



Internal Controls - In Search of the Appropriate Solution - Part III

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By Marcelo Gherman - Security Consultant with Modulo Security Solutions

In the first part of this article, we discussed the global context in which institutions' Internal Controls are embedded. We also defined such systems and explained their importance for corporate risk management and for reaching business objectives. In addition, we addressed the benefits of using frameworks and methodologies containing good practices for managing these risks.

In the second part of our work, we went on to approach the Integrated Framework described by the Committee of Sponsoring Organizations of the Treadway Commission - COSO.

In this third part, emphasis is placed on a different framework - the CoCo -, which will be compared with the COSO for both strengths and weaknesses.

Guidance on Assessing Control - The CoCo Principles

The CoCo methodology (*Criteria of Control*) was created by the *Chartered Accountants* (CICA) and aims at assisting the higher administration in implementing and evaluating a Control Environment so as to allow the organization to reach all of its strategic and operating targets. Like the COSO, the CoCo uses a method that identifies the essential business targets of a given institution and defines the Internal Control and its components, supplying criteria based on which the control systems can be evaluated.

As to the COSO, we saw how the Internal Control is a process that aims to make operations more economical and efficient, and financial statements more veritable, while also improving compliance with local standards and legislation.

The CoCo method uses a **wider concept** of Control. It involves the resources, the systems and the processes, as well as planning, continuous learning, follow-up using performance indexes and corporate culture. These elements should operate conjointly, **allowing people to reach the organization's objectives**.

Therefore, the focus of the evaluation is on the **organization as a whole** (and not a specific part of it), as well on its targets and on the risks that may make more difficult or impede full accomplishment of the organization's mission.

Another important difference is that the evaluation should be carried out using resources from the organization itself, without any independent external assessments. Because it is a **self-evaluation**, both employees and managers are more strongly committed to the results obtained, since they took part in the process themselves.

The Methodology Adopted

People are the **main focus** of the CoCo methodology. One difference from the COSO is that here the formation of a favorable Control Environment takes place as follows:

CoCo Control Model Purpose Monitoring and Learning Action Commitment Capacity In order for an individual or a workgroup to complete a given activity, they have to understand its purpose, as well as to demonstrate their commitment and to possess the necessary skills to accomplish it properly after some time.

They also have to monitor the external environment and their own performance while developing the activities, so that they can contribute to the improvement of the process based on this learning.

We shall now examine the Criteria for Control Evaluation adopted by CoCo regarding each one of its elements:

a) **Purpose** - shows where the organization is going. It consists of:

- Objectives, Vision, Mission, and Strategy;
- Risks and Opportunities;
- Policies;
- Planning;
- Targets and Performance Indexes.

b) **Commitment** - strengthens the organization's values and identity. It consists of:

- Ethical values, including integrity;
- HR policies;
- Authority and responsibility;
- Mutual trust.

c) **Capacity** - refers to the organization's competence. It consists of:

- Knowledge, skills and tools;
- Communication processes;
- Information;
- Coordination;
- Control activities.

d) **Monitoring and learning** - provide a picture of the organization's development. It consists of:

- Monitoring of internal and external environments;
- Monitoring of performance;
- Challenging issues;
- Reassessment of needs and information systems;
- Follow-up procedures;
- Assessment of the control's efficiency.

Motivational factors

According to Fred Jackson, a Canadian consultant associated with the CICA, an audit or evaluation based on the CoCo can quickly identify the most important and sensitive problems in an organization.

The methodology focuses on the Chief Executive and on the Board of Directors. However, by understanding the system well, managers, employees, internal auditors and consultants can ease the evaluation process and motivate those responsible for executing the controls.

People adopt the CoCo model because it uses free language and grants an intuitive meaning to the process. This supports the efforts made, although implementing the framework is no easy task.

The Evaluation Process

The evaluation process comprises a few essential stages, namely:

1. Understanding the Board's expectations;
2. Defining a Workgroup, including Internal Audit and other relevant functions;
3. Understanding the objectives of the evaluation, for example asset security, cost reduction, and quality assurance of products and services;
4. Training those involved in the methodology;
5. Developing an Evaluation Plan;
6. Developing a conclusion;
7. Obtaining approval of the valuation from the Board.

COSO x CoCo - points in common

A comparison of these two methodologies shows us some common features that help an organization support their Corporate Governance needs, that is they allow the higher administration to manage the organization with transparency and control, as well as to relate to every interested party and to meet demands and expectations from the market and from shareholders.

Both are focused on the **business objectives** and on the **entire organization**. They present frameworks that allow the organization to structure its Internal Control System, which in turn allows management of corporate risks, particularly of operating risks.

The higher administration plays a fundamental role in both models, and is responsible for the success of the Internal Control System.

Both models use each other's features. The CoCo uses definitions from the COSO, since there are common goals for implementing an Internal Control System:

- Need for compliance;
- operations have to be economical and efficient;
- financial information has to be factual.

These motivate the systematic risk management process; because they consist in internal and external factors that require implementation and continuous improvement of the management process itself. These are:

COSO x CoCo - significant differences

In spite of the similarities between the COSO and the CoCo, in some aspects they clearly differ from one another. This allows an organization to decide for the model which best fits its needs, characteristics and governance principles.

The COSO model presents a more complex structure and the several aspects of the business are detailed to a higher degree by means of its eight components.

The CoCo model clearly sets the Control Environment as its priority, focusing on people's participation by means of points assigned as ethical values and a control culture - this latter topic is more intensely graded than in the COSO model.

Unlike the COSO, the CoCo expresses the evaluation of the Internal Controls as time intervals and not as specific points in time. Since in addition to this the CoCo encourages the exclusive participation of the organization's employees and managers, it promotes a better self-management of the risks and the guarantee that processes are better managed and more successful.

In turn, the COSO has evolved towards a model which structures the entire risk management process in a more comprehensive way, therefore allowing it to be more widely used with types of risks other than exclusively operating risks.

Conclusion

The role played by a framework focused on business objectives is key for Corporate Governance. Being involved as the most interested party and responsible for the process, the higher administration sets forth a strong possibility to carry out the correct and effective implementation of the Internal Control System.

Although both the COSO and the CoCo allow the customization of specific objectives and criteria by organizations, neither of the methodologies work very much at the operating level - they don't say much on "how to do" things - and therefore require complementation with additional management models.

Comparison of the two models shows that the assessment process provided by the CoCo more quickly identifies the organization's main problems, while the COSO offers more acceptability to meeting requirements concerning regulatory compliance - the Sarbanes-Oxley Act, for example.

Further articles on this series will discuss frameworks and methodologies used for specific objectives: the COBIT (used for IT) and the BS7799 / ISO 17799 for Information Security.

Additional References

Below we present a few references for information on internal control systems and on the models presented above.

Understanding internal controls - County of Orange - Internal Audit Department
http://www.ocgov.com/audit/docs/understanding_ic.pdf

Understanding the COSO - A Practical Guide to COSO Principles
www.auditoriainterna.com.br/coso.htm

CA Chartered Accountants of Canada - www.cica.ca

Internal Controls - Searching for the adequate solution - Part I http://www.checkuptool.com.br/artigo_04.htm

Internal Controls - Searching for the adequate solution - Part II http://www.checkuptool.com.br/artigo_06.htm

Sources:

(1) "New Methodologies", book by internal Febraban's Audit Sub-Commission, 1999

(2) Enterprise Risk Management - Integrated Framework - Executive Summary - September, 2004