Internal Control Policy
(extracts)

Pakistan Stock Exchange

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1.   INTRODUCTION

Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

This definition emphasizes that internal control is:
• Geared to the achievement of objectives in one or more separate but overlapping categories—operations, reporting, and compliance.

• A process consisting of ongoing tasks and activities—a means to an end, not an end in itself.

• Effected by people—not merely about policy and procedure manuals, systems, and forms, but about people and the actions they take at every level of an organization to effect internal control.

• Able to provide reasonable assurance—but not absolute assurance, to an entity's senior management and board of directors.

• Adaptable to the entity structure—flexible in application for the entire entity or for a particular division, operating unit, or business process.

Effective internal control provides assurance that significant weaknesses in the design or operation of internal control that could adversely affect an entity's ability to meet its objectives, would be prevented or detected in a timely manner.

Internal Control affects every aspect of Pakistan Stock Exchange (PSX) operations. It assures that PSX functions efficiently and economically, satisfying the requirements of applicable laws, policies, rules and regulations. Management, Investors and other Stakeholders want to ensure that adequate controls exist to assure that functions and activities are administered in compliance with laws, rules and regulations.

The management of PSX has a fundamental responsibility to develop and maintain effective internal control. The proper implementation of the defined internal controls is an essential responsibility of the overall management. Programs must operate and resources must be used in consistent with the PSX's mission and in compliance with applicable laws and regulations to minimize regulatory violations, fraud, and mismanagement.

2.   PURPOSE

The purpose of this Internal Control Policy is to help management better control the organization and to provide board of directors with an added ability to oversee internal control. A system of internal control will allow management to stay focused on PSX's pursuit of its operations and financial performance goals, while operating within the confines of relevant laws and minimizing surprises along the way.

3.   LIMITATIONS OF INTERNAL CONTROLS

An effective system of internal control provides reasonable assurance of achieving the entity's objectives, however inherent limitations do exist. Even an effective system of internal control can experience a failure. These limitations may result from the:

• Suitability of objectives established as a precondition to internal control

• Reality that human judgment in decision making can be faulty and subject to bias

• Breakdowns that can occur because of human failures such as errors

• Ability of management to override internal control

• Ability of management, other personnel, and/or third parties to circumvent controls through collusion

• External events beyond the organization's control

These limitations preclude the board and management from having absolute assurance of the achievement of PSX's objectives—that is, internal control provides reasonable but not absolute assurance.

4.   INTERNAL CONTROL FRAMEWORK

4.1   Introduction to Committee of sponsoring organizations of the treadway commission's (COSO) internal control – integrated framework

The updated Internal Control – Integrated Framework (the framework) was published in 2013 by COSO which has become the most widely used internal control framework and has been adopted by numerous countries and businesses around the world. The Framework enables organizations to effectively and efficiently develop and maintain systems of internal control that can enhance the likelihood of achieving an entity's objectives related to operations, reporting, and compliance. The Framework is based on 5 components and 17 principles within these components for implementation of an effective system of internal control which provides reasonable assurance of achievement of an entity's objectives.

4.2   Objectives of internal control

Internal controls are established to further strengthen and ensure:

- The reliability and integrity of information.

- Compliance with policies, plans, procedures, laws and regulations.

- The safeguarding of assets.

- The economical and efficient use of resources.

- The accomplishment of established objectives and goals for operations or programs.

The main objectives of the internal controls process can be categorized as follows:

- Operations Objectives

- Reporting Objectives

- Compliance Objectives

Operations objectives pertain to effectiveness and efficiency of the PSX's operations, including operational and financial performance goals, and safeguarding assets against loss.

Reporting objectives These pertain to internal and external financial and non-financial reporting which encompass reliable, timely, and transparent, or other terms as set forth by the regulator, standard setters, or the internal policies pf PSX.

Compliance objectives ensure that all activities of PSX complies with applicable laws and regulations, supervisory requirements, and the organization's policies and procedures. This objective must be met in order to protect PSX franchise and reputation.

In addition, the top management must evaluate and report on the control and financial systems that protect the integrity of the PSX's activities. Managers must carefully consider the appropriate balance between controls and risks in their programs and operations. Too many controls can result in an inefficient and ineffective management therefore management must ensure an appropriate balance between the strength of controls and the relative risks associated with particular programs and operations. The benefits of controls should outweigh the costs. PSX considers both qualitative and quantitative factors when analyzing costs against benefits.

4.3   Components and Principles of Internal Control

The Framework sets out five components of internal control and seventeen principles representing the fundamental concepts associated with components.

4.3.1 CONTROL ENVIRONMENT

The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal controls across PSX. The board of directors of PSX has approved a number of policies to establish the tone

at the top regarding the importance of internal control and expected standards of conduct. The implementation of this component will require PSX to apply the five principles relating to it which are as follows:

i. PSX demonstrates a commitment to integrity and ethical values.

ii. The board of directors of PSX demonstrates independence from management and exercises oversight of the development and performance of internal control.

iii. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.

iv. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.

v. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

4.3.2 RISK ASSESSMENT

Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed i.e. risk evaluation.

Management must establish objectives prior to the identification of risks to their achievement and to take necessary actions to manage the risks.

By setting objectives, both at the entity and activity levels, prior to a risk assessment, PSX can determine the critical success factors; then determine the risks to the critical success factors.

A risk assessment usually includes:
a) Estimating the significance of a risk
b) Assessing the likelihood (or frequency) of the risk occurring
c) Consideration of how the risk should be managed

Management should identify internal and external risks that may prevent PSX from meeting its objectives. When identifying risks, management should take into account relevant interactions within PSX as well as with outside it. Management should also consider previous findings; e.g., received from an auditor, from internal management reviews, or from noncompliance with laws and regulations, when identifying risks. Identified risks should then be analyzed for their potential effect or impact on PSX.

There are four principles relating to Risk Assessment which needs to be adhered to by PSX:

i. PSX specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.

ii. PSX 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.

iii. PSX considers the potential for fraud in assessing risks to the achievement of objectives.

iv. PSX identifies and assesses changes that could significantly impact the system of internal control.

4.3.3 CONTROL ACTIVITIES

Control activities are the actions established by policies and procedures to help ensure that management directives to mitigate risks 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 over the technology environment.

Control activities include:
• Approvals
• Authorizations
• Verifications
• Reconciliations
• Supervisory controls

- Security of assets
- Segregation of duties

Internal controls can be classified as either Preventive or Detective. Preventive controls focus on preventing errors or exceptions. Such preventive controls are standard policies and procedures, proper segregation of duties and authorization levels / approvals. Detective controls are designed to identify an error or exception after it has occurred. Such detective controls are exception reports, reconciliations and periodic audits.

Internal control also needs to be in place over information systems, i.e. general and application controls. General control applies to all information systems such as the mainframe, network, and end user environments, and includes the PSX-wide security program, managing control over data center operations, system software acquisition and maintenance. Application control is designed to ensure that transactions are properly authorized and processed accurately and that the data is valid and complete. Controls, such as edit checks, should be established at an application's interfaces to verify inputs and outputs. General and application control over information systems are interrelated to ensure complete and accurate information processing. Due to the rapid changes in information technology, controls must also adjust to remain effective.

There are three principles relating to Control Activities:

i.   The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.

ii. The organization selects and develops general control activities over technology to support the achievement of objectives.

iii. The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.

4.3.4 INFORMATION AND COMMUNICATION

Information is necessary for PSX to carry out internal control responsibilities in support of achievement of its objectives. Communication occurs both internally and externally and provides PSX 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.

Information systems produces reports, containing strategic, operational, financial and compliance related information, that make it possible to run and control the business. Furthermore, Management information system (MIS) should provide information to the right people in sufficient detail and on time to enable them to carry out their responsibilities effectively and efficiently.

Adequacy of communication across PSX should be ensured through completeness and timeliness of information. Further, openness and effectiveness of channels with external parties and regulatory bodies should be established for communicating information. Pertinent information must be identified, captured and communicated in a form and timeframe that enables people to carry out their responsibilities.

There are three principles relating to Information and Communication:

i.   The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.

ii. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.

iii. The organization communicates with external parties regarding matters affecting the functioning of internal control.

4.3.5 MONITORING

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 effect 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 audit committee/board.

There are two principles relating to Monitoring Activities:

i.   The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.

ii.   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 audit committee / board of directors, as appropriate.