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Entity-Level Control Program

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For smaller companies preparing for financial reporting assessments, detailed documentation of controls and subsequent testing is a daunting task. Often the greatest tool in this program is overlooked and the potential cost savings of a robust Entity-Level Control Program are lost. Entity-level controls, while a simple concept, need to be taken very seriously. The SEC and PCAOB strongly recommend using a topdown risk based approach to identify and assess this set of controls. When this method is utilized effectively, the entire assessment process can be streamlined by reducing the number of key controls over transactions which need to be tested, reducing time and therefore expense.

What is an Entity-Level Control?

To understand the necessary process of identifying and assessing entity-level controls in the setting of a smaller company, we first need to ask “what is an entity-level control and how can it be used to its best advantage for a smaller, less complex company?” According to PCAOB, “*entity-level controls are controls that have a pervasive effect on a company’s internal control*” (PCAOB Guidance for Auditors of Smaller Public Companies, January 23, 2009). These include processes by which a company performs risk assessments, demonstrates a healthy “tone-at-the-top,” maintains an ethical environment through its board and senior management, and conducts robust reviews of period-end financial reporting results.

Dynamics of Smaller, Less Complex Companies

Smaller companies are well positioned to use strong entity-level controls because they tend to have a smaller staff and more direct communication channels from management and the board of directors, to general staff positions. This environment can help ensure these controls are in place and working effectively. While smaller organizations tend to suffer from less segregation of duties over daily processes, their lean structure can actually facilitate tighter controls over the general environment of the firm. As long as these controls are well designed and sufficiently documented, an auditor can evaluate them in relation to their affect on process controls over financial reporting, and “*if an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk*” (PCAOB Guidance for Auditors of Smaller Public Companies, January 23, 2009).

Independence is Important

Unfortunately, unbiased self-assessments are often difficult to perform due to the potential lack of independence of in-house evaluators. This makes entity-level control assessments a prime candidate for bringing in an external party to evaluate. Even an internal audit function reporting directly to the independent audit committee of the board can have difficulties evaluating board effectiveness. The external auditors will always inquire about the relative independence of the assessment evaluators, and



assessing entity-level controls is no different but oftentimes more difficult than other areas of the control assessment due to its “pervasiveness”.

Documentation

Another challenge for many smaller companies is documenting entity-level controls to an extent that will satisfy an assessment. An auditor may interview management to identify these controls and request documentation, however, with little or no proof, it is difficult to evaluate. It is crucial for a smaller company to overcome the challenges of its structure to develop and document entity-level controls which can stand up to an auditor’s scrutiny. A good example of an entity-level control is the overall ethical environment of a company. This is one of the most important deterrents to fraudulent actions, however it is also one of the most difficult controls to document and assess. In an ethical environment, expectations are communicated between the board and management and between management and staff on a regular basis and reinforced through examples. This goes well beyond simply having a written code of ethics policy. It is important to identify communications that support reinforcement and adherence to the code of ethics. Actual examples of a company living its values are more important than simply having a policy. Evidence should be a product of an enterprise risk assessment performed at least annually by the company.

Here are some examples of how to document key entity-level controls to demonstrate a company’s ethical environment:

- 🕒 **Control:** The Statement of Company Ethics provided and discussed with every employee who is hired and retained. This should be reviewed in conjunction with an Employee Manual during the annual review by the employee’s supervisor.
Documentation: A statement is signed by both the employee and supervisor describing the actions and discussion which took place and confirming that the employee understands the ethical expectations of the company and agrees to abide by them. In addition, periodic performance evaluations should have evidence of the supervisor verifying the employee’s understanding of confronting ethical dilemmas. These documents should be stored in the employee’s file as maintained by HR.
- 🕒 **Control:** Employee training sessions and board meetings are held regularly in which the company’s performance and behavior expectations are discussed and feedback on employee concerns are received and followed up upon.
Documentation: Detailed minutes are taken of these meetings along with an attendance sign-in. Accurate minutes will include not only the presentation of management or board expectations, but also the discussion with employees and any actions taken. This should provide the auditors with a healthy level of understanding, appreciation and company involvement on these issues between key parties.
- 🕒 **Control:** Whistleblower Hotline is installed allowing secure and anonymous communication on employee reporting of possible or known fraudulent behavior.
Documentation: Written policies and procedures for the purpose, operation and communication of the hotline are important. In addition, documented dissemination of these policies and procedures to all employees, including employee statement of receipt and comprehension of the process, is recommended. Documentation of employee training for this process, and maintenance of an audit trail of all communications to the hotline is urged. Finally, documentation of reported fraudulent incidents communicated to the audit committee or independent audit function of the board is important in demonstrating an effective fraud hotline.



Control Effectiveness

Remember that an external audit opinion is rendered on the effectiveness of controls, so if people are not following the design of controls on a consistent basis the auditors will likely catch it. It is important to note: a control is only effective when it is:

- 🔗 designed well in relation to its stated purpose,
- 🔗 operates in the manner in which it was designed, and
- 🔗 is used on a consistent basis.

A breakdown in any of these three components can not only render the control useless, it can create a false sense of safety. While effective entity-level controls can lower the number of process controls required for testing, ineffective entity-level controls will actually encourage broader coverage for the testing cycle. A well designed risk assessment process and control environment is the cornerstone for a streamlined control assessment. It can make the difference between an overwhelming and expensive Sarbanes Oxley compliance program and one which not only meets compliance requirements but also enhances a company's ability to achieve its business goals and objectives.

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