COSO — COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION

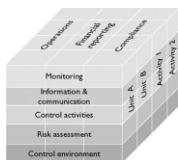## Nashville AGA Winter Seminar 2014
COSO Framework
January 14, 2014

Dr. Sandra B. Richtermeyer, CMA, CPA
COSO Board Member
Professor and Chair of Accountancy and Business Law
Xavier University – Cincinnati USA

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Internal Control – Integrated Framework

1992   2013

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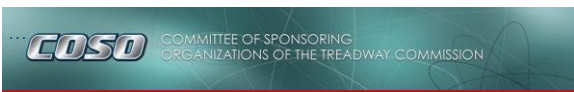## COSO — COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION

"…while effective internal control requires leadership from the top, the responsibility for effective implementation of internal control resides with everyone in the organization, not just the finance function. This includes accountants, compliance officers and those involved in making contracts and supporting operations as well as those working on the production line to ensure that products produced meet quality objectives.

…the individuals that are responsible for achieving the objectives are also responsible for the quality of internal controls. "

Larry Rittenberg
Chair Emeritus, COSO

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History is Important…

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Originally formed in 1985, COSO is a joint initiative of five private sector organizations and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management (ERM) internal control and fraud deterrence.

American Accounting Association — Thought Leaders in Accounting	9,300	
AICPA American Institute of CPAs	386,000	
fei Financial Executives International	15,000	**> 500,000**
ima The Association of Accountants and Financial Professionals in Business	67,000	
The Institute of Internal Auditors	180,000	

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Mission

COSO's Mission is "To provide **thought leadership** through the development of comprehensive frameworks and guidance on **enterprise risk management**, **internal control** and **fraud deterrence** designed to improve organizational performance and governance and to reduce the extent of fraud in organizations."

COSO's Fundamental Message

Good risk management and internal control are necessary for the long term success of all organizations.

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National Commission on Fraudulent Financial Reporting
formed with James C. Treadway, Jr., former SEC
Commissioner and General Counsel, Paine Webber as its
Chairman – becoming known as the "Treadway
Commission" a private-sector initiative, was formed in 1985
to inspect, analyze, and make recommendations on
fraudulent corporate financial reporting.

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The internal control recommendation

All public companies should maintain internal
controls that provide reasonable assurance that
fraudulent financial reporting will be prevented or
subject to early detection - this is a broader
concept than internal accounting controls…
…The Commission also recommends that
its sponsoring organizations cooperate on
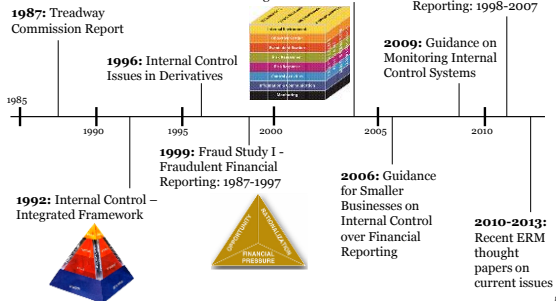developing additional, integrated guidance on
internal controls…

- Treadway Commission report

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Timeline

1987: Treadway
Commission Report

2004: Enterprise Risk
Management Framework

2010: Fraud Study II -
Fraudulent Financial
Reporting: 1998-2007

2009: Guidance on
Monitoring Internal
Control Systems

1996: Internal Control
Issues in Derivatives

1985

1990   1995   2000   2005   2010

1999: Fraud Study I -
Fraudulent Financial
Reporting: 1987-1997

2006: Guidance
for Smaller
Businesses on
Internal Control
over Financial
Reporting

1992: Internal Control –
Integrated Framework

2010-2013:
Recent ERM
thought
papers on
current issues

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COSO Overview – Internal Control Publications

| 1992 | 2006 | 2009 | 2013 |

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Reaching beyond a focus of just internal control…

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"
In the twenty years since the inception of the original framework, business and operating environments have changed dramatically, becoming increasingly complex, technologically driven, and global.

At the same time, stakeholders are more engaged, seeking greater transparency and accountability for the integrity of systems of internal control that support business decisions and governance of the organization
"

Source: COSO September 2012

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Why is COSO a suitable model?

Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a **suitable, recognized control framework** established by a **body of experts that followed due-process procedures, including the broad distribution** of the framework for public comment.

Source: U.S. Securities and Exchange Commission

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In addition to being available to users of management's reports, a framework is suitable only when it:

➤ Is free from bias;

➤ Permits reasonably consistent qualitative and quantitative measurements of a company's internal control over financial reporting;

➤ Is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal control over financial reporting are not omitted; and

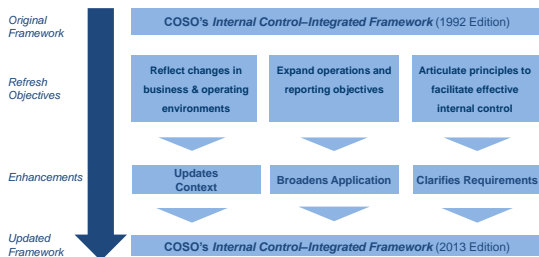➤ Is relevant to an evaluation of internal control over financial reporting.

Source: PCAOB AS2

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Why update what works? The Framework has become the **most widely adopted control framework worldwide**
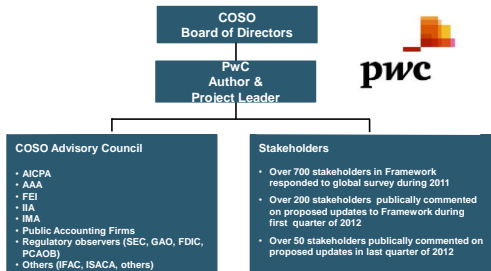
Original Framework	COSO's *Internal Control–Integrated Framework* (1992 Edition)		
Refresh Objectives	Reflect changes in business & operating environments	Expand operations and reporting objectives	Articulate principles to facilitate effective internal control
Enhancements	Updates Context	Broadens Application	Clarifies Requirements
Updated Framework	COSO's *Internal Control–Integrated Framework* (2013 Edition)		

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Project timetable

Assess & Survey Stakeholders	Design & Build	Public Exposure, Assess & Refine	Finalize

2010	2011	2012	2013

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Participation in Framework refresh

COSO Board of Directors

PwC Author & Project Leader

pwc

COSO Advisory Council
- AICPA
- AAA
- FEI
- IIA
- IMA
- Public Accounting Firms
- Regulatory observers (SEC, GAO, FDIC, PCAOB)
- Others (IFAC, ISACA, others)

Stakeholders
- Over 700 stakeholders in Framework responded to global survey during 2011
- Over 200 stakeholders publically commented on proposed updates to Framework during first quarter of 2012
- Over 50 stakeholders publically commented on proposed updates in last quarter of 2012

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Project deliverable #1 – Internal Control-Integrated Framework (2013 Edition)

- ▫ Definition of internal control
- ▫ Categories of objectives
- ▫ Components and principles of internal control
- ▫ Requirements for effectiveness
- ▫ Limitations of internal control
- ▫ Appendices
  - • Glossary
  - • Roles and responsibilities
  - • Methodology and public comment letters
  - • Summary of changes
  - • Comparison with COSO ERM

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Project deliverable #2 – Internal Control over External Financial Reporting: A Compendium....

- Illustrates approaches and examples of how principles are applied in preparing financial statements
- Considers changes in business and operating environments during past two decades
- Provides examples from a variety of entities – public, private, not-for-profit, and government
- Aligns-with the 2013 Framework

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Project deliverable #3 – Illustrative Tools for Assessing Effectiveness of a System of Internal Control

Organized into two fundamental sections – *templates* and *scenarios*

- The tools focus on evaluation of components and relevant principles, not the underlying controls
- The scenarios give several practical examples of how the templates can be used to support assessment of the internal control system

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Summary of scenarios included with the Illustrative Tools

- **Scenario A** – Is a relevant principle and component present and functioning?
- **Scenario B** – Is each of the components present and functioning and operating together in an integrated manner?
- **Scenario C** – How does a material weakness impact relevant principles, components and the system of internal control?
- **Scenario D** – Are relevant principles and components present and functioning in a division, operating unit or function?
- **Scenario E** – How are the assessments of multiple locations combined?

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Update expected to increase ease of use and broaden application…

What did _not_ change...

- Core definition of internal control
- Three categories of objectives and five components of internal control
- Each of the five components of internal control are required for effective internal control
- Important role of judgment in designing, implementing and conducting internal control, and in assessing its effectiveness

What did change...

- Changes in business and operating environments considered
- Operations and reporting objectives expanded
- Fundamental concepts underlying five components articulated as principles
- Additional approaches and examples relevant to operations, compliance, and non-financial reporting objectives added

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Update considers changes in business and operating environments…

Environmental changes...	…have driven Framework updates
Expectations for governance oversight	
Globalization of markets and operations	
Changes and greater complexity in business	
Demands and complexities in laws, rules, regulations, and standards	
Expectations for competencies and accountabilities	
Use of, and reliance on, evolving technologies	
Expectations relating to preventing and detecting fraud	COSO Cube (2013 Edition)

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The new Framework and opportunities for strategic enhancement

- Tone at the top and the relationship between mission, vision, values and strategy are key
- Objectives are strategically critical and the role of objective setting is clarified in the 2013 Framework
- 2013 Framework includes increased emphasis on the role of management and the board of directors
- Enhanced governance concepts and expanded discussion related to board committees such as audit, compensation and nominating/governance activities
- A strategic approach can help at all levels of an organization and if used appropriately, the Framework may be a vehicle for enhanced strategic clarity

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17 principles of effective internal control

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
Risk Assessment	6. Specifies suitable objectives 7. Identifies and analyzes risk 8. Assesses fraud risk 9. Identifies and analyzes significant change
Control Activities	10. Selects and develops control activities 11. Selects and develops general controls over technology 12. Deploys through policies and procedures
Information & Communication	13. Uses relevant information 14. Communicates internally 15. Communicates externally
Monitoring Activities	16. Conducts ongoing and/or separate evaluations 17. Evaluates and communicates deficiencies

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Principles and "Points of Focus"

- The 17 principles are intended to be broad as they apply to any category of objective and any type of entity
- Each of the seventeen principles have points of focus
- There are over 80 points of focus
- The points of focus represent important characteristics of the associated principle
- Each component and relevant principle must be present and functioning and the five components be operating together. **Important note: separate assessment of the points of focus is not required.**

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Key concepts

- Effective internal control provides reasonable assurance regarding the achievement of objectives and requires that:
  - *Each component and each relevant principle is present and functioning*
  - *The five components are operating together in an integrated manner*
- Each principle is suitable to all entities; all principles are presumed relevant except in rare situations where management determines that a principle is not relevant to a component (e.g., governance, technology)
- Components operate together when all components are present and functioning and internal control deficiencies aggregated across components do not result in one or more major deficiencies
- A major deficiency represents an internal control deficiency or combination thereof that severely reduces the likelihood that an entity can achieve its objectives

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Key concepts

- The Framework **does not prescribe controls to be selected, developed, and deployed** for effective internal control
- An organization's **selection of controls** to effect relevant principles and associated components **is a function of management judgment based on factors unique to the entity**
- **A major deficiency in a component or principle cannot be mitigated** to an acceptable level by the presence and functioning of other components and principles
- However, understanding and considering **how controls effect multiple principles can provide persuasive evidence** supporting management's assessment of whether components and relevant principles are present and functioning

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Control environment component and related principles

Control Environment

1. The organization demonstrates a commitment to integrity and ethical values.
2. The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.
3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.
4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.
.

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Update describes important characteristics of principles

Control Environment

1. The organization demonstrates a commitment to integrity and ethical values.

Points of Focus:
- Sets the Tone at the Top
- Establishes Standards of Conduct
- Evaluates Adherence to Standards of Conduct
- Addresses Deviations in a Timely Manner

- Points of focus may not be suitable or relevant, and others may be identified
- Points of focus may facilitate designing, implementing, and conducting internal control
- There is *no* requirement to separately assess whether points of focus are in place

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Slide 30

Update describes how various controls effect principles

Component	Control Environment		
Principle	1. The organization demonstrates a commitment to integrity and ethical values.		
Controls embedded in other components may effect this principle	Human Resources review employees' confirmations to assess whether standards of conduct are understood and adhered to by staff across the entity *Control Environment*	Management obtains and reviews data and information underlying potential deviations captured in whistleblower hot-line to assess quality of information *Information & Communication*	Internal Audit separately evaluates Control Environment, considering employee behaviors and whistleblower hotline results and reports thereon *Monitoring Activities*

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Slide 31

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Slide 32
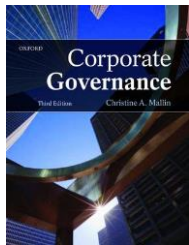
Principle 2- The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.

Points of Focus
- Establishes oversight responsibilities
- Applies relevant expertise
- Operates independently
- Provides oversight to the system of internal control

Focus

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Principle 3 – Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives

Points of focus

- Considers all structures of the entity
- Establishes reporting lines
- Defines, assigns and limits authorities and responsibilities
  – Board of directors
  – Senior management
  – Management
  – Personnel
  – Outsourced service providers

Focus

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Risk assessment component and related principles

Risk Assessment

6. The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.

7. The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.

8. The organization considers the potential for fraud in assessing risks to the achievement of objectives.

9. The organization identifies and assesses changes that could significantly impact the system of internal control.

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Principle 6 - The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives

Points of focus organized around:

- Operations objectives
- External financial reporting objectives
- External non-financial reporting objectives
- Internal reporting objectives
- Compliance objectives

Focus

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Principle 7- The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how they risks should be managed

Points of Focus

- Includes entity, subsidiary, division, Operating unit and functional levels
- Analyzes internal and external factors
- Involves appropriate levels of management
- Estimates significance of risks identified
- Determines how to respond to risks

Focus

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Compliance "Concepts"

- Laws, rules, standards and regulations establish minimum standards of conduct
- Compliance objectives are established
- Management consider acceptable level of variation
- Many laws and regulations depend on external factors, geography and industry- and at times, size

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INFORMATION TECHNOLOGY

Better, faster, enabling, technology

Cloud technology

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Update considers changes in business and operating environments…

Environmental changes...	*…have driven Framework updates*
Expectations for governance oversight	
Globalization of markets and operations	
Changes and greater complexity in business	
Demands and complexities in laws, rules, regulations, and standards	
Expectations for competencies and accountabilities	

Use of, and reliance on, evolving technologies

COSO Cube (2013 Edition)

Expectations relating to preventing and detecting fraud

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Control activities component and related principles

Control Activities

10. The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.

11. The organization selects and develops general control activities over technology to support the achievement of objectives.

12. The organization deploys control activities through policies that establish what is expected and procedures that put policies into place.

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Principle 11- The organization selects and develops general controls activities over technology to support the achievement of objectives

Points of focus

• Determine dependency between the use of technology in business processes and technology general controls

• Establishes relevant:
  – **technology infrastructure** control activities
  – **security management** process control activities
  – **technology acquisition, development and maintenance** control activities

Focus

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Outsourcing alternative

"…While in principle, the same considerations apply whether controls are performed internally or by an outsourced service provider, outsourcing presents unique risks and often requires selecting and developing additional controls over the completeness, accuracy, validity of information submitted to and received from the outsourced service provider ."

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Information & communication component and related principles

| Information & Communication |

13. The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.

14. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.

15. The organization communicates with external parties regarding matters affecting the functioning of internal control.

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Principle 13- The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.

Points of focus

- Identifies information requirements
- Captures internal and external sources of data
- Processes relevant data into information
- Maintains quality throughout processing
- Considers costs and benefits

Focus

Recommended actions

- **Read** COSO's updated Framework and illustrative documents

- **Educate** the audit committee, operational and functional leaders

- **Clearly define roles and responsibilities**

- **Establish a process** for identifying, assessing, and implementing necessary changes in controls and related documentation

- **Develop and implement** a transition plan timely to meet key objectives

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Roles and responsibilities

Responsible parties

- **Governing board and its committees**
  - Audit committees, compensation committees, nominations committees
- **Chief executive officer**
  - Provide leadership and direction to senior management
  - Maintain oversight and control over risks facing the entity
  - Guide development and performance of controls at the entity level, including delegation to senior management
  - Communicate expectations
  - Evaluate internal control deficiencies and their impact

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Roles and responsibilities

Responsible parties - continued

- **Senior management** - **chief officers for administration, audit, compliance, finance, technology, operations, legal, risk and others**
  - Provide leadership and direction
  - Maintain oversight
  - Guide development and performance of controls at the functional and operating unit levels in relation to the entity wide controls
  - Communicate expectations regarding integrity, competence, key policies and information requirements
  - Evaluate internal control deficiencies and their impact on the long-term effectiveness of the system of internal control

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Roles and responsibilities – component view

Control environment – reading, understanding and applying the standards of conduct of the organization

Risk assessment – identifying and evaluating risks to the achievement of objectives and understanding established risk tolerances relating to their areas of responsibility

Control activities – performing reconciliations, following up on exception reports, performing physical inspections, and investigating reasons for cost variance or other performance indicators

Information and communication – producing and sharing information used in the internal control system or taking other actions needed to effect control

Monitoring activities – supporting efforts to identify and communicate to higher-level management issues in operations, non-compliance with the code of conduct, or other violations of policy or illegal actions

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Roles and responsibilities

Internal audit considerations

- Be a **leader!**
- Think **strategically**
- Focus on update and training of staff and others
- Assist with assessment/transition
- Continually identify change
- Discuss expansion/application to operations, compliance and non- financial reporting

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Roles and responsibilities

Intentional inclusion of external parties

- Outsourced service providers
- Important sources of information about the control activities
- Customers
- Vendors
- Potential suppliers
- Outside experts, subject matter specialists
- Legislators and regulators
- Bond rating agencies
- News media

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Focus on the benefits of the principles-based approach

The approach provides flexibility in applying the Framework to multiple, overlapping objectives across the entity

- Clarity is enhanced – it is easier to see what is covered and what is missing
- Focus on principles may reduce likelihood of considering something that's irrelevant

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Benefits of the principles-based approach

- Selecting, developing, and deploying **controls to effect multiple principles** may also reduce the number of discrete, layered-on controls.

- Applying an integrated approach to internal control - encompassing operations, reporting, and compliance – may lessen complexity.

- *In assessing severity of internal control deficiencies, use only the relevant classification criteria as set out in the Framework or by regulators, standard-setting bodies, and other relevant third parties, as appropriate (pages 20 and 21 in Framework).*

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Transition and impact

- Users are encouraged to transition applications and related documentation to the updated Framework as soon as feasible

- Updated Framework will supersede original Framework at the end of the transition period (i.e., December 15, 2014)

- During the transition period, external reporting should disclose whether the original or updated version of the Framework was used

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COSO can help ALL organizations!

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Obtaining COSO publications

The updated Framework and related Illustrative documents are available in 3 formats:

1. **E-book** – This layout is ideally suited for those wanting access in electronic format for tablet use. An e-book reader is required to view this layout. Printing is restricted in this layout.
2. **Paper-bound** – This layout is ideally suited for those wanting a hard copy.
3. **PDF** – This layout is ideally suited for organizations interested in licensing multiple copies.

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Internal Control–Integrated Framework

A Suitable Model for ALL

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Thank you!