



Hot Topic: Coronavirus

Impacts on entities' execution of the COSO Internal Control Framework

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KPMG discusses how components of the COSO Framework¹ are likely to be impacted as a result of the COVID-19 outbreak and what entities and auditors should look out for.

Background

The COVID-19 outbreak has impacted worldwide commerce, sparing no industries, leaving entities to identify new risks, prepare a response plan, implement new controls or augment existing controls, and monitor the effectiveness of internal control over financial reporting (ICFR) – all while employees are working remotely. The necessity of implementing changes to respond to new risks occurring at unprecedented speeds puts pressure on entities to maintain effective ICFR.

Nearly all US registrants use the COSO Framework to design, implement, monitor and evaluate the effectiveness of ICFR. The COSO Framework includes five components of internal control – Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring Activities – as well as 17 principles that need to be 'present' and 'functioning' and operating together in an integrated manner to provide reasonable assurance that financial statements are free from material misstatement. In this Hot Topic, we address how components of the COSO Framework are likely to be impacted as a result of the COVID-19 outbreak.

Key impacts

As a result of the COVID-19 outbreak, the following are key impacts on the components of the COSO Framework.

- The board of directors and management will need to consider the overall impact of changes in business operations to the control environment.
- Risk assessment should be revisited in light of the changes in the external environment.
- New or augmented control activities may need to be designed and implemented to address new or elevated risks.

¹ Internal Control – Integrated Framework, published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission

- Materiality assessments may change, affecting overall risk assessment decisions and considerations relevant to the precision of control activities.
- Relevance and reliability of information used to support the operation of controls should be reevaluated, especially for new or augmented controls.
- Internal and external communications should be tailored to meet the demands of the current landscape.
- Internal control must be effectively monitored to determine whether controls are operating as designed, because a remote work environment presents a new set of challenges.



Control environment

An entity's control environment has a pervasive effect on its system of internal control, and therefore forms the foundation of effective ICFR. Because the control environment is the foundational component of the system of internal control, its relative strength influences the nature, timing and extent of control activities that have a direct impact on financial statement assertions. The five principles of the control environment component of COSO all operate under the oversight of the board of directors to ensure an entity has a sufficient number of trained and competent resources that understand their roles, responsibilities and reporting lines relative to ICFR, and that people are held accountable for their internal control responsibilities. Because of the pervasive effect the control environment has on the rest of the system of internal control, management will want to pay special attention to the evaluation and response to the new risks created by the COVID-19 outbreak and remote working arrangements. Here we highlight a few ways the control environment may be affected by the COVID-19 outbreak.

The organization demonstrates a commitment to integrity and ethical values

[Principle 1]

This commitment is demonstrated through the directives, actions and behaviors of the board of directors and management, as well as leaders at all levels of the entity. Given the changes that an entity is likely facing, it is increasingly challenging to demonstrate the importance of integrity and ethical values (e.g. setting the tone at the top). An entity's board and management should be thinking about how they can continue to demonstrate the appropriate tone at the top to maintain the strength of the control environment.

For example, employees may be faced with financial hardships, which may result in new fraud risk factors (see Principle 8 in *Risk Assessment* below). Further, many employees are now working remotely, and reporting lines may have been modified. How boards of directors and members of management respond to these new risks will have an important impact on the entity's system of internal control.

Management establishes (with board oversight) structures, reporting lines and appropriate authorities and responsibilities in the pursuit of objectives [Principle 3]

An entity's structure and/or reporting lines may require changes because of the potential significant impact on control activities, due to the introduction of a remote work environment. Employees may be performing control activities they were not previously responsible for, they may have a different level of authority or responsibility, or new reporting lines may be established.

It is important for management to identify these changes so they can be satisfied that sufficient competent resources are available and trained to meet the entity's objectives, and that responsibilities and reporting lines are properly communicated (see Principle 14 in *Information and communication* below). It is also important that changes to authorities and responsibilities are sufficiently well-defined

to enable accountability. In light of the current environment, management might consider implementing temporary mechanisms to monitor the assignment of authorities and responsibilities across the entity at all levels.



Risk assessment

Risk assessment involves identifying risks related to reliable financial reporting before identifying specific controls. There are four risk assessment principles, which may need to be revisited as a result of the COVID-19 outbreak.

The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives [Principle 6]

The COVID-19 outbreak will likely result in a reassessment event. The amount that may have been determined to be important to users of the financial statements early in the fiscal year may have changed – significantly impacting an entity’s ICFR. This may result in changes to materiality and the identification of new fraud risk factors and new or heightened assertion level risks. One of the key points of focus in setting objectives is determining what amount is material² to users of the financial statements. Materiality is determined early in an entity’s fiscal year and is then cascaded through the organization so a proper ICFR scoping and control design can be accomplished. While materiality is established annually, it should be reevaluated if there are changes in external or internal factors. A change in materiality may have consequences, such as the significance of components (e.g. segments, subsidiaries, divisions) and financial statement accounts, as well as the precision at which individual control activities operate.

The organization considers the potential for fraud in assessing risks to achieving objectives [Principle 8]

To identify a risk of fraud, an entity identifies potential actions that may lead to an intentional misstatement of the financial statements. These fraud risk factors are derived from incentives and pressures, opportunities and/or attitudes and rationalizations – the factors are not static and may evolve over time.

Entities should consider whether the effects of the COVID-19 outbreak create new fraud risk factors. These events have put unprecedented financial stress on entities and their employees. For example, management may be faced with increased pressures to meet financial performance targets, and employees may be faced with financial hardships that could result in increased pressure, incentive or motivation to commit fraud. Further, opportunities for fraud may be heightened in a remote working environment where providing supervision and review may be more challenging. These fraud risk factors may result in newly identified fraud risks, including new risks of bias and management override of controls. New or augmented controls may need to be designed and implemented to address these risks.

² Defined by COSO as follows: “Information is material if its omission or misstatement could influence the decisions of users taken on the basis of the financial reporting. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement.”

The organization identifies and assesses changes that could significantly impact the system of internal control [Principle 9]

Entities design and implement controls to completely, accurately and timely identify changes in the external environment. The COSO Framework refers to 'early warning systems' to anticipate and plan for significant changes. The impact of COVID-19 on the external environment is widespread and affects many aspects of an entity's operations, including supply chain, manufacturing capabilities, workforce availability and access to customers. All of these changes affect the risk landscape, and proper oversight is required to identify and assess risks in order to design and implement internal controls to provide reasonable assurance that the financial statements are free from material misstatement.

The following are examples where the effects of COVID-19 may have an impact on risks that may require new or revised controls. Some entities may not have had to devote significant attention to certain of these areas in recent years. Conducting a detailed risk assessment will be important to the extent that new risks are now relevant to an entity because the risk assessment decisions ultimately influence, among other things, the design of controls and the nature and extent of monitoring necessary.

Inventory	Identifying idle capacity, abnormal costs, obsolete inventory or losses on firm purchase commitments
Goodwill & long-lived assets	Identifying triggering events, projecting cash flows and selecting assumptions
Leases	Obtaining rent concessions, identifying lease reassessments and abandoning leases
Debt	Defaulting on or restructuring debt obligations, identifying debt covenant breaches and evaluating the balance sheet classification of debt
Credit impairment	Projecting cash flows and selecting assumptions
Other impairment	Identifying other-than-temporary impairments for equity method investments
Cash flow hedge accounting	Assessing whether forecasted transactions are probable of occurring
Revenue	Identifying contract modifications and concessions
Going concern	Evaluating the impacts of the COVID-19 outbreak in a going concern assessment
Disclosures	Identifying disclosure changes, such as those related to risks and uncertainties



Control activities

Once relevant financial reporting risks are identified, management evaluates whether appropriate control activities (individually or in combination with others) adequately mitigate the risks to acceptable levels. As COVID-19 has likely introduced new or elevated risks in an entity's operations and processes, new controls or revisions to existing controls may need to be designed and implemented.

The organization selects and develops control activities that contribute to the mitigation of risks to achieving objectives to acceptable levels [Principle 10]

Required efforts include identifying controls that are manual or automated to prevent, or detect and correct, errors or fraud that result in more than a remote chance of a material misstatements of the financial statements.

Identifying appropriate control responses to new or increased risks will be especially challenging in current circumstances given workforce restrictions such as remote working arrangements. The COVID-19 outbreak will challenge an entity's abilities to not only design and implement controls, but to operate and monitor them as well.

Further, control activities may be preventive or detective, and entities usually employ a mix of the two. In the current environment, if new or augmented controls are deemed necessary, entities may consider implementing detective controls. While detective controls may require management judgment, they may be able to be designed and implemented in a more timely fashion than preventive controls. Further, operating detective controls from a remote location may be more practical.

Entities using service organizations that are relevant to their internal control need to work with those organizations to understand changes to or newly implemented controls by that service organization to address new or increased risks; as well as changes to operating existing controls that could impact the design, implementation or operating effectiveness of the entity's own controls.

The organization selects and develops general control activities over technology to support achieving objectives [Principle 11]

If entities implement new automated controls in response to enhanced or additional risks introduced by the COVID-19 outbreak, consideration should be given to whether new or enhanced general IT controls need to be implemented, or whether the existing general IT controls support the new automated control activities. Likewise, if the entity is using a service organization, it should consider the impact of increased risks and changes in automated controls associated with the disruption of COVID-19 on the service organization's processes and controls, and potential timing and impacts to service organization control (SOC) reports.

Entities should also consider whether they need to enhance or replace existing general IT controls, given the risks that may arise from employees working in remote locations. For example, consideration may need to be given to system access controls that prevent unauthorized user access to IT systems, which may need to be modified in response to remote work environments.



Information and communication

Communication is a continual, iterative process of providing, sharing and obtaining necessary information both internally and externally. Appropriate communication provides the information needed to carry out day-to-day internal control activities and to understand the role that individuals play in internal control.

The organization obtains or generates and uses relevant, quality information to support the functioning of internal control [Principle 13]

Information used in the operation of internal control may be internal or external (e.g. supplier or industry data). Determining that information used in a control's operation is relevant and reliable is a cornerstone of effective ICFR.

As a result of the COVID-19 outbreak, additional information requirements may be needed to operate controls intended to address new or elevated risks. Identifying appropriate sources of information, and controls being designed and implemented over such information, is critical to supporting the relevance and reliability of information.

The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control [Principle 14]

Many entities have been forced to pivot to a remote work environment. As a result, entities need to assess the effectiveness of their communications so objectives and responsibilities are made clear and timely, the frequency of communications is sufficient and the intended audiences are appropriate. With risk assessment evolving and new or augmented controls being implemented, personnel operating internal controls need to have a clear understanding of their responsibilities to achieve the intended financial reporting objectives.

The organization communicates with external parties about matters affecting the functioning of internal control [Principle 15]

Communication channels to and from parties external to the entity may be impacted by COVID-19. It is important that an SEC issuer's disclosure controls and procedures (DCP) are designed and implemented to monitor the effects of the COVID-19 outbreak. Adequate DCP ensures that information required to be communicated is completely and accurately reported on a timely basis.

Additionally, a remote workforce may shift responsibilities to different control owners or geographies, or may include using different IT systems with changes in processing transactions. Any changes in internal controls that have materially affected, or are reasonably likely to materially affect an SEC issuer's ICFR, are required to be disclosed in Item 4 of Form 10-Q or Item 9A of Form 10-K of the issuer's quarterly or annual filings, respectively.



Monitoring activities

The organization selects, develops and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning [Principle 16]

Entities may consider reevaluating their monitoring activities to determine whether controls have become less effective or are no longer operating in the manner for which they were designed and implemented. Existing monitoring activities may need to be modified to operate effectively in a remote working environment. Further, entities will want to implement specific monitoring activities over newly designed or implemented controls to make sure such controls achieve their desired outcomes. The nature and extent of monitoring activities should be commensurate with the risks associated with the new controls.

If entities use service organizations that are relevant to their internal control and rely on SOC reports to obtain an understanding and evaluate those internal controls, entities may need to increase their monitoring of service organizations to understand whether SOC reports will be available on a timely basis to support their internal control evaluations.

Evolving information

The potential global and economic impacts of the coronavirus continue to evolve rapidly, and entities should monitor the situation. Entities are encouraged to maintain close communications with their board of directors, external auditors, legal counsel and other service providers as the circumstances progress. Stay informed at read.kpmg.us/coronavirus

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