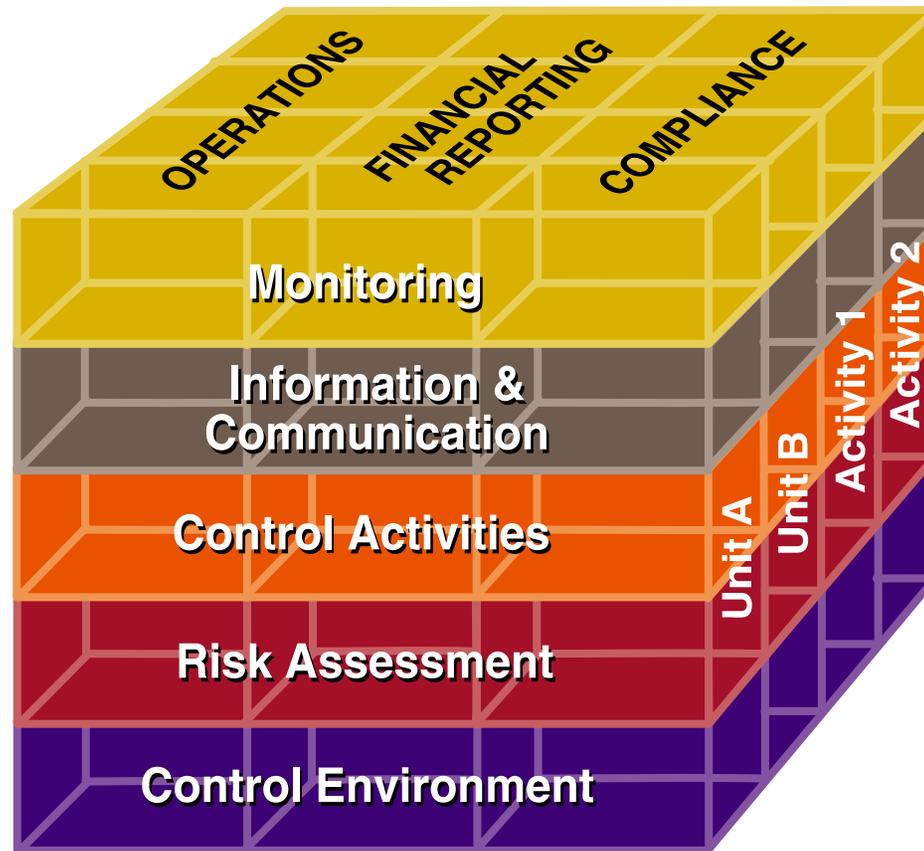


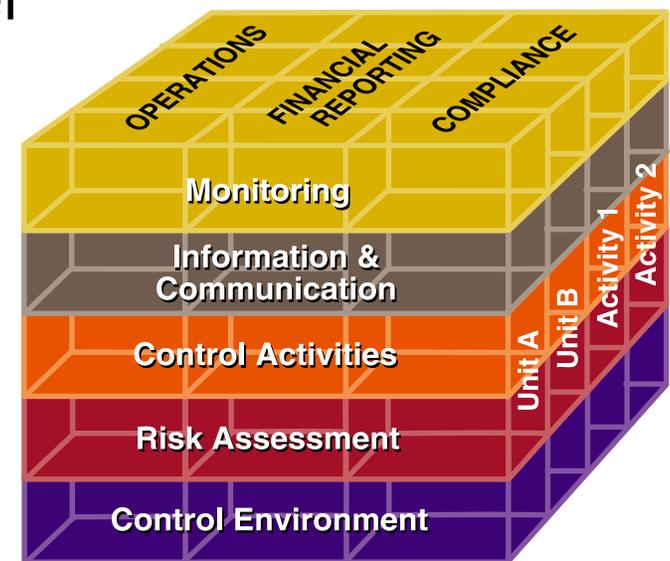
# THE COSO INTEGRATED CONTROL CUBE



# COSO Definition of Internal Control

“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 in the following categories:

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



# Responsibility for Internal Control

- **Everyone in an organization has responsibility for internal control:**
  - ❖ Management: “Owns” internal control system and sets the Tone at the Top. Chief Executive Officer is ultimately responsible
  - ❖ Board of Directors/Audit Committee: Management is accountable to the Board, which provides governance, guidance and oversight
  - ❖ Internal Auditors: Evaluate the effectiveness of the internal control systems and contribute to ongoing effectiveness
  - ❖ Other personnel: Internal control is, to some degree, the responsibility of everyone in an organization

## Responsibility for Internal Control, cont.

- External parties can contribute to internal control:
  - ❖ External auditors bring an independent and objective view, contributing directly through the financial statement audit and indirectly by providing information useful to management and the Board in executing their responsibilities
  - ❖ Legislators, regulators, customers, clients, financial analysts, news media and others provide information useful in effecting internal control
- However, external parties are not responsible for or a part of an entity's control system

# Some Key Principles

- Control Environment – “Tone at the Top”
  - Develops, communicates, reinforces, and monitors integrity and ethical values within the organization and address any deviations
  - Importance of Board of Directors
    - ❑ Oversight responsibility for financial reporting and internal control
  - Management’s philosophy and operating style
  - Organizational structure
  - Commitment to competence
  - Authority and responsibility
  - Human Resources
    - ❑ Policies and practices should facilitate effective internal control

## Some Key Principles, cont.

- Risk Assessment
  - Importance of financial reporting objectives
  - Identification and analysis of financial reporting risks
  - Assessment of fraud risk
  - Design risk response to reduce risk likelihood & impact to a level tolerable to management & the Board
- Control Activities
  - Elements of a control activity
    - ❑ Establishment and communication of policies and procedures throughout the entire organization
  - Control activities linked to risk assessment
  - Selection and development of control activities
    - ❑ Consideration of cost and potential effectiveness of mitigating risks
  - Information Technology
    - ❑ An enabler for effective internal control

## Some Key Principles, cont.

- Information and Communication
  - Personnel clearly understand what constitutes acceptable & unacceptable behavior
  - There are open channels of communication between management & staff, including a mechanism for staff to report relevant issues without fear of reprisal
  - Open communications exist between senior management & the Board of Directors
  - Open communications exist between the entity & its clients or customers, providing a conduit for feedback
  - The entity complies with the requirements of external agencies, regulators, etc.

## Some Key Principles, cont.

- Monitoring
  - Ongoing monitoring
    - Performed in ordinary course of running the business
    - Performed on real-time basis and reacts to changing conditions
  - Separate evaluations
    - Periodic testing, e.g., audits, process evaluations
  - Includes process for reporting deficiencies
    - Should be identified and communicated in a timely manner to the appropriate parties so that corrective action can be taken and/or communicated to management and the Board

## Primary Challenges to Implementing Effective Internal Control in Small Organizations

- ❖ Segregation of duties
- ❖ Management override
- ❖ Ineffective Board of Directors
- ❖ Qualified accounting personnel
- ❖ Information technology

## Primary Challenges in Implementing Internal Control in Small Organizations, cont.

- Addressing Segregation of Duties challenge
  - ❖ Management should:
    - Ensure no one person can initiate, approve, receive, and disburse funds for any purchase
    - Ensure no one person can receive, post, deposit, and reconcile the bank account for any collections
    - Regularly review reports of detailed transactions on a timely basis to identify, investigate, and correct improper transactions
    - Periodically review sample transactions
    - Take periodic asset counts and compare to accounting records for assets such as inventory, equipment, and other tangible assets
    - Review budget analyses and cost trends to identify potential problem areas

## Primary Challenges in Implementing Internal Control in Small Organizations, cont.

- Addressing Management Override challenge
  - ❖ Commitment to competence and strong ethical behavior, reinforced by the oversight of a quality independent Board
  - ❖ Effective whistle-blower program
  - ❖ Informed and inquisitive Audit Committee and Board of Directors
  - ❖ Independent audit
  - ❖ Internal audit

## Primary Challenges in Implementing Internal Control in Small Organizations, cont.

- Addressing ineffective Board of Directors challenge
  - ❖ Broaden the pool of Board and Audit Committee members
  - ❖ Consider highly-qualified individuals with financial expertise to serve on Board and Audit Committee, such as:
    - ❑ Chief Financial Officers
    - ❑ Management Accounting experts
    - ❑ Accounting professors
    - ❑ Chief Audit Executives
    - ❑ Retired public accounting partners
  - ❖ Board members should always be objective and independent in performing their governance duties
  - ❖ Board members should maintain professional skepticism regarding management's representations, and should actively pursue clarification on matters they are uncertain of or uncomfortable with

## Primary Challenges in Implementing Internal Control in Small Organizations, cont.

- Examples of Internal Control Circumvention
  - ❖ Collusion among management, employees, and/or third parties
  - ❖ Withheld, misrepresented, or falsified documentation
  - ❖ The ability of management to override, or instruct or coerce others to override, internal control policies and procedures
  - ❖ Responsibility for reviewing Board and employee expense accounts is assigned to personnel who lack sufficient expertise to evaluate the expenditures, and/or who lack sufficient authority to effectively challenge questionable expenditures

## ➤ **Be Proactive-An Internal Control Review is Strongly Recommended**

- ❖ Management and the Board should assess risk within the key financial processes of their organization:
  - Purchasing
  - Billings & Collections (including donations)
  - Asset Management
  - Payroll
  - Board & Employee Expense Accounts
  - Other significant financial processes related to the organization's specific charge, e.g., grant accounting
- ❖ Once assessed, the Board may wish to engage a CPA to conduct Agreed Upon Procedures examining the controls related to those key financial processes
  - The Board will need to consider costs vs. benefits when selecting Agreed Upon Procedures

## ➤ **SUMMARY**

- ❖ Strong internal controls are essential
- ❖ Tone at the top is critical
- ❖ Ethical business practices are essential
  - If the media reported on your organization's business practices, would you be proud or embarrassed?
  - Would your donors' trust be enhanced or eroded?
- ❖ Protect your organization's reputation
- ❖ Address internal control challenges proactively
  - Consider an Agreed Upon Procedures engagement

## **SOURCES:**

- Committee of Sponsoring Organizations of the Treadway Commission (COSO)
- Crowe Horwath LLP