Summary of Internal Control-Integrated Framework by COSO:

COSO stands for “Commission of Sponsoring Organizations a private commission chartered to research and report on improving quality of financial reporting through business ethics, effective internal controls and corporate governance. The sponsoring organizations of COSO were American Institute of Certified Public Accountants, the Institute of Internal Auditors, Financial Executive International, Institute of Management Accountants, and American Accounting Association. COSO has prepared a document in 1992 on the Internal Controls-Integrated Framework. Because, Internal control has different meanings to different parties, COSO tries to establish a common definition and standard that can serve such parties. Under COSO’s report, (quoted from July 1994 Edition of COSO Internal Controls-Integrated Framework, “COSO Report”), “Internal Control is broadly defined as a process, effectuated by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

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

The first categories address an entity’s basic business objective, including performance and profitability goals and safeguarding of resources. The second relates to the preparation of reliable published financial statements, including interim and condensed financial statements and selected financial data derived from such statements, such as earnings, reported publicly. The third deals with complying with those laws and regulations to which the entity is subject. These distinct but overlapping categories address different needs and allow a directed focus to meet the separate needs”. As defined in COSO Report, Internal Control consists of five interrelated components, Monitoring, Information & Communication, Control Activities, Risk Assessment, Control Environment, as illustrated and defined below:

![Diagram](source.png)

Source: COSO Internal Control-Integrated Framework

The definition of the above components as set forth in the COSO Report and quoted herein are as follows:
• **Control Environment**- The core of any business is its people- their individual attributes, including integrity, ethical values and competence-and the environment in which they operate. They are the engine that drives the entity and the foundation on which everything rests.

• **Risk Assessment**- The entity must be aware of and deal with the risks it faces. It must set objectives, integrated with the sales, production, marketing, financial and other activities so that the organization is operating in concert. It also must establish mechanisms to identify, analyze and manage the related risks.

• **Control Activities**- Control policies and procedures must be established and executed to help ensure that the actions indemnified by management as necessary to address risks to achievement of entities objectives are effectively carried out.

• **Information and communication**- Surrounding these activities are information and communication systems. These enable the entity’s people to capture and exchange the information needed to conduct, manage and control its operations.

• **Monitoring**- The entire process must be monitored, and modifications made as necessary. In this way, the system can react dynamically, changing as conditions warrant.
Summary of Internal Control-Integrated Framework-Control Environment

The control Environment is influenced by the style of management, the competence of the employees and positive ethical values of the corporation, which are determined by the board of directors and get implemented all the way to the functional units. The integrity and ethical values of a corporation are important factors in designing, administering and monitoring of all other internal control components of an organization. The board of directors and its audit committee significantly influence the control environment of a corporation. The level of independence of the board members and its audit committee from executive management team, the extent of board members’ oversight over the operations of the company and questioning management’s performance are important factors in designing an internal control system for a corporation.

The report of the National Commission on Fraudulent Financial Reporting (National Commission on Fraudulent Financial reporting, 1987) suggested that certain organizational factors could influence the likelihood of fraudulent and questionable financial reporting. According to this report the level of “Incentives and Temptations” created by the management style of a corporation can affect the ethical behavior of an organization. These factors as cited in COSO Report are described below:

- **Incentives:**
  - Pressure to meet unrealistic performance targets, particularly short-term results.
  - High performance-dependent rewards.
  - Upper and lower cutoff on bonus plans.

- **Temptations:**
  - Nonexistence or ineffective controls, such as poor segregation of duties in sensitive areas that offer temptations to steal or to conceal poor performance.
  - High decentralization that leaves top management unaware of actions taken at lower organizational levels and thereby reduces the chances of getting caught.
  - A weak internal audit function that does not have the ability to detect and report improper behavior.
  - An ineffective board of directors that does not provide objective oversight of top management.
  - Penalties for improper behavior that are insignificant or unpublicized and thus lose their value as deterrents.

The following chart illustrates the Role of Responsibilities of parties involved in the establishing the Control Environment:
CEO (Ultimate Responsibility & Ownership)

- Integrity & Ethics
- Leadership & direction
- Set Positive Control Environ.

Board of Directors & Audit Committee (Governance, Guidance & Oversight)

Senior/Executive Management (Assign Specific Internal Control Policies & Procedures to Functional Units)
Summary of Internal Control-Integrated Framework-Risk Assessment

According to COSO Report, every entity faces a variety of risks from external and internal sources that must be assessed at entity-wide and activity levels throughout its operation. Examples of external factors affecting the entity’s risks are technological development, changing customer needs, changes in competition pressures, new legislations, natural catastrophes, and economical changes. Examples of internal factors affecting the entity’s risk are disruptions in information processing systems, quality of personnel hired, a change in management responsibilities, nature of entity’s activities, employees’ accessibility to assets, and unassertive on ineffective board or audit committee. In summary, the following are the steps that need to taken by the management to assess its risks:

- **Establishment of company’s risk to achieve its objectives.**
- **Identification, analysis and assessment of Risks to achieve objectives.**
- **Assessment of Risks from internal and external sources at both the entity and the activity levels.**
- **Assessment of Risks related to “change in conditions”.**
- **Assessment of financial impacts of Risk Analysis on financial statements.**
Summary of Internal Control-Integrated Framework-Control Activities

According to COSO Report, control activities are policies and procedures to implement management directives. Control activities can be divided into three types of activities; operation, financial reporting and compliance. Control activities consist of preventive controls, detective controls, manual controls, computer controls, and management controls. Control activities are generally handled by entity’s personnel in the following ways; Top Level Reviews, Direct functional or Activity Management, Information processing, Physical Controls, Performance Indicators and Segregation of Duties. In summary, Control Activities consist of the following:

- Policies/procedures that ensure management directives are carried out
- Control activities occur throughout the company at all levels and functions.
- Control activities include approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties
- Control activities cover controls over IT infrastructure, and software security, including legal/contract activities and off-balance sheet transactions

The following flow charts depict the activities of an entity at various levels:

(Source: from COSO Evaluation tools)
Summary of Internal Control-Integrated Framework- Information and communication

According to COSO Report, Information is needed in all levels of an organization to run the business, and move towards achievement of the entity’s objectives in all categories (operations, financial reporting and compliance). The quality of system-generated information affects management’s decision. The quality of information includes ascertaining whether the content is appropriate, and the information is timely, current, accurate and accessible to the appropriate parties. Communication is inherent in the information system and must take place in a broader sense dealing with expectations, responsibilities of individuals and groups. In summary, Information and Communication consist of the following:

- All personnel must receive a clear message from top management to take control activities seriously
- Information needed by personnel to do their job must be timely identified, captured and communicated to them.
- Access to internal (operational, financial, and compliance) reports must be provided to employees to perform their tasks
- External communication with customers, suppliers, regulators, investors and shareholders must be part of the Framework
- Effective upstream communications by employees of their findings must be established
Summary of Internal Control-Integrated Framework- Monitoring

According to COSO Report, Internal control systems change over time. Once-effective procedures can become less effective or perhaps are no longer performed. Monitoring ensures that the internal control continues to operate effectively. Monitoring can be done in two ways: through ongoing activities or separate evaluations. Internal control systems usually will be structured to monitor themselves on an ongoing basis. The greater the degree of effectiveness of ongoing monitoring, the less need for separate evaluation exists. In summary, Monitoring consists of the following:

- **Internal control systems need to be monitored over time to assess their quality and performance**
- **Combination of ongoing and separate evaluation of Internal Control Systems must be conducted by management**
- **Management and supervisory activities are required to be evaluated and monitored on an ongoing basis**
- **Audit of Internal Control Systems needs to done by management to ensure the internal control are functioning as expected**