

# A Framework for Internal Control:

CoSO's FIVE COMPONENTS OF  
INTERNAL CONTROL



## THE INTERNAL CONTROL INTEGRATED FRAMEWORK ( COSO I )



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# What is COSO?

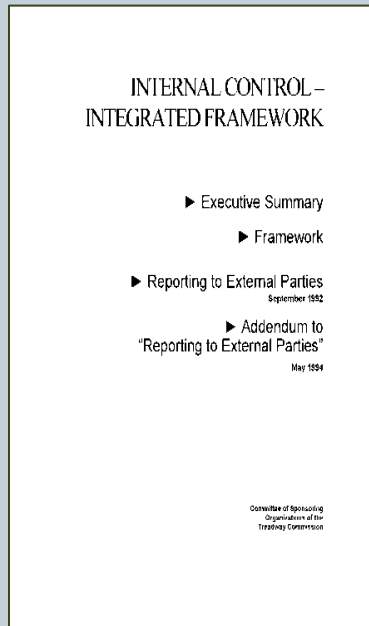


COSO, the Committee of Sponsoring Organizations of the Treadway Commission, is a private sector initiative established in 1985 by five financial professional associations.

1. The Institute of Internal Auditors
  2. American Institute of Certified Public Accountants
  3. American Accounting Association
  4. Institute of Management Accountants
  5. Financial Executives Institute
- COSO's goal is to improve the quality of financial reporting through a focus on

- **CORPORATE GOVERNANCE,**
- **ETHICAL PRACTICES,**
- **AND INTERNAL CONTROL.**

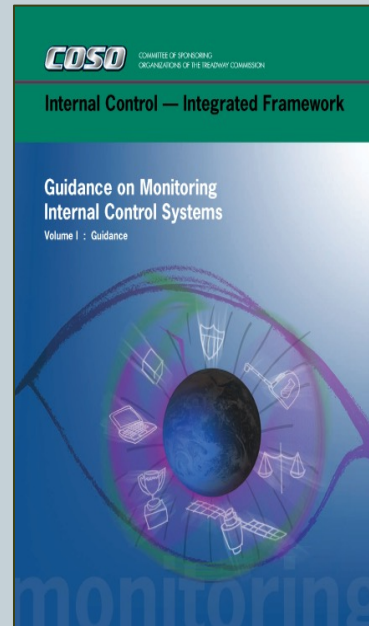
# COSO Overview – Internal Control Publications



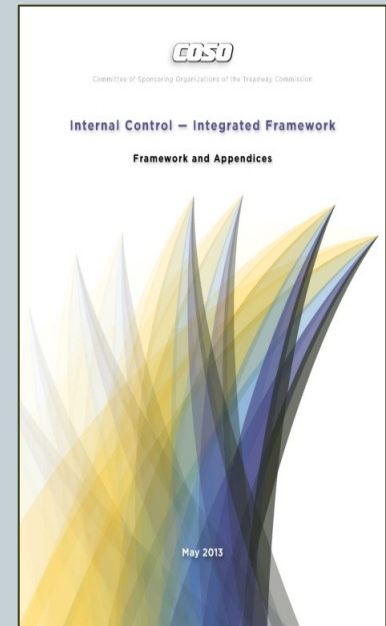
1992



2006



2009

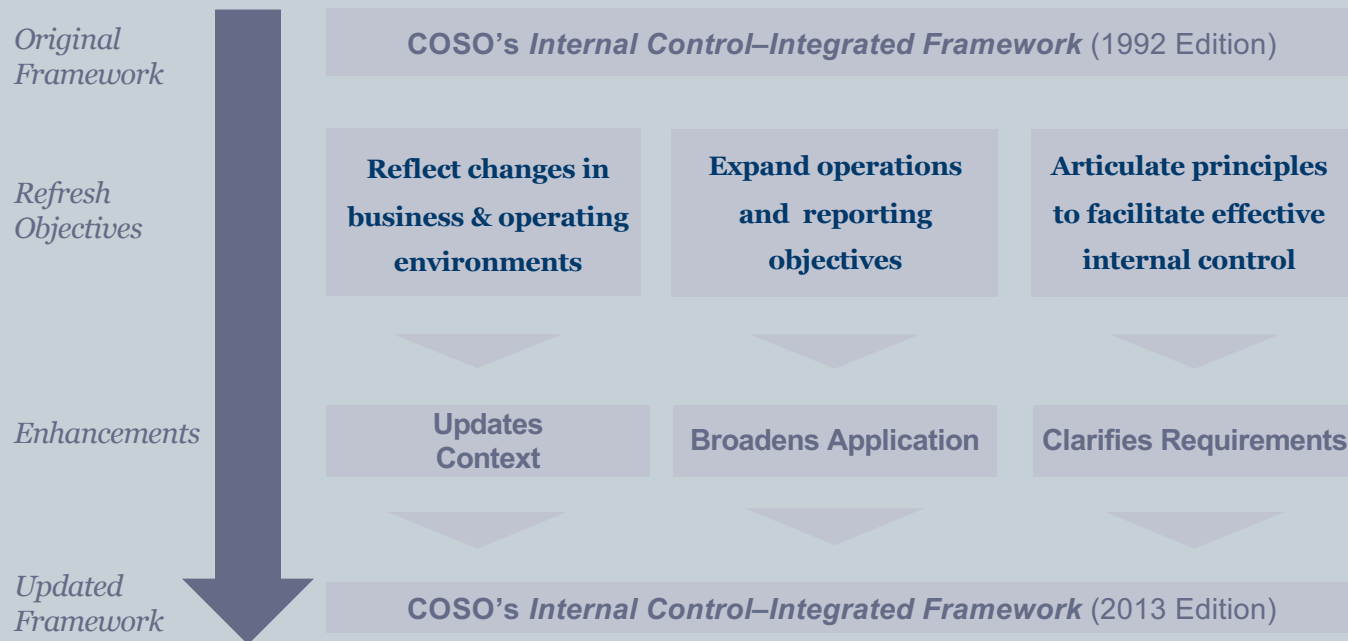


2013

# Why update what works




The Framework has become the most widely adopted control framework worldwide.



# Why update what works

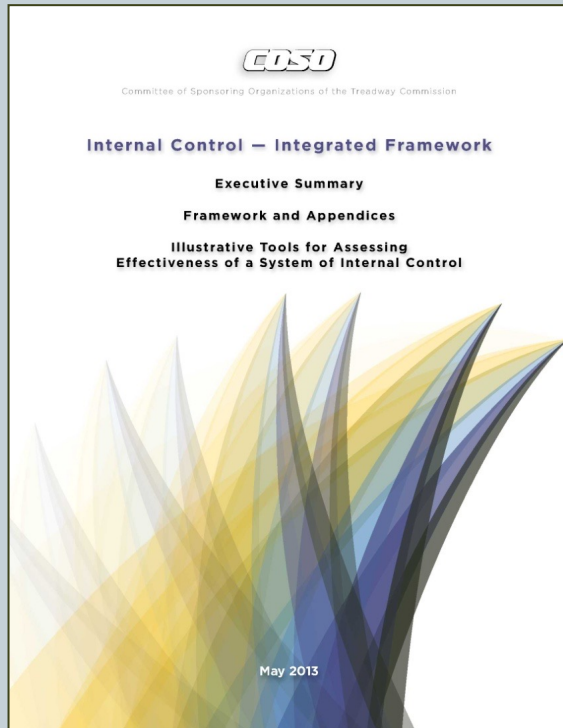


Update considers changes in business and operating environments

<i>Environments changes...</i>	<i>...have driven Framework updates</i>
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)

# Internal Control-Integrated Framework (2013 Edition)



- **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

# Definition of Internal Control



A process, effected by an entity's Board of Directors, Management, and Other Personnel, designed to provide **REASONABLE ASSURANCE** regarding the **ACHIEVEMENT OF OBJECTIVES**.

# Categories of Internal Control objectives



- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations





# A 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

**Mission**

**Vision**

**Values**

**Strategy**

**Objectives (3)**

**Components (5)**

**Principles (17)**

**Points of focus (~80)**

# Components of Internal Control

1. Control Environment
2. Risk Assessment
3. Control Activities
4. Information and Communication
5. Monitoring



# Components and principles



Under the 2013 COSO Framework, effective internal control requires the following:

- Each of the 5 components and 17 principles must be present and functioning.
- The 5 components must operate together in an integrated manner.
- All 81 points of focus are considered, but are not required to be present.

## 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

# Applying the framework –key concepts



Each of the five components and relevant principles is present and functioning.

**“Present”** refers to the determination that the components and relevant principles exist in the design and implementation of the system of internal control to achieve specified objectives.

**“Functioning”** refers to the determination that the components and relevant principles continue to exist in the operations and conduct of the system of internal control to achieve specified objective.

**The five components operate together in an integrated manner**

**“Operating together”** refers to the determination that all five components collectively reduce, to an acceptable level, the risk of not achieving an objective. Components should not be considered discretely; instead, they operate together as an integrated system.

# Control Environment



**Control Environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The resulting control environment has a pervasive impact on the overall system of internal control.**

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



**Risk assessment involves a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Thus, risk assessment forms the basis for determining how risks will be managed.**

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



**Control activities are the actions established through policies and procedures to mitigate risks to the achievement of objectives. Control activities are performed at all levels of the entity, at various stages within business processes, and over the technology environment.**

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



**Information is necessary for entity to carry out internal control responsibilities to support achievement of objectives. Communication is continual, iterative process of providing, sharing, and obtaining necessary information**

- 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



**Ongoing evaluations, separate evaluations, or some combination of the two are used to ascertain whether each of the five components of internal control—including controls to effect the principles within each component—is present and functioning.**

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.

# Six steps in evaluating control deficiencies



1. Determine whether a control deficiency exists

2. Identify and describe the control deficiency

3. Determine whether the control deficiency is indicative of other deficiencies

4. Evaluate the severity of the deficiency by considering magnitude and likelihood of the potential misstatement

5. Identify relevant compensating controls and conclude on the severity

6. Aggregate similar deficiencies and evaluate the aggregated deficiencies for severity



# Distinction Between Monitoring Activities and Control Activities



Control Activity	Monitoring Activity
<ul style="list-style-type: none"><li>■ Operates at precision level to address risks for specific financial statement assertions</li><li>■ Responds to a specified risks (WCGWs)</li><li>■ Designed to detect and correct errors in financial statement assertions</li></ul>	<ul style="list-style-type: none"><li>■ Does not operate at precision level to address risks for specific financial statement assertions</li><li>■ Monitors effective operation of control activities</li><li>■ Monitors remediation of deficiencies</li></ul>

**Monitoring activities assess whether controls in each of five components are operating as intended**

**Monitoring activities are NOT a substitute for control activities—  
BOTH are important**



# **How to use the framework**

**Ask the Right Internal  
Control Questions about:**

# ETHICS



1. Do board members and senior executives set a day-in, day-out example of high integrity and ethical behavior?
2. Is there a written code of conduct for employees, and is it reinforced by training, top down communications, and requirements for periodic written statements of compliance from key employees?
3. Are performance and incentive compensation targets reasonable and realistic, or do they create undue pressure on achievement of short-term results?
4. Is it clear that fraudulent financial reporting at any level and in any form will not be tolerated?
5. Are ethics woven into criteria that are used to evaluate individual and business unit performance?
6. Does management react appropriately when receiving bad news from subordinates and business units?
7. Does a process exist to resolve close ethical calls?

# RISK



1. Is relevant and reliable internal and external information identified, compiled, and communicated in a timely manner to those who are positioned to act?
2. Are business risks identified and candidly discussed with the board of directors?
3. Are risks identified and analyzed, and actions taken to mitigate them?
4. Are controls in place to assure that management decisions are properly carried out?

# INTERNAL CONTROL



1. Do senior and line management executives demonstrate that they accept control responsibility, not just delegate that responsibility to financial and audit staff?
2. Does management routinely monitor controls in process of running the organization's operations?
3. Does management clearly assign responsibilities for training and monitoring of internal controls?
4. Are periodic, systematic evaluations of control systems conducted and documented?
5. Are such evaluations conducted by personnel with appropriate responsibilities, business experience, and knowledge of the organization's affairs?
6. Are appropriate criteria established to evaluate controls?
7. Are control deficiencies reported to higher levels of management and corrected on a timely basis?
8. Are appropriate controls built in as new systems are designed and brought on stream?