


Internal Control, Audit Planning and Financial Statement Preparation

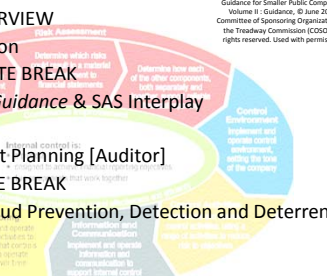
Presented by
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Agenda

- 08:30 HISTORICAL OVERVIEW
- 09:15 COSO by Definition
- 10:00 TAKE A 10 MINUTE BREAK
- 11:45 COSO, *Uniform Guidance* & SAS Interplay
- 11:45-12 LUNCH
- 1:00-COSO, SAS & Audit Planning [Auditor]
- 2:00 TAKE A 10 MINUTE BREAK
- 2:10 COSO's Role in Fraud Prevention, Detection and Deterrence
- 3:45 END



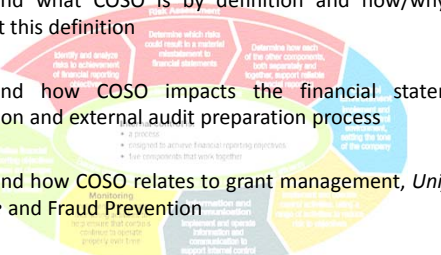
Guidance for Smaller Public Companies
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Learning Objectives

- Understand what COSO is by definition and how/why we arrived at this definition
- Understand how COSO impacts the financial statement preparation and external audit preparation process
- Understand how COSO relates to grant management, *Uniform Guidance* and Fraud Prevention



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An Historical Overview

Internal control is:

- a process
- designed to assure financial reporting objectives.
- Fair companies that work together

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An Historical Overview

- Foreign Corrupt Practices Act - 1977
 - Intended to stop corporate bribery,
 - Strengthen the accuracy of corporate books as companies were falsifying corporate records to hide the payments and
 - Outlawed secret, off-the-books "slush" funds making illegal campaign contributions within the United States.

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An Historical Overview

- Foreign Corrupt Practices Act - 1977
 - First used the words "internal control" in the context of improving the reliability of the audit process which constituted the foundation of our system of corporate disclosure and
 - Required companies to have and use internal controls to prevent and detect violations of the FCPA.

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An Historical Overview

- There was a problem discovered early on in legal proceedings related to prosecution of FCPA violations: what is internal control?
- How much is enough?
- Who is responsible and at what level?

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An Historical Overview

- Hence the National Commission on Fraudulent Financial Reporting (the Treadway Commission) was formed in 1985
 - Original Chair, James C. Treadway, Jr. a Paine Webber attorney and former SEC Commissioner
 - Released a report on fraudulent financial reporting in October 1987
 - COSO was formed as a result of the report

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An Historical Overview

- COSO = the Committee of Sponsoring Organizations of the Treadway Commission
 - 5 Original Sponsors: AICPA, American Accounting Association [AAA], Financial Executives International [FEI], Institute of Internal Auditors [IIA] and Institute of Management Accountants [IMA]

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An Historical Overview

COSO is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance.

The diagram illustrates the COSO framework with five interconnected components:

- Control Environment:** Establishes the tone of the company, including the integrity, ethical values, and competence of the organization's people.
- Information and Communications:** Includes the quality of financial reporting, internal and external communication, and the timeliness and accuracy of information.
- Monitoring:** Involves ongoing or separate evaluations to ensure that controls continue to operate properly over time.
- Internal Control:** Consists of the policies and procedures that help ensure that an organization's objectives are achieved.
- Risk Assessment:** Involves identifying and analyzing the organization's risks, and managing them in a cost-effective manner.

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An Historical Overview

- In a 2006 CFO magazine poll, 82% of respondents claimed they used COSO's framework for internal control.
- Other frameworks mentioned
 - SAS 55/78 (AICPA)
 - COBIT
 - PCAOB AS2

The diagram is similar to slide 10 but includes additional text:

- Internal control is:**
 - a process
 - designed to achieve financial reporting objectives
 - Four components that work together
- Internal control also:**
 - Identifies and manages risks to achievement of financial reporting objectives
 - Relies on the work of the other components, both separately and together, to support reliable financial reporting

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An Historical Overview

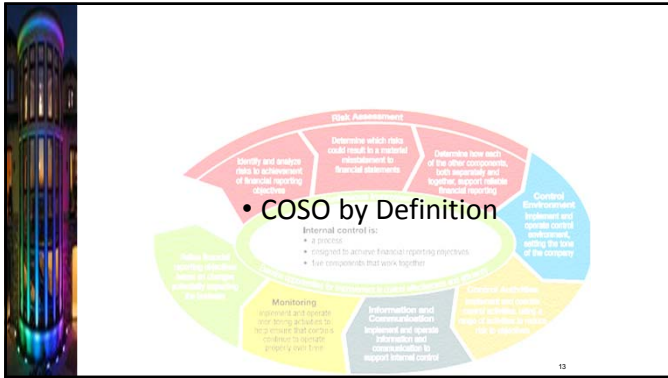
- In no legal way does COSO's framework apply to government or NGO's
- Sarbanes-Oxley does not apply either
- However, as we shall see later, COSO's framework is evaluated by anyone who is required to have a member of the AICPA audit their financial statements

The diagram is similar to slide 11 but includes additional text:

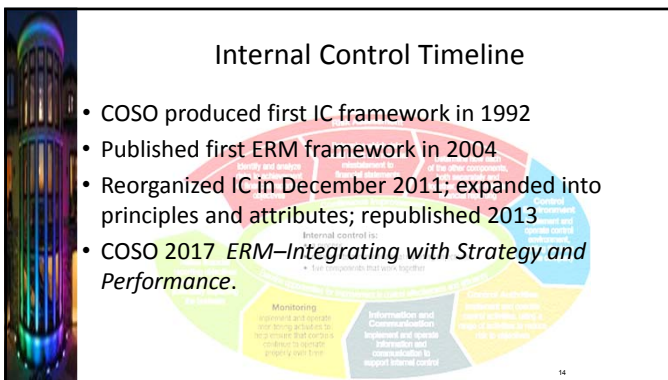
- Internal control also:**
 - Identifies which risks could result in a material misstatement in financial reporting
 - Identifies how each of the other components, both separately and together, support reliable financial reporting

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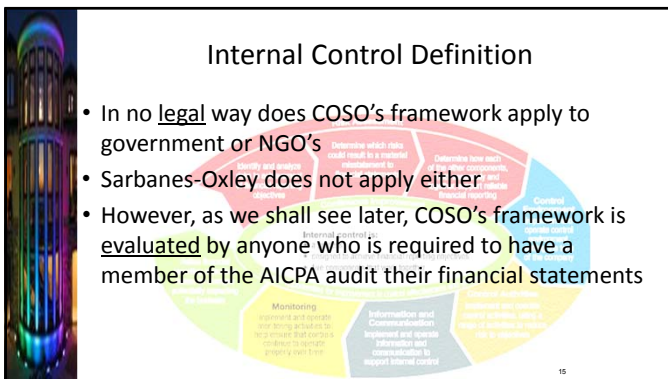
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Internal Control Definition

- 1992 Framework gives us a definition - **a process**, effected by an entity's board of directors, management and other personnel, designed to provide **reasonable assurance** regarding the achievement of **objectives**. [effective/efficient]
- assumes objectives exist

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Internal Control Definition

- COSO Components**
 - Control Environment
 - Control Activities
 - Information & Communication
 - Monitoring
 - Risk Assessment

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Internal Control Definition

Another View at the Refresh 2013
The Framework has become the **most widely adopted control framework worldwide**.

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Internal Control Definition

- **Control Environment Principles**
 - Integrity and Ethical Values
 - Board of Directors
 - Management’s Philosophy and Operating Style
 - Organizational Structure
 - Financial Reporting Competencies
 - Authority and Responsibility
 - Human Resources

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THE "CUBE"

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Responsibilities and Objectives

- "...while effective internal control requires leadership from the top, the **responsibility for effective implementation of internal control resides with everyone in the organization**, not just the finance function. This includes accountants, compliance officers and those involved in making contracts and supporting operations as well as those working on the production line to ensure that products produced meet quality objectives.

...the individuals that are responsible for achieving the objectives are also responsible for the quality of internal controls."

Larry Rittenberg
Chair Emeritus, COSO

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Mission

COSO's Mission is "To provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations."

COSO's Fundamental Principle

Good risk management and internal control are necessary for long term success of all organizations.


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Risk Management Frameworks

- COSO ERM Framework
- ACFE Fraud Risk Management
- ISO 31000 *Risk Management Principles and Guidelines*
- IT COBIT Framework

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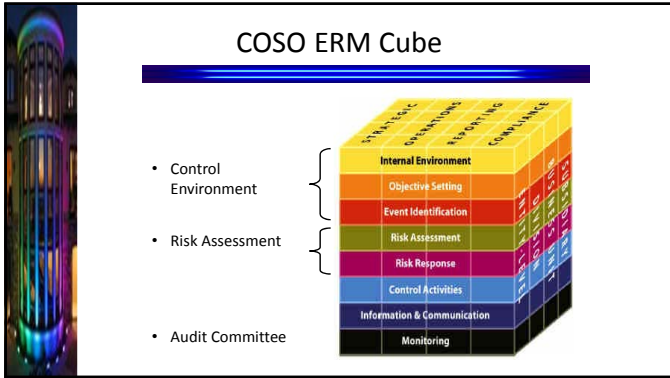


COSO ERM Definition

Enterprise Risk Management (ERM) is a process affected by an entity's board of directors, management and other personnel, applied in a strategic setting and across the enterprise.

ERM is designed to identify potential events or situations that may affect the entity, manage risks to be within the company's risk appetite, and provide reasonable assurance regarding the achievement of entity objectives.

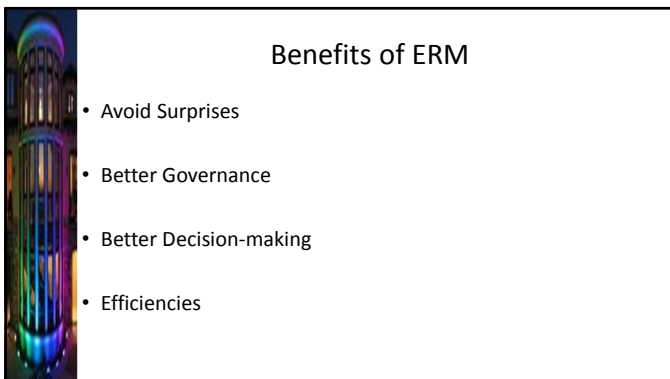
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How Benefits Derived

- Link Goals, Growth and Risk with Resource Allocation in an Organized, Measureable Way
- Across the Entire Entity Focus [Risk Pervades Every Area, Department, Level]
- Coordinate, Define and Align Strategy(ies) with Risk, Risk Appetite and Risk Response

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What ERM is not:

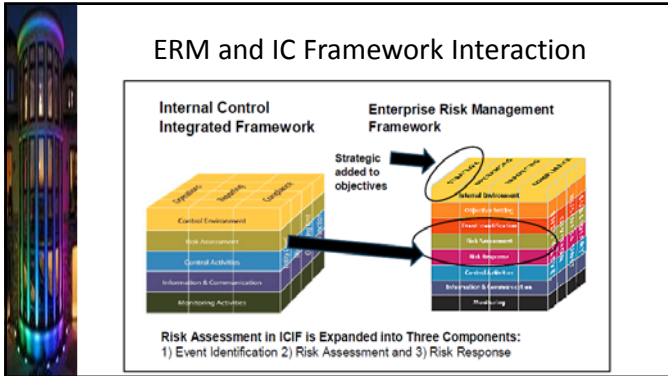
- It is not your risk assessment
- It is not about business continuity or business succession
- It is not about information security or employee/building insurance

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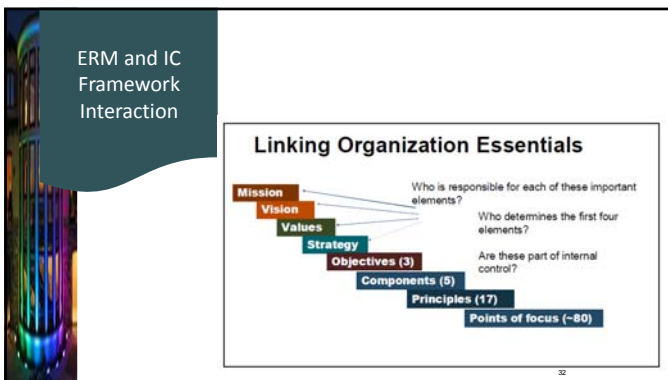
ERM and IC Framework Interaction

- From the Executive Summary of the 2-10-2014 Thought Paper:
 - “Within the context of its mission, an organization is designed to accomplish objectives.”

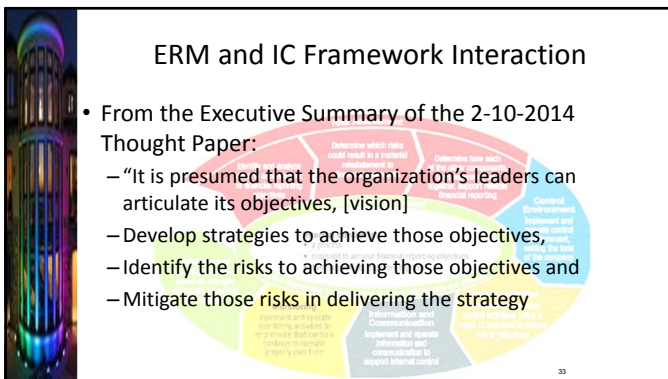
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Strategic View With an Enterprise Wide Approach
 Use of the Framework in the context of
 ■ Mission
 ■ Vision
 ■ Values
 ■ Strategy

Entity level objectives: Operations, reporting (financial, non-financial, external, internal), compliance

ERM and IC Framework Interaction

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ERM and IC Framework Interaction

Addresses Key Roles and Responsibilities

- Board of directors, board structure, board committees
- C-Suite
- Risk and control personnel
- Internal and external audit (of course!)
- Outsourced service providers
- Supply chain
- Legislators and regulators
- Analysts, bond rating agencies, news media, etc.

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Suitability & Relevance

- COSO views ALL five components as relevant & suitable to ALL entities.
- The 17 principles explain the components and, as such, are presumed relevant & suitable to ALL entities
- If a relevant principle is not present AND functioning, the associated component cannot be present & functioning.
 - In this rare instance, management is required to document how the component can be present & functioning when a principle is not.

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Focus Points

- While points of focus help to design, implement and/or evaluate internal control and assess whether the relevant principles are present & functioning, they are not required for effective internal control.

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<p style="text-align: center;">PRESENT</p> <p>COSO defines this as components & principles exist in the design & implementation of the system of IC to achieve the <u>objectives</u>.</p>	<p style="text-align: center;">FUNCTIONING</p> <p>COSO defines this as components & principles continue to exist in the design & implementation of the system of IC to achieve the <u>objectives</u>.</p>
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Internal control is:

• COSO, *Uniform Guidance* and Statements on Auditing Standards [SAS] Interaction

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AICPA Audit Standards

- In AU-C 315 regarding internal control and risk assessment, the standard defines internal control as: "A process effected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the **achievement of the entity's objectives** with regard to the reliability of financial **reporting**, effectiveness and efficiency of **operations**, and **compliance** with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. ¹

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Objective of AU-C 315


- The objective **of the auditor** is to **identify** and **assess** the **risks of material misstatement**, whether due to **fraud** or **error**, at the **financial statement** and **relevant assertion levels** through **understanding the entity and its environment**, including the entity's internal control, thereby **providing a basis** for **designing** and **implementing responses** to the assessed risks of material misstatement.

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Understanding the Entity & It's Environment

- Industry, regulatory and other external factors
- Applicable financial reporting framework
- The nature of the entity:
 - Operations
 - Ownership/governance structure
 - Investment plans [resource investments to accomplish objectives]
 - Structure and financing
- Accounting policies and measurements and review of financial performance

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AU-C Section 315

Division of internal control into components. The division of internal control into the following five components, for purposes of GAAS, provides a useful framework for auditors when considering how different aspects of an entity's internal control may affect the audit:

- The control environment
- The entity's risk assessment process
- The information system, including the related business processes relevant to financial reporting and communication
- Control activities
- Monitoring of controls


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AU-C Section 315

- The **division** does not necessarily reflect how an entity designs, implements, and maintains internal control or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control and their effect on the audit other than those used in this section, provided that all the components described in this section are addressed.


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Financial Reporting Assertions

- Classes of transactions and events , *and related disclosures [income statement oriented; timeframe 'during period']*
 - Occurrence - Classification
 - Completeness - Presentation
 - Accuracy
 - Cutoff

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Financial Reporting Assertions

- Account balances *and related disclosures* [balance sheet oriented; timeframe 'period end']
 - Existence - Classification
 - Completeness - Presentation
 - Rights & Obligations
 - Accuracy
 - Valuation & Allocation


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Financial Reporting Assertions

- Presentation and *disclosure* [Notes to financial statement oriented; timeframe undefined]
 - Occurrence & Rights & Obligations
 - Completeness
 - Accuracy & Valuation
 - Classification & Understandability


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Suitability & Relevance

- COSO views ALL five components as relevant & suitable to ALL entities.
- The **17 principles** explain the components and, as such, are presumed relevant & suitable to ALL entities
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<p>PRESENT</p> <p>COSO defines this as components & principles exist in the design & implementation of the system of IC to achieve the <u>objectives</u>.</p>	<p>FUNCTIONING</p> <p>COSO defines this as components & principles continue to exist in the design & implementation of the system of IC to achieve the <u>objectives</u>.</p>
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LUNCH TIME



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17 COSO Principles

- 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.

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17 COSO Principles

- 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 impact the system of internal control.

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17 COSO Principles

- Control Activities
 - The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.
 - The organization selects and develops general control activities over technology to support the achievement of objectives.
 - The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.

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17 COSO Principles

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

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17 COSO Principles

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

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COSO & Auditor Interaction

- | | |
|---|--|
| <ul style="list-style-type: none"> • Definition is “a process effected ...” • COSO views ALL five components as relevant & suitable to ALL entities. • Objective driven and objectives are assumed to exist • Principles related to actions by design create the system | <ul style="list-style-type: none"> • Auditor defines internal control as “a process effected ...” • Auditor must consider the same five components of COSO when understanding the system • Objective driven and objectives focus on assertions • Must test design and implementation of system |
|---|--|

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Uniform Guidance

- What is Uniform Guidance [UG]?
 - audit requirements of Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance).
 - \$1 of federal grant money = *Government Auditing Standards [GAS]* compliance audit; Major Program = UG;
 - Contractual/regulatory

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Uniform Guidance

- When is Uniform Guidance [UG]?
 - effective for nonfederal entities for all federal awards and certain funding increments provided on or after December 26, 2014;
 - "Audit Requirements," are effective for audits of fiscal years beginning on or after December 26, 2014, with no early implementation permitted

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Uniform Guidance Establishes ...

- requirements for additional audit procedures and reporting relative to the **auditor's** consideration of internal control over compliance for major programs;
- requirements are beyond those of a financial statement audit conducted in accordance with generally accepted auditing standards (GAAS) and *Government Auditing Standards*
- Uniform Guidance does not impose on the financial statement audit any additional audit requirements beyond *Government Auditing Standards*


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Uniform Guidance Establishes ...

- additional considerations of internal control over compliance for major programs and adapts GAAS guidance to a Uniform Guidance compliance audit as applicable
- Auditor Reporting Requirements and Other Communication Considerations in a Single Audit
- *Government Auditing Standards incorporates by reference AICPA Statements on Auditing Standards*. Therefore, auditors performing financial statement audits and Uniform Guidance compliance audits in accordance with *Government Auditing Standards* should comply with generally accepted auditing standards


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Uniform Guidance Defines ...

- The Uniform Guidance defines *internal control* as a **process, implemented by** a nonfederal entity, designed to provide **reasonable assurance** regarding the **achievement of objectives** in the following categories:
 - a. Effectiveness and efficiency of **operations**
 - b. Reliability of **reporting** for internal and external use
 - c. **Compliance** with applicable laws and regulations


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Uniform Guidance Defines ...

- Uniform Guidance defines internal control over compliance requirements for federal awards as the following:
 - Internal control over compliance requirements for federal awards means **a process implemented by** a nonfederal entity designed to provide **reasonable assurance** regarding the **achievement of the following objectives** for federal awards:
 - 1. Transactions are properly recorded and accounted for, in order to:


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Uniform Guidance Defines ...

- 1. Transactions are properly recorded and accounted for, in order to:
 - a. Permit the preparation of reliable financial statements and federal reports;
 - b. Maintain accountability over assets; and
 - c. Demonstrate compliance with federal statutes, regulations, and the terms and conditions of federal awards;
- 2. Transactions are executed in compliance with:


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Uniform Guidance Defines ...

- 2. Transactions are executed in compliance with:
 - a. Federal statutes, regulations, and the terms and conditions of the federal award that could have a **direct and material effect** on a federal program; and
 - b. Any other federal statutes and regulations that are **identified in the OMB Compliance Supplement (Compliance Supplement)**; and
- 3. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.


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Uniform Guidance Requires ...

- 2 CFR 200.303 of Subpart D, "Post Federal Award Requirements Standards for Financial and Program Management," states the **nonfederal entity must:**
 - establish and maintain **effective internal control** over federal awards
 - **comply** with federal statutes, regulations, and the terms and conditions of the federal awards,

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Uniform Guidance Requires ...

- evaluate and monitor the entity's **compliance** with statutes, regulations, and the terms and conditions of federal awards,
- take **prompt action when instances of noncompliance are identified**, including noncompliance identified in audit findings,
- take **reasonable measures to safeguard protected personally identifiable and other sensitive information**

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Interaction & Overlap

- GAAS, COSO and UG
 - Same internal control definition
 - Same objectives: reporting, operations, compliance
 - Cross referenced requirement to use COSO in UG and financial statement audits.
 - Difference being UG are compliance audits
 - Objectives focused; requires [must] internal control

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• COSO, SAS and Audit Planning [Auditor Perspective]

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Auditing Standards AU-C 315

- Although internal control applies to the entire entity or any of its operating units or business functions, an understanding of internal control relating to each of the entity's operating units and business functions may not be necessary to the performance of the audit.
- Which reporting objective from COSO is the auditing standard(s) specifically dealing with?


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Reporting

- Objectives
 - **External Financial**
 - External Non-financial
 - Internal Financial
 - Internal Non-financial


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Auditor Risk Assessment Overview

- Planning the audit [Rebuttable Presumptions]
- Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement
- Materiality in Planning and Performing an Audit


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Auditor Risk Assessment Overview

- Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained
- Audit Considerations Relating to an Entity Using a Service Organization
- Evaluation of Misstatements Identified During the Audit


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Financial Statement Presumptions Overview

- Management override of controls could occur
 - Test Journal Entries
 - Accounting Estimates
 - Transactions Outside the Norm
- Presume that fair value can be measured reliably
 - Test Accounting Estimates where Management has not used fair value or unable to obtain


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Assertions Specific to Governmental Entities

- transactions and events have been carried out in accordance with law or regulation.
- Such assertions may fall within the scope of the financial statement audit

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AU-C 330

- Other items of note:
 - Must test the “Financial Statement Closing Process” as its own separate process to be tested by
 - Comparing the financial statement with underlying accounting records
 - Journal entry testing, especially closing journal entries
 - Significant Risks need specific responses in the form of substantive procedures tied to that risk in the testing of details. In other words, document a link between the response and the risk.

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Financial Statement Presumptions Overview

- Presume revenue is overstated due to fraud
- Presume there are other fraud risks in the financial statements
 - Brainstorm “what if”
 - Determine if there are fraud risk factors present [incentives, pressures, attitudes or rationalizations to commit fraud]

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Auditor Risk Assessment Procedures

- Inquiries;
 - Of management
 - Individuals within the internal audit function, if applicable
 - Others who may have information
- Analytical Procedures
- Observation & Inspection
- Dual/triple purpose tests of transactions, Journal Entries, accounting estimates


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Audit Risk [AR]

- Incorrect Acceptance
- Function of:
 - Risk Management’s Financials ARE Materially Misstated [RMM]
 - AND
 - Auditor will NOT Detect the Misstatement - [DR]
- $AR = RMM * DR$


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Risk of Incorrect Acceptance

- Risk of Material Misstatement [RMM]
 - Inherent and
 - Control Risks
- Audit Risk – Risk Inherent in Applying Audit Procedures [Detection Risk]
 - Test of Details
 - Analytical Procedures
- **AR = (IR * CR) * (TD * AP)**


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Inherent and Residual Risk

- Inherent risk exists in the system before any type of system/management intervention
- Residual risk exists in the system after system or management actions are taken.
- Can be subjective and base on auditor judgment/experience/knowledge


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Control Risk

- Tests of Controls
 - Right Control for the Right Objective – Matching!
 - Attribute Based
 - “Stop and Go” Sampling [25/40/60]
- Reaction to test results ...
 - Empirical
 - Judgmental


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Detection Risk

- Test of Details Risk
 - All Substantive Procedure Based
 - Heavily Influenced by RMM Response
- Analytical and Other Procedures Risk
 - Also Substantive
 - Influenced by RRM and Test of Details


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Auditors' Understanding Limited

- Section 315, paragraph .13: The auditor should obtain an understanding of internal control **relevant to the audit**
- Likely the controls the auditor obtains an understanding of will relate to the financial reporting process, but not all process controls will be understood. Matter of professional judgment.

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Nature & Extent of Understanding Relevant Controls

- The auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures **in addition to inquiry** of the entity's personnel
- The auditor should evaluate and document their understanding of internal control in each of the five component areas.

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Nature & Extent of Understanding Relevant Controls - UG

- UG requires
 - perform procedures to obtain an understanding of internal control over federal programs sufficient to plan the audit to support a **low assessed level of control risk of noncompliance for major programs.**
 - plan the testing of internal control over compliance for major programs to support a low assessed level of control risk of noncompliance for the assertions relevant to the compliance requirements for each major program.
 - perform testing of internal control over compliance as planned.

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Nature & Extent of Understanding Relevant Controls

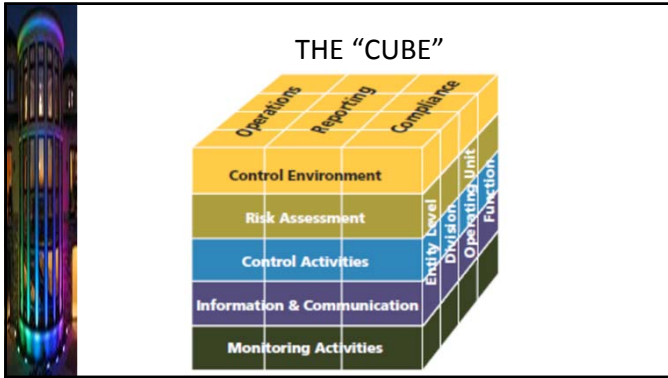
- UG requires
 - **report** on internal control over compliance describing the **scope** of the **testing of internal control** and the **results** of the tests and, where applicable, referring to the **separate schedule of findings and questioned costs**. This schedule includes, where applicable, a statement that significant deficiencies and material weaknesses in internal control over compliance for major programs were identified in the audit.

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• COSO's Role in Fraud Prevention, Detection and Deterrence

Internal control is...

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Integration

- Each component cuts across and applies to all three categories of objectives.
- The three categories of objectives are not parts or units of the entity. For instance, operations objectives relate to the efficiency and effectiveness of operations, not specific operating units or functions such as sales, marketing, procurement, or human resources.

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Objectives

- Management, with board oversight, sets entity-level objectives that align with the entity's mission, vision, and strategies.
- High-level objectives reflect choices made by management and board of directors about how the organization seeks to create, preserve, and realize value for its stakeholders.

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Objectives

- May focus on the entity’s unique operations needs, or align with laws, rules, regulations, and standards imposed by legislators, regulators, and standard setters, or some combination of the two.
- Objective setting is a **prerequisite to internal control** and a key part of the management process relating to strategic planning.

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COSO ERM Cube


The diagram shows a 3D cube with eight horizontal layers. From top to bottom, the layers are: Internal Environment (yellow), Objective Setting (orange), Event Identification (red), Risk Assessment (green), Risk Response (purple), Control Activities (blue), Information & Communication (dark blue), and Monitoring (black). To the left of the cube, three items are listed with brackets pointing to the layers: Control Environment (bracketed to Objective Setting), Risk Assessment (bracketed to Risk Assessment and Risk Response), and Audit Committee (bracketed to Information & Communication).

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Objectives

- Individuals who are part of the system of internal control need to understand the overall strategies and objectives set by the organization.
- As part of internal control, management specifies suitable objectives so that risks to the achievement of such objectives can be identified and assessed.
- Specifying objectives includes the articulation of specific, measurable or observable, attainable, relevant, and time-bound objectives.


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Objectives

- However there may be instances where an entity might not explicitly document an objective.
- Objectives specified in appropriate detail can be readily understood by the people who are working toward achieving them.


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Operations Objectives

- Could include:
 - Safeguarding of Assets
 - efficient use of an entity's assets
 - prevention of loss through waste, inefficiency, or poor business decisions (e.g., selling product at too low a price, extending credit to bad risks, failing to retain key employees, allowing patent infringement to occur, incurring unforeseen liabilities)

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Very Simply ...

INTEGRATION

MISSION

VISION

VALUES

STRATEGY

OBJECTIVES

ACTIONS

COMPONENTS
PRINCIPLES

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