COSO 2013
Translating Principles into Action

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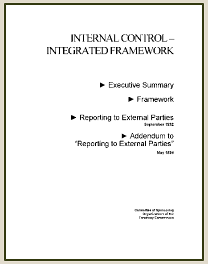
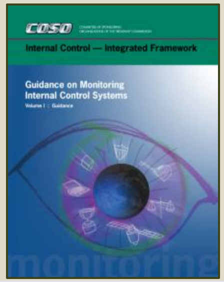
We have been through:



1992: COSO Internal Controls Framework issued



2009: special guidance for unscrambling what is meant by monitoring

2006: a version of the guidance targeted for smaller public companies

2013: we were presented with the updated Framework that will supersede the prior COSO literature after 15 Dec 2014 - and serve as our basis for going forward.

Many entities that began the COSO process prior 2013 have not made major changes in their approach.

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.

Risk Assessment

6. The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.
7. The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.
8. The organization considers the potential for fraud in assessing risks to the achievement of objectives.
9. The organization identifies and assesses changes that could significantly affect 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 action.

Information & Communication

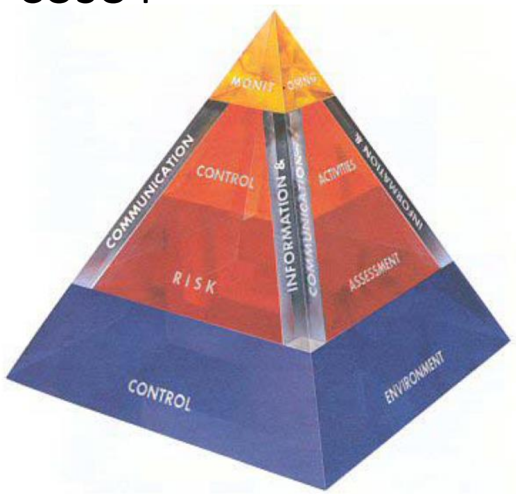
13. The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.
14. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.
15. The organization communicates with external parties regarding matters affecting the functioning of internal control.

Monitoring Activities

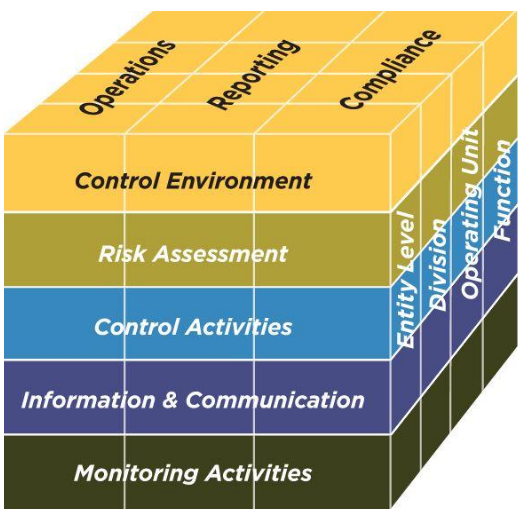
16. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.
17. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

For more information about COSO, visit coso.org.

COSO I



COSO II

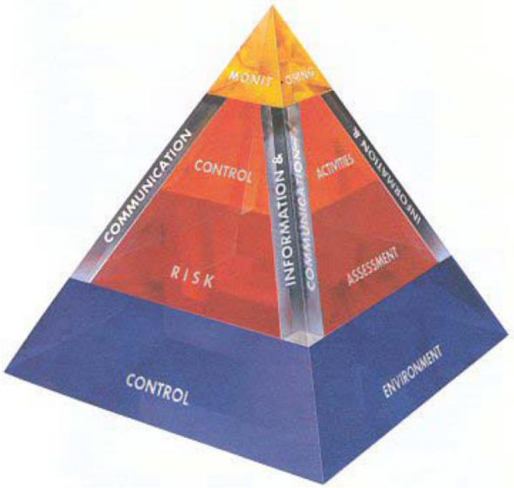


Some key elements of the new guidance include:

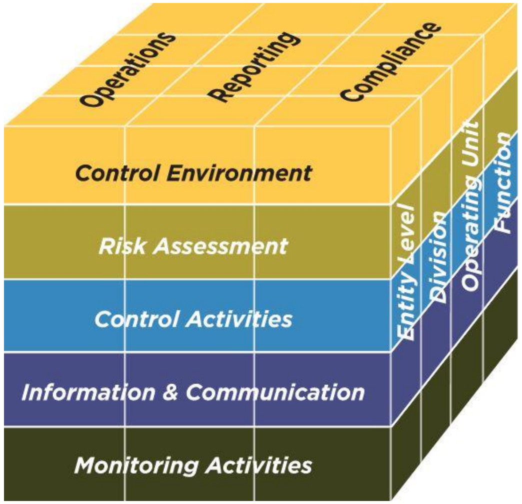
- Retention of the 5 basic components: control environment, risk assessment, control activities, information & communication, and monitoring.
- Identification of 17 principles that are deemed essential to the five components.
- Clear expectations that the elements of internal control work together in an integrated way.

Unless these elements are satisfied, COSO would conclude that the system of internal controls is not effective.

COSO I

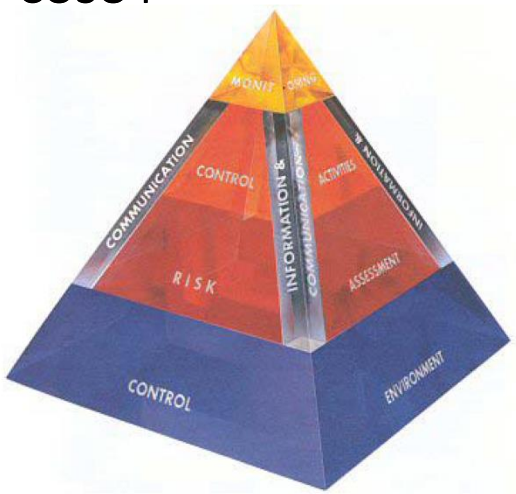


COSO II

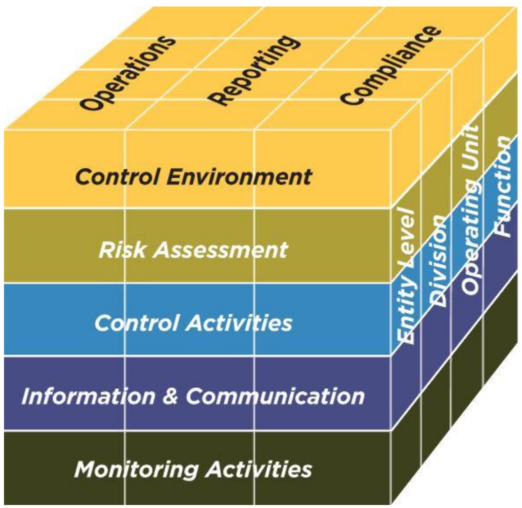


- 1992 COSO Integrated Framework depicts 5 elements of internal control and their interrelationships in a 3-sided pyramid, with the control environment as base.
- Note that information& communication component is positioned along the edge of the pyramid structure, indicating that this component has close linkages to the other components.
- The 2013 revision changed the cube and placed the control environment at the top of the cube.
- The 17 principles in 2013 revision reduce the variability in classifying controls with the framework, i.e. fraud (p. 8), IT (p. 11) – compared to previous version that are more loose and entities can self-decide where such controls belongs.

COSO I



COSO II



- More attention to areas other than control activities. The 17 principles and numerous points of focus will force many entities to gather more information than previously regarding the “softer” controls and assessments. It was perhaps easier for all to focus on transaction controls, but the new COSO guidance attempts to rebalance the efforts.
- More focus on risk assessment. Risk assessment is more carefully articulated, and more assessment is sought of the types of risks as well as the potential magnitude and likelihood of a risk occurring.
- In addition, the COSO introduces 2 new measures of the risk: velocity and persistence. Like a storm, the intensity of a risk and duration can have a very direct effect on the damage sustained.

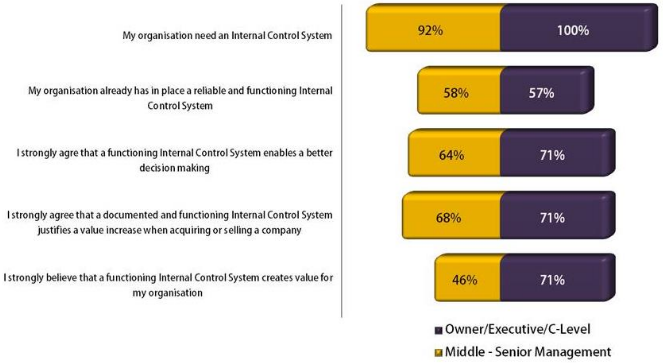
TABLE 3.1 Consideration of Risks and Changes

Economic Factors	Weak local economic growth
Perceived Risk	Sales goals not met
Objectives Impact	To grow by 8–10% in sales per year in local markets
Likelihood/Probability	50% (moderate)
Velocity/Persistence	Foreseeable and not long lasting
Severity/Materiality	85% (high)
Components and Principles Affected	CA inventory (potential excess production and possible write-downs)
Assertions Affected	Valuation
Specific Controls in Place	CA 3.121; CA 3.124
Evidence Examined and Reference	Chamber of Commerce business statistics (file document 1A1), competitor financial information (10-K of Micron Tech)
Changes in the Past Year	Local growth even slower than prior year
Cross-Reference to Monitoring Program*	Covered in management step 17
Comments on Basis for Assessment	C of C report is the primary basis for the assessment

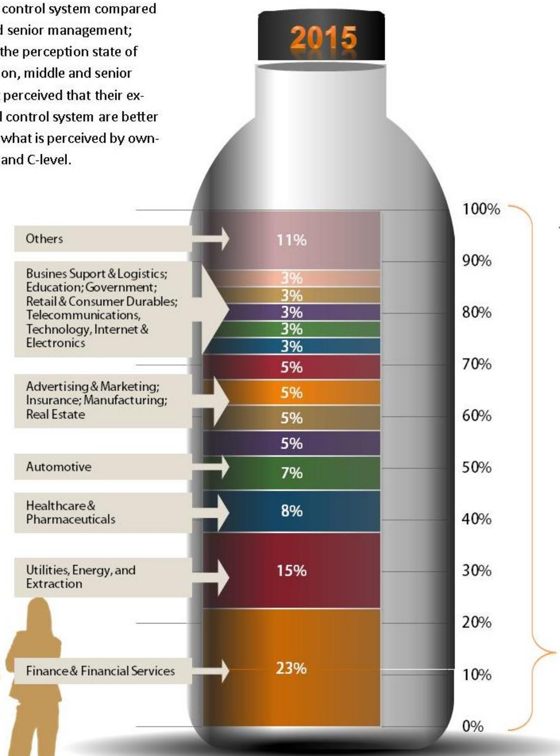
*Note: Cross-reference to how addressed in audit plan. For auditor use, this reference is usually helpful

INFOGRAPHIC: INTERNAL CONTROL SYSTEM IN INDONESIA - 2015

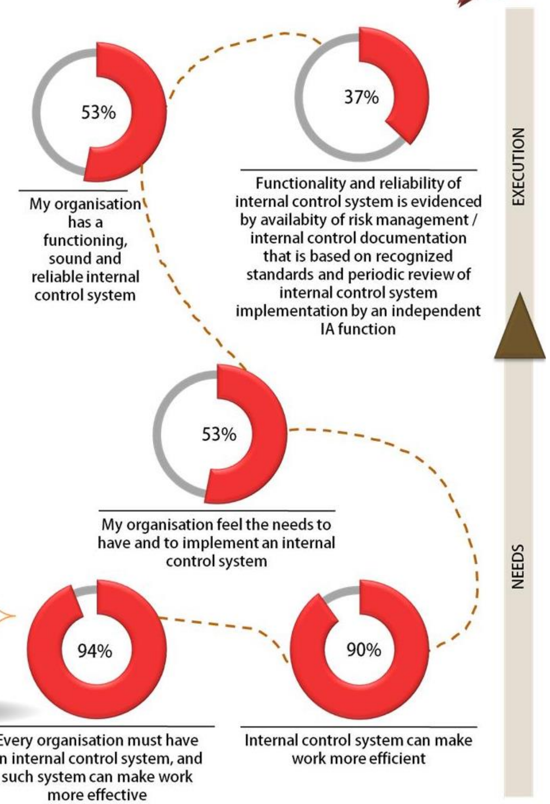
Owner/Executive/C-Level compared to Middle-Senior Management



Owner, executive and C-level have a higher awareness level on the importance and benefit of internal control system compared to middle and senior management; however, on the perception state of implementation, middle and senior management perceived that their existing internal control system are better compared to what is perceived by owner, executive and C-level.

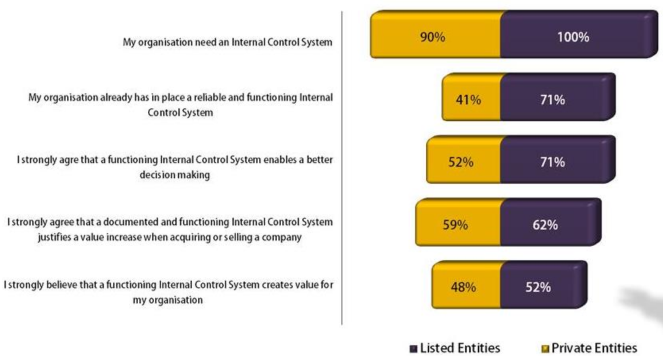


Organisations in Indonesia are very much aware on the importance of a reliable internal control system; unfortunately this awareness was not optimally executed in the implementation stage within their organisation; and of those that already have an internal control system in place, less than halve have different perception to what better practice describe as a reliable and functioning internal control system.



Listed entities have higher awareness level on the importance and benefit of internal control system compared to private entities; and they are also more sure that their internal control system has been soundly functioning compared to what perceived by private entities.

Listed Entity compared to Private Entity



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Globally Connected. Strong Knowledge on Indonesia.

This infographic is part of RSM AAJ Report on the 2015 Survey of Internal Control System in Indonesia.
For further information, please contact:
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What we must do?

- Entities should assess and document their internal controls.
  - An entity without the expertise to document controls might also lack the ability to design and monitor controls or to respond to issues that arise when control fail.
  - If the entity does not view internal control as a priority, then questions arise as to whether the control environment is lacking in some respect.
  - The fact is that many entities would rather not bother with this responsibility, despite its overall value to society in adding integrity to investors reports and to the security and success of the entity itself.
- Attitude is important in shaping the quality of controls and the quality of the oversight and continuous improvement that sustains and strengthens systems.

What we must do?

- Entities and auditors should also have some evidence to support the fact that the descriptions of the internal controls relate to what is actually happening.
- The evidence may be through observation, examination of evidence, or reperformance of the control.
- Auditors are instructed to document their understanding of internal controls (and not the whole system of processes and activities).
- To the extent that the entity has done the process and controls documentation well, the auditor can test that work and draw from it in lieu of reinventing the wheel.

What we must do?

- All entities need to take a broad look of internal control over financial reporting (ICFR) and not to ignore elements that are difficult to assess:
  - the control environment,
  - IT, or
  - processes and controls that are outsourced

What we must do?

- One message that rings clear in the 2013 COSO guidance is the need to articulate various management objectives in terms of operations, financial reporting, and regulatory compliance.
  - These objectives are in turn the genesis for management to identify “risks” to their objectives (answering the question: ‘risk to what’). Entities should try to articulate their specific objectives, since meaningful risk assessment and the design and maintenance of controls to mitigate the risks follow from those objectives.
- While auditors may guess at the company-specific risks related to financial reporting and the related assertions, auditors cannot possibly know all the nuances that management might be considering. Thus the assessment of risks relating to financial reporting is best performed by the entity and shared with the auditor.
- Entities that fail to set objectives and identify risks are likely to exhibit and be assessed a material weakness in the risk assessment component of the Framework.

Transitioning to COSO 2013

- Many entities will seek the quickest and easiest way to transition to COSO 2013.
- For many, there will be a significant number of additional control points to consider, since ‘2013’ is more specific (using 17 principles and numerous points of focus) that the original 1992 framework.
- However this challenge should also be viewed as an opportunity to reconsider any current documentation or approach and not to institutionalise past practices that may not be the most efficient and effective.
- The concept of ‘lets just get through this year’ usually result in needed changes never being made and opportunities lost.

Transitioning to COSO 2013

- Those entities who adopted the 20 Principles outlined in the 2006 COSO guidance directed to smaller public entities will be farther down the road to converting to the 2013 guidance than those that by-passed this guidance and built their assessment process around the original framework.
- The 2006 guidance was potentially useful to all entities and could be a real help in structuring effective assessment projects for any entity. And so it has come to pass. Where there was a change in the 2013 guidance from 2006 version.

Mapping to the 2013 Guidance

- One method used to map the 2013 guidance to current project is to create a spreadsheet with the principles and relevant points of focus along one dimension and the previously identified controls along the other dimension.
- To be more effective, the matrix should also identify the relevant assertion(s) addressed by the controls (when assertions apply, such as for transaction controls) to ensure the coverage of the financial statements assertions and to identify any gaps.
- When identifying assertions, it may be appropriate to assign a numerical letter value to the assertions your are using, so that the assertions covered can be sorted and haps more easily identified.
- It may also be necessary to segregate the transaction – or disclosure – based controls by account or cycle so that the spreadsheet does not become bulky.

Mapping to the 2013 Guidance

- Note that when considering cash controls, a deficiency might also indicate failure in related principle, such as competence and training (Principle 4).
- It is a daunting task to pre-consider all the possible interactions between controls and principles and points of focus, so you may find some common linkages like the aforementioned example will be sufficient for mapping most controls.
- These linkages will not be automatic; they will depend on the specific root cause of the deficiency if it can be determined. A column or two would be allocated to identify potentially related principles. This task will be a new one, requiring familiarity with the 2013 approach and details of the principles and points of focus.

Mapping to the 2013 Guidance

No one design will be perfect for al entities and industries. The important thing is that all currently identified key controls are mapped and that all principles and points of focus are arrayed so that potential gaps can be identified.

(a) Control Environment

Control ID	Primary Assertion	Secondary Assertion	P1 Ethical[3]	POF1	POF2	POF3 ...	P2 ...
CE1	NA	NA	X			X	
CE2	NA	NA	X	x			X

(b) Sales Cycle (P12)

Control ID	Primary Assertion	Secondary Assertion	Sales	POF1	POF2	POF3	POF4 ...
S 1	1	3	X			X	
S 2	3		X				X

Mapping to the 2013 Guidance

- In total, the 2013 guidance notes 88 points of focus across the 17 principles.
- However, a few of these points of focus are more closely related to operations and compliance objectives.
- Before discarding them from your analysis, note that such objectives often have a financial reporting implication in disclosure controls or for estimating allowance or reserve accounts.

Mapping to the 2013 Guidance

- While COSO clearly states that all the POFs need not be met to be able to state that an effective system of ICFR exists, many are using the POFs (and principles) to determine if there might be gaps in controls or yet-undocumented controls of importance that should be recognised.
- From a documentation standpoint, it is a short leap to expect that a POF considered irrelevant or not applicable will be supported with an explanation of why this is so.
- A secondary benefit of this exercise is to assist the independent audit team in relating your assessment to their work paper tools and templates, which often are not customised to your entity approach.

Basic Scoping & Strategies for Maintenance

- All managements and auditors need to consider broadly the scope of ICFR.
- Just because a wide net is cast in examining controls does not mean that all of the controls under that net are key or critical; thus testing and detailed analysis may not be required.
- Current auditing standards require a specific assessment of the internal controls over the fair value estimation process. Non-public entity auditors are likewise directed by auditing standards to assess such controls over all estimates in the financial reporting process.

Basic Scoping & Strategies for Maintenance

- Managements & auditors were embarrassed when an academic professor, Eric Lee, discovered that the values of stock options were being manipulated to benefit management in a number of large companies.

- This activity & process was not included in the early scoping of public company audits of internal control.

- A continuing challenge is the issue of using service organisations for various accounting, IT, and data storage function.

- A contemporary issue is the controls and security of cloud computing and cloud data storage.

- Outsourcing does not remove a function from the scope of internal controls assessment and analysis.

- Examples also exist of the failure to recognise the risks associated with trading operation, i.e. Barings Bank collapse (currency trading) and Orange County CA bankruptcy (interest rate swaps).

Basic Scoping & Strategies for Maintenance

- The natural state of systems is for them to deteriorate over time.
- Managements, through monitoring and thoughtful annual reassessment, can keep a system in tune through an effective monitoring function.
- The absence of or ineffective of an effective monitoring function is likely to be a material weakness that would preclude an effective internal controls assertions or auditor reliance on controls to reduce other auditing procedures.

Where We Depart?

- Financial statement preparers of public, non-public, government, and nonprofit entities have the basic level of responsibility for assessing and documenting controls over financial reporting.
- While still responsible for the scoping, documentation, and verification that the described controls are implemented, non-public entities and their auditors may not need to test the controls as a basis for reliance on controls in setting the audit strategy.
- However, public companies have a specific requirement that they publicly assert the effectiveness of controls over financial reporting; doing that includes tests of the controls to be ale to make the assertion.

Where We Depart?

- However, when auditors of any entity seeks to rely on the effectiveness of internal controls to reduce the scope of their audit procedures, then testing is necessary to confirm the assessment that the controls are designed and are operating effectively.
- Unlike an attestation where high assurance is sought, the financial statement auditor may determine the right amount of testing and assurance to support the desired level of control assurance from ‘low’ to ‘high’.
- When high assurance is sought, the project scope and testing level is similar to that required for an attestation. However the assurance sought for control reliance usually covers the entire audit period, not just the status of internal controls on the date of the report.

Where We Depart?

- Non-public entities may optionally report on the effectiveness of their internal controls.
- Alternative attestations allow for attestation on only the design of the controls, or an attestation on both the design and operating effectiveness of the controls over financial reporting.
  - i.e. a nonprofit entity may wish to report on internal controls to provide assurance to donors of its stewardship over the donated funds and as a competitive tool to attract new donors, or
  - i.e. government entities in the future may be required to publicly report on their internal controls as a demonstration of their stewardship of public funds.

Control vs Process

- COSO and regulatory requirements are directed at controls. Public company assertions about internal control effectiveness are also directed at controls.
- Example:
  - a cash payment (cutting the check) is part of a process. A review of the support for the payment by someone other than the accountant is a control.
  - A sale on credit rating of the customer or checking that the customer is a preapproved control over the validity or existence of the sale.
- The requirements are to document, assess, and test controls, not process. But mountain of documentation are produced and retained in the name of controls documentation, which many times do not contain the description of a single control.

Control vs Process

- Many are fond of flowcharts, narratives that go on and on, and creating a lot of detailed descriptions of how things work.
- There is nothing wrong with all that, but the focus here is controls.
  - How do we ensure completeness?
  - How do we ensure the transactions are recorded in the proper period?
  - How do we ensure ownership of the assets we claim?

Control vs Process

- A current trend is away from the beloved narratives toward to more flowcharting to document the business process and control points.
- By careful adherence to the spirit of COSO framework, the documentation of controls can be concise and organised.
- Whether you are just beginning this process now or are seeking ways out of the swamp of documentation produced previously, there is a way to meet the requirements without producing excessive volumes of documentation.

Control vs Process

- Internal control has limitations:
  - The existence of undesirable outcomes like misstatements and omitted disclosures may indicate that the process itself was flawed.
  - Internal control provides a reasonable but not absolute assurance that an entity will achieve its financial reporting objectives. Even an effective internal control system can experience failure due to:
    - Human error, Management override, Collusion

Control vs Process

- COSO Framework views internal control as built-in into overall business process, as opposed to a separate added-on component that attaches itself to the entity's real business.
- Internal control have limited value by themselves – they do not produce a product or service or generate revenue for the business.
- Controls have value to the degree in which they help entity to achieve its objectives through providing complete, accurate, relevant, and reliable information for decision making and for the fair communication of financial results to third parties.
- The effectiveness of internal controls is judged according to how well it aligns with and addresses the objectives of the entity.

Control vs Process

- Building internal control requires that management do 4 things:

Establish business objectives
(i.e. financial reporting)

Identify the risks to achieving those objectives

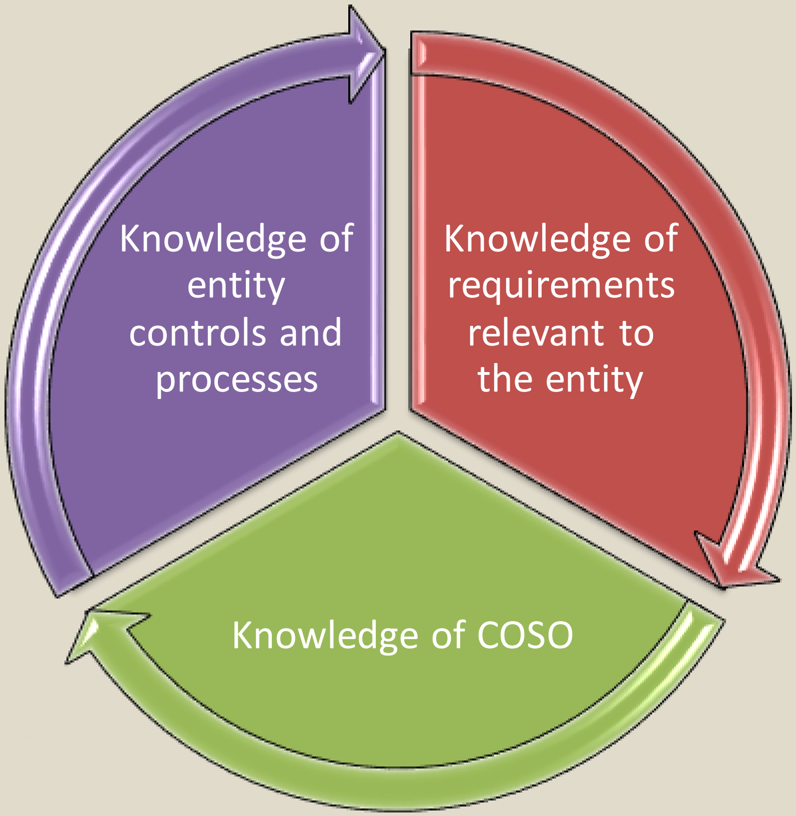
Determine how to manage the identified risks.
(the establishment of internal controls is just one of several options)

Where appropriate, establish controls as a way to manage certain risks.
(individual controls are designed and implemented to meet the stated risks)

Driving Efficiency

- Everyone desires an efficient project. From experience, an important consideration in achieving an efficient implementation of a controls assessment project is an understanding of the tasks and the acquisition of skills before embarking to the documentation, assessment, and testing process.
- Time and again failure of those key elements is the root cause of wasted time and energy, and more often than not it results in an incomplete or incorrect assessment. This is an issue worth mentioning – because false steps will cost money to correct.

Driving Efficiency



- If any of the 3 elements is lacking, then there will be an impact on the efficiency and effectiveness of the overall project.
- Entity's consultants may be very competent in knowing COSO and entity's requirements, but they still have to learn the entity and its controls in order to perform their task.
- Close integration of entity and consulting personnel can contribute greatly to efficiency of the company project over a strategy where the task is given primarily to the consultant.