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## **STANDING ADVISORY GROUP MEETING**

### **PRESENTATION – AUDITING IMPLICATIONS OF COSO PROJECT TO UPDATE THE COSO INTERNAL CONTROL – INTEGRATED FRAMEWORK**

**MARCH 24, 2011**

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#### **Introduction**

At the March 2011 meeting of the Standing Advisory Group ("SAG"), a representative from the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") will make a presentation regarding COSO's project to update its *Internal Control – Integrated Framework* ("IC-IF"), which will be followed by a SAG discussion. The purpose of the SAG discussion is to inform the PCAOB of the SAG's views on any potential implications of COSO's update of IC-IF on the auditor's responsibilities regarding internal control over financial reporting and, in turn, PCAOB auditing standards.

This paper provides SAG members with background information regarding the relationship between IC-IF and PCAOB auditing standards, as well as certain matters that might be relevant to audits of issuers and broker-dealers in light of the IC-IF update.

#### **Background**

For many years, audits of financial statements have involved, among other things, obtaining an understanding of a company's internal control over financial reporting and testing and evaluating controls as necessary.

In general terms, internal control frameworks, such as IC-IF, describe the components of internal control and the principles for effective internal control. Different

<p>This paper was developed by the staff of the Office of the Chief Auditor as of March 10, 2011 to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.</p>
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internal control frameworks<sup>1/</sup> use different terms and approaches to describe the components of internal control over financial reporting. Thus, an auditor's use of a particular framework can affect an auditor's approach to performing and documenting his or her consideration of a company's internal control over financial reporting. Since COSO's IC-IF was released in 1992, many companies and auditors have used IC-IF as their framework in considering internal control over financial reporting.<sup>2/</sup> Also, since companies and auditors began reporting on the effectiveness of internal control over financial reporting ("ICFR") pursuant to §404 of Sarbanes-Oxley Act of 2002 ("the Act"), many of those companies and auditors have used IC-IF as the framework for evaluating and reporting on ICFR.<sup>3/</sup>

In November 2010, COSO announced a project to review and update IC-IF "to make the existing Framework and related evaluation tools more relevant in the increasingly complex business environment so that organizations worldwide can better design, implement, and assess internal control."<sup>4/</sup> The presentation of the COSO representative will include a discussion regarding expected areas of refinement of IC-IF.

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<sup>1/</sup> Another example of an internal control framework is the report published by the Financial Reporting Council, *Internal Control Revised Guidance for Directors on the Combined Code*, October 2005 (known as the Turnbull Report).

<sup>2/</sup> After COSO issued IC-IF, the Auditing Standards Board of the American Institute of Certified Public Accountants amended its Statement on Auditing Standards No. 55, AU Sec. 319, "Consideration of Internal Control in a Financial Statement Audit" to align the requirements related to understanding and testing controls with IC-IF. That amended standard was initially adopted as an interim standard of the PCAOB and has been superseded in connection with the PCAOB's adoption of its standards for assessing and responding to risk in an audit (PCAOB Release No. 2010-004) (August 5, 2010). The standards for assessing and responding to risk are neutral regarding the internal control framework that auditors use for obtaining an understanding of ICFR, testing and evaluating controls; but those standards are not inconsistent with IC-IF.

<sup>3/</sup> SEC rules require that management's evaluation of a company's internal control be based on a "suitable, recognized control framework" established by a group or body that follows notice and comment procedures. The Commission has identified IC-IF as such a framework. See 17 CFR §§ 240.13a-15(c) and 240.15d-15(c).

<sup>4/</sup> COSO press release, "COSO Announces Project to Modernize Internal Control – Integrated Framework." (November 18, 2010). Attachments 1 and 2 to this

## Relevance to PCAOB Auditing Standards

Existing PCAOB auditing standards<sup>5/</sup> are neutral regarding the internal control framework that auditors use for obtaining an understanding of ICFR, testing and evaluating controls, and, in integrated audits, reporting on ICFR. For integrated audits, PCAOB standards state that auditors should use the same internal control framework that management uses.<sup>6/</sup> For audits of only financial statements, auditors may use any suitable recognized internal control framework.<sup>7/</sup> However, because many auditors' approaches to considering internal control is based on IC-IF, changes to IC-IF could have implications for audits conducted in accordance with PCAOB standards. Also, changes to IC-IF could lead companies to make changes to their controls, their control documentation, or management's process for assessing the effectiveness of ICFR, which, in turn, could affect the auditor's procedures regarding ICFR.

## Discussion Topics

The presentation and discussion may address the following topics:

- Potential changes to the auditor's procedures regarding obtaining an understanding of ICFR or testing and evaluating ICFR in the financial statement audit or the audit of internal control over financial reporting resulting from the requirements of the updated IC-IF.
- Potential auditing challenges resulting from the transition from the 1992 IC-IF to the updated IC-IF (for example, challenges with testing and evaluating companies' changes in controls; and changes in firm methodology or training of personnel regarding the firm's approach to considering ICFR)

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briefing paper are COSO's announcement of its intention to update IC-IF and a related set of frequently asked questions published by COSO, respectively.

<sup>5/</sup> See, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

<sup>6/</sup> Paragraph 5 of Auditing Standard No. 5.

<sup>7/</sup> Paragraph 22 of Auditing Standard No. 12.

- Possible need for additional PCAOB guidance or updates to PCAOB auditing standards regarding the auditor's responsibilities with respect to ICFR

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The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection

## ATTACHMENT 1



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## **COSO Announces Project to Modernize Internal Control - Integrated Framework**

**ALTAMONTE SPRINGS, Fla.** -- The Committee of Sponsoring Organizations of the Treadway Commission (COSO) today announced a project to review and update the *COSO Internal Control - Integrated Framework* (Framework). This initiative is expected to make the existing Framework and related evaluation tools more relevant in the increasingly complex business environment so that organizations worldwide can better design, implement, and assess internal control.

"Organizations can continue to apply the current Framework, inasmuch as its basic components are timeless, but the more detailed guidance and examples are somewhat dated," says David Landsittel, COSO chairman. "This project is not intended to change how internal control is defined, assessed, or managed, but rather provide more comprehensive and relevant conceptual guidance and practical examples."

The Framework has been widely accepted as an internal control standard for organizations implementing and evaluating internal control related to operations, compliance, and financial reporting objectives, and more recently, internal control over financial reporting in compliance with the U.S. Sarbanes-Oxley Act of 2002 (SOX) and similar regulatory requirements in other countries.

Enhancements to the Framework are not intended to alter the core principles first developed in 1992, but rather facilitate more robust discussion of internal control. Certain concepts and guidance in the Framework will be refined to reflect the evolution of the operating environment, changed expectations of regulators and other stakeholders. In addition, enhancements are expected to consider more than financial reporting and to consider ways to enrich the guidance on operations and compliance objectives.

COSO has engaged PwC to support its update of the Framework. As such, PwC will be working under COSO's leadership and direction in developing the updated Framework. To help ensure a broad representation of perspectives, COSO is also forming an Advisory Council comprised of representatives from industry, academia, government agencies, and not-for-profit organizations to provide input as the project progresses. In addition, the updated Framework will be exposed for public comment to capture any additional input from the general public. Such due process will help ensure that the update adequately addresses internal control challenges of organizations today.

"The updated Framework is intended to help organizations more effectively design and manage internal control," explains Miles Everson of PwC, project team leader. "Additionally, it will further explain the interconnections with the *Enterprise Risk Management - Integrated Framework*, the *2006 Internal Control over Financial Reporting - Guidance for Smaller Public Companies*, and the *2009 Guidance on Monitoring Internal Control Systems*."

The initiative is expected to culminate in an updated internal control framework publication in 2012, the 20th anniversary of the initial Framework.

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**About COSO**

*Originally formed in 1985, COSO is a voluntary private sector organization dedicated to improving organizational performance and governance through effective internal control, enterprise risk management and fraud deterrence. COSO is jointly sponsored by the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), the Institute of Management Accountants (IMA), and The Institute of Internal Auditors (IIA).*

**About PwC**

*PwC ([www.pwc.com](http://www.pwc.com)) provides industry-focused assurance, advisory, and tax services to build public trust and enhance value for its clients and their stakeholders. "PwC" refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity*

## **ATTACHMENT 2**

### **COSO Internal Control - Integrated Framework Update Project Frequently Asked Questions (November 2010)**

#### **1. What is this nature and timing of this project?**

While the *Internal Control - Integrated Framework* has proven to be one of the most widely accepted frameworks for designing and evaluating internal control, the COSO Board has decided to update the Framework to make it more relevant to the current business environment.

Enhancements to the Framework are not expected to alter the core principles or underlying framework first developed in 1992. It should enable more effective application in practice of internal control over operations, compliance and financial reporting. Certain concepts and discussions are expected to be refined to reflect the evolution of the business environment and changed expectations in the market place. It is also the intent of the COSO Board to keep the Framework as succinct as possible.

The projected publication date of the updated Framework is mid-2012.

#### **2. What are some of the preliminary areas expected to be updated?**

While the nature and extent of updates are still to be defined as the date of this document, preliminary topics of discussion that gave rise to the need for considering an update to the original Framework include the following:

- Reflecting the increased use of IT in business operations (e.g., email, internet, automated workflows);
- Expanding the financial reporting objective to include consideration of management reporting and external reporting more broadly (not intended to affect the scope of Sarbanes-Oxley compliance which remains focused on internal controls over financial reporting), (e.g., enabling reporting on sustainability, chain of custody and other third party standards);
- Providing more detail around key governance principles (e.g., responsibilities of the audit committee, compensation committees, and alignment of incentives);
- Explaining the linkages between Internal Control and Enterprise Risk Management frameworks to enable more effective and integrated application in practice );
- Making more crisp and concise those areas of lengthy discussion in the original Framework that have become institutional knowledge; and
- Incorporating core aspects of the 2006 *Internal Control over Financial Reporting- Guidance for Smaller Public Companies* and the 2009 *Guidance on Monitoring Internal Control Systems*.

The update is expected to be analogous to a software update, where the original version remains valid and usable, but the update reflects the additional knowledge and experience gained over time and provides more up-to-date content and a more user-friendly interface.

**3. Will the conceptual and logical construct of the Framework (i.e. the three objective categories and five components) be overhauled?**

We will review both the conceptual and logical construct with a preliminary expectation that the refresh will be internally consistent with the Framework first developed in 1992 --the three objectives categories: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations; and the five components: control environment, risk assessment, control activities, information and communication, and monitoring. However, it may be refined to reflect changes in expectations of organizations. For example, we will explore whether the objective related to 'reliability of financial reporting' might be changed to 'reliability of reporting' and whether the objectives related to effectiveness and efficiency of operations, and compliance with applicable laws and regulations need updating. Finally, it is our expectation that the five components of the framework will remain relatively unchanged.

**4. Who is involved?**

PwC will serve as the author and project leader for updating the Framework and reporting to the COSO Board of Directors.

To capture views of a broad range of professionals in the market place, COSO has formed an Advisory Council representing industry practitioners as well as representatives and observers from academia, government agencies, and non-profit organizations to capture views of a broad range of professionals in the market place.

The updated Framework will be exposed for public comment to capture any additional input from the general public to help ensure that the update adequately addresses internal control challenges that organizations face today.

**5. To what extent are regulators involved in this initiative?**

The SEC, FDIC, GAO, and PCAOB have been informed of this project and have accepted the invitation to attend the Advisory Council meetings as observers. The Advisory Council will provide input to the project. Other regulators may be involved from time to time.

**6. How will this update to the Framework affect SOX 404 Filers?**

The underlying attestation process, e.g., SOX 404 (a) and 404 (b) is not expected to change. In the spirit of continuous improvement, what will change is the ability to apply the Framework more effectively in practice with more current applications examples (e.g., control environment, IT/IS and governance), greater alignment with enterprise risk management, and a more succinct and focused document.



We anticipate that the Framework will include an appendix of the key revisions made. This appendix may assist Management in reviewing and applying the Framework for its SOX 404 compliance.

**7. To what extent are international constituencies involved in this initiative?**

International input will be sought to maximize alignment with other framework from around the world where possible. Among the organizations forming the Advisory Council, one comes from overseas and several have international representation. In addition, regulators or standard-setters from other parts of the world will be engaged from time to time.

**8. What does this mean for other existing frameworks, guidance and tools, such as the Enterprise Risk Management - Integrated Framework, the Guidance for Smaller Public Companies, and the Guidance on Monitoring Internal Control Systems? Will they become obsolete?**

COSO's 2004 Enterprise Risk Management - Integrated Framework, 2006 Guidance for Smaller Public Companies and 2009 Guidance on Monitoring Internal Control Systems are expected to remain. Depending on the nature and extent of updates deemed necessary, certain concepts from such frameworks, guidance, and tools may be leveraged or enhanced, as applicable.

**9. How was PwC selected as the project leader?**

A thorough selection process was followed for selecting Coopers & Lybrand, a predecessor firm of PwC, to write the original framework in 1992. They were given the right of first refusal for future updating requests and have been engaged to do this update. The PwC team includes senior resources involved in previous COSO projects that bring an in-depth understanding of the 1992 framework and the rationale for decisions made in creating that framework, as well as senior resources that can provide fresh market perspectives.

**10. How will COSO and the Project Team will get input?**

The Project Team will get input from several channels throughout the course of the project:

- The Advisory Council will provide input through quarterly meetings and periodic communications;
- A survey is expected to be made available to the general public through the COSO Board members, Advisory Council, and the COSO website, soliciting input on the Framework (what is dated or challenging to interpret, how it could be improved or made more current, what is unnecessary and why, what is missing, and other observations);
- Comments can also be provided to the Project Team through the COSO website or via email; and
- The updated Framework will be issued for public comment.

If you have any other questions or suggestions, please email [[internalcontrol@coso.org](mailto:internalcontrol@coso.org)]