

# *Internal Control Environment*

## Key considerations & developments

13 January 2014

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# *Agenda*

1. Introduction
2. COSO Update
3. ICFR Considerations (PCAOB Alert)
4. Key Takeaways



*Section 1*  
Introduction

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# ***Introduction***

- The scope of this session is to discuss **recent developments and relevant considerations regarding internal controls.**
- Internal controls are important to every organization, as they represent *‘the processes effected by the BoD, management and other personnel to provide reasonable assurance regarding the achievement of objectives.’*

## *Examples:*

- *Authorizations on transactions, such as payments, vessel acquisitions etc.*
- *Procedures and policies etc.*
- *Reviews and checks, such as MGA reconciliations etc.*
- *Monitoring of business results, such as budget versus actual etc.*
- Listed companies are subject to regulatory requirements for reporting on their internal controls.

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# *Introduction*

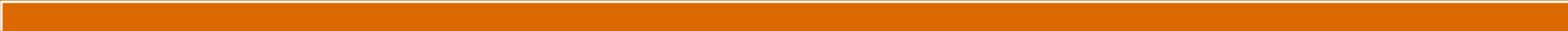
In the context of the aforementioned, this presentation addresses the following:

**1**

**Recent update of the COSO framework**, which is the leading framework used for designing, implementing and assessing internal control and for establishing requirements for an effective system of internal control.

**2**

**Considerations regarding Internal Controls over Financial Reporting** following PCAOB alert release.

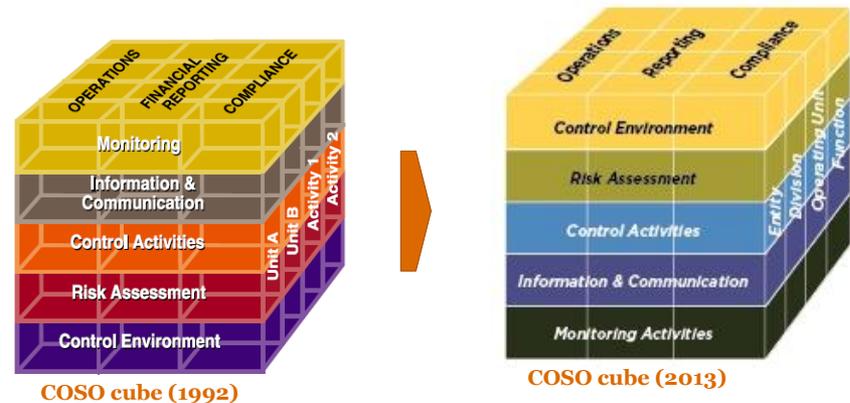


*Section 2*  
COSO Update

# COSO Update

## Overview

- Originally issued in 1992, COSO's *Internal Control – Integrated Framework (the '1992' Framework)* became one of the most widely accepted internal control framework in the world.
- On May 14, 2013 the Committee released an updated version of its *Internal Control – Integrated Framework (the '2013' Framework)*.
- The updates are not meant to be a complete overhaul, but rather serve as more clarification to ease the use and application of the existing guidance.
- The transition period from the '1992' version to the '2013' version runs until **December 15, 2014**.



# ***COSO Update***

## **Drivers for change**

In the last 20 years since the original framework, the business environment has changed driving leading businesses to evolve their internal control systems. The updated framework has been introduced in response to an increasingly complex, technologically driven and global business environment to address key issues for organizational success.

### **Most businesses are planning changes that can impact controls**

Do you anticipate a major change at your company in the following areas over the next 12 months?



Base: 1,330 global CEOs.  
Source: PwC, 16th Annual Global CEO Survey, January 2013.

### **Goals for the 2013 Update:**

- Update the context for reflecting changes in business and operating environments;
- Broaden the framework's application by expanding the operations and reporting objectives;
- Clarify the requirements of effective internal control.

# ***COSO Update***

## Similarities and Differences

### What is not changing

1. Core definition of internal control
2. Three categories of objectives and five components of internal control
3. Effective internal control requires each of the five components
4. Use of judgment remains important on designing, implementing and conducting internal control and in assessing effectiveness



**COSO cube (2013 Edition)**

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# ***COSO Update***

## Similarities and Differences (cont'd)

### What is changing

1. Expansion of the scope of reporting objectives beyond financial information
2. Changes in business and operating environment are considered
3. Formalization of fundamental concepts introduced in the original framework into seventeen principles
4. Points of focus that highlight important characteristics of the principles included
5. Additional approaches and examples added
6. Explicit consideration of outsourced service providers and other third parties affecting internal control
7. Explicit consideration of the potential for fraud in risk assessment
8. Specific principle related to IT

# ***COSO Update***

## 17 Principles associated to Internal Control components

|                             |                                                                                                                                                                                                                                                                                                             |
|-----------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Control Environment         | <ol style="list-style-type: none"><li>1. Demonstrates commitment to integrity and ethical values</li><li>2. Exercises oversight responsibility</li><li>3. Establishes structure, authority and responsibility</li><li>4. Demonstrates commitment to competence</li><li>5. Enforces accountability</li></ol> |
| Risk Assessment             | <ol style="list-style-type: none"><li>6. Specifies suitable objectives</li><li>7. Identifies and analyzes risk</li><li>8. Assesses fraud risk</li><li>9. Identifies and analyzes significant change</li></ol>                                                                                               |
| Control Activities          | <ol style="list-style-type: none"><li>10. Selects and develops control activities</li><li>11. Selects and develops general controls over technology</li><li>12. Deploys through policies and procedures</li></ol>                                                                                           |
| Information & Communication | <ol style="list-style-type: none"><li>13. Uses relevant information</li><li>14. Communicates internally</li><li>15. Communicates externally</li></ol>                                                                                                                                                       |
| Monitoring Activities       | <ol style="list-style-type: none"><li>16. Conducts ongoing and/or separate evaluations</li><li>17. Evaluates and communicates deficiencies</li></ol>                                                                                                                                                        |

# ***COSO Update***

## Components and principles effected by controls

Each component and each relevant principle must be present and functioning and all components must operate together

Controls provide persuasive evidence that relevant principles are present and functioning across the entity



5  
Components

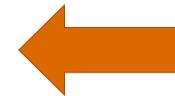
17 Principles

Points of focus

Controls

Principles are important characteristics of components

Points of focus are important characteristics of principles



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

# ***COSO Update***

## **Illustrative example**

### **Component: Risk Assessment**

*Principle 8: The organization considers the potential for fraud in assessing risks to the achievement of objectives*

#### Points of Focus

- Considers various types of fraud
- Assesses incentive and pressures
- Assesses opportunities
- Assesses attitudes and rationalizations.

#### Approach: *Considering approaches to circumvent or override controls*

In identifying and evaluating the presence of entity-wide controls that addresses fraud, management considers how individuals might circumvent or override controls through a number of ways, which may include:

- Recording fictitious business events or transactions
- Changing the timing of recognition of legitimate transactions (particularly those recorded close to year end of an accounting period)
- Establishing or reversing reserves to manipulate results
- Altering records and terms related to significant or unusual transactions.

*For the above please refer to COSO, “Internal Control – integrated Framework”, May 2013*

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# ***COSO Update***

## **Illustrative example (cont'd)**

### **Example: Maintaining oversight**

The Audit Committee of the company takes the issue of management override of controls very seriously. Consequently, every quarter the Committee reviews the fraud risk assessment process. In doing so, the members of the Audit Committee:

- Maintain an appropriate level of skepticism
- Discuss management's assessment of fraud risks
- Use the code of conduct to assess financial reporting culture
- Ensure the entity has a robust whistle-blower program
- Develop a broad information and feedback network

In addition, the Audit Committee asks the Chief Audit Executive about:

- What fraud risks are being monitored by the internal audit team on a periodic basis or regular basis
- What specific procedures internal audit performs to address management override of internal controls
- Whether anything has occurred that would lead internal audit to change its assessment of the risk of management override of internal controls. With this information in hand, the Audit Committee discusses with the full board and senior management any concerns that need added management focus

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# ***COSO Update***

## Implications for the transition

The **impact** of the updated framework on each organisation will **vary based on the specific characteristics of each company**, such as:

- Changes to the current internal control system required to address all principles
- Application and interpretation of the original framework
- New opportunities to apply internal control to cover additional objectives

### Companies applying the SOX Act:

- Not expected to fundamentally change companies' ICFR
- Impact on management's assessment of the effectiveness of the ICFR will depend on how the company applied and interpreted the concepts in the original Framework

# ***COSO Update***

## Steps to transition

| <b>Phase</b>                                                  | <b>Key Actions</b>                                                                                                                                                                                                                                                                   |
|---------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Phase 1: Educate and communicate                              | <ul style="list-style-type: none"><li>▪ Review 2013 Framework and illustrative tools</li><li>▪ Conduct training for BoD, Management and Personnel</li><li>▪ Develop understanding of where principles and points of focus are relevant at the entity and functional levels</li></ul> |
| Phase 2: Conduct preliminary assessment                       | <ul style="list-style-type: none"><li>▪ Map the 17 principles to existing controls</li><li>▪ Identify any 'gaps' in the design or documentation of controls</li></ul>                                                                                                                |
| Phase 3: Complete Assessment & Develop Transition Action Plan | <ul style="list-style-type: none"><li>▪ Assess operating effectiveness of controls</li><li>▪ Identify necessary changes in controls or documentation to effect the principles and remediate 'gaps'</li><li>▪ Develop transition action plan</li></ul>                                |
| Phase 4: Execute Transition Action Plan                       | <ul style="list-style-type: none"><li>▪ Remediate controls and related documentation</li><li>▪ Communicate significant changes to Audit Committee</li><li>▪ Co-ordinate and communicate with external auditor</li></ul>                                                              |

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# ***COSO Update***

## Opportunities and Challenges

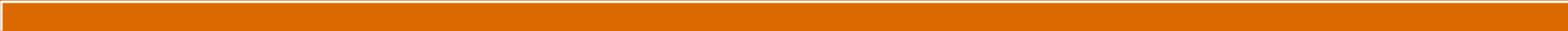
### **Opportunities**

The transition to the updated framework presents an opportunity to Companies to take a fresh look at their Internal Control system and consider new applications of the Framework and:

- Improve governance
- Improve quality of risk assessment
- Respond to increasing internal control and governance requirements imposed by regulators and third parties
- Improve anti-fraud controls and initiatives
- Focus on 'important' risks and controls
- Enhance operations, reporting and compliance

### **Challenges**

- Reluctance to challenge or change how Internal Controls are evaluated
- Explicit considerations related to outsourced activities are included in the updated framework. Limited access and knowledge over controls operated by the service provider might impose a challenge for management
- Effective communication and awareness throughout the organization should be ensured



*Section 3*  
ICFR Considerations (PCAOB Alert)

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# ***ICFR Considerations***

## **PCAOB alert – Considerations for audits of ICFR**

Accounting firms that audit public companies are subject to periodic inspection by the PCAOB according to the requirements of the Sarbanes Oxley Act of 2002.

On 24/10/2013, the PCAOB released an alert regarding audits of Internal Controls over Financial Reporting in light of significant auditing practice issues observed in the past three years.

The alert discusses several topics regarding audits or internal control in which significant deficiencies have been frequently cited in PCAOB inspection reports, including issues related to:

- **Testing management review controls**
- Information technology (“IT”) considerations, including **system generated data and reports**

# ***ICFR Considerations***

## Review controls

Although there is no specific definition, the term “review control” is generally used to describe those controls whereby **the control operator reviews certain information and takes other necessary actions based on the results of the review.**

Examples of “review controls” include:

- Reviews of journal entries
- Reviews of reconciliations
- Entity level controls that monitor the results of operations
- Supervisory review of final calculations or other analyses related to estimates or other accounting judgments
- Reviews of effectiveness of other controls

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# ***ICFR Considerations***

## Review controls - Management considerations

The ability of the auditor to evaluate and ultimately rely on review controls is often impacted by the extent of management documentation that supports the design and execution of such controls.

Thus, management should consider the following regarding documentation and assessment of the company's review controls:

- ✓ Whether the **level of detail of management documentation** is sufficient to support the evaluation of the design of the control (details on what the control operator does in executing the control, including reliability of the data used for the control execution etc.)
- ✓ Whether management documentation supports a reasonable conclusion that the reviewer **would prevent or detect material misstatement**
- ✓ Whether the **documentation produced by the execution of the control is sufficiently detailed** to support a reasonable conclusion about the operating effectiveness of the control
- ✓ **Consistency** of control application

# ***ICFR Considerations***

## Evaluation of review controls precision

The evaluation of review controls should take into consideration the following:

|                                 |                                                                                                                                                                                                   |
|---------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Intended purpose of the control | <ul style="list-style-type: none"><li>• What is the reviewer expected to accomplish for this control activity?</li></ul>                                                                          |
| Source of information           | <ul style="list-style-type: none"><li>• What information is used for executing the control?</li></ul>                                                                                             |
| Level of aggregation            | <ul style="list-style-type: none"><li>• A control that is performed at a more granular level is more precise than one performed at a higher level.</li></ul>                                      |
| Consistency of performance      | <ul style="list-style-type: none"><li>• A control that is performed routinely and consistently is generally more precise than one performed sporadically</li></ul>                                |
| Correlation to relevant risks   | <ul style="list-style-type: none"><li>• How is the control responsive to the likely sources of potential misstatement to which it is linked.</li></ul>                                            |
| Criteria for investigation      | <ul style="list-style-type: none"><li>• The specific criteria and/or thresholds used to guide when follow-up/investigation is to be performed.</li></ul>                                          |
| Predictability of expectation   | <ul style="list-style-type: none"><li>• The extent to which effectiveness depends on the development of sufficiently precise expectations to highlight potential material misstatements</li></ul> |

# ***ICFR Considerations***

## Review controls – Examples

Indicative  
only

### Review of impairment test

Documentation should address the following:

- Assumptions used
- Procedures to review reasonability of assumptions
- Procedures to verify accuracy of data used or inserted in the test
- Procedures to verify clerical accuracy of calculations

### Review of budget and budget versus actual analysis

Documentation should address the following:

- Assumptions used for the preparation of the budget
- Procedures to review reasonability of assumptions
- Procedures to verify clerical accuracy of calculations
- Threshold set for variations explanation

# ***ICFR Considerations***

## System generated reports

There are instances that **the effectiveness of internal controls depends on the completeness and accuracy of system-generated reports or data.**

### Examples:

- At the end of each quarter, the Accounting Manager reviews the recordings of accrued operating expenses based on the 'Open Orders' list generated by the accounting system, which indicates delivery dates, open and invoiced orders.
  - *If the data in Open Orders list is not accurate and complete, will the review be effective?*
  
- The Accounting Manager reviews the depreciation expense based on an excel spreadsheet used for the depreciation calculation.
  - *If data (i.e. vessel cost, additions) and calculation in the spreadsheet is not accurate will the review be effective?*

# ***ICFR Considerations***

## **System generated reports – Management considerations**

When assessing effectiveness of ICFR, management should consider the following related to system generated reports:

Identify significant controls that depend upon system generated reports

Assess whether the relevant control validates the completeness and accuracy of the system generated reports or if other controls have been established

Assess effectiveness of controls in terms of the following elements:

- Source data
- Logic and parameters

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*Section 4*  
Key Takeaways

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# Key Takeaways

1

*The recent developments in the COSO framework represent an opportunity for companies to enhance value and improve their methods and tools*

2

*Challenges in the implementation of the updated framework need to be addressed through effective communication to all related parties and a structured approach to transition*

3

*Additional considerations in internal controls over financial reporting are imposed on US listed companies*

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# *Thank you!*

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