COSO Changes and the impact on ICFR
A presentation to the Puget Sound Chapter of the IIA
January 14, 2014
**Agenda**

Introductions
Current Trends Impacting SOX
COSO – What’s Changing? What’s Not?
Deeper Drive on Selected Principles
Transitioning ICFR to the 2013 Framework
PCAOB Actions Impacting SOX
Manage Costs, Deliver Value from SOX
Questions
Current trends impacting SOX

COSO Update

Driving FY’14 SOX Changes

PCAOB Actions

Manage Costs, Deliver Value
COSO’s Internal Control-Integrated Framework (2013)
Why update 1992 framework?

Changes in the business environment

Changes inside the business

Lack of clarity

Lack of understanding

Do stakeholders understand requirements of effective internal control?

Only 50% thought it was generally easy to interpret

Source - COSO’s survey of users and stakeholders, worldwide – January to September 2011
2013 Framework preserves core strengths embedded in 1992 Framework

What is **Not** fundamentally changing...

- Core definition of internal control
- Three categories of objectives and five components of internal control
- Each of the five components of internal control are required for effective internal control
- Important role of judgment in designing, implementing and conducting internal control, and in assessing its effectiveness
2013 Framework articulates principles and points of focus

2013 COSO Cube

Legend
- Components and Principles are requirements for an effective system of internal control
- Points of Focus and Controls are subject to management judgment

January 14, 2014
### 2013 Framework articulates seventeen principles for effective internal control

| Control Environment                      | 1. Demonstrates commitment to integrity and ethical values  |
|                                       | 2. Exercises oversight responsibility                      |
|                                       | 3. Establishes structure, authority and responsibility     |
|                                       | 4. Demonstrates commitment to competence                   |
|                                       | 5. Enforces accountability                                |
| Risk Assessment                        | 6. Specifies suitable objectives                         |
|                                       | 7. Identifies and analyzes risk                           |
|                                       | 8. Assesses fraud risk                                    |
|                                       | 9. Identifies and analyzes significant change             |
| Control Activities                     | 10. Selects and develops control activities               |
|                                       | 11. Selects and develops general controls over technology |
|                                       | 12. Deploys through policies and procedures               |
| Information & Communication            | 13. Uses relevant information                             |
|                                       | 14. Communicates internally                               |
|                                       | 15. Communicates externally                              |
| Monitoring Activities                  | 16. Conducts ongoing and/or separate evaluations          |
|                                       | 17. Evaluates and communicates deficiencies               |
2013 Framework clarifies requirements for an effective system of internal control

An effective system of internal control requires:

- Each of the five components of internal control and relevant principles is present and functioning
- The five components are operating together in an integrated manner

*Components are present and functioning* if each relevant principles is determined to be present and functioning (e.g., no material weakness exists)

*Relevant principles are present and functioning* if persuasive evidence exists that controls are selected, developed and deployed to effect them

*Components operate together* when:

- Components are present and functioning
- Internal control deficiencies aggregated across components do not result in the determination that one or more material weakness exist
COSO principles – A deeper dive
2013 Framework and ICFR – Principles

Relevant principles are present and functioning if persuasive evidence exists that controls are selected, developed and deployed to effect them

What companies should do:
Document how the design of existing controls map against the 17 principles. Remedy potential design gaps when existing controls are not fully adequate. Test the operating effectiveness of any new controls coming into scope
2013 Framework describes points of focus for each principle, e.g.

<table>
<thead>
<tr>
<th>Component</th>
<th>Control Environment</th>
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<tbody>
<tr>
<td>Principles</td>
<td>Points of Focus</td>
</tr>
<tr>
<td>Principle 1</td>
<td>Demonstrate Commitment to Integrity…</td>
</tr>
<tr>
<td>Component 1</td>
<td>Sets the tone at the top</td>
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<tr>
<td>Component 2</td>
<td>Establishes standards of conduct</td>
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<tr>
<td>Component 3</td>
<td>Evaluates adherence to standards of conduct</td>
</tr>
<tr>
<td>Component 4</td>
<td>Addresses deviations in a timely manner</td>
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<tr>
<td>Principle 2</td>
<td>Exercises Oversight Responsibility</td>
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<tr>
<td>Component 1</td>
<td>Establishes oversight responsibility</td>
</tr>
<tr>
<td>Component 2</td>
<td>Applies relevant expertise</td>
</tr>
<tr>
<td>Component 3</td>
<td>Operate independently</td>
</tr>
<tr>
<td>Component 4</td>
<td>Provides oversight for the system of internal control</td>
</tr>
<tr>
<td>Principle 3</td>
<td>Establishes Structures Authority…</td>
</tr>
<tr>
<td>Component 1</td>
<td>Considers all structures of the entity</td>
</tr>
<tr>
<td>Component 2</td>
<td>Establishes reporting lines</td>
</tr>
<tr>
<td>Component 3</td>
<td>Defines, assigns and limits authorities and responsibilities</td>
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<tr>
<td>Component 4</td>
<td></td>
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<tr>
<td>Principle 4</td>
<td>Demonstrates Commitment to Competence</td>
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<tr>
<td>Component 1</td>
<td>Establishes policies and practices</td>
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<tr>
<td>Component 2</td>
<td>Evaluates competence and addresses shortcomings</td>
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<tr>
<td>Component 3</td>
<td></td>
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<tr>
<td>Component 4</td>
<td>Attracts, develops, and retains individuals</td>
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<tr>
<td>Component 5</td>
<td>Plans and prepares for succession</td>
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</tbody>
</table>
Principle 4 Demonstrates Commitment to Competence
The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.

**Points of Focus**
- Establishes policies and practices
- Evaluates competence and addresses shortcomings
- Attracts, develops, and retains individuals
- Plans and prepares for succession

**Control Environment**
- Individual performance plans define expectations regarding IC
- All accounting staff attend annual update training of new accounting pronouncements

**Deficiency Examples**
- An organization with complex revenue accounting fails to maintain adequately trained CPAs to oversee revenue accounting.
Points of focus describe important characteristics of the principles, for example...

<table>
<thead>
<tr>
<th>Component</th>
<th>Risk Assessment</th>
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<tbody>
<tr>
<td>Principles</td>
<td></td>
</tr>
<tr>
<td>Principle 6</td>
<td>Principle 7</td>
</tr>
<tr>
<td>Specifies suitable objectives</td>
<td>Identifies and analyses risk</td>
</tr>
</tbody>
</table>

**Points of Focus**

- **Principle 6**
  - Complies with applicable accounting standards
  - Considers materiality
  - Reflects entity activities

- **Principle 7**
  - Includes entity, division, operating unit, and functions
  - Analyzes internal / external factors
  - Involves appropriate level of management
  - Estimates significance of risks identified
  - Determines how to respond to risks

- **Principle 8**
  - Considers various types of fraud
  - Assesses incentive and pressures
  - Assesses opportunities
  - Assesses attitudes and rationalizations

- **Principle 9**
  - Assesses changes in external environment
  - Assesses changes in business model
  - Assesses changes in leadership
**Points of focus describe important characteristics of the principles, for example...**

**Component**

**Risk Assessment**

**Principle 9: Identifies and Analyses Significant Change**
The organization identifies and assesses changes that could significantly impact the system of internal control.

**Points of Focus**

- Assesses changes in external environment
- Assesses changes in business model
- Assesses changes in leadership

**Control Examples**

- Risk assessments are required for any significant change, such as:
  - International Exposure
  - Significant Acquisition
- Create an internal control plan for any executive transition

**Deficiency Examples**

- The company failed to update the risk assessment for changes arising from the China acquisition.
Transitioning ICFR to 2013 framework
Transitioning ICFR to 2013 Framework

- COSO decided to supersede the 1992 Framework at the end of the transition period (i.e., December 15, 2014)

- “SEC staff plans to monitor the transition for issuers using the 1992 framework to evaluate whether and if any staff or Commission actions become necessary or appropriate in the future. However, at this time, I’ll simply refer users of the COSO framework to the statements COSO has made about their new framework and their thoughts about transition.”
  (Paul Beswick, S.E.C. Chief Accountant)

- The SEC staff indicated more recently that the longer issuers continue to use the 1992 framework, the more likely they are to receive questions from the staff about whether the issuer’s use of the 1992 framework satisfies the SEC's requirement to use a suitable, recognized framework, particularly after December 15, 2014 when COSO will consider the 1992 framework to have been superseded by the 2013 framework.
  (Center for Audit Quality's SEC Regulations Committee)
## A 404 transition plan (example)

<table>
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<tr>
<th>Four-phases</th>
<th>Key Actions</th>
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| **Phase 1: Educate and Communicate** | • Review 2013 Framework and illustrative tools  
• Conduct training appropriate for board/committee members, senior management, managers, etc.  
• Develop understanding of where principles are relevant at the entity (i.e., corporate) and subunits (divisions, subsidiaries, operating units and functional levels) |
| **Phase 2: Conduct Preliminary Assessment** | • Map 17 principles (considering points of focus) to entity level controls (ELCs)  
• Consider whether differences in controls exist at subunits  
• Identify any significant “gaps” in design or SOX documentation of controls (i.e., assess whether each component of internal control and principle is “present”) |
| **Phase 3: Complete Assessment & Develop Action Plan** | • Perform comprehensive assessment and assess the operating effectiveness of controls (i.e., assess whether each component of internal control and principle is “functioning”)  
• Assess severity of any internal control deficiencies  
• Identify changes in controls or SOX documentation necessary to remediate deficiencies |
| **Phase 4: Execute Action Plan** | • Remediate internal control deficiencies of SOX documentation, as needed |
Potential impact on ICFR

- Reactions and responses will differ depending on circumstances
- If 1992 Framework has been thoroughly applied to current ICFR, the transition should not result in significant changes or incremental effort
- Preliminary assessment (i.e., mapping principles, considering points of focus, to controls) may reveal “gaps” in design or documentation of some controls
  - Design—Controls are not designed to demonstrate a principle is present
  - Documentation—Controls associated with the principle exist, but they are not included in the SOX internal control documentation
**Potential impact on ICFR**

- Focus on design of **indirect entity level controls** (ELCs) that affect the 14 principles associated with the “softer” components of internal control. Indirect ELCs have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis.

- No impact expected on design of **direct ELCs** and **transaction level controls** (e.g., three way match, cash reconciliation) relating to Control Activities.
Potential impact on ICFR

- ELCs operate throughout the entire organization and often have a pervasive impact on controls. For example, the design of an indirect ELC focused on assessing financial reporting risks can be conducted at the corporate level to assess risks relating to all components of the entity (i.e., subunit locations) or at individual components.

- Determining whether a principle is present is a matter of management judgment. Assessing the design of ELCs include:
  - Component(s) of the entity covered by the control being evaluated
  - Objective of the control
  - Who performs the control with necessary authority and competence
  - Frequency of the control's operation
  - Specific procedures that are performed to meet the stated objective, including any information used in the operation of the control.
Potential impact on ICFR

- By taking a fresh look at the design of indirect ELCs, management may identify opportunities to re-design controls to enhance effectiveness or efficiency
Potential impact on ICFR

- Evaluation of the three principles related to the Control Activities component should be focused on the process for selecting, developing and deploying control activities rather than the detailed control activities themselves.
  - Therefore, transitioning to the 2013 Framework will not result in any changes to a company’s risk and control matrices relating to transaction controls (e.g., three way match, cash reconciliations, etc.).
- The mapping of principles to controls will ultimately support the company’s design of the “soft” components of internal control over financial reporting in accordance with the 2013 Framework
**PCAOB actions impacting SOX**

Increased focus by PCOAB on internal control aspects of the Integrated audit leading to increased PCAOB audit findings related to internal control. Documented in inspection reports and the Action Alert, dated October 24\(^{th}\), 2013.

Driving changes in external audit approach to ICFR, increased levels of documentation, changes to control design and requests for additional evidence. The impact on SOX teams in some situations can be significant.
Some Observations

- Are controls properly designed and aligned to risks?
- Testing of management review controls
- Evidence over system generated data and reports
- Use of work of others
- Controls over:
  - Journal Entries
  - Estimates,
  - Unique transactions,
  - Income taxes

Impact to SOX Teams

- Increase documentation of end-to-end process, qualification of control performers, and SOD
- Increase rigor of management review controls and documentation of proper control execution.
- Enhance controls over spreadsheets and other end-user applications. Assistance with testing of key reports.
- Critical assessment of competence and objectivity. Less reliance on management testing.
- Re-design of manual and automated controls over sensitive areas.
Holistic Approach to Manage Costs, Deliver Value

Strategy
- Ensures **stakeholder alignment** around SOX program objectives and change goals

Structure
- Captures **synergies** between SOX programs and external audits to drive high levels of **external audit reliance**.

People
- Understand the **training** and controls knowledge of those employees performing key controls
- Determine the **most cost-effective** resources performing work with limited value.
- Understand the **experience** and background of program management running the SOX program.

Process
- **Lean process framework** applied to controls, related documentation and project management processes to align with risk and **streamline** unnecessary activities
- Identifying capabilities to use a **risk based** testing approach to focus efforts on areas with highest risk of error and misstatement.

Technology
- **Evaluate GRC platforms**, to determine that they enable efficient **workflow** such as hand-offs, approvals and management reporting
- **Automated controls** and **continuous monitoring** are used where possible, such as segregation of duties, interface balancing, reconciliations and transaction monitoring.

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<th>Monitoring</th>
<th>Program Management</th>
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<td><strong>Stakeholder Alignment</strong></td>
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<td><strong>Structure</strong></td>
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<td>Cost Effective</td>
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<td>Risk Based</td>
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<td><strong>Technology</strong></td>
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<td><strong>Quality</strong></td>
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Questions
Thank you...