

October 31, 2007

Professor Larry E. Rittenberg, Chairman
Committee of Sponsoring Organizations

RE: COSO Guidance on Monitoring Internal Control Systems Public Comment Form – Fall 2007

Dear Professor Rittenberg:

The Center for Audit Quality (CAQ or the Center) is an autonomous public policy organization serving investors, public company auditors and the capital markets and is affiliated with the American Institute of Certified Public Accountants. The CAQ's mission is to foster confidence in the audit process and aid investors and the markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. Based in Washington, D.C., the CAQ consists of approximately 800 member firms that audit or are interested in auditing public companies. We welcome the opportunity to share our views on the Committee of Sponsoring Organizations of the Treadway Commission (*COSO*) *Guidance on Monitoring Internal Control Systems (Guidance)*.

We commend the COSO Task Force and the Discussion Document authors for their hard work in developing this Guidance. It will serve as an important resource for companies looking to improve both the efficiency and effectiveness of their internal control systems.

While we recognize that the Guidance is the first phase of a broader monitoring project, we believe that this document should convey more clearly that internal control has five inter-related components that work together, and that monitoring is but one of the components. Perhaps a reference in the Appendix to the COSO's *Internal Control Integrated Framework* principles would serve to better emphasize that the monitoring of internal control systems is not a substitute for effective operation of the other four inter-related components. We agree that an appropriately designed and executed monitoring program supports more efficient assessments of internal controls. We are concerned, though, that readers might incorrectly conclude that such monitoring programs reduce the need for other controls.

In response to your request, we are providing our comments in the attachment to this letter. Although we have not answered each question that was posed, we have selected areas that we believe are key to making this Guidance a valuable resource.

We appreciate the opportunity to comment on the draft Guidance and would welcome the opportunity to meet with you to clarify any of our comments.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc: SEC:

Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Annette L. Nazareth
Commissioner Kathleen L. Casey
Conrad Hewitt, Chief Accountant
Zoe-Vanna Palmrose, Deputy Chief
Accountant, Auditing

PCAOB:

Mark W. Olson, Chairman
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Willis D. Gradison, Member
Charles D. Niemeier, Member
Thomas Ray, Chief Auditor and Director of
Professional Standards

ATTACHMENT

Section I. Monitoring as a Component of Internal Control Systems

1. *This document says that effective monitoring should be designed to identify and correct weaknesses in internal control before those weaknesses can materially impact the organization's objectives. Do you believe the document adequately and properly addresses the concept that, although effective monitoring cannot be expected to identify and correct all internal control weaknesses before they occur, it should be expected to identify and correct them before they lead to material problems?*

Comments:

We suggest that the Guidance more clearly indicate that the role of monitoring is to address whether other controls continue to function effectively and that monitoring controls are not intended to serve in place of those other controls that are designed to address specific objectives related to the other four components of internal controls.

3. *Additional comments regarding Section I*

Comments:

The content of the discussion in the 3rd full paragraph on page 2 of the Guidance regarding variables to consider in the risk assessment process should also include a reference to the fact that the type and nature of the controls would influence the scope of monitoring. Other factors to consider would be the complexity of the control and the competence of the person responsible for the control. We recommend that this section reflect that the nature of the controls and the conclusions from the risk assessment together influence the nature and scope of monitoring. We also recommend that COSO consider whether the risk associated with a particular control influences either the nature (i.e., the suitability) or the amount (i.e., sufficiency) of information that management gathers in determining the ongoing effectiveness of a control.

Section II. Fundamentals of Monitoring

4. *This document suggests that effective and efficient monitoring is achieved through (1) establishing an effective control environment for monitoring, (2) prioritizing monitoring procedures based on control importance, and (3) proper communication and follow-up. Do you agree with that concept?*

Comments:

The 1st paragraph on page 7 of the Guidance, which references Elements of Effective Monitoring, is presented as “the” way management implements effective monitoring; however, there may be other alternative methods.

The terminology “control environment” may potentially confuse users because it suggests there is a second control environment that is different than the control environment component. We agree that an effective tone at the top and organizational structure for monitoring are integral to an effective monitoring component. We suggest that COSO use terminology such as “entity-wide” or “entity-level” to describe these conditions.

5. *The four-point monitoring structure on pages 8 and 9 and in Figure 4 is intended to show how an organization might be able to monitor both efficiently and effectively by focusing on areas of change from a baseline of known effective controls. Is this concept clear, correct, complete, and useful?*

Comments:

We could not decide whether the four-point monitoring structure is intended to illustrate concepts or whether it is just an example. Figure 4 and its related text provide only a limited explanation of each step. More guidance would

be helpful, including better integration of Section III and IV with the structure. Based on our reading, the use of the term "can" instead of "should" in the lead-in seems to indicate this is an example, but it may help to further clarify by using the term "example" as well. Consider adding the concept that monitoring should be prioritized based on additional factors other than control importance, such as complexity of the control and competence of the person performing the control (an automated control should not require the same degree of monitoring as a manual control).

We suggest that the sections on pages 8 and 19-20 of the Guidance related to prioritizing monitoring procedures based on control importance be reworded to better align with the concepts in the PCAOB Auditing Standard No. 5 An Audit of Internal Control Over Financial Reporting that is Integral with an Audit of Financial Statements "Relationship of Risk to the Evidence to be Obtained," (paragraphs 46 and 47), and the SEC's Guidance Regarding Management's Report on Internal Control Over Financial Reporting discussion of internal control over financial reporting risk. These concepts include a top-down and risk-based approach, and the need to consider controls over significant financial reporting objectives, fraud, and those controls that are complex or otherwise have a high likelihood of failure.

6. *This document suggests that the primary roles of the board/audit committee related to monitoring internal control are to (1) verify that senior management has implemented an effective monitoring program, and (2) monitor those controls that members of senior management perform and cannot objectively monitor themselves. Is this description of the role of the board/audit committee in monitoring clear, correct, complete, and useful?*

Comments:

We recommend that COSO clarify the discussion of the roles of the board of directors and the audit committee with respect to those controls that cannot be monitored objectively by senior management. The Guidance implies that these groups need to take on more explicit monitoring roles in place of senior management. We suggest that the Guidance indicate that the board of directors and/or audit committee should recognize those situations where the risk of fraud or override of controls by senior management is greater and focus more on their oversight of these areas. The board or the audit committee might request more information and analysis, with respect to the operation of controls in an effort to make management's activities more transparent and less susceptible to management override or fraud. We suggest that COSO consider including scalability concepts with respect to the roles of the board and audit committee.

7. *Additional comments regarding Section II.*

Comments:

The 2nd bullet under Effective Monitoring on page 6 states, "...ongoing monitoring and/or separate evaluations should provide an appropriately objective consideration." A further discussion of what is "appropriately objective" in this context would be helpful because unit management may be in the best position to provide knowledgeable and timely monitoring, but might not be the most objective.

In a smaller company, it is frequently common for testing to be performed by someone who reports to the CFO, and who doesn't have direct contact with the audit committee. Some level of use of their work might still be possible, and lack of objectivity should be considered in determining the level of reliance placed on that work.

Section III. Nature of Information Used in Monitoring

11. *Are the distinctions between direct and indirect information helpful in identifying information that is more versus less relevant?*

Comments:

The examples of ongoing monitoring activities in the 2nd paragraph on page 13 of the Guidance, under “Direct Information,” appear to be at a very granular level and may be closer to actual control activities. They seem removed from the COSO Framework examples, such as regular management and supervisory activities.

With respect to the discussion of Direct Information versus Indirect Information in “Section III General Comment,” pages 13-15, we recommend that the Guidance provide additional clarification of the role indirect information has in concluding that “persuasive information” exists and in determining the scope of other monitoring activities.

12. *This document states that reliable information is accurate, verifiable, and from an objective source. Is the concept of reliability, as described in the document, clear, correct, complete, and useful?*

Comments:

The 1st and 2nd paragraphs under “Reliability of Information” on page 15 of the Guidance seem overly complicated in that they indicate three distinct attributes for reliability, yet the attributes seem to overlap. “Verifiable” is defined as true and accurate, which seems to make accuracy a redundant attribute. Also, it is not clear how information may be accurate, but not objective. This part of the Guidance may be too theoretical for practical use. We recommend placing it in an appendix.

In addition, in itemizing this list of factors, the Guidance infers that supervisors would have limited objectivity. However, when the guidance discusses objectivity further (see Deciding When and How Often to Monitor, page 23) it indicates that supervisors have ‘more objectivity’ than self-review and peer review (but less than impartial review), as illustrated in Figure 7. Further, it does not discuss that supervisors typically have compensation incentives, reporting responsibilities and personal relationships with those they are monitoring. Accordingly, their involvement is important, but low on objectivity.

We suggest that the text at the bottom of page 15, which contains a discussion of objective individuals performing the evaluation, be moved to the section discussing the capabilities and position of evaluators.

14. *This document suggests that companies need to gather enough suitable information in order for it to be persuasive. Is the sub-section, “Information Sufficiency,” presented on pages 16 and 17, helpful in determining how much suitable information must be gathered in various circumstances to support reasonable conclusions about internal control?*

Comments:

The discussion in the 1st full paragraph on page 17 of the Guidance regarding statistical sample sizes and software appears to deviate from the focus on monitoring controls. This limited reference infers that companies should consider these sampling methods, which may not be applicable to many organizations. We suggest eliminating the reference to sampling.

15. *Additional comments regarding Section III.*

Comments:

While the concepts under the heading “Nature of Information Used in Monitoring” are valid, the length of the discussion may detract from its usefulness. Moreover, it suggests that only information that meets all three tests,

(relevant, reliable and timely), can be suitable. Designing and maintaining such a monitoring process may not be possible, or at least not efficient, even for the larger companies.

Since COSO will be providing examples in a separate document as part of Phase 2, perhaps the example on page 15 in the Guidance can be deleted from this document. The example of how indirect information might be used should acknowledge the variety of risks associated with sales, or indicate that for the purpose of the examples, low risk was associated with these matters. For instance, while review of reported sales numbers, knowledge of sales activity during the period, and visual inspection of the factory floor may be sufficient to determine that sales were recorded accurately for the period based on physical movement, issues remain with timing of delivery (FOB destination), sales terms, side agreements, etc. that have not been addressed. This example does not explicitly state whether or not these potential risks were considered.

Section IV. Designing Effective Monitoring

16. *Is the sub-section, "Prioritizing and Designing Monitoring Procedures" - including the descriptions of the nature of operations, the purpose of monitoring, and the relative importance of controls - clear, correct, complete, and useful?*

Comments:

We believe the "Nature of Operations" section may be a discussion of what constitutes a high risk operation in the focused operations that are subject to change. While changing operations, technology and people do increase risk, other factors such as complexity of transactions and operations, decentralization, geographic dispersion, and operations in countries without a sound legal framework, also increase risks. It is suggested that this section be expanded to provide a more robust discussion of the risks that may be associated with a given company's nature of operations. We also suggest that COSO expand on how the nature of operations discussion correlates with financial reporting objectives and decisions about prioritization.

This sub-section uses adjectives such as "high," "significant," and "more," which are not sufficiently clear, as there is no context for understanding the degree intended by their use or the ramifications on the judgments about scope of monitoring. We recommend that the Guidance be clarified to describe how the degree to which these factors exist drives their impact on the scope of monitoring, rather than implying that they do so only when they are "high."

We recommend not using the term "mission-critical risks" in the Guidance. This terminology seems to introduce a subset of risk that was not defined or discussed previously.

19. *Is the discussion of capabilities and position of evaluators clear, correct, complete, and useful?*

Comments:

While the terms "self-review" and "self-assessment" are described in the footnote on page 22 of the Guidance, we suggest that these terms also be added to the glossary.

20. *In the sub-section, "Using Technology for Effective Monitoring," the document suggests that technology plays two roles in effective monitoring: control monitoring and process management. The document describes technology tools that can be used to monitor other controls and tools that can assist in the overall management of the monitoring process. Is this section clear, correct, complete, and useful?*

Comments:

Some of the bulleted items in the section entitled "Using Technology" on page 23 seem to be closer to control activities, such as transaction data and processing integrity. It is not clear how these items would indicate that a control is not operating.

With regard to the statement made in the 1st paragraph of page 24 of the Guidance that "Process management tools are designed to make monitoring more efficient and sustainable by automating some monitoring activities, including assessing risks, defining and evaluating controls, and communicating;" It is unclear if the "tools" being referred to are company or corporate-level controls that are used to assess risk or to define and evaluate controls. We suggest that this be clarified and that this discussion be moved to the document for Phase 2 of this project.

Section V. Communicating and Addressing the Results of Monitoring

23. *The sub-section, "Ranking Issues and Reporting Internally," describes how organizations might determine what and to whom to communicate the results of monitoring. Does this description provide a better understanding of how to apply Principle 20 from COSO's 2006 Guidance?*

Comments:

The section begins with a discussion of prioritizing and addressing control weaknesses without first establishing that all deficiencies should first be reported upward to those responsible for determining remediation priorities and determining whether identified compensating controls (if any) are adequate to mitigate the risk associated with deficiencies in other controls. We recommend, therefore, that COSO reorder this section of the Guidance to first discuss the communication or roles and responsibilities that have been established for those responsible for monitoring and reporting weaknesses upward to those parties within the organization who have the responsibility and authority to establish priorities for the resolution of identified control weaknesses. It is further recommended that this section indicate that all deficiencies are reported upward, those persons at the appropriate level are responsible for determining remediation priorities and also whether identified compensating controls (if any) are adequate to mitigate the risk associated with deficiencies in other controls.

With respect to the first section of the table on page 26, the phrase "to protect further against material errors" implies that there always would be a material misstatement associated with the deficiency rather than just the possibility of a material misstatement. It is suggested that this phrase be revised.

Section VI. Scalability of Monitoring

26. *The scalability section is designed to show how monitoring might differ between organizations based on their size and complexity. Is this section clear, correct, complete, and useful?*

Comments:

Please refer to our comment with respect to boards of directors and audit committees in answer to Question 6 above. We urge COSO to ensure that the forthcoming "tools and examples" developed in Phase 2 address small companies. More guidance on scalability of the role of the board in smaller companies would be useful, since board monitoring becomes increasingly important, and it is important for the board to be appropriately engaged and hands-on.

Other General Areas/Topics

27. *Does the executive summary bring into focus the concepts of effective and efficient monitoring?*

Comments:

We believe the statement in the 2nd paragraph on page i, “Effective internal control provides reasonable assurance regarding the achievement of an organization’s goals and objectives” reads differently than the definition of internal control in the Appendix. The definition of internal control in the Appendix indicates that internal control provides “reasonable assurance that organizational objectives can be met.” Well controlled companies can fail to achieve their goals because of other factors—i.e., failed business strategy, changes in the business or regulatory environment, etc. Both of these differ somewhat from the 1992 definition. We suggest that COSO use the earlier definition.

The last paragraph on page ii states, “Organizations begin the process of meeting these expectations by placing competent and objective people in the monitoring roles throughout the organization.” Strictly applying the definitions of “competent” and “objective” to this statement, however, would seem to preclude most forms of ongoing monitoring activities, including examples presented in previous COSO framework documents. The Guidance only briefly mentions the many other people in an organization that have daily evaluation responsibilities by virtue of their job title or position and who were not necessarily hired for their role as “evaluator.” The Guidance provides an impression that evaluators are persons separate from management or those with ongoing responsibilities for running the business.

We suggest that the introductory pages discuss the scalability concept as it affects monitoring, with particular emphasis on striking the correct balance for smaller companies.

With respect to the text under prioritizing effective monitoring procedures found on page iii, and also on pages 2-3, we believe that an example of how a risk assessment for control failure may be performed should be included in the next phase of project. Presuming that controls already were designed to meet financial reporting objectives, other than changes in the system, what risks should be considered in designing the monitoring plan? It would be helpful for the readers to have some examples of how, for instance, an audit committee can oversee, monitor, and identify “gaps”.

The section “Communication Structure for Monitoring,” on page iv of the Guidance, should recognize that the size and complexity of the company will impact the nature of the communication structure that companies implement. Smaller, less complex companies where those with overall responsibility have more direct involvement with the internal control system will likely have a different, but equally effective, communication structure than larger companies.

28. *Apart from your comments above, is there anything that should be added or changed to improve the document, making it more practical to implement?*

Comments:

While the Guidance defines the “monitoring component” as one that evaluates the effectiveness of all five internal control components, the document appears focused on monitoring control activities. If the Guidance is intended to cover all components, it should include additional examples and address how to monitor information and communication, the control environment and the risk assessment processes. It may be helpful to include more

examples in the Guidance that explain the difference between monitoring operating effectiveness of controls versus monitoring the design effectiveness of controls.

With respect to the definition of “evaluators” found in Glossary 2, we suggest that the definition be revised to include definitions for both the competencies and the role of the evaluator.

With respect to the definition of “suitable information” found in Glossary 5, we suggest that the second parentheses be revised to say “i.e., produced and able to be used in an appropriate time frame.”

With respect to the definition of “sufficient” and “suitable” information found in Glossary 5 we suggest that there should be an indication that this definition also addresses the terms “sufficiency” and “suitability,” as is done for “verifiable.” Variations of these words are used in the body of the Guidance.