



Developing Effective Internal Controls Using the COSO Model

Office of State Controller
Internal Controls in a COSO Environment Seminar
Raleigh, North Carolina March 2007

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Today's Objectives

- 1. Why all the buzz about COSO?**
- 2. What do we mean by “internal control”?**
- 3. What are the key components for effective internal control?**

Who is COSO?



Why all the recent fuss over Internal Controls?

Fraud!

Perception that effective internal controls help prevent and detect fraud.

Sarbanes-Oxley



- **Section 404**

Annual management assessments of IC over financial reporting

- **Section 302**

**Quarterly certifications by CEO and CFO that they have
Controls that material information is disclosed to them
Evaluated the effectiveness of IC within prior 90 days**

PCAOB Auditing Std No. 2

- Paragraph .13

Management is required to

“...base its assessment...on a suitable, recognized control framework established by a body of experts that follow due process procedures”

- Paragraph .14

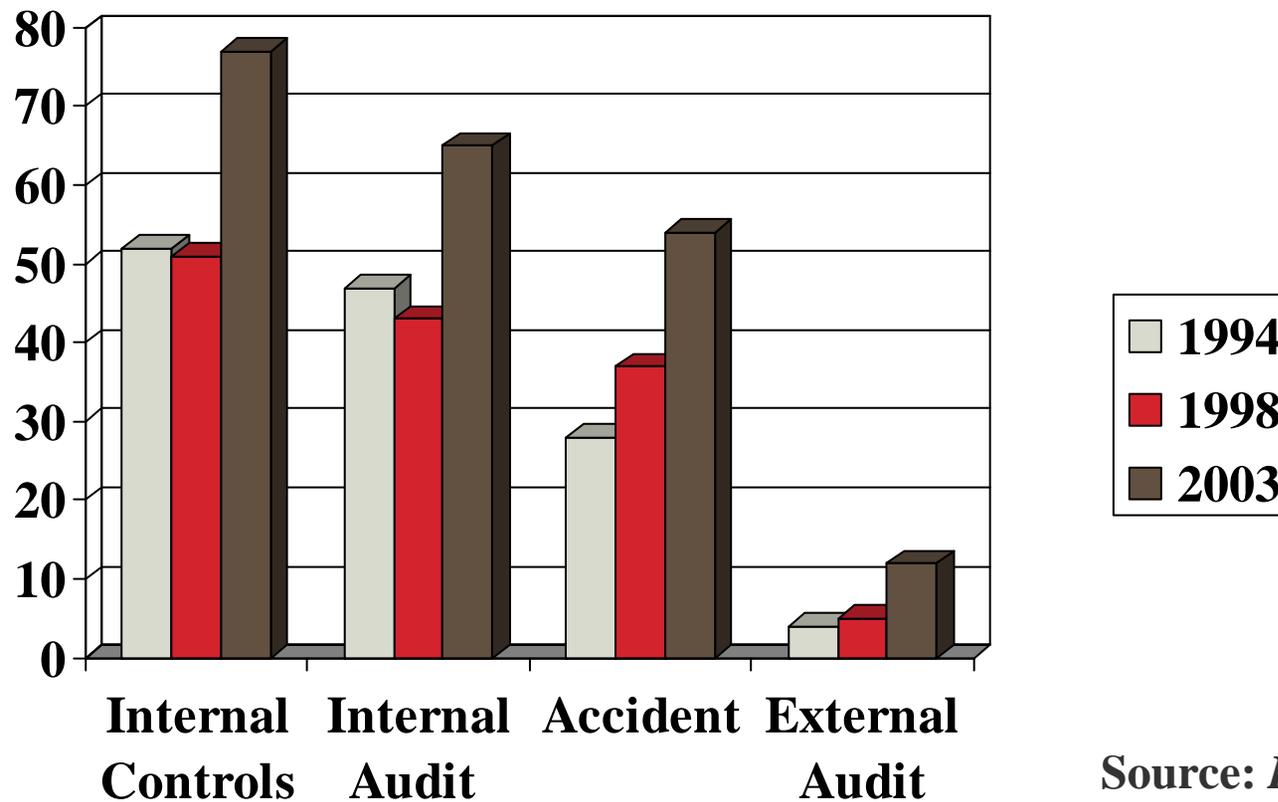
In the United States, COSO’s Internal Control-Integrated Framework

“provides a suitable and available framework for purposes of management’s assessment”



PCAOB

Why All the Focus on IC?



Source: *KPMG Fraud Survey*

Today's Objectives

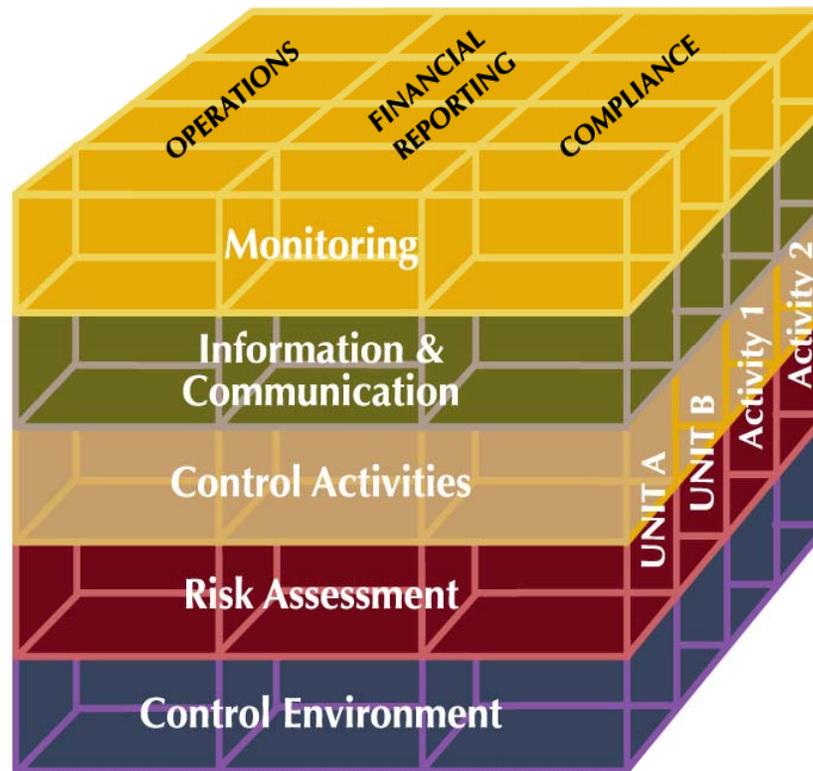
2. What do we mean by “internal control”?

COSO's Definition

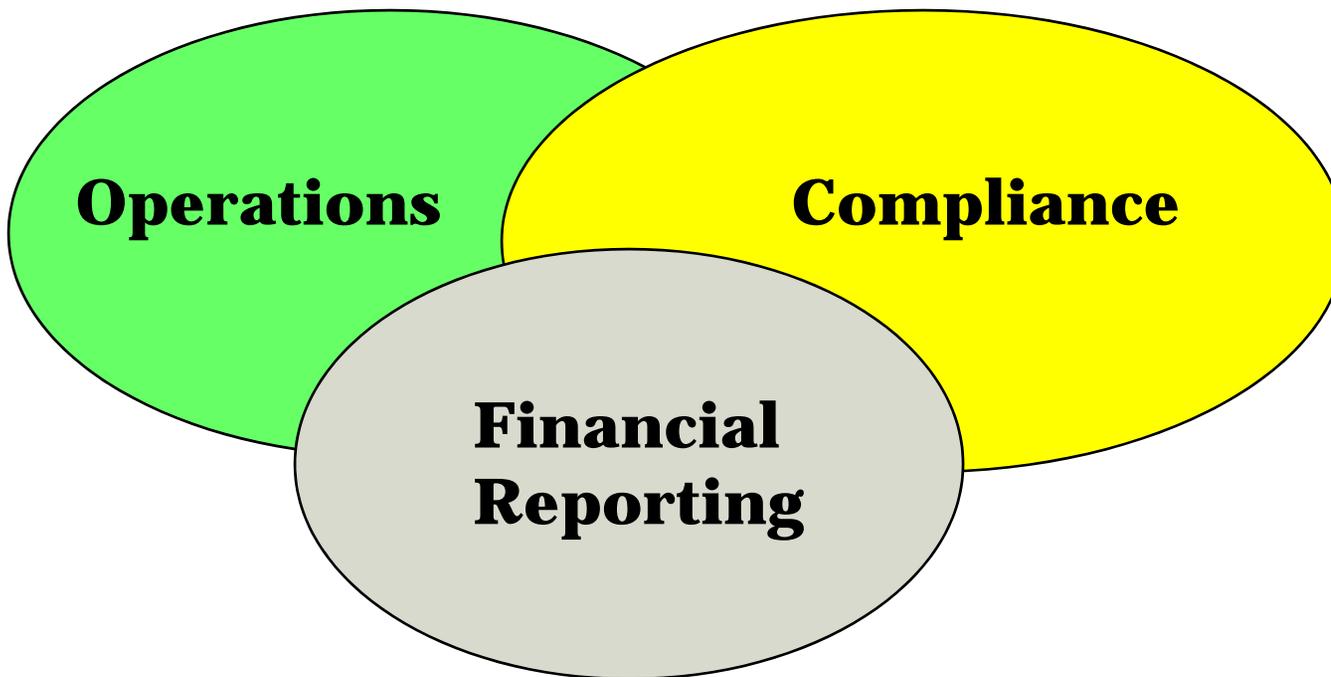
Internal control is

“a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives”

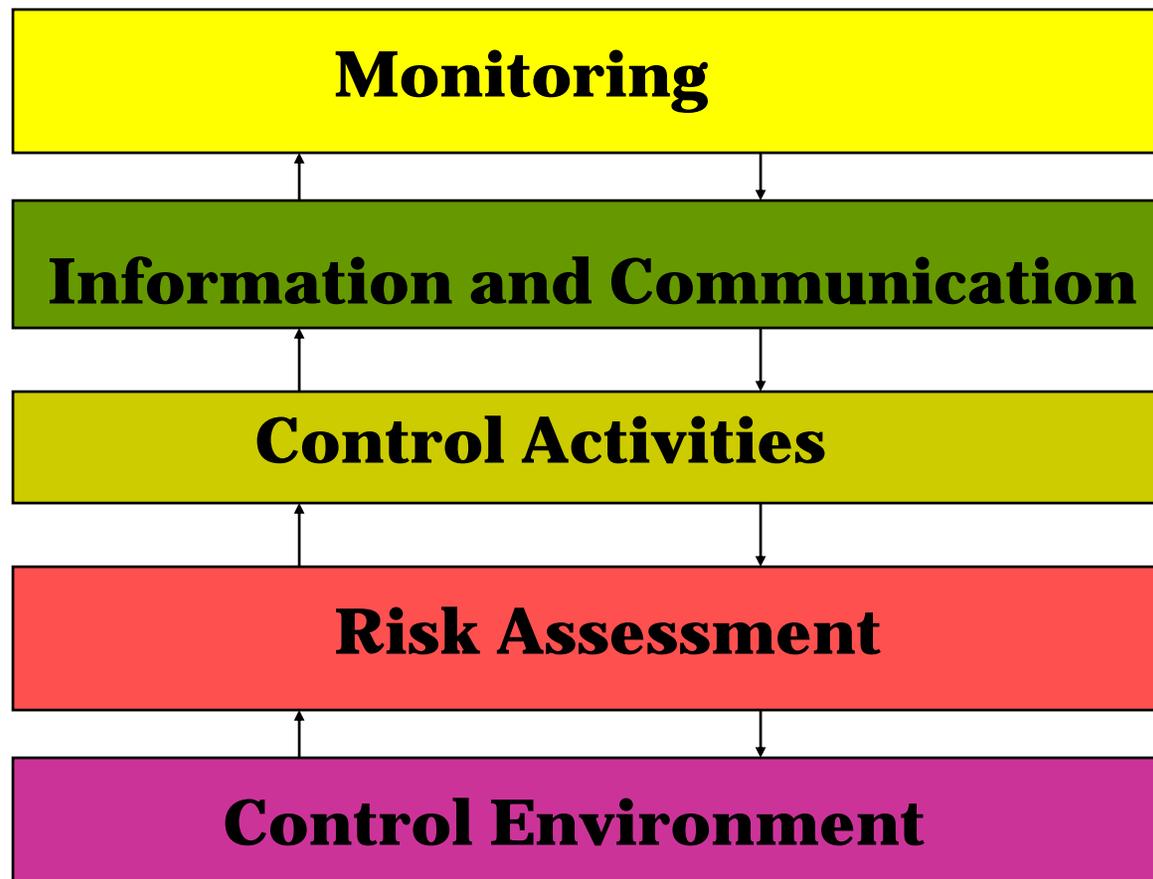
COSO's View of IC



3 Categories of IC Objectives



5 Components of IC



Internal Control as a Process



Key Concept

1. To identify the correct *control*, you must know what *risks* are present.
2. To know what *risks* are present, you need to understand what *objectives* are being sought.
3. Thus,



Today's Objectives

3. **What are the key components for effective internal control?**

Risk Assessment



Risk Assessment

- **Precondition to controls is identifying risks**
Can't determine needed controls without knowing risks
- **Every entity faces risks**
Risks constantly evolve
- **Need a systematic process for risk management**
Focused on both likelihood and consequence

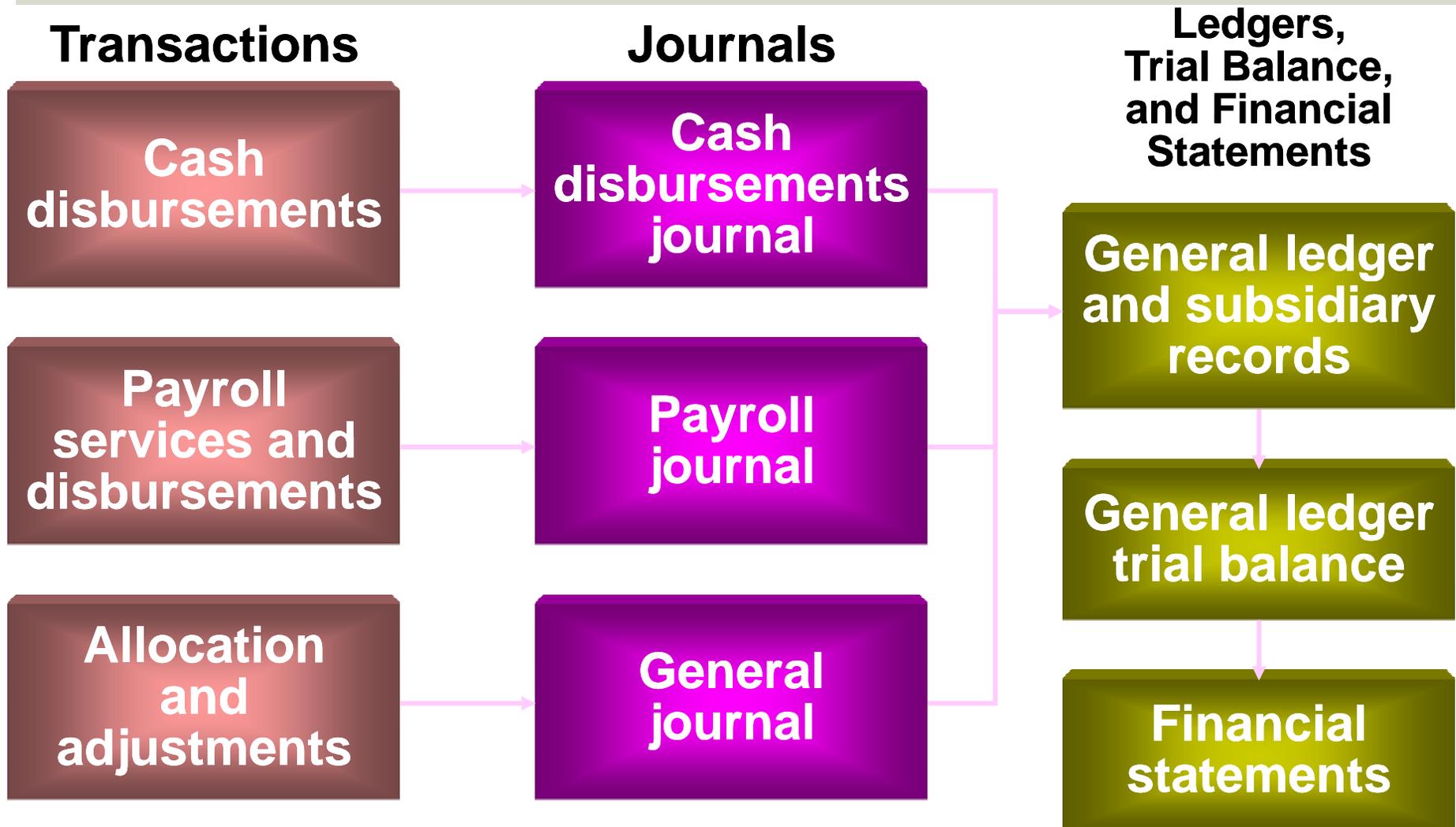
Drivers of Internal Controls



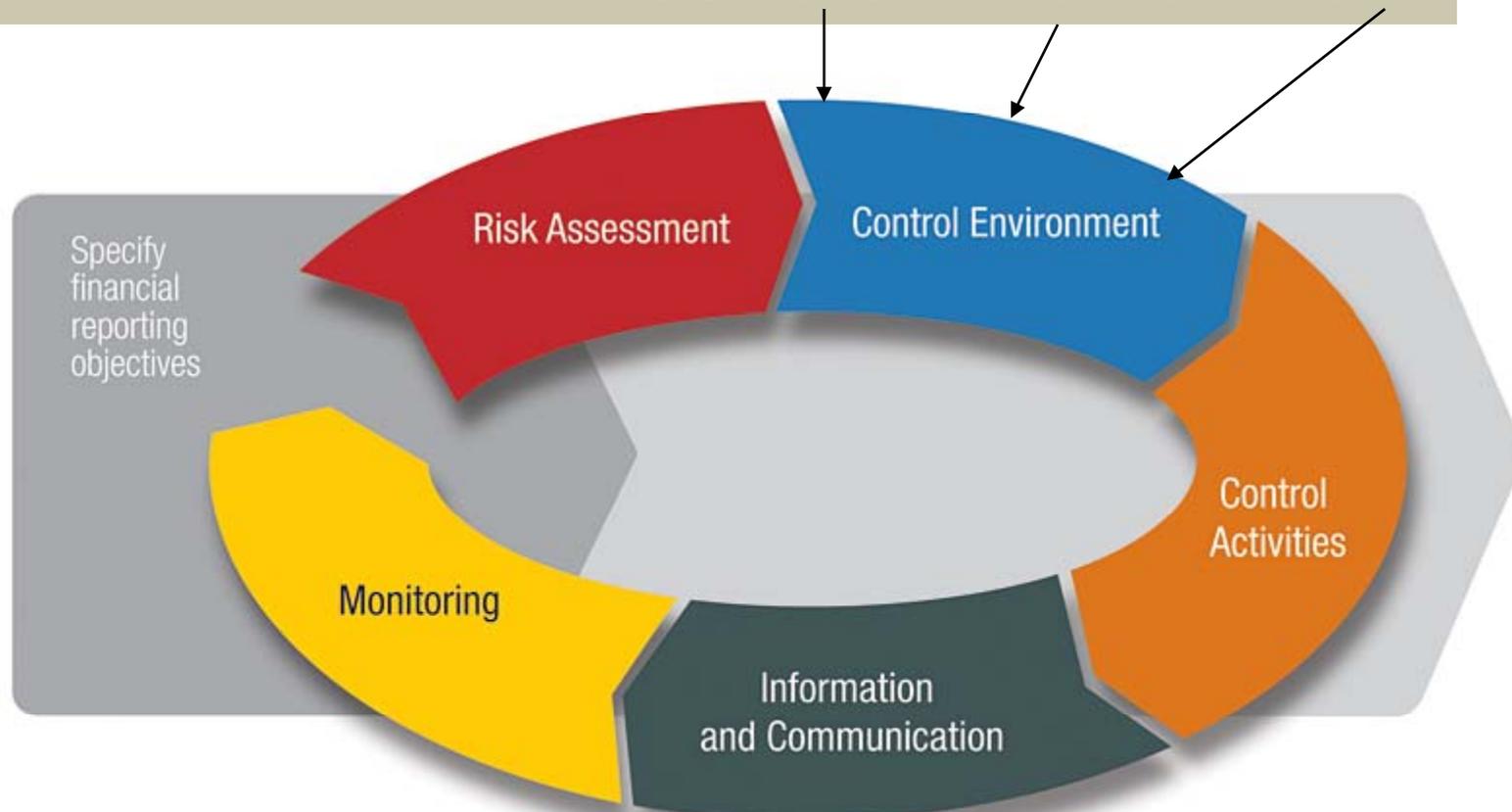
Financial Reporting Objectives

- **Safeguarding of Assets**
- **Emphasize reliable and relevant reporting**
 - Transparent - reflect economic reality**
 - Timely**
 - Meet GAAP – minimum threshold**
- **Account and transaction level objectives**
 - 5 Financial Statement Assertions**

Analyzing Risks Across Transaction Flows



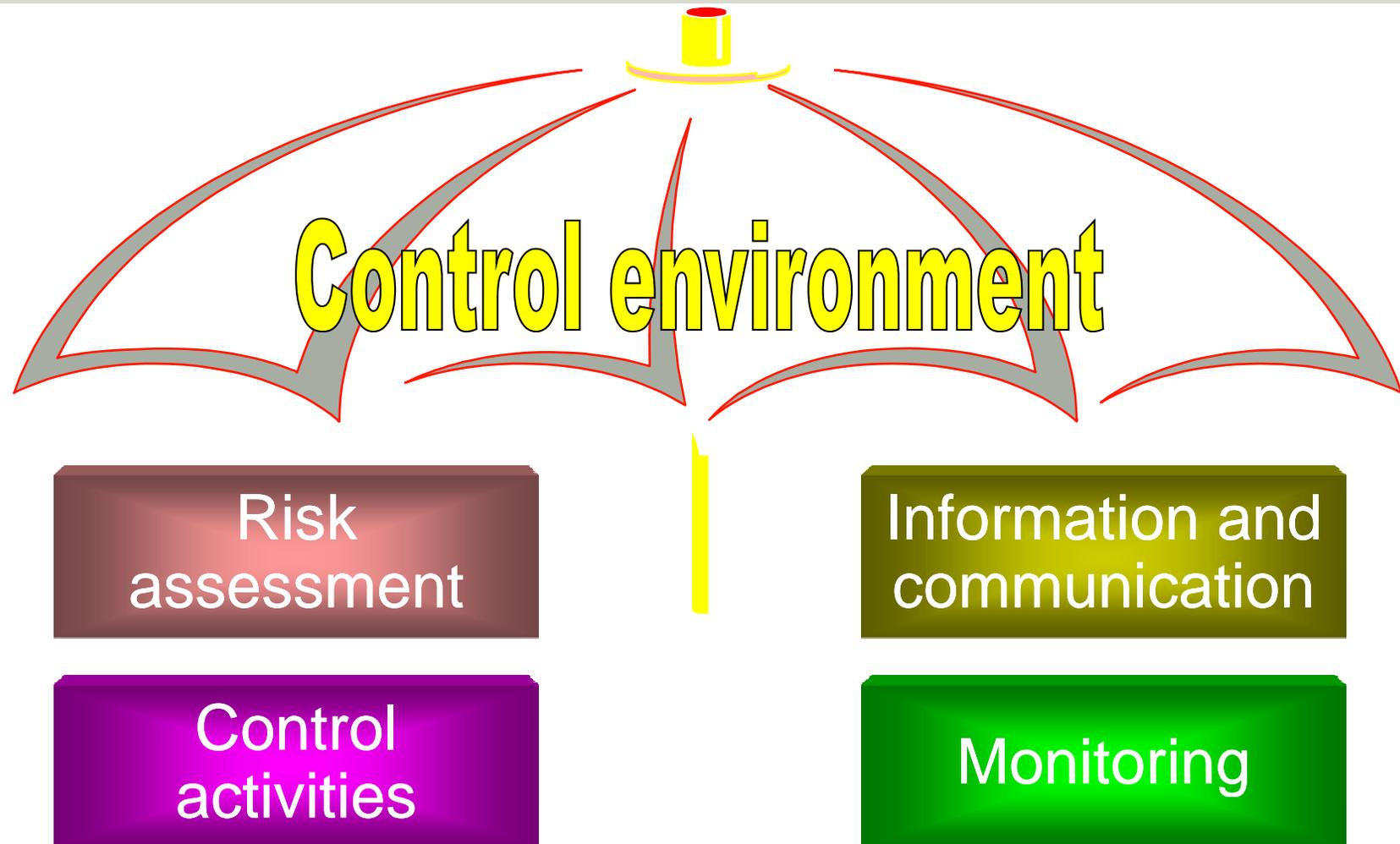
Control Environment



Control Environment

- **Sets the “tone at the top”**
 - Board and Senior Management driven**
- **Influences control consciousness of its people**
 - Core to sound integrity and ethical values**
- **Emphasis on competencies and authorities**
- **Foundation for all other components of IC**

Relationship to Other Components



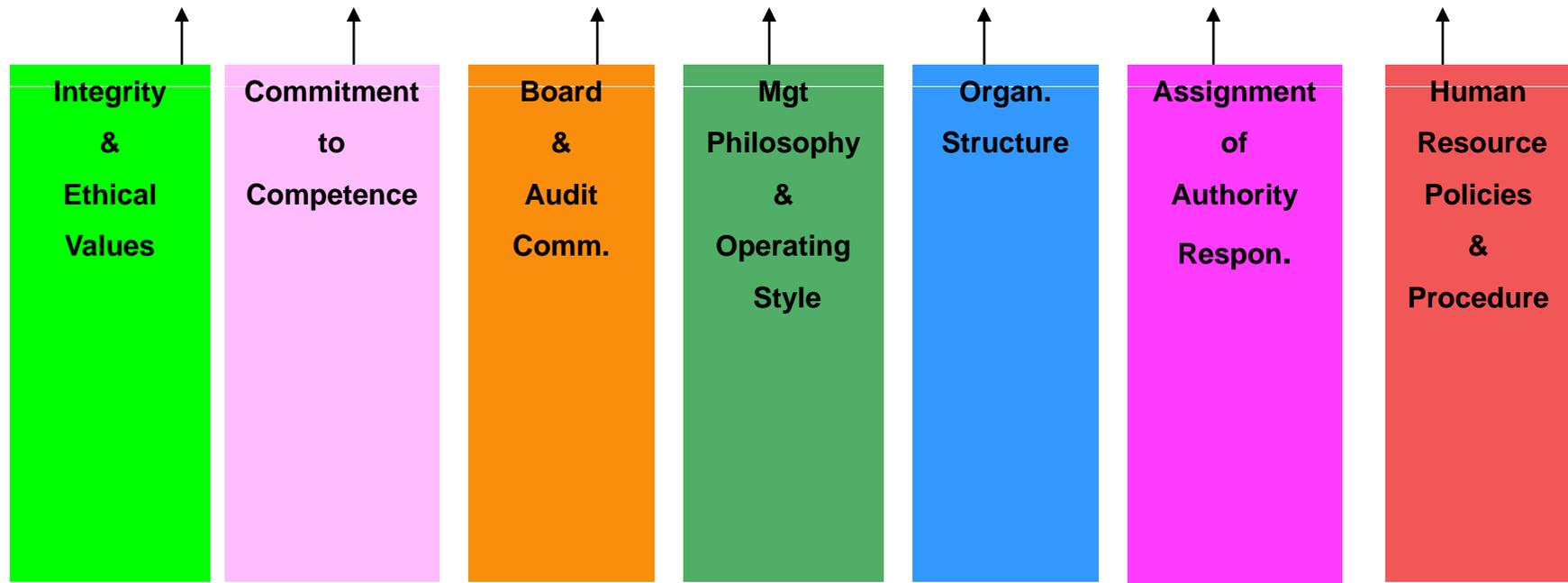
Core Themes

- **Sound integrity and ethical values are critical to IC**
Code of Conduct
- **Board and audit committee play a vital role**
Independence and financial expertise
- **Mgt's philosophy and operating style support IC**
Actions consistent with Code of Conduct
- **Entities must retain individuals with competencies**
Commitment to acquiring needed competencies
- **Employees are assigned appropriate levels of authority**
Delegation is clear and accountable
- **Human resource practices demonstrate commitment to integrity, ethical behavior, and competence**
Screening done not just for employment, but also promotion

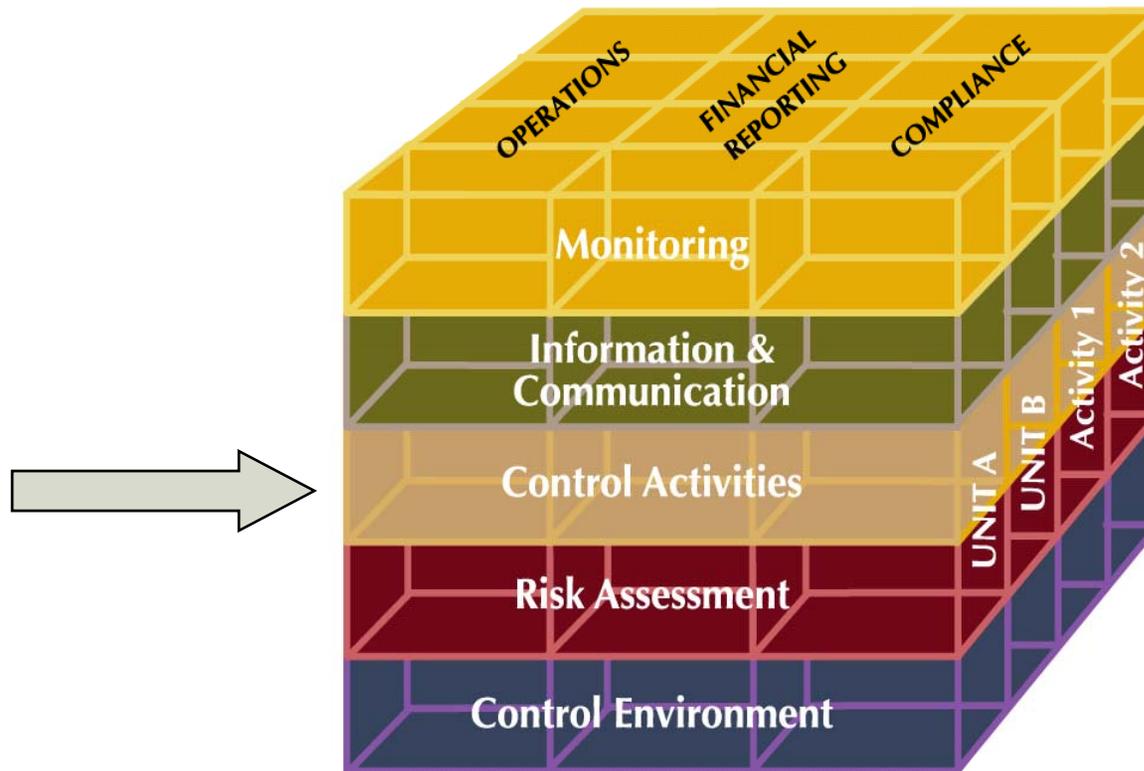


Subcomponents

Control Environment



Control Activities



Control Activities



Control Activities

- **Represent responses to identified risks**
 - Don't need a control if no corresponding risks
- **Control activities are**
 - Actions taken to address risks of achieving objectives
- **Occur at all levels of an organization**
 - Company-wide controls
 - Business process specific tasks
- **Consists of 2 aspects:**
 - Policy of what should be done
 - Procedures to accomplish policy

Example – Revenues

<u>Assertions</u>	<u>Policies & Procedures That Ensure</u>
Exist/Occur	Recorded revenues actually earned
Completeness	Revenues earned are actually recorded
Rights/Oblig	Organization has rights to revenue receivables
Valuation/Alloc	Revenues recorded at correct amounts
Present/Discl	Revenue policies/terms disclosed properly

Categories of Control Activities

1. Adequate separation of duties
2. Proper authorization of transactions and activities
3. Adequate documents and records
4. Physical control over assets and records
5. Independent checks on performance

Adequate Segregation of Duties



Combinations of Control Activities

- Management uses a mix of

Preventative controls

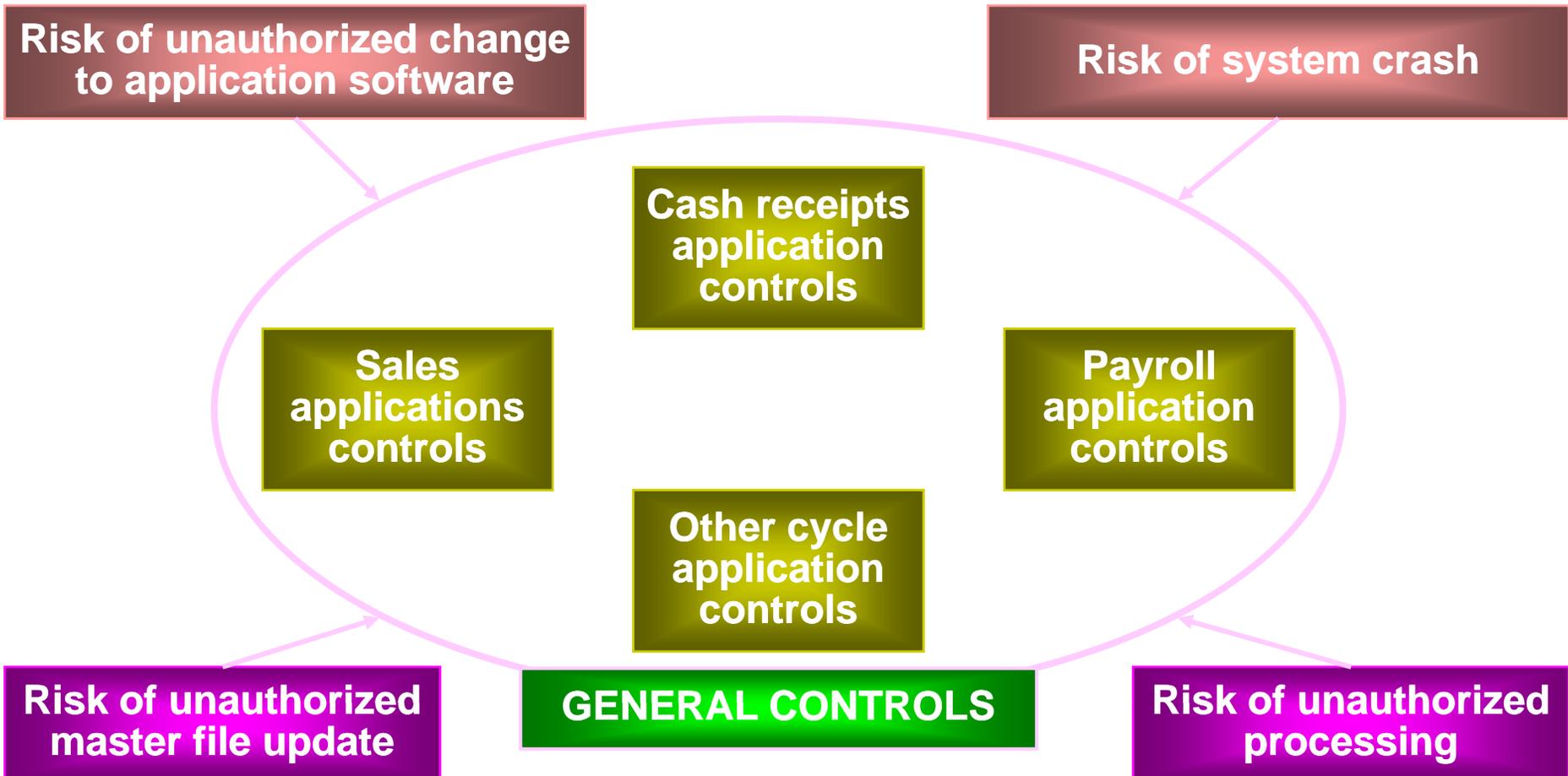


Detective controls



- Combinations of
Manual controls
Automated controls

IT General and Application Controls



Example of IT Controls

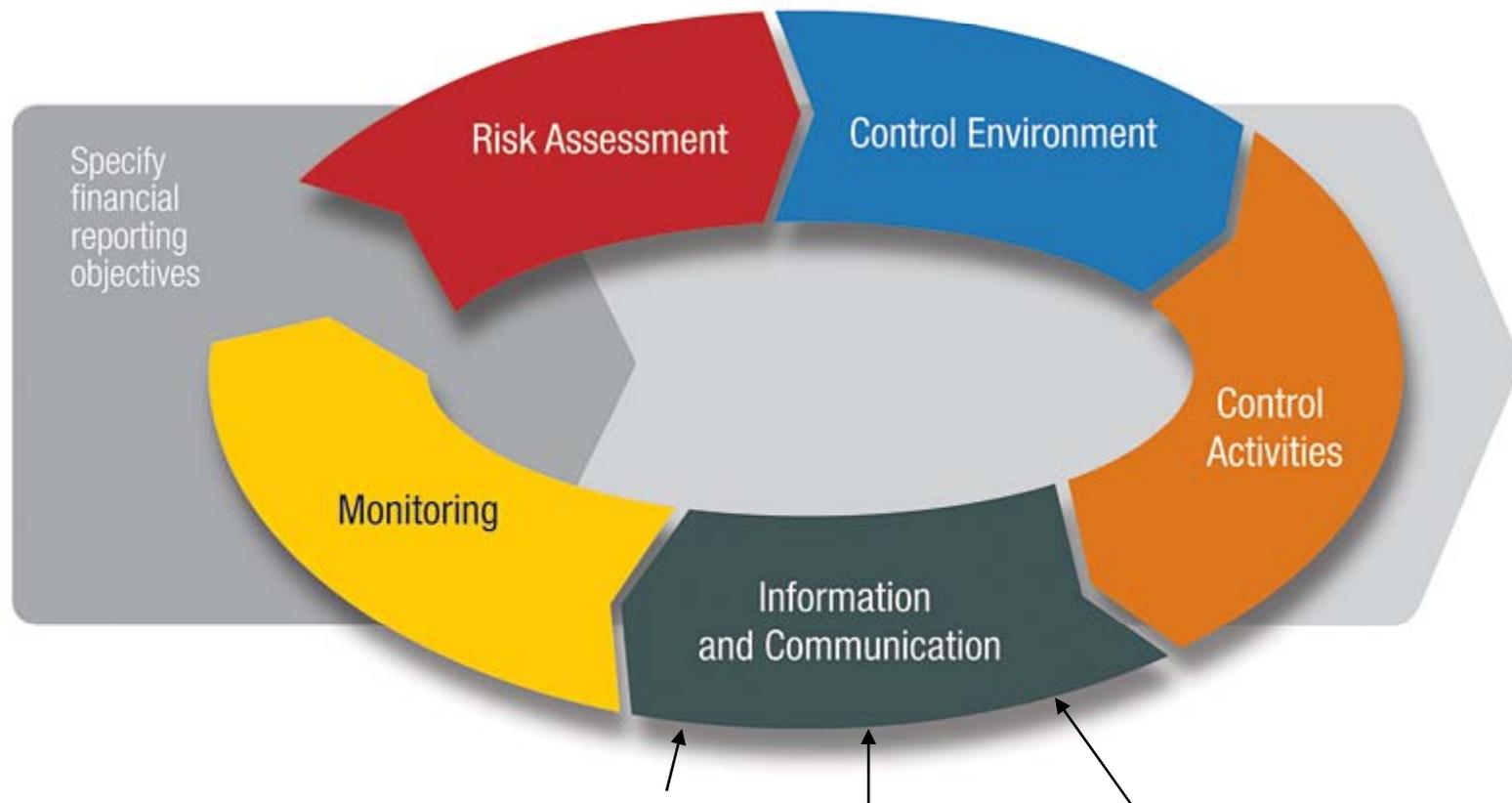
General Controls	Application Controls
IT Organization	Access restriction to application
Physical/Logical Security	Input data validation against master file
Systems Development	Range or Limit Checks
Change Management	Sequence Checks
Backup Planning	Programmed edits – logic tests

Cost – Benefit Considerations



↑
**Impact from
Risks**

↑
**Costs of Implementing
Controls**



Information and Communication

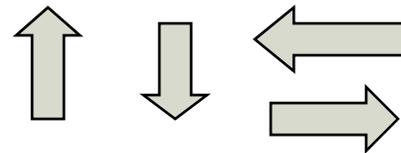
Information and Communication

- Information is needed to carryout responsibilities

Information

From Management

To Management



- Effective Communication is needed

More than just information flow

Key is understanding the messages

- Information & Communication needs to be controlled, too

Information Flow

- Key elements – system must

Identify

Capture

Process

Distribute



- Information based on

Internal and external sources

Operational information used to develop financial information

- Information used to control activities that support objectives

Communication

- **Has management developed**
 - Communications program to reinforce IC objectives?
 - Communications strategy to enable each employee to understand IC responsibilities?
 - Process to determine if information needed by employees is timely and accurate?
 - Communication mechanism for employees to be aware of ethical and legal requirements?
- **Does the entity have “fail-safe” mechanisms in case normal channels of communications are inoperative?**
- **Is the Board of Directors receiving needed information?**



Monitoring

Monitoring

- **Internal control systems need to be monitored**
a/k/a – “Monitoring of controls”
- **Focus – assessing quality of system performance**
More than just information flow
Key is understanding the messages
- **Nature of Monitoring**
Ongoing
Separate Evaluations

Ongoing Monitoring

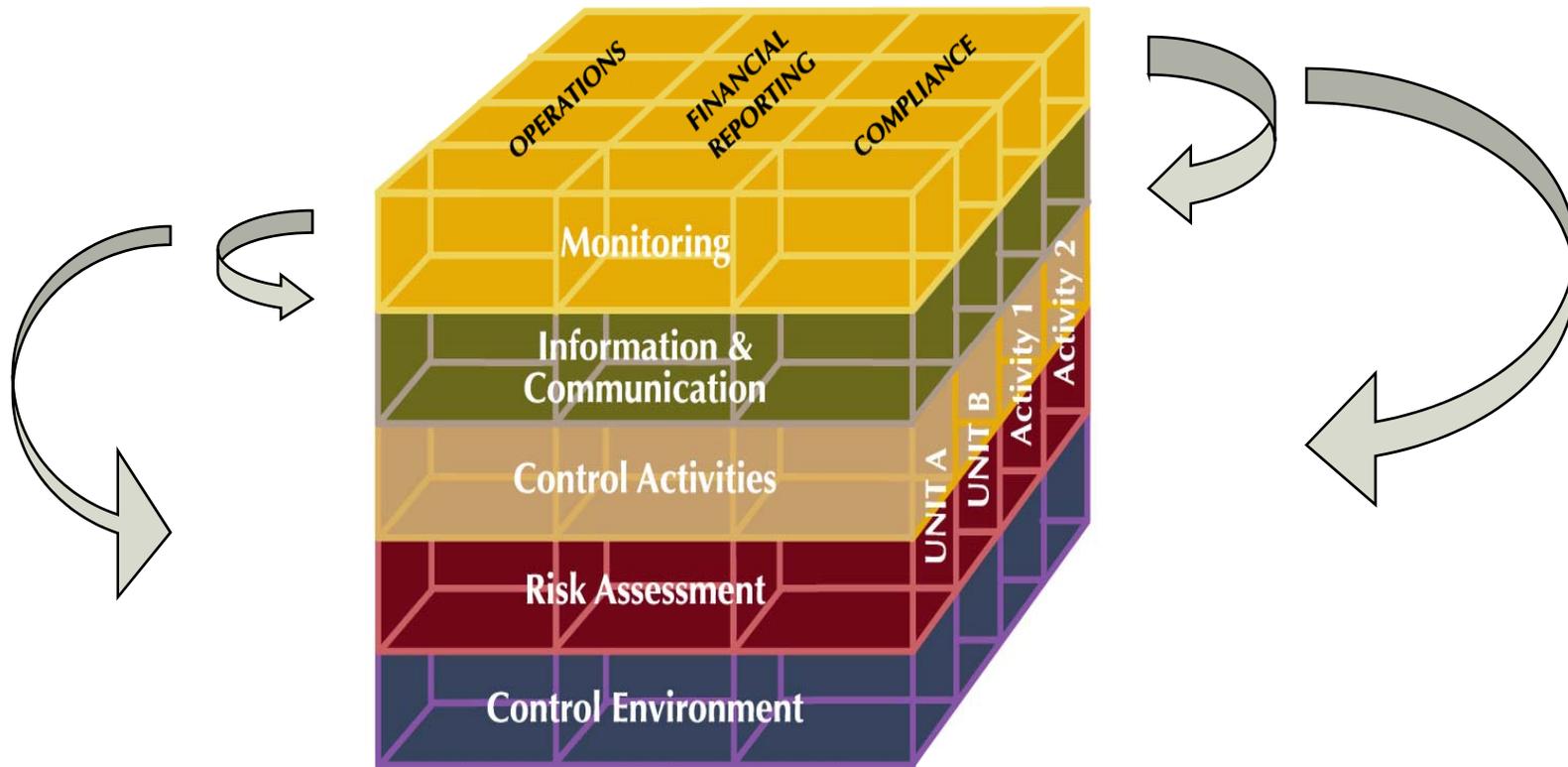
- **Built into operations**
 - Some automated
 - Focus on deviations from norms
- **Provide continual feedback on controls**
 - Should lead to investigations
 - May lead to system changes

Separate Evaluations

- **Evaluate effectiveness of ongoing monitoring**
 - Objective look from time to time**
 - Scope based on significance of risks**

- **Objective and competent evaluator**
 - Internal audit plays vital role**

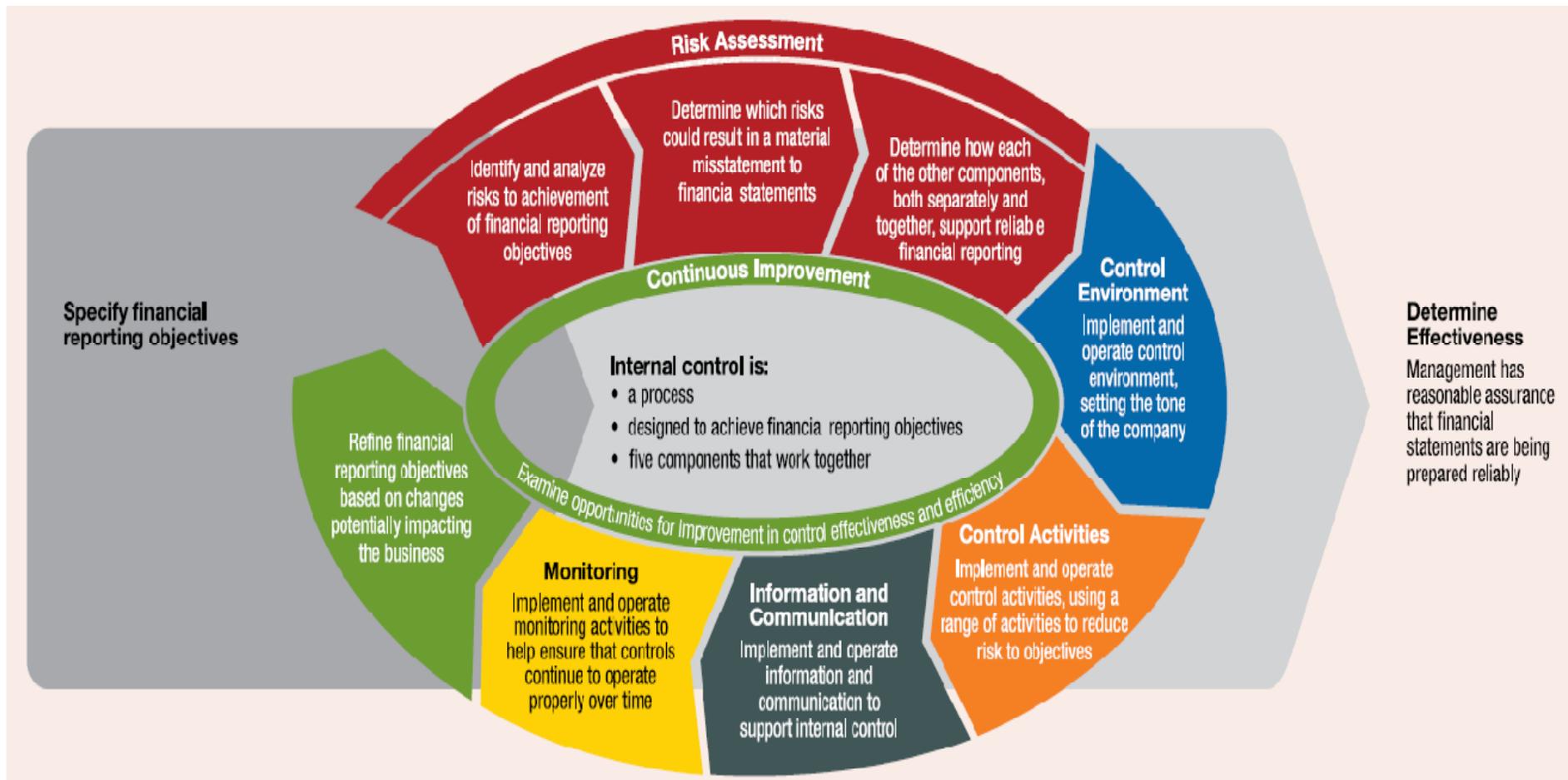
Monitoring of All Elements



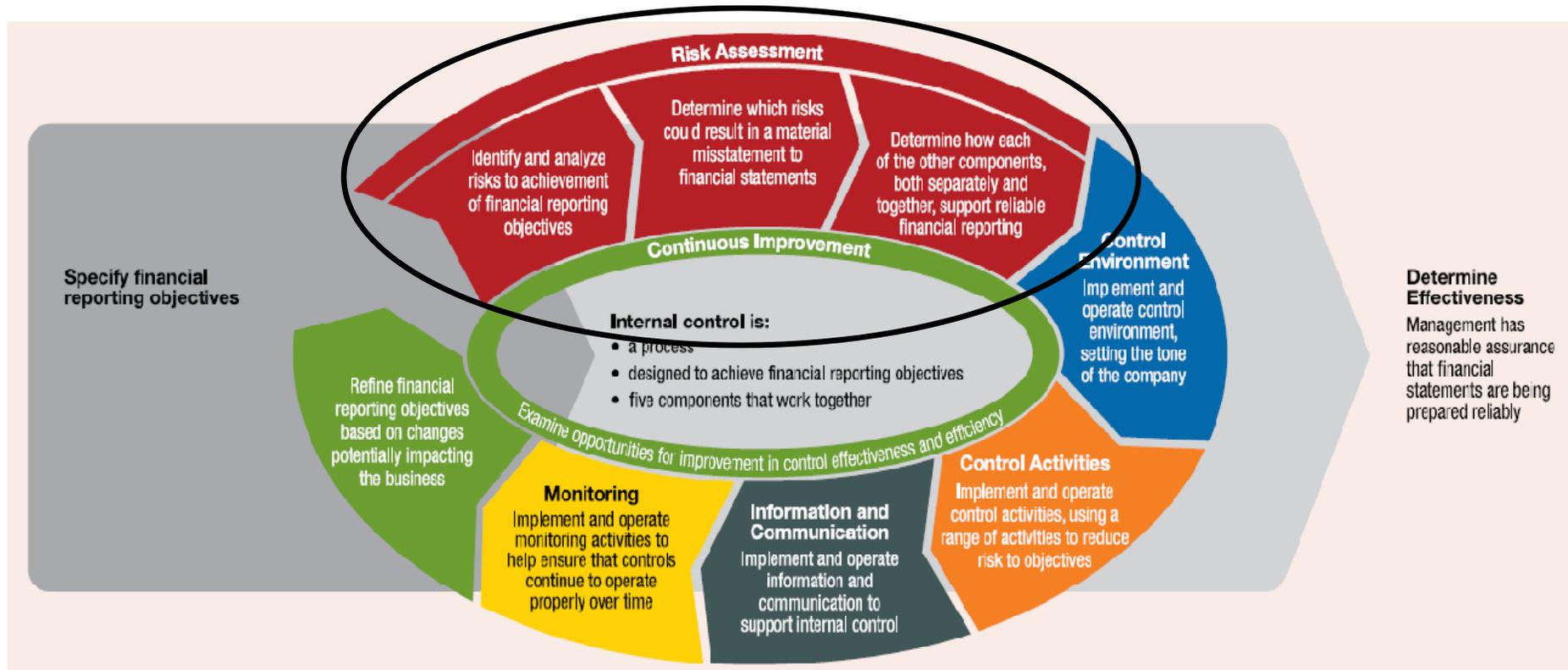
Bringing it All Together

- **5 Components of Internal Control Must Work Together**
- **Can't have effective Internal Control if one component weak**

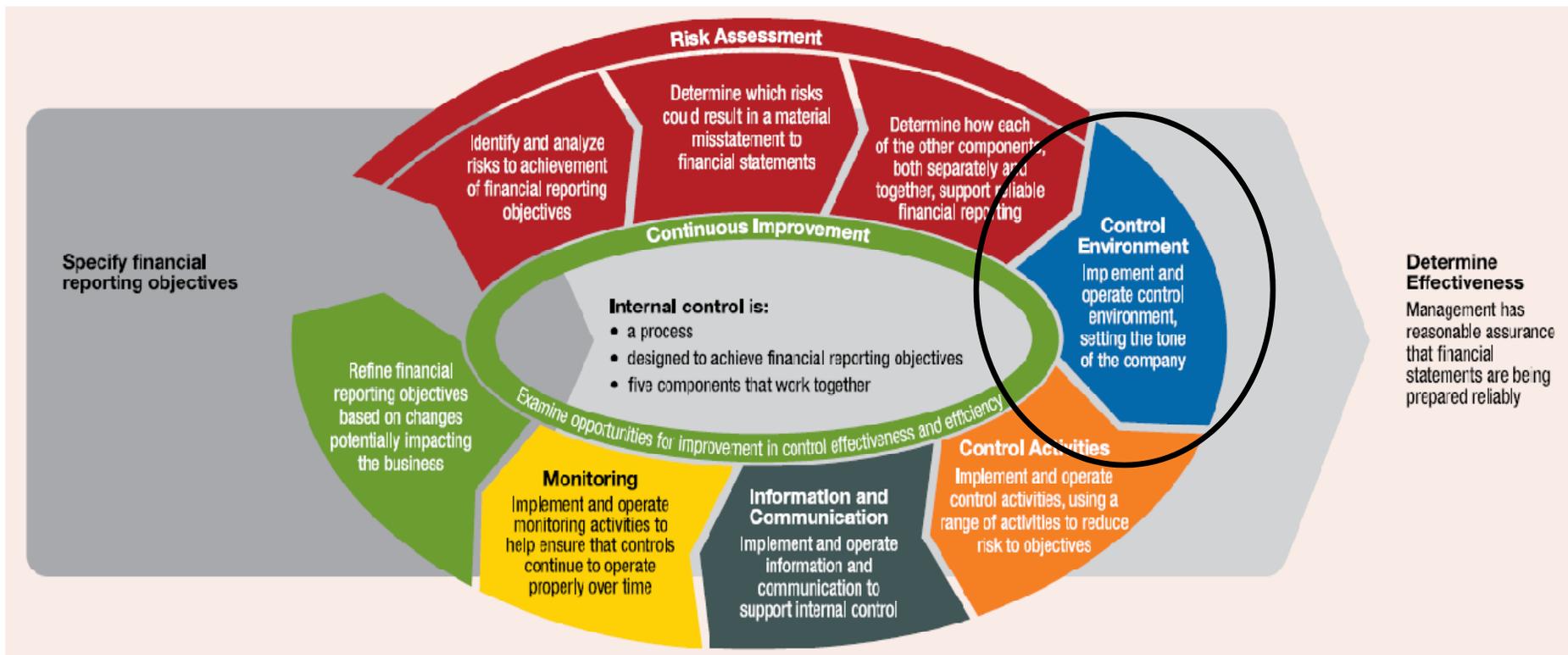
The Big Picture



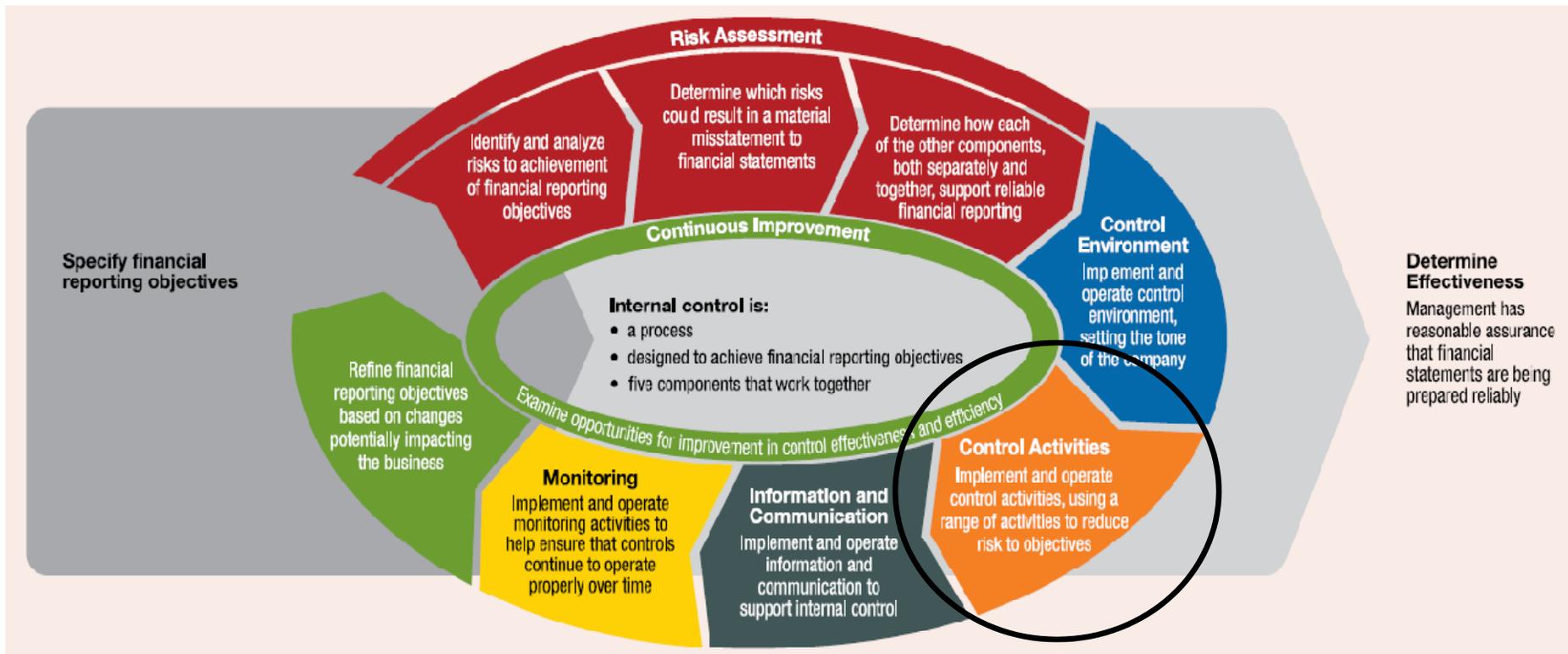
Risk Assessment



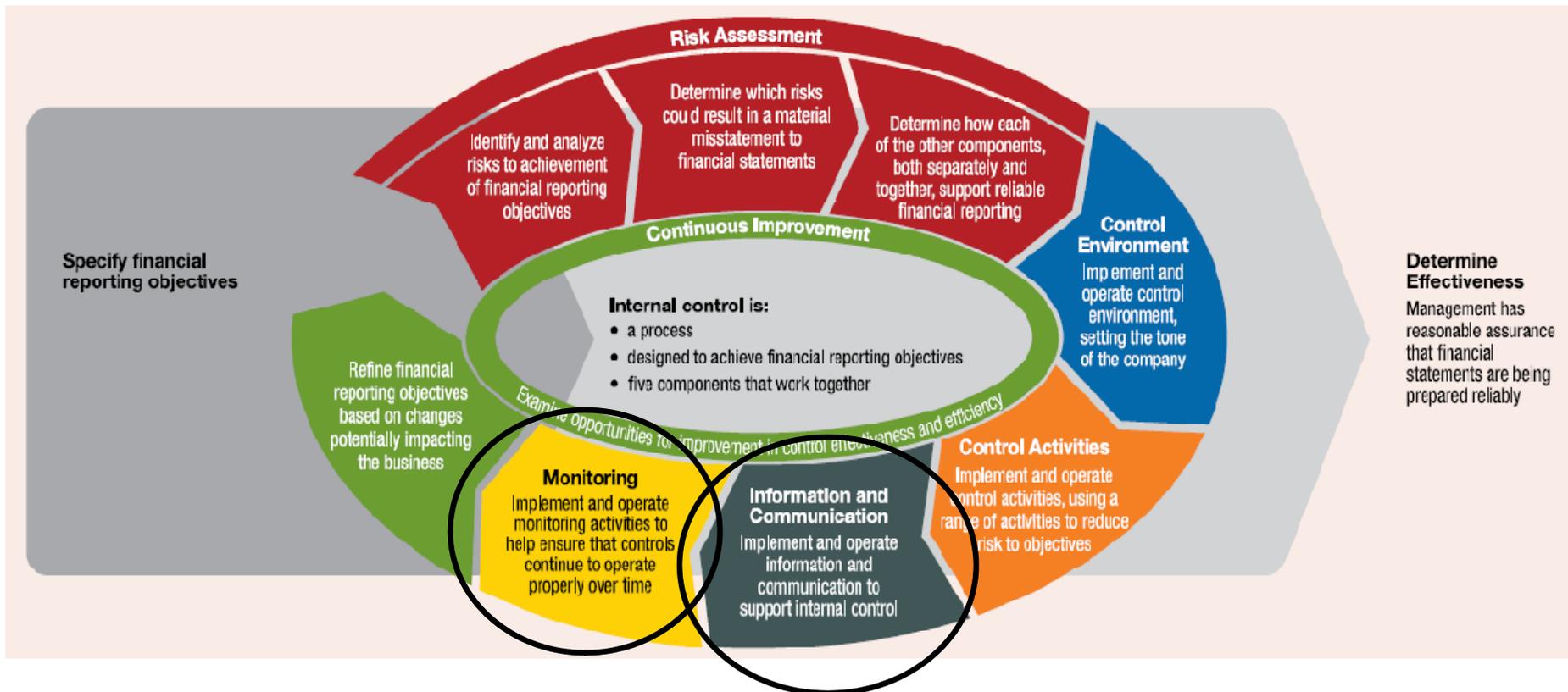
Control Environment



Control Activities



Information and Communication Monitoring



4 Points of Internal Control Failure

1. Focus on 4 Points of Failure

- Assumption it's only the auditor's job

Failure #2

2. 4 Points of Failure

- **Assumption it's only the auditor's job**
- **Failure to link risks and controls**

Failure #3

2. 4 Points of Failure

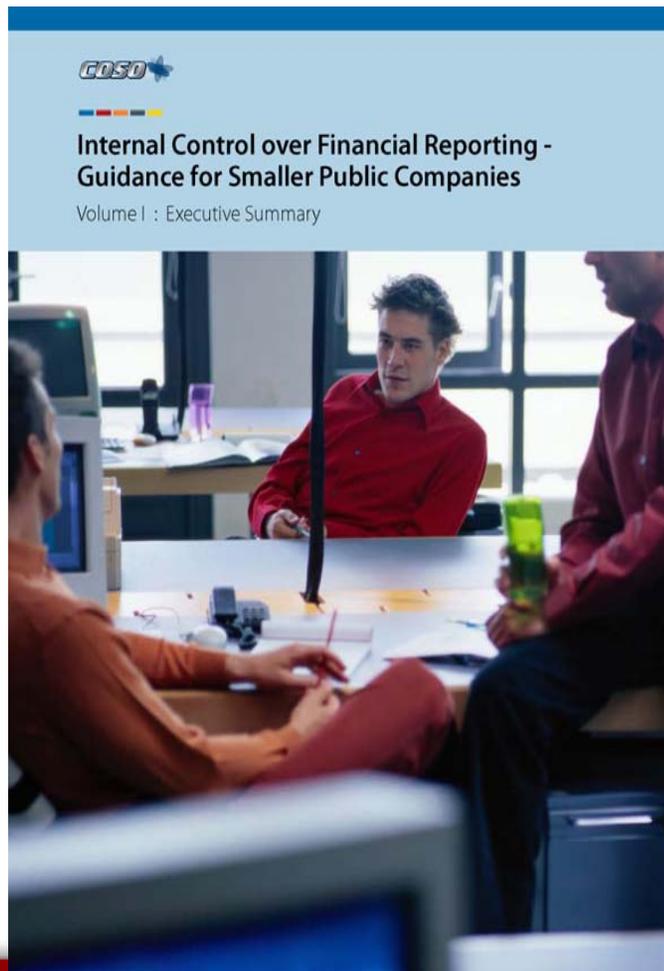
- **Assumption it's only the auditor's job**
- **Failure to link risks and controls**
- **Inadequate monitoring of controls**

Failure #4

2. 4 Points of Failure

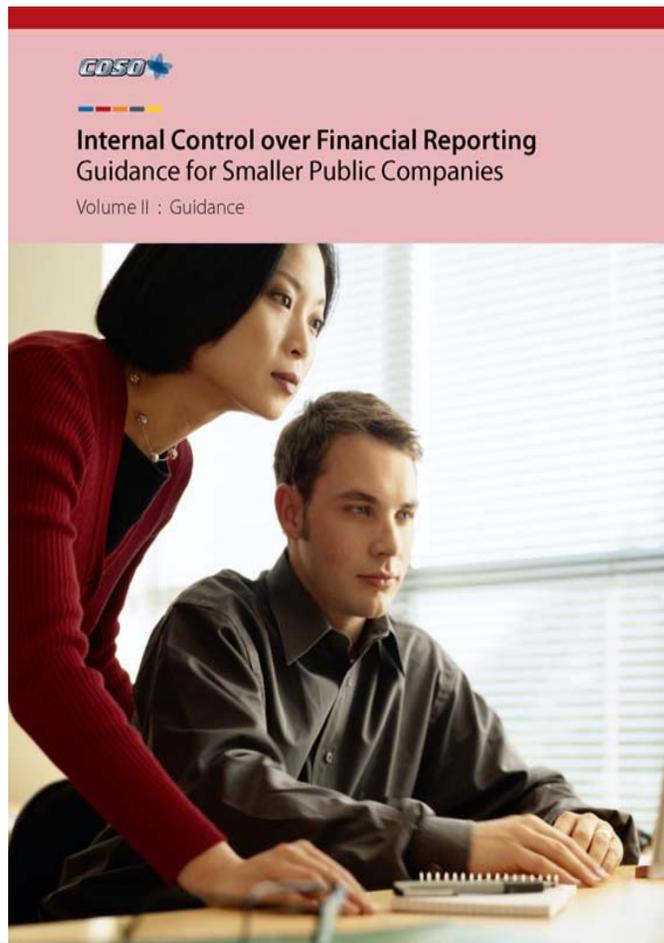
- Assumption it's only the auditor's job
- Failure to link risks and controls
- Inadequate monitoring of controls
- Ignoring reality – risk of management override is always present

Guidance – Volume I



- Provides a high level summary
- Summarizes recent developments, internal control challenges, and the costs and benefits associated with internal control
- Focuses on risk as a basis for developing internal control
- Introduces internal control as a process

Guidance – Volume II



- Focuses on twenty fundamental principles
- These principles are drawn from the original Internal Control – Integrated Framework
- These principles assist smaller businesses in achieving internal control in a cost-effective manner

Guidance – Volume II: Principles, Attributes, Approaches, and Examples

Principle 1

Sound integrity and ethical values, particularly of top management, are developed and understood and set the standard of conduct for financial reporting.

Three Attributes

- Articulates Values
- Monitors Adherence
- Addresses Deviation

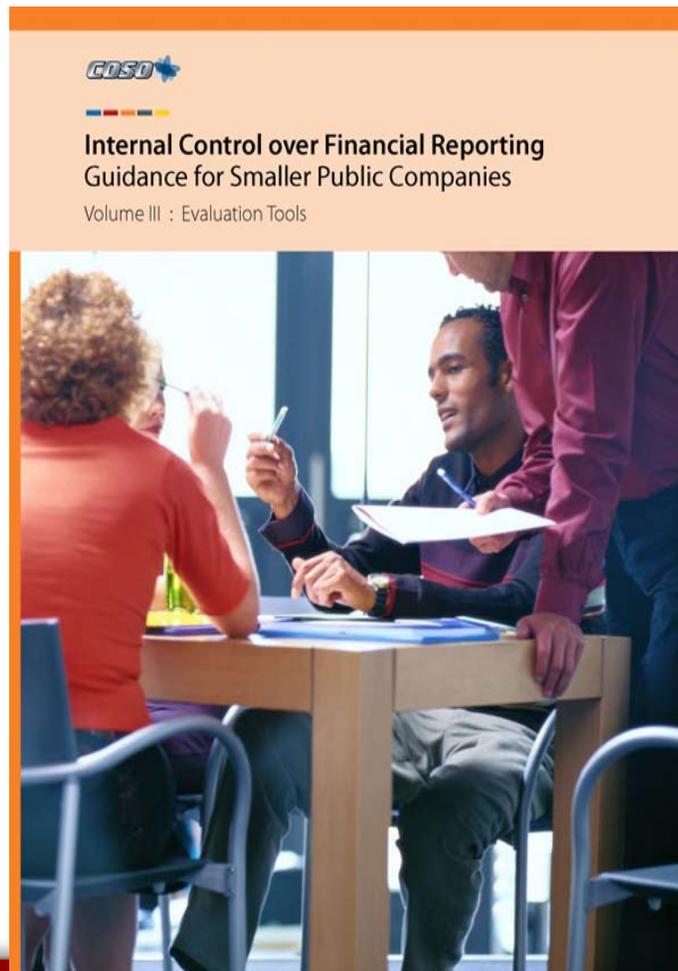
Three Approaches

- Articulating and Demonstrating Integrity and Ethics
- Informing Employees about Integrity and Ethics
- Demonstrating Commitment to Integrity and Ethics

Six Examples

- Company Newsletter Reinforcing Integrity and Ethics
- Promoting Awareness of Ethical Behavior
- Etc...

Guidance – Volume III



- Contains illustrative tools to assist management in evaluating internal control
- Managers may use the illustrative tools in determining whether the company has effectively applied the principles
- It is expected that that other managers will use Volumes II and III as a reference source for guidance in those areas of particular need
- This volume is now also available in a Word format

A Look Back at Today's Objectives

- 1. Why all the buzz about COSO?**
 - Sarbanes-Oxley
 - Good business sense
- 2. What do we mean by “internal control”?**
 - More than just “checks and balances”
 - Responses to risks threatening objectives
- 3. What are the key components for effective internal control?**
 - Complex interactions of 5 core components
 - Range from high-level actions to detailed processes

Internal Controls Provide Bridge to Success



- **For Organizations**
Reduce exposures to risks threatening strategy
- **For You**
Now an expected core competency of management



Reality:

Internal control checklists must link to Risks

Fraud risk is more than the auditor's responsibility

Monitoring of controls must occur on an ongoing basis

Management override is always present risk

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