



**Internal Control —  
Integrated Framework**

**Guidance on Monitoring  
Internal Control Systems**

**September 2007**

**Discussion Document**  
Public Comment Period  
Closes October 31, 2007



# What is COSO?

COSO [*Committee of Sponsoring Organizations of the Treadway Commission*] was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private sector initiative which studied the causal factors that can lead to fraudulent financial reporting and developed recommendations for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions.



# Origin and Major Landmarks

Beginning 1940s - debate on internal control started  
- meaning, elements, implications on audit

1973-76 – Watergate investigations led to more and more attention on internal control

1977 – Foreign Corrupt Practices Act [FCPA] – requiring corporations to maintain a system of internal accounting control to provide a deterrent to illegal payments



# Origin and Major Landmarks

1979 – Securities and Exchange Commission - [SEC] Mandatory Management reporting on internal controls

1980-1985 – Various initiatives taken by AICPA to develop and refine professional standards in the auditing profession related to internal control

1983 – IIA published “Statement of Internal Auditing Standards No.1, on “Control: Concepts and Responsibilities”



# Origin and Major Landmarks

In 1985 the National Commission on Fraudulent Reporting, known as the Treadway Commission was formed with joint sponsorship of five major professional associations in the United States, the American Accounting Association, the American Institute of Certified Public Accountants, Financial Executives International, The Institute of Internal Auditors, and the National Association of Accountants (now the Institute of Management Accountants).

This initiative is also referred to as COSO.



# Origin and Major Landmarks

The Chairman of the National Commission was James C. Treadway Jr., Executive Vice President and General Counsel, Paine Webber Incorporated and a former Commissioner of the U.S. Securities and Exchange Commission. (Hence, the popular name "Treadway Commission").

Currently, the COSO Chairman is Larry E. Rittenberg Ph.D. CIA.CPA Ernst & Young professor of accounting and information systems at the University of Wisconsin, Madison



# MAJOR COSO INITIATIVES

**May 1992**

## **Internal Control — Integrated Framework**

To help businesses and other entities assess and enhance their internal control systems. This Framework has today been incorporated into policies and procedures of a large no of businesses around the world to ensure improved control over their activities in moving towards achievement of their goals and objectives.



# MAJOR COSO INITIATIVES

**September 2004**

## **Enterprise Risk Management [ERM]- Integrated Framework**

**Incorporates the internal control framework into it and provides a more robust and extensive focus on the broader subject of ERM. Provides organizations with a framework both to satisfy their internal control needs and to move towards a fuller risk management process.**



# MAJOR COSO INITIATIVES

**June 2006**

## **Internal Control over Financial Reporting – Guidance for Smaller Public Companies**

**Provides a set of 20 basic principles  
Representing fundamental concepts  
drawn directly from the Framework**



# Integrated Framework – May 1992

## Definition of internal control

### Three main objectives of Internal Control

“A process effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- 1. Effectiveness and efficiency of operations**
- 2. Reliability of financial reporting**
- 3. Compliance with applicable laws and regulations”**



# Integrated Framework – May 1992

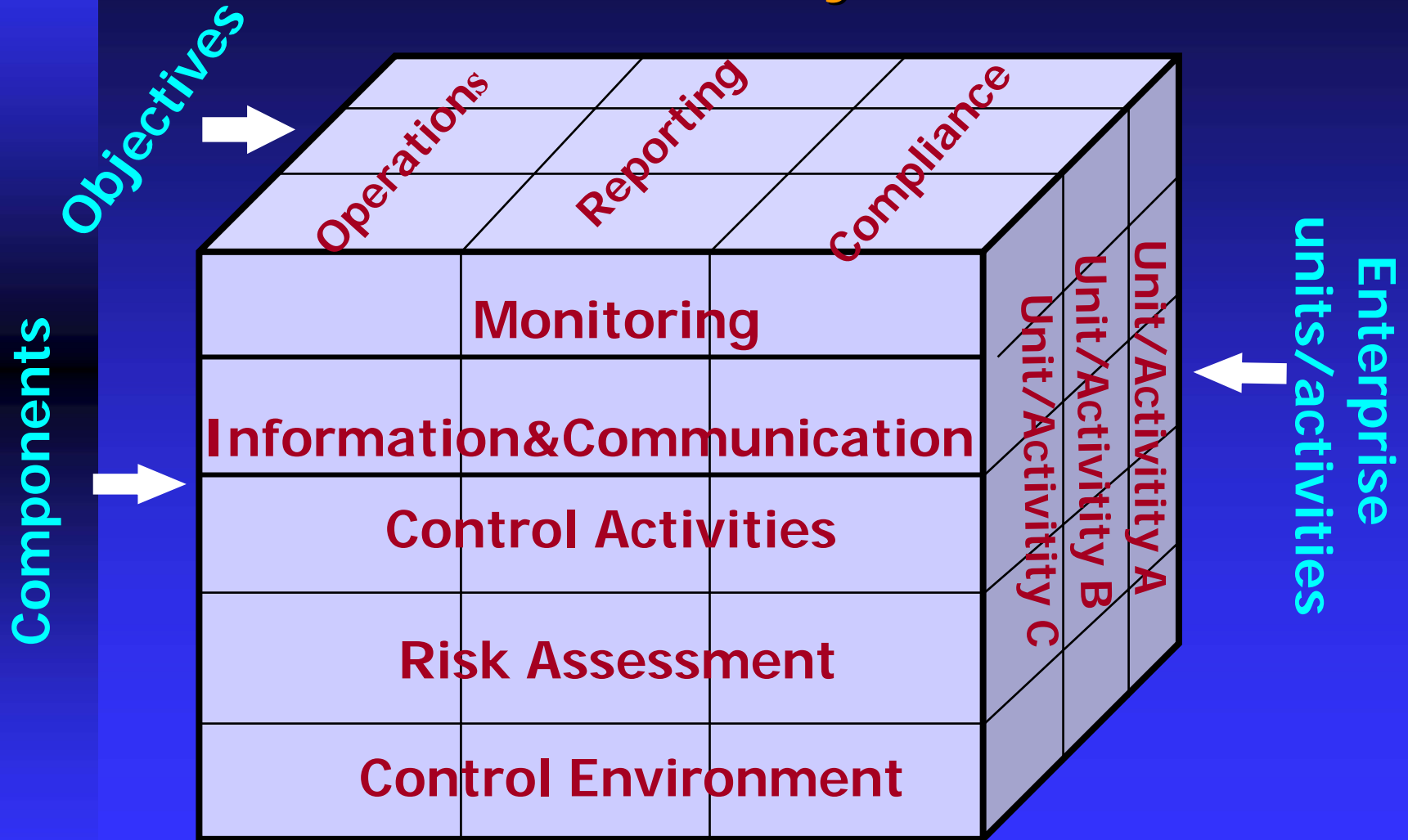
Five inter-related components of internal control

Each of the **THREE** internal control objectives identified by COSO consists of the following **FIVE** interrelated components:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring



# Internal Control – Integrated Framework COSO - May 1992



# KEY COSO CONCEPTS

- **Internal control is a process. It is 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**

Source: [www.coso.org](http://www.coso.org)



# Why this discussion document?

- ❑ The COSO Board believes that the monitoring component of a properly designed and functioning internal control system –utilizing 1992 Framework has been underutilized in many organizations
- ❑ This discussion document is intended to improve the understanding of the building blocks of effective monitoring, thereby improving both the efficiency and effectiveness of the entire system of internal control
- ❑ This discussion document is only intended to reinforce and clarify, not add to, the sound principles of monitoring previously established in the 1992 Framework and 2006 Guidance



# Issues for discussion

1. Monitoring as a component of internal control systems
2. Fundamentals of Monitoring
3. Nature of information used in monitoring
4. Designing effective monitoring
5. Communicating and addressing the results of monitoring
6. Scalability of monitoring



# Monitoring as a component of internal control systems

- ❑ Role of Monitoring
- ❑ Structure of effective internal control systems
- ❑ Difference between Monitoring Activities and Control Activities

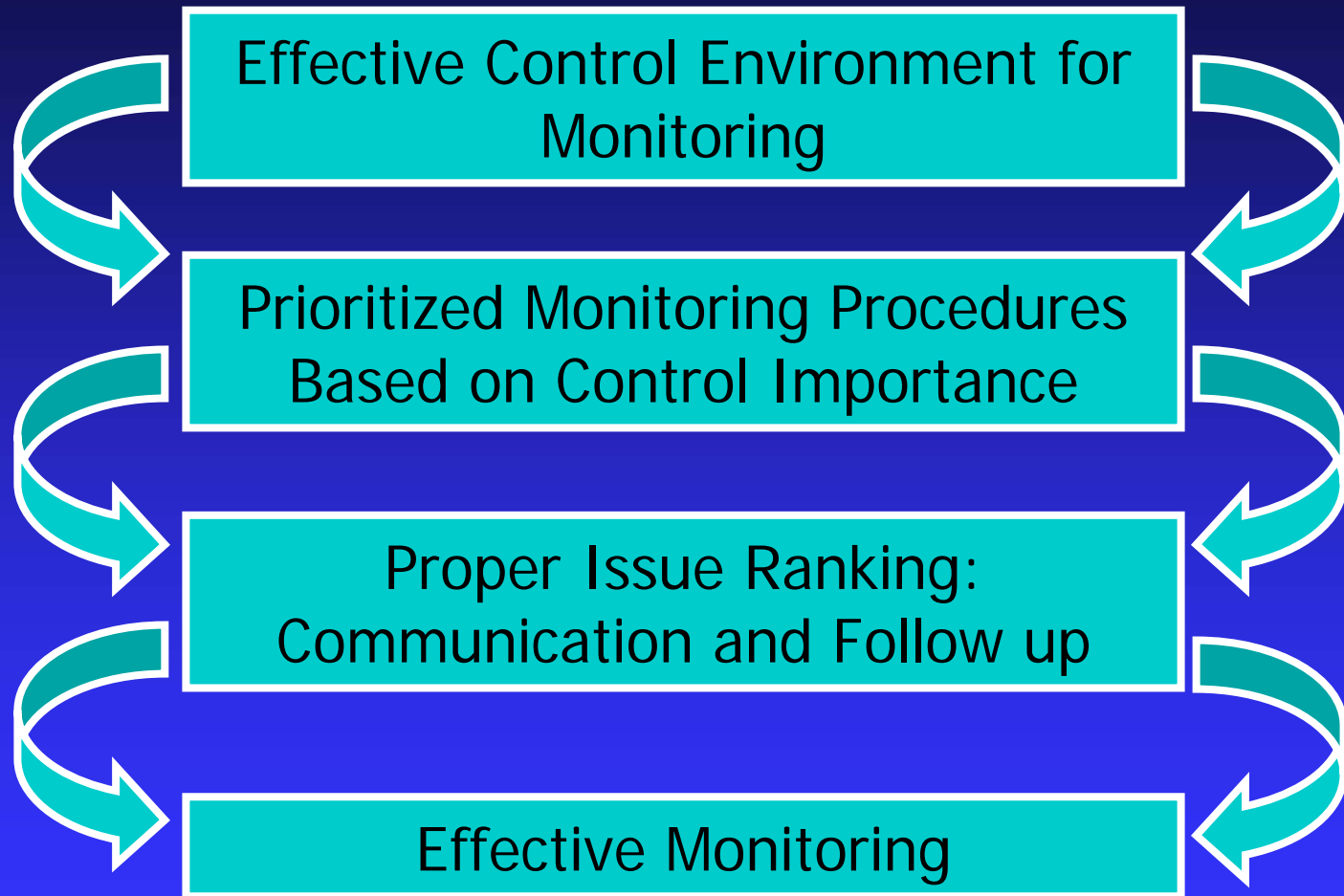


# Fundamentals of Monitoring

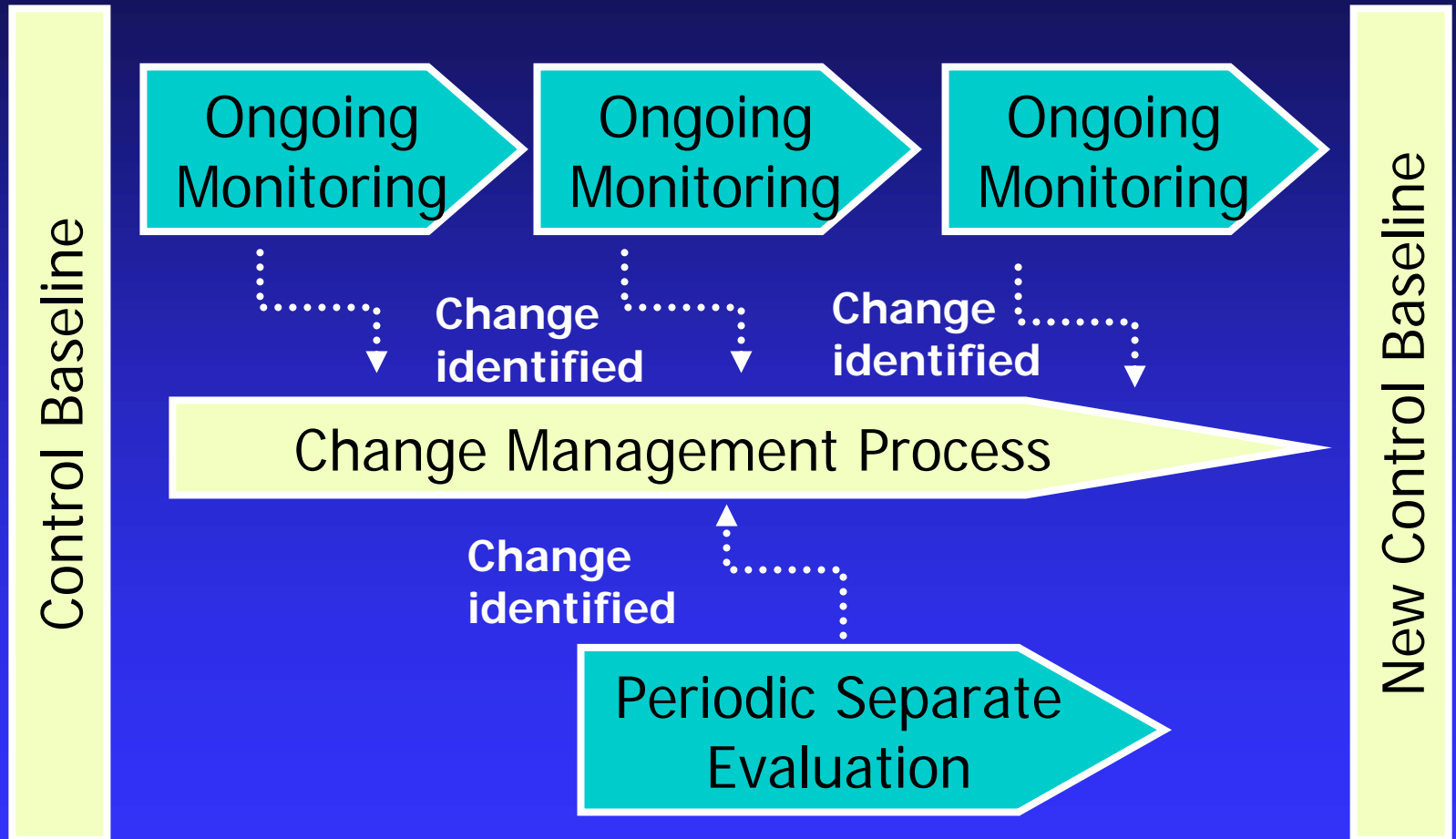
- ❑ Attributes of Ongoing Monitoring and Separate Evaluations
- ❑ Attributes of effective communication and follow up
- ❑ Elements of Effective Monitoring
- ❑ Role of Board/Audit Committee



# Pre-requisites for Effective Monitoring



# Elements of Effective Monitoring



# Nature of information used in monitoring

Monitoring involves gathering and analyzing persuasive information to support conclusions on the effectiveness of controls. Persuasiveness refers to the degree to which information is capable of providing adequate support for the conclusions drawn

Persuasive information should be both:

- 1. Suitable**
- 2. Sufficient**



# Is information suitable?

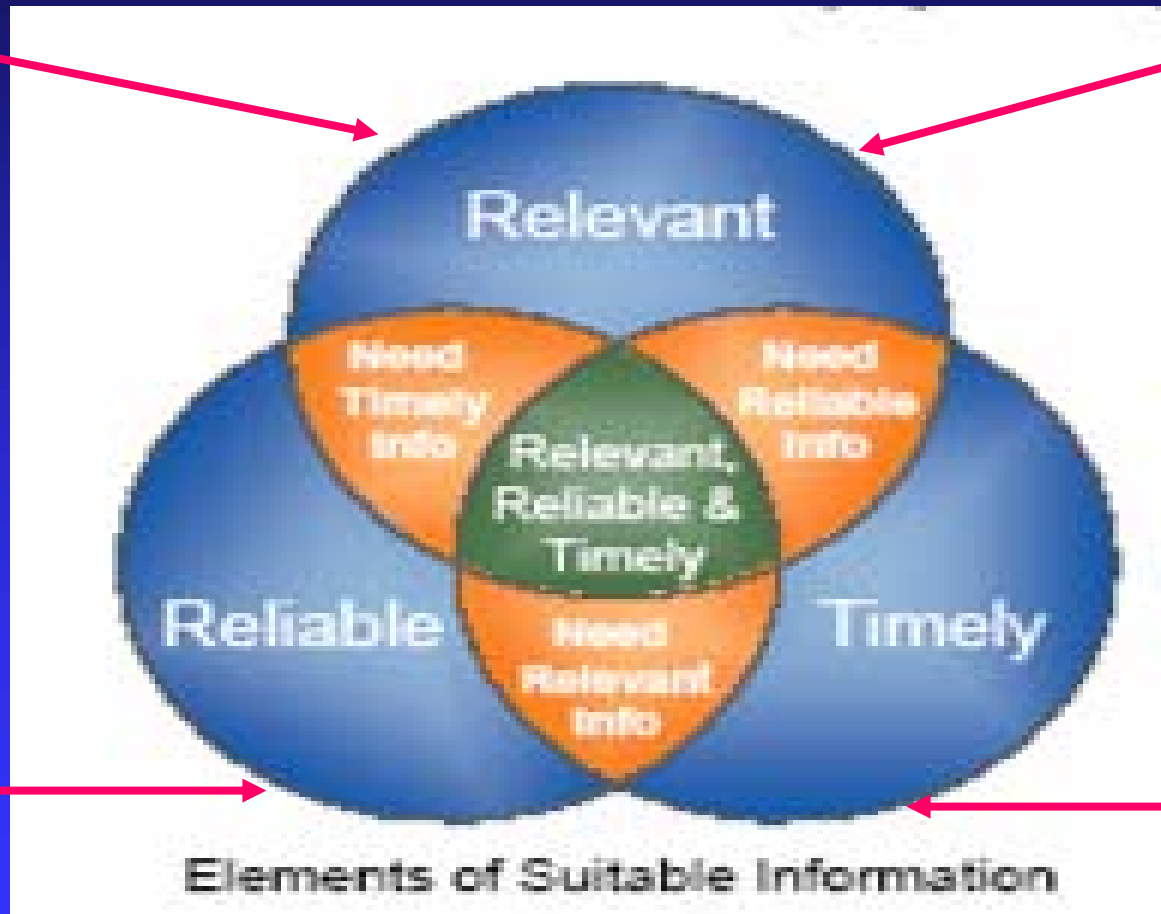
Information is suitable when it is relevant, reliable and timely

Indirect information

Direct information

Accurate  
Verifiable  
From an  
Objective  
Source

Before  
Control  
Weaknesses  
become  
significant



# Is information sufficient?

## Nature of Controls



# Designing effective monitoring

- ❑ Prioritizing and Designing monitoring procedures
- ❑ Deciding on when and how often to monitor



# Prioritizing and Designing monitoring procedures

1. Purpose of monitoring
2. Relative importance of controls
3. Ongoing monitoring using direct information
4. Ongoing monitoring using indirect information
5. Separate evaluation using both
6. Capabilities and position of evaluators
7. Using technology for effective monitoring



# Deciding on when and how often to monitor

## 1. Ongoing evaluations:

Likelihood and significance of risk's  
Occurrence between evaluations

## 2. Separate evaluations:

Depends on the changes in the control baseline  
After last evaluation



# Communicating and addressing the results of monitoring

## 1. Ranking issues and reporting internally

As stated in Principle 20 of COSO 2006 Guidance on Reporting Weaknesses:

“Internal control weaknesses are identified and communicated in a timely manner to those parties responsible for taking corrective action, and to Management and the Board as appropriate”

## 2. Reporting to external parties

Evaluators may need or desire more persuasive information to support external assertions than they would need to support internal conclusions regarding control effectiveness



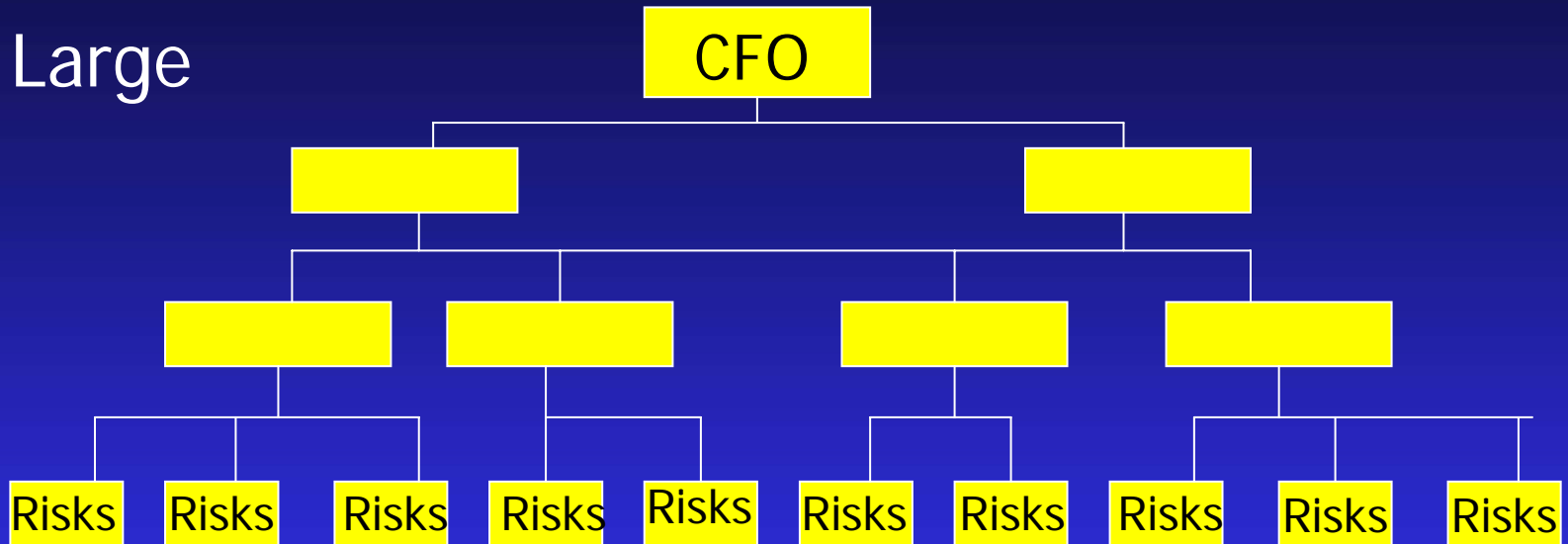
# Scalability of monitoring

- ✓ Scalability based on size
- ✓ Scalability based on complexity
- ✓ Formality of monitoring and level of documentation



# Scalability based on size of Organization

Large



Small



# Scalability based on complexity

1. Industry characteristics
2. Regulatory environment
3. Diversified product lines
4. Level of centralization vs. decentralization
5. Use of packaged vs. customized software



# Formality of monitoring and level of documentation

For large and complex organizations, especially those involving external reporting requirements, formality of monitoring and level of documentation is important, such as:

1. Automated and manual processes to document and retain monitoring information
2. Detailed policies regarding aggregation, evaluation and reporting weaknesses to senior management and audit committee



# To sum up :

If control environment is the foundation of an effective system of internal control, then monitoring is the capstone. Monitoring serves two primary purposes:

1. It provides management and the Board with information that helps them conclude that the internal control system is working as intended over time
2. It promotes good control operation because personnel responsible for the controls being monitored know the proper control operation is verified.

**This discussion document is to help organizations develop monitoring programs that will contribute most effectively and efficiently to the operation of an optimal internal control system**



Thank you

