

Audit Committee *Brief*

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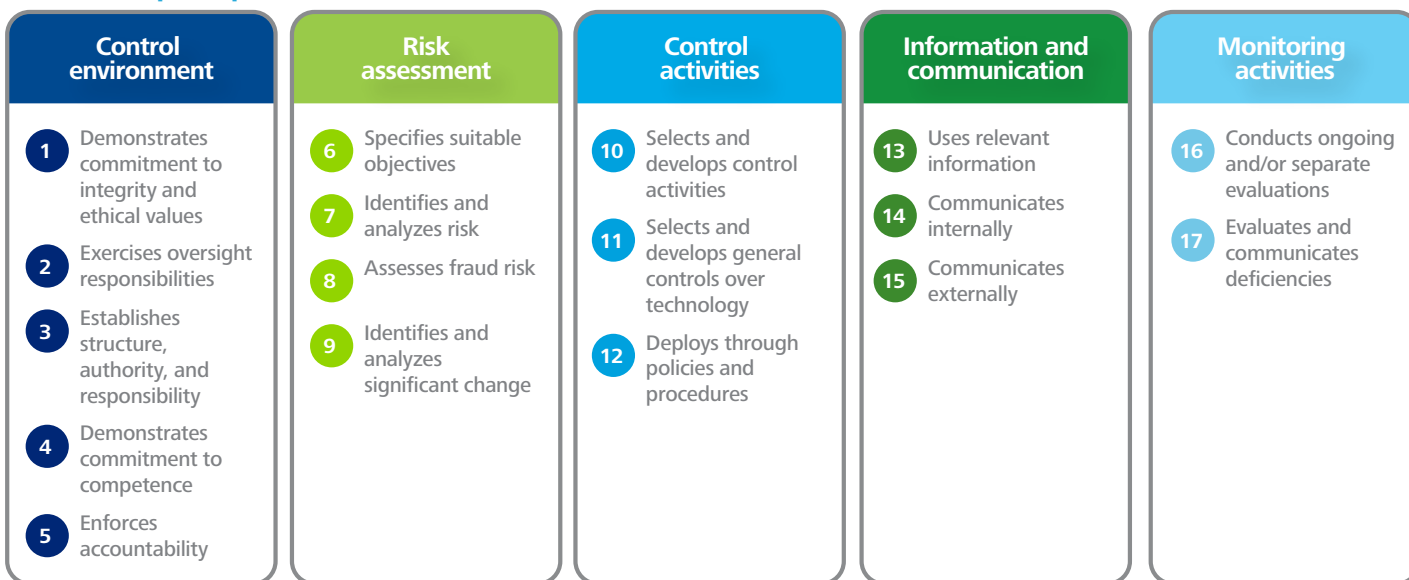
The 2013 COSO Framework and the audit committee

Audit committees play a critical role in overseeing internal control. Although their primary focus may be on internal control over financial reporting, now, more than ever, audit committees are taking the lead in overseeing controls pertaining to compliance and operational matters. Expectations of the audit committee's role have expanded due to enhanced company and external auditor reporting requirements, along with an increased focus on compliance by regulators. This issue of the *Audit Committee Brief* highlights hot topics related to internal control over financial reporting in light of the issuance of the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) updated [2013 Internal Control — Integrated Framework](#) (2013 COSO Framework). Also included are important considerations for audit committees in overseeing the implementation of the 2013 COSO Framework, and a discussion of how the framework can help audit committees manage elevated expectations regarding internal control.

Background

The updated version of the COSO Framework, issued in May 2013, emphasizes the role of the board—and thereby the audit committee, depending on governance structure—in creating an effective control environment and having a robust risk assessment process, including identifying and addressing fraud risks. Further, the updated framework provides additional structure by defining 17 principles of internal control. The framework's enhanced structure increases the level of rigor required to evaluate the design and effectiveness of internal control. In accordance with the 2013 COSO Framework, all principles must be present and functioning in order to conclude that internal control over financial reporting is effective.

COSO's 17 principles of internal control – summarized



Many hot topics associated with internal control over financial reporting, as outlined in the [appendix](#) of this issue of the brief, are discussed in detail in the 2013 COSO Framework. These include the competence and accountability of those performing internal control activities, fraud risk identification and response, the quality of information used in internal control, and business events that may necessitate changes in internal control. For a detailed analysis of the changes in the 2013 COSO Framework, please refer to Deloitte's June 10, 2013, issue of [Heads Up: COSO Enhances Its Internal Control – Integrated Framework](#).

The PCAOB and SEC have also been focusing on internal control-related matters. PCAOB Practice Alert No. 11, *Considerations for Audits of Internal Control Over Financial Reporting*, released in November 2013, highlights common PCAOB inspection findings related to audits of internal control. Although the practice alert is primarily addressed to auditors, SEC Deputy Chief Accountant Brian Croteau has stressed that the issues summarized in the alert may be

indicative of material weaknesses that management has not identified.¹

Public companies using the original 1992 COSO Framework for their internal control reports should be aware of COSO's transition guidance, which states that the older framework will be available until December 15, 2014, at which time COSO will consider it to be superseded by the 2013 COSO Framework.² In addition, SEC Chief Accountant Paul Beswick stated in May 2013 that "the 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."

1 See speech by Brian Croteau, December 9, 2013, which stated in part: "As we maintain or increase the intensity of our focus in [internal control over financial reporting]...I remain convinced that at least some of the PCAOB's inspection findings related to the audits of internal control over financial reporting are likely indicators of similar problems with management's evaluations of ICFR, and thus potentially also indicative of risk for unidentified material weaknesses...[and] I continue to question whether all material weaknesses are being properly identified..." (<http://www.sec.gov/News/Speech/Detail/Speech/1370540472057>).

2 SEC rules state that "the framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment." See 17 CFR §§ 240.13a-15(c).



The SEC staff has also indicated that “the longer issuers continue to use the 1992 framework, the more likely they are to receive questions from the staff about whether the issuer’s use of the 1992 framework satisfies the SEC’s requirement to use a suitable, recognized framework (particularly after December 15, 2014).…”³

With this background in mind, audit committees have both an impetus and an opportunity to use the implementation of the 2013 COSO Framework as a means to challenge management to refresh and reevaluate a company’s internal control. Companies can begin by evaluating the changes needed to meet the December 2014 transition deadline (for calendar year-end public companies reporting on internal control over financial reporting). There is also an opportunity to extend the adoption of the 2013 COSO Framework beyond internal

³ See minutes of the September 25, 2013, meeting of the Center for Audit Quality SEC Regulations Committee with the staff of the SEC: <http://www.thecaq.org/docs/reports-and-publications/2013septembe25jointmeetinghls.pdf>.

Consideration of SEC whistleblower rules

In discussions with management about the adoption of the 2013 COSO Framework, the audit committee may consider asking management the following questions related to whistleblower programs:

- Are there opportunities to enhance internal whistleblowing systems, processes, and responsibilities?
- What consideration, if any, has been given to the effect of repeated allegations being considered as part of the fraud risk assessment?
- Are there appropriate methods to maintain accountability for perpetrators of fraud, as well as those in the chain of command with knowledge of fraudulent activities?
- What consideration has been given to the use of monitoring tools to identify potential fraud?
- Have the potential advantages of implementing incentives to encourage internal whistleblowing been considered?
- Are there policies in place to prevent and monitor for retaliation against whistleblowers?

control over financial reporting and to encompass controls that address other material regulatory compliance or operational risks. Using a common framework to identify and implement controls and address a wide spectrum of material risks can facilitate a consistent, effective approach to evaluation and promote efficiency through leveraging certain controls to address multiple categories of risk. The section of this document on [marketplace trends](#) provides examples of how companies might consider applying the 2013 COSO Framework beyond internal control over financial reporting. As highlighted in the November/December 2013 issue of the [Audit Committee Brief: Top Issues for Audit Committees in 2014](#), the 2013 COSO Framework is likely to remain a hot topic for audit committees throughout 2014.

COSO and the role of the board and audit committee

The 2013 COSO Framework emphasizes the role of the board of directors—and, by delegation or regulation, the role of the audit committee—in overseeing internal control, which remains an essential aspect of effective governance. In particular, the framework highlights:

- The board’s role in the control environment, including providing clarity regarding expectations for integrity and ethics, conflicts of interest, adherence to codes of conduct, and other matters
- The board’s assessment of the risk of management override of internal control and careful consideration of the possibility that management may override such controls⁴
- The establishment and maintenance of open lines of communication between management and the board, and the provision of separate lines of communication, such as whistleblower hotlines.

⁴ Further discussion of actions audit committees can take in this area is included in the AICPA report, [Management Override of Internal Controls: The Achilles’ Heel of Fraud Prevention](#).

The following principles within the control environment component of the framework, in particular, emphasize the role of the board:

Summarized COSO principle	Summarized points of focus
1 Demonstrates commitment to integrity and ethical values	<ul style="list-style-type: none"> • The board and management set the tone at the top • Board and senior management expectations are clear in the standards of conduct • Processes are in place to evaluate adherence to standards of conduct (consistent with board expectations and oversight) • Deviations are addressed in a timely manner (with board oversight)
2 Exercises oversight responsibility	<ul style="list-style-type: none"> • The board identifies and accepts its oversight responsibilities • The board defines, maintains, and evaluates the skills and expertise needed for effective oversight • The board has sufficient independent members • The board oversees the design and conduct of internal control
3 Establishes structure, authority, and responsibility	<ul style="list-style-type: none"> • Management and the board consider all entity structures • Management establishes reporting lines (with board oversight) • Management and the board define, assign, and limit authority and responsibilities
4 Demonstrates commitment to competence	<ul style="list-style-type: none"> • The organization establishes policies and practices related to expectations and competencies • The board and management evaluates competence and addresses shortcomings • The organization has a clear plan for attracting, developing, and retaining individuals • Management and the board plan and prepare for succession
5 Enforces accountability	<ul style="list-style-type: none"> • Management and the board set and oversee structures, authorities, and responsibilities • Management and the board establish performance measures, incentives, and rewards and evaluate them for ongoing relevance • Management and the board consider excessive pressures • Management and the board evaluate performance

As companies implement the 2013 COSO Framework and perform a gap analysis to compare it to the company’s current control structure, we have observed that gaps are commonly identified in three areas:

- In the company’s internal control related to COSO’s 17 principles, where one of the principles is not present or functioning
- In the company’s internal control related to the points of focus; for example, though the points of focus are not formally required, the company may determine improvements are needed and decide to implement additional points of focus in order to meet the objective of the principle
- In the company’s documentary evidence demonstrating the principles have been met and supporting management’s assessment of internal control

In discussing the company’s progress in evaluating the impact of the 2013 COSO Framework with management, audit committees should focus the discussion on these matters.



Marketplace trends and the use of the 2013 COSO Framework

There is a growing trend for companies to use the 2013 COSO Framework for operational and compliance purposes, in addition to its use for internal control over financial reporting. Areas where companies may consider applying the framework include:

- Managing compliance with the Foreign Corrupt Practices Act (FCPA) – As discussed in Deloitte’s October 2013 [Audit Committee Brief: Navigating Anti-Corruption Compliance](#), there has been a significant increase in FCPA enforcement actions by the SEC and Department of Justice. Audit committees may use the 2013 COSO Framework to help manage and control FCPA-related risks.
- Managing compliance with global security and privacy regulations, including payment card industry rules, and managing risks associated with cyber attacks and threats – According to a 2012 Deloitte publication titled [Risk Intelligent Governance in the Age of Cyber Threats](#), the median annualized cost of cyber crime per company in 2011 was \$5.9 million, which was a 56 percent increase over the previous year. In addition, the 2013 COSO Framework may be utilized to manage compliance with third-party contract agreements, including those related to security access and licensing requirements.
- Managing industry-specific regulatory requirements – Examples include meeting Bank Holding Company Act reporting requirements; anti-money laundering regulations; Food and Drug Administration, Federal Aviation Administration, and Defense Contract Audit Agency regulations; and state-specific regulations, where applicable.
- Creating governance, risk, and controls programs related to sustainability – As companies face increasing pressure to address environmental, social, and governance (ESG) issues, the 2013 COSO

Framework may assist in developing a program to manage a growing class of ESG risks. Today, more than ever, investors are scrutinizing a company’s ESG performance and becoming increasingly averse to ESG risks. Companies that are demonstrably prepared for ESG shocks may better mitigate downside risks, both short- and long-term, when they occur.

- Providing a framework to identify, mitigate, and manage board-level operational and strategic risk areas, as identified through companies’ enterprise risk management processes.

Applying the 2013 COSO Framework in areas other than financial reporting may provide helpful and necessary discipline to address the increasingly complex array of risks that boards and audit committees oversee. It may also provide management with a consistent and efficient framework to define, implement, and monitor the control structure and continuously improve risk management processes.

Conclusion

The audit committee plays an integral role in overseeing that the objectives of an internal control program are met across the organization. Regulators and other stakeholders are increasing their focus on internal control and related governance issues, and the 2013 COSO Framework can help audit committees navigate various internal control issues and employ an effective oversight program. The implementation of the updated framework provides a good opportunity to take a fresh look at internal control and create value for the organization, regardless of how mature a company’s system of internal control may be. Improvements in the effectiveness of internal control can lead to more efficient operations, greater compliance rates, and more effective internal and external financial reporting.

Appendix

Internal control over financial reporting hot topics

The following chart provides a summary of the areas commonly observed to be challenging aspects of internal control over financial reporting (ICFR) and indicates which of these areas are also commonly linked to material weaknesses and/or relate to the most common areas of material fraud. We also outline below how these areas map to the principles in the 2013 COSO Framework to highlight areas that may need attention when implementing the updated framework.

ICFR hot topics	Cited in material weakness disclosures ⁱ	Areas/ contributing factors to material fraud ⁱⁱ	Related 2013 COSO Framework principles
Control environment			
Ethics program	✓	✓	1, 2
Delegation of authority			3
Competence and training of accounting personnel ⁱⁱⁱ	✓		4
Establishing accountability and expectations for ICFR through performance and compensation systems			5
Risk assessment			
Appropriateness of and support for accounting policies and procedures	✓		6
Detailed risk assessment for each relevant account and disclosure, and linking the risk assessment to related control activities			7, 10, 11, 12
Fraud risk assessment, including management override, financial statement manipulation, misappropriation of assets, and corruption		✓	8, 10, 11, 12
Revising the risk assessment and controls for one-time or infrequent transactions or events, such as: <ul style="list-style-type: none"> • Significant changes in process, technology, or people • Business combinations 	✓	✓	9, 10, 11, 12
Control activities			
Establishing expectations through internal control policies and procedures			12
Journal entries	✓	✓	10
Segregation of duties ⁱⁱⁱ , such as IT system access issues and incompatible duties	✓	✓	10, 11
Account balance and disclosure specific controls, ^{iv} such as: <ul style="list-style-type: none"> • Revenue • Inventory (including cycle count and/or physical inventory programs) • Taxes • Footnotes and cash flow statement • Account reconciliations 	✓	✓	10, 12

ICFR hot topics	Cited in material weakness disclosures ⁱ	Areas/ contributing factors to material fraud ⁱⁱ	Related 2013 COSO Framework principles
Precision and evidence of management review controls, such as: <ul style="list-style-type: none"> • Reserves, including inventory obsolescence, and bad debts • Impairment, including projections • Fair value of investments • Pension liabilities • Application of GAAP • Involving and/or overseeing specialists • Component financial results/data 	✓	✓	10, 12, 16
Use of outsourced service providers	✓		10, 12, 16
IT security and program change controls	✓		11
Information and communication			
Quality of data, including reports used by controls			13
Whistleblower programs			14, 15
Monitoring activities			
Monitoring approach linked to the risk assessment, including consideration of business units/locations		✓	16
Effectiveness and competence of the monitoring function, such as the internal audit function	✓	✓	16
Substance of the entity's periodic certification program			14, 15, 16
Evaluation of deficiencies to determine the root cause			17

i Based on data from Audit Analytics for the period from November 15, 2012, through November 14, 2013, including 10-K filings for the calendar year ended December 31, 2012.

ii Revenue recognition is the most common area of material fraud. In 2009, 38 percent of material frauds related to revenue recognition, 12 percent related to manipulation of expense, and 12 percent related to improper disclosures. See Deloitte Forensic Center, *Ten Things about Financial Statement Fraud – Third Edition*, 2009.

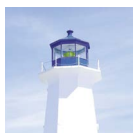
iii Based on the data from Audit Analytics previously referenced, a majority of material weaknesses involve issues with accounting personnel competence, training, and segregation of duties.

iv In addition to those accounts or disclosure-specific control areas identified in the table, material weakness disclosures also commonly cite issues regarding accounts receivable (including loans receivable), investments, cash, intangible or fixed assets, vendor and costs of sales, and contingencies.

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Additional resources

[June 10, 2013, Heads Up: COSO Enhances Its Internal Control—Integrated Framework](#)

[October 2013 Audit Committee Brief: Navigating Anti-corruption Compliance](#)

[November/December 2013 Audit Committee Brief: Top Issues for Audit Committees in 2014](#)

[Risk Intelligent Governance in the Age of Cyber Threats](#)

[Ten Things about Financial Statement Fraud](#)

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