COSO issues the updated Internal Control-Integrated Framework and related illustrative documents

Overview

Background

.1 In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued the original Internal Control—Integrated Framework (original framework). The original framework, authored by PwC under the direction of COSO, has been widely adopted by organizations around the world in designing, implementing, and conducting systems of internal control, especially with respect to internal control over financial reporting.

.2 On May 14, 2013, COSO published an updated Internal Control—Integrated Framework (Framework) and related illustrative documents. These publications, authored by PwC under the direction of COSO, include the:

i. Internal Control-Integrated Framework: Executive Summary (Executive Summary),

ii. Internal Control-Integrated Framework: Framework and Appendices (Framework),

iii. Illustrative Tools: Assessing Effectiveness of a System of Internal Control (Illustrative Tools), and


.3 COSO’s goals for updating the original framework is to (i) clarify the requirements of effective internal control, (ii) update the context for applying internal control to many changes in business and operating environments, and (iii) broaden its application by expanding the operations and reporting objectives. COSO developed the related illustrative documents to provide tools to assist companies in implementing or evaluating their system of internal control and offer specific approaches and examples as to how the Framework applies to external financial reporting.
COSO has stated the key concepts and principles embedded in the original framework are fundamentally sound and broadly accepted in the marketplace; accordingly, COSO has updated and not fundamentally overhauled the original framework.

To help develop these publications, COSO formed an Advisory Council comprising representatives from industries, academia, government agencies, and non-profit entities, as well as regulatory observers and standard setters also provided input as the project progressed. In addition, exposure drafts of these publications were issued for public comments and COSO received more than 100 public responses to its on-line survey and another 97 public comment letters from stakeholders around the world.

On March 20, 2013, COSO announced that the original framework will be available via www.coso.org through December 15, 2014, after which time COSO will consider it as superseded by the Framework. COSO recommended that all organizations currently using the original framework should begin to align existing practices (and related documentation) to the Framework as soon as is feasible under their particular circumstances. It also observed the original framework can continue to be used during the transition period, and that an organization that reports externally should clearly disclose whether it utilized the original framework or the updated Framework.

The possible impacts of adopting the Framework will vary and depend upon many factors, including how well the organization understood and applied the key concepts and principles contained in the original framework. The articulation of principles in the Framework and consideration of many changes in business and operating environments over the past several decades may impact the design, operation and/or documentation relating to existing systems of internal control. In addition, the Framework allows for broader application of internal control to operations and non-financial reporting objectives.

Refer to PwC’s 10Minutes - on why the COSO update deserves your attention for further insights regarding COSO’s update of the Framework.

The main details

COSO has stated the Framework is expected to help organizations design and implement internal control in light of many changes in business and operating environments since the issuance of the original framework, broaden the application of internal control in addressing operations and reporting objectives, and clarify the requirements for determining what constitutes effective internal control.

The Executive Summary provides a high-level overview intended for the board of directors, chief executive officer, and other senior management. The Executive Summary informs leaders how the Framework builds on the core strengths of what has been proven useful in the original framework.

The Framework defines internal control and describes the requirements for effective internal control. The Framework sets forth, and describes in some detail, the five components and seventeen associated principles of a system of internal control. Further, it illustrates application relating to operations, reporting and compliance objectives, and provides direction for all levels of management to use in designing, implementing and conducting a system of internal control, and in assessing its effectiveness.

The Illustrative Tools provide templates and scenarios that may be useful for management when using the Framework to assess the effectiveness of a system of internal control based on the requirements set forth therein.
.13 The ICEFR Compendium is a companion document to the Framework and illustrates additional approaches and examples of how the principles set forth in the Framework can be applied in the context of external financial reporting, a subset of the reporting category of objectives.

.14 COSO has stated the key concepts and principles embedded in the original framework are fundamentally sound and broadly accepted in the marketplace. Accordingly, COSO acknowledges continued use of the original framework during the transition period (May 14, 2013 to December 15, 2014) is appropriate. During this period the COSO Board believes that organizations complying with requirements to report on the effectiveness of their system of internal control should clearly disclose whether the original framework or updated Framework was utilized.

.15 COSO has recommended users of the original framework to transition their current applications and related documentation to the Framework as soon as is feasible under their particular circumstances. For example, an organization with a less complex system of internal control over external financial reporting may be able to make all appropriate changes to its system and documentation in a few months; whereas, an organization with a more complex system may take a longer period to implement changes.

.16 This Dataline highlights noteworthy updates to the Framework relating to internal control over external financial reporting, such as the requirements set out for effective internal control. It also summarizes the purpose of the illustrative documents relating to the Framework and highlights key considerations for clients, such as those changes that are expected to impact management’s assertion on the effectiveness of the entity’s system of internal control over financial reporting in compliance with the Sarbanes-Oxley Act.

Key provisions

Noteworthy updates to the Framework

.17 The original framework was introduced in 1992 and has been widely adopted worldwide. In response to an increasingly complex, technologically driven, and global business environment, COSO recently published the Framework to address key issues for future organizational success. The Framework does not fundamentally alter the key concepts contained in the original framework; rather, it clarifies and builds on core strengths by (i) formalizing these concepts embedded within the five components into seventeen principles, (ii) considering changes in business and operating environments, and (iii) expanding the financial reporting objective to address other important forms of reporting.

PwC observation:

We believe the Framework will assist management, boards of directors, external stakeholders, and others interacting with the entity, regarding an entity’s application of internal control in the preparation of external financial statements, and should provide the organization with more confidence in knowing that the requirements of effective internal control are met without being overly prescriptive or burdensome.

The Framework provides an integrated approach for applying internal control through understanding the connections of specific objectives, risks, and controls across the business. Further, an integrated approach may address risks associated with overlapping objectives. We believe that internal control can be a powerful tool to help organizations achieve their specified objectives. While internal control always has been designed for broader application than external financial reporting, we
believe an integrated approach could help management identify and assess risks across the business and embed greater accountability for achieving financial reporting objectives.

The Appendices provide reference material, including a glossary of key terminology, a discussion of roles and responsibilities, a discussion of the methodology used for developing the Framework, a discussion of comment letters received during the public exposures of the proposed drafts of the Framework and related illustrative documents, a summary of changes to the original framework, and a comparison with the COSO Enterprise Risk Management-Integrated Framework.

.18 One of the more significant updates to the Framework is the formalization of fundamental concepts introduced in the original framework into seventeen principles associated with the five components of internal control—Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring Activities. These principles, which were implicit in the original framework, are now explicitly set out to increase the ease of use and broaden the application of the Framework. They also provide clarity for understanding the requirements of effective internal control and facilitate designing and implementing a system of internal control and in assessing its effectiveness.

.19 The Framework also includes points of focus that highlight important characteristics of the principles. Points of focus may assist management in designing, implementing and conducting internal control and in determining whether relevant principles are, in fact, present and functioning.

PwC observation:

The Framework essentially retains the core definition and the five components of internal control. We believe the articulation of principles and related points of focus will assist organizations in designing controls for achieving their specific objectives, mitigating risk to acceptable levels, and adapting to changes in business and operating environments, while not imposing a higher threshold or additional burden to achieve effective internal control. While no separate evaluation of points of focus is required to demonstrate that a relevant principle is present and functioning, we believe they may be very useful in mapping principles to existing controls embedded within each of the five components.

We believe the principles-based Framework is more flexible and adaptable, and broadly applicable than a rules-based framework. The Framework acknowledges the important role of management judgment in determining whether principles are relevant to the entity and present and functioning across the business. The principles help organizations to specify and communicate suitable objectives, to identify and assess related risks, and to select and deploy controls across the business. Further, since the principles are suitable for operations, reporting, and compliance objectives, they can provide a common approach for achieving multiple objectives.

Requirements for effective internal control

.20 The Framework requires that an effective system of internal control reduces, to an acceptable level, the risk of not achieving an objective relating to one, two, or all three categories of objectives — operations, reporting, or compliance. Management is expected to obtain persuasive evidence to support its determination that each of the components and relevant principles is present and functioning and the five components are operating together in an integrated manner.
.21 In making the determination as to whether each component and relevant principle is present and functioning, management considers controls across the business that effect the component or relevant principle. Controls that effect a principle may be found in one or more components. Understanding and considering how controls effect multiple principles can provide persuasive evidence to support management’s assessment of whether components and relevant principles are present and functioning.

**PwC observation:**

We believe management should map relevant principles to existing controls across the business to ascertain if there is persuasive evidence that these controls sufficiently effect such principles are present and functioning or require clarification, or even to be strengthened, to demonstrate that components and relevant principles are present and functioning. We further believe the update will focus management’s attention as to whether relevant principles are present and functioning since this is a primary factor in determining whether each of the five components of internal control operate together.

While the Framework does not prescribe a process for assessing effectiveness of a system of internal control, it focuses on whether relevant principles are present and functioning. The Framework provides guidance through illustrations of (i) points of focus relating to principles and (ii) approaches and examples relating to controls.

An effective system of internal control does not require that management assess separately whether any points of focus are in place. In fact, the Framework recognizes the possibility that some of the presented points of focus may not be suitable or relevant and that management may identify others based on specific circumstances of the entity. The points of focus should be considered as important considerations that can support management’s determinations as to whether relevant principle(s) are present and functioning.

Similarly, the Framework does not prescribe requirements that any particular controls are in place. Clearly, management must consider how controls effect principles through their selection, development, and deployment, in conjunction with their gathering persuasive evidence to support its determination that each of the components and relevant principles is present and functioning. Management exercises judgment in selecting, developing, and deploying controls necessary to effect principles.

**Deficiencies in Internal Control over Financial Reporting**

.22 The Framework defines an internal control deficiency as a shortcoming in one or more components and relevant principle(s) that reduces the likelihood that an entity can achieve its objectives. If, in management’s judgment, a control deficiency severely reduces that likelihood, then it is defined as a major deficiency under the Framework. The existence of a major deficiency precludes an organization from concluding that it has met the requirements for an effective system of internal control.

.23 The Framework recognizes that regulators, standard-setting bodies, and other relevant third parties establish criteria for defining the severity of, evaluating, and reporting internal control deficiencies. Further, the Framework recognizes and accommodates their authority and responsibility as established through laws, rules, regulations, and external standards. In those instances where an entity must comply with criteria established by the United States Securities and Exchange Commission (SEC), a company uses the definition and guidance set out for classifying internal control deficiencies as a material weakness, significant deficiency, or control deficiency as pertaining to financial reporting.
PwC observation:

The *Framework* sets out descriptions of deficiencies (internal control deficiency, major deficiency) that contrast with those set forth in the original framework (control deficiency, significant deficiency, and material weakness), which are now closely associated with external financial reporting. The updated descriptions contained in the *Framework* are equally applicable to all three categories of objectives, whereas the previous descriptions are not relevant for operations and certain aspects of the compliance objectives. Additionally, the broadening of the financial reporting objective supports a more generic description.

A major deficiency is not, by definition, equivalent to a material weakness, but the practical effect on the evaluation of a system of internal control is the same – the existence of either precludes management from concluding that the system of internal control is effective. In bridging the gap between the descriptions set out in the *Framework* and those established by regulators or standard setters with respect to evaluating operating effectiveness, we believe that any material weakness, significant deficiency, or control deficiency identified by management would ultimately relate to the determination of whether component(s) and relevant principle(s) of internal control are present and functioning. Therefore, we believe the *Framework* is suitable for the purpose of complying with regulatory requirements for reporting on the effectiveness of a entity's system of internal control over financial reporting.

**Related illustrative documents**

**A Compendium of Approaches and Examples**

.24 As part of the project to update the original framework, COSO developed additional approaches and examples that illustrate how the components and principles set forth in the *Framework* can be applied in preparing (i) financial statements for external purposes, and (ii) other external financial reporting derived from an entity’s financial and accounting books and records.

.25 The approaches and examples are samples of activities for management to consider, rather than a complete or authoritative list. For each principle, the *ICEFR Compendium* lists approaches that generically illustrate how organizations can apply the principles to their system of internal control over external financial reporting. For each approach, one or more examples are provided to illustrate how an important aspect of the approach has been put in place by entities that prepare financial statements for external purposes. The approaches and examples also illustrate one or more points of focus corresponding to a particular principle. They are not designed to provide a comprehensive, end-to-end view of how principles may be fully applied in practice.
PwC observation:

The *ICEFR Compendium* is particularly relevant to users who publicly report on the effectiveness of their system of internal control over financial reporting based upon requirements set forth in the *Framework*. We believe the *ICEFR Compendium* provides useful illustrations of principles that are relevant for a variety of entities — public, private, not-for-profit, and government. The approaches and examples do not attempt to illustrate all aspects of each component or relevant principle necessary for effective internal control relating to an entity’s external financial reporting objective; instead, they provide a compendium of practical illustrations of particular aspects of the principles. It is not a "how to" guide for selecting and deploying specific controls.

The approaches and examples are not sufficient for an organization to determine that each component and relevant principle is present and functioning, but instead illustrate how principles may be present and functioning. As such, we caution entities from only referencing or reviewing the *ICEFR Compendium*. It is a companion document and a full review of the *Framework* is required to understand the requirements for effective internal control.

Illustrative Tools

.26 The *Illustrative Tools* can assist users when assessing the effectiveness of a system of internal control based on the requirements set forth in the *Framework*. The *Illustrative Tools* provide templates that focus on evaluating the components and relevant principles, not the underlying controls (e.g., transaction-level control activities) that effect the relevant principles. The templates can be modified to reflect the circumstances (e.g., specified financial reporting objectives and sub-objectives, scope of application, or organizational structure) and assessment processes relevant for any entity. The templates can support an assessment of the effectiveness of a system of internal control and help to document such an assessment.

.27 The scenarios illustrate several important aspects of an assessment of the effectiveness of a system of internal control, including (i) whether a single component and relevant principles are present and functioning and (ii) whether the five components are operating together in an integrated manner. The scenarios also illustrate several practical examples of how the templates can be used to support an assessment of the effectiveness of a system of internal control.

.28 The *Illustrative Tools* is not designed to satisfy any criteria established through laws, rules, regulations, or external standards for evaluating the severity of internal control deficiencies associated with a particular entity objective, such as external financial reporting.

What should companies start to think about?

.29 For users of the original framework, COSO has indicated the *Framework* will help organizations update their systems of internal control to reflect changes in business and operating environments during the last two decades, broaden the application of internal control to their operations, compliance and reporting objectives, and better understand the requirements for demonstrating effective internal control.
.30 For public companies that apply the original framework for compliance with Section 404(a) or (b) of the Sarbanes-Oxley Act of 2002, COSO has further indicated the Framework is not expected to fundamentally change an entity's internal control over financial reporting or related assessment process. It has also recommended that management of these companies should begin to assess how each of the seventeen principles is present and functioning and the five components operate together in their circumstances.

.31 COSO has indicated that senior management should discuss with the board of directors its plan to adopt the Framework as soon as practical. The board of directors should oversee management's assessment of any implications of, and determination of appropriate actions for, applying the Framework.

PwC observation:

We believe that all seventeen principles will be relevant to SEC filers and to most other entities because they have a significant bearing on the presence and functioning of the associated components of internal control. In those rare instances where a principle may not be relevant, the Framework requires management to support this determination with the rationale of how, absent that principle, the component can be present and functioning.

We believe that COSO's requirement for effective internal control – each of the components and relevant principles are present and functioning and the components are operating together in an integrated manner – does not impose a higher threshold or more significant burden for management to demonstrate the entity's internal control over financial reporting is effective.

We believe users of the Framework will first need to determine which principles are relevant for its business. Next, management will need to demonstrate, and provide persuasive evidence, that each of the relevant principles associated with the five components are present and functioning across the business. That evidence will generally entail mapping the relevant principles to existing controls within each of the components to assess whether such relevant principles are present and functioning in support of the entity's objectives. The points of focus will be particularly useful in this respect. For any gaps in design, management will need to establish a process for identifying, assessing, and implementing necessary changes in controls and related documentation.

At the same time, we believe taking a fresh look at internal control over financial reporting will increase confidence through better understanding of how an organization considers the connections of specific financial reporting objectives and related risks and controls across business. In addition, determining whether each relevant principle is present and functioning across a business is expected to help identify and assess hidden risks, as well as new challenges and changes that introduce risks, of achieving external financial reporting objectives.

On a broader scale, the Framework provides an opportunity to refresh systems of internal control and consider new applications of the Framework. For example, controls designed to evaluate whether to accept a new customer agreement may (or may not) consider overlapping operational and internal reporting objectives, in addition to supporting a system of internal control over financial reporting. A comprehensive, integrated approach to internal control may help in designing controls to achieve multiple, overlapping objectives, and mitigate interdependent risks.
Transition

.32 On May 14, 2013, COSO published the Framework, Illustrative Tools, and ICEFR Compendium. COSO has previously announced that it will continue to make available the original framework during the transition period extending to December 15, 2014, after which time COSO will consider the original framework as having been superseded. In addition, the Internal Control over Financial Reporting—Guidance for Smaller Public Companies will be retired when the original framework is superseded.

.33 COSO has indicated that continued use of the original framework is appropriate during this transition period, and that any application of the Framework that involves external reporting should clearly disclose whether the original framework or updated Framework was utilized.

PwC observation:

We believe the transition period of May 14, 2013 to December 15, 2014 will provide sufficient time for organizations to evaluate their existing systems of internal control over financial reporting against the relevant principles set out in the Framework. We concur with COSO’s decision to recognize and support only the Framework as its Internal Control–Integrated Framework after December 15, 2014.

.34 COSO has indicated that users of the original framework should transition their applications and related documentation to the Framework as soon as is feasible under their particular circumstances. As noted previously, during the transition period, COSO acknowledges that organizations that must comply with regulatory requirements for reporting on the effectiveness of their internal control over external financial reporting should clearly disclose whether the original framework or updated Framework was utilized.

PwC observation:

We also encourage users of the original framework to assess as soon as practical any implications of transitioning to the updated Framework and to determine what, if any, new or modified controls and documentation are needed. Then, management should deploy any such controls and update related documentation needed to transition timely applications to the Framework. We understand differing circumstances will impact the extent of time necessary for users to assess and implement any necessary changes in the design, operations or related documentation.

We believe companies could meet COSO’s recommendation by referring to the extant framework as “Internal Control–Integrated Framework (1992)” and the not yet effective framework as “Internal Control–Integrated Framework (2013)”.

Questions

.35 PwC clients who have questions about this Dataline should contact their engagement partner. PwC engagement teams that have questions can obtain additional information on Spark or kCurve or send an inquiry to ICIF@us.pwc.com.

.36 In addition, further information regarding the Framework and related illustrative documents can be found on the COSO website www.coso.org.
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