Board of Directors Series

Risk Management QRD-QFE Skills: Internal Controls

E. Shepard Farrar, NACD.DC, CFA, CAIA

Introduction:

Qualified financial experts (QFEs) are increasingly sought for Boards of Directors for publicly traded and private companies, and non-profit organizations. These experts, particularly those that are independent, are needed for publicly traded companies to comply with New York Stock Exchange, Nasdaq and SEC requirements for audit, compensation, risk and strategy committees[i]. While their subject matter expertise and experience in financial reporting and metrics have long been required, additional skills are needed for 21st century QFEs: internal control (IC) frameworks and sustainability issues and metrics. This article discusses this knowledge area and its importance to effective board governance, suggests resources and preliminary action steps, and concludes with a summary of the role for the 21st century industry leading board.

Internal Control Frameworks

Definition, Importance:

"IC is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance."[ii] The leading standard setter in the field of IC, particularly ICs impacting financial reporting (ICFR) is the Committee of Sponsoring Organizations (COSO). COSO, since its issuance of the IC integrated framework in 1992 has issued additional guidance on: i) monitoring IC systems (2009); ii) complying with Sarbanes-Oxley provisions (2013); iii) leveraging COSO across the three lines of defense (operating business unit, risk division and entity level/board's audit committee, 2015); and iv) achieving effective ICs over sustainability reporting (ICSR, 2023) for company's strategy, key performance indicators (KPIs) and reporting of sustainability metrics (next section).[iii]

Chart I: COSO Framework, Principles amp; Entity Points of Focus

Components	Principles	No. of Points of Focus
Control Environment	1. Commitment to integrity and ethical values	4
	2. Independent board of directors oversight	4
	3. Structures, reporting lines, authorities, responsibilities	3
	4. Attract, develop, and retain competent people	4
	5. People held accountable for internal control	5
Risk Assessment	6. Clear objectives specified	15
	7. Risks identified to achievement of objectives	5
	8. Potential for fraud considered	4
	9. Significant changes identified and assessed	3
Control Activities	10. Control activities selected and developed	6
	11. General IT controls selected and developed	4
	12. Controls deployed through policies and procedures	6
Information & Communication	13. Quality information obtained, generated, and used	5
	14. Internal control information internally communicated	4
	15. Internal control information externally communicated	5
Monitoring Activities	16. Ongoing and/or separate evaluations conducted	7
	17. Internal control deficiencies evaluated and communicated	3

Source: www.cosos.org Achieving effective ICSR, pp. 18, 19.

COSO notes that "effective ICs are good for business (not only in) compliance and external financial reporting (but also to) help an organization articulate its purpose, set its objectives and strategy, and grow on a sustained basis with confidence and integrity in all types of information."[iv] COSO/NACD's recent Request for Proposal (RFP) aims to develop a corporate governance framework (CGF) and application guidance for boards to align corporate practices, policies and governance with COSO's IC framework, ICFR and best-in-class enterprise risk management (ERM) frameworks.[v]

Resources and Action Steps:

Board members, and particularly QFEs, must be knowledgeable about COSO's 3 objectives (operations, reporting and compliance), 5 integrated components (control environment, risk assessment, control activities, information and communication, and monitoring activities) and 17-principle framework (Chart I). Crucially, directors must be able to assess the company's mission and application of COSO's IC framework in its structure, policies and procedures, which are subject to the board's audit committee and external audit review and testing. Significant resources are available from the www.coso.org site, and directors seeking further expertise can obtain the COSO IC Certificate.[vi]

Summary:

This article addresses a key knowledge area in which Boards of Directors, and particularly independent directors who are QFEs, need to develop skills to build effective 21st century companies: IC frameworks. It outlines the importance of IC frameworks, suggests resources and action steps, and notes the integration of these non-financial components to thriving, agile business. While financial metrics have historically driven most strategy and execution, it is increasingly evident that internal controls must be incorporated in the process, and financial expert directors, with their skills in accounting, data management, financial materiality and governance will play a key role in developing the strategies, KPIs and reporting frameworks for these areas.

---

[i] NYSE's Listed Company Manual Section 303A, Nasdaq's Corporate Governance Requirements (IM- 5605-4. Audit Committee Composition, and SEC's Sections 406 and 407 of the 2002 Sarbanes-Oxley Act

[ii] NYSE's Listed Company Manual Section 303A, Nasdaq's Corporate Governance Requirements (IM- 5605-4. Audit Committee Composition, and SEC's Sections 406 and 407 of the 2002 Sarbanes-Oxley Act

[iii] COSO of the Treadway Commission, IC – Integrated Framework, Executive Summary, p. 3, https://www.coso.org/_files/ugd/3059fc_1df7d5dd38074006bce8fdf621a942cf.pdf

[iv] https://www.coso.org/internal-control. COSO's IC Integrated Framework, issued in 1992 and refreshed in 2013 (ICIF-2013 or Framework), now includes guidance on a range of topics and industries. The COSO sponsors include the American Accounting Association (AAA), American Institute of CPAs (AICPA), Financial Executives Int'l (FEI), Institute of Management Accountants (IMA) and Institute of Internal Auditors (IIA).

[v] COSO and NACD RFP issued to "develop a CGF to provide authoritative guidance in the U.S. complementing and aligned with the existing COSO Internal Control and ERM frameworks … the COSO-CGF will (help) public companies … self-assess and enhance governance practices, start-ups desiring to build governance practices and processes, … privates seeking best practices or readiness (for) IPO efforts and (by) external auditors, internal auditors, rating agencies, investors, listing agencies and/or regulators finding such a framework useful in assessing governance practices at related entities." 1/31/2024.

[vi] https://www.coso.org/ic-certificate.