The Evolution of Internal Controls

Carl Hoecker, CPA

Jon T. Rymer CIA, CGAP, CDFM
Internal Controls

1. Definition
2. History - COSO and the Treadway Commission
3. Enter the Green Book
4. Leadership and Controls
5. Assessing Effectiveness
6. An Inspector General’s View
Internal Controls

Defined
Oversight
Definition- Internal controls over financial reporting

Internal controls are set to cover a variety of areas from operational to financial control. Controls over financial reporting have received the most attention from the regulatory and oversight communities.

The Securities and Exchange Commission in its final rules concerning the implementation section 404 of Sarbanes-Oxley provided this definition for internal controls over financial reporting:

The process designed by, or under the supervision of be issuer’s principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer’s Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.
Definition - Internal controls over financial reporting

The SEC went on to describe the some of the policies and procedures required in effective internal controls:

- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer.

- Provide reasonable assurance regarding prevention or timely detection of on authorized acquisition, use, or disposition of the issuers assets that could have a material effect on the financial statements.
History

COSO
Treadway Commission
Results
History | COSO

- Committee of Sponsoring Organizations (COSO) was formed in 1985 by the major accounting and auditing professional organizations:
  - The Institute of Internal Auditors
  - The American Institute of Certified Public Accountants
  - The American Accounting Association
  - Financial Executives International
  - Institute of Management Accountants.

- COSO sponsored the National Commission on Fraudulent Financial Reporting, chaired by former SEC Commissioner James C. Treadway (Treadway Commission)
Evolution of Internal Controls

History | Treadway Commission

- Treadway Commission *(beginning in 1987)*
  - Studied numerous cases of fraudulent financial reporting
  - Made several key recommendations concerning
    - Role of top management in financial reporting
    - Purpose of internal controls
    - Written codes of conduct
    - Role and structure of the internal audit function
    - CEO and CFO should sign management reports
    - Auditor independence
    - SEC’s role in detecting fraudulent financial reporting
History | Result

Issuance of the report *Internal Controls - Integrated Framework* in 1992, defining the five components (composed of 17 principles) of an effective internal controls program.

1. Control Environment - the structure and discipline for a system of internal controls.
2. Risk Assessment - management’s duty to identify risk to achieving predetermined objectives.
3. Control Activities - policies and procedures that mitigate risk and help achieve objectives.
4. Management Information and Communications to stakeholders.
5. Monitoring - external and internal oversight for compliance and improvement.
Enter the Green Book

Standards for Internal Controls in the Federal Government
GAO’s Green Book

All five COSO components emphasize the strong role management must play in controls. As an example, the first attribute of the first principle of the first component in GAO’s Internal Controls in the Federal Government is Tone at the Top.

The oversight body and management must:
- Demonstrate the importance of integrity and ethical values.
- Lead by an example that demonstrates the organization’s values, philosophy, and operating style.
- The attitudes and behaviors of management must reflect the integrity and ethical values expected throughout the entity.
The oversight body and management must:

Reinforce the commitment to doing what is right, not just maintaining a minimum level of performance necessary to comply with applicable laws and regulations, so that these priorities are understood by all stakeholders, such as regulators, employees, and the general public.
Without strong leadership to support an internal control system:

- The entity’s risk identification may be incomplete
- Risk responses may be inappropriate
- Control activities may not be appropriately designed or implemented
- Information and communication may falter, and
- Results of monitoring may not be understood or acted upon to remediate deficiencies.
Identifying and Managing Risk

Effective risk management is the first step to developing controls

• An effective control system enables management to monitor and manage significant risk

• Relevant and reliable internal and external information is identified, compiled and communicated in a timely manner to those who are in a position to act

• Risks are identified and analyzed, and actions are readily taken to mitigate them

• Controls are in place to assure that management decisions are properly carried out

- IIA Tone at the Top newsletter dated March 1998
Managing Internal Controls

Internal control should be monitored by line management on an ongoing basis subject to periodic evaluation. Line management:

- Accepts control responsibility themselves
- Routinely monitors controls
- Clearly assigns responsibility for training and championing of internal controls
- Establishes internal controls evaluation criteria
- Builds appropriate controls into new systems and processes

- IIA Tone at the Top newsletter dated March 1998
Assessing Effectiveness

Oversight Function
Internal Audit Function
Internal Controls
Evaluating Organizational Commitment

Questions to Ask Organization

• Do board members and senior executives set a day-in, day-out example high integrity and ethical behavior?
• Is there a written code of conduct and is it reinforced by training, top-down communications, and requirements for written statements of compliance from employees?
• Are performance and incentive compensation targets reasonable and realistic, or do they create undue pressure on achievement of short term goals?

- IIA Tone at the Top newsletter dated March 1998
Questions to Ask Organization (continued)

- Is it clear that fraudulent financial reporting (now any 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 unit?
- Does a process exist to resolve close ethical calls?
- Are business risks candidly discussed with the board (or governing body)?
How do you know oversight is effective?

Board of Directors Audit Committee (or the oversight function):

- Is there a written charter for the Audit Committee?
- 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 oversee the existence and compliance with ethical standards?
How do you know the Internal Audit function is effective?

• Does internal audit have the complete support of top management and the board? (or oversight committee)?

• Has the written scope of internal auditing responsibilities been reviewed by the audit committee?

• Is the organizational relationship between internal audit and executive managers appropriate? (Independence, professional skepticism)

• Does internal auditing have and use open lines of communications and private access to senior leaders and the audit committee?

• Are audit reports distributed and acted upon?

• Do audit executives possess the appropriate level of expertise?
How do you know that internal controls really do the job?

The benefits of Internal Controls
   Assets are Safeguarded
   Operating reporting is reliable
   Compliance becomes consistent
   Accomplishes operational efficiency
Internal Controls

An Inspector General’s View

Carl Hoecker
Introduction

• Disclaimer

• Background

• Three Buckets
  • Observations of SEC public actions
  • Internal controls – the beginning
  • IG experiences
Bucket One: SEC and Internal Controls

- SEC mission is to: protect the investor; maintain fair, orderly, and efficient markets; and facilitate capital formulation.

- Rules, Inspections, Enforcement

- Civil Actions
  - PowerSecure
  - Orrstown
  - Grupo Simec
Bucket Two: Internal Controls - Beginning

- Babylonian and Egyptian Eras
  - Scribes
  - Tiny marks, dots, ticks and circles
  - Written orders for disbursements

- Roman and Greek Empires
  - Less formalized accounting and controls
  - Slaves were preferred as accountants
Bucket Three: IG Story One

Unnamed agency

- Time and Materials Contract
- One FTE as the COR
- Hundreds of contract employees performing at different locations

- Waive the contractor time and attendance system
- Invoiced for work performed three months prior
- Amended invoices afterwards

- Why was a huge amount of unsupported costs found
IG Story Two

Unnamed agency

- Storefront operation
- Cash operation
- One person in-charge
- No audit requirement

- Why did some merchandise end up at the home of the person in charge
IG Story Three

- OIG made recommendations to improve internal controls
- Head of agency a true believer in positive tone at the top
- Process claimed OIG recommendations can never be closed
- Head of agency learns from IG the true requirements to close recommendations

- Why was that process owner asked to leave
Examples of Leadership and Internal Controls

FDIC Chairman
CENTCOM Intelligence Investigation
OIG at FDIC
DoD OIG
FDIC Conferences