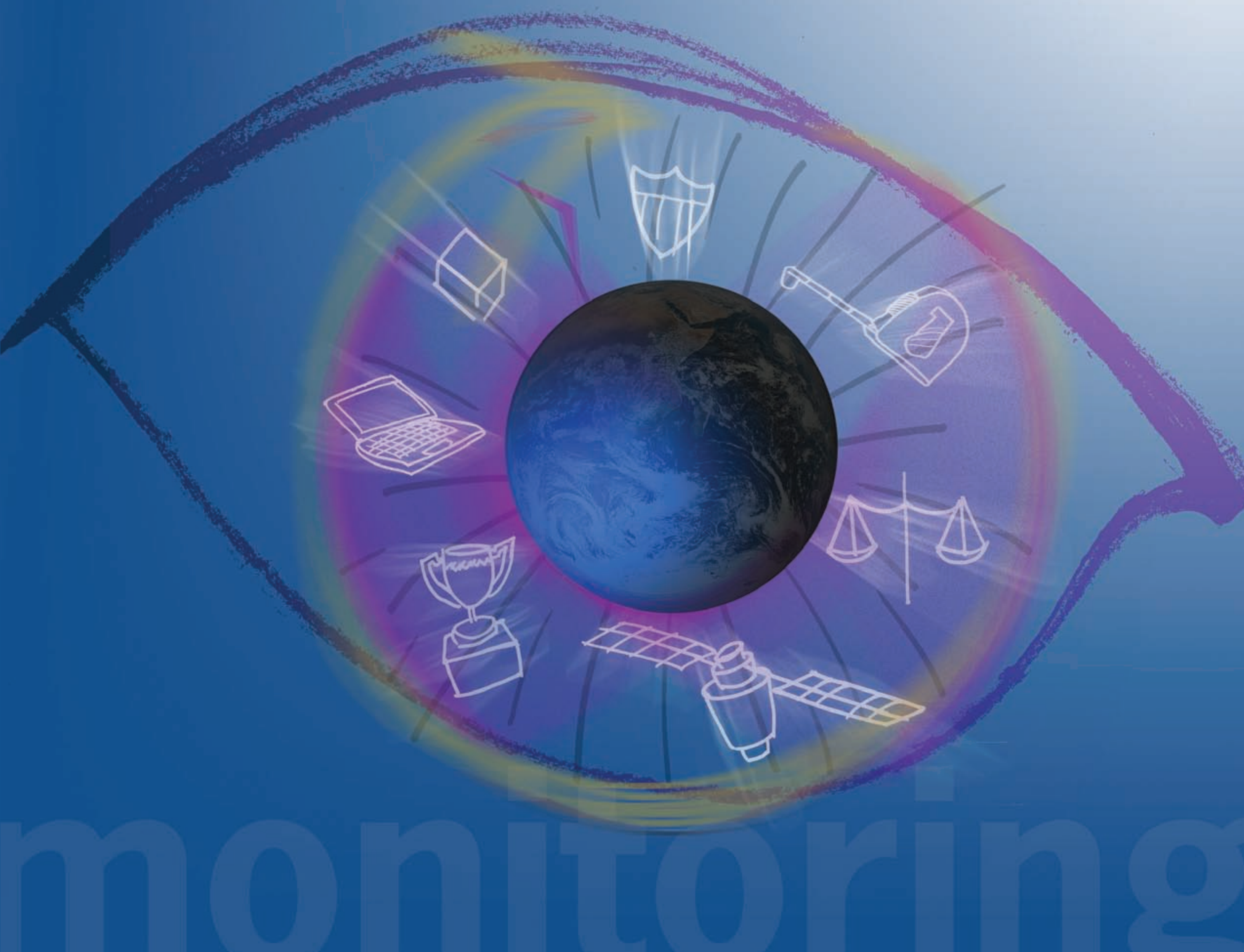
COSO

COMMITTEE OF SPONSORING
ORGANIZATIONS OF THE TREADWAY COMMISSION

Internal Control — Integrated Framework

Guidance on Monitoring Internal Control Systems

Introduction



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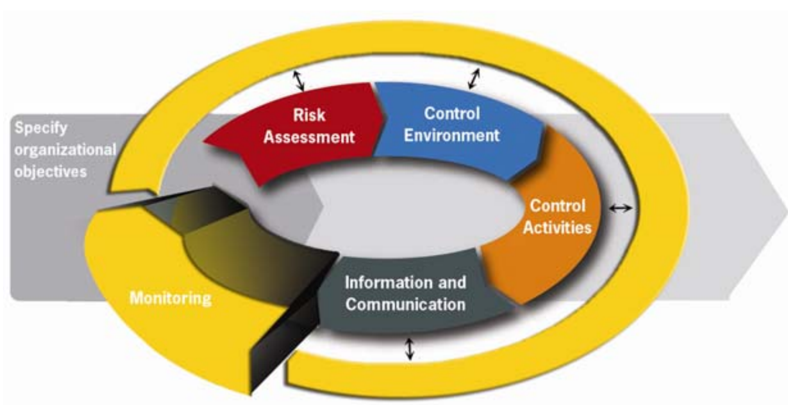
Monitoring: An Integral Component of Internal Control

Over the past decade, organizations have invested heavily in improving the quality of their internal control systems. They have made the investment for a number of reasons, notably: (1) good internal control is good business — it helps organizations ensure that operating, financial and compliance objectives are met, and (2) many organizations are required to report on the quality of internal control over financial reporting, compelling them to develop specific support for their certifications and assertions.

Internal control is designed to assist organizations in achieving their objectives. The five components of COSO's *Internal Control — Integrated Framework* (the COSO Framework) work in tandem to mitigate the risks of an organization's failure to achieve those objectives.

The COSO Board recognizes that management's assessment of internal control often has been a time-consuming task that involves a significant amount of annual management and/or internal audit testing. Effective monitoring can help streamline the assessment process, but many organizations do not fully understand this important component of internal control. As a result, they underutilize it in supporting their assessments of internal control.

Figure 1 depicts the comprehensive nature of monitoring and illustrates how effective monitoring considers the collective effectiveness of all five components of internal control.



Monitoring Applied to the Internal Control Process
Figure 1

COSO's 2008 *Guidance on Monitoring Internal Control Systems* (COSO's Monitoring Guidance) was developed to clarify the monitoring component of internal control. It does not replace the guidance first issued in the COSO Framework or in COSO's 2006 *Internal Control over Financial Reporting — Guidance for Smaller Public Companies* (COSO's 2006 Guidance). Rather, it expounds on the basic principles contained in both documents, guiding organizations in implementing effective and efficient monitoring.

How Does Monitoring Benefit the Governance Process?

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."[1] When monitoring is designed and implemented appropriately, organizations benefit because they are more likely to:

- Identify and correct internal control problems on a timely basis,
- Produce more accurate and reliable information for use in decision-making,
- Prepare accurate and timely financial statements, and
- Be in a position to provide periodic certifications or assertions on the effectiveness of internal control.

Over time effective monitoring can lead to organizational efficiencies and reduced costs associated with public reporting on internal control because problems are identified and addressed in a proactive, rather than reactive, manner.

Fundamentals of Effective Monitoring

COSO's Monitoring Guidance builds on two fundamental principles originally established in COSO's 2006 Guidance:[2]

- 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.

The monitoring guidance further suggests that these principles are best achieved through monitoring that is based on three broad elements:

- **Establishing a foundation for monitoring,** including (a) a proper tone at the top; (b) an effective organizational structure that assigns monitoring roles to people with appropriate capabilities, objectivity and authority; and (c) a starting point or "baseline" of known effective internal control from which ongoing monitoring and separate evaluations can be implemented;

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[1] COSO Framework, p. 69.

[2] See principles #19 and #20 in COSO's *Internal Control over Financial Reporting – Guidance for Smaller Public Companies* issued in 2006 (COSO's 2006 Guidance).

- **Designing and executing monitoring procedures** focused on *persuasive information* about the operation of *key controls* that address *meaningful risks* to organizational objectives; and
- **Assessing and reporting results,** which includes 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 if needed.

Breadth of Monitoring Processes

Organizations may select from a wide variety of monitoring procedures, including 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, and
- Quality assurance reviews of the internal audit department.

Continued advancements in technology and management techniques ensure that internal control and related monitoring processes will change over time. However, the fundamental concepts of monitoring, as outlined in COSO's Monitoring Guidance, are designed to stand the test of time.

Using the Guidance to Move Monitoring Forward

Management can begin the monitoring process by encouraging the people with control system responsibility to read COSO's Monitoring Guidance and consider how best to implement it or whether it has already been incorporated into certain areas. Further, personnel with appropriate skills, authority and resources should be charged by management with addressing these four fundamental questions:

1. Have we identified the meaningful risks to our objectives, for example, the risks related to producing accurate, timely and complete financial statements?
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 further testing?

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 area of meaningful risk, "How do you know the internal control system is working?"

COSO's Monitoring Guidance is designed to help organizations answer these and other questions within the context of their own unique circumstances — circumstances that 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.

The guidance also covers other concepts that are important to effective and efficient monitoring, including:

- The characteristics associated with the objectivity of the evaluator;
- The period of time and the circumstances by which an organization can rely on adequately designed *indirect information* — when used in combination with ongoing or periodic persuasive *direct information* — to conclude that internal control remains effective;
- Determining the sufficiency and suitability of information used in monitoring to ensure that the results can adequately support conclusions about internal control; and
- Ways in which the organization can make monitoring more efficient without reducing its effectiveness.

COSO's Monitoring Guidance encompasses three volumes. Volume I presents the fundamental principles of effective monitoring and develops the linkage to the COSO Framework. Volume II conveys 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.

Many organizations, through applying the concepts set forth in the guidance, should improve the effectiveness and efficiency of their internal control systems. To that end, COSO's Monitoring Guidance is designed to help organizations (1) identify effective monitoring where it already exists and use it to the maximum benefit, and (2) identify less effective or efficient monitoring, leading to improvements. In both instances, the internal control system may be improved, increasing the likelihood that organizational objectives will be achieved.

Committee of Sponsoring Organizations of the Treadway Commission

COSO is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance.

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