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## COSO Updates the Internal Control – Integrated Framework

*May 2013*

### Overview

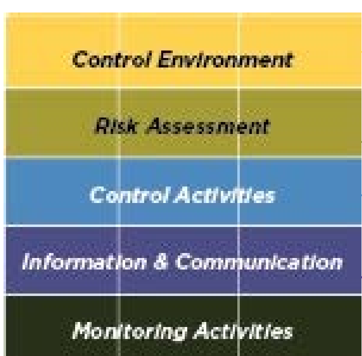
On May 14, 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its updated Internal Control-Integrated Framework (2013 Framework[1]) to take into account the drastic changes that occurred in the business landscape over the last 21 years (since the widely used 1992 Framework was published), to clarify the requirements of sound and effective internal control, to expand its application to an organization's operations and reporting objectives and to decrease ambiguity and divergent interpretations.

Although, we expect many organizations to use the 2013 Framework to assess their internal control over compliance and operations, its main application is anticipated to be a method for management and auditors to evaluate internal control over financial reporting for enclosure in SEC filings. In order to assist organizations to implement, evaluate or assess their system of internal control and to provide specific examples as to how the Framework can be used, COSO simultaneously developed *Illustrative Tools: Assessing Effectiveness of a System of Internal Control* and *Internal Control over External Financial Reporting: A Compendium of Approaches and Examples*. These publications provide different scenarios and templates to assist management's assessment of internal control effectiveness. The aforementioned documents complement the following COSO publications: *Internal Control – Integrated Framework: Executive Summary (Executive Summary)* and *Internal Control – Integrated Framework: Framework and Appendices (Framework).*

### What *is* new?

One of the most important updates included in the Framework was establishing 17 principles, each specifically assigned to one of the five components of internal control, as depicted below. COSO wanted to explicitly increase Management's understanding as to what constitutes effective internal control. An organization that applies all 17 principles has essentially achieved effective internal control. The new framework, therefore, is principles-based.

*Each principle must be present* ***and*** *functioning in an organization for it to have effective internal control.* "**Present**" is about **effective design**, while "**functioning**" is about **effective operation** of the examined controls.




1. Commitment to integrity and ethical values
2. Independent Board of Directors oversight
3. Structures, reporting lines, authorities, responsibilities
4. Attract, develop and retain competent people
5. People held accountable for internal control

6. Clear objectives specified
7. Risks identified to achievement of objectives
8. Potential for fraud considered
9. Significant changes identified and assessed

10. Control activities selected and developed
11. General Information Technology controls selected and developed
12. Controls deployed through policies and procedures

13. Quality information obtained, generated and used
14. Internal control information internally communicated
15. Internal control information externally communicated

16. Ongoing and/or separate evaluations conducted
17. Internal control deficiencies evaluated and communicated

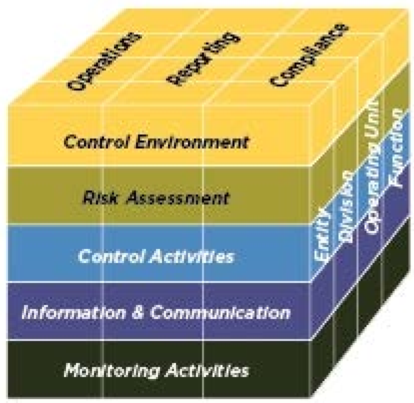
[1] *Update to the Committee of Sponsoring Organization's Internal Control-Integrated Framework,* *http://coso.org/IC.htm*

Furthermore, each principle is further clarified by "*points of focus*" that assist users of the Framework to determine whether a principle is *present and functioning*, while highlighting essential characteristics of the principles. It's important to note that a principle may be present and functioning without all respective points of focus being in place. Although, organizations are not required to evaluate each point of focus to demonstrate that a principle is present and functioning, we encourage mapping principles to existing controls within each of the five components.

The Framework is keeping the five core components of internal control: Control Environment, Risk Assessment, Control Activities, Information & Communication and Monitoring Activities. However, a slight update was formulated for the objectives: Operations, Reporting and Compliance. While, Operations and Compliance remain essentially the same (from the previous version), Financial Reporting is now known as Reporting as to include external financial, external non-financial, internal financial and internal non-financial reporting to various entities.

Additionally, the organizational structure was refurbished to include the overall Entity, Division(s), Operating Unit(s) and Function(s), while including some business processes, such as Marketing, Production and Sales. These changes emphasize governance, business processes and an entity's composition and structure in an ever-changing global business landscape.

## "COSO Cube": An Update [2]




The Framework recognizes the important role of management's judgment in determining whether a principle is relevant to their organization and present and functioning across all processes. Furthermore, management is required to obtain persuasive evidence to validate that each of the components and relevant principles are present and functioning together and the five components are operating in an integrated manner. To make this determination, management needs to consider the internal controls across the organization that effect the principle or component.

## Deficiencies in Internal Control

The Framework defines an internal control deficiency as "a shortcoming in a component or components and relevant principle(s) that reduces the likelihood of an entity achieving its objectives. An internal control deficiency or combination of deficiencies that severely reduces the likelihood that the entity can achieve its objectives is referred to as 'major deficiency'" [2].

The presence of a major deficiency prevents an organization from concluding that it has met the prerequisites for an effective system of internal control.

[2] COSO. *Internal Control – Integrated Framework, Framework and Appendices*. Durham, NC: AICPA, 2013. Print.

## Further Notable Updates

1. **Relevance of Technology**
   As many organizations increased their use and reliance of technology over the past 21 years, various components of internal control are affected by the predominance of technology across business processes.

2. **Enhancement of Governance Concepts**
   To ensure effective internal control, Board oversight is paramount.

3. **Increased Discussion of Fraud**
   Although fraud was considered under the 1992 Framework, the update considers potential causes of fraud as a separate principle of effective internal control.

## First Steps

1. Management should discuss with their respective Boards its plan to transition towards the new Framework, as soon as possible.
2. Management needs to determine which principles are relevant for their organization.
3. Management will need to demonstrate and provide persuasive evidence that all relevant principles associated with the five components are present and functioning across the business (and relevant processes).
4. Mapping pertinent principles to existing controls within each of the components to evaluate if the respective principles are present and functioning in attaining the organization's objectives.
5. Should a gap in design be discovered, management should implement a process for identifying, evaluating and implementing relevant updates and amendments to the controls and accompanying documentation.

## Timeline

Organizations must transition towards the requirements of the 2013 Framework. Essentially, it will be expected that organizations conclude whether the effectiveness of internal control over financial reporting related to the pertinent 17 principles are *present* and *functioning* and update the documentation of their assessment. This updated assessment may assist organizations to identify operational improvements in the system of internal controls and cause organizations to reconsider the effectiveness of previously identified internal controls over financial reporting, as well.

The COSO Board announced that the original 1992 Framework may still be used during the transition period, until December 15, 2014. After this deadline, COSO considers the original Framework superseded. In other words, SEC registrants whose fiscal year ends between May 14, 2013 and December 15, 2014 may continue using the original Framework, but need to clearly indicate it as such. For those with a year-end falling between December 16-31; this current fiscal year (2013) will essentially be the last year these organizations may use the previous Framework.

## Conclusion

We believe the updated 2013 Framework will provide organizations with a personalized baseline to corroborate the strengths and areas for improvement of their internal control environment and will allow them to develop effective and efficient systems of internal control.

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