

Smaller Entities, Costs, And Reporting On Internal Control

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ABSTRACT

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) recently issued an exposure draft (ED) related to internal control (2005). The document, "Guidance for Smaller Public Companies Reporting an Internal Control over Financial Reporting," addresses internal control reporting by smaller publicly-held companies.

Smaller organizations encounter many challenges in implementing and operating a cost-effective system of internal control. However, such challenges can be overcome. Standardizing controls, building them into the system, adding Audit Committee members, and sharpening the entity's risk focus can all prove to be useful tactics.

Other recommendations include enhanced monitoring, outsourcing some activities, and planning and organizing the evaluation of internal control. Further, smaller organizations can benefit from the lessons learned from larger counterparts and can adapt an approach in which the broader components of internal control are tested prior to the final component, control activities.

INTRODUCTION

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) recently issued an exposure draft (ED) of guidance related to internal control (2005). Entitled "Guidance for Smaller Public Companies Reporting an Internal Control over Financial Reporting," the ED presents recommendations regarding internal control reporting by smaller publicly-held companies.

Regardless of whether the ED is adopted as is or if the document is amended and then adopted, the suggestions contained in it bear close scrutiny. Board members serving smaller public companies can benefit from the guidance in the ED as they steer the entity. Also, senior management, such as the CEO and CFO, with responsibilities for the design and operation of the system of internal control, should study the document. The internal audit and the external audit groups, which both shoulder responsibilities for examining controls, should be familiar with COSO's latest guidance.

Designing and operating cost-effective internal control is critical to any entity, regardless of size or whether the entity is publicly-held, a non-profit, or a governmental agency. Smaller organizations face special challenges in implementing cost effective controls. This situation arises because basic controls, such as segregation of duties, are often difficult to implement in smaller entities.

The suggestions in COSO's exposure draft can be tailored to any size entity. However, they are particularly relevant to smaller ones.

WHAT IS "SMALLER?"

In offering its guidance, COSO does not define smaller entities strictly in terms of size. Rather, certain other characteristics aid in classifying an organization.

Often, smaller entities carry a simple product line. Perhaps the company offers one or just a few services. Also, management in a small organization might be dominated by one or a few people. A wide span of control is often present in a smaller entity. Further, small organizations are often reluctant to invest heavily in fixed costs. Such expenditures tend to commit an entity to certain courses of action. Therefore, variable cost expenditures, which can more readily be altered, are typically preferred.

Another characteristic of a small entity is that sales may be concentrated in a particular geographic location. Similarly, production facilities might be located in one or a few places. Finally, an entity may be characterized as small if it faces challenges in achieving economies of scale.

Exhibit I presents the factors which might be considered in determining if an entity is classified as small.

Exhibit I: Characteristics of Smaller Entities

- Simple product line, offers few services
 - Dominated by one or a few people
 - Wide span of control
 - Prefer variable costs to fixed costs
 - Sales or production may be concentrated geographically
 - Achieving economies of scale may be challenging
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SIMILARITIES IN INTERNAL CONTROL: SMALL AND LARGE ENTITIES

There are many similarities between small and large entities in relation to internal control. Both sizes of organization have a need for an effective and efficient system of controls. Good internal control aids the organization in the achievement of its objectives, particularly those related to fair financial reporting. Also, an efficient and effective system produces better information than that obtained under less reliable controls. Information is critical to an entity's decision making and thus, the data produced by the system must be valid and reliable.

An effective and efficient system of internal control also helps to elevate stakeholders' confidence regarding information produced by the entity. For a public entity, this confidence in the reliability of the information resulting from good controls translates to a reduced cost of capital. Further, because the system produces valid information, company's access to capital markets may be eased.

Other similarities between internal control of smaller and larger entities relate to the fundamental concepts of internal controls. Performing reconciliations on a timely basis is a basic tenet of internal control. Regardless of size, entities should regularly reconcile the balances in subsidiary ledgers with the related control accounts in the general ledger. The process typically unearths errors which are easier to address if located shortly after their occurrence rather than months later or at year-end.

Another aspect of internal control which is important for all sizes of entities is management review of operating results. Managers should routinely analyze operating results and initiate appropriate action based upon their discoveries. Management review and any subsequent actions taken should be appropriately recorded. Such documentation is important for management as well as both the internal and external audit groups to be able to track changes and any corrections made.

Still other critical controls applicable to all sizes of entities relate to input controls, the Board, and a whistleblower program. Appropriate controls should be in place for all data input into the accounting and information system. These controls help to ensure that only valid transactions are entered into the system. Documentation of the controls and their effective operation are important to the Board, as that body is responsible for oversight activities related to internal control. Within the Board, the Audit Committee is typically assigned responsibility for the system

of internal control. Reports on controls by management, the internal auditors, and external auditors will be submitted to the Committee; these aid the body in its oversight work.

The Audit Committee is also the party which oversees another aspect of internal control, the whistle blowing program. Regardless of size, entities should have such a system in place. Once the program is established, the submission of information regarding questionable practices should be encouraged. Also, employees and any others who may submit tips should be provided with assurances that policies and controls are in place to protect the whistleblowers.

DIFFERENCES IN INTERNAL CONTROL: SMALL AND LARGE ENTITIES

As noted, there are many essentials of internal control that are similar between small and large entities. However, differences do exist.

In a smaller entity, the approach to internal control is less formal than in a larger organization. With fewer levels in the organizational structure, the channels of communication are more direct, and thus, more structured controls are necessary.

Another difference from a large company is that few, if any, of the controls in a small organization are documented. Further, in a small entity, internal control is more hands-on. In addition, the control system of a small company relies heavily on ongoing monitoring by management. In contrast, large entities may utilize periodic reviews of performance to a greater extent. Finally, a smaller entity may not have a mandate to formally report on internal control (but may voluntarily choose to report), while large public companies are required to do so.

COMPONENTS AND PRINCIPLES

Years before issuing the ED for small publically-held companies, COSO published another seminal document. In that 1992 work, titled "Internal Control—Integrated Framework," COSO defines internal control and presents a framework of control.

The COSO framework is relevant to all sizes of organizations. Five components of internal control, applicable to any size entity, are set forth in the document. Further, 26 principles which relate to the components and to the roles and responsibilities of various parties are given.

For a system of internal control to be deemed effective, all 26 principles must be present. The COSO framework does not change depending on the size of the organization. However, the manner in which controls are implemented may vary depending on entity size.

The five components of internal control and the 23 principles which relate to the components are shown in Exhibit II. In addition, three more principles are presented in the Exhibit; these focus on the roles and responsibilities of various parties regarding internal control.

BENEFITS OF MORE FORMAL CONTROLS

Many smaller entities believe that the costs of designing and operating a more formal system of internal control are high. Thus, they may be reticent to implement a more structured system. Further, a perception may exist that the resources necessary to document a formal system will be significant. While these concerns may be valid, more formal controls and improved documentation often yield significant benefits.

A more formal system of internal control typically results in a financial reporting process which is likely to be efficient and effective. Thus, the resulting financial statements have an increased chance to be fairly stated. Also, more formal controls benefit management as it tests the system and prepares reports on control. In situations in which

an outside party will be attesting to the effectiveness of the system of internal control, a more formal system is also called for.

Other advantages of more formal controls include better decision-making by the entity and increased confidence by investors in the market. With improved controls, the information produced by the system should be more reliable, thus leading to better decisions by top management and the Board. Investors place more confidence in information which they believe is reliable. A more formal control system typically produces more reliable data; this should lead to increased confidence by investors and a reduction in the entity’s cost of capital.

Another advantage of more formal controls also relates to the market. First, the capital markets simply will no longer tolerate inaccurate financial reporting. As noted, by implementing more formal controls over financial reporting, an entity helps to ensure the issuance of fairly stated financial statements. Thus, a more formal system of internal control aids a company both in gaining or maintaining access to capital markets.

Still another advantage of instituting a more formal system of internal control relates to the understanding gained when designing the new controls and to the process of documenting the system. In gaining an understanding of the existing system, the entity reviews the objectives which the controls help to achieve. If deemed necessary, these controls can then be strengthened to more directly address risks. More formal controls can be designed to mitigate risks the organization faces as it attempts to achieve its objectives.

Finally, a more structured system of internal control may impede the occurrence of fraud. A large percentage of fraud takes place in smaller organizations. Schemes flourish in such entities because controls are typically weak and governance practices may be poor. Thus, implementing a more formal system of controls may prevent or deter fraud. The benefits of prevention and deterrence are difficult to quantify, but surely are significant.

Exhibit II: Components and Principles of Internal Control

Component	Principles
Control Environment	Integrity and Ethical Values Importance of the Board of Directors Management’s Philosophy and Operating Style Organizational Structure Commitment to Financial Reporting Competencies Authority and Responsibility Human Resources
Risk Assessment	Importance of Financial Reporting Objectives Identification and Analysis of Financial Reporting Risks Assessment of Fraud Risk
Control Activities	Elements of a Control Activity Control Activities Linked to Risk Assessment Selection and Development of Control Activities
Information and Communication	Information Technology Information Needs Information Control Management Communication Upstream Communication Board Communication Communication with Outside Parties
Monitoring	Ongoing Monitoring Separate Evaluations Reporting Deficiencies
Roles and Responsibilities	Management Roles Board and Audit Committees Other Personnel

MANAGING THE COSTS OF INTERNAL CONTROL

Despite the benefits of more formal controls, smaller organizations may still harbor significant concerns regarding the costs involved. A number of strategies exist which small firms can adopt to manage the costs of internal control.

Audit Committee

In attempting to control costs, smaller entities should consider the number of members serving on the Audit Committee of the Board of Directors. An increase may be beneficial. By adding Audit Committee members with experience related to internal control, the entity can gain valuable insights.

Since the issuance of Sarbanes-Oxley, the demand for Directors, and especially those with financial expertise, has increased substantially. The supply of qualified individuals has not been able to keep pace. Thus, the fees Directors are able to command have also risen dramatically. Smaller firms may find the task of locating qualified candidates who would accept a Directorship and serve on the Audit Committee for a reasonable fee particularly challenging.

Several sources can be tapped by small firms to locate qualified Audit Committee members. Retired public accountants can be considered. Also, accounting or finance professors might be eager to lend their expertise while gaining real world experience. Further, Chief Audit Executives (CAEs) or Chief Financial Officers (CFOs) of similar sized organizations are good candidates to be members of the Audit Committee. While additional costs will be incurred by adding Audit Committee members, the long-term benefit of their expertise will outweigh the expense.

Build in and Standardize

Another way in which the entity can manage the costs of internal control is to build controls into the system. Related to built-in controls is the fundamental concept of standardizing those controls.

When designing a system of internal control or when enhancing controls, the entity is wise to spend considerable time in the planning stage. Controls should be built into, rather than onto, the system. Incorporating controls into the system requires significant upfront time and planning. This effort results in a more thoroughly thought out and integrated system. In the long-run, incorporating controls is more cost effective than attempting to tack controls on at a later date in response to the discovery of misinformation or misstatements which arise as a result of an ineffective system of internal control.

Still another way to manage the costs of controls is to standardize those controls. Standardizing the controls in a system helps to ensure that they are applied on a consistent basis. Because controls embedded in an IT environment are more likely to be standardized and applied on a consistent basis than those performed manually, it is recommended that smaller entities utilize technology as much as possible. Another advantage of operating in an IT environment is that appropriate segregation of duties can be designed into such a system.

Sharpen Risk Focus

As the smaller organization reevaluates and improves its system of internal control, it should be focusing on designing controls which aid the entity in the achievement of its objectives. All organizations face risks which impair the ability of the entity to achieve those objectives. Such risks must be addressed. Often, controls can be enhanced to aid the organization in tracking activities and results related to the objectives and risks. Sharpening the risk focus helps an entity address more directly those activities which are critical to the attainment of an organization's objectives. Also, focusing on risks aids the organization in designing controls to address those risks.

Monitoring by Management

Another way in which the costs of internal control can be managed in a small business is for the entity to leverage the expertise of its managers. Management, especially in a smaller organization, knows the business and its operations intimately. In such an entity, the organizational structure is relatively flat with few layers. The managers are likely to be very involved in the day-to-day operations of the entity. Thus, with their hands-on approach, managers have close contact with the actual operation of controls. That characteristic should be leveraged. The entity should encourage managers, in the course of their duties, to be cognizant of the design of controls and to monitor for their appropriate operation.

While the entity can effectively leverage monitoring performed by management in its quest for good internal control, it should also be aware of a disadvantage of the flat organizational structure found in the smaller organization. That disadvantage is management's ability to override controls. Clearly, a risk exists and must be addressed, perhaps by increased owner oversight.

Outsource Monitoring, Internal Audit

In order to focus on its strategic activities, some entities elect to outsource some functions. By outsourcing activities, managers' time is freed up to focus on issues which are more operational in nature. Smaller entities especially may be able to more effectively focus on their core activities by utilizing outsourcing. Still, organizations should be careful in considering which activities are candidates for outsourcing.

The internal audit activity, which monitors the operating results of the entity, is a prime candidate to be outsourced. Proponents of outsourcing the internal audit function note that the ability to contract for work only as it is needed, rather than having a permanent department, saves costs. When housed internally, the internal audit activity represents a fixed cost. However, if outsourced, the costs are variable; many entities find this attractive.

Although an organization may experience savings from outsourcing the internal audit function, the costs of this action include not having internal auditors available quickly when a control breakdown occurs. Also, without an in-house internal audit function, fewer proactive audits will be performed. Because of the reduction in audit coverage, the number of control errors likely to be found and corrected is decreased. This situation could lead to challenges when management must attest to the effectiveness of the system of internal control. Thus, the benefit and costs of outsourcing the internal audit activity, which helps management monitor the activities of the organization, should be carefully weighed prior to making a decision.

Organize Evaluation of Internal Control

Another way in which the smaller organization can manage its internal control costs is to evaluate its system in a cost effective manner. To accomplish this end, the evaluation should be organized around the COSO framework. By utilizing the five components and 26 principles of internal control, an entity can study its controls in an efficient manner.

The presence of the five components and the 26 principles signifies that an adequate system of internal control is in place. Armed with the knowledge that controls are in operation, management can then assess the effectiveness of the system. Further, once management has completed its assessment, the external audit firm can perform its procedures and opine on the effectiveness of controls.

In the first years of assessing controls, all organizations will discover areas in which they can improve. Smaller organizations traditionally face challenges in appropriately segregating duties, as well as with other basic controls. Thus, these entities in particular should expect to initiate control system changes. Such upgrades may be time-consuming and costly. However, the changes will inevitably lead to a better organized and more effective system of controls.

Once control responsibilities have been clearly assigned, the evaluation of internal control can be organized around those responsibilities. Each responsible party evaluates the operation of the control activities in its area.

To aid the various units in performing these many evaluations, the entity may set a goal for control errors. This objective should be at some relatively low level; for example, the organization may deem that errors in the control system should not exceed, say, five percent. For critical controls, the objective may be set much tighter, say at one half of one percent.

Regardless of the level at which the standard for control deviations is set, managers responsible for each control area are armed with an objective measure to utilize in assessing the performance of the various units. Also, those responsible for performing and evaluating the results of tests of controls have a standard to measure effectiveness against.

Lessons from Large Organizations

Smaller entities have an advantage over their larger counterparts who were mandated to relatively quickly audit of their systems of internal control. The smaller organizations have more time to plan and evaluate the assessment of their systems. Also, they are able to benefit from the valuable lessons those larger entities and their auditors have learned.

Perhaps the most critical lesson learned from the larger entities and their auditors relates to the approach taken. Most organizations and audit firms started with, and focused on, one component of internal control, control activities. While this is certainly an important aspect of the system, a more efficient approach has been suggested by the PCAOB.

The more pervasive parts of the system of internal control should be considered first. The Control Environment impacts the rest of the system and thus, should be examined before the other four components. Next, Risk Assessment, Information and Communication, and Monitoring should be tested. Only then should Control Activities be examined.

Management, internal auditors, and external auditors have a tendency to jump in and examine control activities first. This approach, which is quite time-consuming, should be resisted. By considering the broader aspects of internal control before Control Activities, testing of those activities can be reduced and a more efficient audit of internal control can be achieved.

CONCLUSION

While smaller organizations face challenges in implementing and operating a cost-effective system of internal control, these can be overcome. Controls can be built into the system and can be standardized. Adding Audit Committee members with experience in internal control is often helpful. Also, sharpening the entity's risk focus is useful to managers as they spotlight activities of import.

Other recommendations that an entity should consider in striving towards cost-effective controls include enhanced monitoring by management and outsourcing some monitoring activities. Also, planning and organizing the evaluation of internal control helps entities evaluate internal control in an efficient manner. Finally, smaller organizations can learn from larger entities with more experience in assessing controls and adapt an approach in which the broader components of internal control are tested first. Armed with information on the four broad components, testing of the final component, control activities, can take place at a reduced level.

By utilizing these suggestions, smaller entities can achieve effective internal control at a reasonable cost.

REFERENCES

1. Committee of Sponsoring Organizations of the Treadway Commission (COSO), Exposure Draft, *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting*, 2005.
2. COSO, *Internal Control—Integrated Framework*, 1992.

NOTES