COSO 2013: Updated internal control framework

Athens, 10 October 2013
Background
COSO's structure and mission

COSO\(^1\) is a joint initiative of five sponsoring organizations

- American Accounting Association (AAA)
- American Institute of Certified Public Accountants (AICPA)
- Financial Executives International (FEI)
- Institute of Management Accountants (IMA)
- Institute of Internal Auditors (IIA)

COSO’s mission is...

“...to provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations.”

www.coso.org/aboutus.htm

\(^1\) Committee of Sponsoring Organizations of the Treadway Commission
Background

COSO Overview – Internal Control Publications

1992

2006

2009

2013
Background
COSO Framework– Need for Update

Original Framework

Refresh Objectives

Enhancements

Updated Framework


- Reflect changes in business & operating environments
- Expand operations and reporting objectives
- Articulate principles to facilitate effective internal control

Upgrades Context

Broadens Application

Clarifies Requirements


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Background
COSO transition guidance

• Transition period: May 14, 2013 - December 15, 2014
  - COSO will consider the 1992 Framework superseded after December 15, 2014

• If applying and referencing COSO's Internal Control — Integrated Framework for external reporting purposes
  - External reporting should clearly disclose whether the 1992 or 2013 Framework was utilized
COSO 2013 Internal Control – Integrated Framework
COSO 2013 Internal Control – Integrated Framework Structure

An *Executive Summary* can be downloaded by the public free of charge from [www.coso.org](http://www.coso.org).

1Internal Control over External Financial Reporting (ICEFR)
COSO 2013 Internal Control – Integrated Framework

Not Changing...

• Definition of internal control

“A process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

✓ Effectiveness and efficiencies of operations
✓ Reliability of reporting
✓ Compliance with applicable laws and regulations”

• Three categories of objectives and five components of internal control
• Each of the five components of internal control are required for effective internal control
• Use of judgment in designing, implementing and conducting internal control, and in assessing its effectiveness.
COSO 2013 Internal Control – Integrated Framework

General Enhancements

• Changes in business and operating environments considered
  The updated framework reflects how the business environment has changed and provides guidance to assess risk and keep related controls current

• Operations and reporting objectives expanded
  The updated framework assists companies to implement the internal control framework in an expanding list of objectives

• Fundamental concepts underlying five components articulated as principles
  The updated framework is based on Principles and is more flexible (thus more easily adopted)

• Additional approaches and examples relevant to operations, compliance, and non-financial reporting objectives added
Highlights - Updated COSO

• **Introduces seventeen control principles** (underlying the five control components) which represent the fundamental elements associated with each component of control and recognizing that there are significant interdependences among the various control principles.

• **Provides “points of focus”,** or important characteristics of principles; while acknowledging that the design and implementation of controls relevant to each principle and component requires management judgment and will differ by organization.

• **Articulates management’s responsibility** for ensuring that each of the components and relevant principles of internal control must be present and functioning in order to have an effective system of internal control.

• **New considerations**
  1. Use of outsourced service providers
  2. Increased relevance of information technology
COSO 2013 Internal Control – Integrated Framework

Changing… (cont)

• **Creates a more formal** way of designing and evaluating internal control in accordance with the principles.

• **Explicitly includes the concept of considering the potential for fraud risk** when assessing risks to the achievement of an organization’s objectives.

• **Standardizes the classification of internal control deficiencies** while acknowledging that, in instances in which an entity is using the COSO Framework to comply with a law, rule, or regulation (such as SOX), the entity is required to use the classification criteria established within that law, rule, or regulation.

• Concludes that a **major deficiency** in a component or principle of control cannot be effectively mitigated by the function of other control components and principles.
2013 Framework and guidance

Specific significant enhancements to the 1992 Framework that may pose challenges to management:

Risk Assessment
- More detailed discussions about risk assessment concepts, including those related to inherent risk, risk tolerance, how risks may be managed, and linkage between risk assessment and control activities
- Considering the potential for fraud risk when assessing risks to the achievement of an organization's objectives

Outsourcuses Service Providers (OSPs)
- Considerations related to OSPs are included throughout the framework, including 12 out of 17 principles
- Requires management to specifically consider how OSP's are monitored

Information Technology (IT)
- Considerations related to IT are included in 14 of 17 principles
- Discussion of using IT to assist in continuous monitoring
- Requirements for ensuring quality of information (data integrity)
Effective system of internal control

Per COSO, an effective system of internal control requires:

- 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
## COSO 2013 Internal Control – Integrated Framework

<table>
<thead>
<tr>
<th>Component</th>
<th>Control Environment</th>
<th>Risk Assessment</th>
<th>Control Activities</th>
<th>Information &amp; Communication</th>
<th>Monitoring Activities</th>
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<td>4. Demonstrates commitment to competence</td>
<td>9. Identifies and analyzes significant change</td>
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<td>5. Enforces accountability</td>
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COSO 2013 Internal Control – Integrated Framework
Illustrative example

Component: Control Environment

Principle 1: The organization demonstrates a commitment to integrity and ethical values

Points of Focus: Sets the tone at the top

“The board of directors and management at all levels of the entity demonstrate through their directives, actions, and behavior the importance of integrity and ethical values to support the functioning of the system of internal control”
The CEO and key members of management articulate and demonstrate the importance of integrity and ethical values across the organization.

Examples of mechanisms:

• Communications from senior management that support the expected standards of conduct and that stay consistent as they spread throughout the organization
• Timely inquiries and investigations into any alleged conduct that is inconsistent with the entity’s standards of conduct
• Corrective action when deviations from expected standards of conduct occur

Source: Internal Control over External Financial Reporting (ICEFR) — A Compendium of Approaches and Examples (May 2013)
Comparison of Principles in the 2013 Framework with Related Sections in the 1992 Framework – Illustrative Example*

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Control Environment</td>
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<tr>
<td>1. The organization demonstrates a commitment to integrity and ethical values.</td>
<td>Control Environment</td>
<td>Integrity and ethical values</td>
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<td>Human resource policies and procedures</td>
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<tr>
<td>2. The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.</td>
<td>Control Environment</td>
<td>Board of directors or audit committee</td>
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<td></td>
<td></td>
<td>Roles and Responsibilities</td>
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<tr>
<td>3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.</td>
<td>Control Environment</td>
<td>Management’s philosophy and operating style</td>
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<td></td>
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<td>Organizational structure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Roles and Responsibilities</td>
</tr>
</tbody>
</table>

*Source: DT’s “Heads up”, volume 20, issue 17 - COSO Enhances Its Internal Control — Integrated Framework
Comparison of COSO to other rules
Comparison of COSO to other rules

Effective system of internal control in ICEFR context

<table>
<thead>
<tr>
<th>COSO</th>
<th>SEC</th>
<th>PCAOB</th>
</tr>
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<tbody>
<tr>
<td><strong>Present:</strong> the determination that components and relevant principles exist in the design and implementation of the system of internal control.</td>
<td>&quot;Under the Commission’s rules, management’s annual assessment of the effectiveness of ICFR must be made in accordance with a suitable control framework’s [COSO] definition of effective internal control. These control frameworks define elements of internal control that are expected to be present and functioning in an effective internal control system.&quot;</td>
<td><strong>Design effectiveness:</strong> Controls (if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively) that satisfy the company’s control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.</td>
</tr>
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<td><strong>Functioning:</strong> the determination that components and relevant principles continue to exist in the conduct of the system of internal control.</td>
<td></td>
<td><strong>Operating effectiveness:</strong> Controls that operate as designed and are performed by persons possessing the necessary authority and competence to perform the control effectively.</td>
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2 As defined by Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements; Para. 42-45
## Comparison of COSO to other rules

### Internal control deficiency in ICEFR context

<table>
<thead>
<tr>
<th>COSO</th>
<th>SEC ¹</th>
<th>PCAOB²</th>
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</thead>
<tbody>
<tr>
<td>• <strong>Internal control deficiency</strong>: A shortcoming in a component or</td>
<td>• <strong>Deficiency</strong> in the design of ICFR exists when (a) necessary</td>
<td>• <strong>Deficiency</strong> in internal control over financial reporting exists</td>
</tr>
<tr>
<td>components and relevant principle(s) that reduces the likelihood</td>
<td>controls are missing or (b) existing controls are not properly</td>
<td>when the design or operation of a control does not allow management</td>
</tr>
<tr>
<td>that the entity can achieve its objectives.</td>
<td>designed so that, even if the control operates as designed, the</td>
<td>or employees, in the normal course of performing their assigned</td>
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<td>financial reporting risks would not be addressed.</td>
<td>functions, to prevent or detect misstatements on a timely basis.</td>
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</table>

¹ As defined by Securities Act Release No. 33-8810, File No. S7-24-06 (June 27, 2007); Footnote 29

² As defined by PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements; Appendix A: Definitions, A3
Comparison of COSO to other rules

Significant deficiency in ICEFR context

<table>
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<th>COSO</th>
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<th>PCAOB²</th>
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<td>• COSO does not define significant deficiency, however, COSO acknowledges that when &quot;an entity is applying a law, rule, regulation, or external standard, management should use only the relevant criteria contained in those documents to classify the severity of internal control deficiencies.&quot;</td>
<td>• The term significant deficiency means a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting.</td>
<td>• A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.</td>
</tr>
</tbody>
</table>

¹ As defined by Securities Act Release No. 33-8829, File No. S7-24-06 (September 10, 2007)

² As defined by PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements; Appendix A: Definitions, A11
## Comparison of COSO to other rules

### Major deficiency and material weakness in ICEFR context

<table>
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<th>COSO</th>
<th>SEC ¹</th>
<th>PCAOB ²</th>
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<tbody>
<tr>
<td>• An internal control deficiency or combination of deficiencies that</td>
<td>• The term <strong>material weakness</strong> is a deficiency, or a combination of</td>
<td>• A <strong>material weakness</strong> is a deficiency, or a combination of</td>
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<tr>
<td>severely reduces the likelihood that the entity can achieve its</td>
<td>deficiencies, in internal control over financial reporting such that</td>
<td>deficiencies, in internal control over financial reporting, such that</td>
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<td>objectives is referred to as a <strong>major deficiency</strong>.</td>
<td>there is a reasonable possibility that a material misstatement of the</td>
<td>there is a reasonable possibility that a material misstatement of the</td>
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<td>registrant's annual or interim financial statements will not be</td>
<td>company's annual or interim financial statements will not be</td>
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<tr>
<td></td>
<td>prevented or detected on a timely basis.</td>
<td>prevented or detected on a timely basis.</td>
</tr>
</tbody>
</table>

¹ As defined by Securities Act Release No. 33-8809, File No. S7-24-06 (June 20, 2007)

² As defined by PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements; Appendix A: Definitions, A7
The Opportunities
The Opportunities

• The 2013 Framework provides a good opportunity to create value for your organization and refresh your internal control system.
• Improve anti-fraud programs, new corporate governance paradigms, IT systems and risks, outsourcing to third parties
• Refresh and enhance internal control
  - Synergies and simplifications may be available
  - May also identify gaps to be addressed
  - Improve operations, compliance, and reporting

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Steps towards Adoption of the new Framework
Steps towards Adoption of the new Framework

Companies that use COSO to report on ICEFR (Internal Controls over External Financial Reporting) may wish to consider:

a. Reading the 2013 Framework and identifying new concepts and changes.
b. Assessing their training and education needs.
c. Determining how the 2013 Framework affects the design and evaluation of ICEFR by:
   • Assessing coverage of the principles by existing processes and related controls and considering the points of focus.
   • Assessing current processes, activities, and available documentation related to applying the principles.
   • Identifying any gaps in the above.
d. Identifying the steps, if any, to be performed in making the transition to the 2013 Framework, and:
   • Formulating a plan to complete the transition by December 15, 2014 (i.e., calendar-year-end companies complying with SOX Section 404 should make the transition to the 2013 Framework for reporting periods ending after December 31, 2014).
   • Considering using activities performed in 2013 (e.g., walkthroughs, testing of relevant controls, evaluation of deficiencies) to identify necessary changes and pilot or field test the application of the 2013 Framework.
   • Confirming proper disclosure of the framework used during the transition period and at the time the 2013 Framework is adopted.
e. Coordinating and communicating internally with all groups that are responsible for implementing, monitoring, and reporting on the organization’s ICEFR.
f. Discussing and coordinating activities with internal audit (if applicable) and the external auditor.
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