
SEC FLASH REPORT

COSO Issues Draft of Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting

October 31, 2005

Last week, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) published for comment an exposure draft proposing new guidance on the use of its Internal Control – Integrated Framework to address the needs of smaller businesses in fulfilling the requirements of Section 404 of the Sarbanes-Oxley Act (SOA). The guidance, entitled *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting*, is available at www.coso.org. Interested parties should direct their comments to COSO through its website by December 31, 2005.

The proposed guidance outlines 26 fundamental principles associated with the five key components of internal control included in the COSO Framework. As introduced by COSO, the exposure draft defines and describes each principle, lists a variety of approaches smaller companies can use to incorporate the principles into practice, and includes real-world examples of how smaller companies have effectively applied the principles. The exposure draft also provides illustrative tools and templates. It may be downloaded from the COSO website.

Background

As public companies comply with SOA, many parties have expressed concerns that the COSO Internal Control – Integrated Framework and other existing internal control frameworks are not appropriately tailored to a small business control environment. As a result, many have asserted that the costs and burdens of internal control assessments may fall disproportionately on smaller businesses. Due to these concerns, the SEC staff encouraged COSO to develop guidance on the use of the COSO framework to address the needs of smaller businesses.

In January 2005, COSO initiated this project with the intention to fill a gap in existing guidance and assist smaller companies in their efforts to comply with laws and regulations relating to reporting on internal control over financial reporting. PricewaterhouseCoopers was engaged to conduct the project. During the project, input was obtained from corporate executives of many smaller organizations. COSO held a forum in May with invitees from small businesses to better understand the unique challenges those businesses face in developing and implementing controls and in complying with COSO's framework. An Advisory Council provided input during the course of the project.

Overall Conclusions

Based on the proposed guidance, following are some of the overall conclusions reached by COSO in conjunction with preparing the exposure draft:

- While there are some differences in control approaches, the fundamental concepts of good control are the same whether the company is large or small. Fundamental controls such as reconciliations, management reviews and basic input controls remain the same. While there are differences in approaches used by smaller companies versus their larger counterparts in seeking effective internal control, all approaches must address the same fundamental control principles. Furthermore, the approaches used often manifest themselves in different forms of management review and oversight.
- The control approaches used by a smaller company often mirror those of a larger one, although the scale may vary. For example, due to the increased complexity of larger companies, significantly more effort may be expended in implementing control activities in specific areas.
- Compared to larger companies, smaller companies often have wider spans of control and greater transparency to the senior levels of the company. For instance, smaller companies may find informal staff meetings effective for communicating information with respect to internal control and financial reporting, whereas larger companies may need more formal mechanisms such as intranet portals, town hall meetings and peer group conference calls to communicate similar matters.
- With respect to implementing internal control over financial reporting, smaller companies face challenges larger companies do not. For example, smaller companies have difficulty obtaining sufficient funding and staffing to implement such practices as hiring qualified senior financial staff, sourcing an internal audit function and increasing director's fees and insurance coverage to attract and retain qualified independent directors. Smaller businesses also face challenges achieving adequate segregation of duties, mitigating the risk of management override, establishing a separate audit committee and implementing effective security and change controls over information technology.
- There are 26 principles referred to in the exposure draft, all of which are all derived from the COSO framework. The COSO Internal Control – Integrated Framework is principles-based, and the proposed guidance highlighted key principles based on the framework. Of the 26 principles, 23 of them are fundamental to all companies, regardless of size. Three additional principles were identified to assist organizations, and their personnel, in understanding their roles and responsibilities in implementing effective internal control over financial reporting. There are many approaches available to apply the 26 principles; therefore, there is no one-size-fits-all control approach.
- There is no “short cut” to achieving effective internal control over financial reporting. All five components of the COSO framework and the related 26 principles should be in place in order to evidence a conclusion that internal control over financial reporting is effective. That said, the scale of the approaches to implement the principles may be different for a small company.
- Companies should not reduce costs by reducing the effectiveness of internal control. COSO is of the view that companies should apply the principles and choose a control approach to that best fits each company's circumstances in the most cost-

effective manner. The guidance includes a discussion of alternative approaches and provides detailed examples taken from smaller companies.

What is “Small?”

COSO avoided a “bright line test” to differentiate smaller companies from larger ones. Therefore, COSO decided not to use specific monetary thresholds. COSO also purposefully did not define “small” using control-related characteristics. COSO used the following characteristics to define a “small public company”:

- Simple product line and processing
- Founders or a small group of owners who dominate management of the business
- Wider management spans of control
- Economic strategies that often encompass acquiring services on a variable-cost basis as opposed to making fixed-cost investments
- Defined concentration in either production or sales
- Operating size, as measured by revenues, personnel or assets, that make it difficult to benefit from the economies of scale larger entities enjoy.

COSO points out that none of the above characteristics by themselves are definitive. As companies become larger and revenues and assets grow, management will begin taking advantage of more economies of scale and will have narrower spans of control. These developments will drive modifications to the control approach over time.

Applying the Guidance

All public companies must implement a control structure to reduce risk to an acceptable level. Because smaller companies often do not perceive that they have sufficient resources to fully implement segregation of duties or other controls that are more preventive in nature, they must “rely more on ‘after the fact’ monitoring and personal involvement by top management in setting a control environment that brings in sufficient competence and trust to assist in reducing risk.” In the context of the five components of the COSO framework, this means that smaller companies ordinarily must place more emphasis than larger companies on monitoring and the control environment relative to the other three components combined. Smaller and larger companies would both place equal emphasis on the risk assessment and information and communication components. Smaller companies would place less emphasis than larger companies on control activities relative to the other components because such activities require a minimum level of formalization to operate effectively.

The 26 principles are organized as follows:

- **Control Environment** – Includes seven principles which mirror the seven attributes of this component of the COSO framework, e.g., integrity and ethical values, organizational structure, management’s philosophy and operating style, etc.
- **Risk Assessment** – Includes three principles relating to importance of financial reporting objectives, identification and analysis of financial reporting risks and assessment of fraud risks. These three principles are consistent with the application of the risk assessment component, as described by the COSO framework.

- **Control Activities** – Includes four principles to define this component of the COSO framework, e.g., elements of a control activity, control activities linked to risk assessment, selection and development of control activities and information integrity.
- **Information and Communication** – Includes six principles to further define this component of the COSO framework, e.g., information needs, information control, management communication, upstream communication, board communication and communication with outside parties.
- **Monitoring** – Includes three principles which mirror the three attributes of this component of the COSO framework, e.g., ongoing monitoring, separate evaluations and reporting deficiencies.

The above 23 principles relating to the five components of the COSO Internal Control – Integrated Framework are supplemented with three additional principles relating to the roles that various parties play with respect to internal control over financial reporting, and how those roles translate into specific responsibilities. As described further below, these principles are also derived from the COSO framework:

- **Roles and Responsibilities** – Includes three principles – management roles, board and audit committees and other personnel.

COSO's guidance in the exposure draft is organized into six chapters, with each chapter addressing the principles applicable to one of the six areas above. An appendix provides illustrative tools and templates that are organized around the five components and 26 principles. The objective is to provide management with illustrative templates and tools for use when evaluating the design and operating effectiveness of internal control over financial reporting.

Summary

While the exposure draft will require some time for organizations and their personnel to review and digest, COSO believes the proposed guidance offers a number of benefits. For example, smaller companies will have an approach that is more tailored to their unique operating environment. Senior management and internal auditors can use the 26 principles of effective internal control to determine how to appropriately apply the COSO framework. The illustrative tools and templates show how the 26 principles can be used to document the evaluation of internal control over financial reporting. Finally, the individual chapters provide more guidance to explain the application of the principles and facilitate a better understanding by boards, management, other company personnel and internal and external auditors.