Internal Control–Integrated Framework

September 2012
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Project Overview
Why Update What Works


- Fundamental concepts relating to effective internal control
- Changes in business, operating, and regulatory environments
- Internal and non-financial reporting objectives


- Formalizes Principles Underlying Components
- Updates Context
- Expands Application
Project Timetable

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

2010  2011  2012  2013
Project Participants

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

Stakeholders
- Over 700 stakeholders in original Framework responded to global survey during 2011
- Over 200 stakeholders commented on proposed updates to original Framework during first quarter of 2012
- Additional public exposure of proposed publications during fourth quarter of 2012
Project Deliverables: Internal Control-Integrated Framework

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

- Sets out:
  - Definition of internal control
  - Requirements for effectiveness
  - Categories of objectives
  - Components of internal control
Project Deliverables: Internal Control over External Financial Reporting: A Compendium

- Approaches and Examples illustrate how principles are applied in preparing financial statements
- Considers changes in business, operating, and regulatory environments during past two decades
- Is relevant for variety of entities – public, private, not-for-profit, and government
- Is consistent with the updated Framework
Updates to Internal Control—Integrated Framework
Internal Control-Integrated Framework

- First published in 1992
- Gained wide acceptance following financial control failures of early 2000’s
- Most widely used framework in the US
- Also widely used around the world

Original COSO Cube
Fundamental concepts of internal control are timeless

- *Geared to achievement of objectives* – operations, reporting, and compliance
- *A process* – ongoing tasks and activities
- *Effected by people* – actions taken at every level of the organization
- *Able to provide reasonable assurance* – but not absolute assurance
- *Adaptable to entity structure* – flexible in application
- *Five components of internal control* – requirements to achieve effective internal control
  - Control Environment
  - Risk Assessment
  - Control Activities
  - Information and Communication
  - Monitoring Activities
Updates intended to ease use and application

**What is not changing...**
1. Retains the core definition of internal control
2. Retains the five components of internal control
3. Retains the requirement of five components for an effective system of internal control
4. Retains important role of judgment in designing, implementing, and conducting internal control, and in assessing effectiveness of internal control

**What is changing...**
1. Formalizes fundamental concepts underlying the five components as principles
2. Considers changes in business, operating, and regulatory environments
3. Expands financial reporting objective to include other important forms of reporting
4. Provides additional approaches and examples relevant to operations, compliance, and non-financial reporting objectives
Requirements for effective internal control

- Retains concept that effective internal control provides reasonable assurance regarding achievement of objectives
- Effective internal control requires that:
  - Each of the five components of internal control and relevant principles are present and functioning
  - The five components are operating together in an integrated manner
- When a component or relevant principle is deemed not present and functioning, or when components are deemed not operating together, a “major deficiency” exists
- When a major deficiency exists, the entity cannot conclude that it has met the requirements for effective internal control

An effective system of internal control reduces, to an acceptable level, the risk of not achieving an objective.
Update formalizes fundamental concepts embedded in the original Framework as principles

| 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                |
Update considers changes in business, operating, and regulatory environments

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Updated COSO Cube
Public exposure of updated Framework: Summary of public responses to on-line survey

- Interest across geographies –approximately 50% of respondents from North America and 50% from international regions
- Concurrence that the updated Framework:
  - Will help strengthen systems of internal control
  - Provides important considerations of effective internal control through formalization of concepts introduced in the original Framework
  - Appropriately expands the reporting objective
- Divergent views exist – for instance, the updated Framework:
  - May set a higher threshold for attaining effective internal control
  - May impose additional burden on entities’ reporting on internal control
  - Should incorporate aspects of ERM-Integrated Framework, e.g., objective setting
Public exposure of updated Framework: Summary of revisions arising from comment letters

- Definition of Internal Control
  - Removes modifiers (e.g., reliable financial reporting) from categories of objectives

- Assessing Effectiveness
  - Clarifies that effective internal control requires (i) each of the five components and relevant principles are present and functioning and (ii) the five components are operating together
  - Modifies classification of internal control deficiencies into two tiers: (i) major deficiency, which precludes effective internal control, and (ii) internal control deficiency
  - Clarifies that points of focus (formerly attributes) are important considerations in determining whether a principle is present and functioning
  - Removes presumption that points of focus are present and functioning, and clarifies use of judgment in identifying and considering relevant points of focus

- Principles
  - Clarifies descriptions of several principles
Public exposure of updated Framework: Summary of other considerations arising from comment letters

- **Objective Setting**
  - Retains five components of internal control
  - Retains view that specifying objectives is part of internal control but establishing objectives is not

- **Objectives**
  - Retains operations, reporting, and compliance objective categories, and expands descriptions
  - Retains view that safeguarding of assets primarily relates to operations objectives, and recognize its consideration within reporting and compliance
  - Retains view that strategic objectives is not part of internal control

- **Structure and Layout**
  - Retains view that the Framework comprises all chapters
Public exposure of updated Framework: Summary of other considerations arising from comment letters (continued)

• Enterprise Risk Management (ERM)
  – Retains distinction between ERM and Internal Control
  – Retains view that strategy-setting, strategic objectives, and risk appetite are aspects of ERM and not part of the updated Framework
  – Retains definition of risk appetite and application of risk tolerance

• Smaller Entities and Governments
  – Includes excerpts from COSO’s Guidance for Smaller Public Entities (Appendix C)
  – Appendix C includes considerations relevant for smaller entities

• Technology
  – Expands discussion in the points of focus and in several chapters
  – Excludes discussion on specific technologies and associated risks due to rapid pace of change of technology
Overview of Illustrative Tools for Assessing Effectiveness of a System of Internal Control

- Tools include collection of Templates and Scenarios that can assist users when assessing the effectiveness of a system of internal control based on the requirements set forth in the updated Framework.

- Templates help management present a summary of assessment results and its determination of whether components and principles are present and functioning.

- Scenarios illustrate how Templates can be used to support an assessment of effectiveness of a system of internal control, including:
  - Is a component and relevant principles present and functioning?
  - Are the five components present, functioning and operating together in an integrated manner?

- Illustrative Tools do not replace or modify the updated Framework.
Overview of Internal Control over External Financial Reporting: A Compendium of Approaches and Examples
Overview of ICEFR Compendium

- **Types of external financial reports** – financial statements for external purposes and other external financial reporting derived from an entity’s financial and accounting books and records
- **Suitable objectives** – financial reporting rules and standards form the basis upon which management specifies suitable objectives for the entity and subunits
- **Judgment** – proper application of suitable objectives to the entity’s transactions mitigates risk of material misstatement.
- **Overlapping objectives** – operations, compliance and non-financial reporting objectives may overlap or support the external financial reporting objective
- **Deficiencies in internal control** – material weakness and significant deficiency reflect definitions established by regulators for internal control over financial reporting
- **Smaller entities** – principles are suitable and presumed relevant for all entities, and smaller entities may apply these principles using different approaches
Overview of ICEFR Compendium (continued)

• Selected Approaches and Examples illustrate various aspects of applying the principles in an ICEFR context:
  – Approaches and Examples are intended to assist users in understanding how the updated Framework can be applied when preparing financial statements for external purposes and other external financial reporting
  – Definitions, components, principles, and points of focus are consistent with the updated Framework
• Stakeholders should refer to the updated Framework for comprehensive discussion of an effective system of internal control
• Compendium supplements and can be used in concert with the updated Framework when considering ICEFR
Public Exposure Process
Public exposure of proposed COSO documents

- COSO released for public comments its proposed *Internal Control over External Financial Reporting: Compendium of Approaches and Examples*
- In conjunction with releasing the ICEFR Compendium, COSO made available the revised version of its previously exposed updated *Framework*, which incorporates revisions arising from consideration of public comment letters
  - *Internal Control–Integrated Framework: Framework and Appendices*
  - *Internal Control–Integrated Framework: Executive Summary*
- COSO also made available its *Illustrative Tools for Assessing Effectiveness of a System of Internal Control*
- Public comment period began on September 18, 2012 and ends on November 20, 2012
  - Please visit [www.ic.coso.org](http://www.ic.coso.org) for more information
COSO seeks public comments

- Proposed ICEFR Compendium
  - Will it be useful in applying the updated Framework to your entity’s external financial reporting objectives?
  - Does it impose additional burdens on your entity when reporting on the effectiveness of internal control? If yes, please explain.
  - Does it clearly illustrate the principles set out in the updated Framework?

- Proposed updates to the Internal Control-Integrated Framework
  - Does it provide a clear understanding of the requirements for an effective system of internal control?
    - Does it appropriately require that each of the five components be present, functioning and operating together?
    - Does it appropriately require that relevant principles be present and functioning?
  - Does it appropriately discuss the role and relevance of components, principles and points of focus?
Transition to the Updated Framework

- COSO expects the updated Framework will eventually supersede the original Framework; accordingly, the ICEFR Compendium will supersede the 2006 *Internal Control over Financial Reporting - Guidance for Smaller Public Companies*
- COSO believes users should update their systems of internal control and related documentation as quickly as is feasible under the circumstances
- COSO recognizes that differing applications of the Framework and differing circumstances will impact how quickly an update can occur
- COSO will make the original Framework available following the issuance of the updated Framework until it becomes clear that transition in the marketplace has been substantially completed
- Users who are required to report upon the effectiveness of internal control should monitor guidance by regulators and standard setters for any preference regarding the framework to use for reporting purposes during the transition period
- COSO believes continued use of the original Framework during the transition period would be acceptable
Questions or Comments?

- Direct correspondence with COSO and PwC via icif@us.pwc.com