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Improving Internal Control Over Financial Reporting

COSO's Guidance Not Just for Public Companies Anymore

By Jeffrey E. Michelman and Bobby E. Waldrup

When the Committee of Sponsoring Organizations (COSO) released its *Internal Control—Integrated Framework* (ICFR) in 1992, the event went largely unnoticed. The importance of this framework changed dramatically with the passage of the Sarbanes-Oxley Act of 2002 (SOX). Because SOX required all covered entities to base their assessment of internal control on a recognized framework, COSO was readily embraced. Unfortunately, smaller public and nonpublic companies have found the 1992 framework complicated to apply and to understand.

Since the application of COSO by SEC registrants that were accelerated filers in 2004, smaller publicly traded organizations have continued to argue that complying with SOX section 404 was an unfair burden. As a means for improving both the understandability and the applicability of the ICFR, COSO released *Internal Control over Financial Reporting—Guidance for Smaller Public Companies* (ICFR-SPC). Although the true value and utility of the ICFR-SPC for compliance with SOX section 404 will become clearer over the next several years, the authors believe that the value of the ICFR-SPC goes far beyond publicly traded

companies. In particular, ICFR-SPC offers great utility to small businesses, but only if it is properly understood and applied.

ICFR-SPC offers a significant opportunity for small CPA firms to offer value-added services to existing and potential clients. This importance is illustrated in a 2005 survey by the AICPA's Private Companies Practice Section (PCPS), which found that the number-three challenge for small CPA firms was "marketing/practice growth." Small businesses often lack internal controls because the costs are perceived to outweigh the benefits. Yet these same organizations are often burdened by excessive regulatory costs-per-employee and higher-than-average fraud costs and occurrence of fraud. These pressures on small business are listed in *Exhibit 1*. Many will no doubt interpret this as more evidence of the regulatory burdens placed on small businesses, and will say that small businesses should continue to advocate for continued exemption from compliance with laws like SOX. The authors, however, believe that CPAs have failed to recognize the opportunity to provide added-value internal control services, because small businesses either do not understand the value of internal controls or are unwilling to pay for the evaluation and, ultimately, the application of internal controls. As a result, small businesses are often the organizations most susceptible to fraud.

The inability of CPAs to sell these services to small businesses has often been due to a lack of usable tools to evaluate, apply, and communicate both the importance of internal control and suggestions for its application. (The *Sidebar* presents a case study of an opportunity missed and the related fraud that ensued.) Unfortunately, small CPA firms often see the need for their services as solely stemming from compliance with a direct demand by an external party (i.e., the IRS or a lender). In contrast, the authors believe that the ICFR-SPC offers a powerful tool for practitioners to provide value-added services that go beyond complying with external demands and pass a cost-benefit test. Moreover, CPAs not involved in the assurance function can seize the opportunity to act as business advisor.

The original five components of internal control in the 1992 ICFR (control environ-

ment, risk assessment, control activities, information and communication, and monitoring) offered more insight into how large organizations operate than how small businesses do. In contrast, ICFR-SPC is a framework that offers a clear explanation of the five components of internal control as well as how they apply to small business-

es, both for-profit and nonprofit. Because the focus of the ICFR is on financial risk, the secondary benefits to nonassurance clients is not always readily apparent.

The importance of internal control to many small businesses is characterized by 10 factors that the authors believe are particularly important for businesses to

EXHIBIT 1 Costs of Being Small

In a 2005 study on the impact of regulatory costs on small firms:

■ Average cost per employee for complying with all regulatory requirements for companies with less than 20 employees	\$7,647
■ Average cost per employee for complying with all regulatory requirements for companies with more than 500 employees	\$5,282

In a 2006 study of occupational fraud in the United States:

■ Median loss of organizations with less than 100 employees with a fraud occurrence	\$190,000
■ Median loss of all organizations with a fraud occurrence	\$159,000

Sources: W. Mark Crain, *The Impact of Regulatory Costs on Small Firms*, SBA Office of Small Business Advocacy, www.sba.gov/advo/research/rs264tot.pdf, 2005; Association of Certified Fraud Examiners, 2006 Report to the Nation on Occupational Fraud and Abuse, www.acfe.com/fraud/report.asp.

EXHIBIT 2 Top 10 Characteristics of Small Businesses Likely to Benefit from Applying COSO SPC

1. Large number of cash transactions.
2. Complicated accounting issues, yet relatively simple accounting systems.
3. Large number of clients/customers with relatively small transaction amounts.
4. Professional owner of the organization who is very focused on service delivery but lacks any formal training in accounting or business.
5. An office manager who is professionally trained in some field other than business.
6. Lack of attention to background screening or employment policies.
7. A "black box" information system with no useful management reports.
8. An organizational structure that complicates the supervision process.
9. Complicated regulatory reporting issues.
10. No audit.

enhance their system of internal control (see *Exhibit 2*). While these 10 characteristics are not necessarily formal internal control threats, they can act as red flags to a CPA.

In contrast to the original ICFR, the ICFR-SPC links the components in a feedback loop, stressing the importance of internal control as a dynamic process. Although the paramount importance of internal control for public companies is to ensure the integrity of the financial reporting process, the authors think that the three secondary factors of internal control are what make

them most valuable to small businesses:

- Reliable and timely information supporting management's decision-making on matters such as product pricing, capital investment, and resource deployment;
- Consistent mechanisms for processing transactions across an organization, enhancing the speed at which transactions are initiated and settled, the reliability of related recordkeeping, and the ongoing integrity of data; and
- Ability and confidence to accurately communicate business performance with business partners and customers.

The importance of these secondary characteristics of internal control can offer untapped value to small businesses. COSO believes that the 20 principles of ICFR-SPC apply to all organizations, with size or complexity affecting only the scope of implementation. In particular, of the 20 basic principles of internal control, the authors believe that CPAs should focus on the importance of 11 of these with businesses of all sizes (highlighted in *Exhibit 3*). The following discussion focuses on professional service organizations in particular.

CASE STUDY: PROGRESSIVE STEP REHABILITATION SERVICES

Progressive Step Rehabilitation Services (PSRS), in Jacksonville, Fla., allowed an opportunity for fraud to be committed. The tone of the management philosophy and its operating style did not enforce an effective control environment. Rather, management believed in the employees and trusted them accordingly. This attitude, combined with a single employee's delegated responsibility of handling all checks and cash that came in through the mail and the reception desk, left the company at risk.

Although PSRS had security policies established, management and the employees ignored several important ones. When asked for a copy of company policy, it was unavailable. When reperforming the totals as part of a forensic investigation, bank deposits were often missing signatures, and at times the signatures approved miscalculated totals or incomplete deposit slips. These results suggest that some policies were merely perfunctory and clearly not enforced.

A single employee had the opportunity to set checks aside because she was the only one who picked up the mail. She never relinquished the mailbox key, even when repeatedly instructed to do so. Days after giving birth, the employee was back at the office, picking up the mail and the insurance copayments from the physical therapists' offices. Even when she worked only part-time, she always held on to these two tasks. Management did not segregate these duties, and there were no safeguards in place to monitor her activities.

The method of defalcation was a traditional lapping scheme. Checks were set aside by the employee after the mail was opened at the office and were used later to substitute for cash on the bank deposit slip. The bank deposit was altered to include the checks set aside for the same amount as the cash collected. The copy of the deposit slip at the office was not the same as the one used at the bank. The manager would check to see if the totals deposited and the

amount on the bank deposit slip matched, but no closer inspection occurred. A single employee had control of the money entering the billing office from beginning to end. It was later determined that the employee had a history of writing bad checks and had committed a similar lapping scheme in another physical therapy practice approximately 10 years earlier.

When asked by the authors about their CPA's role in the business, management noted that the CPA was involved in compiling the monthly financial statements and annual tax returns. When asked if the CPA had been involved in choosing and setting up the accounting and billing system, management responded that the CPA was concerned only that the system would produce the records electronically in order to streamline the process of the month-end reporting. When the authors asked if the CPA was involved in determining the appropriateness of the system selection or evaluating the internal control system of this practice with annual billings of more than \$800,000, management responded, "No, but we never asked our CPA to do this." In response, the authors suggested that if one of them entered their practice complaining of a sore hand, but also was unable to walk, he would hope that he would question about the reason for the limp.

When management later learned that PSRS's insurance coverage was inadequate to cover the loss, they further stated that they had never discussed insurance coverage with their CPA, either. There is, of course, no guarantee that the CPA, if applying the principles in COSO's ICFR, could have prevented the over \$60,000 fraud, but the authors hope that it would have reduced the amount. Moreover, the CPA's involvement in the business should have represented an important mitigating control whose benefits outweighed the cost.

Control Environment

Of the seven principles that relate to the control environment, four are pervasive across organizations of all types and sizes. Because small nonpublic companies will often have no board of directors or in-house financial reporting unit, this discussion will not address them. Furthermore, the critical aspects of management philosophy and operating style are sufficiently important for small business to be necessary parts of the first principle, integrity and ethical values. Integrity and ethical values are the basis by which the control model is built. Although CPAs cannot instantiate these traits into a client, they can help a business communicate these values to employees on a regular basis, and also remind them of these tenets if a client has “lost their way.” It is particularly important for a CPA in these situations to link their code of professional ethics with ethical business practices.

Organizational structure is often difficult for small business owners to understand, particularly if their professional training is technical. In such cases, CPAs can help a business define the administrative relationships in the organization. A logical adjunct to this process is helping a company define the authority and responsibilities of employees, especially the segregation of duties necessary under the circumstances. In particular, human resources is one area in which many companies falter significantly. Because many professionals (e.g., attorneys and physicians) do not take courses in management, they have inadequate knowledge of hiring, training, supervision, performance evaluation, and compensation. In this regard, CPAs need to know when to provide advice and when to seek the help of human resources professionals.

Risk Assessment

Medical and legal professionals often understand and advise their clients on risk

assessment, yet they often fail to adequately transfer these concepts to their own businesses. Although the risk of non-compliance with GAAP is an important concept, many small businesses use cash-basis accounting, and therefore should focus on fraud risk rather than on financial reporting objectives and risks. In this respect, a CPA has a twofold role: to understand how the fraud triangle—opportunity, pressure, and rationalization—affects both the business and how the business must pay attention to the dynamic nature of these factors in its employees. Moreover, a CPA should ensure that a client understands whatever fraud risks are unique to the industry, the location, or the broader economy.

Control Activities

Because CPAs in this context are not providing attest services, they should be particularly involved in helping clients identify control activities that facilitate

integration with risk assessment. For example, CPAs can advise a small business on the choice of a service bureau to provide payroll services when the fraud-related risk of processing payroll in-house is significant. A CPA can review the service provider's Statement on Auditing Standards (SAS) 70, *Service Organizations*, report, and advise the client appropriately. In small businesses, selection and development of control activities should focus on mitigating any risks of fraud that have been identified. In particular, small businesses are often

unwilling or unable to implement certain types of segregation of duties. CPAs should initiate a discussion about additional outsourcing activities or increased owner involvement.

Because many small businesses do not rely on information technology (IT) controls, CPAs should advise clients of the need to integrate control activities and document them as part of its policies and procedures. Perhaps one of the greatest opportunities for CPAs is to help clients develop and maintain policies and procedures that are appropriate for the organization and are reevaluated as the organization changes. For example, as organizations move from paper to digital format for both financial and nonfinancial data, policies that deal with record maintenance are crucial. Although IT is important, the internal control application will generally be less complex, and the available off-the-shelf software is generally satisfactory. In the authors' opinion, IT is not a significant issue for most small businesses.

Information and Communication

In a vibrant, growing organization, the owners often become increasingly removed from day-to-day administration. This sense of disconnection requires the regular communication of internal control information in the form of easily understood metrics that have been developed jointly by the client and the CPA. For example, has the mix between cash and credit sales increased the organization's risk of theft?

An organization's internal communication structure is often overlooked, although it is critical to the success of the internal control model. Organizations should encourage employees to communicate with management or owners when they believe that issues of efficiency and effectiveness—or, more important, fraud—have arisen. In this context, the effectiveness of the internal control model is limited by the engagement of the employees involved. Because non-publicly held organizations often do not prepare external reports, they often ignore the importance of information and communication altogether. A critical built-in control of small organizations is involvement of the owner, but as professionals focus on providing a service they

become increasingly removed from the administrative and control processes.

Monitoring

Small-business professionals often overlook monitoring because internal control deficiencies do not generally have to be reported to a third party. Nevertheless, ongoing and separate evaluations are quite important for small businesses. The authors believe that a CPA should meet with clients at least once a year to discuss changes in both the internal and external environments. Although professionals understand their service delivery process, they often lose touch with administrative processes that are critical for their business's financial health and viability. Unfortunately, too many organizations develop internal controls but never reexamine them as the organization changes. The area of monitoring is a particularly robust opportunity for CPAs to provide value-added services to clients.

Opportunity for Adding Value

CPAs without public company clients may tend to dismiss the ICFR-SPC as irrelevant. The authors encourage them to reconsider this attitude and work diligently with new or existing clients to communicate the value of these services. CPAs in small practices who do not see the benefits of this framework miss an opportunity to expand their practices. Internal control is not just about complying with SOX section 404. Rather, internal controls, when applied appropriately, help businesses of all sizes thrive and enhance competitiveness. □

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EXHIBIT 3

Roadmap for Applying Principles in Achieving Effective Internal Control in Small Businesses

Control Environment

- Integrity and ethical values
- Board of directors
- Management's philosophy and operating style
- Organizational structure
- Financial reporting competencies
- Authority and responsibility
- Human resources

Risk Assessment

- Financial reporting objectives
- Financial reporting risks
- Fraud risk

Control Activities

- Integration with risk assessment
- Selection and development of control activities
- Policies and procedures
- Information technology

Information and Communication

- Financial reporting information
- Internal control information
- Internal communication
- External communication

Monitoring

- Ongoing and separate evaluations
- Reporting deficiencies

Note: Adapted from Internal Control over Financial Reporting—Guidance for Smaller Public Companies, COSO, 2006.