COSO

Internal Control over Financial Reporting – Guidance for Smaller Public Companies

Frequently Asked Questions

Internal Control over Financial Reporting – Guidance for Smaller Public Companies

Frequently Asked Questions

June 2006

1. Need for Internal Controls

Why does an organization need internal controls?

Answer:

An organization needs internal controls to provide greater assurance that they will achieve their operating, financial reporting, and compliance objectives; in other words to help the organization succeed in its mission. Internal control helps ensure that the directions, policies, procedures, and practices designed and approved by management and the board are put in place and are functioning as desired. The more elaborate the organization, the more the need for internal control to counteract any loss of effectiveness sustained when adding more people and processes to transact business.

2. Nature of Guidance

How does the COSO small business guidance help small businesses implement an effective system of internal control within their unique environment?

Answer:

The COSO small business document provides principles and attributes, aligned with COSO's 1992 internal controls framework, that allows organizations of all sizes to understand the necessary elements to ensure a robust system of internal control reflecting size, structure, and degree of complexity. The document further provides examples of how small businesses have actually implemented the principles and related attributes identified in the document.

3. Structure of the Guidance

What is the general format of the small business guidance and its intended audience(s)?

Answer:

The COSO small business document contains three volumes: an executive summary, guidance for small businesses, and a set of examples / tools. The guidance is composed of 20 principles related to the overall framework and 75 attributes related to these principles. The attributes are meant to help identify the methods that can be used to implement a control principle. All attributes may not be present based on the complexity of the organization and its specific situation.

4. Intended users

Who are the intended users of the guidance?

Answer:

This document is meant for use by boards of directors, audit committees, management, accountants, internal auditors, external auditors, regulators, and others involved in structuring and assessing internal control. It provides a framework organizations can use to determine their overall internal control structure and assess its effectiveness.

5. Objectives of Internal Control

What are the objectives of good internal control?

Answer:

There are three objectives of good internal control – all established in the COSO Internal Control – Integrated Framework in 1992. They are: 1) accuracy of financial reporting; 2) compliance with laws and regulations; and 3) effective and efficient operations. The COSO control components are designed to assist the organization in achieving those objectives.

6. Understanding COSO Components

Explain in general how the COSO components of internal control relate?

Answer:

There are five control components to the COSO integrated framework: Control Environment, Risk Assessment, Control Activities, Information & Communication, and Monitoring.

Effective internal control requires a strong control environment under which the other components are implemented. The underlying principles of good control and commitment to adhering to sound control compliance must be present to ensure a healthy interactive control structure. Risk Assessment is the basis for determining where internal control activities are needed. An effective risk assessment will enable the organization to focus on those risks which are important to its overall success in meeting its control and operating objectives. Collecting and communicating information resulting from the exercise of internal controls keeps key leaders informed of potential problems. Ensuring that the feedback from control operation is captured is a vital part to the overall organization's ability to respond to issues in a timely manner. An effective monitoring system oversees the design, implementation, and effectiveness of controls in mitigating risks. Effective monitoring can be structured as an ongoing assessment program or as a point in time program when a point in time assessment is required.

7. Relationship to 92 Framework

Has anything changed from the 1992 COSO Integrated Framework? If yes, what?

Answer:

The COSO internal control framework is still the same as it was in 1992. The new guidance clarifies the underlying principles contained in the framework, discusses attributes that most commonly exist, and provides specific small-business examples of how these principles and attributes are used.

8. Importance of Control Components

Are all the components of internal control equal? If not, which are more important?

Answer:

All five of the control components are important to strong internal control within an organization. COSO believes that the 20 principles outlined in the small business document are essential to good internal control and cannot be compromised. In some cases, the attributes described in the document are optional, based on the specific complexity of the organization. Management and the board should discuss situations where the attributes are not applicable. However, COSO emphasizes that the guidance is "principles-based" and there are a wide variety of choices that management can make in achieving effective internal control over financial reporting. The principles and attributes help management in making choices. Management should make choices that assist them in achieving the most effective internal control at a reasonable cost.

9. Scope of Guidance

Is the guidance intended to cover all control objectives or just financial controls?

Answer:

The COSO small business document is intended to address the unique needs of the financial reporting objective. However, many of the principles and attributes apply to all three control objectives (financial reporting, compliance, and operations).

10. Principles-Based

If the COSO Guidance is "principles-based", does it contain sufficient guidance to assist a small business that is not used to making internal control decisions?

Answer:

Yes – and in two ways. First, the Guidance recognizes that good internal control is good business. Most managers are familiar with fundamental principles of good control, such as a strong ethical climate, a commitment to financial reporting competencies, the need to assure that human resource practices reinforce strong control. Second, the guidance breaks down the five elements of internal control into understandable underlying principles and recognizes that many different approaches may be used to achieve an underlying principle. It further provides a host of examples – all taken from existing smaller businesses – to achieve a particular principle. A company can utilize any of the examples, or can use some of the templates to assist them in designing and implementing controls. However, the Guidance is not intended to be a "cookbook" for companies.

11. Principle of Internal Control

What is an internal control "principle?"

Answer:

A "principle" is a fundamental concept associated with effective internal control over financial reporting and drawn directly from the five components of the original Framework. A "principle" should remain constant over time and relates specifically to one of the five control components in the framework.

12. Attributes of Internal Control

What are "attributes" of control principles? How do they help define a principle?

Answer:

Attributes represent characteristics associated with the principle. Although each attribute generally is expected to be present within a company, it may be possible to apply a principle without every listed attribute being present.

13. Examples of Controls

What types of examples are in the guidance?

Answer:

For each principle and related set of attributes, specific real-world examples are presented with references to the concepts contained in the principle and attribute. Examples have been taken from actual small businesses to provide a basis for further understanding of how a control functions in a small business environment.

14. Tools Provided

What types of tools are included in this COSO Small Business guidance?

Answer:

The tools contained in volume 3 provide examples of how internal controls can be documented to demonstrate the principles and attributes related to the five control components (control environment, risk assessment, control activities, information & communication, and monitoring), and the achievement of the objective regarding reliable financial reporting. The tools provided, however, are guides and are not meant to be checklists. They are designed to provide a customizable format. The tools provide examples for account and process assessments, as well as entity-level overall assessments.

15. Small Business Challenges

What challenges do small companies face regarding internal control and how does the COSO guidance help to deal with these challenges?

Answer:

Among the challenges are:

- Resources. Obtaining sufficient resources to achieve adequate segregation of duties.
- Management Domination. Management's ability to dominate activities and significant opportunities for improper management override of processes. This could result in the appearance that business performance goals have been met, when in fact, they have not.
- Board Expertise. Recruiting individuals with requisite financial reporting and other expertise to serve effectively on the board of directors and audit committee.
- Financial Competence. Recruiting and retaining personnel with sufficient experience and skill in accounting and financial reporting.
- Running the Business. Taking critical management attention away from running the business in order to provide sufficient focus on accounting and financial reporting.
- Information Technology. Controlling information technology and maintaining appropriate general and application controls over computer information systems with limited technical resources.

The COSO guidance provides examples of actual companies that have addressed these challenges and correlates these examples to the principles they support.

16. Internal Control & Small Business

Can smaller businesses achieve effective internal control?

Answer:

Yes, COSO believes that small businesses can, and should, maintain effective internal control. COSO recognizes that control implementation in a small business will generally be less complex and may be less formally documented in some areas.

17. Applicability to Other Companies

Can the Small Business guidance help large and medium sized companies as well? How?

Answer:

Although targeted to smaller public companies, the COSO small business document contains information that should be helpful to all businesses, regardless of size. The 20 principles and supporting attributes clarify the 1992 COSO Internal Control - Integrated Framework, so that all organizations might more readily apply it as well as configure their assessment model.

18. Narrower Objective for This Guidance

This guidance is intended for smaller public companies that are required to meet the requirements of Sarbanes-Oxley Section 404. What specific objectives are covered by the guidance?

Answer:

This guidance addresses only with one narrow objective – the reliability of financial statements. As such, it is only one element of the broader objectives set out in the COSO Internal Control – Integrated Framework. COSO encourages all organizations to focus on all of the objectives developed in the framework because (a) all three objectives are important to the success of the organization, and (b) considerable efficiencies might be attained by addressing the three objectives in developing and implementing internal controls.

19. Exemptions

Does COSO support exemptions for small businesses regarding internal control?

Answer:

COSO believes that any organization (public, private, governmental, non-profit, or family-owned) should maintain effective internal control to ensure the accuracy of information, completeness of transaction recordings, and appropriate financial disclosures. In addition, organizations should maintain effective internal control to address financial reporting, compliance, and operational risks. Developing and implementing effective internal control is simply good business. Size of the organization does not decrease the need for effective internal control. COSO does believe that the structure of internal control systems will vary, based on the size and complexity of the organization.

20. Relationship to SOX 404

How does the COSO Internal Control-Integrated Framework work to help management in a risk-based internal control assessment as prescribed by SOX 404?

Answer:

The COSO framework recognizes the reliability of financial reporting as one of the three major objectives of internal control. An organization begins with a clear articulation of its objectives and the implementation of a control environment to reinforce the importance of achieving those objectives. The guidance suggests that a risk assessment of the financial information be performed by determining which general ledger accounts contain information that is significant to the overall financial disclosures of the organization. Key business processes that support entries to these accounts are then identified and associated risks are qualified. The key risks (high impact, high probability) are assessed and the mitigating control activities are determined. A risk based approach is fundamental to the COSO Internal Control-Integrated Framework and thus is consistent with the suggested guidance by various regulatory agencies.

Overall, COSO's Internal Control - Integrated Framework and this new small business guidance provide a basis for not only developing a good control structure, but also for assessing its effectiveness.

21. Evaluation of Internal Control and Objectives

The guidance talks about the five components of the control framework as they relate to achieve the objectives. How do the components of internal control relate to the objectives of internal control, and how does that relationship affect management's assessment of internal control?

Answer:

Internal control is a process that supports continuous improvement. The five components need to be present and functioning to assure the continued reliability of the company's internal controls. However, the assessment of the effectiveness of internal control relates to whether the components, acting together, and implemented according to management's judgment, achieve the objectives of internal control over financial reporting (in this guidance).

22. Assessment

Does the COSO document provide "assessment" tools?

Answer:

The COSO small business document contains (in volume 3) tools that are designed to provide examples of methods which can be used to assess a control. Examples are presented as guides to implementation and should be carefully aligned with the organization's unique structure of internal control and management's judgments on controls to implement. The guidance does not present a "cookbook" or a prescriptive approach to a control assessment as COSO believes it is critical for management to exercise judgement in determining the nature and extent of tests to be used in performing an assessment. Further, the guidance does not paint any "bright line" as to extent of evidence necessary to assert controls as effective as that too is a matter of management judgement.

23. Assessment and Monitoring

How do monitoring and assessment differ? Are they related?

Answer:

Monitoring is a process established to ensure the effectiveness of internal control design and operations. Monitoring controls can be "ongoing" or they can be "separate evaluations" made at a point in time, or over several points in time on different parts of control processes or components of control. Because many companies find it beneficial to build ongoing monitoring into their day to day operations, companies have not traditionally thought of monitoring as a point in time process. However, this guidance points out that monitoring can be either a separate evaluation, or an on-going process.

An assessment, currently required by SOX 404(a), is a process that requires management to assert on the effectiveness of internal control over financial reporting as of its balance sheet date. That assessment requires that some part contain a "point in time", or "separate evaluation" of internal control that supplements the knowledge management has from its continuous monitoring activities. In other words, management has to obtain sufficient evidence from their own testing to know that all of its components of internal control, including the monitoring component, are working effectively. Thus, while much of the evidence for management's assessment might come from management ongoing monitoring activities, management has to perform enough of a separate evaluation as of the balance sheet date to know that its internal control over financial reporting is working effectively at that point in time.

Although monitoring and assessments are often looked at as separate activities, in reality an assessment is part of a good monitoring process. Assessments are an integral part of the periodic evaluation of the control structure. Ongoing monitoring ensures key information is communicated regarding the accuracy, completeness, existence, recording, classification, and reporting of information.

24. Information Technology

To what extent is information technology that would be used by smaller businesses addressed in the guidance?

Answer:

All business processes today are impacted in some respect by information technology (IT) applications, policies, and controls. IT is key to financial information collection, classification, allocation, and reporting. The guidance provides recommendations on using information technology to facilitate the achievement of internal control in smaller businesses.

25. Cost of Internal Control Assessment

Will use of the COSO small business guidance reduce overall costs of internal control assessment?

Answer:

COSO believes that this guidance will enable management and the board of directors to make smarter decisions regarding the types of controls necessary and the level of controls necessary to achieve the organization's objectives. Those decisions will consider an organization's complexity, as well as the complexity of transactions, dispersion of operations, and sophistication of computer applications. The guidance, once applied, will enable an organization to determine the important controls, assess those controls efficiently, and make a statement as to their effectiveness. By designing and monitoring only those important controls that are right sized for a small public company, management will hopefully be able to avoid unnecessary or duplicate controls and testing.

26. COSO Membership

Who are the members of COSO and how was the document developed?

Answer:

The COSO members are: The American Accounting Association (AAA), The American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), The Institute of Internal Auditors (IIA), and The Institute of Management Accountants (IMA). This document was developed by a task force comprising small business experts and professional project management from PricewaterhouseCoopers. The task force engaged in a number of fact-gathering efforts to look at the practice of internal control in a wide variety of different sizes of small businesses. Examples were gathered from numerous small businesses to support the implementation of the COSO framework.

27. Authority of Guidance

What authority does this document have?

Answer:

COSO has been recognized by the SEC as a framework that companies can use in evaluating the effectiveness of internal control over financial reporting. Although the guidance went through an exposure period, the guidance is that of the COSO organization and as such constitutes professional guidance to management, boards of directors, practitioners, and regulators. However, it carries no formal requirement for compliance, other than an organization's desire to achieve excellence in internal controls over financial reporting.