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COSO – An Approach to Internal Control Framework

The importance of Internal Control in the Operations and Financial Reporting of an entity cannot be over-emphasized as the existence or the absence of the process determines the quality of output produced in the Financial Statements

Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In my last article, I made mention of the Committee of Sponsoring Organization (COSO) which published the "Internal Control Integrated Framework" which is the internal control framework widely adopted the United States of America.

A commission led by James C. Treadway, Jr., the then Executive Vice President and General Counsel, Paine Webber Incorporated and a former Commissioner of the U.S. Securities and Exchange Commission was set up. This commission was sponsored and funded by five United States private sector organizations made up of the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), The Institute of Internal Auditors (IIA), and the National Association of Accountants (now the Institute of Management Accountants [IMA]). These organizations are collectively called the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

The Committee of Sponsoring Organizations were charged by the Treadway Commission to develop an integrated guidance on Internal Control. As a result of this, a framework for designing, implementing and evaluating internal control for organizations was released.

The COSO Framework was designed to help businesses establish, assess and enhance their internal control. The importance of Internal Control in the Operations and Financial Reporting of an entity cannot be over-emphasized as the existence or the absence of the process determines the quality of output produced in the Financial Statements. A present and functioning Internal Control process provides the users with a "reasonable assurance" that the amounts presented in the Financial Statements are accurate and can be relied upon for informed decision making.

COSO Internal Control Framework

Internal Control over Financial Reporting therefore are the controls specifically designed to address the risks of intentional or unintentional misstatements in the financial statements.

The COSO Integrated Framework for Internal Control has five (5) components which include:

1. Control Environment: The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The board of directors and senior management establish the tone at the top regarding the importance of internal control including expected standards of conduct. Management reinforces expectations at the various levels of the organization. The control environment comprises the integrity and ethical values of the organization; the parameters enabling the board of directors to carry out its governance oversight responsibilities; the organizational structure and assignment of authority and responsibility; the process for attracting, developing, and retaining competent individuals; and the rigor around performance measures, incentives, and rewards to drive accountability for performance. The resulting control environment has a pervasive impact on the overall system of internal control.

2. Risk Assessment: Every entity faces a variety of risks from external and internal sources. Risk is defined as the possibility that an event will occur and adversely affect the achievement of objectives. Risk assessment involves a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Risks to the achievement of these objectives from across the entity are considered relative to established risk tolerances. Thus, risk assessment forms the basis for determining how risks will be managed.

A precondition to risk assessment is the establishment of objectives, linked at different levels of the entity. Management specifies objectives within categories relating to operations, reporting, and compliance with sufficient clarity to be able to identify and analyze risks to those objectives. Management also considers the suitability of the objectives for the entity. Risk

assessment also requires management to consider the impact of possible changes in the external environment and within its own business model that may render internal control ineffective.

3. Control Activities: Control activities are the actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of the entity, at various stages within business processes, and over the technology environment. They may be preventive or detective in nature and may encompass a range of manual and automated activities such as authorizations and approvals, verifications, reconciliations, and business performance reviews. Segregation of duties is typically built into the selection and development of control activities. Where segregation of duties is not practical, management selects and develops alternative control activities.

4. Information and Communication: Communication is the continual, iterative process of providing, sharing, and obtaining necessary information. Internal communication is the means by which information is disseminated throughout the organization, flowing up, down, and across the entity. It enables personnel to receive a clear message from senior management that control responsibilities must be taken seriously. External communication is twofold: it enables inbound communication of relevant external information, and it provides information to external parties in response to requirements and expectations.

5. 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. Ongoing evaluations,

built into business processes at different levels of the entity, provide timely information. Separate evaluations, conducted periodically, will vary in scope and frequency depending on assessment of risks, effectiveness of ongoing evaluations, and other management considerations. Findings are evaluated against criteria established by regulators, recognized standard-setting bodies or management and the board of directors, and deficiencies are communicated to management and the board of directors as appropriate.

Associated with these five principles are seventeen components which is aimed at providing clarity for designing and implementing systems of internal control and for understanding requirements for effective internal control.

Every organization is expected to assess the effectiveness of their Internal Control function and revise their Internal Audit function's effectiveness. The benefits that can be derived from the

application of the COSO Internal Control Framework cannot be underestimated because the application of the COSO Internal Control Framework would provide a solid foundation for determining the degree of assurance provided by controls. The level of reliance that can be placed on the Financial Information produced is based on the level of application of the five control components to an entity's internal control process. Also, the use of the Framework in reporting helps to reveal the strengths and weaknesses in an entity's Internal Control System. All control components and principles are subjected to tests to determine whether they are either present and/or functioning and the overall assessment reveals the severity of the deficiencies when aggregated across the components (if any). Finally, the use of a common audit framework and rating system enables the controls in different business segments to be compared and contrasted.

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COSO: A Framework for enhancing Internal Control over Financial Reporting

The 2013 COSO Framework update provides an avenue for audit committees and management teams to have a fresh look at internal control and create value in an organization. The framework can also help the regulators manage shareholders expectations as regards internal control over financial reporting.

At Deloitte we assist companies and regulators in performing the following

1. Readiness/Gap Assessment
2. Education and Training
3. Implementation of COSO internal control framework
4. Review of operating effectiveness of internal control

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