

March 5, 2009

Streamlining Control Assessments

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Many organizations will be facing financial reporting control assessments and related external audit pressures for the very first time over the next two years. Yes, public companies have suffered millions of dollars in costs with limited benefits. Yes, there are regulatory inefficiencies and strained auditor relationships. Yes, I am talking about Section 404 of the Sarbanes-Oxley Act of 2002 (SOX). No, it does not have to be a wasteful exercise resulting in minimal benefits. This article identifies newer applicable organizations and the cornerstones to streamlining control assessment leading to cost-efficient and effective results.

New Applicable Organizations

First, it is widely anticipated that the Securities and Exchange Commission (SEC) will end the history of delays of SOX-404(b) for smaller public companies. This is the external audit requirement on the effectiveness of financial reporting controls. It means that non-accelerated filers will “likely” have this kick-in for their fiscal years ending on or after December 15, 2009. Of course, it is dangerous to assume anything from the SEC, as they could opt to do otherwise, but the drumbeats are for SOX-404(b) to finally be applicable for all SEC filer groups. The SEC is still awaiting information from a cost-benefit survey that should be completed in the coming months. A definitive decision on 404(b) for nonaccelerated filers should follow.

While *Management's Annual Report on Internal Control over Financial Reporting* has been a periodic reporting requirement for non-accelerated filers for the last two years per SOX-404(a), the lack of an external audit requirement has led some companies to not take SOX-404 seriously. Now that an external audit is likely, the priorities for these companies must change or otherwise they face the consequences of potential material weaknesses leading to adverse audit opinions.

Second, larger insurance organizations will be subject to the new Annual Financial Reporting Model Regulation (Model Audit Rule or MAR) beginning in 2011 for the 2010 reporting period. The purpose of the revised MAR is to improve the state insurance departments' oversight of the financial condition of insurers; similar to what the Sarbanes-Oxley Act of 2002 (SOX) did for public companies, but not as burdensome since there is no external audit opinion on controls as with SOX. However, applicable insurance companies will need to file a *Management's Report of Internal Control over Financial Reporting* similar to the report required by Section 404(a) of Sarbanes-Oxley.

Finally, any organization looking to aggressively combat fraud and mitigate the risk of errors should consider implementing a streamlined financial reporting assessment.

What is a “Streamlined” Assessment?



Financial reporting controls and relating assessments must be scalable to reflect the size of the organization and the complexity of its environment. No set of templates, control matrices, or surveys should be applied universally among companies. That said, all companies should be applying a top-down, risk-based, approach in conducting control assessments as suggested by the SEC and the Public Company Accounting Oversight Board (PCAOB). A top-down approach means evaluating controls in a sequential manner starting with entity-wide controls, while a risk-based effort simply directs resources to the highest risk areas relative to fraud and financial misstatement. Understanding a company's culture, board oversight, management and staff competencies, organizational structure, and the associated risks are critical in rolling out a successful top-down and risk-based approach.

Smaller, Less Complex Companies

Non-accelerated filers are typically smaller and less complex organizations by definition since the SEC defines them as companies with less than \$75 million in public equity float. While this definition does not relate to the complexity of companies, oftentimes, companies of a smaller size are less complex due to fewer revenue and cost centers. There has been plenty of guidance from the SEC, PCAOB, and the Committee of Sponsoring Organizations of the Treadway Commission (COSO) geared towards smaller companies over the last few years. The guidance is consistent in that smaller companies are well advised to follow a top-down and risk-based approach.

The PCAOB issued guidance for external auditors of smaller public companies in January, 2009. As the auditing standard setter for external auditors of public companies, it is heartening to know that PCAOB is strongly encouraging auditors to scale their audits for smaller companies. As a result, the PCAOB guidance identifies the following examples of internal control matters that may be particularly important for smaller, less complex companies:

- 🕒 **Use of entity-level controls to achieve control objectives:** Entity-wide controls are those that have a pervasive influence across the company. They include: promoting ethical values, a commitment to competence, the board's influence on "tone-at-the-top," organizational structure, assignment of authority, and human resource practices.
- 🕒 **Risk of management override:** This becomes increasingly important because typically the senior management team is more involved with day-to-day activities.
- 🕒 **Implementation of segregation of duties and alternative controls:** Fewer employees exist thus limiting the opportunity to segregate incompatible duties. This motivates smaller companies to explore creative compensating controls.
- 🕒 **Use of information technology (IT):** Oftentimes, less complex business processes and centralized accounting operations rely on off-the-shelf packaged software allowing management to utilize application controls built into the software.
- 🕒 **Maintenance of financial reporting competencies:** While this is always an important factor regardless of size, it sometime makes more economical sense for smaller companies to supplement their internal resources by engaging outside professionals.
- 🕒 **Nature and extent of documentation:** Typically less formal documentation exists to run the business, which has a significant bearing on what can eventually be tested.

In conclusion, companies do not need to make their financial reporting control assessments any more complex and intensive than their environment dictates. The key is in planning and executing the assessment in a top-down, risk-based manner. Securing the expertise to help ensure this path is followed will pay huge dividends. Bringing in a competent third-party advisor to supplement in-house resources can be a cost-efficient and effective manner to obtain this expertise, especially for smaller organizations who can not justify a full-time position geared towards these efforts.



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This is an article reprint from the Governance Issues™ Newsletter, Volume 2009, Number 2, published on March 5, 2009

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