REVIEW THE INTERNAL CONTROL FRAMEWORK BASED ON COSO APPROACH

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ABSTRACT

Today’s world is always in progress, the fast movement of farms, transactions increase, constant technological advance, resource scarcity pressure and intensive compete, pressures and variety of risks in all fields, threaten objectives and policies of the organization from outside and inside, all these factors led the management to consider countless issues, and practically it is almost impossible to control a farm directly and individually. Indirect control of organizational operations and distance of the top management from all of the entity’s activities has caused to management for doing their responsibility stewardship inclined to establishment an effective system of internal control as an integral component of management system. Variety of patterns designed and introduced for Internal controls, these systems always have advantages and disadvantages, the most important cause of internal control systems of trade commercial units is traditional nature and as well as not being updated. The most important and best known of internal control systems in terms of comprehensiveness and effectiveness and extent of use is introduce pattern by The Committee of Sponsoring Organizations of the Treadway Commission (COSO). In this paper In order to get more familiar with concepts and principles of COSO and to improve the internal controls weaknesses, examine the objectives and component’s COSO updated integrated framework.

KEYWORDS: Internal Control, COSO, Enterprise Risk, Internal Control Framework

Internal control was born when the need of the guidance and supervision of company’s operational activities to ensure the achievement of company came up. In fact, internal control is a dynamic system that covering variety of risks and threats, and the deviation from the policies and procedures (Chorafas, 2007). Another definition of internal control concept implies that; internal control is process designed by board of directors, managers and other employees to obtain acceptable ensure for achieve organizational goals related to reporting, operations and compliance (implementation) (COSO\textsuperscript{1,2013}). Every company, due to the nature of their operational characteristics, has different internal controls from the others company (Woods et al, 2008). According to the current importance of corporate governance or the same set of internal and external control operations to create value for all stakeholder groups, internal audit’s role has received great importance as one of the organization internal mechanisms.

Professional associations attempted to publish the internal control framework for accountability to the organizations requirement in the areas of internal controls and create uniformity and consistency (kasiry, 2013). This framework is the body, structure and strategic principles and provides format and model to organizations so that they can identify and evaluate process, environment or groups of activities and their specific methods from the sufficient adequacy, design and implementation of effective and efficient controls based on the framework structure (kasiry, 2013).

DEFINITION OF COSO

In fact, COSO is organizational established in 1985 to support the national commission for the prevention of fraudulent financial reporting. This organization is privately owned, and provides guidelines for the use of various factors to prevent fraud from financial reporting. The organization also publishes recommendations for public joint stock companies and their independent auditors, Securities and Exchange Commission, and other legislators in this area, as well as for educational institutions. COSO supported by five professional entity, The American Accounting Association, The American Institute of Certified Public Accountants, Financial Executives International, The Institute of Management Accountants and the Institute of Internal Auditors.

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The first integrated internal control framework prepared by the COSO published in 1992. Ten years after the publication of this framework, Sarbanes-Oxley Act specifically formed on the importance of establishing internal controls. This legislation force organization to establishing and maintaining effective internal control over the financial reporting and force directors and independent auditors to assessment and report the effectiveness of the control. In Iran led to guidelines internal control publishers accepted in the Tehran stock exchange, which was adopted on 5 may, 2012, directors of listed companies in the Tehran stock exchange were obliged to make sure about establishment and implementation appropriate and effective internal controls and inserted the results in a report as "internal controls report". Independent auditors of these companies also obliged to comment about the establishment and implementation an effective internal controls system to the general assembly of the shareholders. Companies in the Stock exchange that financial year of them end in 21 March 2013 and thereafter obliged to observe and enforce these guidelines and in addition to provide the financial statements and reports to the general assembly on the activities of the board of directors and general conditions must provide internal control report.

COSO framework as a guide of the above resources widely used in the design, implementation and evaluation of internal controls by board of corporations and professional groups throughout the world. The identify internal control in independent audit is necessary and inevitable. This recognition be used to identify the types of potential distortions, evaluation effective factors on risk of significant distortions and in designing content test (Auditing Standards Codification committee, 2010). Despite to available other framework, accounting profession acceptable internal control integrated framework provided by COSO more than other framework due to the timeliness in consider a framework main concepts for the design, internal controls implementation and effectiveness evaluation. Also with several updates, the latest changes done with PWC audit Institute's guidance and published in May 2013, changes covered operational and commercial units and their performance environmental. In interesting interpretation, Bill Schneider, director of accounting at AT&T and a member of the COSO Advisory Council, said in an AICPA webcast, “If you think about any document that has lasted 20 years without any revisions, that’s pretty amazing”.

OBJECTIVES AND COMPONENTS OF INTERATED INTERNAL CONTROL

COSO define objectives and components of internal control integrated framework as a process that influenced by the board of directors, managers and other employees to ensure of achieving the designed goals in following categories:

1- Effectiveness and efficiency of operations
2- Reliability of financial reporting and
3- Compliance with laws and regulations

These three objectives are directly related with five integrated components as control environment, risk assessment, control procedures, information and communication and monitoring. Objectives determines what organization wants to achieve and what components are needed to achieve these goals. In figure 1, provided cube shows the relationship between the three objectives and five components and the third dimension shows the organizational structure. This cubic comes to mind everywhere speaking about internal control framework and COSO. Consider that none of the two different organization should not have a similartype system of internal controls.

Figure 1: COSO cubic

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2- Price, Waterhouse and coopers
3- www.aicpa.org/interestareas/frc/accountingfinancialreporting/pages/cosoupdatedinternalcontrolframework.aspx
4- Public Company Accounting Oversight Board
PRINCIPLES OF INTERNAL CONTROL

Principles of internal controls framework including 17 case and discussed on designing, implement, and evaluate the effectiveness of internal controls. Specifically, these principles are relevant to any of the components mentioned above. Therefore, if relevant principle is not efficiently assumed that the part related to it is not efficiently. In following we show each of the five main components and involved principles:

Control Environment

Control environment is a set of standards, procedures and structures and also the foundation of internal controls in the organization. The following five principles are relevant to this component:

Principle 1: The organization demonstrates commitment to integrity and ethical values. Therefore the management and board of directors proceedings should be reinforcing this commitment. Behavior standards should introduce ethical values and expectations and should be clearly understandable. These expectations should be investigated at the time and used to assessment the actual performance with the expect performance and used to determine any deviation and should be reform inappropriate time.

Principle 2: The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control. In fact board of directors should accept oversight responsibilities and determine and maintain skills and needed expertise for accountability and also evaluate this skills periodically.

Principle 3: Management actions should be monitored by board of directors and structure and appropriate reporting methods for achievement of objectives. Management and board of directors should consider multiple structures to support the achievement of objectives (For example, different functional units and outsourcing service providers). In addition, they should delegate authority, determine responsibilities and use appropriate processes and technology so that the stakeholders have various responsibilities.

Principle 4: The organization to achieve the desired objectives is committed to attracting and developing abilities and maintaining qualified individuals. Board of directors and management should be assessment professional competence of personnel at various levels of the organization, including outsourcing service providers and adequate training and supervision should be done in these areas.

Principle 5: Organization in order to achieve the objectives of internal controls have individuals accountable for responsible to internal control (D’Aquila, 2013). Management and the board of directors should establish a mechanism to hold individuals accountable. They should also do corrective actions and appropriate evaluation actions that include both short term and long term objectives in order to granting the incentives or rewards. Incentives and rewards should be aligned with internal control responsibilities. Management and the board of directors should assessment accountability of individuals and expand measurement of their performance. They should also assessment accountability of performance internal control in order to reward or impose appropriate disciplinary actions (D’Aquila, 2013). It is notable that the basis of the updates is the primary framework that is releases in 1992. In the Updated framework in 2013, the role of "accountability" in control environment part be highlighted.

Risk Assessment

Dynamic and iterative process to identify and analyze the risks of organizational goals. The following principles are relevant to this section:

Principle 6: The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives. The objectives should relate to operations, reporting and compliance and show the management decisions about the structure of industry and organizational performance considerations.

Principle 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. The organization when identifying risks should consider both of internal factor and external factors. The organization should implement risk assessment mechanisms at appropriate levels of management too. These level, include the general, subsidiary, sections and operating units. An important part of the risk assessment process, include the potential importance of risk assessment and how it should be managed.
Principle 8: The organization should consider the potential of fraud in assessment of the risks of achieving the objectives. There are three general types of fraud: financial corruption, misuse of assets and fraudulent financial reporting (Taghinataj, 2012).

Principle 9: The organization identifies and assesses changes that could significantly impact the system of internal control. These changes include the external environment, business model, and leadership. External environment factors include the regulatory, economic, and physical environment. The business model is characterized by new business lines, dramatically altered existing business lines, acquired or divested business operations, rapid growth, changing reliance on foreign geographies, and new technologies. Finally, leadership relates to management’s attitude about internal control.

In the risk assessment, it maybe necessary to review the internal controls to consider with proper procedures new risks or risks that have previously been considered as uncontrollable risks (Bcbs, 1998). In addition, should be noted in the new framework, the inherent risk and risk of fraud (skimming) have a more important role in the risk assessment and the risk assessment process that includes risk identification, risk analysis and response to it has been highlighted in more details.

Control Activities

These are the actions established by an organization’s policies and procedures to help ensure that management directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of an entity, at various stages within business processes, and throughout the technology environment. Each control activities of companies should be commensurate with the operational, financial reporting and compliance goals. Although design and carried out of these activities should depend on the size, type of operation, objectives and requirements of each company, but each control activities in addition to the general controls and practical information systems, include the principles are met: Surveys of senior management, direct management activities and functions, validation and transaction processing controls, physical controls, performance parameters, separation of duties, policies and procedures, and other control activities and documentation (Internal control guidelines issuers listed on the Tehran Stock Exchange and OTC Iran, 2012). Control activities are related to the following three principles:

Principle 10: The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels. Combination should be used to control a variety of activities. Control activities can be manual or automated (Minnesota management & budge, 2012), and preventive or detective.

Principle 11: The organization selects and develops general control activities over technology to support the achievement of objectives. Management should determine the dependency and linkage between business processes, automated control activities, and technology general controls. Management should develop technology control activities designed to help ensure the completeness, accuracy, and availability of technology processing; to restrict access to authorized users commensurate with their job responsibilities in order to protect assets from external threats; and to provide control over acquiring, developing, and maintaining technology.

Principle 12: The organization deploys control activities through policies that establish what is expected and procedures that put policies into action. Control activities should be performed in a timely manner, and any necessary corrective actions should be taken. Lastly, management should periodically review control activities to determine their continued relevance and should refresh them when necessary. It can be said that the new framework fully discussed about the relationship between risk assessment and risk control activities, control activities at different levels of the organization, prevention versus inspection technologies and related concepts.

Information and Communication

In fact these part of the control objectives include: The information identify, collect, process, and report with information systems and effective communication across the organization and with external parties is established or not. Information and communication are necessary for an entity to carry out internal control responsibilities in support of its financial operations.
objectives. The updated framework provides a more detailed description of the types of control techniques and how to categorize them. Communication occurs both internally and externally, and it provides the organization with the information needed to carry out day-to-day internal control activities. Communication enables personnel to understand internal control responsibilities and their importance. It can be said that communication is the frequent and continuous process that includes provision, share and necessary information. Also employees should be understood external information and important decisions with recommendations from upstream (COSO, 1994). The following principles are relevant to this section:

Principle 13: The organization obtains or generates and uses relevant, quality information to support the functioning of internal control. Information systems should capture internal and external sources of data; process and transform relevant data into information and produce information that is timely, current, accurate, complete, accessible, protected, verifiable, and retained. Information should be reviewed for relevance in supporting the internal control components. Lastly, the nature, quantity, and precision of the information communicated should be commensurate with the achievement of objectives.

Principle 14: The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control. Such communication should include a process for the communication of required information. Communication between management and the board of directors so that both have necessary information and separate communication channels. These channels should serve as fail-safe mechanisms to enable anonymous or confidential communication when normal channels are inoperative or ineffective. Finally, the timing, audience, and nature of the information should be considered when determining the method of communication.

Principle 15: The organization communicates with external parties regarding matters affecting the functioning of internal control. External communication to parties such as shareholders, partners, owners, regulators, customers, and financial analysts should be both timely and relevant. Open communication channels should allow input from customers, consumers, suppliers, external auditors, regulators, financial analysts, and others. The updated framework has gained more attention to improving the quality of information, legal requirements, interaction with third parties, Security and limited access to information, costs and benefits of obtaining and managing information and finally technology advances.

Monitoring Activities

Ongoing evaluations, separate evaluations, or some combination of the two are used to ascertain whether all five components of internal control, including controls to effect the principles within each component, are present and functioning. These findings are evaluated and any deficiencies are communicated in a timely manner and serious matters are reported to senior management and the board. The principles of monitoring activities:

Principle 16: The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning. Also should consider changes in business and its processes during the selection and development of ongoing and separate valuations. It should be noted that a separate evaluation should be performed periodically to provide goal feedback.

Principle 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. The results of evaluations should be assessed and any deficiencies communicated to the parties responsible for taking corrective action, as well as to senior management and the board of directors, as appropriate. Finally, management should track whether deficiencies are remediated on a timely basis. A new COSO framework, fully detailed and more described technology and outsourcing.

At the end, it looks good to comparison of key differences of approach to identifying, evaluating and documenting internal controls for financial reporting (Using the standard internal control questionnaires) COSO’s approach (Professional Notes - Audit and consulting firm "Fardapadid " - Webpage 7):

7- http://www.fardapadid.com/?page=specreader&pg=50
Paragraph (a): Using the approach of COSO, Unlike traditional methods of identifying, evaluating and documenting internal controls for financial reporting, all Operations reflected in the worksheet entitled "Risk Assessment Worksheet", and don't need to the system record separately through "draw or describing a flow chart of the operation".

Paragraph (b): By using the COSO approach, identification of risk factors for achieving the intended goals of the important activities will be objectively done, Unlike the traditional approach in paragraph (a), that risk factors associated with managing claims does not specify the financial reporting.

Paragraph (c): COSO’s approach able to identifying, evaluating and documenting internal controls of activities related to the different nature, unlike the traditional approach set out in paragraph which only used on internal controls of financial reporting.

Paragraph (d): With respect to the material contained in paragraphs (a) to (c) above, just by using the COSO approach, identification, documentation and evaluation of all the control of activities with "Different nature" is possible. In other words, by using the traditional methods specified in paragraph (a) above, risk assessment of activities of firms may not be prepared.

Paragraph (e): Using the COSO’s approach provides the basis for enterprise risk management (ERM).

Paragraph (f): To observe International standards for Internal Auditing (IIA) about assessment across the corporate governance, risk management and control must use COSO’s approach.

CONCLUSION

Nowadays, the importance of implementing internal controls in economic units are undeniable. An effective internal control system can assist management in achieving organizational goals. Today, integrated system of internal controls provided by the COSO is considered and performed by must organizations in the different countries. In this article, COSO framework, principles and objectives for deployment of suitable internal control system in organizations and enhance the traditional internal control deficiencies was generally introduced and investigated.

REFERENCES


