Internal Control—Integrated Framework

COSO Framework
Learning Objectives

• Participants will be able to:
  – Summarize the basic COSO framework.
  – Identify the controls required of government financial managers.
  – Differentiate between control components, principles and characteristics.
  – Apply the COSO framework to the business processes of the State.
Table of Contents

- COSO & Project Overview
- Internal Control-Integrated Framework
- Illustrative Documents
  - Illustrative Tools for Assessing Effectiveness of a System of Internal Control
  - Internal Control over External Financial Reporting: A Compendium of Approaches and examples
- Transition & Impact
- Recommended Actions
- Questions & Comments
COSO & Project Overview
COSO Overview – Internal Control Publications

The Framework has Become the **Most Widely Adopted Control Framework Worldwide**

**Original Framework**

**Refresh Objectives**
- Reflect changes in business & operating environments
- Expand operations and reporting objectives
- Articulate principles to facilitate effective internal control

**Enhancements**
- Updates Context
- Broadens Application
- Clarifies Requirements

**Updated Framework**


Project Timetable

- Assess & Survey Stakeholders
- Design & Build
- Public Exposure, Assess & Refine
- Finalize

2010 → 2011 → 2012 → 2013
Project Participants

COSO Board of Directors

PwC
Author & Project Leader

COSO Advisory Council

- AICPA
- AAA
- FEI
- IIA
- IMA
- Public Accounting Firms
- Regulatory observers (SEC, GAO, FDIC, PCAOB)
- Others (IFAC, ISACA, others)

Stakeholders

- Over 700 stakeholders in Framework responded to global survey during 2011
- Over 200 stakeholders publically commented on proposed updates to Framework during first quarter of 2012
- Over 50 stakeholders publically commented on proposed updates in last quarter of 2012

- 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
Project Deliverable #2 – Internal Control over External Financial Reporting: A Compendium....

- 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
Internal Control–Integrated Framework
## Updated to Increase Ease of Use and Broaden Application

### What is *not* 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

### What is changing...

- 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 considered changes in business and operating environments

*Environments 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 technologies
- Expectations relating to preventing and detecting fraud

COSO Cube (2013 Edition)
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
Control Environment

1. The organization demonstrates a commitment to integrity and ethical values.

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

3. Management establishes, with 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.
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.
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.
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.
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 the board of directors, as appropriate.
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
Characteristics of Principles

Control Environment

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

– Points of focus may not be suitable or relevant, and others may be identified
– Points of focus may facilitate designing, implementing, and conducting internal control
– There is no requirement to separately assess whether points of focus are in place
Role of Controls to Effect Principles

- The Framework does not prescribe controls to be selected, developed, and deployed for effective internal control
- An organization’s selection of controls to effect relevant principles and associated components is a function of management judgment based on factors unique to the entity

• A major deficiency in a component or principle cannot be mitigated to an acceptable level by the presence and functioning of other components and principles
  - However, understanding and considering how controls effect multiple principles can provide persuasive evidence supporting management’s assessment of whether components and relevant principles are present and functioning
How Various Controls Effect Principles

Component: Control Environment

Principle 1. The organization demonstrates a commitment to integrity and ethical values.

Controls embedded in other components may effect this principle

- Human Resources review employees' confirmations to assess whether standards of conduct are understood and adhered to by staff across the entity.

- Management obtains and reviews data and information underlying potential deviations captured in whistleblower hot-line to assess quality of information.

- Internal Audit separately evaluates Control Environment, considering employee behaviors and whistleblower hotline results and reports thereon.
Summary of Public Exposure of Proposed Update

- Interest across geographic regions – approximately 50% of respondents from North America and 50% from international regions
- Proposed updates to Framework released for public comments:
  - December 20, 2011 to March 31, 2012
  - September 18, 2012 to December 4, 2012
- COSO sought comments from the general public on proposed updates, including whether the:
  - Requirements of effective internal control are clearly set forth
  - Roles of components, principles, and points of focus are clearly set forth
  - Framework remains sound, logical, and useful to management of entities of all types and sizes
Responsive to Public Comments

• Principles
  – Provide clarity regarding the role of principles in designing, implementing, and conducting internal control, and assessing its effectiveness
  – Clarify descriptions of some principles, but no additional principles
• Effectiveness
  – Recognize effective internal control can provide reasonable assurance of achieving effective and efficient operations objectives (as noted before)
  – Clarify requirement that each of the components and relevant principles must be present and functioning and components must operating together
  – Remove presumption that points of focus are present and functioning, and clarify that no separate assessment of points of focus is required
  – Standardize classification of internal control deficiencies, and clarify use of only relevant criteria established in laws, rules, regulations and standards
Responsive to Public Comments (continued)

- **Objective Setting**
  - Retain five components of internal control
  - Retain specification of objectives as a principle of effective internal control, but objective setting may be driven by laws, rules, regulations, or external standards that are outside a system of internal control

- **Objectives**
  - Retain view that safeguarding of assets primarily relates to operations objectives, and recognize its consideration within reporting and compliance
  - Acknowledge some laws rules, regulations and standards establish safeguarding of assets as a separate category of objectives
  - Retain view that strategic objectives is not part of internal control
  - Retain operations, reporting, and compliance objective categories, and expand descriptions
Responsive to Public Comments (continued)

• Enterprise Risk Management (ERM)
  – Retain distinction between ERM and internal control, and acknowledge these frameworks are complementary
  – Retain view that strategy-setting, strategic objectives, and risk appetite are aspects of ERM, not Internal Control-Integrated Framework
  – Retain discussion of risk appetite and application of risk tolerance
• Smaller Entities and Governments – Provide additional guidance specific to smaller entities and governments (Appendix C)
• Technology
  – Expand discussion in the points of focus and in several chapters
  – Decline suggestion to address risk associated with specific technologies because of the rapid pace of change
Responsive to Public Comments (continued)

- Structure and Layout – Retain view that all chapters 1-10 comprise the Framework
- Due Process – COSO believes there has been a substantive due process effort to capture views on proposed update
  - Surveyed stakeholders to ascertain preferences concerning nature and extent of needed updates; 700 responses (December 2010 to September 2011)
  - Conducted eleven meetings with COSO Advisory Council
  - Provided exposure drafts of proposed updates for public comments (December 2011 to March 2012, and September to December 2012)
  - Participated in many conferences, webinars, and seminars with membership of COSO to seek views of stakeholders (January 2011 to January 2013)
Illustrative Documents:

- Illustrative Tools for Assessing Effectiveness of a System of Internal Control

- Internal Control over External Financial Reporting: A Compendium of Approaches and Examples
Illustrative Tools for Assessing Effectiveness of a System of Internal Control

• Assist users when assessing effectiveness of internal control based on the requirements set forth in the Framework
  – Templates illustrate a possible summary of assessment results
  – Scenarios illustrate practical examples of how the templates can be used to support an assessment and important considerations in performing an assessment

• Focus on evaluating components and relevant principles, not the underlying controls that affect relevant principles

• Cannot satisfy criteria established through laws, rules, regulations, or external standards for evaluating the severity of internal control deficiencies

• Can customize level and amount of detail included in the templates as management may deem necessary
Internal Control over External Financial Reporting (ICEFR): A Compendium of Approaches and Examples

- Approaches and Examples illustrate how various characteristics of principles may be present and functioning within a system of internal control relating to external financial reporting
  - Approaches are designed to give a summary-level description of activities that management may consider as they apply the Framework
  - Examples illustrate one or more points of focus of a particular principle. They are not designed to provide a comprehensive, end-to-end example of how a principle may be fully applied in practice.
  - Selected approaches and examples do not illustrate all aspects of components and relevant principles that would be necessary for effective internal control
- Stakeholders should refer to the Framework for the requirements of effective internal control
  ◇ Compendium supplements and can be used in concert
Summary of public exposure of the Illustrative Documents

- Proposed Internal Control over External Financial Reporting: Compendium of Approaches and Examples was released for public comment from September 18, 2012 to December 4, 2012
- In conjunction with the public exposure of ICEFR Compendium, COSO made available revised versions of the previously exposed Framework and Appendices and Executive Summary
- COSO made available the proposed Illustrative Tools for Assessing Effectiveness of a System of Internal Control
- COSO sought comments from the general public on relevant topics
Illustrative documents are responsive to public comments

- ICEFR: A Compendium of Approaches and Examples
  - Add or clarify specific examples, including:
    ◊ Establishing responsibilities for reviewing financial statements
    ◊ Monitoring investigation and reporting of whistleblower allegations
    ◊ Monitoring identification and protection of sensitive financial information
    ◊ Monitoring identification and analysis of risk of material misstatement due to fraud
  - Address a risk-based approach for achieving external financial reporting objectives
    ◊ Specify suitable objectives for external financial reporting
    ◊ Risks to achieving suitable objectives
    ◊ Responses to risks
Transition & Impact
Transition & 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 (i.e., 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 in business?
  ◊ Does your system of internal control need to be updated to address all principles?
  ◊ Does your organization apply and interpret the original framework in the same manner as COSO?
  – Is your organization considering new opportunities to apply internal control to cover additional objectives?
Transition & Impact (continued)

- The principles-based approach provides flexibility in applying the Framework to multiple, overlapping objectives across the entity
  - Easier to see what is covered and what is missing
  - Focus on principles may reduce likelihood of considering something that’s irrelevant
- Understanding the importance of specifying suitable objectives focuses on those risks and controls most important to achieving these objectives.
- Focusing on areas of risk that exceed acceptance levels or need to be managed across the entity may reduce efforts spent mitigating risks in areas of lesser significance.
- Coordinating efforts for identifying and assessing risks across multiple, overlapping objectives may reduce the number of discrete risks assessed and mitigated.
Transition & Impact (continued)

- Selecting, developing, and deploying controls to effect multiple principles may also reduce the number of discrete, layered-on controls.
- Applying an integrated approach to internal control - encompassing operations, reporting, and compliance – may lessen complexity.
- In assessing severity of internal control deficiencies, use only the relevant classification criteria as set out in the Framework or by regulators, standard-setting bodies, and other relevant third parties, as appropriate.
Recommended Actions

- Read COSO’s updated Framework and illustrative documents
- Educate the audit committee, C-suite, operating unit and functional management
- Establish a process for identifying, assessing, and implementing necessary changes in controls and related documentation
- Develop and implement a transition plan timely to meet key objectives – e.g., apply updated Framework by December 31, 2014 for external reporting
Getting COSO’s Publications

• The updated Framework and related Illustrative documents are available in 3 layouts

• E-book – This layout is ideally suited for those wanting access in electronic format for tablet use. An e-book reader from the AICPA is required to view this layout. Printing is restricted in this layout.
  ◊ Purchase through www.cpa2biz.com

• Paper-bound – This layout is ideally suited for those wanting a hard copy.
  ◊ Purchase through www.cpa2biz.com

• PDF – This layout is ideally suited for organizations interested in licensing multiple copies.
  ◊ Contact the AICPA at copyright@aicpa.org
Welcome to the State of Vermont
Internal Control (SAIC) Conference
Statewide Compliance Program

Department of Finance & Management
Financial Operations - Statewide Reporting
Internal Control, Compliance Program
May 30th, 2019
Jeffrey Montgomery

VISION Operations Analyst IV

- Background includes 25 years of healthcare industry experience. Independence BC, BC/BS of Vermont, BC/BS of Delaware, Highmark BC/BS

- Employed with the State 5 years, past positions: Revenue Accounting Supervisor - Department of Taxes, Budget Manager I - Agency of Human Services, Department for Children & Families. Now at the Department of F&M

- Bachelor of Science degree, majoring in Accounting from Widener University, State of Pennsylvania. Member of the IMA, COSO, as well as a participating member of the NASACT, National Association of State Auditors, Comptrollers, and Treasurers.

- Contact: F&M - Financial Operations, IC 109 State Street 4th Floor, Rm 446 Montpelier, VT 05609-5901 802.828.0672 Voice 802.828.0374 Fax

- Email: Jeffrey.Montgomery@vermont.gov

- Website: https://finance.vermont.gov/policies-and-procedures/internal-controls

Introduction
SAIC Compliance Program

State of Vermont - SAIC Background

- January 2005, the Department of Finance & Management embarked on a statewide initiative to strengthen internal controls in Vermont State Government.

- As public sector managers and employees we are accountable for the resources entrusted to us and for ensuring our programs and services are administered effectively and efficiently.

- A significant component in fulfilling this responsibility is ensuring that an adequate system of internal control exists within each State government entity.

- Simple Definition:
  - Internal control is what we do to see that the things we want to happen will happen
  - ...And the things we don’t want to happen won’t happen.
The Department of Finance & Management provides organizations with guidance & support to improve Internal Controls through the following resources:

- Self-Assessment of Internal Control (SAIC)
- Internal Control Standards Guide
- Our “Best Practice” Series
- Quarterly IC Newsletters
- Finance & Management Policies
- VISION Procedures & AOA Policies
- Operational SAIC Reviews
Flow Schedule of the 2019 SAIC (Self-Assessment of Internal Control) Project

**Phase I – Questionnaire**

- Solicit New VISION Questionnaires & Eliminate Overruns
  - 4th Mar – 22nd Mar 2019
  - 3 Weeks

- Develop XLS Questionnaire
  - 200+ Q’s
  - 2 Weeks
  - Due 4.7.19

- Compile and Analyze Data
  - May – Jun 2019

- For all 56 Agencies & Departments
  - Approx. 12,000 SAIC Answers to compile

- Collect 56 SAIC Results
  - 29th Apr

- Produce 56 Statewide Detail Agency Reports
  - 280 pages
  - Jul 2019

**Phase II – Data Validation Review**

- Share Statewide SAIC Detail
  - Aug 2019

- Move into Phase II

- Develop 50 Q’s for DVR Analysis
  - 10 Q’s / 10% of 56 SAIC
  - Sep 2019

- Randomly Select 5 Participants

- Collect 5 DVR Results
  - 23rd Sep

- Analyze Q’s to VISION, SOP, P&P, BP, with Test DVR Submissions
  - Oct 2019

- Produce 5 Agency Summary and 1 Executive Report
  - Nov 2019

- Notify 5 Agencies of their Results
  - Nov 2019

- Approval of the Summary Agency Results
  - Nov 2019

- Approval of the Statewide Agency Results
  - Nov 2019

- File SAIC Summary Reports

- File SAIC Detail Reports

- DVQ = Data Validation Questions
  - DVR = Data Validation Reviews

*Curled pages represent Milestones.....

*Shaded Areas are completed Tasks or Milestones....

*DVQ = Data Validation Questions
  - DVR = Data Validation Reviews
Exercise

• Pick an internal control.

• Ask and answer these questions (write it down):
  – What does management do to ensure they meet the objective?
  – How does management communicate to others what they do?
  – Why does management do what it does?
  – How does management ensure control activities are performed?
  – What does all that say about management?
Sean M. Walker, CPA, CFE, CGFM, CGMS
Principal
Sean.Walker@CLAconnect.com

Jeffrey Montgomery
State of Vermont
VISION Operations Analyst IV
Jeffrey.Montgomery@vermont.gov