Guam Professional Development Conference

"Trends, Tools, and Techniques in Today's Financial Environment"

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COSO and Internal Control – Implementation of the New COSO Framework

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Internal Controls and the New COSO

Guam Chapter
AGA
September 2014

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Agenda

- What is the COSO?
- Industry Standards that have Developed from COSO – present and future – **government perspective**
- History of COSO
- The “Rubik’s Cube” of COSO
- Examples
- Enterprise Risk Management and COSO

What is the COSO?

- Committee of Sponsoring Organizations of the Treadway Commission (COSO)
- Five Sponsoring Organizations

American Accounting Association

fei

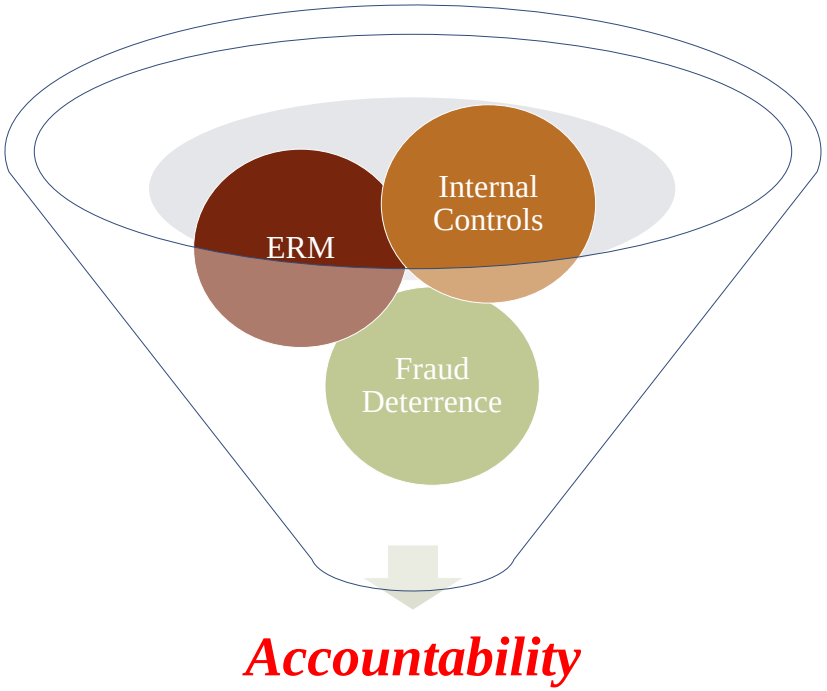
financial executives international

www.financialexecutives.org

The Association for Accountants and Financial Professionals in Business

Mission / Goals of COSO

- Provide thought leadership through
  - Development of comprehensive frameworks
  - Guidance on enterprise risk management (ERM),
  - Internal control and fraud deterrence
  - Improve organizational performance and governance
  - Reduce the extent of fraud in organizations



Standards that Have Developed from COSO since 1992 related to COSO

- COSO - 1992
- SAS-74 Compliance Auditing - 1995
- SAS 78 Internal Controls - 1995
- **Single Audit Act - 1996**
- SAS 82 Consideration of Fraud - 1997
- **First OMB Circular A-133 - 1997**

Standards that Have Developed from COSO since 1992 related to COSO

- Sarbanes – Oxley - 2002
- SAS-99 Consideration of Fraud - 2002
- Amendment to A-133 - 2003
- PCAOB AS-2 Audits of Internal Controls - 2004
- AICPA Risk Assessment Suite – (SAS 106-111) - 2006
- **Yellow Book 2007 Revisions (January & July)**
- Amendment to A-133 - 2007
- SAS-115 Internal Control Communication 2008
- SAS-117 Compliance Audits 2009
- **Yellow Book December 2011**

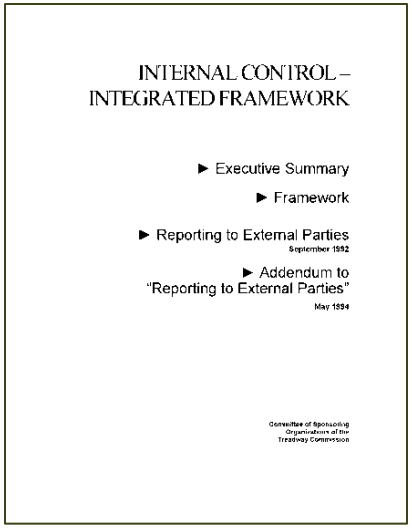
Common Themes

- Continuous improvement on internal control testing and reporting
- Continuous understanding of new risks in the environment with regard to audit, technology and management
- Continuous process improvement with regard to changes in organizational structure (Google didn't exist 10 years ago)
- Continuous process improvement to detect fraud
  - Each economic cycle brings new challenges to detect / deter fraud

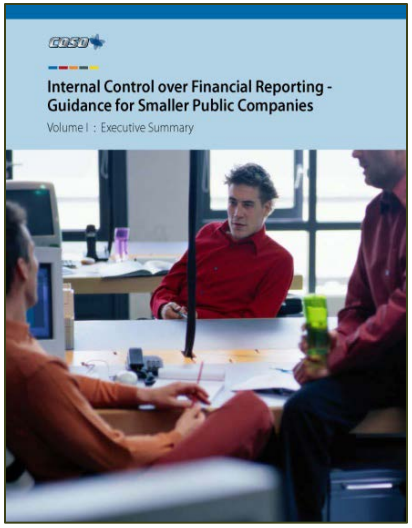
History of COSO

- Founded in 1985 to sponsor the National Commission on Fraudulent Financial Reporting
  - Commission headed by James Treadway Jr. – general counsel of Paine Webber (now UBS) and former SEC Commissioner
  - Private sector initiative in advance of threat of SEC involvement in internal controls (*came true in 2002)*
  - Developed recommendations for *publicly traded* companies and auditors, SEC, regulators, educational institutions.
  - COSO independent of sponsoring organizations

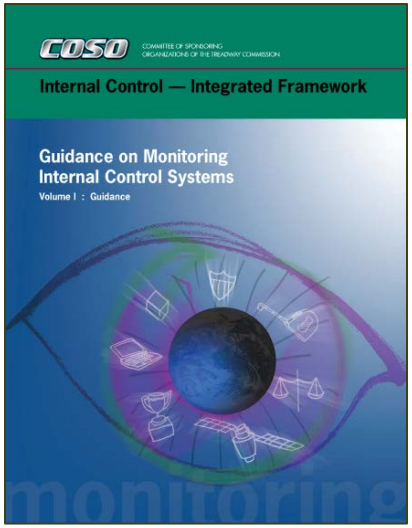
COSO – Internal Control Publications



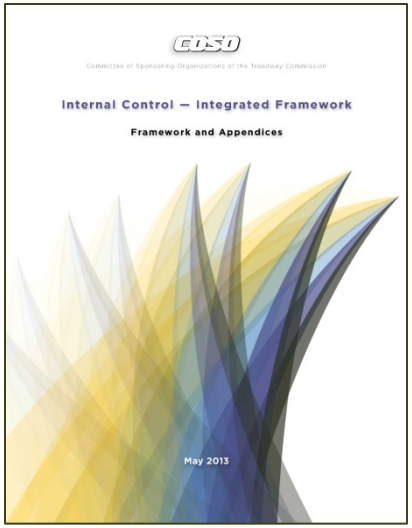
1992



2006



2009



2013

It's already working…

- 2011 Yellow Book –
  - ¶A.04 discusses that in addition to the COSO framework – *Standards for Internal Control in the Federal Government* (aka the Green Book) provides definitions and fundamental concepts pertaining to internal control at the federal level and may be useful to auditors at other levels of government. The related "Internal Control Management and Evaluation Tool" based on federal internal control standards, provides a systematic, organized, and structured approach to assessing the internal control structure.

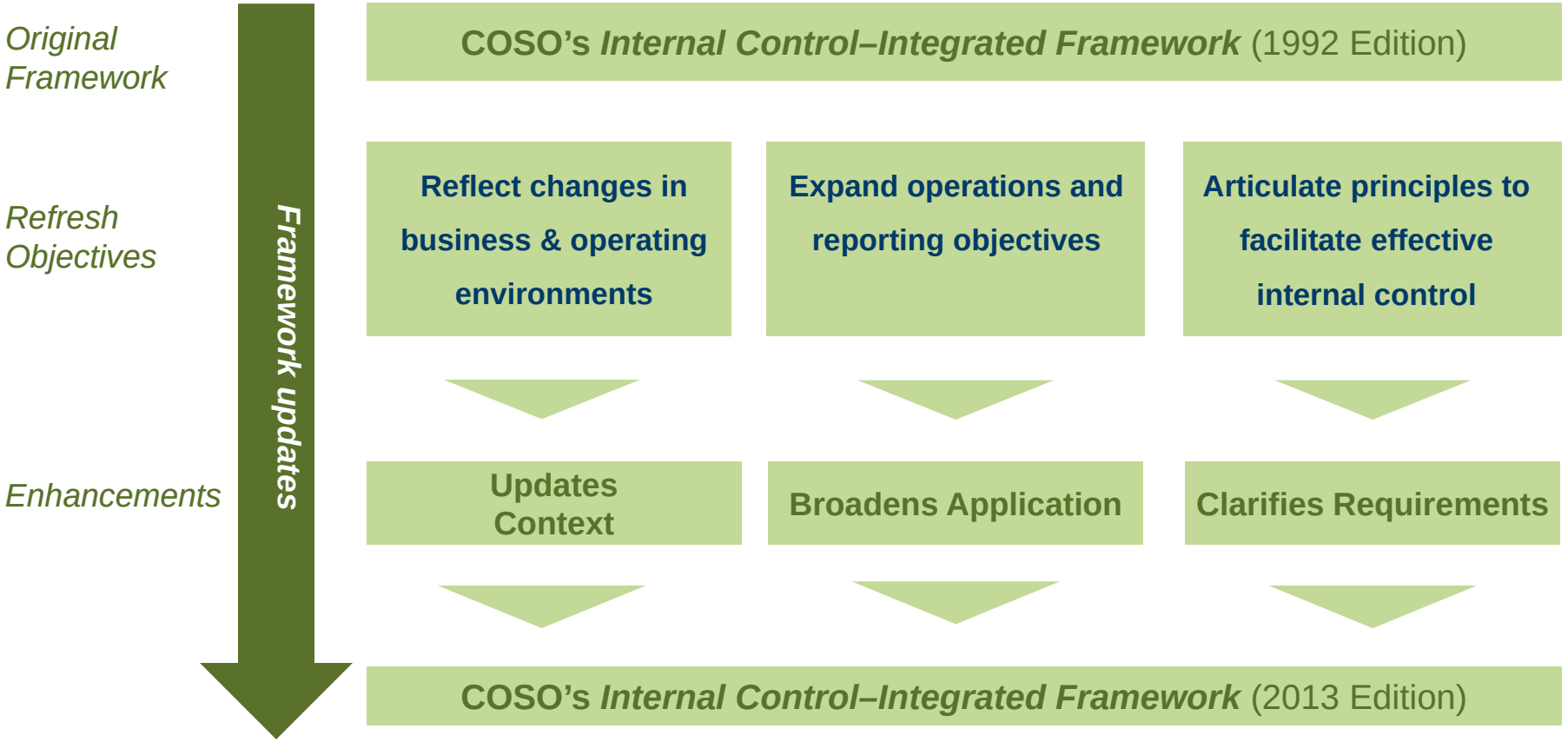
Federal Government “Green Book” – September 2013 Exposure Draft

- 17 COSO Principles applied to the Federal Government
- Proposed revision does not change standards on a conceptual level
  - Retains 5 components of internal controls
  - Introduces 17 principles adopted from COSO
  - Introduces attributes that support these principles and further define the requirements for an effective internal control system.
    - Comments due 12/2/13 to GAO

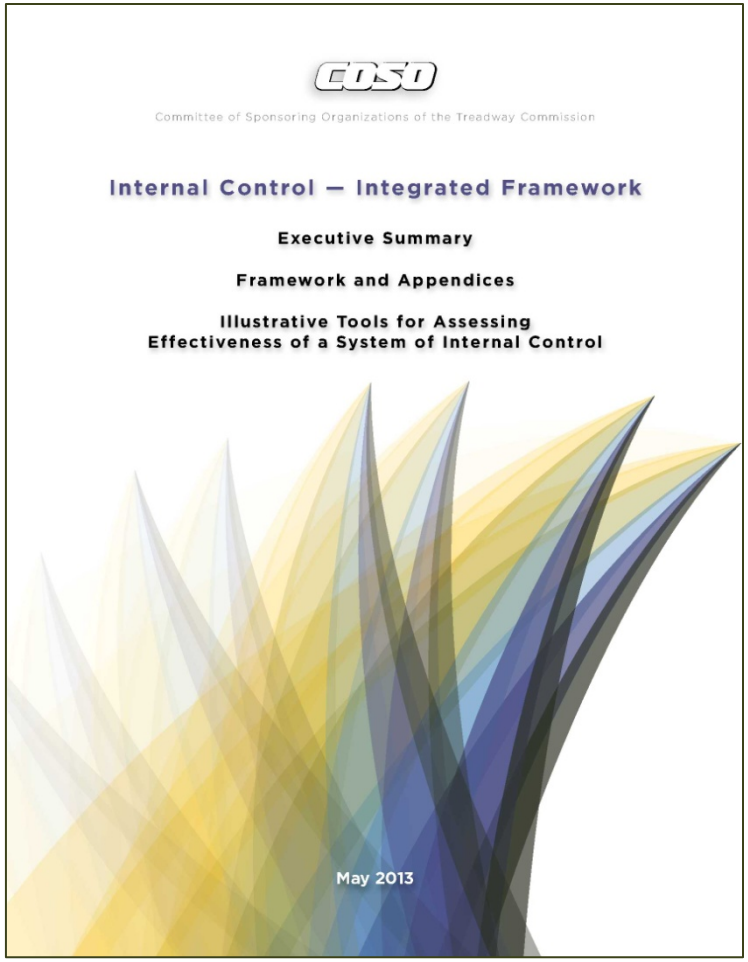
Impact

- Users are encouraged to transition applications and related documentation to the updated Framework as soon as feasible
- **Updated Framework will supersede original Framework at the end of the transition period (December 15, 2014)**
- During the transition period, external reporting should disclose whether the original or updated version of the Framework was used
- Impact of adopting the updated Framework will vary by organization
  - Does your system of internal control need to address changes?
  - Does your system of internal control need to be updated to address all principles?
  - **Does the government apply and interpret the original framework in the same manner as COSO?**

The process of updating what works - The Framework has become the most widely adopted control framework worldwide.

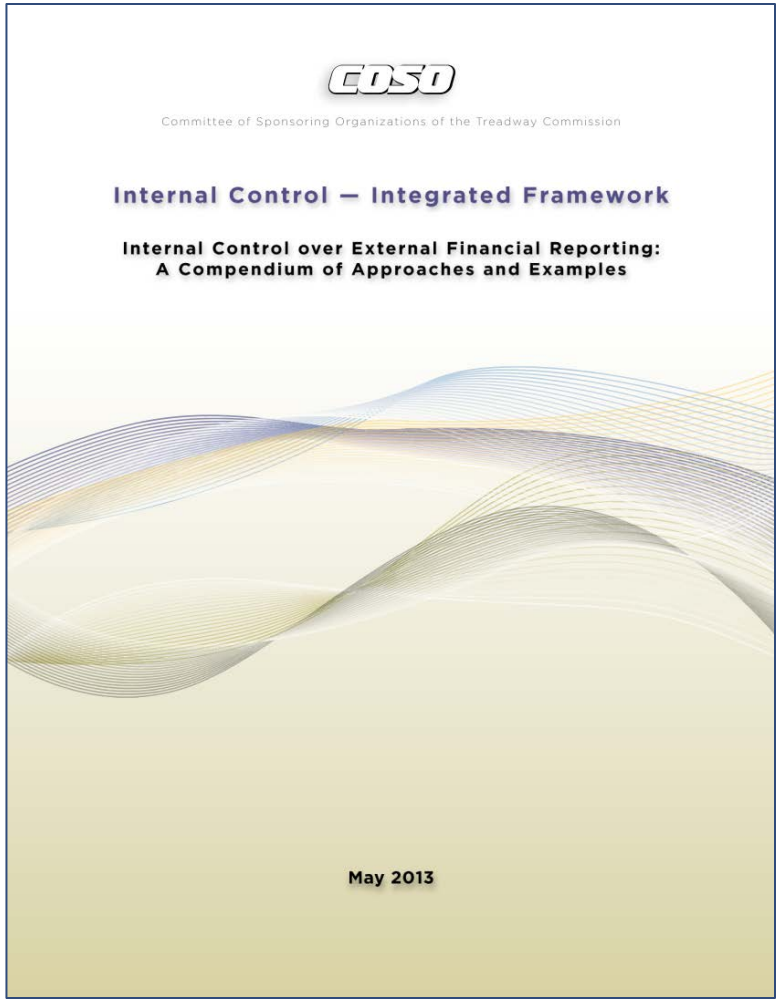


Two Parts in COSO Update- Part #1 – Internal Control-Integrated Framework (2013 Edition)



- Consists of three volumes:
  - Executive Summary
  - Framework and Appendices
  - Illustrative Tools for Assessing Effectiveness of a System of Internal Control
- Sets out:
  - Definition of internal control
  - Categories of objectives
  - Components and principles of internal control
  - Requirements for effectiveness

Part #2 – Internal Control over External Financial Reporting: A Compendium of Approaches and Examples



- Illustrates approaches and examples of how principles are applied in preparing financial statements
- Considers changes in business and operating environments during past two decades
- Provides examples from a variety of entities – public, private, not-for-profit, **and government**
- Aligns with the updated Framework

Update Increases Ease of Use and Broadens Application due to movement to Principles

The More Things Stay The Same...

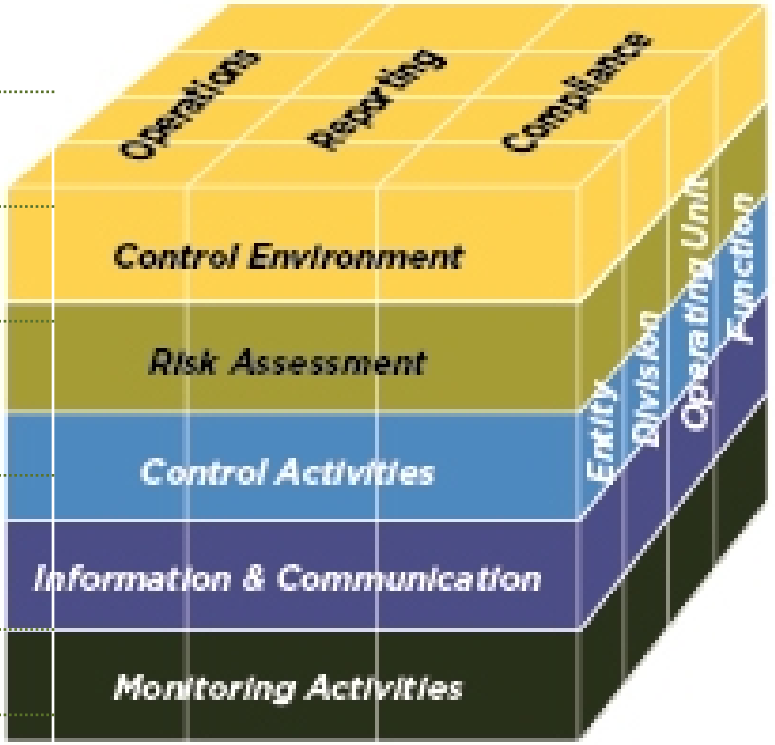
- Core definition of internal control
- Three categories of objectives and five components of internal control
- **Each of the five components of internal control are required for effective internal control**
- Important role of judgment in designing, implementing and conducting internal control, and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

The More Things Change….

- Changes in business and operating environments considered
- Operations and reporting objectives expanded
- Fundamental concepts underlying five components articulated as principles
- Additional approaches and examples relevant to operations, **compliance**, and **non-financial reporting objectives added**

Update Considers Changes in Business and Operating Environments

Environment changes...	*...have driven Framework updates*
Expectations for governance oversight	
Globalization of markets and operations	
Changes and greater complexity in business	
Demands and complexities in laws, rules, regulations, and standards	
Expectations for competencies and accountabilities	
Use of, and reliance on, evolving technology	
Expectations relating to preventing and detecting fraud	



COSO Cube (2013 Edition)

Components and Principles of Effective Internal Control

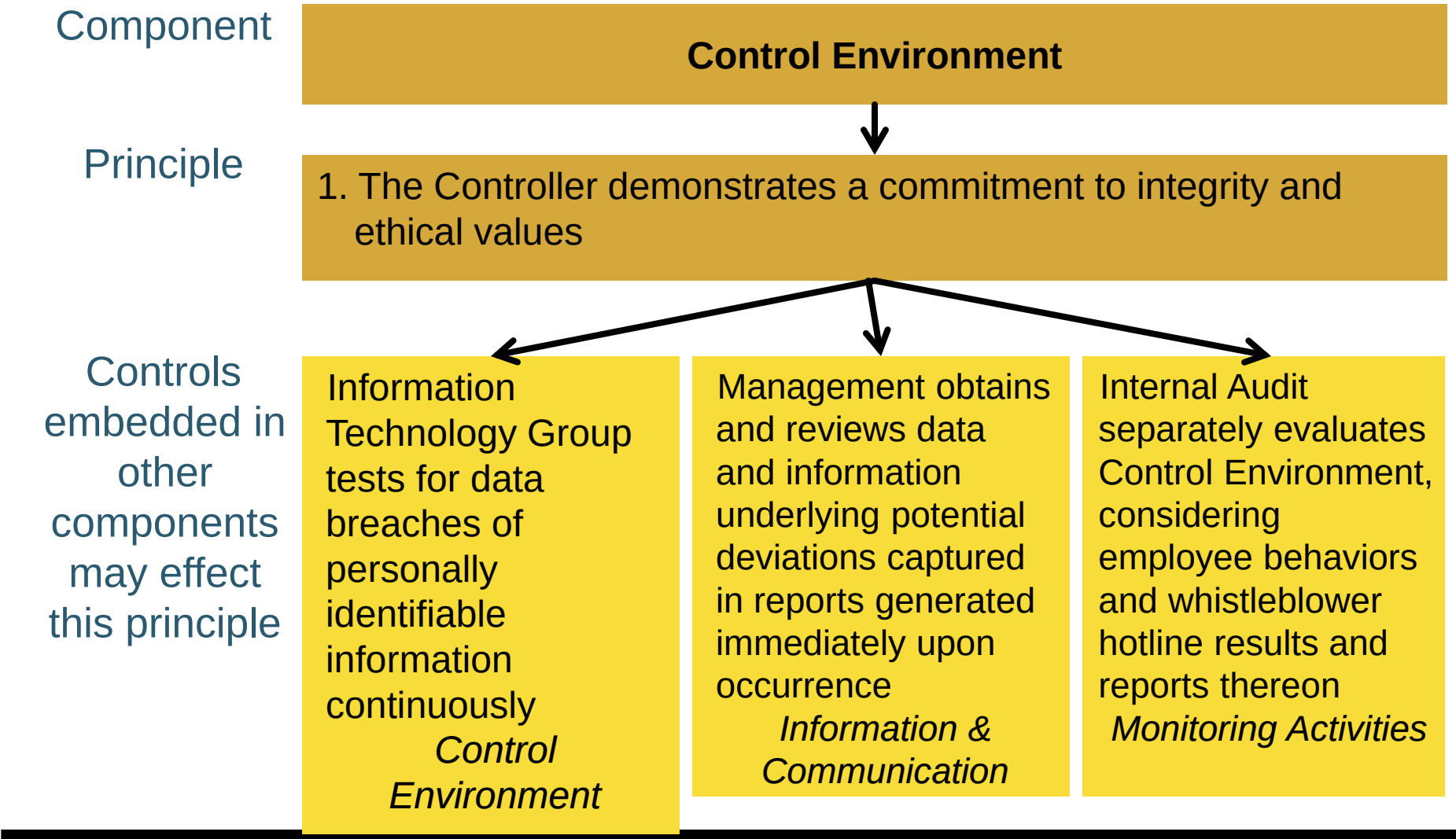
Components	Principles
Control Environment	1. Demonstrates commitment to integrity and ethical values 2. Exercises oversight responsibility 3. Establishes structure, authority and responsibility 4. Demonstrates commitment to competence 5. Enforces accountability
Risk Assessment	6. Specifies suitable objectives 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

Components and Principles of Effective Internal Control

Control Environment

1. The organization demonstrates a **commitment** to **integrity and ethical values**.
2. Those charged with **governance demonstrate independence from management** and exercises oversight of the development and performance of internal control.
3. Management **establishe**s, with governing 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.

How Various Controls Effect Principles, e.g.,



Control Environment - Principle 1 Further Example – Commitment to Integrity and Ethical Values

- The State has created, maintains, and distributes a code of conduct and ethical standards
- Distributed to all employees and external parties acting on behalf of the State, and has posted it on the State website.
- Code of conduct is available in all relevant languages for ease of access and understanding by Citizens.
- State requires all employees to complete periodic interactive web-based training sessions on various aspects of the code and ethical standards.
- The State provides a supplier code of conduct to its vendors as part of its contracting process, which provide a basis for evaluation alongside product / service delivery evaluation.

How is this effective?

Components and Principles of Effective Internal Control

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.

How Various Controls Effect Principles, e.g.,

Component

Risk Assessment

Principle

The Controller identifies risks to the achievement of the objectives across the office and analyzes risks as a basis for determining how the risks should be managed.

Controls embedded in other components may effect this principle

As part of the meetings with senior staff on goals and objectives, risks are noted and potential controls against those risks are brainstormed and initiated if approved by the audit committee. *Risk Assessment*

The result of the brainstorming is communicated to staff as part of semi-annual reviews *Information & Communication*

A dashboard of risks is established and is updated with each batch cycle. Employee reviews are completed timely. *Monitoring Activities*

Components and Principles of Effective 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 place.

How Various Controls Effect Principles, e.g.,

Component

Control Activities

Principle

The Controller selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.

Controls embedded in other components may effect this principle

Every two years, the Controller rotates duties among the divisional managers not only to provide them with a broader experience but also to lower the risk of financial reporting fraud. Staff enjoys the rotation as they are not working the same job repeatedly. *Control Activity*

A report is developed predicting payables over the next 30 days and disseminated to fiscal officers. The payables are compared to encumbrances. *Information & Communication*

The Comptroller reviews payables that are unusual, or above $5,000 or infrequent. *Monitoring Activities*

Control Activities - Principle 11 Example – Government Selects and Develops General Control Activities over Technology

- An Agency CFO recently evaluated the use of **spreadsheets** in its financial close process. In doing so, it identified that the **spreadsheets** supporting the calculation of the fair values of investments, those supporting capital assets, and debt were of high risk, based on their susceptibility to error and significance to the financial statements. The A/C also classified the spreadsheets as high in complexity because they included the use of macros and multiple supporting spreadsheets to which cells and values were interlinked. The spreadsheets were used either as the basis for journal entries into the general ledger or as financial statement disclosures.
- **How would you solve this?**

Components and Principles of Effective Internal Control

Information & Communication

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

How Various Controls Effect Principles, e.g.,

Component

Information & Communication

Principle

The Controller obtains or generates and uses relevant, quality information to support the functioning of internal control.

Controls embedded in other components may effect this principle

With each transaction, if the transaction is outside of allotted funds, an error is generated and is workflowed to a department fiscal officer who only has limited approval authority. Authority then escalates with documentation to Controller.
Control Activity

Interim reports are issued to the audit committee within 45 days of fiscal quarter end. These reports include amended budget to actual numbers along with a qualitative analysis of activities, metrics and key performance indicators. The audit committee reviews it, provides feedback within 7 days and the Controller makes necessary changes. Reports are then published on the State's website.
Information & Communication

With each payroll cycle, predictive reports are generated with amount anticipated to be paid, budgeted amount and percentages of allotments / budgets
Monitoring Activities

Information and Communication - Principle 13 Example – Government Obtains or Generates and Uses Relevant, Quality Information to Support the Functioning of Internal Control

- The Agency CFO receives a daily update at 8 AM on her desk compiled by staff. The update consists of newspaper clips, other publications, event press releases, and other information from external parties (including social media) to gather information relevant to performing her responsibilities.
- **Do you have an issue with this?**

Components and Principles of Effective 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 those charged with governance, as appropriate.

How Various Controls Effect Principles, e.g.,

Component

Monitoring Activities

Principle

The Controller selects, develops, and performs ongoing and / or separate evaluations to ascertain whether the components of internal control are present and functioning.

Controls embedded in other components may effect this principle

The quality assurance division reports are also transmitted to the division where the problem occurred. Corrective action is taken. If no corrective action is accomplished, the employee's personnel file contains the issue and if repeated, could be grounds for termination.

Control Activity

Statistical reports on uses of personally identifiable activity are reported to employees on a monthly basis. All employees are trained semi-annually on when / how / who can access PII

Information & Communication

Reports on detections of improper use of personally identifiable information by employees are escalated to a senior review board that investigates all activities and reacts to breaks in accordance with state law.

Monitoring Activities

How Update Clarifies Requirements for Effective Internal Control

- Effective internal control provides reasonable assurance regarding the achievement of objectives and requires that:
  - Each component and each relevant principle is present and functioning
  - The five components are operating together in an integrated manner
- Each principle is suitable to all entities; all principles are presumed relevant except in rare situations where management determines that a principle is not relevant to a component (e.g., governance, technology)
- Components operate together when all components are present and functioning and internal control deficiencies aggregated across components do not result in one or more major deficiencies
- A major deficiency represents an internal control deficiency or combination thereof that severely reduces the likelihood that an entity can achieve its objectives

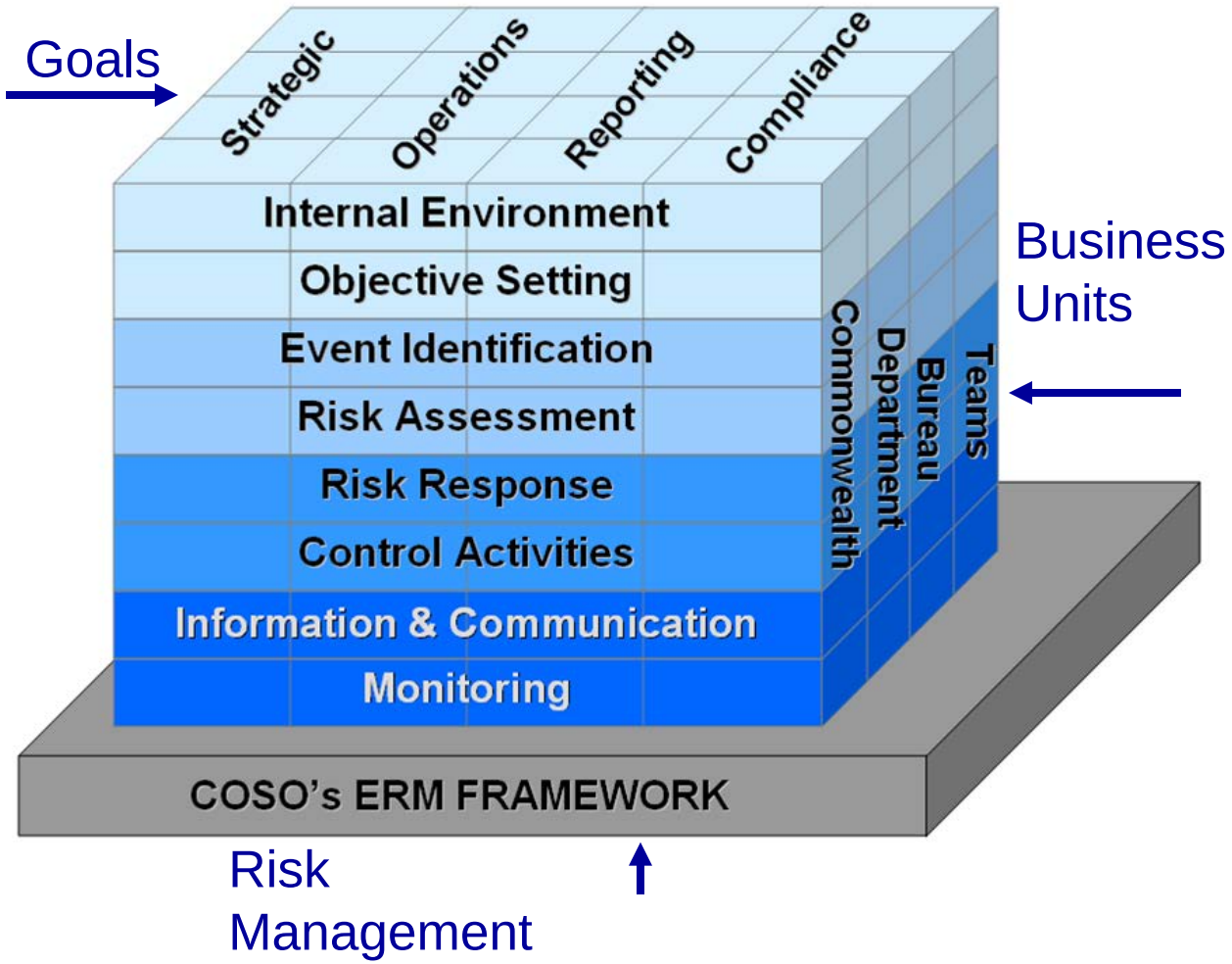
Effective Internal Control

- If effective management and the board –
  - Achieves effective and efficient operations
  - Understands the extent to which operations are managed effectively
  - Prepares reports
  - Complies with laws and regulations

How did we assess risk here and how is it mitigated?

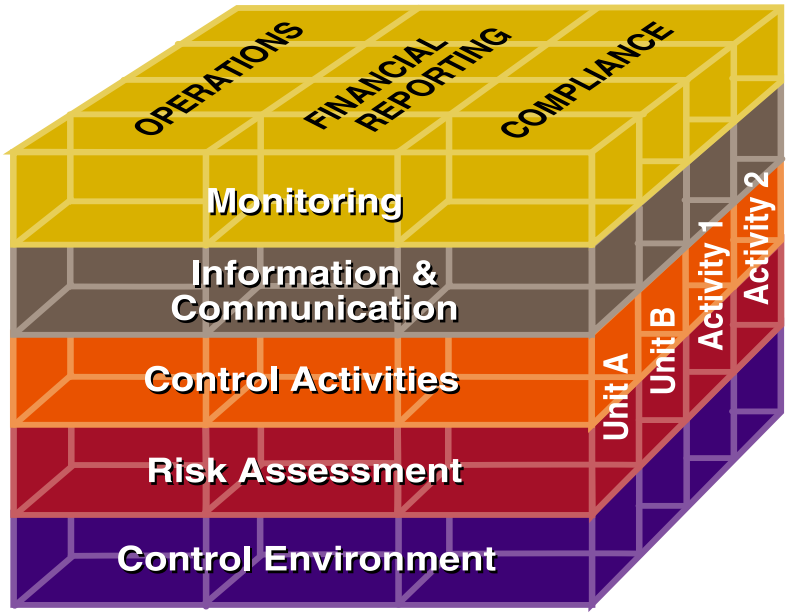
Enterprise Risk Management

Source: Howard Olsher & Eric Berman – 2007 OSC CFO Conference!

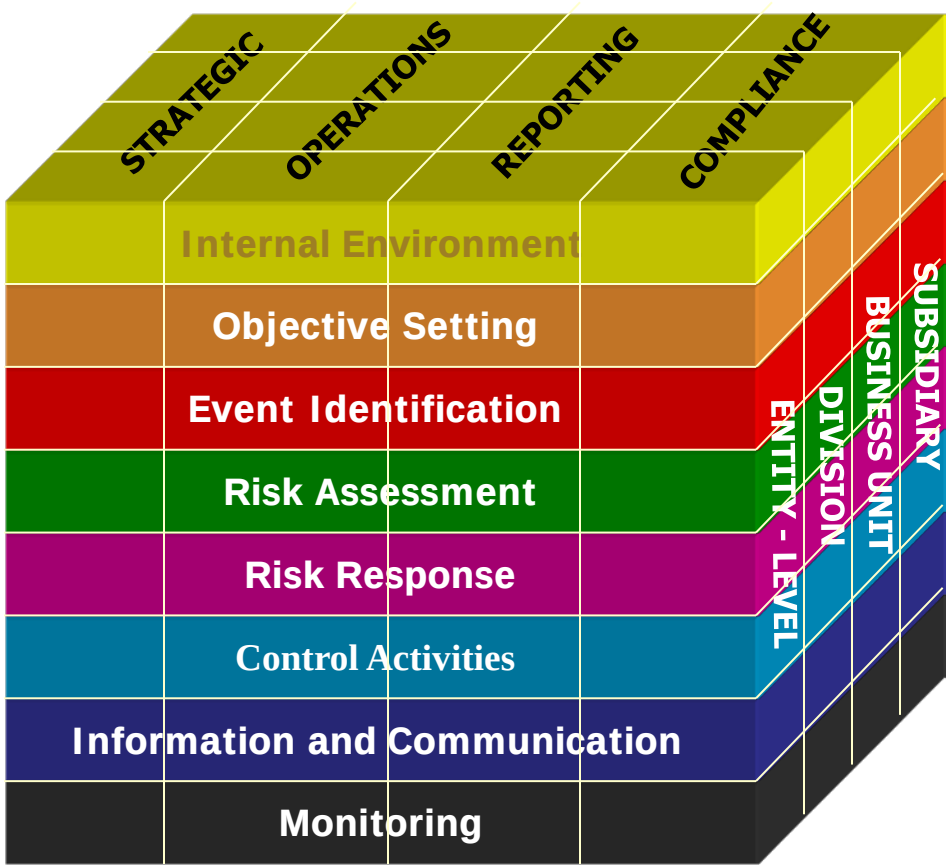


COSO ERM Framework and the Internal Control Framework

Internal Control



ERM is a Supersized COSO



Risk Universe

- The risk universe is a multi layered approach to identifying Risk

  - Strategic level - Government - Wide
  - Operational - Department
  - Reporting - Division / Unit
  - Compliance - Law / Regulation

Risk Universe all can be Applied to Government

- Strategic Risk
- Interest rate Risk
- Balance sheet Risk
- Credit Risk
- Operational Risk
- Regulatory Risk
- Reputation Risk

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