Ethics, Blockchain, Internal Controls

as considered in COSO Research Paper

“Blockchain and Internal Control”

Presented by:

Dr. Sri Ramamoorti, Associate Professor, University of Dayton

Eric E. Cohen, Proprietor, Cohen Computer Consulting
IESBA June 10, 2021 Presentation Agenda

• Introductory comments
• About 2020 COSO *Blockchain and Internal Controls* Research Paper¹
  • Background and Key Insights
  • Implications for Ethics and Organizational Culture
• Related Issues Beyond the COSO Research paper
• Concluding Remarks
• Q&A

### From Pre-reading: Key Insights from Exec. Summary

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</table>

We are not talking about a technology of tomorrow; Blockchain is already here.
Change is Here Already: TrustExplorer

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Environmental Scan: Tracking Change

• Setting the stage
  • Blockchain is here and impacting the world more quickly than we can adapt
    • Martec’s Law, technology advances exponentially, organizations change only logarithmically and standard setters are forever playing catch up
  • Automation/other biases
    • Increased Efficiency does not imply increased Effectiveness
    • IESBA Exploring the Code Installment 11 *Focus on Bias*
  • Internal Controls are the very DNA of the organization
    • The Control Environment will affect how blockchain is integrated into the organization
    • Blockchain will have an impact on the Control Environment for organizations
    • IC components: Risk Assessment, Control Activities, Info & Comm, Monitoring also apply
technology changes *exponentially*...

...but organizations change *logarithmically*

management must choose carefully which changes are adopted

this challenge grows harder with time

Source: Chief Martec aka Scott Brinker, [Martec's Law - Only Dead Fish](https://martec.com/2017/03/martecs-law-only-dead-fish/)
# About the 2020 Research Paper

## Blockchain and Internal Control

The COSO Perspective

## Contents

<table>
<thead>
<tr>
<th>Contents</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive Summary</td>
<td>1</td>
</tr>
<tr>
<td>I. Introduction</td>
<td>3</td>
</tr>
<tr>
<td>II. The Wave of Change Known as Blockchain</td>
<td>4</td>
</tr>
<tr>
<td>III. Components and Principles Overview</td>
<td>7</td>
</tr>
<tr>
<td>Conclusion and Next Steps</td>
<td>20</td>
</tr>
<tr>
<td>Appendix 1. Technical Appendix</td>
<td>22</td>
</tr>
<tr>
<td>Appendix 2. Key Insights: 10 Things to Know About Blockchain</td>
<td>25</td>
</tr>
<tr>
<td>Appendix 3. Blockchain, Financial Reporting Assertions, and Audit Evidence</td>
<td>27</td>
</tr>
<tr>
<td>Supplementary Resources and References, including those provided by COSO Bodies</td>
<td>29</td>
</tr>
</tbody>
</table>
COSO’s Internal Control: Integrated Framework

Control Environment

1. Demonstrates commitment to integrity and ethical values
2. Exercises oversight responsibility
3. Establishes structure, authority and responsibility
4. Demonstrates commitment to competence
5. Enforces accountability
6. Specifies suitable objectives
7. Identifies and analyzes risk
8. Assesses fraud risk
9. Identifies and analyzes significant change
10. Selects and develops control activities
11. Selects and develops general controls over technology
12. Deploys through policies and procedures
13. Uses relevant information
14. Communicates internally
15. Communicates externally
16. Conducts ongoing and/or separate evaluations
17. Evaluates and communicates deficiencies
Control Environment – Example Impacts

Control Environment - Principles

1. Demonstrates commitment to integrity and ethical values
2. Exercise oversight responsibility
3. Established structure, authority, and responsibility
4. Demonstrates commitment to competence
5. Enforces accountability

Enhancements

• Avoid human error and combat transactional and reporting fraud.
• Cryptographically-verifiable immutability and irreversibility.
• Real-time financial reports due to increased visibility.
• Timelier identification of deviations from organization’s standards of conduct

May facilitate removal of management’s manual intervention from processes

New Threats/Risks

• Threat that a permissionless blockchain may be used for unethical exploits.
• Decentralization and lack of a central intermediary, system or oversight body
• Depending on nature of the blockchain and the fellow blockchain participants, an organization may face reputational risk
• Competent personnel are hard to find, and a commitment to competence is difficult to guarantee or assess

Mitigation

• Develop a code of conduct which governs the conduct of parties within a blockchain and establishes guidelines for addressing noncompliance
• Consider expectations regarding outsourced service providers
• Develop due diligence policies which establish guidelines and criteria for determining parties with whom the organization will transact, grant access to, and public blockchains that an organization may elect to use
• Assess the need to obtain or build expertise surrounding blockchain
• Ensure that the organization is capable of assessing and evaluating the new technology and processes
• Establish cross-disciplinary teams, which include blockchain specialists and representatives from each aspect of the business that may be effected
• Define degrees or levels of responsibility and authority surrounding the blockchain technology
• Establish clear reporting lines for consortium or private blockchains which identify individuals or a group responsible for handling disputes, if not built into the underlying protocol

Paper covers potential enhancements blockchain can offer, new risks and threats, and approaches to mitigate the risks

Note: there is a reciprocal relationship between blockchain and the internal control environment.
Blockchain and Internal Control: The COSO Perspective
Key Takeaways Regarding Ethics from COSO Research Project Activities

• Relevant References in the Control Environment Component of Internal Control
  • Ethical values
  • Human behaviour
  • Management decisions, integrity, and ethics
  • Perceived and actual ethical practices
  • Keeping Ethical issues top of mind

• Risks of unethical exploits exacerbated in permissionless blockchain
Beyond 2013 Framework to 2017 (ERM)

• Issues of ethics and culture expanded on in 2017 Framework, possible add-on to COSO Research paper
  • Principle 1. Demonstrates commitment to integrity and ethical values
  • Organizational culture and business ethics play integral roles in compliance risk management
Multi-dimensional Consideration

• Analysis at different levels
  • What is inherent to the technology
    • Blockchain alone; Blockchain PLUS (p 2)
  • Application of the technology
  • Institutional and Societal adoption, impact, change

• Key change – blurring of lines across enterprises, across regions, laws, cultures
Broad Consideration Beyond ICFR

- Technology
- Application
- Institutions and Society

- Privacy, accuracy, security, and digital rights
  - Misconceptions and “ownership”
  - Misconceptions and immutability, validation – https://cryptograffiti.info/

- Pre-reading: Blockchain’s distinctive characteristics (unique vs amplified)
  - Glossary included references to tokens, smart contracts, pseudonymity, consensus mechanisms, and using the IESBA framework as a lens
Technology, Application, Society and Institutions

Decentralization

Tokenization

Immutability

Smart Contracts

Trustlessness

Pseudonymity

<table>
<thead>
<tr>
<th>Topic</th>
<th>Peer-to-peer (no central intermediary)</th>
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<tbody>
<tr>
<td>Description</td>
<td>Rather than being stored on a central computer, processing and data is shared on a number of computers (called &quot;nodes&quot;) recording the public history of transactions and sharing computational responsibilities, with little coordination.</td>
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<tr>
<td>Definition Source</td>
<td>Derived from <a href="https://bitcoin.org/bitcoin.pdf">https://bitcoin.org/bitcoin.pdf</a></td>
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<td>Integrity</td>
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<tr>
<td>Objectivity</td>
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<td>Professional Competence and Due Care</td>
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<td>Confidentiality</td>
<td></td>
</tr>
<tr>
<td>Professional Behaviour</td>
<td></td>
</tr>
</tbody>
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Beyond Blockchain Alone: Human Intelligence/Machine Intelligence

Human aspects; HCI
• Supplemented
• Blockchain +/plus
• Supplanted
Additional Observations

• You cannot effectively manage, account for, or audit what you don’t understand (what blockchain plus accelerates)

• Blockchain and other emerging technologies pose a competency threat for the profession

• Sources of risk for PAIB and PAIPP
  • within the organization (business or public practice)
  • within the client’s environment
  • individual PAIBs
  • Individual PAIPPs
## 10 Things to Know about Blockchain

1. Information about blockchain in the news and on the Internet is often misleading or incorrect.

2. Blockchain encompasses far more than digital assets; the benefits it can bring to an organization can be substantial.

3. Blockchain is, however, not “magic”, comes at a cost, and doesn’t eliminate all risks; in fact, it introduces new risks.

4. Knowing how blockchain works is crucial for evaluating, preparing for and managing blockchain’s impact on internal control and the organization as a whole.

5. Blockchain has both technology and governance implications.

6. Blockchain will not make management, accountants, or auditors less relevant, although it will impact what they do and how they do it.

7. Blockchain requires new skillsets (e.g., data science for greater insight and foresight) and new collaboration within and across organizations.

8. Now is the time to educate and engage stakeholders throughout the organization.

9. Blockchain is still in flux and continues to evolve.

10. Adoption of blockchain may not be a choice.
Conclusion

• As noted in IESBA TWG Phase 1 Report, and already reflected in upcoming updates, technology is impacting ethics and culture

• Blockchain alone and in conjunction with emerging technologies may change business in evolutionary and revolutionary ways

• Blockchain is not tomorrow’s problem; the impact is already being seen

• **Design thinking mindset** to cope with and benefit from the change
  • Dennis Gabor: “The future cannot be predicted, but futures can be invented.”
Questions?

Dr. Sri Ramamoorti
Associate Professor, University of Dayton
+1-630-347-9172, sramamoorti1@udayton.edu

Eric E. Cohen
Proprietor, Cohen Computer Consulting
+1-559-492-7545,
eric.e.cohen@computercpa.com