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The New COSO Framework: What Changed and How It Affects Your Financial Statement Audit

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A change is coming in how healthcare organizations and their auditors approach and evaluate internal controls.

In May 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its update to the integrated framework for internal controls, its first update since the framework was originally issued in 1992. Although the original framework remains the foundation for evaluating internal controls, the 2013 update—which must be implemented by Dec. 15, 2014—adds key principles that will affect how companies and their auditors apply the COSO’s integrated framework.

Most companies and their auditors who have been using the 1992 framework will be familiar with the “COSO Cube,” which illustrates the three key dimensions of the COSO model:



- The three broad objectives organizations generally have, relating to operations, reporting, and compliance

- The five components of internal control necessary to meet each of those objectives (i.e., control environment, risk assessment, control activities, information and communication, and monitoring)
- The relevance of the broad objectives and the five internal control components at all levels of an organization (entity level, division, operating unit, or function)

The 2013 framework maintains this model, brings changes in several areas, and most important, builds on the framework by adding 17 key principles, which are spread across the five internal control components. The principles are outlined in a June 2013 COSO document, *The 2013 COSO Framework & SOX Compliance: One Approach to an Effective Transition*, by J. Stephen McNally.

The principles represent fundamental concepts that apply to the three broad overall objectives, and they each map to one of the five components of internal control to bring clarity to the component. Their purpose is to clarify what criteria an organization should be striving to meet to have a system of effective internal controls. The first component, *Control Environment*, for example, now incorporates five of the 17 supporting principles, as follows:

- The organization demonstrates a commitment to integrity and ethical values.
- The board of directors demonstrates independence from management and exercises appropriate oversight.
- Management, with board oversight, establishes structures and reporting lines, along with appropriate authorities and responsibilities.
- The organization demonstrates a commitment to attract, develop, and retain competent individuals, aligned with objectives.
- The organization holds individuals accountable for their internal control responsibilities.

Each of these principles provides clarification regarding objectives that need to be met for an organization to have an effective internal control environment.

To enhance the understanding and evaluation of each principle, COSO also provides 77 underlying points of focus for the various principles. Although these points of focus are not required to be assessed separately, they do provide important tools for applying the new framework.

As an example, McNally lists four points of focus that are intended to support an organization's assessment of how well it acts in accordance with the first principle (i.e., "The organization demonstrates a commitment to integrity and ethical values"):

- Sets the tone at the top
- Establishes standards of conduct
- Evaluates adherence to standards of conduct
- Addresses deviations in a timely manner

Judgment remains an integral part of evaluating internal controls under the updated model, but the points of focus offer organizations and auditors alike a more clearly defined set of criteria to assess how the 17 principles are being achieved and how the five components are being met.

To effectively implement and apply the new 2013 framework, company management must understand the changes. Likewise, auditors must have a solid grasp of the changes to effectively complete their audits. Fortunately, COSO has issued some useful companion documents—including the one cited previously—to supplement the new framework and help organizations apply it to their unique operations and to help document their internal controls. (The framework and companion documents may be purchased at COSO's website, coso.org.)

Private healthcare companies and other organizations that have yet to implement the framework, as well as the auditors of these organizations, should read the 2013 framework and familiarize themselves with its main features. Special consideration should be given to the two key features described here: By understanding the 17 principles and how each principle maps to one of the five internal control components, organizations can more clearly assess how well they are achieving each component. And by understanding the important points of focus that support each principle, they can more easily evaluate whether the principles are in place.

Other features of the updated framework that should be well understood include:

- Its expanded discussion around preventing and detecting fraud
- Its recognition and discussion of the increased importance of technology
- Its enhanced discussion of governance concepts and emphasis on the importance of board oversight

COSO has allowed a transition period from May 2013 through Dec. 15, 2014. All organizations that are applying the COSO framework must do so for fiscal years ending after Dec. 15, 2014. Thus, calendar-year companies must apply the new 2013 framework for the year ending Dec. 31, 2014. The COSO framework applies to all entities, large and small, including public, private, government, and not-for-profit entities.

As the Dec. 15 deadline approaches, healthcare organization managers and senior executives should consult with their auditors, seeking guidance to understand the changes and implement the updated framework to reflect the changes in their documentation of internal controls. These organizations also should consider obtaining the tools and resources that COSO has made available to support organizations in these efforts.

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