



**BDO Seidman, LLP**  
Accountants and Consultants  
**Risk Advisory Services**

A decorative horizontal bar spanning the width of the slide. It features a gradient from light grey on the left to dark blue on the right, with a solid red bar at the bottom.

# **COSO – Application to Smaller Public Companies**

**Bepsy Fakir Strasburg**  
Director & Practice Leader, Risk Advisory Services,  
BDO Seidman, LLP  
March 20, 2007

# Control Frameworks

**COSO** – Internal control-integrated framework developed by the Committee Sponsoring Organization of the Treadway Commission and sponsored by the AICPA, FEI, IIA and others. This is the most dominant control model in the U.S.



COSO is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance.

# The COSO Framework - What Is It?

- Framework developed by The Committee of Sponsoring Organizations (FEI, AICPA, IIA, IMA and AAA) and published in 1992. (Chairman: James C. Treadway)
- The result of many years of rulemaking starting with the Foreign Corrupt Practices Act in the 1970s, then the Treadway Commission in the 1980s
- COSO is the “control criteria” most widely accepted in the U.S.
- ***Principles-based*** framework that:
  - Establishes a common definition of internal control
  - Provides a standard to assess a company’s internal control (company and independent auditor)

# The COSO Framework - Overview

- As defined in COSO, Internal Control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
  - Effectiveness and efficiency of operations
  - Reliability of financial reporting
  - Compliance with applicable laws and regulations
- COSO identifies five components of control that need to be in place and integrated to ensure the achievement of each of the objectives.

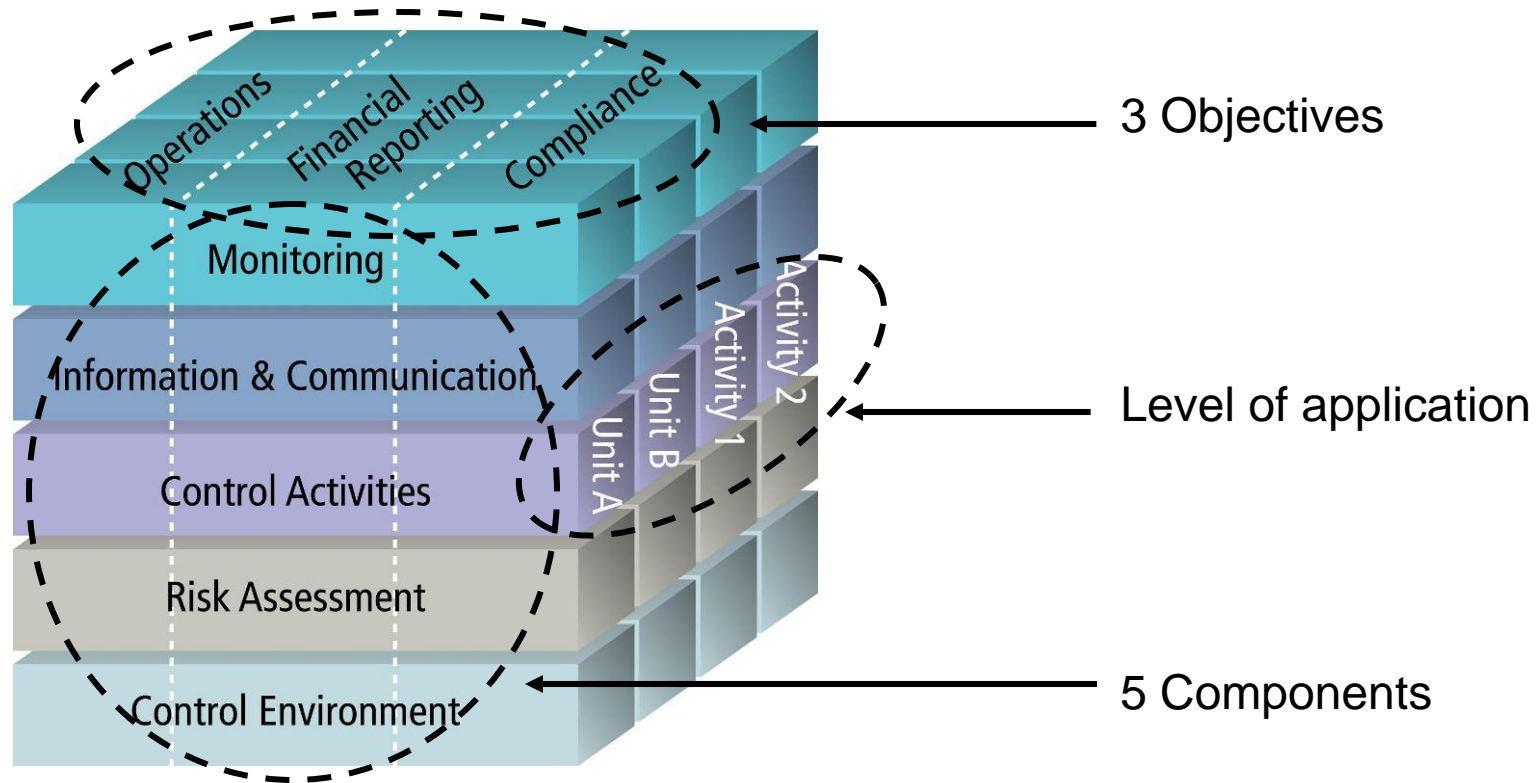
## The COSO Framework - Overview - cont'd

- There is a direct relationship between:
  - **Objectives** ---- What an entity strives to achieve,
  - **Components**--- What is needed to achieve the objectives.
- All components are relevant to each objective category.

For Example:

- When looking at any one category - the reliability of financial reporting, for instance - all five components must be present and functioning effectively to conclude that internal control over reliable financial information is effective.

# The COSO Framework - Overview - cont'd



## The COSO Framework - Overview - cont'd

The overall assessment of internal control at the corporate level ultimately comes down to two important questions:

- Has management created a control environment in which people are motivated to comply with controls rather than to ignore or circumvent them?
- Has the company installed the necessary control mechanisms to monitor and correct noncompliance, and are the mechanisms functioning effectively?

## Other Control Frameworks

---

**Turnbull Report** – Internal Control: Guidance for Directors on the Combined Code developed by the Committee on Corporate Governance of the Institute of Chartered Accountants in **England & Wales**, in connection with the London Stock Exchange. The Turnbull Report required companies to identify, evaluate and manage their significant risks and to assess the effectiveness of the related internal control system.

**ACC** – Australian Criteria of Control developed by the Institute of Internal Auditors – **Australia**, emphasizes the competency of management and employees to develop and operate the internal control framework.

## Control Frameworks - cont'd

---

**The King Report** – Released by the King Committee on Corporate Governance, promotes high standards of corporate governance in **South Africa**. The King Report goes beyond the usual financial and regulatory aspects of corporate governance by addressing social, ethical and environmental concerns.

**CoCo** – The control model developed by the Criteria of Control Committee of the **Canadian** Institute of Chartered Accountants. CoCo focuses on behavioral values rather than control structure procedures as the fundamental basis for internal control in a company.

# The Bottom Line

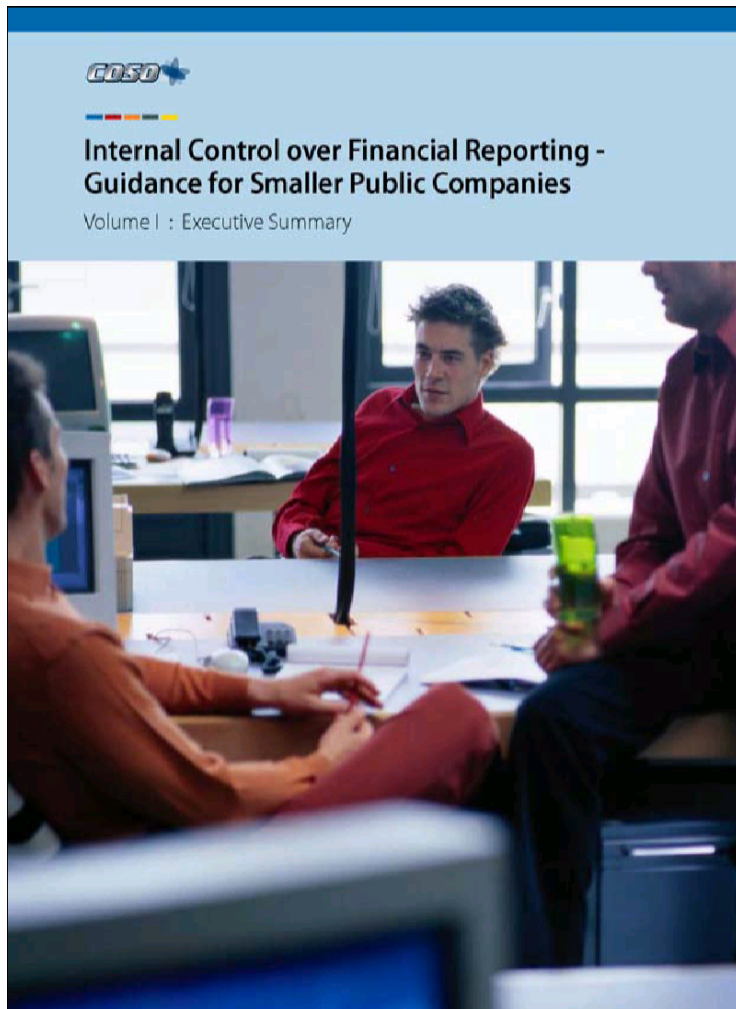
- Internal control is a **process**. It is a means to an end, not an end in itself.
- Internal control is effected by **people**. It's not merely policy manuals and forms, but people at every level of an organization.
- Internal control can be expected to provide only **reasonable assurance**, not absolute assurance, to an entity's management and board.
- Internal control is geared to the achievement of **objectives** in one or more separate but overlapping categories.
- Controls can be circumvented by the collusion of two or more people and management can override the system.

# COSO for Smaller Public Companies

# What we will Cover

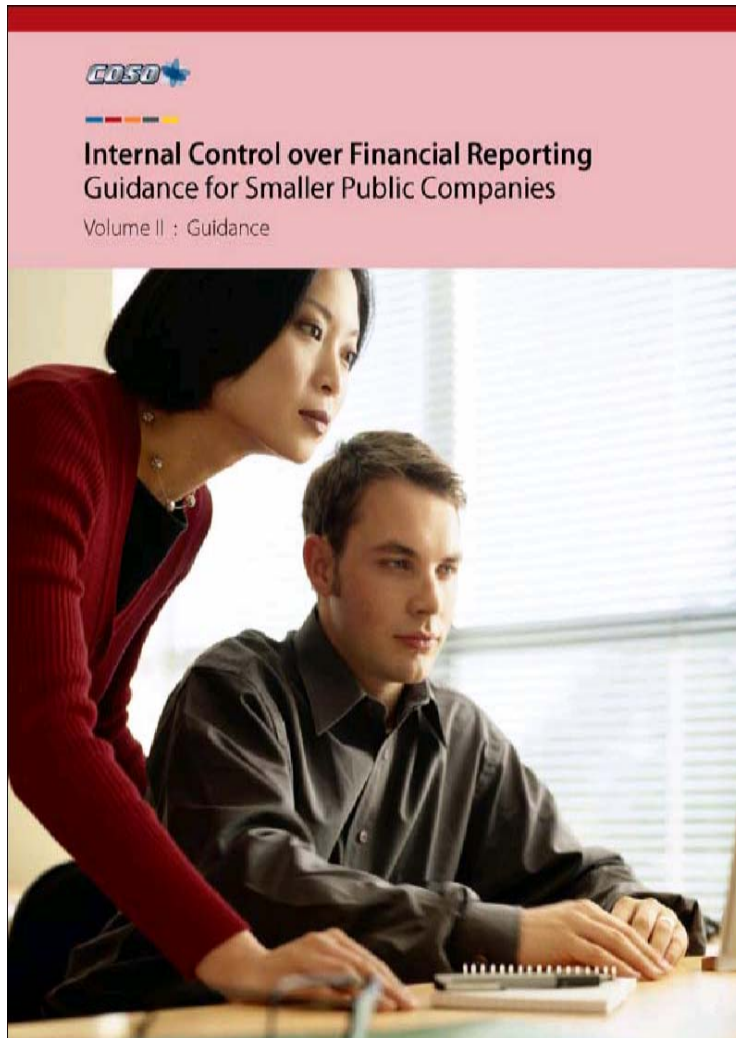
- **New Guidance structure**
- **COSO for Smaller Public Companies (SPC) Overview**
- **Key challenges facing smaller public companies**
- **Evaluation Tools**

# Volume I – Executive Summary



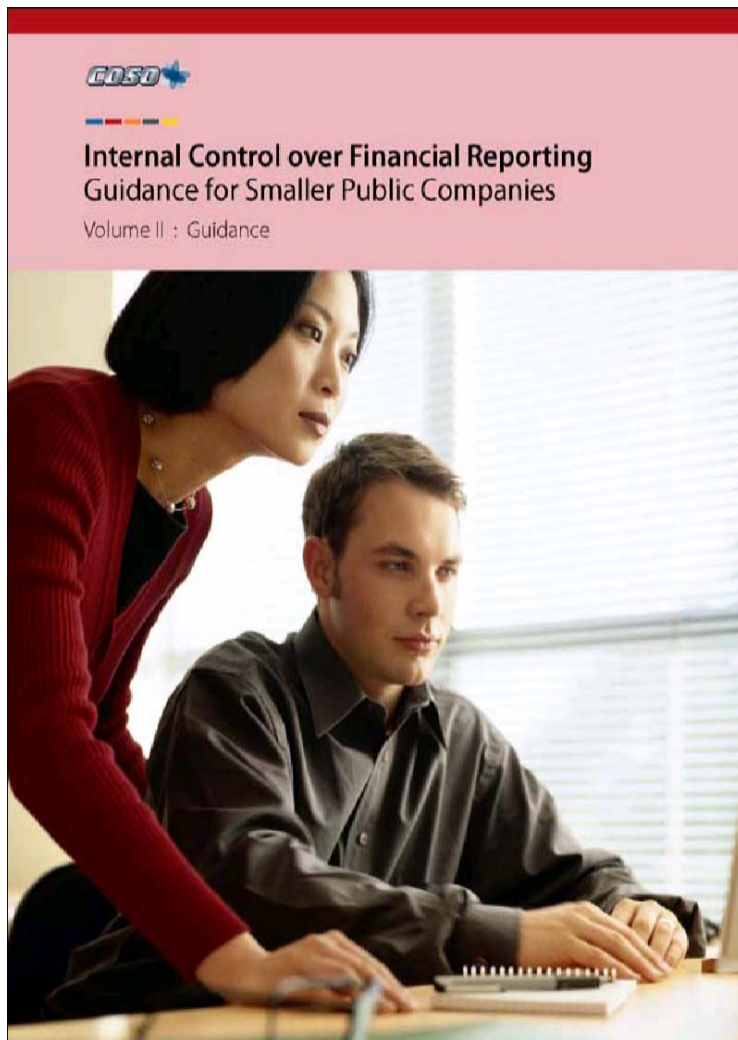
- Provides a high level summary
- Summarizes recent developments, internal control challenges, and the costs and benefits associated with internal control.
- Focuses on risk as a basis for developing internal control
- Introduces the discussion of internal control as a process.

# Volume II - Guidance



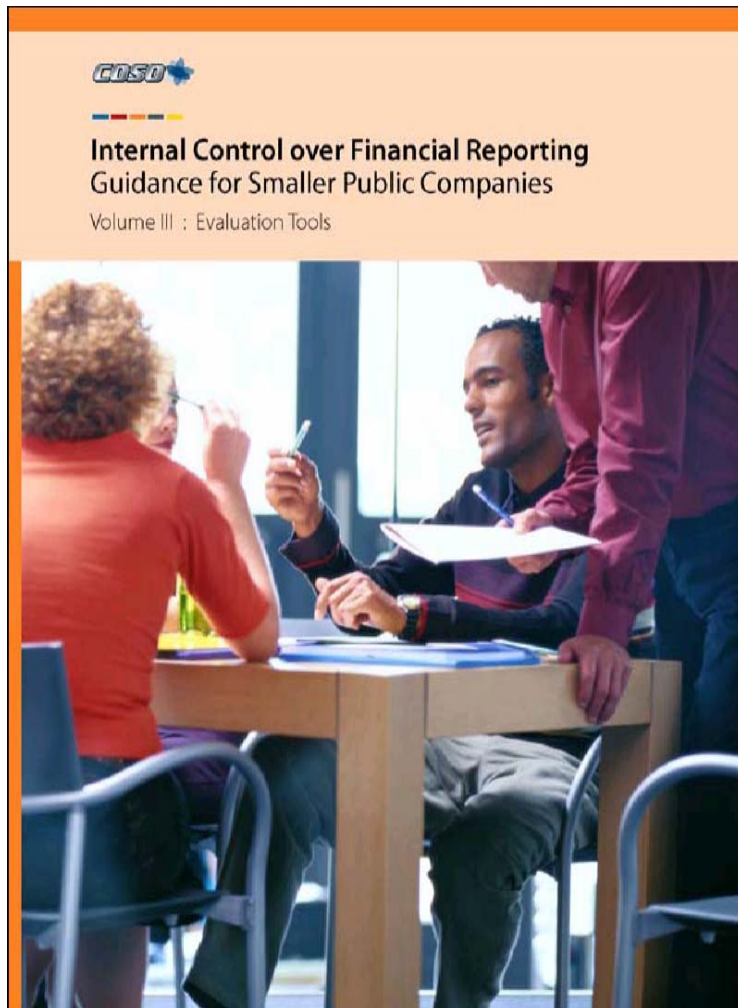
- Provides an overview of internal control over financial reporting in smaller businesses.
- Discusses the costs and benefits of internal control, how companies can meet the challenges of attaining cost-effective internal control, and provides other considerations for achieving further efficiencies.

# Volume II – Guidance... cont'd



- Focuses on twenty fundamental principles.
- These principles are drawn from the original *Internal Control – Integrated Framework*.
- These principles assist smaller businesses in achieving internal control in a cost-effective manner.

# Volume III – Evaluation Tools



- Contains illustrative tools to assist management in evaluating internal control.
- Managers may use the illustrative tools in determining whether the company has effectively applied the principles.

# COSO for Smaller Public Companies (SPC) Overview

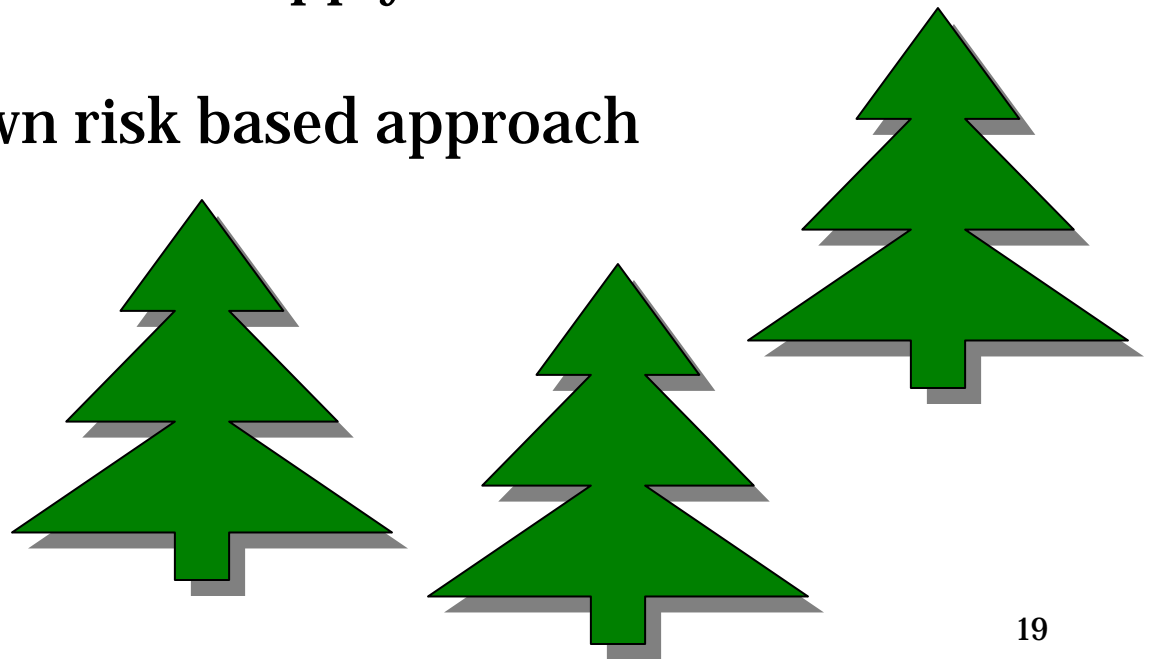
# Objectives

- Help smaller companies to design and implement **cost-effective** internal control over financial reporting (in particular Sarbanes-Oxley requirements)
- Concepts applicable to other areas of COSO Framework (operations, compliance)



# The Forest

- COSO SPC does not replace or modify the COSO Internal Control Framework
- Provides guidance on how to apply it
- Emphasizes top-down risk based approach
- Issued in 2006



# Intended Users

- **Smaller Companies\***
  - Fewer lines of business
  - Concentration of marking focus
  - Fewer levels of management, wide spans of control
  - Less complex transaction systems
  - etc.

# Internal Control as a Process



# Are All 5 Components Equally Important?

**Yes, all are important \***

- **While all 5 components must be satisfied....**
  - each component may operate at a different level
  - trade-offs exist between components
- **Determining effectiveness involves judgment**

# Approach

- **Guidance is principles - based**
  - Management judgment is needed
  - Guidance NOT EQUAL to cookbook
- **Effective Internal Control is a continuous process**
  - Interrelationship of components
  - Focus on objectives of Internal Control
  - Focus on improvement, efficiency

# SEC Compliance Dates

<b>Company Type</b>	<b>Report</b>	<b>Prior Date</b>	<b>New Date</b>	<b>Proposal or Final Action</b>
Smaller Company (Non-Accelerated)	Management's ICFR Attestation	FYE On/After 7/15/07	FYE On/After 12/15/07	Final Action
Smaller Company (Non-Accelerated)	Auditor's ICFR Attestation	FYE On/After 7/15/07	FYE On/After 12/15/08	Final Action
Foreign Private Issuer (Accelerated)	Auditor's ICFR Attestation	FYE On/After 7/15/06	FYE On/After 7/15/07	Final Action
Newly Public Company	Management's ICFR Attestation	1st Annual Report	2nd Annual Report	Final Action
Newly Public Company	Auditor's ICFR Attestation	1st Annual Report	2nd Annual Report	Final Action

A horizontal bar with a gradient from light blue on the left to dark blue on the right, spanning the width of the slide.

# Key Challenges facing smaller public companies

# Reducing Cost of Compliance

- **Design controls for specific environment**
  - Companies complexity, scope and geography of operations, IT sophistication
- **Help implementing a top down approach to eliminate unnecessary efforts**
- **Tools and templates provide a more structured guide**



# How to Evaluate Effectiveness

- **Little guidance in the new framework – refer to existing guidance**
- **White paper – A Framework for evaluating exceptions and deficiencies\***
- **Does the company’s internal control process achieve the objective of reliable financial reporting?**

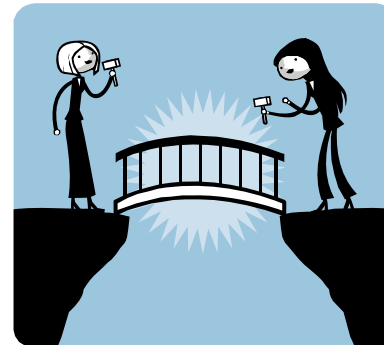
\* v3.0, Dec, 2004. A collaboration between 9 accounting firms

# How to Evaluate Effectiveness

- **Are the Five Components of Internal Control Implemented & Operating Effectively?**
  - Principles provide guidance to evaluate components
  - Attributes provide guidance to evaluate principles

# Span of Control

- **Situation:** Founder or leader exercises ‘great deal of discretion’
- **Challenge:** Take advantage of company knowledge while minimizing opportunity for internal control override

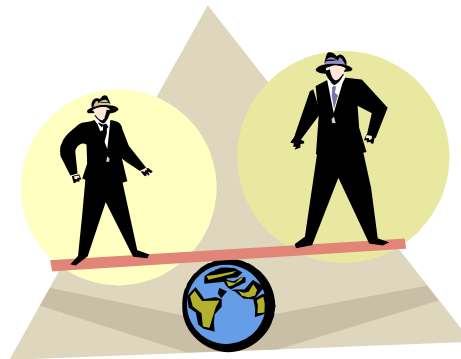


# Span of Control – cont'd

- **Options:**
  - maintain strong ethical values – employee training is key
  - whistle-blower program
  - internal audit function
  - qualified board and audit committee

# Segregation of Duties

- **Situation: Limited resources within Finance**
- **Challenge: Balancing increase resource cost with profitability**



# Segregation of Duties – cont'd

- **Options:**
  - Review existing activities – many address this risk
  - Manager review of detailed transaction reports
  - Manager review of detailed transactions
  - Monitoring controls – e.g. bank reconciliations and suspense accounts

# Information Technology – Automated Controls

- **Situation: Limited IT Resources and/or in-house systems**
- **Challenge: Simplify IT support needs while maximizing control effectiveness**
- **Options:**
  - Implement packaged software – avoid in-house customization
  - Utilize package application controls (edit checks, segregation of duties, etc.)

# Documentation

- **Situation:** Smaller companies often have minimal documentation (eg, policy manuals, systems flowcharts, job descriptions, org charts, etc)
- **Challenge:** Determining the right level of documentation vs cost

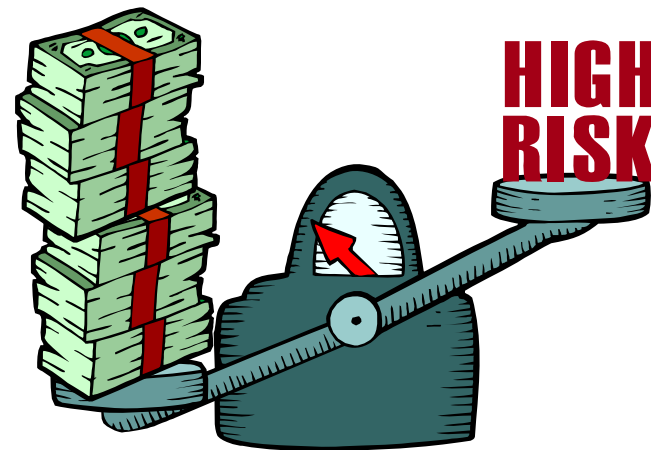


# Documentation – cont'd

- **Options:**
  - Base documentation on the process risk assessment
  - Consider management assessment and external auditor needs
  - Capture evidence of control operation vs design (policy manual)

# Risk Assessment

- **Situation: High cost of compliance due to lack of a risk assessment**
- **Challenge: Identifying company specific risks and related processes**



# Risk Assessment – cont'd

- **Options:**
  - Focus on key financial reporting objectives only (scope creep)
  - Consider qualitative and quantitative factors (transaction complexity)
  - Limit documentation of key controls to mitigate risks (vs entire process)
  - Set triggers to re-evaluate risks as they change
  - Perform a discrete Fraud Risk Assessment

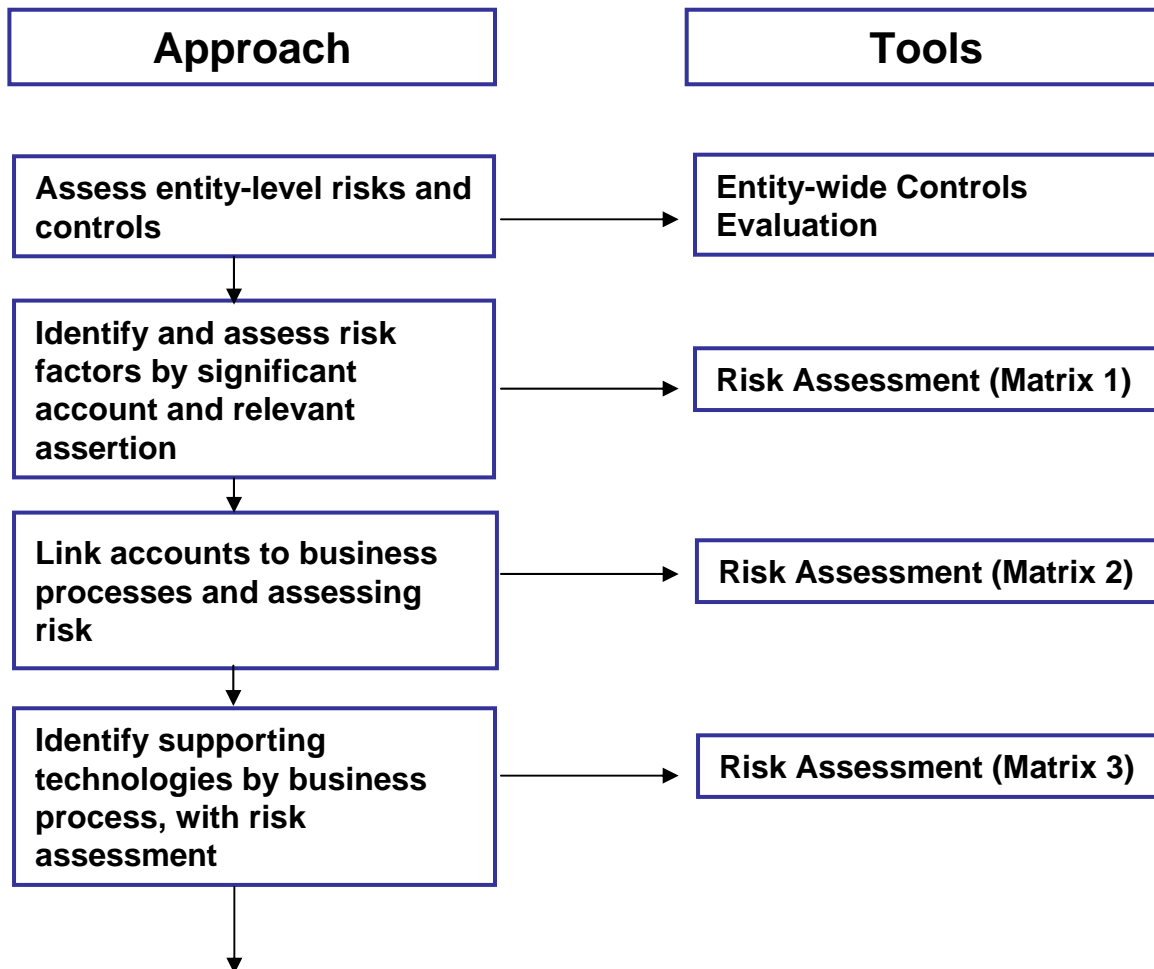


**BDO Seidman, LLP**  
Accountants and Consultants  
**Risk Advisory Services**

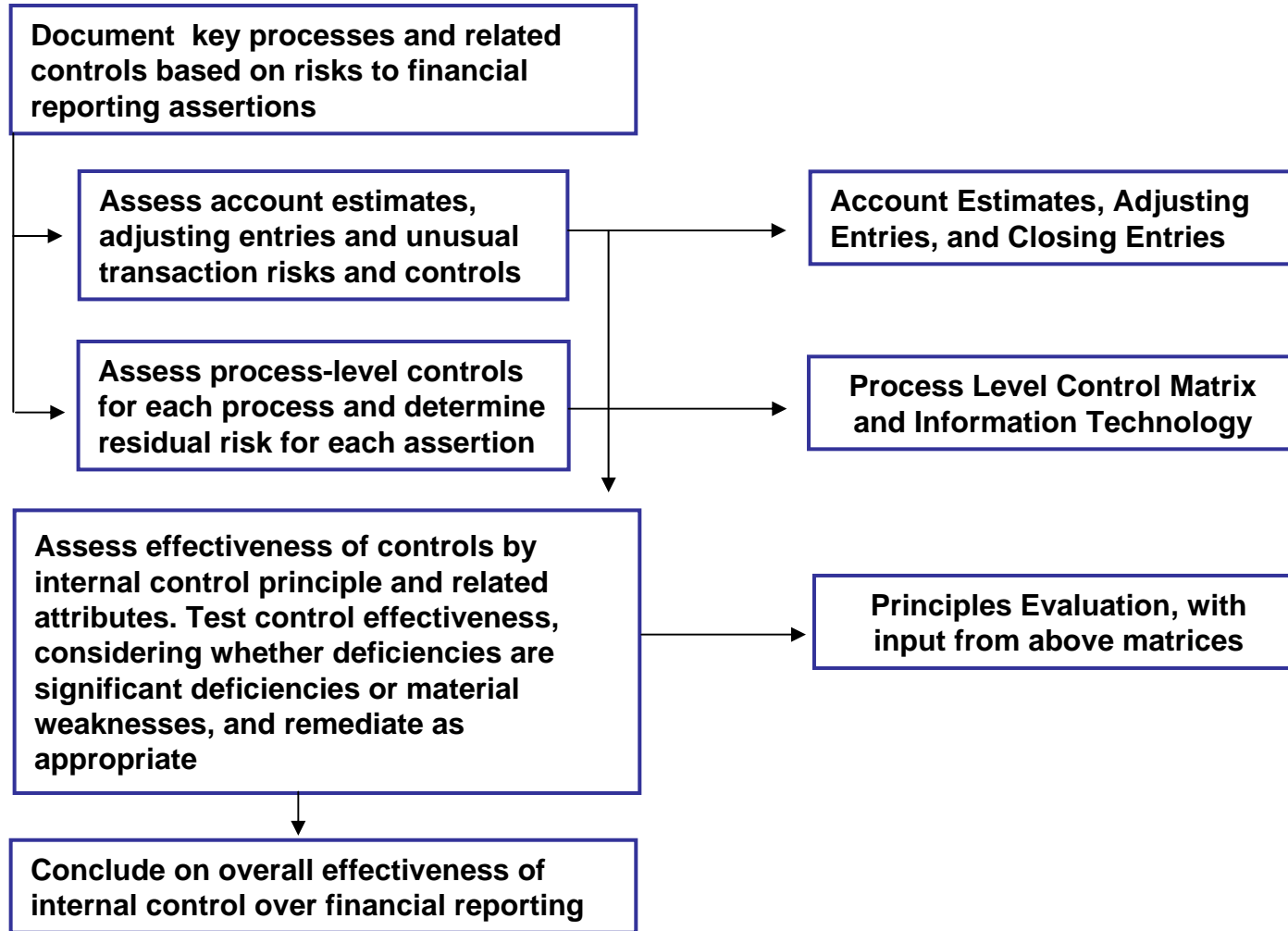
# Evaluation Tools

# Volume III - Evaluation Tools

## Documentation and Assessment of Internal Control over Financial Reporting



# Volume III - Evaluation Tools



# Principles Evaluation



BDO Seidman, LLP  
Accountants and Consultants  
Risk Advisory Services

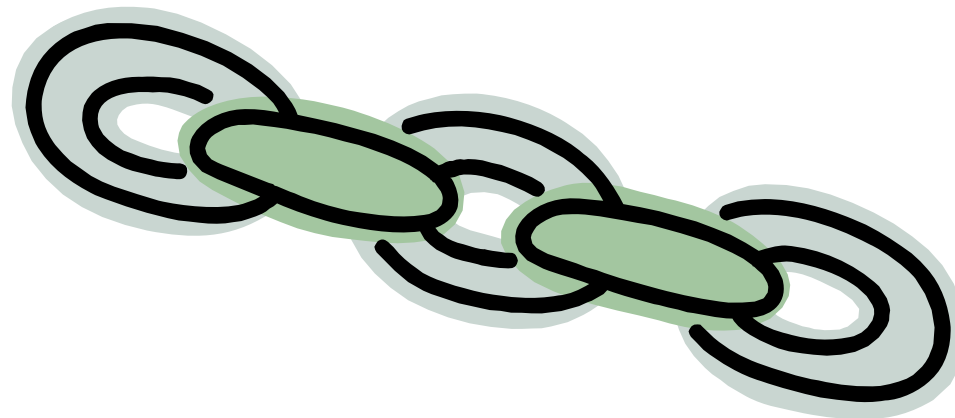
Control Environment Principles	Summary of Controls		Design Effectiveness (Fully met, partially met, not met)	Summary Evidence of Control	Operating Effectiveness (Fully met, partially met, not met)
	Entity Wide	Process Level			

1. Integrity and Ethical Values – Sound integrity and ethical values, particularly of top management, are developed and understood and set the standard of conduct for financial reporting.

1.1	Has top management developed a clearly articulated statement of ethical values that is understood at all levels of the organization?				
1.2	Are processes in place to monitor adherence to principles of sound integrity and ethical values?				
1.3	Are deviations from sound integrity and ethical values identified in a timely manner and addressed and remedied at appropriate levels within the company?				

# Principles Evaluation

- **Good summary of Entity-Level and Process Level controls**
- **Linkage of Process-Level controls to the 5 COSO components is more detailed than we currently see**



# Entity-Wide Controls Evaluation



BDO Seidman, LLP  
Accountants and Consultants  
Risk Advisory Services

Control Environment <sup>2</sup> Principle and Attribute	Summary of Entity-Wide Control and Management's Documentation
<p>1. <b>Integrity and Ethical Values</b> – Sound integrity and ethical values, particularly of top management, are developed and understood and set the standard of conduct for financial reporting.</p>	
<p>1.1 Has top management developed a clearly articulated statement of ethical values that is understood at all levels of the organization?</p> <ul style="list-style-type: none"> <li>• Is there an established "tone at the top" that reinforces acceptable moral guidance about what is right and wrong? How is this tone communicated and practiced by executives and managers throughout the organization?</li> <li>• Does a code of conduct exist and does it include guidance on acceptable business practice, conflicts of interest, and expected standards of ethical and moral behavior?</li> </ul> <p>Are the standards and guidance effectively implemented within the organization?</p> <ul style="list-style-type: none"> <li>• How does the company attain confidence that dealings with employees, suppliers, customers, investors, creditors, insurers, competitors, and auditors, etc., are ethical?</li> </ul>	<p>The Employee Handbook contains employee responsibilities.</p> <p>Quarterly meetings with company top management are held, where the CEO reinforces the position that staff may not act inappropriately in order to "get the sale."</p> <p>All Sales Executives must sign a "no side letter agreement" quarterly.</p> <p>The Code of Conduct is posted on the external and internal website. All employees receive the Code of Conduct upon employment. New employees certify this receipt by signature. The signed copies are retained by HR, with a report sent to the CEO in March of each year listing any employees that have not yet signed acknowledging receipt.</p> <p>Last year the company also compared its Code to several publications setting out good practices for such codes. Minor revisions were made and communicated across the company and to the board.</p> <p>See also comments to questions 1.2 and 1.3.</p> <p>Confidence is primarily attained by sending the right message coupled with managers' observations of employees' behavior. The company does not undertake separate evaluations to assess customers' perceptions of company ethics.</p>

# Entity-Wide Controls Evaluation

---

- **A subset of principles from the COSO Internal Control Framework (covers all 5 components, but fewer points of focus)**

# Risk Assessment (Scoping)



BDO Seidman, LLP  
Accountants and Consultants  
Risk Advisory Services

Financial Statement Account/Disclosure	As % of Total	Impact on F/S	Account Characteristics	Business Process Characteristics	Fraud Risk	Entity-wide Factors	Overall Rating	Significant Assertions <sup>2</sup>				
								E	C	V/A	R/O	P/D

## BALANCE SHEET

### Assets

Cash & Cash Equivalents	6%	M	H	M	H	M	H	✓	✓		✓	✓
Accounts Receivable	30%	H	H	H	H	L	H	✓	✓	✓		✓
Prepaid Expenses	4%	L	M	L	L	L	L					✓
Inventory	35%	H	M	M	M	L	M	✓	✓	✓	✓	✓
Property & Equipment	15%	H	L	L	L	L	L	✓		✓	✓	✓
Intangible Assets	10%	H	M	M	M	M	M	✓		✓	✓	✓
<b>Total Assets</b>	<b>100%</b>											

# Risk Assessment (Scoping)



BDO Seidman, LLP  
Accountants and Consultants  
Risk Advisory Services

- **Illustrative representation from AS 2 guidance**

# Process Level Controls

Financial Statement Assertion	Risk	Process Level Control	Preventive/ Detective	Manual/ Automated
<b>Order Processing</b>				
Valuation – Prices used in recorded sales are accurate.	Inaccurate prices are used.	Prices are verified to authorized price lists or standing data before order is processed.	Preventive	Manual
		Periodic reviews of master price file information are performed by authorized management.	Preventive	Manual
		An approved price list is maintained and communicated to sales staff and customers.	Preventive	Manual
	Staff or supporting systems inaccurately calculate discounts, incentives, etc.	Discounts, incentives, etc. are recalculated and/or confirmed before shipment.	Preventive	Automated
Occurrence – Only valid orders are fulfilled.	Invalid orders are taken and processed.	Key elements of the order (customer name, address, credit limits,	Preventive	Manual

# Process Level Controls

- **Matrix does not include assessment of design effectiveness, testing results or assessment of operating effectiveness (on purpose per Volume III, pg 2 footnote)**

**Note: same items missing from ELC and IT matrices**

# Walkthru

- **Not included in SPC Framework**
- **Not required for management by AS2**
- **Valuable to:**
  - Confirm the accuracy of control design
  - Identify design or operating deficiencies earlier
  - Eliminate inefficient testing later in the project



# Cost versus Benefit of SOX Process?

- Is your company deriving value from SOX?

<b>Some Value</b>	<b>63%</b>
<b>Great Value</b>	<b>7%</b>
<b>Not Sure</b>	<b>10%</b>
<b>No</b>	<b>20%</b>

- If you have seen value from compliance, in what areas? (% who have seen "some" or "great" value from compliance)

<b>Business Process Improvement</b>	<b>93%</b>
<b>New Technology</b>	<b>23%</b>
<b>Lower Cost of Capital</b>	<b>1%</b>
<b>Other</b>	<b>15%</b>

CFO Survey of 213 finance executives – CFO.com Sept. 2006

**“Main Street” Benefit instead of Wall Street**

# Questions

Betsy Strasburg is Director and Practice Leader of Risk Advisory Services of BDO Seidman, LLP. Her responsibilities include leading client engagements in Sarbanes Oxley compliance, internal audit, information risk assessments, business process improvements and change integration. Her clients include VNUS Medical Technologies, Netlogic Microsystems, Micrel, Qualcomm, Form Factor, Sunrise Telecom, Hana BioSciences, Riverstone Networks, Synarc and VitalSystems among others. Most recently, she has published an article on compliance software in the Technology update newsletter of the AICPA, authored various risk advisory updates and frequently participate in the development of service offerings.

Prior to joining BDO Seidman, Ms. Strasburg spent over 17 years at Sun Microsystems, Inc in expanding management positions including Director of Finance supporting a multi-billion computer hardware, software and services revenue business unit covering US and International region. Her team of approximately 90 people was responsible for Revenue Management, Forecasting, Order Administration, Accounting, Management Reporting, Financial Planning/Analysis, Business Systems, Credit & Collections, Tax and Treasury functions. She also served as an Integration Manager responsible for 6 teams to integrate Product and Service Sales divisions comprising of 3,500 professionals in record time of 6 months by rationalizing and implementing common systems, processes and policies.

Prior to Sun, Ms. Strasburg was at Stanford Research Institute (SRI International) where she was engaged in strategic planning and analysis projects for the Institute and SRI clients. Concurrent to SRI, she served as a part-time Lecturer in the MBA program of California State University, Hayward.

Ms. Strasburg has a BS Honors degree in Chemistry from Aberdeen University, Scotland; a MBA from California State University, Hayward.

**Betsy Strasburg**

[bstrasburg@bdo.com](mailto:bstrasburg@bdo.com)

415-490-3227