

EXCLUSIVELY FOR SENIOR MANAGEMENT, BOARDS OF DIRECTORS, AND AUDIT COMMITTEES

Does Your Control System Pass the COSO Test?

Many of the audit failures of the 1980s and 1990s could have been avoided had senior management and boards of directors focused more on critical issues of corporate governance, ethical standards, and internal control.

In the past, internal control was perceived as an arena reserved for accountants and controllers. Today, control means much more than financial control, and effective boards and audit committees are charged with confirming that an appropriate control environment exists and remaining in control of that environment as it moves toward its objectives.

The work of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) is intended to guide senior managers, boards, and audit committees who seek to improve their understanding and effectiveness in this broadened arena of internal control.

COSO, a private sector initiative established in 1985 by five financial professional associations, comprises representatives from the American Accounting Association, the American Institute of Certified Public Accountants, the Financial Executives Institute, The Institute of Internal Auditors, and the Institute of Management Accountants. COSO's goal is to improve the quality of financial reporting by focusing on corporate governance, ethical practices, and internal control.

In 1992, COSO published *Internal Control — Integrated Framework*, a multi-volume report that establishes a common definition of internal control and provides a standard by which organizations can assess and improve their control systems. Since then, *Internal Control — Integrated Framework* has been widely heralded as the most comprehensive study ever undertaken on control.

COSO's concept of internal control assigns roles and responsibilities to everyone in the organization, including directors as key drivers of the control process. The report defines the control environment to include ethical values, integrity, and competence of management and the board — and the attention and direction provided by the board of directors.

To fulfill their responsibilities, the board of directors must be sure the organization has an effective internal control process, as defined in this report. In response, COSO developed a series of questions (page 2) to help senior executives, directors, and audit committees gain a better understanding of their organizations' control systems.

After reading these questions, and applying them to your own understanding and thinking about your organization, ask yourself one more important question: What is the "tone at the top" of my organization?

COSO Defines Internal Control

COSO defines internal control as a process effected by an entity's board of directors, management and other personnel, and designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- ◆ Effectiveness and efficiency of operations.
- ◆ Reliability of financial reporting.
- ◆ Compliance with applicable laws and regulations.

This definition reflects certain fundamental concepts: Internal control is a process. It's a means to an end, not an end in itself. Internal control is effected by people. It's not merely policy manuals and forms, but people at every level of an organization. Internal control can be expected to provide only reasonable assurance, not absolute assurance, to an entity's management and board. Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.



COSO Checklist: Is Your Organization's Internal Control Effective?

1. How Do the Board of Directors and Management Establish and Maintain a Strong Ethical Environment and Culture?

◆◆◆ The control environment sets the tone of an organization and provides the foundation for an effective system of internal controls.

- Do board members and senior executives set a day-in, day-out example of high integrity and ethical behavior?
- Is there a written code of conduct for employees, and is it reinforced by training, top-down communications, and requirements for periodic written statements of compliance from key employees?
- Are performance and incentive compensation targets reasonable and realistic, or do they create undue pressure on achievement of short-term results?
- Is it clear that any fraudulent financial reporting will not be tolerated?
- Are ethics woven into criteria that are used to evaluate individual and business unit performance?
- Does management react appropriately when receiving bad news from subordinates and business units?
- Does a process exist to resolve close ethical calls?
- Are business risks identified and candidly discussed with the board of directors?

2. How Does the Organization Identify and Manage Risk?

◆◆◆ An effective control system enables management to be apprised of, monitor, and manage significant risks.

- Is relevant and reliable internal and external information identified, compiled, and communicated in a timely manner to those who are in a position to act?
- Are risks identified and analyzed, and are actions readily taken to mitigate them?
- Are controls in place to assure that management decisions are properly carried out?

3. How Does the Organization Assess Its Internal Control System To Ascertain That It Is Effective?

◆◆◆ Internal controls should be monitored by line management on an ongoing basis and subject to periodic evaluation.

- Do senior and line management executives demonstrate that they accept control responsibility rather than just delegate that responsibility to financial and audit staff?
- Does management routinely monitor controls in the process of running the organization's operations?
- Does management clearly assign responsibilities for training and monitoring of internal controls?
- Are periodic, systematic evaluations of control systems conducted and documented?
- Are such evaluations carried out by personnel with appropriate responsibilities, business experience, and knowledge of the organization's affairs?
- What criteria are used to evaluate controls?
- Are control deficiencies reported to upper management and corrected on a timely basis?
- Are appropriate controls built in as new systems are designed and brought on stream?



4. How Can You Determine That the Board of Directors' Audit Committee Is Effective?

◆◆◆ An enlightened and proactive audit committee is a powerful agent for corporate self-regulation.

- Has the board recently reviewed the adequacy of the audit committee's written charter?
- Are audit committee members functioning and independent of management?
- Do audit committee members possess an appropriate mix of operational and financial control expertise?
- Does the audit committee understand and monitor the broad organizational control environment?
- Does the audit committee oversee appropriateness, relevance, and reliability of operational and financial reporting to the board, as well as to investors and other stakeholders and external users?

COSO'S COMPONENTS OF INTERNAL CONTROL

CONTROL ENVIRONMENT

RISK ASSESSMENT

CONTROL ACTIVITIES

INFORMATION & COMMUNICATION

MONITORING

Management must convey the message that integrity and ethical values cannot be compromised, and employees must receive and understand that message.

— Internal Control — Integrated Framework

- Does the audit committee oversee the existence of and compliance with ethical standards?
- Does the audit committee or full board have a meaningful but challenging relationship with independent external auditors, internal auditors, senior financial control executives, and key business-unit operating executives?

5. How Do You Know That the Internal Auditing Function Is Effective?

- ◆◆◆ Properly organized and effectively operated, internal auditing can give management and the audit committee a way to help monitor the reliability and integrity of financial and operating information.
- Does internal auditing have the complete support of top management, the audit committee, and the board of directors?

Roles and Responsibilities

Everyone in an organization has responsibility for internal control.

Management — The chief executive officer is ultimately responsible and should assume "ownership" of the system. More than any other individual, the chief executive sets the "tone at the top" that affects integrity and ethics and other factors of a positive control environment.

Board of Directors — Management is accountable to the board of directors, which provides governance, guidance and oversight. A strong, active board, particularly when coupled with effective upward communications channels and capable financial, legal and internal audit functions, is often best able to identify and correct such a problem.

Internal Auditors — Internal auditors play an important role in evaluating the effectiveness of control systems, and contribute to ongoing effectiveness. Because of organizational position and authority in an entity, an internal audit function often plays a significant monitoring role.

Other Personnel — Internal control is, to some degree, the responsibility of everyone in an organization and therefore should be an explicit or implicit part of everyone's job description.

— Excerpted From
Internal Control — Integrated Framework

- Has the written scope of internal auditing responsibilities been reviewed by the audit committee for adequacy?
- Is the organizational relationship between internal auditing and senior executives appropriate?
- Does internal auditing have and use open lines of communication and private access to all senior officers and the audit committee?
- Are audit reports covering the right subjects, distributed to the right people, and acted upon in a timely manner?
- Do key audit executives possess an appropriate level of expertise?

6. But — How Can You Be Sure That the Organization's Internal Controls Really Are Doing the Job?

- ◆◆◆ Internal controls cannot ensure success — bad decisions, poor managers, unethical behavior, collusion and override of controls, and competition can still present problems. But good controls help organizations get where they want to go while minimizing pitfalls and surprises.

Conclusion


- ◆◆◆ Review your completed checklist to determine whether COSO's five components of control are effective within your organization. If they are, you can be reasonably sure that future reportable conditions are likely to be detected, prevented, and corrected in the course of normal operations.

TONE at the TOP MISSION


To provide executive management, boards of directors, and audit committees with concise, leading-edge information on such issues as ethics, internal control, governance, and the changing role of internal auditing; and guidance relative to their roles in and responsibilities for the internal auditing function.

To add colleagues to the *Tone at the Top* mailing list, forward an electronic version (if possible) of their mailing information to the editor.

Your comments and suggestions are welcomed.

 THE INSTITUTE OF INTERNAL AUDITORS
249 Maitland Avenue ♦ Altamonte Springs, FL 32701-4201
Tel: 407 830-7600 ♦ Fax: 407 831-5171

Editor: Lisa M. Krist, APRP, E-mail: lkrist@theiia.org
Managing Editor: Trish W. Harris, E-mail: tharris@theiia.org

 Web site: www.theiia.org

IIA *Fast Facts*

I Would Like More Information.

Please send me a listing of The Institute of Internal Auditors' offerings on:

- | | |
|--|---|
| <input type="checkbox"/> Audit Committees/Governance | <input type="checkbox"/> Fraud, Ethics, and the Law |
| <input type="checkbox"/> Auditing Skills/Management
of the Audit Function | <input type="checkbox"/> Fundamental References |
| <input type="checkbox"/> Certification | <input type="checkbox"/> Industry-Specific Auditing |
| <input type="checkbox"/> Communication | <input type="checkbox"/> Information Technology |
| <input type="checkbox"/> Environmental Auditing | <input type="checkbox"/> Internal Control/Control Self-Assessment |
| | <input type="checkbox"/> Standards |

Name (if different than mailing label): _____

IIA Member # (if applicable): _____

Title: _____

Organization: _____

Organization Address: _____

City: _____ State/Province: _____

Country: _____ ZIP/Mail Code: _____

Tel: _____ Fax: _____ E-mail: _____

THE INSTITUTE OF INTERNAL AUDITORS (IIA) is the only international professional association dedicated to the promotion and development of internal auditing.



Established in 1941, The IIA serves more than 65,000 members in internal auditing, governance, internal control, IT audit, education, and security from more than 100 countries. The world's leader in certification, education, research, and technological guidance for the profession, The Institute serves as the profession's watchdog and resource on significant auditing issues around the globe.

The Institute presents important conferences and seminars for professional development, produces leading-edge educational products, certifies qualified auditing professionals, provides quality assurance reviews and benchmarking, and conducts valuable research projects through The IIA Research Foundation.

Please return to:

*The Institute of Internal Auditors
Customer Service Center
249 Maitland Avenue
Altamonte Springs, FL
32701-4201*

*E-mail: custserv@theiia.org
Fax: 407 831-5171
Tel: 407 830-7600, Ext. 1
Web site: www.theiia.org*