is still on going | | |

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Internal Control Questionnaire and Assessment

Information and communication.

Information is necessary for the entity to carry out internal control responsibilities in support of achievement of its objectives. Communications occur both internally and externally, and provide the organisation with the information needed to carry out day-to-day controls. Communication enables personnel to understand internal control responsibilities and their importance to the achievement of objectives.

| # | Principle | Point of Focus | Assessment | Evaluation | Recommendation |
|----|--|--|--|------------|----------------|
| 13 | The organization obtains or generates and uses relevant, quality information to support the functioning of other components of internal control. | Processes Relevant Data into Information | Strategic Planning and Management Control, and relating monitoring and reporting systems, are in line with current Group's requirements and practices. The ABC's accounting system and financial reports are based on International Accounting procedures . At the moment there isn't any consolidated monthly management report at ABC / Country level | | |
| | The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control | Provides Separate Communication Lines | (See principle 5) | | |
| | The organization communicates with external parties regarding matters affecting the functioning of internal control" | Communicates to External Parties | There isn't any procedure on External Relations Management. <i>Price sensitive</i> information must be handled in adherence with MP "Continue Information Management", which is an generalprocedure applicable also to foreign subsidiaries. | | |

Internal Control Questionnaire and Assessment

Monitoring activities

Ongoing evaluations, separate evaluations, or some combination of the two are used to ascertain whether each of the five components of internal control, including controls to affect the principles within each component, is present and functioning. Findings are evaluated and deficiencies are communicated in a timely manner, with serious matters reported to senior management and to the board

| # | Principle | Point of Focus | Assessment | Evaluation | Recommendation |
|----|---|--|--|------------|----------------|
| 16 | The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning | Considers a mix of ongoing and separate evaluations | Monitoring activities are basically performed on a on going basis by the first level of defense, with management oversight provided by Strategic Planning & Management Control Dept, Project Control and Adm & Finace Dept. Coordination and oversight activities are as well under the responsibility of Area Managers, which report to Australia Deputy General Manager (Strategic Sourcing Procurement Coordinator, Overseas HR coordinator, Area Sustainability and Integrated Management Coordinator). Regarding the second level of defense, Quality Assurance Dept (SGIP) has been just established, but internal auditing activities will be initiated after the implementation of IMS and related procedures. In any case, Quality Assurance Dept has been involved in auditing activities executed by SGIG (Group's Sustainability And Integrated Management Department). The 262 testing activities (financial audit) are performed by CFO with checklist, which are periodically sent to Parent Company. Independent audit are not performed by an Internal Audit Department. Independent assurance is also by external auditors | | |
| 17 | The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate" | Assesses results / Communicates deficiencies / Monitors corrective actions | With a focus on the second line of defense, there aren't any procedure on Internal Audit, Non conformances, Corrective/Preventive Actions, Management Review | | |