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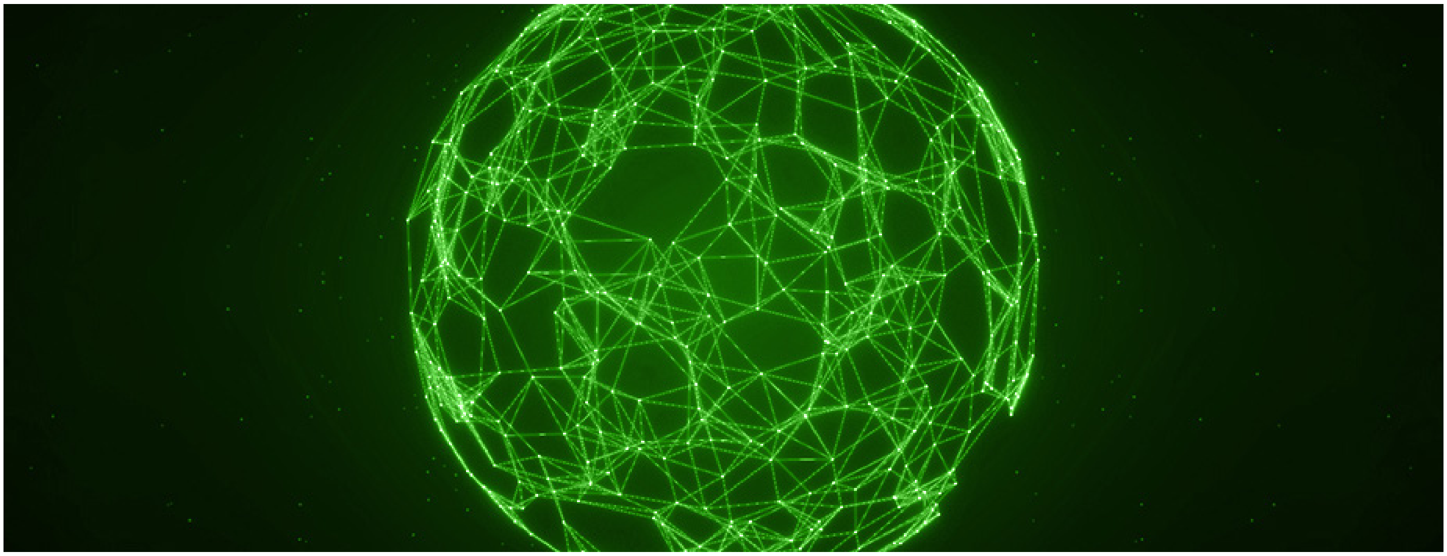

Private company internal controls: Extending value over time

Sustaining, monitoring, and rationalizing your internal control framework

In the first of our three-part point of view series, we discussed the value that private company owners, executives, and investors can gain from a risk assessment and strategically implemented internal controls. Our second point of view in the series offered important considerations for internal control design and implementation.

In this, the third point of view in the series, we suggest that if you invest time, resources, and budget in deploying internal controls, you should also consider ways to sustain and even extend the value of that investment into the future. An effective internal control framework must be nimble and scalable, as well as adaptable as the company evolves. Developing a monitoring program can help you make the control framework sustainable and increase your confidence that the controls you've implemented operate effectively and remain relevant as the business and its operating environment change.

Considerations for designing a monitoring program

When designing a monitoring program, it may be tempting to jump right in and start reviewing controls. However, it's important first to take a step back and consider the following questions:

1. *Who will be on the monitoring team?* Typically, a monitoring program should separate the people who review the performance of the control activity and determine whether the control is operating effectively from the "control owners"—those who actually perform the control activities. "Operating effectively" means that the control is functioning as designed and mitigating the risk it is intended to address.

The number of people needed to support a monitoring program, whether internal to the company or outsourced to a service provider, can vary depending on the number of controls and the complexity of the control framework. For example, the risk assessment conducted by a smaller private company whose operations aren't overly complex may identify only a few areas of focus and determine that limited controls are required to mitigate those risks. That organization may determine that existing managers will be able to review the outputs of the controls in addition to their other responsibilities.

Alternatively, a larger, more complex company may find many areas of risk and design many more controls to mitigate them. That organization may determine that a separate, dedicated team should be established to perform the monitoring.

Just as segregation of duties is an important element of effective internal control, the managers assigned to monitor specific controls should not be the owners of those controls—again, the person who performs the control activity itself. This approach puts a "fresh set of eyes" on the control to help identify when a control is not operating as designed or is not designed to effectively mitigate the risk identified.

2. *What is expected of team members?* After the key people involved in the monitoring program have been identified, it's important to clearly define their roles and responsibilities. Each person on the team should understand what controls they are expected to monitor, how frequently they should perform the monitoring activities, and what information they need to maintain about the results of those activities.

   A process should also be devised for the monitoring team to communicate and evaluate the outcomes of monitoring activities they perform. For example, a smaller, less complex private company may choose to store the results of their monitoring activities on a secure shared network drive. Then they may have a monthly or quarterly meeting between the managers who perform the monitoring activities to discuss the results of their review, whether they found control deficiencies, and corrective actions planned or implemented.

   Alternatively, a larger or more complex company may use a dedicated tool for managing documentation related to the risks, controls, monitoring results, and any corrective action plans. The team may also have more formal and frequent meetings to address those matters.

3. *How will control deficiencies be defined and identified?* Essentially, a deficiency occurs:
   - When a control isn't operating as designed such that the control owner is not performing the control activity the way it was intended to be performed, or
   - When a control wasn't designed adequately up front to mitigate the identified risk or the risk evolves due to changes in the organization or its environment and the control isn't modified appropriately.

Your monitoring program should clearly define expectations for when and how deficiencies are identified, as well as an escalation process that enables the monitoring team to address them effectively and in a timely manner. It should also clearly describe how and to whom deficiencies should be communicated, as well as how and when corrective actions should be initiated and carried out.

Considerations for rationalizing and sustaining internal controls

It's important to instill scalability and flexibility into your internal control framework as it's being developed. Your internal control framework doesn't need to be overengineered or overly complicated. Instead, it should be designed to be scalable and flexible so it can adapt to changes within and around your company.

For example, as your company grows, its business and operating models may change, mergers or acquisitions may be undertaken, market conditions may shift, and new product opportunities may arise. If these and other events occur, they should be included as updates to your risk assessments to identify whether there are new areas of risk. That, in turn, may require existing controls to be modified or additional controls to be designed and implemented. While new risks may be introduced, previously identified risks may no longer be an area of focus. This can be an opportunity to rationalize controls within the internal control framework and eliminate those controls that may no longer be relevant.

Such changes may also mean modifications to the monitoring program itself may be needed. For example, a smaller, less complex private company may want to consider if management is still able to perform the control monitoring activities or if a dedicated monitoring team should be established.

Additionally, you may want to consider changing how the results of your control activities are maintained—examples mentioned earlier were on a secure shared network drive or a dedicated tool for managing risk and control information. As your company grows and evolves, it would not be unusual to choose a more sophisticated approach.

Bottom line: It's important to step back periodically and assess whether you've identified all material applicable risks to your company, analyzed your controls to so they are effective and mitigate the risks they were designed to address, and evaluated your monitoring program to incorporate any updates.

Another important consideration is what's on the horizon for your company. The pace at which your company develops its internal controls framework and monitoring program may be driven at least in part by short-term and long-term business goals. Where is your company in its life cycle, and what direction is it going? Those factors could influence the complexity of your framework and the timeline for deploying it.

For example, if you plan for your company to remain private for the foreseeable future, you may have more runway to identify areas of risk focus and to design and implement internal controls with a relatively less complicated monitoring program. If, however, your company plans to execute an initial public offering (IPO) or may be the target of a special-purpose acquisition company (SPAC), the timeline for identifying risks, implementing controls, and designing a monitoring program may need to be shortened.

In fact, if an IPO or SPAC are part of your future, it could give your company a significant leg up to design an internal control framework that meets the standards for publicly traded companies, such as those recommended by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Why? Because, although private companies aren't necessarily compelled to comply with regulatory requirements for effective internal controls, public companies are. So if you conduct a more detailed risk assessment, develop more extensive controls, and overlay them with an effective monitoring program, it may help you get a head start on the path to compliance with the Sarbanes-Oxley Act of 2002 (SOX), and it could even help you gain favor with potential investors and acquirers.

Summing it up

When it comes to core operations, continuous improvement has long been a mantra for businesses across the industry spectrum. It's hard work, but its benefits have been demonstrated in many ways.

A thoughtful and nimble internal control framework, focused on key risks, provides a mechanism to support the strategic direction of your company. An effective internal control program can help generate sustainable value by providing business insights; validate the data used to develop financial reports and support strategic decision-making is timely, accurate, and reliable; and help extend your return on investment in the program long into the future. It can even help make your company more competitive and attractive to suitors in the future, depending on your strategic objectives.

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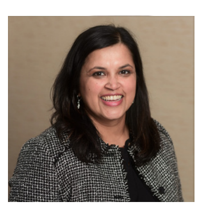

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Special thanks to Stuart Rubin for his contributions.

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