The Bulletin

The Updated COSO Internal Control Framework: Frequently Asked Questions

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) – an organization providing thought leadership and guidance on internal control, enterprise risk management (ERM) and fraud deterrence – has released its long-awaited updated *Internal Control – Integrated Framework* (New Framework). The original version (framework), released by COSO in 1992, has gained broad acceptance. It has been widely used, particularly as a suitable – and the predominant – framework in conjunction with reporting on the effectiveness of internal control over financial reporting by public companies listed in the United States in accordance with Section 404 of the Sarbanes-Oxley Act. Today, this time-tested framework continues to be recognized as a leading resource for purposes of providing guidance on the design and evaluation of internal control.

This issue of *The Bulletin* addresses various questions regarding the New Framework from COSO, including the reasons why it was updated; what has changed; the process for transitioning to its use; and steps companies should take now. For interested parties, the New Framework is available at www.coso.org.

So Why Change?

"If it ain't broke, don't fix it." This old saying begs a question regarding the 1992 framework: Was it broken? In a word: No. In the spirit of continuous improvement, COSO's decision to update the framework was driven by the extent of change over the past two decades. Much has happened in the business environment since 1992. For example, expectations for governance oversight have increased; risk and risk-based approaches now receive greater attention; globalization of markets and operations has become a megatrend; the complexity of business and organizational structures has increased, including outsourcing and strategic suppliers; technology has evolved dramatically; and the demands and complexities in laws, regulations and standards have all increased – substantially.

We also have seen the damaging effects of spectacular, large-scale governance and internal control breakdowns, including the derivatives fiascos of the 1990s, Long-

Term Capital Management, the Enron era, and the more recent global financial crisis. These breakdowns have taught valuable lessons around a number of themes – for example, the effects of management override, conflicts of interest, lack of segregation of duties, poor or nonexistent transparency, siloed risk management, ineffective board oversight, and unbalanced compensation structures that enabled or drove dysfunctional and/or irresponsible behavior.

While no internal control framework provides answers to all of these issues, there is no denying that much has transpired since COSO's 1992 framework was issued, and it makes sense for it to be updated in light of those changes. Add to the above developments the increased expectations for competencies and accountabilities at all levels of organizations, and the heightened expectations around preventing and detecting fraud, and you've got a viable business case for a refresh of a 20-year-old framework.

What Hasn't Changed?

Those experienced at using the 1992 version will find much familiar in the 2013 New Framework, as it builds on what has proven effective in the original release. For example, the New Framework retains the core definition of internal control and the five components of internal control that provide the face of the well-known, three-dimensional "cube." We discuss further below.

The core definition of internal control is largely unchanged. The updated definition reflects the expansion of the reporting objective (discussed later):

> Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

The cube retains its familiarity. It begins with objectives along the top relating to operations, reporting and compliance, representing the cube's columns. Every organization establishes relevant objectives and formulates

strategies and plans for achieving them. The side of the cube, as shown below, depicts that objectives may be set for the entity as a whole, or be targeted to specific divisions, operating units and functions within the entity (including business processes such as sales, purchasing and production), illustrating the hierarchical top-down structure of most organizations.
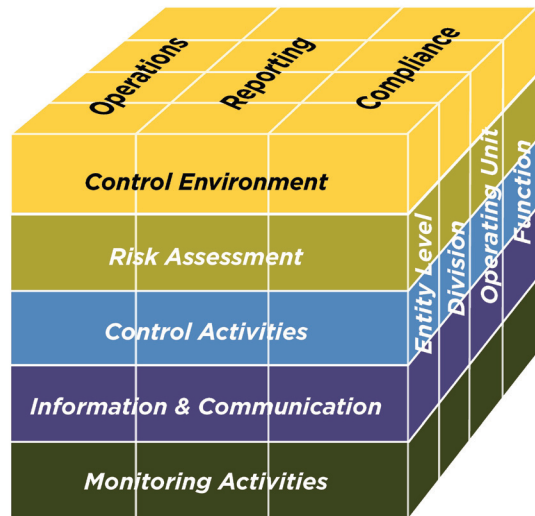
Source: Chapter 2 of 2013 COSO *Internal Control: Integrated Framework.*

On the face of the cube are the five components of internal control, representing the rows of the cube. Similar to the 1992 framework, these components support the organization in its efforts to achieve its objectives. The five components are Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring Activities. They are relevant to an entire entity, meaning they operate at the entity level, as well as at all divisions, operating units, functions, subsidiaries or other subsets of the entity.

All told, the cube depicts the direct relationship among the organization's objectives (which are what the entity strives to achieve); the components of internal control (which represent what is needed to achieve the objectives); and the operating units, legal entities and other structures within the entity (which are the levels of the organization where the components of internal control operate). Each internal control component cuts across and applies to all three categories of objectives.

With the definition of internal control and the structure of the cube and its dimensions fundamentally the same as the original 1992 version, *the criteria used to assess the effectiveness of an internal control system remain largely unchanged.* The effectiveness of internal control is assessed, using a principles-based approach, relative to the five components of internal control. To have an effective system of internal control relating to one, two or more categories of objectives, all five components must be present and functioning and operating together. For example, when

considering internal control over a particular operations objective, all five components must be present and functioning and operating together in order to conclude that internal control relating to the operations objective is effective.

The other aspect of the New Framework that is unchanged is the exercise of judgment. The New Framework continues to emphasize the importance of management's judgment in evaluating the effectiveness of a system of internal control. Determining whether a particular internal control system is effective is a subjective judgment resulting from an assessment of whether each of the five components of internal control is *present and functioning,* and that the five components of internal control *operate together* to provide "reasonable assurance" the relevant objectives are met. To facilitate this exercise of judgment, principles are provided for each internal control component and management exercises judgment in determining the extent to which these principles are *present and functioning*.

What Has Changed?

The New Framework has several important changes. Seven are discussed below:

First, the New Framework codifies principles that support the five components of internal control. While the 1992 version implicitly reflected the core principles of internal control, the 2013 version explicitly states 17 principles representing fundamental concepts associated with the five components of internal control.[1] COSO decided to make these principles explicit to increase management's understanding as to what constitutes effective internal control. These principles remain broad, as they are intended to apply to for-profit companies (including publicly traded and privately held companies), not-for-profit entities, government bodies and other organizations.

Supporting each principle are points of focus, representing important characteristics associated with the principles. Points of focus are intended to provide helpful guidance to assist management in designing, implementing and conducting internal control and in assessing whether relevant principles are present and functioning; however, the New Framework does not require separate evaluations of whether they are in place. Management has the latitude to exercise judgment in determining the suitability or relevancy of the points of focus provided in the New Framework and may identify and consider other important characteristics germane to a particular principle based on the organization's specific circumstances.

Together, the components and principles constitute the criteria and the points of focus provide guidance that will assist management in assessing whether the components

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[1] This is not a new concept for COSO. A principles-based approach was undertaken by COSO in its 2006 release of *Internal Control over Financial Reporting — Guidance for Smaller Public Companies.* The idea is to use principles to enhance understanding of, and simplify, the internal control design and evaluation process.

Components	Principles	No. of Points of Focus
	1. Commitment to integrity and ethical values	4
	2. Independent board of directors oversight	5
	3. Structures, reporting lines, authorities, responsibilities	3
	4. Attract, develop and retain competent people	4
	5. People held accountable for internal control	5
	6. Clear objectives specified	5
	7. Risks identified to achievement of objectives	5
	8. Potential for fraud considered	4
	9. Significant changes identified and assessed	3
Control Environment	10. Control activities selected and developed	6
Risk Assessment	11. General IT controls selected and developed	4
Control Activities	12. Controls deployed through policies and procedures	6
Information & Communication	13. Quality information obtained, generated and used	5
Monitoring Activities	14. Internal control information internally communicated	4
	15. Internal control information externally communicated	5
	16. Ongoing and/or separate evaluations conducted	7
	17. Internal control deficiencies evaluated and communicated	4

of internal control are present, functioning and operating together within the organization. Each of the points of focus is mapped directly to one of the 17 principles, and each of those principles is mapped directly to one of the five components. The graphic above shows the number of points of focus underlying each principle, 79 in all, as provided by the New Framework.

Second, the New Framework clarifies the role of objective-setting in internal control. The 1992 framework from COSO stated that objective-setting was a management process, and that having objectives was a pre-condition to internal control. While the New Framework preserves that conceptual view, it moves the primary discussion of the concept from the chapter on risk assessment to the second chapter to emphasize the point that objective-setting is not part of internal control.

Third, the New Framework reflects the increased relevance of technology. This is important because the number of organizations that use or rely on technology, and the extent of that use, have both grown substantially over the past 20 years. Technologies have evolved from large stand-alone mainframe environments that process batches of transactions to highly sophisticated, decentralized and mobile applications involving multiple real-time activities that cut across myriad systems, organizations and processes. More sophisticated technology can impact how all components of internal control are implemented.

Fourth, the New Framework incorporates an enhanced discussion of governance concepts. These concepts relate primarily to the board of directors, as well as subcommittees of the board, including audit committees, compensation committees and governance committees. The key message is that board oversight is vital to effective internal control.

Fifth, as evidenced through being the primary visual change in the cube, the New Framework expands the reporting category of objectives. The financial reporting objective category is expanded to consider other external reporting beyond financial reporting,[2] as well as internal reporting, both financial and non-financial. Thus, there are four types of reporting – internal financial, internal non-financial, external financial and external non-financial.

Sixth, the New Framework enhances consideration of anti-fraud expectations. The 1992 framework considered fraud, although the discussion of anti-fraud expectations and the relationship between fraud and internal control were less prominent. The 2013 version contains considerably more discussion on fraud and also considers the potential causes of fraud as a separate principle of internal control.

Finally, the New Framework increases the focus on non-financial reporting objectives. This expanded focus on operations, compliance and non-financial reporting objectives has resulted in more robust guidance in these

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[2] The internal control report issued under Section 404(a) of the Sarbanes-Oxley Act in the United States is an example of "other external reporting." Another example might include where management operates in accordance with the International Organization for Standardization (ISO) standards for quality management. In such instances, it may report publicly on its operations (e.g., an independent audit might be conducted to report on the entity's conformance with ISO 9001). A third example is the voluntary sustainability report companies are issuing. While sustainability reports may or may not be subject to some form of external assurance, information contained within them is being made publicly available to investors.

areas. This guidance is provided in hopes that more users will apply the New Framework beyond financial reporting.

The above changes, while important, in no way constitute a complete overhaul. Those individuals familiar with the 1992 framework will find the New Framework to be similar in substance in all material respects.

What's the Most Important Change?

The most significant change in the New Framework is the explicit articulation of 17 principles representing the fundamental concepts associated with each component of internal control. Because these principles are drawn directly from the components, an entity can achieve effective internal control by applying all of them. All of the principles apply to each category of objectives, with the intent of making the New Framework more principles-based.

The use of principles is not meant to imply a checklist. This was a major concern raised in comments on the exposure drafts circulated by COSO, particularly with respect to the points of focus related to each principle. In using the principles to assess whether the system of internal control is effective, management and the board of directors determine the extent to which the principles associated with each of the five components are present and functioning. This evaluation entails consideration of how the principles (and the underlying points of focus, if considered) are being applied.

Five components of internal control are about as broad as you can get. The 1992 version explained each component and the supporting application guidance incorporated much of the explanatory material into the various evaluation tools that users of the original framework leveraged to design their own customized tools. The New Framework now organizes explanatory material under the 17 principles arrayed under the five components. While people can call it what they want, the desired end result is to help users better understand what constitutes effective internal control so they are positioned to apply informed judgment when evaluating effectiveness.

To illustrate, the 17 principles are listed below and grouped according to the applicable COSO component:

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.

5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

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.

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 action.

Information and Communication

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

Monitoring Activities

16. The organization selects, develops and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.
17. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

The principles enable effective operation of the five internal control components and the overall system of internal control. To demonstrate that a principle is present and functioning, the organization must understand the intent

of the principle and how it is being applied; work to help personnel understand and apply the principle consistently across the entity; and view weakness in or absence of a principle as requiring management's attention. These are factors management considers when exercising appropriate judgment during the evaluation of internal control.

To enhance the rigor of understanding of each principle, the New Framework provides points of focus. To illustrate, the first principle provided for the Control Environment component is: "The organization demonstrates a commitment to integrity and ethical values." The New Framework provides four points of focus for this principle:

- Sets the "Tone at the Top" – The board of directors and management at all levels of the entity demonstrate through their directives, actions and behaviors the importance of integrity and ethical values to support the functioning of the system of internal control.

- Establishes Standards of Conduct – The expectations of the board of directors and senior management concerning integrity and ethical values are defined in the entity's standards of conduct and understood at all levels of the organization and by outsourced service providers and business partners.

- Evaluates Adherence to Standards of Conduct – Processes are in place to evaluate the performance of individuals and teams against the entity's expected standards of conduct.

- Addresses Deviations in a Timely Manner – Deviations from the entity's expected standards of conduct are identified and remedied in a timely and consistent manner.

Many will consider these four points of focus useful when evaluating whether the principle itself is present and functioning. That said, it may be possible to determine that the corresponding principle is present and functioning, without all four points of focus. For instance, management may be able to determine that Principle 1 related to integrity and ethical values is present and functioning based on an assessment that only three of the above four underlying points of focus are in place. The organization may set the tone at the top, evaluate adherence to standards of conduct, and address deviations in a timely manner, but it does not formally define the expectations of management and the board of directors in the organization's standards of conduct. In addition, alternative or compensating controls may be in place that provide further support for this conclusion.

A principle that is present and functioning operates within a range of acceptability – but does not imply that the organization must achieve the highest level of performance in applying the principle. Management may exercise judgment in assessing the trade-offs between the cost of achieving perfection and the benefits of seeking to operate at various lower levels of performance. There is no one-size-fits-all in designing an internal control system.

How Are Deficiencies in Internal Control Assessed?

The New Framework states that a deficiency is "a shortcoming in a component or components and relevant principle(s) that reduces the likelihood that the entity can achieve its objectives." ***It is important to recognize that not every deficiency will result in a conclusion that an entity does not have an effective system of internal control.*** When an organization determines that a deficiency exists, management must assess the severity of impact of that deficiency on the internal control system. A major deficiency in internal control is defined as "an internal control deficiency or combination of deficiencies that severely reduces the likelihood that the entity can achieve its objectives. " Such a deficiency exists when management determines that a component (and one or more relevant principles) is not present or functioning or that the components are not operating together. The existence of a major deficiency prevents the organization from concluding that the system of internal control is effective.

The New Framework makes it clear that assessing the severity of a deficiency or combination of deficiencies to determine whether components and relevant principles are present and functioning, and components are operating together, requires judgment. The criteria set forth by the New Framework (i.e., through the components and principles) provide the basis for management to apply judgment when assessing the effectiveness of internal control. In addition, circumstances may arise where management may be required to consider additional criteria established by external parties (e.g., regulators, standard-setting bodies, listing agencies and other relevant third parties). While the New Framework does not prescribe such additional criteria, it recognizes the authority and responsibility of relevant external parties and is flexible enough to accommodate any additional criteria they require, including the manner in which the severity of internal control deficiencies is classified.

Overall, the assessment of the effectiveness of internal control is directed to the five components and their underlying principles. The assessment line of sight addresses whether each of the five components of internal control is present and functioning, the five components of internal control operate together, and the supporting principles are present and functioning, to provide "reasonable assurance" that relevant objectives are met.

What Does "Present and Functioning" Mean?

The New Framework states that the phrase "present and functioning" applies to both components and principles. "Present" refers to "the determination that components and relevant principles exist in the design and implementation of the system of internal control to achieve specified objectives." "Functioning" refers to "the determination that components and relevant principles continue to exist in the conduct of the system of internal control to achieve specified

objectives." Therefore, **"present" is about effective design and implementation, whereas "functioning" is about effective operation.** In determining whether a component of internal control is present and functioning, senior management, with the board of director's oversight, needs to determine to what extent relevant principles underlying the component are present and functioning.

How Does Management Assess Whether All Components "Operate Together?"

Evaluating each of the five components of internal control requires consideration of how it is being applied by the entity within the overall system of internal control, and not whether it is functioning on its own. This means that the five components of internal control are an integral part of an effectively functioning system. While management may preliminarily determine that each of the five components is present and functioning, they cannot conclude the organization has effective internal control until a determination is reached that the five components are operating together. To this end, the New Framework states that "operating together" refers to "the determination that all five components collectively reduce, to an acceptable level, the risk of not achieving an objective." "Operating together" recognizes that components are interdependent with a multitude of interrelationships and linkages, particularly in terms of how principles interact within and across components. From a practical standpoint, the New Framework states that **management can demonstrate that components operate together when they are present and functioning and internal control deficiencies aggregated across components do not result in the determination that one or more major deficiencies exist.**

To illustrate the inherent interdependencies and linkages among components, 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. For another illustration, the communication of internal control deficiencies to those responsible for taking corrective actions as part of Monitoring Activities reflects 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. The New Framework includes other examples.

Are External Parties a Part of the System of Internal Control?

External parties, including external auditors and regulators, are not part of the system of internal control, and cannot be considered a source of detection and assessment of internal control deficiencies when a company assesses the effectiveness of its internal control structure. Responsibility for identifying and assessing internal control deficiencies

rests with the organization's personnel, in the normal course of performing their ongoing functions.

When Are We Required to Apply the New Framework?

This question is relevant for organizations that already use the 1992 framework. This is particularly the case for companies that will apply the New Framework to their Sarbanes-Oxley compliance efforts.

The COSO Board has stated that users should transition to the 2013 New Framework in their applications and related documentation as soon as it is feasible given their particular circumstances. COSO will continue to make available the original 1992 framework through December 15, 2014, after which time it will consider the framework as having been superseded. The COSO Board believes the key concepts and principles embedded in the original version of the framework are fundamentally sound and broadly accepted in the marketplace and, accordingly, considers it appropriate for companies to continue their use of the original version during the transition period (May 14, 2013 to December 15, 2014). This means calendar-year companies may apply the 1992 version to calendar year 2013, and must transition to the New Framework for purposes of applying it by no later than calendar year 2014.

What If We Continue to Apply the Original Framework Beyond COSO's Transition Period?

For companies complying with Sarbanes-Oxley, this would not be a wise choice. During the transition period, the COSO Board believes that application of its *Internal Control – Integrated Framework* that involves external reporting should clearly disclose whether the original or 2013 version was utilized. As noted above, there is a presumption that the 2013 New Framework will be used after the transition period expires. If it isn't, companies are likely to receive pushback from their external auditors – and perhaps from the U.S. Securities and Exchange Commission (SEC) staff as well.[3]

What Are the Implications for Sarbanes-Oxley Compliance?

As discussed earlier, the company must clearly disclose in its internal control report whether the original or 2013 version was utilized during the transition period. In addition, the existing internal control documentation must be converted to the principles-based approach of the New Framework. For companies that have experienced the rigor of several years of compliance under Section 404 of Sarbanes-Oxley, we do not believe this will be a significant undertaking. To illustrate, the six attributes for the Control Environment under the original 1992 version can be

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3 The SEC staff may issue implementation guidance on this point. However, in the absence of such guidance, the staff could raise concerns if issuers use the 1992 version as a "suitable framework" after December 15, 2014.

organized easily under the five principles provided in the 2013 New Framework.

Note that the New Framework and related illustrative documents consist of an executive summary, the actual framework itself, several appendices, an applications guide providing illustrative tools, and a separate compendium of approaches and examples for application of the framework to internal control over financial reporting. The latter compendium may be useful to companies complying with Sarbanes-Oxley.

What Do We Need to Do Now?

Companies that currently use the original 1992 framework must determine their transition plan to evolve from it to the 2013 New Framework. For example, for calendar-year companies, does the company apply the 2013 New Framework early in 2013 or continue to use the 1992 version? In addition, once the transition plan is defined, it should be communicated to senior management and the audit committee.

What Tasks Are Necessary in Applying the 2013 New Framework?

Depending on the nature and timing of the transition plan, companies may want to deploy a centralized, project management office (PMO)-like discipline to ensure a top-down, cost-effective approach to converting the underlying documentation to support a determination that the underlying principles outlined in the New Framework are present and functioning. This approach would entail designating roles, responsibilities and authorities for converting the documentation.

In finalizing the approach, the expectations of the external auditor should be considered to ensure the audit requirements are addressed without resorting to costly rework following the completion of the conversion process. In addition, the internal audit function should begin focusing on its transition to the New Framework for purposes of planning, conducting and reporting on risk-based audits. A communications plan also would be appropriate (see next question).

Although the desired end-result of issuing the New Framework is not intended to create another "checklist," it's possible a checklist will be employed somewhere, by someone – including possibly by the external auditors. In converting the documentation, the PMO should map controls back through each of the five components and the supporting principles and, if management desires, the points of focus. Assuming management intends to use points of focus when evaluating whether the principles to which they apply are present and functioning, given the New Framework's commentary regarding points of focus, management should assess whether they are suitable, relevant and complete based on the company's specific circumstances.

To Whom Do We Communicate – and What Do We Tell Them?

For companies that currently use the original framework in their Sarbanes-Oxley compliance, communications are likely needed to the certifying officers and the audit committee. These executives and directors should be informed of the release of the New Framework, what's new, what's unchanged, the company's recommended transition plan, the company's disclosure obligations during the transition period, and any issues envisioned for the transitioning process.

Will There Be a "Street Reaction" to Companies That Do Not "Early Apply"?

For companies that currently use the 1992 version of the framework in their Sarbanes-Oxley compliance, we do not believe there will be any market repercussions if they decide to apply the 1992 version of the framework during the transition period. COSO has laid out an orderly process for transitioning to the New Framework, and the COSO Board asserted that the 1992 version is fundamentally sound and broadly accepted in the marketplace.

Does the New Framework Comment on the Limitations of Internal Control?

Yes. While internal control provides important benefits, the New Framework makes clear that limitations do exist. Limitations may result from the quality and suitability of objectives established as a precondition to internal control; the potential for flawed human judgment in decision-making; management's consideration of the relative costs and benefits in responding to risk and establishing controls; the potential for breakdowns that can occur because of human failures (such as simple errors or mistakes); the possibility that controls can be circumvented by collusion of two or more people; and the ability of management to override internal control functions and decisions. These limitations preclude the board and management from ever having absolute assurance of the achievement of the entity's objectives. Therefore, controls only provide reasonable – but not absolute – assurance.

How Does the New Framework Relate to ERM?

COSO included Appendix G in the New Framework to address this question. Rather than repeat all of the relevant points here, reference is made to this appendix. In addition, the COSO 2004 *Enterprise Risk Management – Integrated Framework,* which established a framework for evaluating ERM, includes an appendix that addressed this topic.

The basic premise of the aforementioned appendices is as follows: ERM is broader than internal control and focuses more directly on risk. Internal control is an integral part of ERM, while ERM is part of the overall governance process.

Summary

Internal control helps companies achieve important business objectives and sustain and improve performance. Companies using the 1992 framework for Sarbanes-Oxley compliance and other purposes should familiarize themselves with the New Framework and companion materials, determine their transition plan, and communicate to the appropriate stakeholders the release of the New Framework and its implications to the organization.

The New Framework issued by COSO is an important development, as it enables organizations to develop systems of internal control effectively and efficiently. It also supports organizations as they become more agile in managing performance (by adapting to the increasing complexity and pace of a changing business environment), more confident (by mitigating risks to acceptable levels), and better informed (by providing clarity through reliable information for decision-making).

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