Putting COSO’s Theory into Practice

The U.S. Sarbanes-Oxley Act of 2002 (SOX) requires management of public companies — both large and small — to annually assess and report on the effectiveness of internal control over financial reporting. Fortunately, businesses can rely on an industry standard, Internal Control — Integrated Framework, to assess and enhance their internal control systems.

Issued in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), this Framework has long served as a blueprint for establishing internal controls that promote efficiency, minimize risks, help ensure the reliability of financial statements, and comply with laws and regulations. It has been praised and embraced by many organizations throughout the world for its comprehensiveness, effectiveness, and universal principles of strong internal control.

Many changes have taken place in the financial reporting, corporate governance, and regulatory environments since the Framework was issued. Today, SOX 404 is a major driver of a company’s evaluation of internal control over financial reporting. Over the years, smaller businesses with limited human and monetary resources have struggled with the efficient and cost-effective application of COSO’s principles.

In response, COSO has exposed for comment the draft Guidance for Smaller Public Companies Reporting on Internal Controls over Financial Reporting. Based on the sound guidance of the 1992 Framework, this new report supplements the original by focusing on several themes that address issues faced by smaller businesses. That being said, this guidance is appropriate for, and applicable to, organizations of all sizes.

The Five Key Components of Internal Control
COSO’s report outlines 26 fundamental principles associated with the five key components of internal control: 1) control environment, 2) risk assessment, 3) control activities, 4) information and communication, and 5) monitoring. The report systematically defines the principles associated with each of these components, examines their attributes, lists a variety of approaches that smaller companies can take to achieve them, and includes real-world examples of effective ways to evidence their effectiveness.

A Mindset of Strong Internal Control
Internal control is a process designed and implemented by management to mitigate risks and achieve objectives. In this context, risk refers to the possibility of an event that could affect the achievement of objectives.

Although COSO's Guidance for Smaller Public Companies Reporting on Internal Controls over Financial Reporting was developed in response to new laws and regulations to limit financial shenanigans by businesses, neither corporate misbehavior nor the need for internal control is limited to the financial area. The Framework provides a control structure for all aspects of the organization.

For an organization to truly have a strong system of internal control, there also must be in place effective controls in the operations, compliance, and financial areas. Policies and procedures should be understood and followed. Emanating from an ethical tone at the top, there should be an organization-wide commitment to strong internal controls and effective risk management; and to meeting expectations, not only of the investment community, but of all stakeholders.
**CONTROL ENVIRONMENT**

Because the control environment represents an organization’s first line of defense to mitigate the risks of financial reporting errors, a strong tone at the top plays a pivotal role. Research continues to prove that companies perform better and last longer when top management makes a commitment to strong internal control and clearly conveys this through their actions. COSO discovered that, while a commitment to a board of directors with outside members helps mitigate the risk of management override, smaller companies often don’t add qualified, outside personnel to their board. Why? The report asserts that dominating shareholders are often reluctant to share control with or be challenged by other parties.

COSO believes that the advantages of having effective outside board members generally exceed the additional expense of directors’ and officers’ liability insurance, and this can significantly add to the long-term value of the company. COSO also recommends that the audit committee primarily be composed of independent board members.

The most efficient and cost-effective way to implement and assess internal control over financial reporting is to build control-consciousness throughout the organization’s culture.

**RISK ASSESSMENT**

According to COSO, the major principles related to the achievement of control objectives at the risk assessment level are 1) the importance of financial reporting objectives; 2) the identification and analysis of financial reporting risks; and 3) the assessment of fraud risk. Although smaller companies are more likely to have a more informal, less structured risk assessment process, the basic concepts of this internal control component should exist in every organization.

Thanks to the in-depth involvement of the CEO and other key managers, smaller businesses reap the benefits of remarkably effective risk management. How?

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**COSO’s Principles of Internal Control**

1. Integrity and Ethical Values
2. Importance of Board of Directors
3. Management’s Philosophy and Operating Style
4. Organizational Structure
5. Commitment to Financial Reporting Competencies
6. Authority and Responsibility
7. Human Resources
8. Importance of Financial Reporting Objectives
9. Identification and Analysis of Financial Reporting Risks
10. Assessment of Fraud Risk
11. Elements of a Control Activity
12. Control Activities Linked to Risk Assessment
13. Selection and Development of Control Activities
14. Information Technology
15. Information Needs
16. Information Control
17. Management Communication
18. Upstream Communication
19. Board Communication
20. Communication with Outside Parties
21. Ongoing Monitoring
22. Separate Evaluations
23. Reporting Deficiencies
24. Management Roles
25. Board and Audit Committees
26. Other Personnel
Because risks are assessed by people with both access to the appropriate information and a good understanding of its implications.

**CONTROL ACTIVITIES**

Control activities occur throughout the organization, at all levels and in all functions. In smaller businesses, control activities reflect their organizational characteristics, which include greater concentration of decision-making authority, wider spans of control, and shorter channels of communication. Smaller companies can provide controls to mitigate risks through a combination of methods, including oversight controls applied by management, segregation of duties, and independent reconciliations. Smaller businesses also can prepare and maintain a level of documentation that allows for the effective transition of job responsibilities, policies, and procedures.

**INFORMATION AND COMMUNICATION**

Regardless of size, all businesses must identify, capture, and communicate pertinent information in a form and timeframe that enables people to carry out their responsibilities. Building sound management practices into information and communication processes affordably puts internal control over financial reporting in place. Information systems and internal communication in smaller organizations are likely to be less formal than in large ones, but they play equally significant roles.

The use of information technology can help small businesses standardize controls. Also, their information systems typically will identify and report on relevant external events, activities, and conditions. And, thanks to the greater visibility and availability of their CEO, smaller businesses may more easily achieve effective internal communication than larger businesses.

**MONITORING**

Effective monitoring comprises 1) ongoing monitoring, 2) separate evaluations, and 3) reporting deficiencies. As a key component of the small-business control structure, monitoring confirms that all five components are in place, properly designed, and functioning effectively. Smaller businesses can reduce the cost and effort of monitoring by building it into processes.

Ongoing monitoring activities of smaller companies are more likely to be hands-on and involve the CEO and other key managers. Furthermore, highly effective ongoing monitoring activities may offset the lack of separate evaluations of internal control systems commonly found in smaller businesses. Smaller businesses also can take advantage of the ease of communicating “red flags” to the right person.

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**WHAT THIS MEANS TO YOU**

- **Board Member** – As a member of the board of directors, you can use this information as a catalyst for discussion with senior management on the state of the organization’s internal control system. It will also improve your knowledge of internal control and enhance the effectiveness of your oversight responsibilities.

- **Senior Management** – As chief executive officer, chief financial officer, or other senior management, you can access suggested approaches for designing and evaluating the effectiveness of your organization’s internal control system. The guidance also will help determine the desired formality of controls and requisite documentation.

- **Other Personnel** – Controls are everybody’s business. This guidance will help managers and other personnel recognize responsibilities and exercise accountability in strengthening control. It also will help the internal auditors in their internal control evaluation process.

- **External Auditor** – The guidance will help external auditors better understand acceptable approaches for applying the COSO Framework to their smaller public clients.

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**COMMENTS WELCOMED**

The draft Guidance for Smaller Public Companies Reporting on Internal Controls over Financial Reporting will be exposed for approximately two months. Board members, senior management, internal auditors, external auditors, and other individuals are invited to visit [www.coso.org](http://www.coso.org), download the draft, and provide comments.

**COSO comprises** The Institute of Internal Auditors, Financial Executives International, the American Institute of Certified Public Accountants, the American Accounting Association, and the Institute of Management Accountants. It is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance.
Mission
To provide executive management, boards of directors, and audit committees with concise, leading-edge information on such issues as ethics, internal control, governance, and the changing role of internal auditing; and guidance relative to their roles in, and responsibilities for, the internal audit activity.

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