Improving Internal Controls Under the New COSO Framework

Meeting Stricter Principles-Based Standards and Identifying Material Weaknesses

TUESDAY, FEBRUARY 24, 2015, 1:00-2:50 PM EASTERN

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Improving Internal Controls Under the New COSO Framework

Feb. 24, 2015

Lorraine Kelly, Delaney Consulting

lkelly@delaneyllc.com

Kim Mobley, Johnson Lambert

kmobley@johnsonlambert.com

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The New COSO Framework

Planned Topics

- New COSO Framework

  - Why update the original framework?
  - What is changing?
  - New areas of emphasis
  - Overview of principles
  - Impact and opportunities

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Transition Commentary – Tone has become more aggressive

"**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 at some point in the future."

> Paul Beswick, *Chief Accountant, Office of the Chief Accountant*
> *U.S. Securities and Exchange Commission*
> May 30, 2013

"I continue to **question whether all material weaknesses are being properly identified**. It is surprisingly rare to see management identify a material weakness in the absence of a material misstatement."

> Brian T. Croteau, *Deputy Chief Accountant, Office of the Chief Accountant*
> *U.S. Securities and Exchange Commission*
> December 9, 2013

"Unfortunately, over the decades, we've seen multiple cycles in which **company management and internal and external auditors simply didn't get it right** in the area of internal control, resulting in failures to effectively define, understand, implement, and assess internal control."
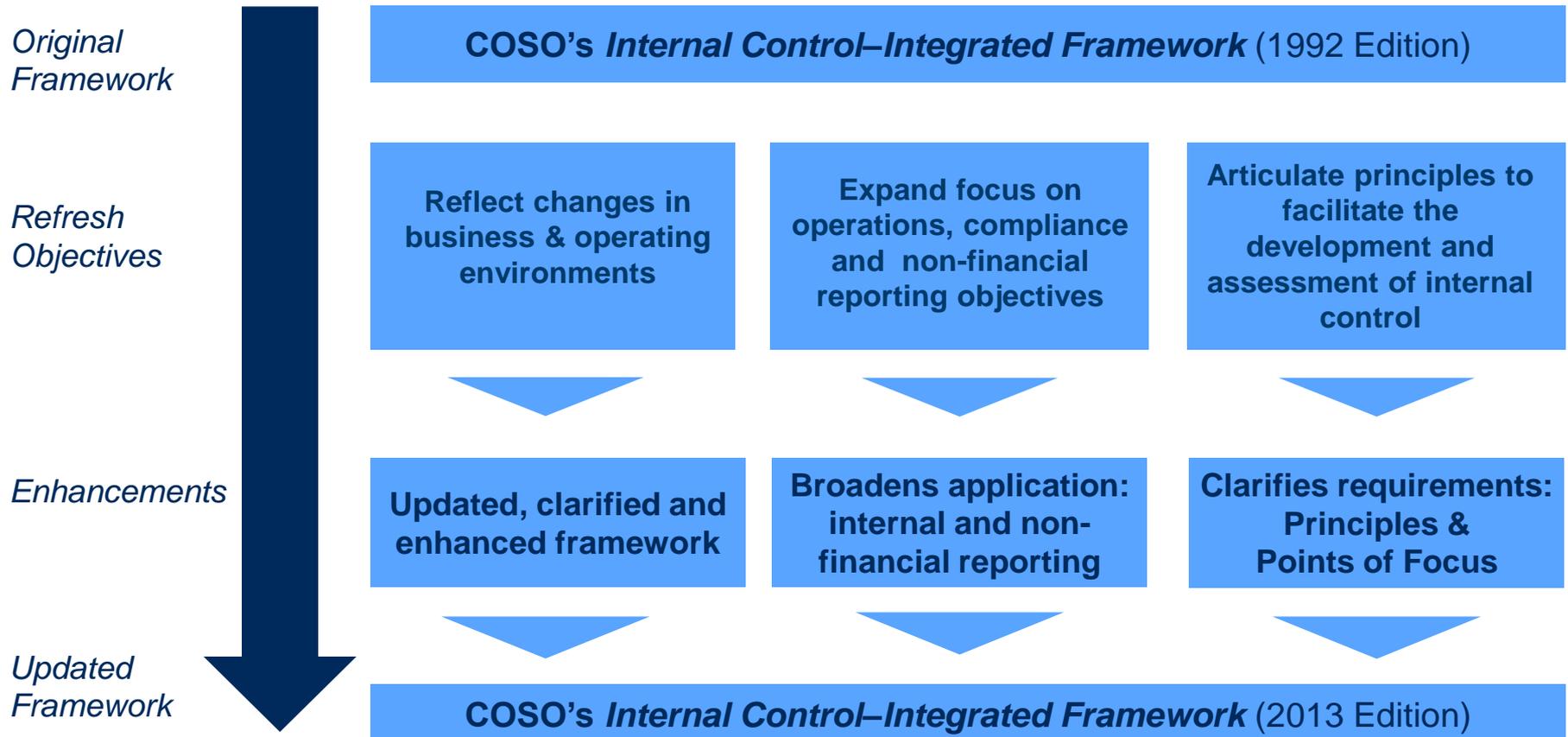
> Jeanette M. Franzel, Board Member
> PCAOB
> March 26, 2014

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Background

- COSO is a joint initiative of five supporting organizations
  - Institute of Management Accountants (IMA)
  - American Accounting Association (AAA)
  - American Institute of Certified Public Accountants (AICPA)
  - Institute of Internal Auditors
  - Financial Executives International (FEI)

- 1992 Original Framework
  - Established a common internal control model against which companies and organizations may assess their control systems

- Enhancing the Original Framework
  - Updates to reflect changes in the business world over the past 20 years

Why update the original framework?

Original Framework

COSO's *Internal Control–Integrated Framework* (1992 Edition)

Refresh Objectives

Reflect changes in business & operating environments

Expand focus on operations, compliance and non-financial reporting objectives

Articulate principles to facilitate the development and assessment of internal control

Enhancements

Updated, clarified and enhanced framework

Broadens application: internal and non-financial reporting

Clarifies requirements: Principles & Points of Focus

Updated Framework

COSO's *Internal Control–Integrated Framework* (2013 Edition)

Source: COSO Outreach Deck – May 2013 (www.**coso**.org/documents/**COSOOutreachDeck**May2013.pptx)

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What is remaining the same?

- The 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 relating to operations, reporting and compliance.
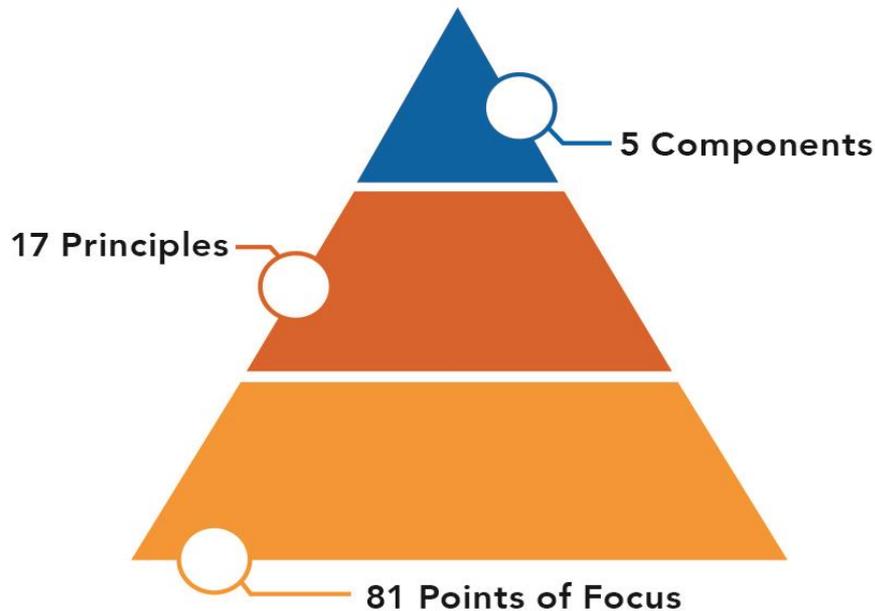
- The three categories of objectives
- The five components of internal control
- The requirement to consider each of the five components to assess effectiveness
- The use of judgment in designing, implementing and evaluating the effectiveness of systems of internal control

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What are the key changes?

- Principles-based approach

- 5 components of internal control

- 17 principles that must be present and functioning in an effective system of internal control

- 81 points of focus are typically important characteristics of the 17 principles

Source: COSO Outreach Deck – May 2013 (www.**coso**.org/documents/**COSOOutreachDeck**May2013.pptx)

What are the key changes?

- 17 principles are aligned with each of the five components

- Requirements of COSO principles
  - Must be <u>present</u> and <u>functioning</u>
  - Must operate in an integrated manner

- Added <u>Points of Focus</u> for each principle
  - Important characteristics of principles
  - Items management can consider to determine if the principles are present and functioning

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New areas of emphasis

- **Risk assessment**
  - Increased focus on risk assessment process, and responding to assessed level of risk
  - Risk assessment related to fraud (Principle 8)

- **Information technology**
  - 14 of the 17 Principles include IT considerations
  - Includes IT general controls, and quality of data used to execute controls (Principe 13)

- **Outsourced service providers (OSPs)**
  - 12 of the 17 principles address monitoring of control activities performed by third-parties
  - Management retains responsibility for the controls

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COSO Components and Principles

Update articulates principles of 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

Source: COSO Outreach Deck – May 2013 (www.**coso**.org/documents/**COSOOutreachDeck**May2013.pptx)

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| Control Environment | Risk Assessment | Control Activities | Information & Communication | Monitoring Activities |

Principle 1

➢ The organization demonstrates a commitment to integrity and ethical values

Points of Focus

- Sets the tone at the top

- Establishes standards of conduct

- Evaluates adherence to standards of conduct

- Addresses deviations in a timely manner

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Principle 2

➢ The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control

Points of Focus

- Establishes oversight responsibilities

- Applies relevant expertise

- Operates independently

- Provides oversight on Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring Activities

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Principle 3

➢ Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives

Points of Focus

- Considers all structures of the entity

- Establishes reporting lines

- Defines, assigns, and limits authorities and responsibilities

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Principle 4

➢ 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

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Principle 5

➤ The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives

Points of Focus

- Enforces accountability through structures, authorities and responsibilities
- Establishes performance measures, incentives and rewards
- Evaluates performance measures, incentives and rewards for ongoing relevance
- Considers excessive pressures
- Evaluates performance and rewards or disciplines individuals

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Principle 6	Points of Focus

➢ The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives
  ➢ Operational
  ➢ External Financial Reporting
  ➢ External Non-Financial Reporting
  ➢ Internal Reporting
  ➢ Compliance
	• Reflects management's choices
	• Considers tolerances for risk
	• Includes operations and financial performance goals
	• Forms a basis for committing of resources
	• Complies with applicable accounting standards
	• Considers materiality
	• Reflects entity activities
	• Complies with externally established standards and frameworks
	• Considers the required level of precision
	• Reflects entity activities
	• Reflects management's choices
	• Considers the required level of precision
	• Reflects entity activities
	• Reflects external laws and regulations
	• Considers tolerances for risk

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Principle 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

Points of Focus

- Includes entity, subsidiary, division, operating unit, and functional levels

- Analyzes internal and external factors

- Involves appropriate levels of management

- Estimates significance of risks identified

- Determines how to respond to risks

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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 incentives and pressures

- Assesses opportunities

- Assesses attitudes and rationalizations

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Principle 9

➤ The organization identifies and assesses changes that could significantly impact the system of internal control

Points of Focus

- Assesses changes in the external environment

- Assesses changes in the business model

- Assesses changes in leadership

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"Control activities are the actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives are carried out.

Control activities are performed at all levels of the entity, at various stages within business processes, and over the technology environment.

They may . . . encompass a range . . . of activities . . .

Where segregation of duties is not practical, management selects and develops alternative control activities."

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Principle 10

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

Points of Focus

- Integrates with Risk Assessment
- Considers Entity-Specific Factors
- Determines Relevant Business Processes
- Evaluates a Mix of Control Activity Types
- Considers at What Level Activities Are Applied
- Addresses Segregation of Duties

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Principle 11

➤ The organization selects and develops general control activities over technology to support the achievement of objectives

Points of Focus

- Determines Dependency between the Use of Technology in Business Processes and Technology General Controls
- Establishes Relevant Technology Infrastructure Control Activities
- Establishes Relevant Security Management Process Control Activities
- Establishes Relevant Technology Acquisition, Development, and Maintenance Process Control Activities

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Principle 12

➢ The organization deploys control activities through policies that establish what is expected and procedures that put policies into action

Points of Focus

- Establishes Policies and Procedures to Support Deployment of Management's Directives
- Establishes Responsibility and Accountability for Executing Policies and Procedures
- Performs in a Timely Manner
- Takes Corrective Action
- Performs Using Competent Personnel
- Reassesses Policies and Procedures

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| Control Environment | Risk Assessment | Control Activities | Information & Communication | Monitoring Activities |

"Information is necessary for the entity to carry out internal control responsibilities to support the achievement of its objectives. Management obtains or generates and uses relevant and quality information from both internal and external sources to support the functioning of internal control. Communication is the continual, iterative process of providing, sharing, and obtaining necessary information. Internal communication is the means by which information is disseminated throughout the organization, flowing up, down, and across the entity. It enables personnel to receive a clear message from senior management that control responsibilities must be taken seriously. External communication is twofold: it enables inbound communication of relevant external information and provides information to external parties in response to requirements and expectations.

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Principle 13

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

Points of Focus

- Identifies Information Requirements
- Captures Internal and External Sources of Data
- Processes Relevant Data into Information
- Maintains Quality throughout Processing
- Considers Costs and Benefits

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| Control Environment | Risk Assessment | Control Activities | Information & Communication | Monitoring Activities |

Principle 14

➢ The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control

Points of Focus

- Communicates Internal Control Information
- Communicates with the Board of Directors
- Provides Separate Communication Lines
- Selects Relevant Method of Communication

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| Control Environment | Risk Assessment | Control Activities | Information & Communication | Monitoring Activities |

Principle 15

➢ The organization communicates with external parties regarding matters affecting the functioning of internal control

Points of Focus

- Communicates to External Parties
- Enables Inbound Communication
- Communicates with the Board of Directors
- Provides Separate Communication Lines

"COSO's 2008 *Guidance on Monitoring Internal Control Systems* (COSO's Monitoring Guidance) was developed to clarify the monitoring component of internal control. It does not replace the guidance first issued in the COSO Framework or in COSO's 2006 *Internal Control over Financial Reporting — Guidance for Smaller Public Companies* (COSO's 2006 Guidance). Rather, it expounds on the basic principles contained in both documents, guiding organizations in implementing effective and efficient monitoring."

Source: **Guidance on Monitoring**
Internal Control Systems - The Committee of Sponsoring Organizations of the Treadway Commission (COSO)

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"Unmonitored controls tend to deteriorate over time. Monitoring, as defined in the COSO Framework, is implemented to help ensure "that internal control continues to operate effectively."
When monitoring is designed and implemented appropriately, organizations benefit because they are more likely to:
Identify and correct internal control problems on a timely basis, Produce more accurate and reliable information for use in decision-making, Prepare accurate and timely financial statements, and
Be in a position to provide periodic certifications or assertions on the effectiveness of internal control. Over time effective monitoring can lead to organizational efficiencies and reduced costs associated with public reporting on internal control because problems are identified and addressed in a proactive, rather than reactive, manner.

Source: **Guidance on Monitoring**
Internal Control Systems - The Committee of Sponsoring Organizations of the Treadway Commission (COSO)

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Principle 16

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

Points of Focus

- Considers a Mix of Ongoing and Separate Evaluations
- Considers Rate of Change
- Establishes Baseline Understanding
- Uses Knowledgeable Personnel
- Integrates with Business Processes
- Adjusts Scope and Frequency
- Objectively Evaluates

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Principle 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 the board of directors, as appropriate

Points of Focus

- Assesses Results
- Communicates Deficiencies
- Monitors Corrective Actions

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Delaney Consulting, LLC

We Know Finance

Lorraine J. Kelly, CEO
LKelly@DelaneyLLC.com
www.DelaneyLLC.com

3535 Peachtree Rd N.E.
Suite 520-310
Atlanta GA 30326
Tel: 678-462-0455