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Studies in Management and Accounting for the

FOREST PRODUCTS INDUSTRY

CONTROL PROCESS FOR SMALLER FOREST PRODUCTS COMPANIES

Don R. Doerr
P. Martin Daley
Gregory G. Byrne

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Don R. Doerr is the market managing partner of the Eugene office and business assurance partner in the Portland cluster offices of Coopers & Lybrand. Don has been in public accounting since 1965. He has significant experience in the forest products industry and serves as engagement partner for all of the Eugene office wood products clients. He has also provided special services to an international forest products company. He is a member of OSU Advisory Council for Studies in Management and Accounting for the Forest Products Industry and is on the Forest Products Committee of the Oregon Society of Certified Public Accountants.

P. Martin Daley is an audit and business advisory senior associate in the Eugene office of Coopers & Lybrand. He has four years of public accounting experience, with the forest products industry as one of his specialties. He also had over three years of experience within the industry prior to public accounting.

Gregory G. Byrne is the Vice President, Finance and Strategic Planning for Fibreboard Wood Products Company. Prior to joining Fibreboard, he spent ten years with Coopers & Lybrand working with a variety of privately-held forest products companies. Greg is a graduate of the University of Oregon.

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INTRODUCTION

Internal controls have often been thought of as specific activities that are performed to ensure accounting transactions have been recorded properly and to ensure security over assets. This definition was supplemented in a previous monograph on internal controls, "Accounting Controls for a Forest Products Firm," published in January 1981. That monograph outlined an internal control review program used by Georgia- Pacific and provided a limited discussion of the control environment. Since that time, the theory of internal control has been continually evolving and has been broadened to include a concept of a control process that is over all aspects of a business.

The purpose of this monograph is to provide a synopsis of the current thinking and implementation of the concepts of the internal control process. This monograph describes the concepts of internal controls as developed from a study by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). It also presents the results of a survey of smaller forest products companies and describes their implementation of these concepts. For purposes of the survey, nine companies with less than three operating locations (and which are closely held), were selected as representative of smaller forest products companies.

COSO FRAMEWORK

The Treadway Commission is the National Commission on Fraudulent Financial Reporting. Participants in the COSO project included corporate executives, legislators, regulators, consultants, auditors and academics who developed a common definition for internal control as well as guidance for judging the effectiveness of and improving internal controls.

Definition: Internal control is a process, established by an entity's board of directors, management and other personnel, which is designed to provide reasonable assurance regarding the achievement of objectives in one or more categories:

- Effectiveness and efficiency of operations
- Reliability of financial information
- Compliance with applicable laws and regulations

Any internal control system can only provide reasonable assurance that objectives will be achieved if the achievement is within the control of management. If the objective is not under the control of management, such as general economic conditions affecting operating results, then the internal control process provides reasonable assurance that management is aware of the progress toward the objective. The internal control process is an integration of the entity's control environment, risk assessment, control activities, information and communication, and monitoring.

Control Environment

In analyzing the control environment, concentration should be placed in the substance of control measures and management actions rather than their form. An environment may appear to be favorable but in reality may not be. For instance, a budgetary reporting system may provide adequate reports, but if the information is not analyzed and acted on, the system does not contribute to the control environment. Similarly, an enterprise may establish appropriate policies; however, to be effective, they must be enforced by management. For example, although a company may have a formal code of conduct, management may have a record of condoning actions that violate it. By not reprimanding such actions, management sends a clear message of approval. Components of the control environment include the following:

- Management's philosophy and operating style. An important component of the control environment is the tone set within the company by management through philosophy and operating style. Appropriate tone may be set by establishing objectives at an entity-wide level as well as providing the strategies and interim targets for getting there. The objectives and strategies set by management must be clearly communicated and reasonably attainable in order to maintain an appropriate level of control.

- Integrity and Ethical Values. The effectiveness of internal controls will depend largely on the integrity and ethical values of the people who develop, administer, and monitor the controls. The potential for major internal control failure exists when dishonest or unethical managers allow or force subordinates to falsify reports, cheat customers or cover up mistakes. High levels of integrity and ethical values need to be prevalent throughout the organization to maintain effective control.

- The organizational structure of an enterprise is an important consideration in the enterprise's ability to control its activities. The structure should be neither so simple that it cannot adequately monitor the enterprise's activities nor so complex that it inhibits the flow of necessary information. In order to carry out their responsibilities effectively within the organizational structure, executive officers, senior management and others in key management positions should possess the requisite experience and level of knowledge commensurate with their positions.

- Competent personnel. Effective internal control recognizes that people do not always understand, communicate or perform consistently. However, the people must know their responsibilities and limits of authority. Internal controls will bridge the gap to link people's responsibilities with management objectives.

Risk Assessment

Risk assessment is an important element of an integrated control process. Identifying risks is essential to allow for proper planning of control activities which will minimize those risks.

- External and internal factors. As an entity faces risks to its success from both external and internal factors, the control process should address those risks which could impede the achievement of the entity's objectives. Management's strategic planning will play an important role in identifying those risks and analyzing appropriate actions to be taken. The assumptions underlying strategic plans and budgets need to reflect the entity's historical experience as well as conditions currently affecting operations.

- Changing conditions. In performing risk assessments as part of the internal control process, an entity must recognize and address the fact that change is inevitable. An entity that does not adapt well is ill prepared to take advantage of or mitigate the disadvantages of changing conditions.

- Process to mitigate risk. As risks are identified, control activities can be put into place to address the pertinent risk factors.

- Prudent business risk. No company can operate without accepting some level of risk. It is management's responsibility to ensure that the risk accepted is indeed prudent business risk.

Control Activities

Internal control is typically thought of in terms of the specific control activities of an entity. However, these specific control activities are only a component that is integrated within the overall control process.

- Operating Controls. Control over the operations of a company is crucial and thus merits significant attention from management. Activities as simple as walking around the production facilities and talking to employees about how things are going will greatly enhance control over operations, as well as provide management with direct feedback.

  Review of operating performance is a key activity in the control process. However, to be effective, the operating results must be available in a timely manner and reviewed in appropriately selected intervals (i.e., monthly, weekly, daily). As noted previously, some factors may be out of the control of management but the internal control process should alert management to changing conditions in a timely manner.

- Financial Controls. Classical controls over financial reporting continue to be effective, including segregation of duties, reconciliations, reviews, verifications, and authorizations. For an indepth discussion of these control procedures see the bibliography for reference material.

- Compliance Controls. Controls over compliance-related issues often involve having procedures in place to recognize compliance issues, which can be done through consultations with outsiders including attorneys, accountants, and consultants.

Information and Communication

The control process should be linked together by a framework of communication channels that expedite the flow of appropriate information. The communication channels should be tailored to the organization with a proper mix of formal and informal channels, depending on the style of management. The timeliness of information is an important consideration in developing communication systems since dated information is not as useful. Consideration of communication from management should be done to ensure objectives, duties, and responsibilities are appropriately disseminated. Control activities over information and communication should focus on ensuring management is well informed in a timely manner allowing for identification and anticipation of changing conditions.

Monitoring

The internal control process must be monitored to confirm its effectiveness. Reliance on input from auditors and regulators is not sufficient for monitoring the process. As noted previously, changing conditions may warrant the modification of control activities, however, the system should be evaluated on a periodic basis rather than only when problems arise. Monitoring should include preventative aspects as well as reactive. Appropriate monitoring will provide a basis for analyzing the costs versus benefits of specific control activities.

THE SURVEY

Nine companies participated in discussions regarding their internal control processes. They are small closely-held companies with less than three operating sites. Some of the surveyed companies have demonstrated that they employ what could be considered the "best practices" of internal controls as they relate to smaller forest products companies. Because times have been extremely hard on the smaller companies, those that have survived have either intentionally developed comprehensive systems or have employed management practices that were very innovative when they were originally installed. The survey included discussions with different people within the companies, including owners, operations personnel and financial personnel. A brief synopsis of these discussions as they relate to the control process follows.

Control Environment

Within the majority of the companies surveyed, the tone is set by the owners or CEOs. Clear and stated objectives from the top of the organization are communicated to everyone. In one case, the company's mission statement is reviewed with every new hire, from top management positions to basic production positions. Several of the companies have set making a profit as the number one priority. The companies set high priorities on maintaining integrity and high ethical values which is evidenced in the fair and consistent treatment of employees. Other top priorities include safety, technology utilization and survival.

While all the companies have boards of directors, three of the nine surveyed companies have boards of directors which include non-owner/manager members. The frequency of the board meetings and level of involvement by the outside directors varies from company to company but in each of the three it is apparent they add an important element to the control environment. None of the outside directors were described as being shy or reserved when expressing their views. The outside directors seem to have been selected because in each case they possess valuable knowledge, including relevant industry experiences, financial expertise, or other special talents.

The organizational structure of these companies is well defined with competent personnel filling positions that clearly indicate authority and responsibility. This structure is not necessarily done using formal techniques, because with owner-managers' involvement a formal written plan is not required to delineate authority or responsibility.

Due to the involvement of owner-managers, decision making is generally autocratic in these companies. Authority is given to managers to make decisions but approval from the top is required.

Management has a very "hands on" approach in every company surveyed. In several companies the owners approve all capital projects and major decisions. Each area of the business is continually evaluated by these autocratic CEOs and their "never satisfied" attitude is known to everyone.

The majority of the companies surveyed use an informal management style.

Risk Assessment

Three of the nine surveyed companies have developed five-year strategic plans. The plans incorporate the general business mission and goals, however they are not so narrow as to restrict management from responding to change. One of the five-year plans is supplemented with annual and monthly plans and are monitored against weekly results.

The other companies vary in their approach to strategic planning. Two have annual budgets that are used primarily for bank financing purposes. Others, while not actually having formal plans, have established a strategic direction to address external and internal factors.

The most often expressed external factor was raw material supply and the most often expressed internal factor was cost control. To deal with these factors companies are variously looking to:

- Diversify markets,
- Develop niche markets,
- Expand into secondary manufacturing products,
- Maintain margins between log price and sales value of products,
- Constantly evaluate and update manufacturing technology,
- Utilize market technology such as linear programming, and
- Acquire their own resource base.

Two of the companies actually have looked at management succession and have established plans to address this critical internal risk factor. One company has actually established separate groups to evaluate different business risks such as environmental, raw materials, human resources, and insurance. The groups research the issues and present their results to the key management team.

Control Activities

The processes used by the surveyed companies to control operating, financial and compliance activities were diverse. They ranged from very formal to quite informal, however in nearly all cases the companies believed they were performing appropriate processes to control the three separate areas.

Operating

The variety and creativity found in the nature of the operating control activities was the most interesting part of the survey. The basis for the operating control activities starts with management's identification of the company's critical success factors. The most common factors identified were log supply and cost, recovery, value of production, retaining and motivating people, and market reaction time.

Once management determines their critical success factors, they develop the various control processes. Examples of operating control processes are as follows:

1) Walking around was common in all surveyed companies. The CEOs/owner-managers all utilized this technique to monitor operations. The very nature and characteristics of these small companies makes this a very viable control technique. It continually reinforces the organization philosophy and allows for rapid implementation of changes.

2) Most companies have daily production reports and daily sales information which included in some:

    - Labor hours and absenteeism reports,
    - Down time,
    - Shipments and sales data by type of product,
    - Shift and mid-shift machine production against preestablished standards,
    - Log tagging and tracking recovery, value of output and costs (in one case, control actually provides net income by log type), and
    - Order file analysis for production scheduling.

Financial Controls

Although the survey did not focus on specific financial accounting controls, it was clearly evident that these controls were in place within these companies. Four of the nine companies surveyed indicated that they compile financial statements at least on a weekly basis, with the statements available within a couple of days after the week is ended. In addition, some of the companies do complete weekly or biweekly physical inventories. Although these control activities have been done on a less frequent basis in general, volatility within the wood products industry has prompted these companies to analyze financial results more frequently.

The frequent financial statements of the companies surveyed have an operational focus to them with management accounting concepts used (such as financial results by department). This type of financial report allows management to focus on the profitability of production efforts. The majority of the companies also prepared a full set of traditional external financial statements at least monthly.

Authorizations, reviews and reconciliations play a major role in control over financial information. These control activities are universally used by the companies surveyed. The consistency and completeness of these procedures, to the extent they are performed, can be attributed to the close scrutiny of the owner-managers.

Compliance Controls

Due to the size of the companies surveyed, expertise in a wide range of compliance areas is usually not available from within the company. Most of the companies do have a safety program or committee to ensure compliance with worker safety laws and regulations. If a question arises regarding other compliance issues, outside sources are tapped to ensure appropriate treatment by the company. These companies have demonstrated control over compliance issues through the efficient use of attorneys, accountants and insurance agents.

Information and Communication

Immediate communication to management of production and operating results is key to the companies surveyed. Again, this is a component of the control process where these small companies have an advantage due to their size and owner-manager involvement. Frequency of production reports and financial statements as noted above offer management the timely information they require to make quick decisions. Each company surveyed had both formal and informal channels of communication, although the informal channels have proven to be invaluable to the majority of these companies.

Monitoring

All of the companies surveyed have formal monthly meetings for all top management to review results of the company. In two of the companies, top management meets formally each week. One company has two meetings for management each week, with one meeting focused on analyzing the results of the prior week and the other focused on planning the week's activities.

The companies surveyed monitored operational controls through visual display of historical operating results over time, identification of significant operating trends, and required explanations for negative variances.

SUMMARY

The control process for smaller forest products companies necessarily needs to address similar objectives of those for larger multinational companies: effectiveness and efficiency of operations, reliability of financial information and compliance with applicable laws and regulations. The methods and procedures used by the smaller companies does seem to differ however, from the more complicated systems and structures used by the larger companies.

Generally, the survey indicated that the control environment for smaller companies is greatly influenced by an autocratic managerial style by the CEO. Risk assessment tends to be more informal and short-term focused, primarily addressing raw material solutions and cost control issues.

Control activities have been implemented by the companies toward the three distinct areas of operations, financial and compliance. It was interesting to note the specific and sophisticated production measurements and tracking systems that the companies had developed. The identification by the companies of critical data was very revealing as to their analytical approach to successful operations.

The information, communication and monitoring features of the total control structure were distinguished by the speed in which they were accomplished. The relatively informal organizational structures and "hands on" styles of the CEOs seemed to contribute to the timeliness in achieving positive results in these areas.

APPENDIX A

Forest Products Industry Internal Control Monograph
Interview Questionnaire

DEFINITION

What are the key components of an effective system of internal controls?

CONTROL ENVIRONMENT

Focus: Management's perception regarding the importance of an appropriate "tone-at-the-top": Is it important to effective internal control, who sets it, what are its characteristics, how is it communicated?

How important are the following to a successful company?

- Integrity and ethical values
- Competent personnel
- Appropriate philosophy and operating style
- Organizational structure

Who are the decision makers within your company?

- Operational issues
- Financial reporting issues
- Compliance issues

Management philosophy and operating style:

- Describe it:
  - Emphasize results, growth, technology, people, or customers
  - Consensus vs. autocratic decision making
  - Hands-on vs. hands-off approach
  - Formal vs. informal
  - By the numbers vs. intuitive

- Who sets it?
  - Chairman
  - CEO
  - Others

- How is it communicated?
  - Employee handbooks
  - Code of conduct
  - By example
  - Meetings

- What are your primary methods for communicating tone-at-the-top, objectives, duties, responsibilities, suggestions, etc.?
  - By example
  - Meetings

- Written policies and procedures

MONITORING

Focus: Is there a monitoring process?

- How do you monitor the effectiveness of your internal control?
  - Who does it?
  - Periodic formal evaluation or only when problems are identified?

RISK ASSESSMENT

Focus: Management's approach to evaluating risk, strategic planning and managing change.

- What are your company's critical success factors (e.g., log supply, personnel, technology, products)?

- Describe your strategic planning process:
  - Formal or informal, budgets, written plans?
  - Who is involved?
  - Time frame?
  - Company-wide objectives:
    - Are they set?
    - Who sets them?
    - How are they communicated?
  - How are objectives linked to strategies, critical success factors, compensation?
  - Plant tours, discussions with industry peers?

- How does your management anticipate, identify and react to change?

CONTROL ACTIVITIES

Focus: Management's key controls.

- What are your key operating, financial and compliance controls?
  - Walking around
  - Personnel
  - Manuals, policies and procedures
  - Management or employee meetings
  - Where are your points of focus: Log supply, overrun, breakeven, daily sales, production mix, daily operating statistics, customer relations
  - Outsiders: Customers, vendors, consultants, accountants, attorneys
  - Strategic plans, budgets, financial statements

INFORMATION AND COMMUNICATION

Focus: Management's information needs and sources. How things are communicated throughout the organization.

- How are information needs identified and met? Are your information systems effective?

- What are your most valued information sources?
  - Walking around
  - Regular employee or management meetings
  - Internal financial statements
  - Daily sales or operating reports
  - Outsiders: plant tours, customers, suppliers

APPENDIX B

Assessing the Control Environment

An outline can be useful in the assessment of an entities control environment. The following presents the key components to be considered in such an assessment.

ORGANIZATION, ROLES AND RESPONSIBILITIES:

Role of the Board of Directors:

The composition and activities of members of the board of directors, and the information provided to it, are important considerations in its effectiveness in reducing the likelihood of management:

- involving the enterprise in material illegal acts (violations of laws and regulations)
- misappropriating material resources
- subjecting material assets of the enterprise to inordinate risks
- otherwise failing to act in the material interests of noncontrolling interests
- failing to ensure an adequate control structure.

Effectiveness of the organization and key management:

The organizational structure of an enterprise is an important consideration in the enterprise's ability to control its activities. The structure should be neither so simple that it cannot adequately monitor the enterprise's activities nor so complex that it inhibits the flow of necessary information. Executive officers, senior management, and others in key management positions (particularly those that have direct responsibility for the financial statements) should possess the requisite experience and level of knowledge commensurate with their positions. In assigning responsibility and delegating authority, management should establish policies that provide a basis of accountability and control, and set out individuals' respective roles.

Human resource policies and procedures:

Policies and procedures should establish that sufficient competent people are recruited and retained to enable the enterprise's plan to be carried out so that its business objectives can be achieved.

INTEGRITY:

Integrity and ethical values:

Management should convey the message that integrity and ethical values within the organization cannot be compromised, and employees should receive and understand that message. Management should continually demonstrate, through words and actions, a commitment to high ethical standards and proper working practices.

Reliability of management's estimates:

The development of reliable estimates is an important management responsibility. To ensure that estimates are appropriate in the circumstances, management should establish a methodology based on current and reliable data, supervise the development of the estimates and seek input from those who possess the knowledge to contribute to the reasonableness of the estimates.

MONITORING:

Reasonableness of management plans and budgetary control:

Management develops strategic plans and budgets to monitor the activities of the business. To be effective, these plans and budgets should be realistic, based on valid assumptions and developed by knowledgeable individuals. Management must also have sufficient reliable information on a timely basis to review and evaluate the enterprise's operations. Many of management's procedures will be specific to particular transaction cycles and account balances and should be considered in relation to the relevant monitoring control objectives.

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Contact:

Don R. Doerr, Partner
Coopers & Lybrand
400 Country Club Road, Suite 300
Eugene, OR 97401
(503) 485-1600

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