IMPLEMENTING AND ASSESSING INTERNAL CONTROL IN SMALLER PUBLIC COMPANIES

There are issues in implementing and assessing internal control over financial (ICFR) reporting that are unique to smaller public companies. The author examines the ICFR problems that stem directly from the defining characteristics of smaller companies.

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For fiscal years ending after December 15, 2007, the smallest public companies must begin including in their annual filings with the Securities and Exchange Commission (SEC) a report under Sarbanes-Oxley Section 404 on management's assessment of internal control over financial reporting (ICFR). A year later these companies must undergo audits of internal control. Both the SEC and Public Company Accounting Oversight Board (PCAOB) have made considerable efforts to issue guidance that will assist smaller companies in complying with Section 404. One important piece of new guidance from the PCAOB is aimed at helping accountants audit internal control in smaller companies, but this guidance will be useful to management as well.

In October 2007 the PCAOB released *Preliminary Staff Views—An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies* (*Preliminary Staff Views*). As the title says, this guidance is preliminary. The PCAOB is currently evaluating comments solicited in *Preliminary Staff Views,* which were due December 17, 2007. Still, even this preliminary document will be useful for both auditors and management in understanding the financial-reporting risks unique to smaller companies, the ways to control those risks, and the manner of assessing the effectiveness of ICFR.

In this article we will look at problems in implementing and assessing ICFR that are unique to smaller public companies. These are by no means all of the problems that will be encountered, but these are problems that stem from the defining characteristics of smaller companies.

Management override of controls

Two of the defining characteristics of smaller companies are management's significant involvement in day-to-day activities and fewer levels of management. These characteristics lead directly to a serious internal control risk: the ability of management to override con-

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trols. In the worst case, management may override controls in order to defraud the company or its shareholders. ICFR is ordinarily not effective if a company does not have controls in place to prevent or detect management override on a timely basis, even if all of the other controls in the company's system of ICFR are effective.

Preliminary Staff Views discusses a number of controls that can be implemented to prevent management override. Two of these, which we will discuss here, are oversight by the audit committee and whistleblower systems.

The importance of active audit-committee oversight over the company's external financial reporting and ICFR cannot be overemphasized. It is so important that ineffective oversight is, by itself, an indicator of a material weakness in ICFR. Because the risk of management override is so serious in a smaller company, the audit committee has to address this risk. As part of its oversight duties, the audit committee might meet with management to discuss significant accounting estimates and review the reasonableness of significant assumptions and judgments. It can also monitor certain transactions, such as those involving related parties. It can also work closely with internal auditors or third-party consultants who perform internal audit functions on a contract basis so that the committee can gauge the extent to which management overrides controls or does not brief the audit committee on important transactions.

The audit committee of a listed company must establish a whistleblower system for receiving complaints regarding accounting, internal accounting controls, or auditing matters. Studies by the Association of Certified Fraud Examiners (ACFE) have consistently shown that "tips" are one of the best sources for uncovering fraud in the workplace. In its *2006 ACFE Report to the Nation on Occupational Fraud & Abuse*, the ACFE found that nearly half of all fraud cases involving company owners and executives were discovered through tips. A whistleblower system established by and reporting to the audit committee can be an important tool for preventing, or at least detecting, management override and fraud.

Segregation of duties

A frequently cited criticism of internal control in smaller companies is that because these companies have fewer employees there is limited opportunity for segregating incompatible duties. For a company that has only a handful of people performing all of the accounting functions, the same person may perform many incompatible duties, which can result in deficiencies in control. An extreme example of this would be a case in which the person responsible for receiving cash payments was also responsible for reconciling bank accounts or applying payments to customer accounts.

If lack of personnel prevents a company from segregating duties, the company can achieve the objectives of segregation of duties through alternative methods. According to *Preliminary Staff Views*, smaller companies have two good options. The first is outsourcing certain functions and the second is management oversight and review.

If lack of personnel does not permit the segregation of incompatible duties, the company can bring in temporary employees or consultants to perform these duties, or it can outsource an entire function. For example, smaller companies will often outsource the handling of cash receipts, payroll processing, and employee benefits. Note that outsourcing a function does not relieve management of the responsibility for assessing the effectiveness of internal control over this function. Management is responsible for determining that third-party service providers maintain adequate internal controls over the functions they perform.

Management can also compensate for lack of segregation of duties through oversight and review, such as reviewing transactions, checking reconciliations, reviewing transaction reports, or taking periodic asset counts. Such activities are often detective controls, which can be less effective in preventing errors or

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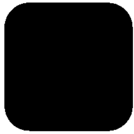

A BASIC REQUIREMENT FOR EFFECTIVE INTERNAL CONTROL OVER FINANCIAL REPORTING IS THE EMPLOYMENT OF INDIVIDUALS WHO ARE COMPETENT IN FINANCIAL REPORTING AND RELATED OVERSIGHT ROLES.

fraud than the segregation of duties. However, if a manager is rigorous in the performance of his or her oversight and review activities, these activities can be effective in catching material misstatements or fraud on a timely basis.

Information technology controls

The starting point for establishing strong ICFR over information technology (IT) is general controls, which include controls over program updates and changes, system-access controls, testing of applications, data-backup procedures, and controls over installation and configuration of software. If general IT controls are weak, this casts doubt on the reliability of controls over specific applications and on any other control that depends on information from the IT system.

General IT controls over modification of software applications are usually not necessary, since smaller companies generally use off-the-shelf software that cannot be modified. However, supervisory controls are needed to insure that the IT personnel have installed the correct version of the software and all necessary updates.

Software controls are necessary to make sure off-the-shelf software is properly installed and configured and that the software application works properly. Applications in smaller companies are relatively simple, and lend themselves to testing by comparing data inputs to system outputs. Management, internal auditors, or third-party consultants can evaluate the operation of important applications by periodically reconciling data inputs with expected system outputs.

Smaller companies may outsource certain IT functions to third-party service organizations or consultants. When this is the case, management is responsible for insuring that the third party has effective controls over application processing and the protection of the company's data and property.

Smaller companies often depend on spreadsheets and other end-user tools rather than on system-wide custom applications, which are the norm in larger companies. These tools are used to process and analyze information on business operations and perform calculations using simple formulas. Analyses and calculations performed using these tools do not benefit from built-in controls, and the uncontrolled nature of these tools means that a calculation that was correct in November is not necessarily correct in December. One of the only controls that effectively detects errors when using these tools is manual review by a supervisor. In its assessment of ICFR, management can evaluate controls over the use of these applications by examining evidence of supervisory review.

There are, of course, end-user spreadsheets and applications that are quite complex and include formulas, macros, and scripts. These should be treated like other software applications, and the output of these applications should be regularly tested for completeness and accuracy. Moreover, unlike off-the-shelf software, end-user applications such as spreadsheets can be modified. Therefore, controls should exist over unauthorized modification and they should test the continued accuracy of applications after they are modified. Finally, procedures should exist for backing up the applications and data. Management should periodically evaluate the effectiveness of the controls over these applications.

Off-the-shelf applications often include a number of automated controls to assist in achieving control objectives. An example is password protection to restrict access. Many of these are preventive controls, which are highly effective if used properly. Management should make sure these controls are operational and are being used properly.

Competence of financial accounting personnel

A basic requirement for effective internal control over financial reporting is the employment of individuals who are competent in financial reporting and related oversight roles. It is obvious that a person with the necessary train-

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ing is less likely to cause a material misstatement than one without that training. In addition, where a company faces specialized accounting issues, such as the accounting for income taxes or stock options, the most effective control for preventing material misstatement is to acquire the services of a person with expertise in that area. Acquiring the services of people with the appropriate skills to address the company's financial-reporting needs is a key part of establishing effective ICFR. Therefore, an important consideration in implementing ICFR is identifying the necessary financial-accounting competencies and determining whether the company has access to people with the required expertise.

The full-time accountants employed by many smaller companies are usually generalists: individuals who are competent in performing day-to-day accounting operations and can close the books and prepare basic financial statements, but are not familiar with the accounting required for complex or nonroutine transactions, or relevant changes in rules, regulations, and accounting practices. Often, such companies address their lack of in-house expertise by engaging outside professionals. If the company uses an outside professional, management must take steps to ensure the person has the necessary skills. In addition, management should establish controls over the work of the consultant, including controls over the exchange of information in addition to controls for testing the completeness and accuracy of the information provided to the consultant and the accuracy of the work performed.

Warning signs of a lack of competent financial-accounting personnel are material adjustments to accounts, or significant changes in financial reports or disclosures, made by independent auditors in past periods.

Evidence supporting an assessment of ICFR

Management *must* have reasonable support for its assessment of ICFR. Reasonable support includes the basis for management's assessment, including documentation of the methods and procedures it utilizes to gather and evaluate evidence, plus the evidence itself. The evidence available in a smaller company can differ substantially from that in a larger company. The primary differences are less formal documentation of controls and more reliance on direct observation of control activity for evidence of the operating effectiveness of controls.

Formal documentation of existing processes and controls in a company, such as in-depth policy manuals and system flowcharts, is the norm for large companies but is ordinarily not present in smaller companies. Instead, documentation of systems and controls in a smaller company might take the form of email, memoranda, operating instructions, checklists, software manuals, various forms used in processing transactions (e.g., purchase orders), or job descriptions. In addition, in such a company documentation might not cover all systems and controls, and might not be consistently formatted. Still, this kind of less formal documentation may be sufficient because in less complex companies systems are generally straightforward, and controls within the system are easy to understand and communicate to personnel performing the controls.

In a smaller company, documentation to support the operating effectiveness of controls may not be extensive. One reason is that in smaller companies direct supervision of employees represents much of the control activity; this type of control can be quite difficult to document as it is taking place. However, according to the SEC, in a smaller company, management's daily interaction with its controls can provide the basis for its ICFR assessment. Daily interaction may be sufficient, for example, when the operation of controls is centralized and the number of personnel involved is limited. Where daily interaction forms the basis for assessing control, management should include in its ICFR assessment documentation of how its interaction provided it with sufficient evidence.

What happens if the evidence of a control's effectiveness does not exist? *Pre-*

IN A SMALLER COMPANY, MANAGEMENT'S DAILY INTERACTION WITH ITS CONTROLS CAN PROVIDE THE BASIS FOR ITS ICFR ASSESSMENT.

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liminary Staff Views warns auditors that "[i]f the auditor cannot obtain enough evidence about a control's operation, he or she might be unable to reach a conclusion about its effectiveness." In this situation independent auditors are permitted to disclaim an opinion on the effectiveness of ICFR.

Management likewise might not be able to reach a conclusion about the effectiveness of a control if the evidence of its operation is not there. Management, however, must issue a Section 404 report stating that ICFR is either effective or not. Disclaimers are not permitted. If management has identified material risks of misstatement and does not have evidence to show those risks are adequately addressed, then it will probably have to conclude that ICFR is not effective. ■

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