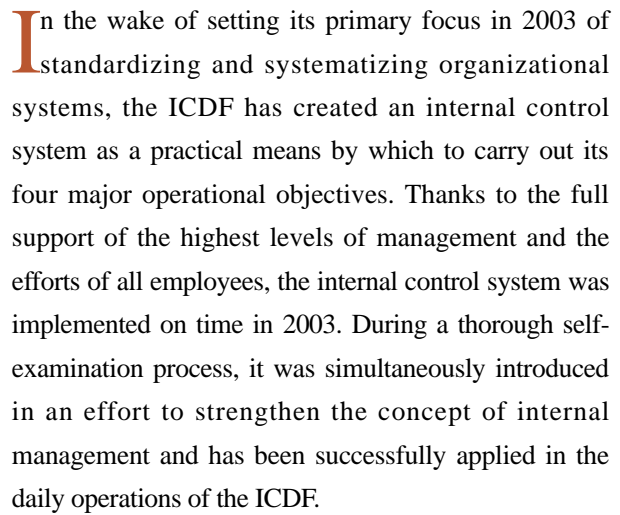


The Establishment of an Internal Control System

A close-up photograph of a person's hand using a calculator. The background is blurred, showing what appears to be a laptop screen with some data or charts.

In the wake of setting its primary focus in 2003 of standardizing and systematizing organizational systems, the ICDF has created an internal control system as a practical means by which to carry out its four major operational objectives. Thanks to the full support of the highest levels of management and the efforts of all employees, the internal control system was implemented on time in 2003. During a thorough self-examination process, it was simultaneously introduced in an effort to strengthen the concept of internal management and has been successfully applied in the daily operations of the ICDF.

This special report is divided into three sections. First, the internal control, auditing and self-audit concepts will be explained in “Internal Controls and the Internal Control System.” The second part details the background of the system, the process in devising and implementing it and the completion of the system. The final portion of the report explains the continued efforts of the ICDF in implementing the system.

Internal Controls and the Internal Control System

Even though the ICDF is a non-profit institution, it seeks to institute corporate governance just like a private sector organization. Corporate governance requires a strong systematic foundation. Given the increasingly diverse nature of operations and the dynamic transfer of officials within an organization, a systematic internal control mechanism is of great importance. Generally speaking, internal control systems, standards and regulations are generally made with profit-oriented companies in mind and have few examples in the non-profit sector. Below is an introduction to the ICDF’s internal control, internal auditing and self-auditing systems.

Definition of Internal Control

According to the definition by Taiwan’s Securities



and Futures Commission, internal controls are designed by a public company's management and are administered and managed by the board, management and all employees. Internal controls aim to guarantee (1) Efficient operational results; (2) Reliability of financial reports; and (3) Adherence to related rules and regulations.

According to this definition, non-profit organizations also need to abide by established operational standards to achieve expected results. The utilization of funds should be based only on established budgetary screening processes and according to rules and regulations. This fulfills the mission and responsibility for the use of base capital.

Important Components of an Internal Control Platform

Public companies, when designing and administering or carrying out self-audits, must consider a wide variety of factors in internal control systems. Only by being comprehensive will these systems operate effectively and achieve the desired effects. Internal control system components were unveiled in 1992 by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission and included Control Environment, Management's Risk Assessment, Information and Communication, Control Activities, and Monitoring. The definition of each component is as follows:

• Control Environment

Control environment refers to the composite factor that impacts employee awareness of the organizational culture. Factors that impact the control environment include: (1) Employee discretion, values and ability; (2) The management philosophy and operational style of the board and managers; (3) The hiring and training of employees; and (4) The concerns and guidance of the board and supervisors. The control environment is the basis of the other components.

• Risk Assessment

Risk assessment refers to recognizing the internal and external factors that prevent goals from being achieved, and assessing the potential risk and impact of a variety of factors. The result of assessments can assist the organization in designing, amending and implementing necessary control operations.

• Control Activities

Control activities refer to designing a comprehensive control framework and setting control procedures at all levels. This guarantees that instructions from the board and managers are carried out, including approvals, authorization, certification, adjustment, reexamination, routine inventory, record verification, division of labor, guaranteeing asset safety, projects, budgets or comparisons with previous results.

• Information and Communication

Information refers to the targets of an information system, such as recognition, consideration, processing and reporting. The system includes operations, financial reporting and adherence to regulations by financial and non-financial information. Communication refers to the relay of information to various people, and to internal and external communications. The internal control system requires information from production planning to supervision and offers a mechanism for the person requiring specific information to obtain it.

• Monitoring

Monitoring refers to the process of self-auditing within the internal control system and includes assessing whether the control environment is satisfactory, whether risk assessment is timely and accurate, whether control operations are appropriate and accurate, and whether information and communication systems include the proper items. Monitoring can be ongoing or done on a case-by-case basis. The former includes



routine supervision of operations, while the latter includes monitoring carried out by internal auditors, supervisors or the board. Reports are made on ongoing supervision, case assessments and oversights.

Internal Audits

The goal of internal audits is to assist the board and managers to investigate and reexamine any problems in internal controls and to judge operational results. Audits also provide constructive suggestions to ensure the continuous and effective implementation of internal control systems. Audits are also used to examine and make amendments to the system.

To ensure the objectivity of internal auditing work, auditing departments are usually directed by the board or president and operate independently. The ICDF's Auditing Office has become more and more professional since its establishment and fully achieves its functional goals.

Self-Auditing Under the Internal Control System

The goal of the self-auditing internal control system is to implement a mechanism under which departments monitor themselves, make necessary modifications to compensate for changes in the environment, and adjust the internal control system when necessary to improve the quality and efficiency of audits. The overall goal is for the organization to become more dynamic. The scope of examination covers all areas of the internal control system, as well as the procedures and methods designed under the self-audit system.

Examination covers all employees and all departments on a regular basis. The Auditing Office then reviews the self-audit reports and compiles them together with any reports on identified oversights or irregularities. The reports are then furnished to the board and the Secretary General, with the reports used as reference in designing management strategies.

A Governance Mechanism

Corporate governance refers to a type of guidance and management that realizes various mechanisms and procedures among management and other persons with an interest in the company to strengthen company results and protect shareholder rights. An effective internal control system provides the foundation for corporate governance. This is carried out under the principles of information transparency and ethical business practices.

Risk Management

Risk management uses management techniques to systematically identify, evaluate, and effectively minimize risk. It also seeks to transform risk into opportunity to create an even greater competitive advantage. The creation of an ideal governance mechanism comes from the drafting and implementation of internal control procedures. It also considers risk as a component of operations and utilizes risk management to adjust organizational strategies as appropriate. Risk evaluation considers systems, strategies, procedures, operations and authorizations to determine potential risks arising from specific procedures or during daily routines. The system also seeks to find a balance between risk and advantage to reduce the level of risk to the organization as much as possible.

The above descriptions of internal controls, internal auditing and self-audit indicate that internal controls and internal auditing are necessary in the framework of organizational operations. Self-auditing, however, is related to internal management and can be used to increase operational efficiency and reduce operational risks. Organizations should establish and administer a comprehensive internal control system as well as undertake self-audits. The board and top-level management must emphasize the function of internal auditing and provide ample authority to auditors to carry out audits and investigations, evaluate oversights

in the internal control system, and quantify operational efficiency. This ensures the effective implementation of the internal control system and helps the board and managers exercise responsibility and institute a governance mechanism. Internal controls and internal auditing must be carried out to ensure that internal operations are being executed effectively.

After appropriately designing and implementing risk management and internal controls, a risk control mechanism can be established. This ensures proper use of resources, increases transparency, strengthens decision-making quality and offers better results in the process of evaluation.

Implementing the Internal Control System

The ICDF carries out international development work on behalf of the government. A wide variety of regulations govern the running of the organization, from rules governing overseas assistance to those governing operations. Each area of operations requires different operational procedures. In light of the increasingly broad and complex operations of the ICDF, as well as the public's increasing interest in Taiwan's foreign assistance work, the ICDF must have even more transparent systems and put its internal management and control mechanism down on paper for all to see.

In light of the subjective and objective environment inside and outside of the ICDF, the organization has established an internal control system. The process used to put the system into practice is detailed below.

Creating an Internal Control System Task Force

Internal controls are a management tool. The implementation and administration of these controls are focal points of work for top-level managers. The system also requires participation by all departments. The ICDF's Secretary General serves as the convener of the

Internal Control System Task Force and department heads comprise the task force. The Auditing Office serves as the secretariat, with the auditing office head serving as the secretary. The primary work of the task force is to set goals and timetables, have regular discussions and evaluate the internal control proposals formulated by each department. The task force also assigned composite ratings based on self-audits.

Dissemination of Concepts

In the initial stage of implementation, each department may be unclear as to the function and content of internal controls. Prior to establishing formally a framework for internal controls, the ICDF held four lectures on relevant topics to enable all employees to have a better understanding of the system.

A brief description of the content of each lecture follows:

• The Establishment of an Internal Controls and Internal Audit System

The financial scandals at Enron in Texas and at Barings in Singapore illustrate the necessity to establish internal controls. An analysis of the relationship between internal controls and corporate governance indicates that internal controls, self-audits and internal audits provide the basis of corporate governance (governance mechanism = internal control system × self-audits × internal audits). A company can achieve sustained operations only through information transparency and by operating in an ethical manner.

In order to introduce systems and boost confidence among ICDF employees, the lecture stressed the advantages of having ICDF employees design the system. Different control methods would be used for different organizational structures. In any event, internal controls should be designed with practical use in mind. The lecture explained various procedures used to create an internal control system for the ICDF.



• **The Use of Corporate Governance in Institutions**

This lecture stressed the concepts of corporate governance as a means to protect shareholder interests, the fair treatment of shareholders, the guarantee of corporate interests, the announcement and transparency of major corporate news, as well as the duties of the board. The use of corporate governance in institutions is necessary to ensure the adherence to regulations in the use of donated funds and budgetary procedures, the release of information, the strengthened functions of the board and supervisors, as well as the implementation of management theories. The internal control system implemented by the ICDF promotes and ensures that such goals are achieved.

• **Organizational Operations and Risk Management**

The content of this lecture included (1) Understanding the present operational environment; (2) Understanding risk management; (3) Recognizing an organization’s operations and potential risks; (4) Outlining the responsibility of contemporary risk management specialists.

• **Internal Controls, ISO and Internal Auditing**

This lecture defined quality and total quality

management from the perspective of the customer and emphasized that the foremost consideration for customers is quality. To be competitive, the organization must guarantee quality. High-level management must have special insight into continuing to improve quality, and all employees have the responsibility to maintain quality. ISO confirms quality systems, not products or services. ISO further achieves verification, not simply certain certification standards. Passage of a quality management system is the starting point for an organization to continue to improve. This is implemented in conjunction with internal controls and internal auditing, enabling the spirit of the quality management system to be introduced into overall operations.

Stages in Establishing the System

To make sure that the establishment of an internal control system is carried out carefully, the ICDF invited an expert as its consultant. The Auditing Office also planned various timetables for implementation. As a general understanding of the system was established, the task force designed a system compatible with ICDF’s environment and culture and set out specific goals. According to the timetable, the ICDF was to complete the written proposal for an internal control system in March 2003, which would be reviewed and

Lecturer	Topic	Time	Position
Hsu Shih-to	The Establishment of an Internal Controls and Internal Audit System	September 26, 2002	Consultant, China Textile Institute Senior
Hsu Hsiao-po Su Wen-tang Tseng Keng-ying	The Use of Corporate Governance in Institutions	September 30, 2002	Director, ICDF (Hsu) Lawyers, Li and Lee Attorneys
Hsu Ting-jung	Organizational Operations and Risk Management	October 2, 2002	Accountant Supervisor, ICDF and Chairman, Risk Management Society
Su Chin-huo	Internal controls, Internal Auditing and ISO	October 14, 2002	President, Corporate Synergy Development Center

passed by the board. Self-audits would begin on a trial basis in the second half of the year.

In order to enable the internal control plan to be implemented smoothly and throughout the organization in its daily operations, the task force decided for the organization to jointly study the system and implement the system in stages to accumulate experience. Three goals were set: (1) Erasing skepticism—increasing the strength of management; (2) Sharing knowledge—increasing organizational study; (3) Forming a consensus—implanting the system into the organization’s culture.

Just as the self-audits were to start, the SARS epidemic hit Taiwan. The implementation of self-audits was delayed from May/June until August. The interim was designated as a study period. To date, only a handful of examinations have been held in departments. The system will be fully implemented during 2004. The delay in implementation this year due to SARS again proves the importance of risk management and the necessity of an internal control system.

Operations related to the establishment of the internal control system and self-audits are detailed below.

Internal Control System Establishing Steps

Draft Plan to Establish and Implement an Internal Control System

In September 2002, the Auditing Office composed the “Draft Plan to Establish and Implement an Internal Control System.” The department analyzed the strengths and weaknesses of the ICDF’s internal controls at the time, evaluated the conditions for implementing internal controls, and made suggestions as to methods to institute the system and a corresponding timetable. The proposal stated that at the present stage of the ICDF’s internal controls, top-level management and all departments were cooperating. In addition, the ICDF exhibited rational organizational planning and a good management structure. The report

concluded that it was the perfect time to further strengthen internal auditing.

Publicizing the Concepts and Methods of the Internal Control System

In addition to being the right time to implement the program and enjoying the full support of management, the plan, to be successful, required the support of department heads as well as the participation of all employees. Therefore, the Secretary General decided to start publicizing the system in operational reports, announcing his determination to achieve certain goals and the efforts made by the task force to design the system. The task force also used a variety of methods to inform employees of the significance, function, and scope of the system in an effort to reach a consensus and foster determination to reach goals.

Organizing Current Management Regulations

The task force also examined all ICDF customs and regulations. This included all rules as well as customs and practices that had yet to be formalized on paper. The task force reviewed all the regulations, organized them, and categorized them into the Internal Control Handbook.

Determining the Mechanism for Various Operations

After understanding the overall control environment and operational procedures, the task force, based on the ICDF’s organizational status, designated eight mechanisms to control operations. Under this, there are 93 types of work that can be controlled. These include the following:

- **Planning Management Mechanism:** This covers planning of the ICDF’s strategies, organization and core work, as well as coordination with supervisory agencies.
- **Investment and Lending Mechanism:** This refers to the



ICDF's investment and lending operations, loan guarantees and the utilization of funds that have yet to be lent out.

- **Operations Mechanism:** This covers the ICDF's technical cooperation, education and training programs, publishing operations and general affairs.
- **Procurement Mechanism:** This encompasses procurement and repair operations.
- **Salary and Personnel Mechanism:** This refers to human resources and personnel management operations.
- **Asset Mechanism:** This refers to operations related to the ICDF's fixed assets, property, materials, information equipment, and management of securities.
- **Accounting and Expenditures Mechanism:** This centers on accounting management, budget management and capital management operations.
- **Service Management Mechanism:** This refers to the ICDF's information system management, supervision of ICDF chops, document management, and management of miscellaneous affairs.

Finalizing the Procedures of Each Control Operation

Clearly delineating the procedures in each operational control is important in clarifying each step of work and responsibilities. Clear documentation of each control procedure facilitates comparisons against procedural charts or regulations.

Designing Document Structure, Form Style and Usage

The ICDF's internal control system has designed forms that highlight operation and management controls as well as a management operations flow chart. The style of the forms meets the practical needs of the ICDF and affords flexibility. The forms are used in conjunction with internal audits and self-audits.

Producing a Management Operations Procedural Chart

After procedures are finalized, a chart is designed and produced to display the procedure of various mechanisms, which becomes the basis for management procedures.

Producing Operations and Management Control Procedures

The focus of this is to point out procedural risks and control points. This is different from standard operating procedures in that the latter centers on the explanation of various procedures. Each department not only must concisely state the focus of their operations, but also must assess risks. After clarifying risk sources, departments then identify specific risks and corresponding preventative measures in the "Risk and Controls" column.

Should controls not be instituted, risks could become obstacles on the path of achieving goals. This is the point of internal controls. After each office and department finalizes controls required in their operations, they must implement them. They must refer to the content of the control system mechanism and also take into consideration operational flexibility and costs to make sure that controls and operational procedures complement each other.

The overall spirit of the internal control framework must be kept in mind in the design and production of the procedural chart and control procedures. As an example, control components are indicated in the following table, which focuses on financing operations.

Finalizing Procedures on Document Management, Safeguarding and Issuance

Each supervisor in the various departments reviews their respective procedural and operational charts. After this review, charts are forwarded to the task force for screening and approval.

Screening Through the Internal Control System Task Force

Work by the task force in designing the system is key to the success or failure of the system. Objectives, operational cycles, operational procedures, the organization of rules, the design of forms and their production

and implementation, and reports to the board are all aspects which the task force needs to discuss and screen.

In 2003, all departments standardized their operational procedures and systems to conform to operational internal controls. This work was carried out close to Chinese New Years, and most departments

Framework Component Area to Judge	Example of ICDF's Financing Operations
Control Environment	
Character and values	ICDF's assistance strategies; diplomacy by the general public
Obligation on abilities	Rules on handling loans and investments based on ICDF assistance strategies
Concern and guidance by board members and supervisors	Supervision and review of projects; achieving goals of the supervisory agency and diplomatic objectives
Management philosophy and operational style	Chairman focuses on principles of creativity, action, speed and results to systemize overall operations; Secretary General establishes organizational system as major goal for the year
Organizational structure	Investment and Lending Department operations are handled by the Credit Reviewing Committee
Delegation of authorization and duties	Setting clear boundaries on plans, investigations, evaluations, and approvals
Workforce resource policies and practical affairs	Designing a standards handbook to serve as foundation
Risk Assessment	
Setting goals	Do goals conform to the ICDF's assistance strategies?
Setting goals at various operational levels	Determining projects, actual investigations, project evaluation, contract negotiation, risk evaluation and finalizing control components and operations
Risk analysis	Unsatisfactory control operations cause overall and operational risks
Changing management	Measures in case of political or environmental changes in recipient nations
Control operations	
Information and Communication	Implemented according to control operations procedures for investment and lending operations
Information	Will provide loan conditions, recipient finalizing, assembling plans for implementation, carrying out investigations and screening
Communication	How to inform related persons of financing application information including communications with the MOFA, embassies and consulates
Monitoring	
Ongoing supervision	Monitoring by administering supervisor and self-audits
Routine case evaluations	Examination of internal audits, re-audits and signs of improvement
Oversight reports	Self-audit reports, annual composite internal audit report



reported being under severe time constraints. At discussions held bi-weekly, departments that had yet to finish their drafts could provide justifications for delay. Nonetheless, given the importance of the internal control system and the weight given to it by senior management, all departments continued to work hard to draft controls and the composition of the system was completed within four-and-a-half months.

Systems Content Discussions with the MOFA

Internal control content is discussed with the MOFA before submission for ICDF board approval.

Self-Auditing under the Internal Control System

The draft of the system was finalized did not mean there would be no changes. Amendments would be required based on any changes in the organization's structure or external environment. The system is a dynamic one that takes into consideration the ICDF's operations and activities. The system is reviewed regularly in light of changes in the operating environment, ensuring the system remains effective. In addition, self-auditing is a trend in modern management. It forms one of the three pillars of corporate governance along with internal controls and internal audits.

Self-audits are carried out using the same concepts as the internal control system. The ICDF provides instruction and courses to familiarize employees with the concept and meaning of self-auditing. Furthermore, examples and practical drills are also given to hone awareness.

Guidance for self-audits was carried out for operations and administrative bodies separately, due to the difference in control components and risks for each. Since the ICDF staff had already become familiar with internal controls during the design process, they

understood the concept of self-audits with regard to operational procedures, risk determination and assessment. As a result, the self-audit drills were quite successful.

The following explains the self-audit operations under the internal control system:

Goals and Scope

The goal of staging self-audits is to implement the self-monitoring mechanism under the internal control system and react to changes in the environment. Self-audits can also help in making adjustments to the internal control system, thus raising the quality and efficiency of the internal auditing department.

Self-audits are to be carried out in all areas under the internal control system. The Internal Control Task Force is responsible for setting out timetables, procedures, controls and reviews for all self-audits. The Auditing Office is responsible to carry out training, contact, and arrangement and explain any areas that departments do not understand with regard to self-audits. The task force also reviews the examination when it is being carried out.

Types and Use of Forms

Three types of forms are used in self-audits: (1) the Internal Control Component Checklist - This focuses on reviewing the control environment, risk assessment, control operations, information and communication, and monitoring; (2) the Operations Self-Audit Form - This records the self-audit process and results in each area of operations; and (3) the Improvement Status Form from the Auditing Office used in its re-audits.

Examination Procedures

Before the start of each year, each department takes into consideration internal control risk and decides on the examination goals for the year, areas of

examination, frequency and state of progress. The examination procedure is divided into three stages. First, the department carries out a self-audit. Secondly, auditors review the self-audit. Lastly, the self-audit is evaluated by the task force.

The results of the self-audit are combined with the degree of success in making improvements and an incentive program. Through learning, procedural education and joint participation, employees gain a better understanding of the internal control system. This also strengthens their sense of responsibility toward their work and raises internal efficiency.

Scope and Frequency of Examinations

Self-audits and internal audits are considered equally important under the internal control system. Therefore, the scope of examination covers those areas designed under the internal control system. In principle, overall operations should undergo a composite examination once a year, while the frequency of examinations for specific levels of operations can be determined as needed. This ensures the effectiveness of the internal control system.

Definition of Evaluation and Judging Language

The language used in self-audits is classified as either appropriate or not appropriate. This refers to the effectiveness of the system's design with regard to the operation being examined and whether goals and objectives are being achieved. In addition, the words "effective/ not effective" are used to judge the system and whether it helps to achieve goals.

Review

The Internal Control System Task Force is responsible for reviewing all of the aspects related to self-audits.

Conclusion

The implementation of the internal control system has practical value for the ICDF in the following four specific areas:

- **Establishing an Organizational System**—The Internal Control System was completed in 2003, enabling the ICDF to take a significant step toward creating a governance mechanism.
- **Exhibiting Sustainable Operations**—The continued implementation of self-audits and internal audits will build experience and broaden their usage within the organization, leading to sustainable operations.
- **Strengthening Management Leveraging**—The management of operational cycles in each area of operations helps management to leverage resources effectively and completes the mission of the board and the supervising agency.
- **Seeking Consensus From All Employees**—In the implementation of the internal control system, all ICDF employees learn methods to quantify risk and reach consensus based on systemic considerations.

Over the past year, the ICDF has taken the difficult first step to establish an internal control system. These efforts have been successful thanks to the support of senior management and the efforts of all employees. In the days ahead, the ICDF will continue to administer internal audits and carry out self-audits in an effort to further improve the organization and enable the system to be implemented in all areas of operations. Through these mechanisms, the ICDF will continue to work toward its goal of becoming a professional, systematic, transparent, and accountable international development institution.