

# The COSO Monitoring Discussion Document: A Control Quiz

*Paisley's Bruce McCuaig weighs in on the recently issued COSO discussion document on monitoring internal control systems.*

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has recently released a discussion document on the subject of monitoring in order to add clarity and assist companies in the use of monitoring controls, primarily to reduce Sarbanes-Oxley compliance costs. Although of direct interest to audit and control professionals, many managers and other non-audit professionals will benefit from understanding COSO's *Internal Control-Integrated Framework: Guidance on Monitoring Internal Control Systems*. COSO invited comments until October 31, 2007, and plans to issue further guidance on monitoring controls in late 2007 and early 2008.

The premise of the discussion document is that if controls are monitored, management can have assurance that internal controls continues to operate effectively. As a result, management will have additional assurance that its objectives will be achieved.

The problem is that COSO has taken a rather radical approach in determining what constitutes evidence, or as the discussion document puts it, persuasive information, that controls are effective. In addition, COSO is not realistic either in its view of how managers manage or in assessing the value auditors or evaluators can add by monitoring controls.

COSO makes a distinction between direct information, obtained when an independent evaluator observes the controls in operation, and indirect information, a term broadly covering all other types of information, specifically including key performance indicators and key risk indicators.

According to the discussion document, indirect information does not demonstrate explicitly to evaluators that the underlying controls are operating effectively.

It's the old "absence of evidence is not evidence of absence rule."

This premise may not seem radical at first. In practice it may prove impractical. Let's test the basic premise in a real life situation.

## Multiple Choice Question No. 1

Imagine you are driving a car speeding down a dark Alaskan highway. Suddenly in the distance you see the telltale bright reflections of the eyes of a 1,200-pound moose standing in the middle of the road. You grip the steering wheel tightly and jam on the brakes as hard as you can. You feel the ABS system pulsing as you bring the car to an emergency stop just a few feet from the moose as it contentedly wanders off the highway. Your car's braking system performed exactly as it was supposed to in an emergency.

Using the monitoring guidance provided by the COSO monitoring discussion paper, are your brakes effective?

- Of course. The car stopped safely didn't it? Achieving the intended result is evidence of control effectiveness isn't it?
- Only the moose knows for sure and it is hardly independent or objective.
- Neither of the above. Only a trained mechanic e.g., evaluator, can assess the effectiveness of your brakes by pulling off your wheels and visually checking the brake pads and calipers and possibly also inspecting the tires and steering system. That is direct evidence. Merely stopping is indirect evidence, a performance indicator, and inherently unreliable as evidence of brake system performance.

## Multiple Choice Question No. 2

The next night, you're on the same highway and encounter the same moose, in a different car. You hit the brakes as hard as you can. You hear a screeching and grinding from your wheels. The steering wheel vibrates wildly. You pump the brakes hard. You manage to stop, but it was a close call.

Using the guidance provided by the COSO monitoring discussion paper, should you think about getting your brakes repaired?

- a. Immediately. Grinding noises and vibrations in the steering wheel are key risk indicators of impending brake failure.
- b. Ask your mechanic next time you take your car in for service. Key risk indicators are indirect evidence of impending brake failure. Only your mechanic knows for sure. Don't worry for now.
- c. Moose hunting season opens tomorrow. Your problems will soon be over.

## Correct Answers Per COSO Monitoring Discussion Document

Question 1: (c) Only a mechanic can objectively assess the effectiveness of your brakes. Key performance indicators are indirect evidence. If it is your car, and you are driving, you can't be objective. Key performance indicators only support your belief that your brakes are working. Brakes are important and an important control needs an objective evaluator. The key performance indicator might be more reliable if you were driving a rented car, and not your own, but it is still not good enough.

Question 2: (b) Again, rely on your mechanic. You might want to think about moving your brake inspection up a week or two, depending on your luck in hunting season, but according to COSO, key risk indicators are indirect and therefore inconclusive.

## Is Control Monitoring Important?

Clearly it is important to monitor controls. By all means have the brakes checked regularly. The prob-

lem is that good key performance indicators and key risk indicators, however indirect, are extremely valid, highly objective, efficient and plausible indicators of process performance. Managers rely on them daily and they count as much or more than control testing.

It may be useful to have periodic evaluations of control, but so far, however direct independent evaluations might be, an opinion on control effectiveness is subjective, and assumes substantial knowledge on the part of the evaluator regarding inherent risks and objectives of the process in question. The COSO monitoring discussion document does not spend much time on either topic.

Managers aren't likely to perform or request additional control monitoring unless some evidence suggests it is required.

## What is Wrong with the COSO Discussion Document?

COSO presumes that without internal control testing, management and the board does not have reasonable assurance that their objectives will be achieved, and as a result, monitoring of internal control is essential.

What management monitors on a day-to-day basis is business and process performance. If goals are being achieved, it is a pretty good indication that controls are working. Management focuses on end result business performance. If it is unclear whether goals or results are being achieved, the goals or their measures should be reconsidered.

Sometimes management measures the wrong thing and sometimes the measures themselves are wrong. But the Sarbanes-Oxley Act has made management accountable. No longer does the defense of "my accountant/auditors said it was OK" work.

Managers must decide themselves if controls are effective and other risk responses are appropriate. Auditors or evaluators are on dangerous ground if they elect to take on that responsibility.

## What's The Answer?

Business needs help achieving objectives—operational, strategic, financial reporting and compliance. Any help audit and control professionals can provide will add value. Sound risk identification and assessment is essential. Efficient, creative, cost effective control design is critical. Key performance indicators and key risk indicators are invaluable. Control monitoring has its place, but it should take its place in the total context. Rather than dismiss the measures management relies on daily, COSO should help build on them and help management improve them.

First, COSO should consider shifting the direction of this discussion document from control monitoring to risk response monitoring, and consider measures to monitor all relevant risk responses, not just controls.

COSO should reevaluate its position on the quality and reliability of management risk and control assessment. Experience has shown that management risk and control self assessment can and typically does produce far more detailed, richer information on risk and control than is possible in periodic audits or evaluations. Self-assessments routinely outperform audits in every way. They should be encouraged as a primary source of evidence.

Rather than reject management self assessment as not objective, COSO should provide guidance in how auditors can assess and report on the reliability of management risk assessment and response processes. In fact the IIA Professional Practice Framework suggests that is what internal auditors should be doing.

COSO should not provide technical advice on how to conduct tests, what to test or how often. That ground has been covered far better by standard auditing texts. COSO can add far more value by providing guidance and research in cost effective control design, e.g., what kinds of controls work best in different situations.

Little work has been done on the root cause of control breakdowns and on identifying factors to consider in deciding where auditors should allocate their time. This discussion document continues to suggest that factors like size and complexity, and degree of change are important variables. No evidence is offered to support these conclusions. Little work has been done analyzing the root cause of reported internal control deficiencies and correlating them to complexity, size, change or any other variable.

COSO plans to receive comments on this paper until October 31 and then proceed with a document containing case studies, tools and examples to help practitioners implement the advice in the discussion paper. Let's hope they proceed cautiously. ■

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