

COMPLIANCE WEEK

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The Missing Link In Implementing Effective Internal Controls

By Mike Lambert and Marsha Carter, Special to Compliance Week — April 24, 2003

Senior executives have long sought ways to better control the enterprises they run and reduce risk. Effective IC promotes efficiency, reduces risk of asset loss, and helps ensure the reliability of financial statements and compliance with laws and regulations. IC enables management to effectively react to rapidly changing economic and competitive environments, and shifting customer demands and priorities. Companies spend increasing dollars on IC and view it as an operational issue needing management attention.

Most organizations have a number of IC violations that go unnoticed or are ignored. Part of the reason for this is lack of awareness of the scope of IC elements and/or the belief they are not important. For instance, which of the following examples are IC issues and should be corrected in addition to having a remediation plan that will prevent their recurrence?

1. An engineering manager is concerned he may be over budget and behind schedule in the release of a new, important product.
2. A finance manager, responsible for approving invoices for payment, recently married another employee who works as a purchasing agent.
3. Long time employees who know their jobs inside and out staff the field offices for the corporation. They have no formal departmental policies or procedures.

The answer is: All of them!

The Sarbanes-Oxley Act of July 30, 2002 and the related SEC regulations require that the CEO and CFO assess the effectiveness of IC and the firm's external accounting firm attest to and report on the assessment. This has increased the focus on IC, but a significant gap still exists in many companies. Managers, particularly finance managers, may be aware of IC, but all employees in all departments play a role in IC implementation. Awareness training for employees can benefit organizations by highlighting the importance of IC and employee roles in IC effectiveness. For example, employees should be able to answer the following questions:

- What is your level of authority and the authority of those around you?
- What behaviors are expected, or acceptable, and what is unacceptable?
- What policies and procedures should you follow in your job?
- What are fraud indicators?

ABOUT THE AUTHORS

Mike Lambert, Principal, joined Bradley Lambert, Inc. in 1988 and has helped to develop the finance and technical side of the firm. He has developed and delivered finance and internal controls training workshops for finance and senior operations personnel in the US and internationally at Fortune 50 companies. In addition to Internal Controls these workshops have included ethics and Foreign Corrupt Practices Act subjects. He worked with key departments in large organizations to help them pass their internal audits. He also delivered numerous finance training programs to General Managers and their direct reports around how their decisions affected certain finance metrics correlated with the stock price of the Corporation. He has been a member of the Executive Committee for the Caltech Enterprise Forum for fifteen years and in that capacity has reviewed and given expert opinion on business plans of a variety of companies.

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- How do you avoid conflict of interest?
- How do you appropriately protect the company's data?
- If you see something you think is wrong, dishonest or is detrimental to the company, what should you do about it?
- What is proprietary, confidential and secret in your company?
- What is your role in protecting company assets?

Achieving Effective IC

The new requirements to assess IC and attest to their effectiveness has caused many CFOs, working with their corporate counsel, internal audit executive, training director, and their external accounting firm to reexamine their IC system, incorporate new requirements required by Sarbanes Oxley and assure their system's effectiveness.

Using the COSO (1) Model to Systematize Your Internal Control

The COSO model is widely recognized as the definitive standard used by organizations to measure the effectiveness of their systems in IC. COSO provides a framework on which to base your IC system.

There are many ways this model can be used. A simple one is for management, both operations and financial, to conduct a gap analysis in each department or function to determine where there are significant risks. The COSO framework can then be applied to determine how to eliminate or remediate the gaps.

For example:

Vision or the Control Environment

Management needs to set the "Tone at the Top" and the company's IC foundation. This includes assuring personal integrity, ethical values and competence.

Potential Gap Items	Remediation
No statement of ethical values	Codes of ethics are made available to employees and the public. Training is conducted so that employees know what is expected of them.
No HR Policies and procedures	HR policies are written and available. HR procedures are published and HR employees have received training in them.
Competence of the employees is low	Employees at all levels receive training in their jobs. Part of the selection criteria for new employees is their competence.

Policies and Procedures or Control Activities

Control processes, policies and procedures must be established to ensure management objectives are carried out and risks are addressed.

Potential Gap Items	Remediation
No approvals	Duties are divided, or segregated, among different people to reduce the risk of error or inappropriate actions.
Equipment is unaccounted for	Equipment, inventories, securities, cash and other assets are secured physically, and periodically counted and compared with amounts shown on control records.
No reviews of operating performance	Reviews are made of actual performance versus budgets and forecasts. Major initiatives are tracked.

Information and Communication

People must be able to capture and exchange information needed to conduct, manage and control operations.

Potential Gap Items	Remediation
Employee responsibilities not detailed	Provide information to the right people in sufficient detail and on time to enable them to carry out their responsibilities efficiently and effectively.
Employee unsure where to report improprieties	Establish channels of communication for people to report suspected improprieties.
Customer complaints	Put process in place for timely and appropriate follow-up by management resulting from communications received from customers.

Risk Assessment

The organization must be aware of and deal with the risks it faces. Management must establish mechanisms to identify Circumstances that may impede the ability of the company to achieve its objectives.

Potential Gap Items	Remediation
Employees unaware of the business objectives	Company-wide objectives are effectively communicated to employees and board of directors.
Activity-level objectives not linked to business objectives	Activity-level objectives are linked with company-wide objectives and strategic plans.
Risks appear as surprises	Mechanisms are in place to adequately identify risks arising from internal and external sources.

Monitoring

A process must be in place to assess the quality of the IC system's performance over time and ensure modifications are made as needed.

Potential Gap Items	Remediation
No reviews of operating and financial reports	Costs and expenses are monitored and controlled. Comparisons of actual expenses to budgeted amounts are performed on a regular basis, and all significant variances are researched.
No checks on separation of duties	Duties (roles) are assigned to individuals in a manner so that no one individual can control a process from start to finish.
Poor control of physical assets	Equipment, inventories, cash, and other property are secured physically, counted periodically, and compared with amounts shown on control records.

Alignment among all employees

Laws and rules must be followed and implemented by people. The Enron/WorldCom cases may have ended differently if people acted sooner and knew what they should look for what they should do to surface problems. Key steps to implement IC and creating alignment among all employees are:

- Executives need to demonstrate support for IC. This includes setting the tone at the top and leading by example.
- All employees need awareness training so that they know what is expected of them and others.
- A gap analysis should be performed to identify deficiencies for remediation using the COSO model.
- Ongoing monitoring of IC validates that the controls are working
- Implementation training should be delivered to key financial and operations personnel.
- Follow-up on prior deficiencies to assure corrective action has been completed.

Companies who implement effective IC will help to return investor faith in US companies and the performance they claim.

This column solely reflects the views of its author, and should not be regarded as legal advice. It is for general information and discussion only, and is not a full analysis of the matters presented.