



Internal Control over Financial Reporting – Guidance for Smaller Public Companies

Volume I : Executive Summary





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June 2006

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992 issued *Internal Control – Integrated Framework* to help businesses and other entities assess and enhance their internal control systems. Since that time the *Framework* has been recognized by executives, board members, regulators, standard setters, professional organizations and others as an appropriate comprehensive *Framework* for internal control.

Also, changes have taken place in the financial reporting and related legal and regulatory environments. Significantly, the Sarbanes-Oxley Act was enacted into United States law in 2002. Among its provisions, Section 404 requires management of public companies to annually assess and report on the effectiveness of internal control over financial reporting.

With these developments and the passage of time, the *Framework* nonetheless remains relevant today and is used by management of public companies large and small in complying with Section 404. Many companies, however, have experienced unanticipated costs, with smaller companies facing unique challenges in implementing Section 404.

This document neither replaces nor modifies the *Framework*, but rather provides guidance on how to apply it. It is directed at smaller public companies – although also usable by large ones – in using the *Framework* in designing and implementing cost-effective internal control over financial reporting. Although this guidance is designed primarily to help management with establishing and maintaining effective internal control over financial reporting, it also may be useful to management in more efficiently assessing internal control effectiveness, in the context of assessment guidance provided by regulators.

This report is in three volumes. The first consists of this *Executive Summary*, providing a high level summary for companies' boards of directors and senior management.

The second provides an overview of internal control over financial reporting in smaller businesses, including descriptions of company characteristics and how they affect internal control, challenges smaller businesses face, and how management can use the *Framework*. Presented are twenty fundamental principles drawn from the *Framework*, together with related attributes, approaches and examples of how smaller businesses can apply the principles in a cost-effective manner.



The third contains illustrative tools to assist management in evaluating internal control. Managers may use the illustrative tools in determining whether the company has effectively applied the principles.

It is expected that senior management will find the *Executive Summary and Overview* chapter of Volume II of particular interest and might refer to certain of the following chapters as needed, and that other managers will use Volumes II and III as a reference source for guidance in those areas of particular need.

Characteristics of “Smaller” Companies

Although there is a tendency to want a “bright line” to define businesses as small, medium-size or large, this guidance does not provide such definitions. It uses the term “smaller” rather than “small” business, suggesting there is a wide range of companies to which the guidance is directed. The focus is on businesses that have many of the following characteristics:

- Fewer lines of business and fewer products within lines
- Concentration of marketing focus, by channel or geography
- Leadership by management with significant ownership interest or rights
- Fewer levels of management, with wider spans of control
- Less complex transaction processing systems and protocols
- Fewer personnel, many having a wider range of duties
- Limited ability to maintain deep resources in line as well as support staff positions such as legal, human resources, accounting and internal auditing.

None of these characteristics by themselves is definitive. Certainly, size by whatever measure – revenue, personnel, assets, or other – affects and is affected by these characteristics, and shapes our thinking about what constitutes “smaller.”

Costs and Benefits

While incremental cost to assess and report on internal control has become a focal point for many corporate stakeholders, it is useful to balance costs with the related benefits.

Management and other stakeholders of public companies, particularly smaller ones, have focused great attention on the cost of complying with Section 404, with less attention given to the associated benefits. Although it may be difficult to measure impacts associated with inaccurate financial reporting, market reactions to corporate misstatements clearly signal that the investment community does not readily tolerate inaccurate reporting, regardless of company size. In that respect and with other benefits described below, effective internal control adds significant value.

Among the most significant benefits is the strengthened ability of companies to access the capital markets, providing capital which drives innovation and economic growth. Other benefits include reliable and timely information supporting management’s decision-making, consistent

mechanisms for processing transactions across an organization enhancing speed and reliability, and ability to accurately communicate business performance with partners and customers.

Meeting Challenges in Attaining Cost-Effective Internal Control

The characteristics of smaller companies provide significant challenges for cost-effective internal control. This particularly is the case where managers view control as an administrative burden to be added onto existing business systems, rather than recognizing the business need and benefit for effective internal control that is integrated with core processes.

Among the challenges are:

- Obtaining sufficient resources to achieve adequate segregation of duties
- Management's ability to dominate activities, with significant opportunities for management override of control
- Recruiting individuals with requisite financial reporting and other expertise to serve effectively on the board of directors and audit committee
- Recruiting and retaining personnel with sufficient experience and skill in accounting and financial reporting
- Taking management attention from running the business in order to provide sufficient focus on accounting and financial reporting
- Maintaining appropriate control over computer information systems with limited technical resources.

While all companies incur incremental costs to design and report on internal control over financial reporting, costs can be proportionally higher for smaller companies. Yet despite resource constraints, smaller businesses usually can meet this challenge and succeed in attaining effective internal control in a reasonably cost-effective manner. This is accomplished in a variety of ways, outlined in this guidance, many of which already exist today in smaller companies and for which management can "take credit" in considering internal control effectiveness.

Wide and Direct Control from the Top

Many smaller businesses are dominated by the company's founder or other leader who exercises a great deal of discretion and provides personal direction to other personnel. While key to enabling the company to meet its growth and other objectives, this positioning also can contribute significantly to effective internal control over financial reporting. In-depth knowledge of different facets of the business – its operations, processes, array of contractual commitments and business risks – enables its leader to know what to expect in reports generated by the financial reporting system and to follow up as needed when unanticipated variances surface. A related downside in terms of ability to override established control procedures can be addressed with specified protocols.

With use of this guidance, management of smaller companies can meet the challenges of their unique environments, lessening incremental costs and achieving the benefits of effective internal control.



Effective Boards of Directors

Smaller companies typically have relatively straightforward business operations with less complex business structures, enabling directors to gain more in-depth knowledge of business activities. Directors may have been closely involved with the company during its evolution and have a strong historical perspective. Coupled with what often is exposure to and frequent communication with a wide range of managers, this assists the board and its audit committee in performing oversight responsibilities for financial reporting in a highly effective manner.

Compensating for Limited Segregation of Duties

Resource constraints may limit the number of employees, sometimes resulting in concerns regarding segregation of duties. There are, however, actions management can take in order to compensate for potential inadequacy. These include managers reviewing system reports of detailed transactions; selecting transactions for review of supporting documents; overseeing periodic counts of physical inventory, equipment or other assets and comparing them with accounting records; and reviewing reconciliations of account balances or performing them independently. In many small companies managers already are performing these and other procedures supporting reliable reporting, and credit should be taken for their contribution to effective internal control.

Information Technology

The reality of limited internal information technology resources often can be dealt with through use of software developed and maintained by others. These packages still require controlled implementation and operation, but many of the risks associated with in-house developed systems are avoided. Typically there is a limited need for program change controls, inasmuch as changes are done exclusively by the developer company, and generally a smaller company's personnel lack technical expertise to make unauthorized modifications. Such commercially available packages also bring advantages in the form of embedded facilities for controlling which employees can access or modify specified data, performing checks on data processing completeness and accuracy, and maintaining related documentation.

Further advantage can be gained by utilizing software that comes with a variety of built-in application controls that can improve consistency of operation, automate reconciliations, facilitate reporting of exceptions for management review, and support proper segregation of duties. Smaller companies can take advantage of these capabilities, ensuring "flags" or "switches" are properly set to take advantage of the software's capabilities.

Monitoring Activities

The monitoring component is an important part of the *Framework*, where a wide range of activities routinely performed by managers in running a business can provide feedback on the functioning of other components of the internal control system. Management of many smaller

businesses regularly perform such procedures, but have not always taken sufficient “credit” for their contribution to internal control effectiveness. These activities, usually performed manually and sometimes supported by computer software, should be fully considered in designing and assessing internal control.

From a different perspective, there is another way monitoring activities can promote efficiency. After the first year of assessing and reporting on internal control, many companies repeated the assessment process in year two with little if any cost savings.

A different approach, however, can be taken to promote efficiency. By focusing on monitoring activities already in place or that might be added with little additional effort, management can identify significant changes to the financial reporting system since the prior year, thereby gaining insight into where to target more detailed testing. While for effective internal control all five components must be in place and operating effectively and some testing of each component is necessary, highly effective monitoring activities can both offset certain shortcomings in other components and sharpen targeting of assessment work with resulting overall efficiency.

Management of many smaller businesses routinely perform monitoring activities in running the business, and they should take sufficient “credit” for their important contribution to internal control effectiveness.

Achieving Further Efficiencies

In addition to considering the above, companies can gain additional efficiencies in designing and implementing or assessing internal control by focusing on only those financial reporting objectives directly applicable to the company’s activities and circumstances, taking a risk based approach to internal control, right sizing documentation, viewing internal control as an integrated process, and considering the totality of internal control.

The *COSO Framework* recognizes that an entity must first have in place an appropriate set of financial reporting objectives. At a high level, the objective of financial reporting is to prepare reliable financial statements, which involves attaining reasonable assurance that the financial statements are free from material misstatement. Flowing from this high level objective, management establishes supporting objectives related to the company’s business activities and circumstances and their proper reflection in the company’s financial statement accounts and related disclosures. These objectives may be influenced by regulatory requirements or by other factors that management may choose to incorporate when setting its objectives.

Efficiencies are gained by focusing on only those objectives directly applicable to the business and related to its activities and circumstances that are material to the financial statements. Experience shows that this can be most efficiently accomplished by beginning with a company’s financial statements and identifying supporting objectives for those business activities, processes and events that can materially affect the financial statements. In this way, a basis is formed for giving attention only to what is truly relevant to the reliability of financial reporting for that company.



A risk based approach can bring significant efficiencies to internal control assessments.

Focusing on Risk

While management considers risks in several respects, its overarching consideration is the risks to key objectives, including the risks to reliable financial reporting. Risk-based means focusing on quantitative and qualitative factors that potentially affect the reliability of financial reporting, and identifying where in transaction processing or other activities related to financial statement preparation something could go wrong. By focusing on key objectives management can tailor the scope and depth of risk assessments needed. Often risk is considered in the context of initially designing and implementing internal control, where risks to objectives are identified and analyzed to form a basis for determining how the risks should be managed. Another is in the context of assessing whether internal control is effective in mitigating risks to objectives.

In the context of assessing internal control effectiveness, there sometimes is a tendency to consider internal control using generic lists of controls appropriate to a “typical” organization. While these tools in questionnaire or other form may be useful, an unintended result is that management sometimes focuses on “standard” or “typical” controls that simply are not relevant to the company’s financial reporting objectives or risks associated with those objectives. A related problem encountered is starting assessments with the details of accounting systems and documenting them in extreme depth without recognizing whether the entirety of processes are truly relevant to achieving reliable financial reporting. This is not to say that such approaches cannot be useful, as they can be. However, whatever approach is followed, efficiencies are gained when attention is directed to the objectives management has established specific to the company’s business activities and circumstances.

Right-Sizing Documentation

Documentation of business processes and procedures and other elements of internal control systems is developed and maintained by companies for a number of reasons. One is to promote consistency in adhering to desired practices in running the business. Effective documentation assists in communicating what is to be done, and how, and creates expectations of performance. Another purpose of documentation is to assist in training new personnel and as a refresher or reference tool for other employees. Documentation also provides evidence to support reporting on internal control effectiveness.

The level and nature of documentation varies widely by company. Certainly, large companies usually have more operations to document, or greater complexity in financial reporting processes, and therefore find it necessary to have more extensive documentation than smaller ones. Smaller companies often find less need for formal documentation, such as in-depth policy manuals, systems flowcharts of processes, organization charts, job descriptions, and the like. In smaller companies, typically there are fewer people and levels of management, closer working relationships and more frequent interaction, all of which promotes communication of what is expected and what is being done. A smaller business, for example, might document human resources, procurement



or customer credit policies with memoranda and supplement the memoranda with guidance provided by management in meetings. A larger company will more likely have more detailed policies (or policy manuals) to guide their people in better implementing controls.

Questions arise as to the extent of documentation needed to deem internal control over financial reporting as effective. The answer is, of course, it depends on circumstances and needs. Some level of documentation is always necessary to assure management that its control processes are working, such as documentation to help assure management that all shipments are billed, or periodic reconciliations are performed. In a smaller business, however, management is often directly involved in performing control procedures and for those procedures there may be only minimal documentation because management can determine that controls are functioning effectively through direct observation. However, there must be information available to management that the accounting systems and related procedures, including actions taken in connection with preparation of reliable financial statements, are well designed, well understood, and carried out properly.

When management asserts to regulators, shareholders or other third parties on the design and operating effectiveness of internal control over financial reporting, management accepts a higher level of personal risk and typically will require documentation of major processes within the accounting systems and important control activities to support its assertions. Accordingly, management will review to determine whether its documentation is appropriate to support its assertion. In considering the amount of documentation needed, the nature and extent of the documentation may be influenced by the company's regulatory requirements. This does not necessarily mean that documentation will or should be more formal, but it does mean that there needs to be evidence that the controls are designed and working properly.

In addition, when an external auditor will be attesting to the effectiveness of internal control, management will likely be expected to provide the auditor with support for its assertion. That support would include evidence that the controls are properly designed and are working effectively. In considering the nature and extent of documentation needed by the company, management should also consider that the documentation to support the assertion that controls are working properly will likely be used by the external auditor as part of his or her audit evidence.

There may still be instances where policies and procedures are informal and undocumented. This may be appropriate where management is able to obtain evidence captured through the normal conduct of the business that indicates personnel regularly performed those controls. However, it is important to keep in mind that control processes, such as risk assessment, cannot be performed entirely in the mind of the CEO or CFO without some documentation of the thought process and management's analysis. Many of the examples contained later in this guidance illustrate how management can capture evidence through the normal course of business.

The extent of documentation supporting design and operating effectiveness of the five internal control components is a matter of judgment, and should be done with cost-effectiveness in mind.

Documentation of internal control should meet business needs and be commensurate with circumstances. The extent of documentation supporting design and operating effectiveness of the five internal control components is a matter of judgment, and should be done with cost-effectiveness in mind. Where practical, the creation and retention of evidence should be embedded with the various financial reporting processes.

Viewing Internal Control as an Integrated Process

An assessment of internal control considers whether the components, all logically interrelated, are working together to accomplish the company's financial reporting objectives.

It is useful to view the *Framework's* five internal control components as comprising an integrated process, which indeed internal control is. A process perspective highlights the interrelationship of the components, and recognizes that management has flexibility in choosing controls to achieve its objectives and that an organization can adjust and improve its internal control over time.

As noted, the internal control process begins with management setting financial reporting objectives relevant to the company's particular business activities and circumstances. Once set, management identifies and assesses a variety of risks to those objectives, determines which risks could result in a material misstatement in financial reporting, and determines how the risks should be managed through a range of control activities. Management implements approaches to capture, process and communicate information needed for financial reporting and other components of the internal control system. All this is done in context of the company's control environment, which is shaped and refined as necessary to provide the appropriate tone at the top of the organization and related attributes. These components all are monitored to help ensure that controls continue to operate properly over time. An overview of *Framework's* components working together from a process perspective can be depicted as follows:



The Totality of Internal Control

Each of the five components of internal control set forth in the *Framework* is important to achieving the objective of reliable financial reporting. Determining whether a company's internal control over financial reporting is effective involves a judgment. Internal control has five components that work together to prevent or detect and correct material misstatements of financial reports. When the five components are present and functioning, to the extent that management has reasonable assurance that financial statements are being prepared reliably, internal control can be deemed effective.

While each component must be present and functioning, this does not mean, however, that each component should function identically or even at the same level in every company. Some trade-offs may exist between components. Accordingly, effective internal control does not necessarily mean a "gold standard" of control is built into every process. A deficiency in one component might be mitigated by other controls in that component or by controls in another component strong enough such that the totality of control is sufficient to reduce the risk of misstatement to an acceptable level.



This guidance centers on a set of twenty basic principles representing the fundamental concepts associated with and drawn directly from the five components of the *Framework*.

Applying Principles in Achieving Effective Internal Control over Financial Reporting

This guidance provides a set of twenty basic principles representing the fundamental concepts associated with, and drawn directly from, the five components of the *Framework*.

Control Environment

- 1. Integrity and Ethical Values** – Sound integrity and ethical values, particularly of top management, are developed and understood and set the standard of conduct for financial reporting.
- 2. Board of Directors** – The board of directors understands and exercises oversight responsibility related to financial reporting and related internal control.
- 3. Management's Philosophy and Operating Style** – Management's philosophy and operating style support achieving effective internal control over financial reporting.
- 4. Organizational Structure** – The company's organizational structure supports effective internal control over financial reporting.
- 5. Financial Reporting Competencies** – The company retains individuals competent in financial reporting and related oversight roles.
- 6. Authority and Responsibility** – Management and employees are assigned appropriate levels of authority and responsibility to facilitate effective internal control over financial reporting.
- 7. Human Resources** – Human resource policies and practices are designed and implemented to facilitate effective internal control over financial reporting.

Risk Assessment

- 8. Financial Reporting Objectives** – Management specifies financial reporting objectives with sufficient clarity and criteria to enable the identification of risks to reliable financial reporting.
- 9. Financial Reporting Risks** – The company identifies and analyzes risks to the achievement of financial reporting objectives as a basis for determining how the risks should be managed.
- 10. Fraud Risk** – The potential for material misstatement due to fraud is explicitly considered in assessing risks to the achievement of financial reporting objectives.

Control Activities

- 11. Integration with Risk Assessment** – Actions are taken to address risks to the achievement of financial reporting objectives.
- 12. Selection and Development of Control Activities** – Control activities are selected and developed considering their cost and their potential effectiveness in mitigating risks to the achievement of financial reporting objectives.
- 13. Policies and Procedures** – Policies related to reliable financial reporting are established and communicated throughout the company, with corresponding procedures resulting in management directives being carried out.
- 14. Information Technology** – Information technology controls, where applicable, are designed and implemented to support the achievement of financial reporting objectives.

Information and Communication

- 15. Financial Reporting Information** – Pertinent information is identified, captured, used at all levels of the company, and distributed in a form and timeframe that supports the achievement of financial reporting objectives.
- 16. Internal Control Information** – Information used to execute other control components is identified, captured, and distributed in a form and timeframe that enables personnel to carry out their internal control responsibilities.
- 17. Internal Communication** – Communications enable and support understanding and execution of internal control objectives, processes, and individual responsibilities at all levels of the organization.
- 18. External Communication** – Matters affecting the achievement of financial reporting objectives are communicated with outside parties.

Monitoring

- 19. Ongoing and Separate Evaluations** – Ongoing and/or separate evaluations enable management to determine whether internal control over financial reporting is present and functioning.
- 20. Reporting Deficiencies** – Internal control deficiencies are identified and communicated in a timely manner to those parties responsible for taking corrective action, and to management and the board as appropriate.

Business and related accounting processes of many smaller businesses are dynamic, changing as the company changes. The scalable nature of these principles accommodates new and efficient ways to achieve effective internal control.



Using this Guidance

Suggested actions with respect to this guidance depend on parties' positions and roles:

- **Board Members** – Members of boards of directors can use this guidance as a catalyst for discussion with senior management on the state of the company's internal control system and how best to ensure cost-effectiveness. As noted, this *Executive Summary* is particularly relevant to board members.
- **Senior Management** – The chief executive, chief financial officer and other senior managers can gain insights into how the company can use conceptually sound yet pragmatic and efficient ways to achieve effective internal control. These individuals may find this *Executive Summary* and the *Overview* chapter of Volume II of particular interest, and might want to refer to certain other chapters of Volume II as needed.
- **Other Personnel** – Other managers and personnel should consider how their control responsibilities are conducted in light of this guidance and discuss with more senior personnel ideas for improving cost-effectiveness. Where an internal audit function exists, its leader can consider this guidance in relation to its control evaluation process. It is expected that these individuals will use Volumes II and III as a reference source for guidance in those areas of particular need.

While this guidance is not directed to external audit firms, they too may wish to consider this guidance in gaining a better understanding of how the *Framework* can be applied cost effectively by their smaller public company clients.



COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION

COSO is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance.

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