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August 15, 2008

Professor Larry E. Rittenberg
Chairman
Committee of Sponsoring Organizations

Re: **COSO Guidance on Monitoring Internal Control Systems – Spring 2008**

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 or Exposure Draft).

We commend the COSO Task Force and the Exposure Draft authors for their hard work in developing this Guidance. We believe that the Guidance reflects many of the comments that were made last October on the first draft. The reorganization of the Guidance provides a much clearer presentation of the material.

We appreciate the opportunity to comment on this Exposure Draft and 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:

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COSO Guidance on Monitoring Internal Control Systems Public Comment Form – Spring 2008

Questions/Commentary

Volume II – The Guidance

Chapter I. Monitoring as a Component of Internal Control Systems

1. Does the Guidance adequately describe the role of internal control monitoring (paragraphs 6–10)?

Yes

Comments:

Paragraph 7 refers to material misstatements in an organization’s “published” financial statements. We suggest that the word “published” be deleted. It may be confusing for non-public companies and is not necessary.

Also, the Guidance does not discuss monitoring as a “control activity.” We would suggest that the document include guidance related to the fact that a given control activity, depending on its nature and the manner in which it is intended to operate, could also be a monitoring activity and vice versa. Please see our response to Question 7 below.

2. Additional comments regarding Chapter I.

Comments:

Paragraph 2 is intended to summarize Principles 19 and 20 (which appear in a box on page 3) but different terminology is used, such as “operates” instead of “function” and “deficiencies” in place of “weaknesses.” We suggest that consistent terms be used to avoid confusion. We also suggest that COSO refer to the 1992 *Internal Control-Integrated Framework* as Principles 19 and 20 originate from that document.

Paragraph 3 states that not making the best use of monitoring procedures “forced” certain organizations to implement inefficient year-end evaluations. We suggest that “caused” rather than “forced” is a more accurate statement.

Paragraph 5 states that the Guidance is designed to apply the “three objectives addressed in the COSO Framework” We suggest that “Internal Control-Integrated” be inserted between COSO and Framework.

The proposed Guidance is intended to help organizations design, implement and evaluate monitoring procedures under COSO’s Internal Control Framework. It may be appropriate to include in Chapter 1 a discussion regarding how, if at all, this monitoring guidance also may apply to other frameworks, such as COSO’s Enterprise Risk Management Integrated Framework.

Chapter II. Establishing a Foundation for Monitoring

3. Is the model for monitoring presented in paragraph 19 a complete and accurate outline of the monitoring process?

Yes

Comments:

The bullets in paragraph 19 under subparagraphs 2, Designing and executing monitoring procedures, and 3, Assessing and reporting results, while accurate, do not correlate easily to Figure 3. We recommend that COSO more closely correlate the description of the monitoring steps under (2) Design and Execute and (3) Assess and Report in paragraph 19 with the corresponding items in Figure 3.

4. Do you agree with the description of the roles of management and the board with respect to monitoring (see paragraphs 23–24)?

Somewhat

Comments:

The statement is made in paragraph 24 that the board has ultimate responsibility for determining whether management has implemented effective internal control. We suggest that it be emphasizing that the Board’s role is one of oversight and not actual implementation.

Also, in the second paragraph of “Applying the Concepts” on page 10, we suggest that “non-management” either be deleted or changed to “management.” Audit committees may not need to interact with non-management personnel to perform their oversight role.

Also, in “Applying the Concepts” on page 10, we recommend providing an example of how management and the board work in tandem to monitor controls.

5. Do you agree with the description of the characteristics of evaluators (see paragraphs 25-33)?

Yes

Comments:

No additional comments

6. Is the discussion about establishing a baseline understanding of internal control effectiveness clear, correct, complete, and useful (see paragraphs 34–36)?

Yes

Comments:

We agree with the concepts that monitoring may revalidate control operations and the emphasis on the proactive gathering of information through either ongoing monitoring or separate evaluations.

It is unclear whether Figure 6 on page 15 represents the evaluation of one control or the entire system of controls. Clarification of how to apply Figure 6 would be helpful.

7. Additional comments regarding Chapter II.

Comments:

The Guidance does not discuss monitoring as a “control activity.” We would suggest that the document include the following guidance: A given control activity, depending on its nature and the manner in which it is intended to operate, could also be a monitoring activity and vice versa. The concept of monitoring as a control activity could also be pointed out in the Executive Summary as well as in the glossary. For example, sometimes the monitoring is the control (e.g., review of certain expenses against budget), while sometimes it monitors the existence of other controls (e.g., someone checks to ensure all bank reconciliations have been performed and reviewed). In this latter case, the bank reconciliation is the control, and the monitoring adds an additional layer.

Chapter III. Designing and Executing Monitoring Procedures

8. Figure 7 on page 18 and paragraphs 42–49 are designed to provide an overview of the core of monitoring — designing and executing monitoring procedures. Do the graphic and related summary paragraphs properly summarize the process of monitoring?

Somewhat

Comments:

In Figure 7 in paragraph 41, we recommend adding a reference indicating that the concepts in boxes 1 (prioritize risks), 2 (identify key controls) and 3 (identify relevant information) often are identified under the baseline described in paragraph 35.

Paragraph 43 notes that the operation of certain controls may warrant the attention of a store manager but not the attention of the CEO. A similar point is made in paragraph 57. We suggest that these paragraphs be clarified to stress that the difference in who pays attention to a control is a function of the individuals’ roles and responsibilities in management and does not necessarily indicate the relevance or importance of the control to the effective operations of the internal control system.

The third caveat in “Applying the Concepts” on page 24 states that it should not be assumed that non-key controls will never be monitored, and that non-

key controls for “channel-stuffing” may be monitored in relation to other risks or may be evaluated less frequently than key controls. Paragraphs 45-47, however, do not discuss the fact that non-key controls may be monitored at some point. By focusing on key controls, paragraphs 45-47 appear to present a strategy for increasing the efficiency of monitoring procedures as opposed to describing the broader concept that all controls, even non-key controls, are subject to monitoring. We suggest that this point be clarified.

We have some concern that readers may confuse the definitions of “key” and “important” controls. The first paragraph in Chapter III (paragraph 37) mentions “important” controls (in italics), and then connects the term to “key controls” (in boldface) in paragraph 46. The two terms are then used interchangeably without clearly stating that they mean the same thing. Also, the definition of “key controls” in paragraph 46 uses the term “most important” controls which could be construed to create a potentially different class of controls.

When trying to decide whether to monitor a control, it may be appropriate to consider other, compensating controls. Accordingly, we suggest that paragraphs 45-47 be linked to the discussion in paragraph 97 regarding compensating controls and that a reference be made to the chart on page 47 that describes risk ranking considerations.

Please see our responses to questions 10, 24, and 31, *infra*, for additional comments related to this section.

- 9. The Guidance indicates that effective and efficient monitoring evaluates controls that address “meaningful risks” to an organization’s objectives. Paragraphs 50–54 provide guidance regarding assessing risks and how prioritizing risk influences monitoring. The intent is to provide guidance (1) without being prescriptive as to how risk assessment should be done, and (2) without delving so deeply into the risk assessment component that the focus of the Guidance shifts away from monitoring. Do you believe the Guidance properly addresses the role of risk assessment in the context of internal control monitoring?**

Somewhat

Comments:

We suggest that the word “only” be deleted from last sentence of paragraph 51.

In paragraph 53, we suggest “those” be inserted between “where” and “risks.”

In the third bullet in paragraph 54, and elsewhere, we suggest that “etc.” be deleted from parentheticals that begin with “e.g.”

In “Applying the Concepts” on pages 21-22, it is unclear whether the last sentence on page 21 is meant to be an additional bullet explaining the rationale for the analysis or a separate conclusion. If it is a separate conclusion, perhaps it should be placed in a separate box.

- 10. The Guidance defines the term “key controls” (see paragraphs 46–47 and 55–57). The project team chose to define the term because (1) it is widely used in practice, but is not consistently defined; and (2) the Guidance proposes that, in order to conclude that the internal control system effectively addresses a given risk, organizations may not need to evaluate every control that addresses that risk — thus, the term distinguishes between controls that will be subjected to monitoring procedures and those that will not. Do you believe the concept of “key controls” is properly addressed in the Guidance?**

Somewhat

Comments:

Please see our comments regarding “key controls” in response to Question 8, above. We are concerned that the definition might result in some important controls not being monitored. For example, the discussion in paragraph 57 regarding the differing views of the plant manager and senior management create doubts about whether the plant-level controls should be monitored. We agree that all important controls should be monitored, however, labeling them with one defined term (“key controls”) and trying to use that term throughout the document may be creating unnecessary confusion. This problem may be corrected by clearly stating that key and important controls mean the same thing.

In paragraph 55, we suggest mentioning again that a baseline knowledge of controls and their effectiveness is needed before identifying the important or key controls.

In paragraph 56, the reference to “three related processes” is unclear.

In paragraph 57, we suggest changing “support” in the last sentence to either “evidence” or “persuasive information.”

- 11. Information that is evaluated to assess controls effectiveness provides varying levels of support. The Guidance defines “persuasive information” as that which is capable of providing adequate support for a conclusion about the effectiveness of internal control. Persuasive information is further defined as that which is “suitable and sufficient in the circumstances” (see paragraphs 59–60). Do you agree with the general premise of persuasive information as outlined in the Guidance?**

Yes

Comments:

Further examples of the criteria to be applied when judging the three elements of suitable information may be helpful.

12. The Guidance discusses the difference between direct and indirect information as being one of the primary factors influencing the persuasiveness of information. Feedback from the September public discussion document indicated broad support for this aspect of the Guidance, but also indicated a need to refine and clarify the material. Is the current discussion of direct and indirect information (in paragraphs 64–72 and in the Applying the Concepts section beginning on page 34) clear, correct, complete, and useful?

Yes

Comments:

Consider whether footnote 20, on page 28, addresses the concept of observing controls in operation too much from an auditor’s perspective.

13. The Guidance states that reliable information is accurate, verifiable, and from an objective source (paragraphs 73–75). Is the concept of reliability, as described in the document, clear, correct, complete, and useful?

Yes

Comments:

Paragraph 73 refers to an “objective source” and has the word “objective” in bold type, indicating that it is a defined term. The glossary defines “objective or objectivity” as “a measure of the factors that might influence any person to report inaccurately or incompletely information necessary for evaluators to reach appropriate conclusions. It includes personal integrity, as well as factors that might motivate even a person with perceived high integrity to misrepresent facts, such as having a vested, personal interest in the outcome of the monitoring procedures.” This definition “objective” does not fit easily into the concept of an “objective source” in paragraph 73. It seems to equate “person” and “source.”

14. Is the concept of timeliness of information (paragraphs 76–77), as described in this document, clear, correct, complete, and useful?

Yes

Comments:

No additional comments

15. The “Sufficient Information” section (paragraphs 78–79) has been expanded based on feedback from the September public discussion document. Is this expanded material clear, correct, complete, and useful?

Yes

Comments:

In “Applying the Concepts” on page 34, terms such as “we” and “us” appear to reference the evaluators conducting the monitoring but are confusing. We suggest that they be replaced.

- 16. Based on feedback from the September discussion document, the section regarding “Ongoing Monitoring and Separate Evaluations” has been simplified. It now more clearly articulates that the primary difference between the two is not how they are performed, but how often and by whom. The Guidance then addresses the factors an organization might consider in deciding between the two processes. Do you believe this section is clear, correct, complete, and useful?**

Yes

Comments:

No additional comments.

- 17. A paragraph has been added to the document to address the monitoring of controls outsourced to others (paragraph 90). Is this paragraph clear, correct, complete, and useful?**

Yes.

Comments:

Companies often do not appreciate the importance of control weaknesses and user considerations cited in service auditor reports prepared in accordance with Statement on Auditing Standards No. 70, *Service Organizations*. We recommend that this section of the Guidance emphasize in common terms that monitoring a service organization entails assessing risk by the user, reviewing the detailed SAS 70 report to assess whether control considerations and testing address the identified risks, and, when appropriate, implementing user controls to address control weaknesses and user considerations identified by service auditors and ensuring risks identified by the user are adequately addressed.

We suggest that COSO’s guidance also discuss other sources of information about the service provider’s internal controls, such as past experiences and interactions with the service provider and reports by regulatory authorities. Further, if the company is able to reconcile the information coming from the service provider to other independent records, then it may be able to monitor the service provider’s controls on a less frequent basis.

- 18. The “Using Technology for Monitoring” section has been simplified from the September 2007 draft, and a discussion regarding “continuous controls monitoring” has been added (see paragraphs 9 1–94). Is this**

section clear, correct, complete, and useful? (Note: Some commenters to the September 2007 discussion document indicated a desire for direction in applying the monitoring guidance to controls over information technology (IT). A comprehensive discussion regarding monitoring IT controls has been included in Volume III.)

Somewhat

Comments:

We believe that paragraph 93, on process management tools, may be too detailed and not necessary for a conceptual document.

Paragraph 94 indicates that tools performing “continuous controls monitoring” may be highly effective in detecting errors before they become material. We believe that these tools generally would be important controls that should be monitored and that the parameters for such tools should be reassessed and adjusted as the entity grows and changes.

19. Additional comments regarding Chapter III.

Comments:

Under “ 4. Implement Monitoring Procedures” in “Applying the Concepts,” which begins on page 43, it may be useful to indicate the relative importance of controls number 1, 6, 10 and 11 so that readers may better understand the extent of monitoring procedures.

Paragraph 58 lists factors that may be considered when conducting an analysis of key controls. The list, however, does not include those controls that are of such importance that, if they are ineffective, the entity’s objectives would not be achieved. Therefore, we suggest that a factor addressing the overall importance of a control be added to this paragraph. In addition, it should be noted that these factors may change over time and should be re-evaluated periodically.

Chapter IV. Assessing and Reporting Results

20. Is the section “Prioritizing and Communicating Results” clear, correct, complete, and useful?

Yes

Comments:

No additional comments.

21. Is the section “Reporting Internally” clear, correct, complete, and useful?

Somewhat

Comments:

Paragraph 100 refers to monitoring that is “material” to only a small part of the organization. The term “material” in financial reporting has a well-understood meaning that may not translate well into operational or compliance contexts.

We suggest a clearer tie between the “Applying the Concepts” on page 48 and the concepts preceding it.

22. Is the section “Reporting Externally” clear, correct, complete, and useful?

Somewhat

Comments:

We suggest that terms like “external assertions,” as used in paragraph 103, be avoided. Such terms may imply an auditor perspective.

We also suggest that “and agree” be deleted from the second sentence of paragraph 105. This language implies auditors or others should agree on the scope of management’s assessment process. Based on recent changes in rules and guidance from the Securities and Exchange Commission and the Public Company Accounting Oversight Board’s Auditing Standard No. 5, management and auditors do not have to agree on management’s evaluation or assessment process.

This section (as well as paragraph 117) appears to assume that external assertions will be audited, which is not necessarily the case. The Guidance should discuss the various forms and levels of reporting to third parties that go beyond financial reporting (which may include due diligence, operations, compliance with anti-money laundering laws, and so on) and do not have a corresponding audit requirement..

23. Additional comments regarding Chapter IV.

Comments:

To be consistent with the broad scope of the document, we suggest expanding paragraph 108 beyond auditors to include regulators, examiners, and other third parties.

Chapter V. Scalability of Monitoring

24. Chapter V, “Scalability of Monitoring,” is designed to show how monitoring might differ between organizations based on their size and complexity. It is designed to complement and summarize other references to size and complexity that are spread throughout the document. Is this chapter clear, correct, complete, and useful?

Somewhat

Comments:

The discussion in paragraph 110 of reliance on monitoring by successive levels of management should be considered in view of the discussion in paragraph 57 about the disparity of views between a plant manager and senior management. We found the result to be confusing and left unanswered questions about the subset of key or important controls to be monitored. As noted above in our responses to Questions 8 and 10, the fact that a lower level of management implements or evaluates a control does not necessarily mean that the control is less important to achieving the entity’s control objectives.

Similarly, we suggest that “external assertions” be replaced in the “Applying the Concepts” box on pages 52 and 53 with a phrase that might be more understandable for readers other than auditors.

The first bullet in “Applying the Concepts” should be written to clearly state that regulatory requirements need to be considered in risk assessment and planning. Also, it may be helpful to flip the third and fourth bullets, to discuss procedures before discussing documentation.

Section VI. Assessing the Effectiveness and Efficiency of Monitoring

25. Is Chapter VI, “Assessing the Effectiveness and Efficiency of Monitoring,” clear, correct, complete, and useful?

Yes

Comments:

No additional comments.

Other General Areas/Topics

26. Does the Executive Summary (Volume I) effectively summarize the guidance contained in Volume II?

Yes

Comments:

Paragraph 16 of Volume 1, the Executive Summary, states that controls performed directly by members of senior management “cannot” be monitored objectively by those individuals or their designees. Because there may be exceptions to this statement, we suggest that it may be more accurate to say that the controls “may not” be monitored objectively by those individuals or their designees.

27. Apart from your comments above, should anything be added or changed to improve the Guidance, making it more practical to implement? If so, please summarize your recommended additions or changes below.

No

Comments:

In the glossary, the definition of risk assessment states, “A precondition for risk assessment is establishing objectives that are linked at different levels and internally consistent.” We are not sure of the source or meaning of “linked at different levels and internally consistent” and suggest that it be explained.

Additionally, to enhance the integration of this Guidance with an organizations internal control system, it may be helpful to insert a summarized chart (or provide a discussion) in the Executive Summary laying out the process for the organization to implement this Guidance. This may help eliminate any duplicate activities (e.g., risk assessment process) from being performed and may help users apply the Guidance.

28. Overall, do you believe the document advances the understanding of what effective monitoring should look like in any given organization?

Yes

Comments:

No additional comments.

Volume III – Application Techniques

Chapters II–IV. Brief Examples Linked to Volume II Chapters

29. Chapters II–IV of Volume III contain brief examples of how various organizations currently monitor internal control in ways that are consistent with the concepts embodied in Volume II — the Guidance and are organized to correspond with the Guidance. As the introduction to Volume III indicates, the examples are not intended to mandate how monitoring should be performed, but to articulate how the Guidance might be applied. Do the examples achieve that objective? (Note: Please elaborate if you believe certain of the examples should be edited or deleted or if you recommend inclusion of other examples.)

Yes

Comments:

We found that the examples which identified the risks addressed, the control description and the monitoring activities (for instance, the examples beginning on page 62) to be the most helpful. We suggest, to the extent practicable, this

format be used for the earlier examples in the document. It would be helpful if each example in the document explained the risk addressed, the control in place, and the monitoring activity. This would improve the clarity and understanding of the examples provided.

- 30. The appendices to Volume III relate to the examples discussed in question #29 and show some of the tools the various organizations use for monitoring. Are the appendices helpful without appearing to be prescriptive?**

Comments:

To make the document easier to use, we suggest that the table of contents include a description of the Appendices.

Chapter V. Comprehensive Examples

- 31. Chapter V of Volume III contains comprehensive examples of how two organizations monitor internal control over a given risk area. These examples attempt to demonstrate application of the monitoring process from start to finish, as outlined in the Guidance. Like the earlier examples, those in Chapter V are intended to be descriptive rather than prescriptive. Do these two examples help demonstrate application of the Guidance?**

Somewhat

Comments:

On page 54, it appears that the items in the first three bullets have not been designated as “key controls,” while the items in the last two bullets have been designated as key controls, yet it appears that all of them are being monitored. This creates confusion about which controls are important enough to monitor. If only key controls should be monitored, then we are not certain why non-key controls are included in the example.

- 32. Chapter V of Volume III also contains a discussion of monitoring information technology (IT) controls that address financial reporting-related risks. This discussion was included because (1) many people have requested specific guidance regarding monitoring IT controls related to financial reporting, (2) IT-related risks are pervasive across most organizations, and (3) the ways in which those risks are controlled are fairly consistent across organizations, making the discussion applicable in a broad sense. Without being prescriptive, does the discussion about monitoring IT controls articulate how such monitoring might be performed?**

Yes

Comments:

No additional comments.

33. Additional comments regarding Volume III.

Comments:

No additional comments

Demographic Information

34. Your name

Cynthia Fornelli

35. Your email address

cfornelli@thecaq.org

36. Your position (select the position from which you answered the questions above)

Executive Director, The Center for Audit Quality

37. Country

U.S.A.

38. Name of organization (should correspond to position selected in Question 36 above)

The Center for Audit Quality

39. Classification of the above-named organization (select one)

Non-profit professional organization

40. Annual revenues of the above-named organization

Not applicable

41. Public float (market cap) of the above-named organization, if a public company

Not applicable