



task force on monitoring

August 15, 2008

Dr. Larry E. Rittenberg
Chair, Committee of Sponsoring Organizations of the Treadway Commission (COSO)
Submitted online at www.coso.org and by email to: cosomonitoring@gt.com

Re: Comments on COSO Exposure Draft: “Guidance on Monitoring Internal Control Systems”

Dear Dr. Rittenberg,

Financial Executives International’s (“FEI’s”) Task Force on Monitoring (“TFM”) is pleased to comment on the Committee of Sponsoring Organizations of the Treadway Commission’s (COSO’s) Exposure Draft entitled, “Guidance on Monitoring Internal Control Systems” (the “ED” or the “monitoring guidance”). FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. FEI’s TFM was formed to coordinate FEI’s response on COSO’s monitoring project. This letter reflects the views of FEI’s TFM, and not necessarily the views of FEI or its individual members.

We would like to thank COSO for forming a diverse task force of issuers, auditors and other experts to assist in development of the guidance, and we appreciate the dedication of the Grant Thornton team drafting the guidance under the auspices of the COSO monitoring task force.

We believe COSO’s monitoring guidance has the potential to improve the quality of monitoring at some companies, reinforce effective monitoring already in place at other companies, and enhance understanding of the role of monitoring among issuers, auditors, board members, investors and others. TFM members have noted the guidance will provide an opportunity to reinforce the important role that monitoring and internal control can play in an organization, and why it makes business sense to have effective internal control.

Additionally, we believe the guidance goes a long way toward COSO’s stated goal of not only improving monitoring, but helping companies to better leverage - or ‘take credit’ for – their monitoring activities, to help reduce unnecessary testing and other procedures that are performed, often in clusters at or near year-end, to assess the effectiveness of internal control. These benefits can accrue to both public and private companies in reaching an optimal mix of company and auditor work, including with respect to assertions under Sarbanes-Oxley Section 404 and applicable AICPA standards.

However, we note that the ultimate cost-benefit and potential value-add in applying COSO’s monitoring guidance will vary based on company facts and circumstances. Additionally, particularly in light of the fact that the guidance was not ‘field tested’ or cost-benefit tested per se, the ultimate cost-benefit will depend on COSO maintaining guidance that is principles-based and practical, and not cause inconsistencies with existing layers of regulation companies are subject to, including SEC, PCAOB, AICPA and major listing standards. Additionally, the ultimate success of the guidance will depend on the commitment of all parties (including companies and auditors) to maximize efficiency and effectiveness.

Our comments on the ED are organized in the two attachments that follow:

- (1) Major concerns, and
- (2) Responses to the detailed questions posed by COSO

Thank you for considering our views. We would be happy to discuss this further at your convenience or respond to any questions you may have. Please feel free to contact Edith Orenstein, Director of Technical Policy Analysis, in FEI’s office at (973) 765-1046 or myself at (510) 774-1969 should you have any questions.

Sincerely,

A handwritten signature in cursive script that reads "Richard D. Brounstein".

Richard D. Brounstein
Chairman, Task Force on Monitoring (TFM)
Financial Executives International (FEI)

Cc: Michael P. Cangemi, FEI Representative on COSO Board
Christine DiFabio, FEI Vice President, Technical Activities

ATTACHMENT 1 – FEI TFM Response to COSO – August 2008

Major Concerns

This attachment includes major concerns of FEI’s Task Force on Monitoring (TFM) with respect to COSO’s Exposure Draft, “Guidance on Monitoring Internal Control Systems” (the “ED” or the “monitoring guidance”).

The Need For COSO to Remain Principles-Based, Practical, and Consistent

Due to the many new concepts introduced in COSO’s Monitoring ED, which are not new to external auditing literature, but are new to the COSO framework (e.g. the role of ‘persuasive evidence,’ ‘sufficiency’ and ‘objectivity’) we urge COSO to remain principles-based, so that companies can most effectively apply the guidance to their facts and circumstances.

Additionally, we recommend COSO be as practical as possible in its guidance and examples, and to be cognizant of, and not cause inconsistencies with, the many layers of regulation companies are already subject to, particularly regulations issued by the Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB) and major exchanges such as NYSE-Euronext. This is especially true for the ED’s discussion of the role of boards of directors on which we note our concern below, as well as all other aspects of the guidance.

The Need for a Preamble Stating This Guidance Is Not Necessarily Additive

In addition to the new terminology included in the guidance, the sheer size of COSO’s proposed monitoring guidance (hundreds of pages in Volumes 1, 2 and 3) implies to some that this is a big new project, and will add an attendant amount of time and dollars in some proportion to the height or weight of the COSO document(s). Our members are highly concerned that the sheer length of the document and the introduction of significant new terms like ‘persuasive evidence’ and subdefinitions of that term will be used as an opportunity to increase external auditing and consulting fees. We are also concerned that some of the key partners in the financial reporting chain, including potentially some auditors, may not be willing to ‘give credit’ where credit is due to recognize effective monitoring, although that was part of COSO’s stated intent in issuing this guidance.

To combat this perception, which can be misused by some to sell or impose unnecessary or excessive audit or ‘compliance’ related services, or to impose unnecessary or excessive internal processes, we recommend COSO state affirmatively in a preamble section up front (e.g., in the “Purpose of this Guidance” section of the Executive Summary and in the Guidance) that the monitoring guidance is not aimed at being ‘additive’ and indeed may not necessarily be ‘additive’ for companies that already have effective internal control.

Another way to support this message in the ‘preamble’ would be to emphasize that the examples in Volume 3 are current procedures in place, not new processes added, that exhibit ways in which companies are complying with the proposed guidance today.

Management and Auditors Have Different Perspectives, Approaches to Persuasive Information

Unless COSO strives to remain highly principles-based in its guidance, new terms being injected into the COSO framework by this guidance like ‘persuasive information’ may be abused by some to generate new fees by telling management they must do XYZ to fulfill these ‘new’ requirements. In substance, we believe companies with effective internal control have been gathering suitable information already, whether it went by the label ‘**persuasive**’ information or not. Further, there is a need to recognize that management and auditors operate differently and are subject to different circumstances and constraints; COSO could emphasize this more as well, and needs to emphasize that substance, not form or labels, matter most.

Additionally, we urge COSO to be practical in defining terms like ‘**objective**’ in this guidance. Since this guidance is meant primarily for management to use, it should not scope out the important role of self-testing, peer testing, and other routine monitoring that takes place within organizations. It is appropriate to note there is a continuum of objectivity rather than creating a bright line, and we believe COSO is trying to achieve that balance in the guidance.

Similarly, we find COSO's definition of **'key controls'** to be broad enough to be useful for companies to apply to their particular facts and circumstances, and we urge COSO to remain principles-based in that regard. Acceptance of this principles-based definition by all parties within and outside companies (such as auditors) will be an important step in bringing a consistent overall approach.

COSO Guidance Blurs Line Between Board, Management; May Impose Undue Role on Boards

A major concern we have with COSO's proposed monitoring guidance is the discussion of the role of the board, particularly paragraphs 23 and 24 in Vol. 2 of the guidance, and related language in other sections of the guidance. We strongly recommend COSO change references to the board's role in 'monitoring' to instead say 'oversight,' and remove prescriptive requirements for the board, in favor of reiterating COSO's broad guidance from 1992 and providing reasonable examples.

Here is why we recommend using the term 'oversight' instead of 'monitoring' with respect to the board:

- The language used in COSO's 1992 framework - which we believe continues to be appropriate guidance – describes the board's role as "governance, guidance and oversight."
- The board was not assigned a 'monitoring' duty by COSO in 1992 and, we believe, to use that term now with respect to the board, particularly in light of the specificity with which monitoring is defined in this proposed guidance aimed at management - with the new guidance taking up hundreds of pages describing how management should conduct 'monitoring' - could place a management-like role on the board that is not only inappropriate, but could set an overly high and impractical threshold on directors that could impose undue liability, and threaten the independence of independent board members. Therefore the terms 'monitoring' and 'oversight' should not be used interchangeably with respect to the board within COSO's guidance, and the word 'oversight' should be used, consistent with COSO's 1992 framework, with respect to the role of the board.
- We believe the term 'oversight' with respect to the board is also more consistent with the principles-based requirements of listing standards of major exchanges such as the NYSE-Euronext. For example, **Section 303A.09, Corporate Governance Guidelines, in the NYSE Listed Company Manual**, states: "No single set of guidelines would be appropriate for every listed company." Under Director Responsibilities, the NYSE-Euronext guidelines continue, "Director responsibilities... should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials." However, the exchange does not prescriptively mandate what those duties should be, it simply requires listed companies to set forth those duties in their charter and make the charter available to the public.
- Based on our informal discussion with a number of experts in the field, including **Marty Lipton** of Wachtell, Lipton, Rosen & Katz and **Ira Millstein** of Weil, Gotshal & Manges LLP, they concur that it would be preferable for COSO to retain use of the word 'oversight' to describe the role of the board within this guidance (consistent with COSO's description of the role of the board in COSO's 1992 framework as being 'governance, guidance and oversight'), vs. describing the role of the board as 'monitoring,' given the specificity with which 'monitoring' is described in this guidance.
- Additionally, based on our informal discussion with research staff at the National Association of Corporate Directors (**NACD**), citing usage from the NACD Blue Ribbon Commission series, they also concur that it would be preferable for COSO to retain use of the word 'oversight' to describe the role of the board within this guidance (consistent with COSO's description of the role of the board in COSO's 1992 framework as being 'governance, guidance and oversight'), vs. describing the role of the board as 'monitoring,' given the specificity with which 'monitoring' is described in this guidance.

In general, our concern with the role of the board as currently described in paragraphs 23 and 24 of the ED's Guidance (Vol. 2) and other places in the document **blurs the line between management's responsibility** to establish and monitor internal controls, **and the board's oversight responsibility**.

This blurring of role can become particularly troublesome for independent board members, as we believe COSO's requirements for board members to 'monitor' senior management (particularly in a new publication on 'monitoring' which sets forth such detailed requirements for management to conduct

monitoring) may threaten the very independence of independent board members which is central to the control environment.

Companies should endeavor to establish controls that would prevent and detect potential fraud perpetrated by senior management, all the way up to the CEO.

In conducting its oversight role, the board should be proactive in seeking information from management, particularly on critical matters, in considering management's assertions, and seeking information from other sources as appropriate. Importantly, the board should review all such information with requisite skepticism.

As a practical matter, as noted by COSO, the board relies on internal audit where that function exists, and considers matters brought to their attention by the external auditor. These matters would include, for instance, indications of possible fraud on the part of senior management.

However, the wording in COSO's ED as currently written implies that if internal audit is not present, or even potentially in situations when it is, that the board must directly engage in 'monitoring' senior management in the same manner that senior management monitors other functions at the company. We do not see this as practical or as being within the bounds of the oversight role of boards.

The terminology we recommend COSO change includes but is not limited to:

Paragraph 23:

- Remove "**The board may also need to monitor such controls**";
- Remove reference to "**board-level monitoring**"

Paragraph 24 – shaded box "Applying the Concepts":

- 1st paragraph: we question if the language specifying 'inquiries and observation of management' and 'inquiries of nonmanagement personnel, customers, and/or vendors' goes beyond the role boards typically play and could threaten independence of the board members and suggest COSO insure this description is consistent with NYSE listing requirements.
- 2nd paragraph states the absence of an internal audit function at a small company "increases the need for board members to interact with non-management personnel and possibly creates the need to **observe some controls in operation**, especially controls in areas of higher risk." The description in this paragraph sounds like a management function, not a board function. The second paragraph also says "As organizations grow in size and complexity, **the board** may need to hire or engage internal auditors or other experts to **help evaluate the effectiveness of the internal control system** in certain areas." This language also sounds like it is the board that is doing the first level assessment of the effectiveness of internal control, vs. overseeing management's process and conclusions on the effectiveness of internal control.
- 3rd paragraph states: "**neither management nor the board should plan to reduce its monitoring efforts** in other areas simply because the external auditor did not find errors or control deficiencies." Once again, we believe this is blurring the role of management in monitoring and the board in overseeing management, including with respect to monitoring.

Overall, it appears COSO is trying to impute a monitoring role for the board to oversee senior management in the same manner that management conducts monitoring. Even with wording to the contrary, use of the word 'monitoring' as applied to the board in this particular document may subsume the responsibilities set forth in the hundreds of pages of guidance and examples that are geared toward how management should monitor, not how the board (and in particular, independent board members) should oversee management.

There is a practical reality that although the board is a higher authority than management, the board cannot perform managerial functions like monitoring in the same way that management does, in order to maintain its independence as a board (i.e., particularly for independent board members to maintain their independence).

Instead, as noted in some sections of the ED which could be amplified, the board can rely on alternative independent sources of information about senior management and alternative processes established by the company itself, to prevent and detect potential senior management fraud or control breakdowns.

Deputizing board members as ‘senior, senior managers’ is not the right approach; board oversight is the right approach. This may seem like a minor wording change but the ramifications are significant, particularly as relate to board independence and to maintain consistency with listing regulations and the original COSO 1992 framework.

Lack of Field Test or Cost-Benefit Study To Support Assertions in COSO ED

“The **objectives** of COSO’s Monitoring Guidance are two-fold,” states paragraph 5 in the ED’s Executive Summary, are:

- *“To help organizations **improve the effectiveness and efficiency** of their internal control systems. The COSO Framework emphasizes that organizations with effective internal control systems monitor the effectiveness of those systems over time — just as a manufacturing organization monitors the continued effectiveness of its manufacturing procedures. This guidance is designed to help organizations recognize and maximize the use of monitoring when it is effective and enhance monitoring in areas where improvement may be warranted,” and*
- *“To **provide practical guidance that illustrates how monitoring can be incorporated into an organization’s internal control processes**. The “Applying the Concepts” sections in Volume II of the guidance provide easy reference points — demonstrating how organizations might apply the general concepts of monitoring. Volume III goes further by providing a variety of monitoring examples from organizations interviewed during the project.”*

In spite of the stated goals of “effectiveness and efficiency,” we believe the thrust of COSO’s monitoring guidance is effectiveness seen through the prism of an external auditor’s eyes. This is demonstrated through the amount of text devoted to evidentiary type terms common to auditors like persuasive evidence, sufficiency of evidence, and so forth. That is why we strongly recommend, as noted further above, that COSO strive to remain principles-based and practical, and not cause inconsistencies with the many layers of existing regulation companies are already subject to. Additionally, we would like to point out with respect to the first bullet above, that manufacturing organizations not only monitor the effectiveness of their manufacturing procedures, but also monitor their efficiency and we recommend COSO insert ‘and efficiency’ in that paragraph after ‘continued effectiveness’.

Additionally, as to the stated objectives of the guidance, we note:

- COSO’s press release issued on June 4, 2008 said the monitoring ED: “... is designed to assist organizations of any size or structure in **developing efficient means** to monitor the continued operating effectiveness of internal control related to financial reporting, operational, and compliance control objectives... It also includes examples of effective monitoring from a wide variety of organizations observed by the Grant Thornton team.”
- The COSO Chairman’s letter issued with the monitoring guidance states: “The Board believes that **proper implementation of monitoring** can assist greatly in organizations **achieving the dual objectives of improving internal control** while **reducing the costs of gaining continued assurance** that internal control operates effectively.”
- Paragraph 4 in COSO’s Executive Summary states: “COSO observed that some organizations had effective monitoring in certain areas, but were **under-utilizing the results of that monitoring** to support their conclusions about the effectiveness of internal control. Instead, they were **adding redundant (often unnecessary) internal control evaluation procedures** designed to test controls for which management — through its existing monitoring efforts — already had sufficient support. Other organizations were not making the best use of ongoing monitoring procedures, or lacked necessary monitoring procedures altogether, which forced them to implement inefficient year-end evaluations to support their conclusions as of the end of the fiscal year.”

We agree with COSO’s stated goals for this guidance, i.e., including not only effectiveness but also efficiency, leading to potential cost reduction while maintaining effectiveness. However, although many of the recommendations appear reasonable in theory, we note that the proposed guidance was not field tested per se, and we see no evidence that the ED’s guidance will necessarily move the cost-benefit needle to the ‘benefits’ side. (Note: we do not consider the ‘mapping’ of the guidance to examples at

existing companies, or the 'composite' IT example in Volume 3, to be the same thing as a 'field test' aimed at determining relative cost-benefit of applying the proposed standards vs. alternative approaches.)

We recognize that the lack of field testing is not uncommon in the standards-setting environment and among issuers of guidance such as COSO, and we appreciate it can be difficult to find companies or auditors willing to undergo a field test. Nonetheless, standard-setters are others are appropriately being encouraged to move more in the direction of field testing, and we contrast the extensive feedback gathering process that took place when COSO's original 1992 guidance was issued – including, as noted in the Methodology section of the 1992 framework, that five companies were involved in field tests of the 1992 guidance, in addition to receiving over 500 questionnaire responses, 45 interviews conducted, and over 200 comment letters. We recognize that on the current project, Grant Thornton made an extensive effort to try to identify companies to interview, and interviews which they conducted and other client experience provided the basis of the extensive examples in Volume 3 of the guidance. The purpose of our pointing out the relatively more extensive outreach conducted when the original 1992 framework was issued is that there was more of a basis for confidence in the conclusions, vs. assertions made as to likely benefits from some of COSO's more recent projects.

If companies and their auditors are indeed empowered to reduce redundant testing and other redundant and ineffective procedures as a result of COSO's monitoring guidance, while maintaining effective internal control, that would be a significant and worthwhile achievement. However, the ability to accomplish this will depend on COSO's guidance remaining principles-based and practical, and to not create inconsistencies with other regulatory and listing requirements. Additionally, it will depend not only on management and internal auditors implementing the guidance, but also on the ability to negotiate with auditors in determining audit plans that will support the goal of maximizing all-in efficiency and effectiveness by leveraging as appropriate management's work, including in monitoring.

We continue to believe, as we did in support of COSO's 1992 framework, that internal control makes business sense. COSO could also cite as an additional benefit the use of monitoring as an integral part of effective compliance programs under which companies are afforded credit under the U.S. Sentencing Guidelines.

**ATTACHMENT 2 – FEI TFM Response to COSO August, 2008
Response to Detailed Questions**

Copied below are the responses we provided to the 33 questions in COSO's online form at www.coso.org.

Question No.	Yes	Somewhat	No	Comment
1	X			
2				See Attachment 1 to our letter, "major concerns"
3		X		
4			X	See Attachment 1 to our letter, "major concerns"
5		X		See comment to Q13, below.
6		X		
7				See Attachment 1 to our letter, "major concerns"
8		X		
9	X			
10	X			
11		X		
12	X			
13		X		do not be overly limiting on 'objective' given this is guidance for management and company personnel to apply, and, e.g. not all companies (particularly smaller companies) have internal audit functions
14		X		
15		X		
16		X		it is important that this guidance not detract from the flexibility and balance noted in COSO's 2006 small business guidance, that monitoring can be built into ongoing processes, not only added on
17		X		
18		X		We believe the COSO guidance is still 'light' on IT and if significant new material is to be added it should be released for public comment before incorporating it into the final guidance (e.g. for a 30 day comment period). Additionally, the discussion in the IT comprehensive example appears to be relatively theoretical which may reflect that it is not based on real-world application of the guidance by an actual company, but an amalgamation of anecdotal information from the perspective of the Grant Thornton auditors drafting this guidance.
19				See Attachment 1 to our letter, "major concerns"
20		X		
21	X			
22		X		
23				See Attachment 1 to our letter, "major concerns"
24		X		
25		X		
26	X			We especially like the 10 point summary at the end of the Exec. Summary, perhaps that can be made more of a standalone chart up front. However, we also recommend further strengthening of the Exec. Summary and Vol.2 to state this will not necessarily be 'additive' to companies (which otherwise may get that impression due to the sheer length of Vol 2, let alone Vol. 3; see our comments in Attachment 1 to our letter, "major concerns."
27				See Attachment 1 to our letter, "major concerns"
28	X			
29	X			
30	X			It is important to have clear disclaimers that this is not meant to be a one size fits all checklist.
31	X			important to include a disclaimer that examples are illustrative only and portray one way but not the only way to implement the guidance
32		X		
33				See Attachment 1 to our letter, "major concerns"