

## **COSO *Internal Control-Integrated Framework* Frequently Asked Questions**

(May 2013)

### **1. What was the nature of the project to update the *Internal Control-Integrated Framework* and fundamentally what has changed?**

The original *Internal Control-Integrated Framework* (original framework), published in 1992, remains fundamentally sound and broadly accepted in the marketplace for designing, implementing, and conducting systems of internal control and assessing their effectiveness. The COSO Board decided to update the original framework recognizing there have been many changes in business and operating environments.

The experienced reader will find much that is familiar in the updated *Internal Control-Integrated Framework (Framework)*, which builds on what has proven useful in the original version. It retains the core definition of internal control and the five components of internal control – Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring Activities. The requirement that each of the five components is present and functioning for an effective system of internal control remains fundamentally unchanged. The *Framework* continues to emphasize the importance of management judgment in designing, implementing and conducting internal control, and in assessing its effectiveness. The COSO Board wants the core strengths of the original framework to be preserved and the enhancements and clarifications included in the *Framework* to ease its use and application.

The *Framework* and related illustrative documents are intended to (i) clarify the requirements of effective internal control, (ii) update the context for applying internal control by reflecting many of the changes in business and operating environments, and (iii) broaden its application by expanding the operations and reporting objectives.

#### Clarify Requirements by Articulating Principles

One of the more significant updates is the formalization of fundamental concepts introduced in the original framework. In the *Framework*, these concepts are now principles associated with the five components. These principles provide clarity for understanding the requirements of effective internal control to facilitate designing and implementing a system of internal control and in assessing its effectiveness. The *Framework* also includes points of focus that highlight important characteristics relating to these principles.

#### Update Context by Reflecting Changes in Business and Operating Environments

In the twenty years since the original framework was published, business and operating environments have changed dramatically, becoming more complex, technologically driven and global in scale. 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. The *Framework* reflects considerations of many of these changes, including:

- Expectations for governance oversight
- Globalization of markets and operations
- Changes and greater complexities 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

### Broaden Application by Expanding Operations and Reporting Objectives

The *Framework* can help organizations in their efforts to obtain reasonable assurance of achieving their entity and subunits' operations, non-financial external reporting, and internal reporting objectives.

For instance, where external events are unlikely to have a significant impact on achieving a specified operations objective – such as financial performance, productivity, quality, environmental practices, innovation, customer and employee satisfaction – or where the organization can reasonably predict the nature and timing of such events and mitigate the impact to an acceptable level, the entity may be able to attain reasonable assurance that such an objective can be achieved. In addition, the *Framework* can provide reasonable assurance of preparing external non-financial reports in accordance with laws, rules, regulations, standards, or other frameworks, and of internal reports to management and the board of directors, as deemed necessary, about the entity and its subunits.

The COSO Board's goal in updating the original framework has been to formalize more explicitly the principles embedded in the original framework to facilitate development of effective internal control and assessment of its effectiveness, to reflect many of the changes in the business and operating environments over the past 20 years, and to increase the ease of use and application of the *Framework* to specified objectives of the entity and subunits.

## **2. What was the nature of the project to develop the illustrative documents relating to the *Framework*?**

In connection with developing the *Framework*, the COSO Board also developed (i) *Illustrative Tools for Assessing Effectiveness of a System of Internal Control (Illustrative Tools)* to provide templates and scenarios that may be useful in applying the *Framework*, and (ii) *Internal Control over External Financial Reporting: A Compendium of Approaches and Examples (ICEFR Compendium)* to provide practical approaches and examples that illustrate how the components and principles set forth in the *Framework* can be applied in preparing external financial statements. The *Framework* applies to any type of entity, including large and small public, private, governmental and not-for-profit, so do the *Illustrative Tools* and *ICEFR Compendium*.

The templates and scenarios included in the *Illustrative Tools* focus on the components and relevant principles, not the underlying controls that affect the principles. These tools are not designed to satisfy any criteria established through laws, rules, regulations, or external standards for evaluating the severity of internal control deficiencies associated with a particular entity objective, such as external financial reporting. The templates are designed to present only a summary of assessment results. They are not an integral part of the *Framework*, and they may not address all matters that need to be considered in assessing a system of internal control. Management can modify the templates to reflect unique facts and circumstances (e.g., specified objectives and sub-objectives, scope of application, organizational structure) and assessment processes for their entity. The scenarios present several practical examples of how the templates can be used to support an assessment of effectiveness of a system of internal control based on the requirements set forth in the *Framework*.

The *ICEFR Compendium* was developed in connection with expanding the financial reporting category of objectives to include four sub-categories – financial or non-financial reporting, and internal or external reporting. The COSO Board developed additional approaches and examples for the *ICEFR Compendium* to assist users of the *Framework* who are responsible for designing, implementing, and conducting a system of internal control over external financial reporting. The approaches and examples illustrate how organizations may apply the principles set forth in the *Framework* in the context of preparing financial statements and other external financial reporting for an entity and subunits. The approaches provide a summary-level description of activities, and the examples provide specific illustrations on the application of each principle based on situations drawn from practical experiences. The *ICEFR Compendium* illustrates how various characteristics of the principles may be present and functioning within a system of internal control relating to external financial reporting objectives. However, the *ICEFR Compendium* does not illustrate all aspects of the components and principles that would be necessary for effective internal control, and therefore, is not sufficient to demonstrate that each of the five components and relevant principles are present and functioning.

The Board decided that the *ICEFR Compendium* will supersede the 2006 *Guidance on Internal Control over Financial Reporting-Guidance for Smaller Public Companies* when the original framework is superseded (see FAQ 6 below). The COSO Board believes that the *ICEFR Compendium* provides additional reference material relating to internal control over external financial reporting, while allowing the *Framework* to focus more broadly on internal control relating to operations, reporting, and compliance objectives.

### **3. What are the requirements for an effective system of internal control in the *Framework*?**

In response to public comments on the exposure draft, COSO clarified the requirements for effective internal control. An effective system of internal control reduces, to an acceptable level, the risk of not achieving an objective relating to one, two, or all three categories of objectives – that is, operations, reporting, and compliance. It requires that (i) each of the five components of internal control and relevant principles is present and functioning, and that (ii) the five components are operating together in an integrated manner.

The *Framework* views all components of internal control as suitable and relevant to all entities. Since principles are fundamental concepts associated with these components, the Framework also views the seventeen principles as suitable to all entities. The Framework presumes that principles are relevant because they have a significant bearing on the presence and functioning of an associated component. Accordingly, if a relevant principle is not present and functioning, the associated component cannot be present and functioning. There may be a rare industry, operating, or regulatory situation in which management has determined that a principle is not relevant to a component.

The components of internal control are interdependent with a multitude of interrelationships and linkages among them, particularly the manner in which principles interact within and across components. Components that are present and functioning capture the inherent interdependencies and linkages among them. Examples of components operating together include:

- The organization establishes expected standards of conduct and sets performance measures and incentives within the Control Environment to reduce the potential for fraudulent behavior and may impact the assessed level of fraud risk evaluated within Risk Assessment.
- The development and deployment of policies and procedures as part of Control Activities contributes to the mitigation of risks identified and analyzed within Risk Assessment.
- The processing of relevant, quality information within Information and Communication supports deployment of business process and transaction controls within Control Activities and performance of ongoing and separate evaluations of such controls within Monitoring Activities.
- The communication of internal control deficiencies to those responsible for taking corrective actions as part of Monitoring Activities requires a full understanding of the entity's structures, reporting lines, authorities and responsibilities as set forth in the Control Environment and as communicated within Information and Communication.

Accordingly, management can demonstrate that components operate together when (i) components are present and functioning, and (ii) internal control deficiencies aggregated across components do not result in the determination that one or more major deficiencies exist.

When an organization determines that an internal control deficiency exists, the *Framework* requires management to use judgment to assess the severity of that deficiency in determining whether each of the components and relevant principle is present and functioning and the five components are operating together, and ultimately the effectiveness of the entity's system of internal control. Further, these judgments may vary depending on the category of objectives.

Regulators, standard-setting bodies, and other relevant third parties may establish criteria for defining the severity of, evaluating, and reporting internal control deficiencies. The *Framework* recognizes and accommodates their authority and responsibility as established through laws, rules, regulations, and external standards. In those instances where an entity is applying such laws, rules, regulations, and external standards, management should use only the relevant criteria contained in those documents to classify the severity of internal control deficiencies, rather than relying on the classifications set forth in the *Framework*.

For example, a company that must comply with the criteria established by the United States Securities Exchange Commission (SEC) would use only the definitions and guidance set out for classifying internal control deficiencies as a “material weakness, significant deficiency, or control deficiency.” If an internal control deficiency is determined to rise to the level of a material weakness, the organization would not be able to conclude that the entity’s system of internal control over financial reporting has met the requirements for effective internal control as set out in the *Framework*. On the other hand, if an internal control deficiency does not rise to the level of material weakness the entity could achieve effective internal control over financial reporting.

#### **4. What are the roles of "points of focus" and "controls to effect principles" in the *Framework*?**

The *Framework* describes points of focus that are typically important characteristics of principles. In response to public comments on the exposure draft, COSO replaced the term "attributes" with points of focus. Points of focus may assist management in designing, implementing and conducting internal control and in assessing whether relevant principles are, in fact, present and functioning.

The *Framework* neither prescribes a process for assessing the effectiveness of a system of internal control nor requires that management assess separately whether points of focus are in place. The *Framework* recognizes the possibility that some points of focus may not be suitable or relevant to all entities and may consider others based on specific circumstances of the entity.

The Framework also does not prescribe any requirements that specific controls must be selected, developed, and deployed for an effective system of internal control. Instead, that determination is a function of management judgment that considers factors unique to each entity, such as the:

- Laws, rules, regulations, and standards to which the entity is subject
- Nature of the entity's business and markets in which it operates
- Scope and nature of the management operating model
- Competency of the personnel responsible for internal control
- Use and dependence on technology
- Management's responses to assessed risks

Management is expected to obtain persuasive evidence to support its determination that each of the components and relevant principles is present and functioning and the five components are operating together in an integrated manner. In making the determination as to whether the components and relevant principles are present and functioning, management can consider controls that affect a component or relevant principle (whether or not associated with that particular component or principle). Understanding how controls affect principles through their selection, development, and deployment can provide persuasive evidence to support management’s assessment of whether the entity's system of internal control is effective. Further, in assessing whether a component or relevant principle is not present and functioning, management can consider controls to effect other principles.

## 5. How will the *Framework* affect SOX 404 Filers?

Management's assertion relating to internal control over financial reporting, e.g., SOX 404 (a) and 404 (b), is not expected to change. In the spirit of continuous improvement, the principles are expected to clarify how to apply the *Framework* in designing, implementing, conducting a system of internal control, and in assessing its effectiveness. Further, the principles-based approach makes it easier to see what is covered and what is missing.

It's possible that some organizations may apply and interpret the narrative included in the original framework in a manner different than the COSO Board. For example, an existing system of internal control may not clearly demonstrate or document that all relevant principles associated with the five components are present and functioning. Accordingly, the COSO Board recommends management to:

- Review existing controls embedded within the components of a system of internal control to assess whether the relevant principles are present and functioning in support of the entity's objectives, and
- Establish a process for identifying, assessing, and implementing necessary changes in controls and related documentation.

To transition from the original framework to the *Framework* in connection with an entity's reporting on internal control over financial reporting for regulatory purposes, senior management needs to assess how the entity's system of internal control applies the seventeen principles associated with its five components of internal control. Where the entity has applied the original framework, management will need to first identify and assess any implications of applying the *Framework* to the entity's current system of internal control. Senior management should discuss with the board of directors its plan to adopt the *Framework*, and the board of directors should oversee management's assessment of any implications of, and determination of appropriate actions for, applying the *Framework*.

A user can develop an understanding of the more significant changes to the original framework by reviewing Appendix F: Summary of Changes to the COSO Internal Control-Integrated Framework (1992).

## 6. When will COSO replace the original framework?

The COSO Board's goal in updating the original framework has been to formalize more explicitly the principles embedded in the original framework to facilitate development of effective internal control and assessment of its effectiveness, to reflect changes in the business and operating environments over the past twenty years, and to increase the ease of use and application of the *Framework*. Accordingly, the COSO Board encourages users to transition their applications and related documentation to the *Framework*, in order reflect the enhancements and clarifications, as soon as is feasible under their particular circumstances.

The COSO Board recognizes that differing applications of the *Framework* by users in differing circumstances will likely result in differences in how quickly an update can occur in a specific application. For example, a profit or nonprofit organization with a less complex system of internal control over external financial reporting may be able to make all appropriate changes to its system and documentation in a few months; whereas, organizations with a more complex system may take a longer period to implement changes.

The COSO Board believes that the key concepts and principles embedded in the original framework are fundamentally sound and broadly accepted in the marketplace. COSO has announced that it will continue to make available the original framework during the transition period that extends to December 15, 2014, after which time COSO will consider it as having been superseded. The COSO Board believes that continued use of the original framework is appropriate during this transition period, and that any application of its *Internal Control-Integrated Framework* that involves external reporting should clearly disclose whether the original or 2013 version was utilized.

Similarly, COSO will consider the 2006 *Internal Control over Financial Reporting - Guidance for Smaller Public Companies* as having been superseded by the *ICEFR Compendium* after December 15, 2014.

## **7. How can application of the *Framework* contribute to efficiency in the design, implementation, and conduct of internal control?**

Entities have limits on human and capital resources and constraints on how much can be spent on designing, implementing, and conducting systems of internal control. The *Framework* can help management consider alternative approaches and decide what action it ultimately takes. Depending on circumstances, these approaches and decisions can contribute to efficiencies in the design, implementation, and conduct of internal control. For example,

- Understanding the importance of specifying suitable objectives may focus management's attention on those risks and controls most important to achieving the entity objectives.
- Focusing on those areas of risk that exceed acceptance levels and need to be managed across the entity may reduce efforts spent mitigating risks in areas of lesser significance.
- Coordinating efforts for identifying and assessing risks across multiple objectives may reduce the number of discrete risks assessed and mitigated.
- Selecting, developing, and deploying controls to effect multiple principles may also reduce the number of discrete, layered-on controls.
- Applying a common language—the *Framework*—encompassing operations, reporting, and compliance processes and controls may lessen the number of languages used to describe internal control across the entity.

## 8. How does the *Framework* relate to COSO's 2004 *Enterprise Risk Management - Integrated Framework*?

The COSO Board believes that enterprise risk management is broader in scope than internal control. The Board continues to believe that internal control is an integral part of enterprise risk management and the issuance of the *Framework* is not intended to alter that relationship.

The Board believes there may be differing regulatory and stakeholder expectations relating to enterprise risk management and internal control. For example, entities may not be required by statute, rules, or standard setters to apply the *Enterprise Risk Management-Integrated Framework*; however management may choose to do so to enhance their ability to create and sustain value. Conversely regulators and standard-setters may require entities to develop maintain, and report on effective internal control.

## 9. Who was involved in the project?

PwC served as the author and project leader for developing the *Framework* and the related *Illustrative Tools* and *ICEFR Compendium* publications under the direction of the COSO Board.

COSO had conducted a thorough selection process before selecting Coopers & Lybrand, a predecessor firm of PwC, to write the original framework. COSO granted the firm the right of first refusal for future updating requests and engaged PwC to develop these publications. PwC's project team included senior resources involved in previous COSO projects that bring an in-depth understanding of the original framework and the rationale for decisions made in creating that framework, as well as senior resources that can provide current and relevant perspectives on internal control.

To capture views of a broad range of professionals in the market place, COSO formed an Advisory Council representing industry practitioners as well as representatives and observers from professional service firms, corporations, non-profit entities, academia, and government agencies to capture views of a broad range of professionals in the market place. The Advisory Council was comprised of the following members:

<b>Members</b>	<b>Company</b>	<b>COSO Affiliation</b>
<i>(in alphabetical order by last name)</i>		
<b>James DeLoach</b>	Protiviti	Accounting & Consulting Firm
<b>Jennifer Burns</b>	Deloitte	Accounting & Consulting Firm
<b>Trent Gazzaway</b>	Grant Thornton	Accounting & Consulting Firm
<b>Audrey A. Gramling</b>	Bellarmine University	American Accounting Association (AAA)
<b>Steven E. Jameson</b>	Community Trust Bank	Institute of Internal Auditors (IIA)
<b>Cees Klumper</b>	The Global Fund to Fight AIDS, Tuberculosis and Malaria	The Global Fund
<b>J. Stephen McNally</b>	Campbell Soup Company	Institute of Management Accountants (IMA)
<b>Thomas Montminy</b>	PwC	Accounting & Consulting Firm
<b>Al Paulus</b>	Ernst & Young	Accounting & Consulting Firm



Members	Company	COSO Affiliation
<i>(in alphabetical order by last name)</i>		
Ray Purcell	Pfizer	Financial Executives International (FEI)
Tom Ray	Baruch College (KPMG retired partner)	Accounting & Consulting Firm
Dr. Larry E. Rittenberg	University of Wisconsin	Chair Emeritus COSO
Bill Schneider, Sr.	AT&T	American Institute of Certified Public Accountants (AICPA)
Sharon Todd	KPMG	Accounting & Consulting Firm
Ken Vander Wal	ISACA	Information Systems Audit and Control Association (ISACA)

The Advisory Council served as a sounding board for and provided input to COSO and PwC in connection with reviewing draft documents and participating in eleven meetings throughout all phases of the project.

#### 10. How were regulators involved in this initiative?

The FDIC, GAO, IFAC, PCAOB, and SEC participated as observers in all Advisory Council meetings and provided input throughout the project. Other regulators were involved from time to time.

#### 11. How did COSO obtain input from stakeholders in determining the scope and nature of changes to the original framework?

The COSO Board solicited input from a broad audience of stakeholders in determining the scope and nature of changes to the original framework from January to September 2011. During this period, the Board received more than 750 responses from stakeholders, representing many different types of entities and organizations around the world. Overall, a large majority of respondents supported updating (i.e., clarifying, enhancing), but not overhauling the original framework.

#### 12. Did COSO seek comments from stakeholders before issuing the *Framework*, the *Illustrative Tools* and the *ICEFR Compendium*?

Yes. The COSO Board believes there were extensive communications and activities with stakeholders over the past 2 ½ years that captured a wide range of views on the *Framework* as described in Appendix D, Methodology for Revising the *Framework*.

- Surveyed users and stakeholders in the original framework to capture user views on the nature and extent of necessary updates, receiving over 750 responses (December 2010 to September 2011)
- Conducted eleven meetings with the Advisory Council (whose members include representatives of AICPA, AAA, FEI, IIA, IMA, public accounting firms, other professional organizations and various regulatory observers)

- Provided exposure draft of the *Framework* for public comments (December 2011 to March 2012). . During this public exposure period more than 21,000 copies of the draft document were downloaded from [www.ic.coso.org](http://www.ic.coso.org), and COSO received more than 100 responses to its online survey questionnaire and another 97 comment letters from organizations and professionals around the world.
- Made available a revised draft of the *Framework* for public comments, in connection with providing exposure drafts of the proposed *Internal Control over External Financial Reporting: A Compendium of Approaches and Examples*, along with *Framework* and *Illustrative Tools for Assessing Effectiveness of a System of Internal Control* (September to December 2012). COSO welcomed comments on the proposed *ICEFR Compendium*, as well as on the post public exposure version of the *Framework* and *Illustrative Tools*. During this public exposure period more than 6,500 copies of these draft documents were downloaded from [www.ic.coso.org](http://www.ic.coso.org), and COSO received another 23 comment letters and 26 responses to its online survey questionnaire from organizations and professionals around the world.
- Participated in many conferences, webinars, and seminars with membership of COSO and sought views from stakeholders and users (January 2011 to January 2013)

The COSO Board believes these efforts represented a substantive due process that captured broad views on the *Framework and Appendices, Internal Control over External Financial Reporting: A Compendium of Approaches and Examples*, and *Illustrative Tools for Assessing Effectiveness of a System of Internal Control*.

The exposure drafts of the *Framework* and *ICEFR Compendium*, the revised version of the *Framework* and the *Illustrative Tools*, and all public comment letters will remain available to the general public at [www.coso.org](http://www.coso.org), until December 31, 2013.

### 13. What was the methodology used for updating the original framework?

PwC under the direction of the COSO Board executed the project in five phases:

- *Assess and Envision*—Through literature reviews, global surveys, and public forums, this phase identified current challenges for organizations in implementing the original framework. During this phase, PwC analyzed information, reviewed various sources of input, and identified critical issues and concerns. Also, COSO conducted a global survey, available to the general public for providing input on the original framework and solicited over 700 responses.
- *Build and Design*—PwC developed the *Framework, Illustrative Tools, and ICEFR Compendium*. Multiple drafts of the documents were reviewed by the Advisory Council and COSO Board, and various user and stakeholder groups provided additional insight about proposed updates and publications via participation in conferences, webinars, and seminars sponsored by COSO organizations.
- *Preparation for Public Exposure*—With assistance provided by the Advisory Council and oversight of the COSO Board, PwC prepared exposure drafts and on-line questionnaires to facilitate reviews by the general public. The Board and PwC asked for comments from the general public on many relevant topics, including whether the:

- The requirements of effective internal control are clearly set forth in the *Framework*
  - The roles of components, relevant principles, and points of focus are clearly set forth in the *Framework*
  - The *Framework* is sound, logical, and useful to management of entities of all sizes
  - The *ICEFR Compendium* adequately illustrates principles set forth in the *Framework* toward designing, implementing, and conducting internal control over external financial reporting.
- *Public Exposure*—In this phase, PwC refined draft documents through reviews with the general public. The *Framework* was issued for public exposure for a 104-day comment period. During this phase, PwC, COSO Board members, and Advisory Council members presented the *Framework* at numerous professional conferences, seminars, round tables, and meetings with users and stakeholders. The *Framework* was also made available for comments during the public exposure of the *ICEFR Compendium* and *Illustrative Tools*. PwC analyzed all comments received during these public exposure periods, and reviewed resolutions and modifications related to more significant issues raised during public exposure with the COSO Board and Advisory Council.
  - *Finalization*—PwC finalized the *Framework*, *Illustrative Tools*, and *ICEFR Compendium* and provided final documents to the COSO Board for review and acceptance.

Within each project phase and between phases, as one might expect, many different and sometimes contradictory observations or recommendations were expressed on fundamental concepts relating to internal control. PwC, with COSO Board oversight, carefully considered the merits of positions put forth, both individually and in the context of related issues, and revised the publications to help the development of a relevant, logical, and internally consistent publication on internal control.

#### **14. To what extent were international constituencies involved in this initiative?**

PwC's project team includes representatives from a number of countries.

In addition, input was sought from international constituencies to maximize alignment with other frameworks from around the world where possible. Approximately 30% of total respondents to COSO's 2011 survey of stakeholders and more than 40% of total downloads of the *Framework* were located internationally.

Also, an IFAC representative served as an observer to the Advisory Council. Among the organizations forming the Advisory Council, one comes from overseas and many had international representation. In addition, regulators or standard-setters from other parts of the world were engaged from time to time.

#### **15. How will the issuance of the *Framework* affect the availability of COSO's 2009 *Guidance on Monitoring Internal Control Systems*?**

The *Framework* incorporates guidance contained in COSO's 2009 *Guidance on Monitoring Internal Control Systems*, which will continue to be a reference document for management. This publication will remain available to the public via [www.coso.org](http://www.coso.org).

If you have any other questions or suggestions, please email [icif@us.pwc.com](mailto:icif@us.pwc.com).