

SEC FLASH REPORT

COSO Publishes Guidance on Monitoring Internal Control Systems

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In June 2007, the Securities and Exchange Commission (SEC) issued its interpretive guidance for management regarding a company's evaluation and assessment of internal control over financial reporting (ICFR). As part of rationalizing its conclusion to focus primarily on principles in formulating its guidance, the SEC staff noted that they did not wish to limit or hinder the natural evolution and further development of control frameworks. One example the staff cited was that "COSO is currently working on a project to further define how the effectiveness of control systems can be monitored." Because the effectiveness and efficiency of internal control systems, including the process by which such systems are evaluated, have been a priority by many companies in recent years, the fruits of COSO's labors on this project have been of interest to many executives for some time. The wait is over.

COSO, or the Committee of Sponsoring Organizations of the Treadway Commission, is a private-sector initiative in the United States formed to, among other things, establish a common definition of internal controls, standards, and criteria against which companies and organizations can assess their control systems. After two years of work, debate and research, including consideration of leading practices at both large and small organizations, COSO has completed its three-volume *Guidance on Monitoring Internal Control Systems*, which includes:

- Volume I: Presents the fundamental principles of effective monitoring and develops the linkage to the COSO *Internal Control – Integrated Framework* (COSO Framework) issued in 1992
- Volume II: Presents in greater detail the principles outlined in Volume I and provides guidance to those responsible for implementing effective monitoring
- Volume III: Contains examples of effective monitoring

The new guidance provides in-depth insight for implementing the monitoring component of COSO's Framework. As noted by COSO Chair, Larry Rittenberg, in his statement in Volume I, "The COSO Framework contemplates that monitoring is implemented as an active part of an organization's internal control system." As the new guidance was developed to clarify the monitoring component of internal control, it does not replace the guidance first issued in the COSO Framework. Nor does it replace the guidance included in COSO's 2006 publication, *Internal Control over Financial Reporting – Guidance for Smaller Public Companies* (COSO's 2006 Guidance). The objective of the new guidance is to expound on the basic principles contained in both the 1992 and 2006 documents guiding organizations in implementing effective and efficient monitoring.

The issuance of the new COSO guidance is very timely in this era of financial distress when many companies are implementing cost reduction plans and streamlining their processes as well as pursuing employee headcount reductions. As management formulates and executes these plans to "right size" their organizations, care should be taken to ensure that essential

control, compliance and risk management functions remain intact. For example, key control activities essential to financial reporting should not be compromised as management demands “more with less” from the remaining workforce. New acquisitions, new business activities and new IT systems can and will place the control structure under further stress, and that reality should be carefully considered. In this dynamic environment, effective monitoring should reduce the risk of noncompliance or exposure to breakdowns in risk management processes, vital internal controls and other essential safeguards. The new COSO guidance provides a common sense approach to monitoring for companies that really want to implement effective monitoring processes.

The following discussion provides an overview of the new guidance, a summary of the fundamentals of effective monitoring, a discussion of the benefits and breadth of monitoring, and insights on how to use the guidance going forward. Continued advancements in technology and management techniques ensure that internal control and related monitoring processes will change over time. However, COSO's Monitoring Guidance states that the fundamental concepts of monitoring, as outlined in the guidance, are intended to stand the test of time.

For parties interested in purchasing a copy of the guidance for their personal use, go to: http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/InternalControls/COSO/PRDOVR~PC-990021/PC-990021.jsp.

Overview of New Guidance

Over time, organizations have invested heavily in improving the quality of their internal control systems. One of the drivers of these investments, of course, is the requirement to report to the public on the effectiveness of ICFR. There are other drivers as well – compliance with other laws and regulations and efforts to improve quality, time and cost performance (operational effectiveness and efficiency). In accordance with the COSO Framework, internal control is designed to assist organizations in achieving their objectives. If controls fail to perform, objectives may not be achieved. The five components of the Framework are intended to work together to mitigate the risk of controls failure. Monitoring is one of the five components. The COSO Board believes that many organizations do not fully understand this important component of internal control. As a result, companies often underutilize it in supporting their assessments of internal control.

COSO asserts that effective monitoring considers the collective effectiveness of all five components of internal control. Thus, the application of monitoring is not limited to the evaluation of the effectiveness of control activities. Because management's assessment of internal control often is time-consuming and involves a significant amount of manual testing, effective monitoring presents an opportunity to streamline the assessment process. The new COSO guidance is designed to help organizations take full advantage of this important component of internal control by accomplishing two goals: (1) identifying and maximizing effective monitoring and (2) identifying and improving ineffective or inefficient monitoring. If both of these goals are achieved, the internal control system may be improved, increasing the likelihood that organizational objectives will be achieved.

Fundamentals of Effective Monitoring

The COSO Monitoring Guidance builds on two fundamental principles originally established in COSO's 2006 Guidance:

- Ongoing and/or separate evaluations enable management to determine whether the other components of internal control continue to function over time, and

- Internal control deficiencies are identified and communicated in a timely manner to those parties responsible for taking corrective action and to management and the board as appropriate.

COSO recommends that “organizations should consider ongoing monitoring, when feasible, over separate evaluations where the risks and availability of information merit such an approach.”

COSO's Monitoring Guidance suggests that effective and efficient monitoring is best achieved through monitoring that is based on three broad elements:

- Establish a foundation for monitoring, including: a proper tone at the top; an effective organizational structure that assigns monitoring roles to personnel with appropriate capabilities, objectivity and authority; and a starting point, or baseline, understanding of internal control effectiveness from which ongoing monitoring and separate evaluations can be implemented in an effective and efficient manner
- Design and execute monitoring procedures, with the purpose of evaluating "persuasive information" about the performance of "key controls" addressing "meaningful risks" to organizational objectives
- Assess results and report them to appropriate parties, which entails evaluating the severity of any identified deficiencies and reporting the monitoring results to the appropriate personnel and the board for timely action and follow-up as necessary

These three phases – Establish a Foundation, Design & Execute, and Assess & Report – provide a model for monitoring. They provide a systematic process for determining “what” and “how” to monitor. Determining “what” to monitor is influenced by the underlying risk, the nature of the controls designed to mitigate significant risks and the persuasiveness of the information needed to conclude that the controls are operating effectively.

The point made regarding “persuasive information” in designing and executing monitoring procedures bears further discussion. COSO states:

To be effective, monitoring must evaluate a sufficient amount of suitable information. Suitable information is relevant, reliable and timely in the given circumstances. Sufficient suitable information provides the evaluator with the support needed to conclude on the internal control system’s ability to manage or mitigate identified risks...information that meets these conditions [is] “persuasive.”

Direct information obtained by observing controls in operation, or by reperforming them, or by otherwise evaluating their operation directly can be useful in both ongoing monitoring and separate evaluations. Direct information is highly relevant because it provides what COSO refers to as “an unobstructed view of control operation.”

Indirect information is “all other information that may indicate a change or failure in the operation of controls.” According to COSO, such information includes operating statistics, key risk indicators, key performance indicators and comparative industry statistics. Indirect information is less effective than direct information in identifying control deficiencies. Its value depends on such factors as: its level of precision; the degree of potential variability in potential outcomes (i.e., the more predictable the process, the more useful indirect information is); the adequacy of follow-up procedures to investigate anomalies, exceptions and so-called “red flags”; and the length of time since the operation of the underlying controls was last validated through persuasive direct information. According to COSO, the latter point regarding validation through direct information suggests that the utility of indirect information is limited to a finite period of time.

COSO points out that persuasive information must be evaluated by “appropriately competent and objective evaluators” for monitoring to be effective. COSO acknowledges that management is in the best position to exercise reasonable judgment in determining the appropriate approach to monitoring. In addition, COSO’s guidance covers the determination of the sufficiency and suitability of information used in monitoring, evaluating the period of time and the circumstances by which an organization can rely on adequately designed indirect information and identification of ways in which the organization can make monitoring more efficient without reducing its effectiveness. COSO’s end in mind is to ensure that the results of monitoring can adequately support conclusions about the effectiveness of internal control.

Benefits of Monitoring

Unmonitored controls tend to deteriorate over time. Monitoring, as defined in the COSO Framework, is implemented to help ensure "that internal control continues to operate effectively." COSO asserts that when monitoring is designed and implemented appropriately, organizations benefit because they are more likely to: (a) identify and correct internal control problems on a timely basis; (b) produce more accurate and reliable information for use in decision-making; (c) prepare accurate and timely financial statements; and (d) be in a position to provide periodic certifications or assertions on the effectiveness of internal control. Over time, COSO notes that effective monitoring can lead to organizational efficiencies and reduced costs associated with public reporting on ICFR because problems are identified and addressed in a proactive, rather than reactive, manner.

Breadth of Monitoring Processes

Organizations may select from a wide variety of monitoring procedures. Examples cited by COSO include but not limited to:

- Periodic evaluation and testing of controls by internal audit
- Continuous monitoring programs built into information systems
- Analysis of, and appropriate follow -up on, operating reports or metrics that might identify anomalies indicative of a control failure
- Supervisory reviews of controls, such as reconciliation reviews as a normal part of processing
- Self-assessments by boards and management regarding the tone they set in the organization and the effectiveness of their oversight functions
- Audit committee inquiries of internal and external auditors
- Quality assurance reviews of the internal audit department

COSO asserts that the board has important oversight responsibilities in monitoring internal control in terms of ensuring a strong tone at the top and in mitigating the risk of management override. To this end, COSO suggests that organizations may benefit from periodically evaluating the overall effectiveness and efficiency of monitoring. COSO provides questions for evaluating monitoring with this objective in mind.

Using the Guidance to Move Monitoring Forward

Management can begin the monitoring process by encouraging the people with control-related responsibilities to read COSO’s Monitoring Guidance and consider how best to implement it or whether it has already been incorporated into certain areas. COSO recommends that

personnel with appropriate skills, authority and resources should be charged by management with addressing four fundamental questions:

- (1) Have we identified the meaningful risks to our objectives?
- (2) Which controls are "key controls" that will best support a conclusion regarding the effectiveness of internal control in those risk areas?
- (3) What information will be persuasive in telling us whether the controls are continuing to operate effectively?
- (4) Are we presently performing effective monitoring that is not well utilized in the evaluation of internal control, resulting in unnecessary and costly manual testing?

Note that the above questions can be applied narrowly (e.g., the risks related to reliable financial reporting) or broadly to internal controls covering a broad spectrum of operational and compliance objectives. COSO intended for the guidance to be useful to the design of effective monitoring processes to evaluate the effectiveness of controls pertaining to any control objective.

Management and the board of directors should understand the concepts of effective monitoring and how it serves their respective interests. As the board learns more about monitoring, it will develop the knowledge necessary to ask management in relation to any risky area (referred to by COSO as "meaningful risk"), "How do you know the internal control system is working?"

Because COSO's Monitoring Guidance is designed to help organizations answer these and other questions within the context of their own unique circumstances, it must be understood that circumstances will change over time. As they progress in achieving effectiveness in monitoring, organizations likely will have the opportunity to further improve the process through the use of such tools as continuous monitoring software and exception reports tailored to their processes.

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