Implementing the New COSO
Internal Control – Integrated Framework

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Today’s Agenda

Background and overview

Internal Control–Integrated Framework

Some key changes

Transition to the new framework

Transition period

Working with the auditors
Background and Overview
About COSO

Formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting (aka the Treadway Commission)

Joint initiative of five private sector organizations

Sponsors

American Accounting Association (AAA)
American Institute of Certified Public Accountants (AICPA)
Financial Executives International (FEI)
The Institute of Internal Auditors (IIA)
The Institute of Management Accountants (IMA)
COSO’s Mission

“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.”
The Original Framework

• First published in 1992
• Gained wide acceptance in early 2000s with passage of Sarbanes Oxley
• Most widely used internal control framework in U.S.
• Widely used around the world
Internal Control—Integrated Framework
Update expected to increase ease of use and broaden application

<table>
<thead>
<tr>
<th>What is <strong>not</strong> changing...</th>
<th>What is changing...</th>
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<tbody>
<tr>
<td>• Core definition of internal control</td>
<td>• Changes in business and operating environments considered</td>
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<tr>
<td>• Three categories of objectives and five components of internal control</td>
<td>• Operations and reporting objectives expanded</td>
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<td>• Each of the five components of internal control are required for effective internal control</td>
<td>• Fundamental concepts underlying five components articulated as principles</td>
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<td>• Important role of judgment in designing, implementing and conducting internal control, and in assessing its effectiveness</td>
<td>• Additional approaches and examples relevant to operations, compliance, and non-financial reporting objectives added</td>
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Update considers changes in business and operating environments

**Environmental changes...**

- 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

**...have driven Framework updates**

COSO Cube (2013 Edition)
Update articulates Five Components and Seventeen principles of effective IC

**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
Points of Focus describe important characteristics of each principle

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
Project Deliverable #1 – Internal Control-Integrated Framework

Consists of three volumes:
- Executive Summary
- Framework and Appendices
- Illustrative Tools for Assessing Effectiveness of a System of Internal Control

Sets out:
- Definition of internal control
- Categories of objectives
- Components and principles of internal control
- Requirements for effectiveness
Project Deliverable #2 – ICEFR: A Compendium of Approaches and Examples

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 updated Framework
Getting COSO’s Publications

The updated framework and related Illustrative documents are available in 3 layouts

1. E-book – This layout is ideally suited for those wanting access in electronic format for tablet use. An e-book reader from the AICPA is required to view this layout. Printing is restricted in this layout.
   - Purchase through www.cpa2biz.com

2. Paper-bound – This layout is ideally suited for those wanting a hard copy.
   - Purchase through www.cpa2biz.com

3. PDF – This layout is ideally suited for organizations interested in licensing multiple copies.
   - Contact the AICPA at copyright@aicpa.org
Some Key Changes
Some Key Changes

Technology

The 1992 Framework included many concepts directly relevant for technologies of the time. Since then, technology has rapidly evolved from something embraced by the largest and most advanced companies to a foundation block of nearly all companies.

The updated framework includes:

• more focus on technology throughout the components and principles
• a broader focus on the impacts of the technology on the internal control rather than on the specific types of technology
Some Key Changes

Governance

The updated framework clarifies the role of boards of directors and audit committees (or those charged with governance) to oversee the system of internal control.

The updated framework addresses considerations for those responsible for governance of an organizations’ internal control.

Outsourcing

More companies are outsourcing key portions of their business processes or controls to third parties.

It includes expanded guidance and considerations relating to outside resources, such as third-party processors.
Some Key Changes

Reporting

Competitive pressures, advances in technology, and regulatory scrutiny have contributed to increasing expectations for providing relevant information immediately.

Investors, owners, regulators, and other users continue to demand more and quality reporting from an entity.

The updated framework expanded the financial reporting objective to provide clarity when internal control supports other important forms of reporting (e.g., operations, compliance) for investors, owners, boards of directors, regulators and others.
Some Key Changes

Globalization

For many entities, local or national borders no longer serve as significant barriers. Rather, businesses are increasingly operating in a multi-location and global business environments.

Complexities in global and local laws, regulations, and standards make it difficult to maintain compliance.

Advances in technology and communications have also increased the reach of many companies from a supply and development side and also in sales or service delivery.

The 2013 Framework includes guidance and consideration for businesses operating in these arenas (e.g., principles relating to structures, reporting lines, authorities and to identification and assessment of risk).
Some Key Changes

Fraud

Putting fraud right out in the forefront. A business's control structure must now address issues of fraud directly.
Transition to the New Framework
What you need to do...

• Read, understand, communicate and train others
• Meet with your audit firm
• Take 17 Principles Inventory
• Map your Controls to Principles, consider POF’s
• Evaluate results and plan change
• Meet with your audit firm again
• Execute the transition plan
What will NOT change...

- Top-down, risk-based approach
- “Scoping” the financial statements
- ICFR objectives
- Identification of processes and controls
- Walkthroughs
- Risk and Control Matrices
- Roll-forward to year-end
- ITGC approach
- Deficiency identification, assessment and aggregation
- Criteria to assess any significant deficiencies and material weaknesses
- Evaluation of significant change quarterly and other changes
The Five-Step Transition

**STEP 1**
DEVELOP AWARENESS, EXPERTISE, AND ALIGNMENT

**STEP 2**
CONDUCT PRELIMINARY IMPACT ASSESSMENT

**STEP 3**
FACILITATE BROAD AWARENESS, TRAINING, AND COMPREHENSIVE ASSESSMENT

**STEP 4**
DEVELOP AND EXECUTE COSO TRANSITION PLAN FOR SOX COMPLIANCE

**STEP 5**
DRIVE CONTINUOUS IMPROVEMENT
• Gain senior leadership and board alignment and support
• Build awareness and expertise
• Educate management
• Map principles to existing controls
• Identify opportunities to expand applications of internal control
STEP 2
CONDUCT PRELIMINARY IMPACT ASSESSMENT

• One significant factor - how well management understood and implemented the original version and updated it for changes in the business.
• Leverage the original mapping of components to controls
• Remediate gaps
• Engage broader organization
• SOX compliance efforts may occur centrally, or there may be multiple layers of assessment.
• Pressure test preliminary impact assessment
Phase 1: Documentation and Evaluation
Phase 2: Validation Testing and Gap Remediation
Phase 3: External Review and Testing
There’s a difference between an adequate and a best-in-class system of internal control.
Don’t be surprised...

• There’s some work to do
• Additional documentation
• Changes in some controls
• Potential for identification of deficiencies that require attention/remediation
• Watch for “PCAOB inspection impact”
Transition Period
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: SEC
Transition & 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
“The staff indicated the longer issuers continue to use the 1992 framework, the more likely they are to receive questions from the staff about whether the issuer's use of the 1992 framework satisfies the SEC's requirement for a suitable, recognized framework”, especially after the Dec. 15, 2014, transition date.
Transition Considerations

• Does your system of internal control need to address changes in business?

• Does your system of internal control need to be updated to address all principles?

• Does your organization apply and interpret the original framework in the same manner as COSO?

• Is your organization considering new opportunities to apply internal control to cover additional objectives?
Working with the Auditors
Working with the Auditors

An external auditor of a private entity is required to obtain an understanding of the entity’s internal control, evaluate the design, and determine whether controls have been implemented. Testing operating effectiveness is the auditor’s discretion. (AICPA AU 315-C)

An external auditor of a US public registrant is required to express an opinion on the effectiveness of a company’s internal control over financial reporting. (PCAOB AS 5)

Accordingly, an external auditor will want to understand how your organization demonstrates the principles are present and functioning.

Any relevant principle determined not present and functioning is a ‘major deficiency’ and results in ineffective internal control.
Auditing Standards

The ASB (and other auditing standard setters) will need to consider whether to update the attestation standards, where an auditor is engaged to provide an opinion on internal control over financial reporting.

Attestation Standard AT 501 will need to conform with and incorporate the 17 principles set out in the updated framework.

The ASB (and other auditing standard setters) will need to consider whether to provide guidance on how an auditor examines whether the 17 principles are present and functioning when evaluating management’s design of a system of internal control.
Transition Assistance

An external auditor can assist you with various aspects of the five-step transition to the updated framework

For example,

- **Develop awareness** among board members and c-suite about COSO’s updated framework and potential implications on the ICFR

- **Develop expertise** in applying the updated framework through L&D

- **Perform preliminary assessments** of areas where principles are (or are not) present and functioning or where documentation needs to be enhanced across the business

- **Consider new opportunities** to apply internal control (e.g., other reporting, over-lapping objectives)
Working with the auditors

Coordinate your transition planning and activities with your external auditor to ensure your plans and their expectations are in alignment

• Communicate necessary changes in the design or documentation of your existing system of internal control over financial reporting based on the updated framework.

• Communicate necessary changes in your overall assessment process for determining whether the system of internal control over financial reporting is effective.

• Communicate any required disclosure in your quarterly internal control certification documentation and forms.

• Ultimately, for registrants, your external auditor will need to assess and gain comfort with your updated SOX compliance program and supporting documentation before the transition date.
Any Final Questions?
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