Committee of Sponsoring Organizations

of the Treadway Commission

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September 19, 2005

Mr. James Thyen
Mr. Herbert Wander
Co-Chair SEC Advisory Committee on Smaller Public Companies
Securities & Exchange Commission
101 F Street NW
Washington, DC 20549-9303

Re: File Number 265-23

Dear Mr. Thyen and Mr. Wander:

I am pleased to provide information to the committee on behalf of the Committee of Sponsoring Organizations of the Treadway Commission (hereinafter referred to as COSO). COSO came into existence in the mid-1980's as our five supporting organizations identified a need to actively address the increase in fraudulent financial reporting that was taking place in the U.S. To that end, the COSO organization sponsored the *National Commission on Fraudulent Financial Reporting*, which is more widely known as the Treadway Commission.

The five sponsoring organizations of COSO are:

- American Accounting Association (AAA)
- American Institute of CPA's (AICPA)
- Financial Executives International (FEI)
- Institute of Internal Auditors (IIA)
- Institute of Management Accountants (IMA)

A History of Large Projects that Stand the Test of Time

Since its start in the mid-1980's, COSO has published five major reports:

- *The National Commission on Fraudulent Financial Reporting*, October, 1987
- *Internal Control, Integrated Framework, 1992*
- *Internal Control Issues in Derivatives Usage,* 1996

- *Fraudulent Financial Reporting 1987 – 1997: An Analysis of U.S. Public Companies, 1999*
- *Enterprise Risk Management – Integrated Framework*, 2004

In process:

- *Internal Control Integrated Framework, Guidance for Smaller Public Companies Reporting on Internal Controls Over Financial Reporting* (exposure draft expected to be issued between Oct 1 and Oct. 15, 2005).

All of our reports, except the guidance on derivatives and the 1999 study on fraud, have gone through an extensive exposure process. The final reports have been adjusted to incorporate the comments made during the exposure process. An overview of the COSO reports is attached as an Appendix to this letter.

The *National Commission on Fraudulent Financial Reporting* made a number of recommendations aimed at improving the quality of financial reporting. Interestingly, many of the recommendations have been enacted – either literally, or in spirit, in the passage of the Sarbanes-Oxley Act of 2002. The Appendix contains an executive summary of those recommendations.

One of the recommendations of the *National Commission on Fraudulent Financial Reporting* was that a comprehensive, integrated framework of internal control should be developed. COSO devoted its resources to the development of the *Internal Control, Integrated Framework* published in 1992. The framework was a breakthrough in thinking because it:

- is comprehensive, i.e. the framework is broader than financial reporting and identifies important control objectives related to operations, and to compliance with regulations and company policies,
- recognizes that internal control is an integrative process that starts with a strong control environment,
- is conceptual and principles based, i.e. it lays out the fundamental characteristics of good internal control without prescribing specific control activities that all companies must perform.

We believe one of the real values of the COSO Internal Control Framework, and one that allows it to stand the test of time, is that it is a principles-based approach to internal control. The framework establishes broad concepts of controls that allow best practices to emerge over time. As an example, it is now an accepted best practice that an audit committee should be composed of independent board members who are knowledgeable about accounting and auditing. COSO did publish a compendium piece in 1992 that provided evaluation tools to assist organizations in implementing the internal control integrated framework.

The COSO *Enterprise Risk Management – Integrated Framework* (ERM) follows the same conceptually-based approach evident in the internal control framework. The risk framework develops objectives related to reporting, not just financial reporting, and adds objectives that relate risk to organizational strategy. Like the internal control framework, the ERM framework does not prescribe specific procedures or approaches that need to be performed. Rather, the framework allows users the ability to tailor risk management principles to their specific circumstances. Similar to the internal control publication, COSO provides examples of how companies have implemented effective risk management.

The 1999 study, *Fraudulent Financial Reporting 1987 – 1997: An Analysis of U.S. Public Companies,* has particular relevance to this committee. That study, by three independent academic researchers, examined AAER actions issued by the SEC during the 11 year period of 1987 – 1997[1]. The authors found that 78% of the actions taken by the SEC for fraudulent financial reporting were against companies with less than $100 million in revenue. They also found that the CEO was involved in the fraud in about 72% of the cases. The companies generally did not have effective oversight; the audit committees often met only once a year. But, and this is important, it was not just the "tone at the top" that was deficient; rather management was able to carry out the fraud because the underlying control structure within the organization was also deficient.

Progress on the Guidance for Smaller Businesses

The current COSO project to develop guidance for smaller businesses represents a departure from the "major conceptual project" approach that COSO has used in the past. We have taken on the project because many smaller businesses wanted more specific guidance in applying the COSO internal control framework. The project began in February. Since that time we have assembled a project task force and held a forum seeking input from various preparers, users, and auditors regarding specific issues the guidance should address.

As we have progressed through the project, we have refined the basic principles embodied in the internal control framework. As shown in the supporting materials, our approach has been to explicitly lay out the underlying (fundamental) principles applicable to the five components of the integrated internal control model. After laying out the principles, we identify specific attributes associated with the principles that help an organization accomplish the principle's objective. The remainder of the document identifies specific approaches that a company can take in accomplishing the principles. We also provide real-world examples of how smaller businesses have implemented specific procedures to accomplish the underlying principle.

We have developed a draft that has been reviewed on a pre-exposure basis by various parties, including the SEC and the PCAOB, and by the task force members. We are

[1] Beasley, Mark, Joe Carcello, and Dana Hermanson, *Fraudulent Financial Reporting 1987 – 1997: An Analysis of U.S. Public Companies.*

currently responding to the comments we have received. Our intent is to have an exposure draft that will be issued for public comment by the first part of October.

As we develop the guidance, it is important to understand that the COSO internal control framework is a principles-based framework. Our approach has been to develop the fundamental concepts of internal control, make recommendations where best practices have emerged, and provide guidance on how an organization might achieve the control objectives. At this point, we have refrained from developing specific checklists for individual companies. We do recognize, however, that the guidance we provide lends itself to the development of checklists. We do not object to the use of such checklists as long as they focus on the accomplishment of the internal control objectives and address the principles of control embodied in the framework. We have refrained from publishing checklists because best practices evolve over time; but the fundamental principles of control do not change. We also believe that internal control can be best accomplished if those in charge of implementing and evaluating the controls actively think about the risks to be mitigated and the control processes to mitigate those risks.

COSO Thoughts on Issues Affecting the Advisory Committee

Our publications have taken the position that accurate, reliable, and transparent financial reporting should be an objective of all organizations – not just public companies, not just corporations, not just large or small companies. Reliable and transparent financial reporting is part of the stewardship function that is owed by an organization to its stockholders and other stakeholders. Developing good internal control that serves that objective should be part and parcel of every organization's activities. With that in mind, we offer the following specific comments:

Reports on the Quality of Internal Control Ought to be Required of All Public Companies. This is a recommendation that was made in the original Treadway Commission Report. Our research on fraudulent financial reporting during the decade of the 1987 – 1997 indicates that fraudulent financial reporting took place in greater proportion in smaller companies than in larger companies. While the amounts in small company frauds may not be as large as in the recent scandals, the amounts are certainly important to those individual or organizations that invested in those companies. The extent of the fraudulent financial reporting in these smaller companies is just too large to ignore. We believe that exempting such companies from the internal control reporting requirement is counter-productive and inconsistent with the research that has been performed. One interpretation of the costs in implementing 404 in smaller companies is that the costs are simply too large. However, there is an equally compelling interpretation: the costs are large because companies have not sufficiently invested in their control infrastructure.

Internal Control is a Pervasive Concept that Should be Built into the Fabric of the Organization. The *Internal Control, Integrated Framework* is aptly named because the framework is intended to work as an integrated model of internal control. One control element by itself, without the effective operation of the other elements, is not internal control. A strong control environment, by itself, will not necessarily lead to effective internal control if strong transactions controls are not established over transaction execution, the accounting closing process, or in making accounting estimates.

Evaluating only the Control Environment or the Tone at the Top is Risky. As noted above, the internal control framework is based on all of the parts working together. If history has taught us anything, it is that it is difficult to judge a management that is intent on fooling the auditors or the investing public. Further, history has also taught us that a risk-based approach must be founded on an understanding of control processes. In personal correspondence with Dana Hermanson, one of the co-authors of the 1999 study on fraud, he responded to my question on a recommendation to focus the control evaluation on the control environment and substantive testing as follows:

> *"I think this can be a risky strategy because of the great potential for management override of controls. If you only assess the control environment and you "guess wrong", then the managers can have a field day overriding the weak internal controls without auditors knowing where the "weak spots" are in the control processes."*[2]

We would further point out that the criteria for only evaluating the control environment does not exist by itself because the COSO internal control framework is comprehensive and is based on all of the components working together.

The Incidence of Fraudulent Financial Reporting in Smaller Businesses Continues. In a study currently underway, Joe Carcello, one of the authors of the 1987 – 1997 study on fraudulent financial reporting, is working with two new colleagues to examine the incidence of AAER's issued during the period of January 1998 to December 2003. He reports:

- AAER's were issued related to 160 different company's alleged frauds,
- 130 of the 160 companies could be identified on Compustat[3],
- Only 96 had market cap data available on Compustat,
- Of the 96:
  - 39 had a market cap below $100 million.
  - 33 had a market cap between $100 million and $700 million,
  - 24 had a market cap over $700 million.

The data are compelling; 75% of the firms where AAER's were issued to smaller firms. His view is that exempting such firms from Section 404 would leave investors, particularly minority investors, unprotected[4].

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[2] Personal correspondence with Dana R. Hermanson, one of the coauthors of the *Fraudulent Financial Reporting 1987 – 1997: An Analysis of U.S. Public Companies, September 18, 2005.*
[3] Compustat is a widely used database of financial reporting. If a company cannot be found on the Compustat database, it is most likely a smaller company.
[4] Personal correspondence with Joe Carcello about research in progress.

Management should Monitor and Evaluate the Quality of its Internal Controls on a Frequent Basis. Internal control is best when it is built into the organization and its processes. Management can most effectively and efficiently manage internal control when it develops, documents, and periodically assesses the effectiveness of its internal control structure. The COSO *Internal Control, Integrated Framework* stresses the importance of building an information system that identifies deviations from effective controls. Management needs to monitor the design and operating effectiveness of the other elements of internal control on a regular basis through exception reports and periodic performance analyses, and then periodically through other monitoring activities such as internal auditing. Integrating internal control into the organization and monitoring the effectiveness of it throughout a year is both (a) more effective, and (b) less costly than performing an evaluation of internal control only on a periodic basis. In fact, as described below, an effective monitoring program of the internal control system should provide management with sufficient evidence to make its 404 assertion without performing a separate assessment or additional testing.

The Cost of Poor Internal Control is Large. The Treadway Commission made this point in 1987. Lynn Turner, in other testimony and other presentations to the SEC, cites numerous examples of both large and small companies where very large costs are incurred when a company has control deficiencies that lead to either restatements or corporate failures. Academic research, such at that by Palmrose et. al., finds a negative cumulative abnormal return of -20% when a restatement due to fraud is announced (days 0, 1), and -6% when the restatement doesn't involve fraud. [5] Other research by Palmrose et. al. shows an absolute drop in share price of 11% when a restatement is announced and 22% when the restatement involves fraud.[6]

Small Businesses can Tailor Specific Control Processes to their Unique Circumstances. The analysis of the current COSO task force reemphasizes that the fundamental principles of internal control allow each organization to tailor specific control elements to their organization. The analysis performed by the Task Force reinforces the concept that good internal control is good business. The costs that companies seem to complain about (at least as we heard) focus on the cost of documenting the controls and testing the controls. However, adequate documentation and standardization of control procedures lead to long-term cost advantages by companies in training and ultimately lower operating costs. Standardizing documentation procedures should reduce future documentation costs. The upcoming guidance provides numerous examples of how smaller businesses can implement effective internal controls in a cost-effective manner.

Businesses, including smaller businesses, can tailor their controls to be cost effective. One of the challenges that small businesses often face is inadequate segregation of duties. However, rather than assuming that it is always a deficiency, the smaller business should

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[5] Palmrose, Zoe-Vonna, Vernon J. Richardson, and Susan Scholz, "Determinants of Market Reaction to Restatement Announcements", Journal of Accounting and Economics 27 (2004), p. 73

[6] Palmrose, Zoe-Vonna and Susan Scholz, "The Circumstances and Legal Consequences of Non-GAAP Accounting", Contemporary Accounting Research, Vol. 21, No. 1, (Spring 2004), p. 153.

look at monitoring controls, independent review, or other compensating controls that would mitigate the risk associated with inadequate segregation of duties.

One word of caution regarding small businesses – internal control concepts are pervasive. Thus, basic control concepts such as a strong tone at the top, periodic reconciliation of account detail to account balances, and monitoring of the design and operating effectiveness of the other elements of internal control are applicable to all organizations. Thus, while there will be differences in approaches by smaller companies, there will also be many similarities with larger companies.

The Initial Benefits of Section 404 are Readily Apparent, but Not Easily Measured. There have been a number of studies on the benefits of Section 404. They range from early reports of approximately 8 – 10% of public companies receiving adverse reports on internal control. A study by Rittenberg and Miller[7] shows significant improvements in internal control that are attributable to 404 work. Many of the deficiencies were remediated before reports on internal control were provided. Many companies reported a more active control environment, including improvements in audit committee oversight activities, as well as fundamental improvements in areas such as segregation of duties and account reconciliations. A fuller report that summarizes benefits and costs of internal control reports can be found in an article by Hermanson.[8]

Small Businesses Can Find Effective Ways to Implement Good Internal Control. The task force examined the "economies of scale curve" as it is associated with smaller businesses and noted that smaller businesses find effective ways to compete against other larger companies that benefit from greater economies. The task force identified a number of ways in which smaller businesses can address accounting and control issues – some through compensating controls that focus on detection rather than preventive controls, outsourcing arrangements, retainer relationships with accounting experts, or hiring personnel on a temporary basis. Companies can utilize their auditors, to the extent permitted by standards, as a resource in dealing with accounting and control issues.

Monitoring should be Emphasized as Companies move Forward. Much of the work performed in the current year has focused on documenting, evaluating, testing, and then re-evaluating the effectiveness of internal controls over financial reporting. In many instances this was necessary because some companies had not invested in their control infrastructure. In other cases, it was necessary to set a benchmark against which future control states could be measured. As companies invest in the control structure and gain confidence in its reliability, the COSO internal control framework suggests that companies should place more emphasis in building more robust monitoring processes as an efficient way to assess the reliability of its internal controls over financial reporting.

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7 Larry Rittenberg and Patty Miller, *Sarbanes-Oxley Section 404 Work: Looking at the Benefits*, Institute of Internal Auditors Research Foundation, 2005.

8 Dana Hermanson, Is the Sarbanes-Oxley Act Worth It? Internal Auditing 2005 (July / August): 33-35.

COSO: LOOKING INTO THE FUTURE

COSO has existed as a 'virtual organization' for the past 20 years with a focus on large projects. With the advent of Section 404 of the Sarbanes-Oxley Act of 2002, we plan on devoting a significant amount of time during the next year to address strategic planning. As Chair of COSO, I can say that I take great pride in the foresight and commitment of the sponsoring organizations to improve the effectiveness of financial reporting, governance, risk management, and control. COSO has been able to take positions that have pushed the business community and accounting profession forward in its thinking about fraudulent financial reporting, control, risk, and governance. It will continue to do so in the future and we will start with a strategic planning process later this year.

Next Project

The COSO Board has discussed a future project related to enhancing the business community's understanding of monitoring controls. The feedback we have received during the current project reiterates the importance of better understanding monitoring controls. However, there are a number of other projects that relate to better integrating internal control across operations, standardizing control objectives and procedures, leveraging information technology, as well as others not mentioned, that can be addressed.

COSO is pleased to have the opportunity to discuss our work with the Committee. We are committed to our major mission of improving the effectiveness of business through improved control, risk management, and governance processes.

Sincerely,

Larry E. Rittenberg

Larry E. Rittenberg
Chair

SEC Advisory Committee on Smaller Public Companies
Public Testimony Session – Tues. Sept. 20, 2005
Questions for Larry Rittenberg, COSO Chair's Witness Testimony to the Advisory Committee

The committee is looking for input from COSO on application of SOX404 to Smaller Public Companies. These questions reflect some of the areas we have been addressing, but should not be considered as limiting to your testimony. We have provided a summary background to help frame the questions (see attached). We expect many of these questions will be considered and reflected in your prepared remarks and as a result may no longer be relevant for the Q&A session.

Goal/Purpose of COSO Small Business Guidance (overview and insight into the COSO small business guidance process)

1) What did the SEC ask COSO to do with respect to COSO's small business project?

   a. Did COSO achieve this goal?
   b. Were there any constraints on COSO's ability to achieve this goal that reside in the regulatory framework itself – e.g. how much of the burden on small business do you think is attributable to the legislation (Sarbanes-Oxley Section 404) vs. the SEC rule for the management report, PCAOB's AS2, and COSO?

Response: *We were asked to prepare guidance that will help smaller businesses implement the COSO Internal Control Integrated Framework. We believe we have accomplished that objective. However, it is important to realize that internal control is fundamental to all businesses and controls recommended for smaller businesses would appear to be very much like controls recommended for larger businesses. We did not feel any constraints in performing our work. In some ways, I believe the biggest constraint we faced is one of an "expectations gap", i.e. many parties interested in smaller businesses are looking for a "COSO – Lite" – a simpler framework that applies to smaller businesses. Internal controls can, and should be, tailored to the circumstances of each organization, but the essential principles of internal control are the same for all businesses.*

2) What was COSO's goal for this project?

   a. For example, was COSO's goal to create more controls for small business?
   b. Did COSO achieve these goals?

Response: *COSO's goal was to provide more detailed assistance to smaller businesses. We did not feel it necessary to develop or create new controls for smaller businesses. Rather, we detailed the principles that underlie the basic structure of the Internal Control Integrated Framework (COSO ICIF) and lay out approaches that smaller businesses might choose in achieving those principles. However, as noted earlier, it still requires thought on the part of those designing and implementing the controls to anticipate risks and implement the most cost-effective controls to address those risks. We believe we have met that goal.*

Cost/Benefit of COSO's Small Business Guidance

3) How does COSO's draft guidance for small business differ from the original COSO 1992 framework in terms of:

    a. Cost. Will complying with the small business guidance cost companies more, or less, than the original framework, and why?
    b. Complexity vs. simplicity
    c. Level of documentation
    d. Formal vs. informal controls
    e. Operationally – is the guidance specific enough, practical?

Response: *In some ways, the market will tell us whether or not we met this test. I will address each of your sub-parts:*

a. *<u>We did not develop a new framework</u>. The guidance provides more clarity regarding implementation of the internal control framework and we believe the clarity should reduce overall costs. However, we should also recognize that the guidance is based on the on the COSO Internal Control Integrated Framework. To the extent that companies have already embraced the concepts in the framework, their cost reduction will likely be less. .*

b. *<u>Complexity vs. Simplicity</u> often relates to the types of transactions that an organization enters into. For example, if an organization becomes involved in hedging transactions against foreign currencies, or takes speculative positions with financial derivatives, those transactions are inherently complex and highly risky. The increase in risk ought to require controls that effectively mitigate those risks. Thus, the controls mirror the risks that the organization takes. Companies with generic transactions, a single location, and defined market approaches, can have relatively simple controls. Companies with complex transactions require more complex controls. The concepts here are the same as in the 1992 document because the concepts of effective internal control has not changed.*

c. *The <u>level of documentation</u> is addressed in our guidance. Our analysis is driven by two fundamental points:*

- *Some level of documentation is necessary for companies to ensure that their controls are (a) understood, and (b) implemented consistently and efficiently across the organization. That level of documentation should enhance the effectiveness of internal control.*

- *Further levels of documentation relate to the need to publicly report by management, and publicly attest to that report by external auditors. As the public accountability for stewardship over the organization's assets increases and independent attestation is recommended, then significant control processes should be documented and there must be some way to provide evidence that the controls are working effectively.*

d. *We do talk about <u>'formal vs. informal'</u> controls and provide examples where informal controls (a) can be effective, and (b) can be documented efficiently. For example, a company can provide evidence of its ethical behavior by posting a* *statement of values in prominent places. A CEO can document actions taken in a secretary's notebook. However, controls that deal with high complexity or high volumes of transactions can, and should be, documented to ensure that they are understood and are uniformly implemented. There is more discussion of documentation in the upcoming guidance than there was in 1992.*

e. *Practicality of the Guidance.* *As noted earlier, the guidance is practical, but it is not a panacea, nor is it a "Cliff's Notes version" for those who want a simple 'check the box' approach to implementing effective internal control. Cost effectiveness is attained when companies think proactively about the risks associated with financial reporting and implement controls to deal with those risks. While we have provided an overview checklist that will help an entity organize its approach to implement effective controls, it still requires practical implementation by management. As noted in my letter to the committee, the reason we focus on the fundamental principles is that the market will develop "best or better practices" to accomplish a control objective over time. We do not want to hinder that innovative process for implementing effective controls.*

4) What incremental benefit is there to small businesses in implementing COSO's draft guidance for small business versus the original (1992) COSO framework? What incremental benefit is there to the investing public?

Response: *The benefit to smaller businesses is that the new guidance sharpens the underlying principles on which the COSO ICIF is built. It is more specific in many places and we believe that it will help small businesses, as well as other organizations, in better implementing effective internal control. The increased clarity should help the investing public in analyzing a company's report on internal control over financial reporting.*

As noted in my letter, the Treadway Commission had recommended public reports on internal controls by public companies. That recommendation applies to all public companies. We believe the empirical evidence amassed over the past two decades, including the study sponsored by COSO, reinforces the recommendation of the Treadway Commission.

Expected Timing and Extent to Which Coordinated with Actions of SEC Advisory Committee

5) What is COSO's expected timing for issuance of Exposure Draft, comment period, and issuance of final standard?

Response: *We hope to issue the Exposure Draft some time between October 1 and October 15 of this year. Our intent is to have a 60 day comment period followed by a short time for us to digest and respond to the comments. Our intent is to issue the final guidance in the first quarter of 2006.*

6) To what extent will actions of the SEC Advisory Committee and any related action by the SEC impact COSO, to what extent is COSO running parallel to such SEC actions, e.g.:

a. If SEC grants an additional year delay for non-accelerated filers to file their Section 404 internal control reports, will COSO adjust the timing of release of its documents?
b. To what extent does COSO's small business guidance rely on or parallel the current regulatory framework. To the extent that the SEC Advisory Committee has been charged with recommending any improvements to the regulatory framework, for Section 404 and otherwise, to make regulation more cost-beneficial for small public companies, how will COSO reflect such changes? Will COSO issue its guidance prior to the SEC Advisory Committee's April 2006 final recommendations, or will COSO hold off to consider those recommendations and any further guidance that may follow?

Response: *These are good questions. We have been requested to provide more detailed guidance for smaller businesses. Our intent is to issue the exposure draft as soon as practicable, elicit feedback, consider that feedback, and issue final guidance some time early next year. We believe having the guidance available to businesses as soon as possible will assist them in addressing their implementation and reporting obligations – whether those reporting obligations be delayed one year or not.*

COSO plans on working closely with the SEC in determining the issuance of our guidance, as well as responding to requests for additional guidance. We will work with the SEC and your committee regarding key issues that we may want to mutually address before issuing our reports.

Due Process

7) Explain due process undertaken by COSO and its task force.

Response: *As indicated, it is our intention to publicly expose the draft guidance for public comment in October this year. To ensure the widest possible circulation of the exposure draft, we plan on making the report publicly available on our web site. We plan to send hard copies of the document to regulatory agencies, including the SEC, the PCAOB, the GAO, as well as other interested parties. We are in the process of compiling a list of potentially interested parties. We will issue a press release and will reach out to as many of the smaller SEC registrants as we can reach to elicit feedback. We will have a form which should facilitate response to the proposed guidance. Parties will be able to respond via web, via email, or by paper. Each party will indicate whether or not they are giving permission to have their responses made publicly available (with or without their name attached).*

8) Will COSO hold public hearings on its Exposure Draft; will it be webcast to accommodate small businesses that do not have staff or budget to attend in person?

Response: *We have not planned on holding hearings regarding the exposure draft. Although not currently contemplated, we will reconsider the need for a public hearing based upon the responses to the exposure draft. We believe that the exposure draft will merit serious consideration by smaller businesses. We will treat all comments seriously and will indicate in a public document how we have responded to the major comments that we have received.*

Questions in Support of the SEC Advisory Committee's Process

9) We are considering an alternative control environment focused model (the CE Model) for evaluating internal controls at smaller companies. The question is whether the CE Model is a potential viable alternative for smaller companies and whether it is something COSO could explore further?

    a. Would COSO be supportive of an SEC Advisory Committee recommendation to develop a more limited scope approach for management's assessment and the auditor's opinion on internal control for small companies, such as focusing on the Control Environment and/or Monitoring Components of the COSO framework?

Response: *While we are certainly supportive of a strong control environment, we do not believe that a smaller public entity can achieve effective internal control over financial reporting by focusing and testing only one element of the internal control framework. The COSO ICIF is an integrated framework and all elements must be designed and working effectively together to have an effective system of internal control over financial reporting. As an example, a company might have a great control environment, but the strength of that environment might not be translated into the processing controls of the organization. Human error can occur. Computer systems may become infected by viruses, or deliberate manipulation by one bad person. The strong control environment needs to be complemented by strong processing controls.*

Additionally, we would question how management (and auditors) could assert that its control environment was effective without evaluating the design and operating effectiveness of other elements? If, for example, management simply ignored the design of controls, wouldn't that be evidence of a weakness in the control environment?

As noted earlier, we do think there is considerable potential in focusing more on monitoring controls as we move forward. Effective monitoring controls will signal problems and the need for corrective action by management. A strong control environment, coupled with effective monitoring controls, can take on added importance for smaller businesses. We believe that greater cost efficiency can be achieved as companies get their basic control processes in place and then monitor them effectively.

As stated earlier, we believe it will take time to fully measure the costs and benefits of testing the design and operating effectiveness of internal control over financial reporting. The initial evidence is not strong enough to make a decision on the cost-effectiveness. However, as pointed out in my letter, there is a long history that the costs of ineffective internal controls over financial reporting are large. Should the SEC or the PCAOB wish to discuss with us the advantages and disadvantages of a limited scope engagement, we would be most happy to meet with them.

10) Has COSO been able to identify what is unique about small business in terms of internal control, and how they should be able to assess, and have their auditors opine on, internal control? Our understanding is that the current COSO project is meant to fit within the existing internal control audit standards - i.e. that it would not result in a change to AS2, whereas the CE Model would necessitate changes to AS2. Are there conflicts between these 2 statements?

Response: *We had hoped to find more things that are unique about smaller businesses in applying controls than we did. However, as we have reflected on it, we have concluded that the reason we have not found more uniqueness is that internal control is a process and all organizations must address internal control from the process view. The uniqueness of small businesses is often in the span of control of management, the informality of some controls (typically at the control environment level), smaller staffs devoted to the financial and reporting process and the challenges related to high fixed costs for some accounting or audit services (which we have addressed). On the other hand, to the extent that a smaller business is less complex, then they can have a less sophisticated control structure.*

I think there are two important point that seems to be missed when talking about smaller public businesses. First, there have been many cases in which smaller businesses have attempted to become larger and have failed. They have often failed because they had not invested in the control infrastructure that allows them to grow. Thus, in the quest to find relief for these smaller businesses, we (collectively) might actually be doing them a disservice. Good internal controls are built into the organization; they cannot just be 'turned on' when a company gets bigger. Second, these companies have voluntarily chosen to access the public capital markets and the providers' of this capital expect these entities to provide reliable financial reports. Creating multiple meanings of what it means to have effective internal control over reliable financial reporting will lead to confusion and a dilution in the accountability of management and the board to providers' of capital.

11) Within small companies in particular, a large portion of the evidence with respect to the effective of internal controls, including the control environment, comes from results of the financial statement (F/S) audit. In an approach where the auditor only tests the control environment, the auditor should still get substantial evidence on the effectiveness of internal controls and the control environment through the F/S audit. Many of the material weaknesses identified to date were identified as a result of substantive testing. Should substantive testing be an equally important element of an auditor's identification of deficiencies in the control environment? Can COSO play a role in providing additional guidance to auditors with respect to identification and assessment of indicators of deficiencies in the control environment while performing the substantive audit?

Response: *We concur that auditors often find out information about internal control through their substantive tests of account balances. We believe it is an important part of the evaluation of internal control and we would be happy to explore areas where substantive testing may be helpful in analyzing controls. However, we do feel there are limitations in relying only on a substantive testing approach to evaluate controls. Auditors have been required to link internal control assessments to the direct tests of account balances. Weaknesses or deficiencies in controls signal areas that auditors should examine more carefully. The assessment of internal control deficiencies is an integral part of auditing and is not separate from substantive testing. I believe these concepts are consistent with the risk-based and integrated audit approach that has been recommended by the SEC and PCAOB.*

We believe our COSO guidance about internal control over financial reporting will be helpful to auditors as well as preparers. While we can provide more guidance, and do *more research that links the control environment to patterns of weaknesses, we are respectful that the issuance of auditing standards and guidance relative to audits of public companies belongs with the PCAOB. I would also caution the committee to exercise restraint in this area.*

My personal research shows that many companies found control deficiencies during the initial process of documenting, evaluating and testing internal controls. There were opportunities for many of those control deficiencies to be remediated before year end. Thus, we caution the committee from focusing only on the last stage of audit testing.

We believe that over time auditors will become better at identifying control deficiencies and their processes will improve. We would suggest exercising caution in focusing only on substantive testing to identify control deficiencies.

The absence of misstatements also provides evidence that controls are operating effectively. For larger companies we understand that the evidence provided is not in itself sufficient. However, for smaller companies, does the absence of misstatements detected by substantive procedures provide a more significant level of evidence that the control environment is effective?

<u>**Response:** *We do not concur that the absence of misstatements provides evidence that internal controls are operating effectively.*</u> *We have known for years that some companies can have financial statements that are free from material misstatements even though they do not have adequate segregation of duties. We are also aware that such companies can have massive frauds that will go undetected in the following year because they have trusted individuals in the organization who take advantage of the weaknesses in the system.*

12) We are looking for 'best practices tools' for companies and examples and are interested in the role COSO could play. Some of this may already be coming out in your exposure draft? For example

    a. Internal control testing approaches
    b. Documentation pf design and evaluation
    c. Testing approaches
    d. Compliance guidelines

Response: *Our guidance provides detailed examples, from real world companies that should help the businesses. We do not focus on testing approaches. We do provide guidance on monitoring of internal controls by management. Monitoring includes both continuous-type assessments as well as one-time assessments.*

Report to the SEC Small Business Advisory Committee

September 20, 2005
San Francisco

Larry E. Rittenberg
Chair, COSO
E&Y Professor of Accounting and Information Systems at University of Wisconsin-Madison

Treadway Commission Report

OVERVIEW:

The National Commission on Fraudulent Financial Reporting issued its report in October, 1987. The Commission's report, often referred to as the Treadway Commission named after its chair, was the first effort by the sponsoring organizations of COSO. Those organizations include:

- American Accounting Association (AAA)
- American Institute of CPA's (AICPA)
- Financial Executives International (FEI)
- Institute of Internal Auditors (IIA)
- Institute of Management Accountants (IMA)

Those organizations recognized a significant problem in the quality of financial reporting that existed at that time. In many ways, the recommendations of the Commission parallel many of the requirements that were enacted into law with the Sarbanes-Oxley Act of 2002. Included among the recommendations that are directly applicable to Section 404 of the Sarbanes-Oxley Act were:

- Management should accept responsibility for, and maintain, an effective system of internal control over financial reporting, and should develop an effective system to ensure compliance with the organization's code of ethics.
- Management should publicly report on that system of internal control.
- The external auditor should attest to the public reports on internal control.
- COSO should sponsor a second project to develop a comprehensive, integrated framework to assist organizations in evaluating their internal control.
- Public companies needed active, competent, and independent audit committees.

MAJOR OBJECTIVES:

The Commission had three major objectives:

1. Consider the extent to which acts of fraudulent financial reporting undermine the integrity of financial reporting; the forces and the opportunities, environmental, institutional, or individual, that may contribute to these acts; the extent to which fraudulent financial reporting can be prevented or deterred and to which it can be detected sooner after occurrence; the extent, if any, to which incidents of this type of fraud may be the product of a decline in professionalism of corporate financial officers and internal auditors; and the extent, if any, to which the regulatory and law enforcement environment unwittingly may have tolerated or contributed to the occurrence of this type of fraud.

2. Examine the role of the independent public accountant in detecting fraud, focusing particularly on whether the detection of fraudulent financial reporting has been neglected or insufficiently focused on and whether the ability of the independent public accountant to detect such fraud can be enhanced, and consider whether changes in auditing standards or procedures -- internal and external – would reduce the extent of fraudulent financial reporting.

3. Identify attributes of corporate structure that may contribute to acts of fraudulent financial reporting or to the failure to detect such acts promptly.

Accountability

When a company raises funds from the public, that company assumes an obligation of public trust and a commensurate level of accountability to the public. If a company wishes access to the public capital and credit markets, it must accept and fulfill certain obligations necessary to protect the public interest. One of the most fundamental obligations of the public company is the full and fair public disclosure of corporate information, including financial results.

Three Relevant Factors

Even though precise quantification proved to be impossible, the Commission concluded that three other factors are relevant: (1) the seriousness of the consequences of fraudulent financial reporting, (2) the risk of its occurring in any given company, and (3) the realistic potential for reducing that risk.

Consequences of Fraudulent Financial Reporting. First, when fraudulent financial reporting occurs, serious consequences ensue. The damage that results is widespread, with a sometimes devastating ripple effect. Those affected may range from the immediate victims-the company's stockholders and creditors-to the more remote-those harmed when investor confidence in the stock market is shaken. Between these two extremes, many others may be affected: employees who suffer job loss or diminished pension fund value; depositors in financial institutions; the company's underwriters, auditors, attorneys, and insurers; and even honest competitors whose reputations suffer by association.

Risk of Occurrence. To assess the risk that fraudulent financial reporting may occur, the Commission analyzed its causes. We concluded that the causal factors, the forces and opportunities that were present in numerous SEC enforcement cases, are present to some extent in all companies. No company, regardless of size or business, is immune from the possibility that fraudulent financial reporting will occur. That possibility is inherent in doing business.

Realistic Potential for Reducing Risk. We believe a realistic potential exists for reducing the risk of fraudulent financial reporting, provided the problem is considered and addressed as multidimensional. The problem's multidimensional nature becomes clear when we merely consider the many participants who shape the financial reporting process: the company and its management, the independent public accountant, regulatory and law enforcement agencies, and even educators. Each one has the potential to influence the outcome of the financial reporting process. Thus we believe that a multidimensional approach that analyzes and addresses the role of each participant has the maximum potential for reducing the incidence of fraudulent financial reporting.

Participants in the Financial Reporting Process

The responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management-starting with the chief executive officer-sets the tone and establishes the financial reporting environment. Therefore, reducing the risk of fraudulent financial reporting must start within the reporting company.

We have identified a number of practices already in place in many companies that can help all public companies meet their responsibilities and reduce the incidence of fraudulent financial reporting. One key practice is the board of directors' establishment of an informed, vigilant and effective audit committee to oversee the company's financial reporting process. Another is establishing and maintaining an internal audit function.

Report of the National Commission on Fraudulent Financial Reporting

October 1987

SUMMARY OF RECOMMENDATIONS

This summary is a synopsis of the organization and content of the Commission's recommendations, which appear in Chapters Two through Five of the report. The Commission urges readers to consider the recommendations along with the accompanying text, which explains, adds guidance, and in certain cases makes ancillary recommendations.

I. Recommendations for the Public Company (Chapter Two)

Prevention and earlier detection of fraudulent financial reporting must start with the entity that prepares financial reports. Thus the first focus of the Commission's recommendations is the public company. These recommendations, taken together, will improve a company's overall financial reporting process and increase the likelihood of preventing fraudulent financial reporting and detecting it earlier when it occurs. For some companies, implementing these recommendations will require little or even no change from current practices; for other companies, it will mean adding or improving a recommended practice. Whether it means adding or improving a practice, the benefits justify the costs. The Commission's recommendations for the public company deal with (1) the tone set by top management, (2) the internal accounting and audit functions, (3) the audit committee, (4) management and audit committee reports, (5) the practice of seeking second opinions from independent public accountants, and (6) quarterly reporting.

The Tone at the Top

The first three recommendations focus on an element within the company of overriding importance in preventing fraudulent financial reporting: the tone set by top management that influences the corporate environment within which financial reporting occurs. To set the right tone, top management must identify and assess the factors that could lead to fraudulent financial reporting; all public companies should maintain internal controls that provide reasonable assurance that fraudulent financial reporting will be prevented or subject to early detection-this is a broader concept than internal accounting controls-and all public companies should develop and enforce effective, written codes of corporate conduct. As a part of its ongoing assessment of the effectiveness of internal controls, a company's audit committee should annually review the program that management establishes to monitor compliance with the code. The Commission also recommends that its sponsoring organizations cooperate in developing additional, integrated guidance on internal controls.

Internal Accounting and Audit Functions

The Commission's recommendations turn next to the ability of the participants in the financial reporting process within the company to prevent or detect fraudulent financial reporting. The internal accounting function must be designed to fulfill the financial reporting responsibilities the corporation has undertaken as a public company. Moreover, all public companies must have an effective and objective internal audit function. The internal auditor's qualifications, staff, status within the company, reporting lines, and relationship with the audit committee of the board of directors must be adequate to ensure the internal audit function's effectiveness and objectivity. The internal auditor should consider his audit findings in the context of the company's financial statements and should, to the extent appropriate, coordinate his activities with the activities of the independent public accountant.

The Audit Committee

The audit committee of the board of directors plays a role critical to the integrity of the company's financial reporting. The Commission recommends that all public companies be required to have audit committees composed entirely of independent directors. To be effective, audit committees should exercise vigilant and informed oversight of the financial reporting process, including the company's internal controls. The board of directors should set forth the committee's duties and responsibilities in a written charter. Among other things, the audit committee should review management's evaluation of the independence of the public accountant and management's plans for engaging the company's independent public accountant to perform management advisory services. The Commission highlights additional important audit committee duties and responsibilities in the course of discussing other recommendations affecting public companies.

Management and Audit Committee Reports

Users of financial statements should be better informed about the roles management and the audit committee play in the company's financial reporting process. The Commission recommends a management report that acknowledges that the financial statements are the company's and that top management takes responsibility for the company's financial reporting process. The report should include management's opinion on the effectiveness of the company's internal controls. The Commission also recommends a letter from the chairman of the audit committee that describes the committee's activities, Both of these communications should appear in the annual report to stockholders.

Seeking a Second Opinion and Quarterly Reporting

Finally, the Commission's recommendations for the public company focus on two opportunities to strengthen the integrity of the financial reporting process. Management should advise the audit committee when it seeks a second opinion on a significant accounting issue, explaining why the particular accounting treatment was chosen. The Commission also recommends additional public disclosure in the event of a change in independent public accountants. Furthermore, the Commission recommends audit committee oversight of the quarterly reporting process.

II. Recommendations for the Independent Public Accountant (Chapter Three)

The independent public accountant's role, while secondary to that of management and the board of directors, is crucial in detecting and deterring fraudulent financial reporting. To ensure and improve the effectiveness of the independent public accountant, the Commission recommends changes in auditing standards, in procedures that enhance audit quality, in the independent public accountant's communications about his role, and in the process of setting auditing standards. On February 14, 1987, the Auditing Standards Board (ASB) exposed for comment a series of proposed auditing standards that address many issues the Commission considered. The Commission commends the ASB for its efforts in these exposure drafts, some of which are responsive to Commission concerns.

Responsibility for Detection and Improved Detection Capabilities

Generally Accepted Auditing Standards (GAAS) should be changed to recognize better the independent public accountant's responsibility for detecting fraudulent financial reporting. The standards should restate this responsibility to require the independent public accountant to take affirmative steps to assess the potential for fraudulent financial reporting and design tests to provide reasonable assurance of detection. Among the affirmative steps recommended is assessment of the company's overall control environment along with improved guidance for identifying risks and designing audit tests. In addition, the independent public accountant should be required to make greater use of analytical review procedures, to identify areas with a high risk of fraudulent financial reporting. The independent public accountant also should be required to review quarterly financial data before its release, to improve the likelihood of timely detection of fraudulent financial reporting.

Audit Quality

Improved audit quality increases the likelihood of detecting fraudulent financial reporting. In this regard, the Commission makes three recommendations. The first two are designed to improve two aspects of the profession's existing quality assurance program. Peer review should be strengthened by adding reviews, in each office reviewed, of all first-year audits performed for public company clients that were new to the firm. Concurring, or second partner, review should be enhanced by adding more explicit guidance as to timing and qualifications. In the third recommendation, the Commission encourages greater sensitivity on the part of public accounting firms to pressures within the accounting firm that may adversely impact audit quality.

Communications by the Independent Public Accountant

Independent public accountants need to communicate better to those who rely on their work. The auditor's standard report can and should convey a clearer sense of the independent public accountant's role, which does not include guaranteeing the accuracy of the company's financial statements. The standard audit report should explain that an audit is designed to provide reasonable, but not absolute, assurance that the financial statements are free of material misstatements arising as a result of fraud or error. It also should describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. These two steps will promote a better appreciation of an audit and its purpose and limitations and underscore management's primary responsibility for financial reporting.

Change in the Process of Setting Auditing Standards

Finally, the Commission recommends that the process of setting auditing standards be improved by reorganizing the AICPA's Auditing Standards Board (ASB). The Commission believes that the setting of auditing standards should involve knowledgeable persons whose primary concern is with the use of auditing products as well as practicing independent public accountants, Such individuals would have particular sensitivity to the operating implications of auditing standards and to emerging policy issues concerning these standards. The recommendation contemplates a smaller ASB, composed of equal numbers of practitioners and qualified persons not presently engaged in public accounting and led by two full-time officers, that would look beyond the technical aspects of auditing and set an agenda reflecting a broad range of needs, serving public and private interests, The agenda would be implemented by auditing standards of continuing high technical quality, and the ASB would adopt these standards on the basis of their technical quality and their addressing these public and private needs.

III. Recommendations for the SEC and Others to Improve the Regulatory and Legal Environment (Chapter Four)

Strong and effective deterrence is essential in reducing the incidence of fraudulent financial reporting. While acknowledging the SEC's significant efforts and achievements in deterring such fraud, the Commission concludes that the public- and private-sector bodies whose activities shape the regulatory and law enforcement environment can and should provide stronger deterrence. The Commission's recommendations for increased deterrence involve new SEC sanctions, greater criminal prosecution, improved regulation of the public accounting profession, adequate SEC resources, improved federal regulation of financial institutions, and improved oversight by state boards of accountancy. In addition, the Commission makes two final recommendations in connection with the perceived insurance and liability crises.

New SEC Sanctions and Greater Criminal Prosecution

The range of sanctions available to be imposed on those who violate the law through fraudulent financial reporting should be expanded. Congress should give the SEC additional enforcement tools so that it can impose fines, bring cease and desist proceedings, and bar or suspend individual perpetrators from serving as corporate officers or directors, while preserving the full range of due process protections traditionally accorded to targets of enforcement activities. Moreover, with SEC support and assistance, criminal prosecution for fraudulent financial reporting should be made a higher priority.

Improved Regulation of the Public Accounting Profession

Another regulatory function, the regulation of the public accounting profession, seeks to reduce the incidence of fraudulent financial reporting through ensuring audit quality and thereby enhancing early detection and prevention of such fraud. The Commission studied the existing regulation and oversight, which includes the profession's quality assurance program, and concluded that additional 'regulation-particularly a statutory self-regulatory organization-is not necessary, provided two key elements are added to the present system. The first element is mandatory membership: all public accounting firms that audit public companies must belong to a professional organization that has peer review and independent oversight functions and is approved by the SEC. The SEC should provide the second element: enforcement actions to impose meaningful sanctions when a firm fails to remedy deficiencies cited by a quality assurance program approved by the SEC.

Adequate SEC Resources

The Commission directs many recommendations to the SEC, the agency with primary responsibility to administer the federal securities laws. In that regard, the SEC must have adequate resources to perform its existing functions, as well as additional functions, that help prevent, detect, and deter fraudulent financial reporting.

Improved Federal Regulation of Financial Institutions

Federal regulatory agencies, other than the SEC, have responsibility for financial reporting by certain public companies that are banks and savings and loans. The Commission recommends that these other agencies adopt measures patterned on the Commission's recommendations for the SEC. To enhance efforts to detect fraudulent financial reporting within financial institutions, the Commission also recommends that these federal agencies and the public accounting profession provide for the regulatory examiner and the independent public accountant to have access to each other's information about examined financial institutions.

Improved Oversight by State Boards of Accountancy

State boards of accountancy can and should play an enhanced role in their oversight of the independent public accountant. The Commission recommends that these boards implement positive enforcement programs to review on a periodic basis the quality of services rendered by the independent public accountants they license.

Insurance and Liability Crises

Finally, the Commission's study of fraudulent financial reporting unavoidably has led to certain topics beyond its charge or ability to address. The perceived liability and insurance crises and the tort reform movement have causes and implications far beyond the financial reporting system. They are truly national issues, touching every profession and business, affecting financial reporting as well. Those charged with responding to the various tort reform initiatives should consider the implications for long-term audit quality and the independent public accountant's detection of fraudulent financial reporting. Moreover, the SEC should reconsider its long-standing position, insofar as it applies to independent directors, that corporate indemnification of officers and directors for securities law liabilities is against public policy and therefore unenforceable.

IV. Recommendations for Education (Chapter Five)

Education can influence present or future participants in the financial reporting system by providing knowledge, skills, and ethical values that potentially may help prevent, detect, and deter fraudulent financial reporting. To encourage educational initiatives toward this end, the Commission recommends changes in the business and accounting curricula as well as in professional certification examinations and continuing professional education.

Business and Accounting Curricula

The complexity and serious nature of fraudulent financial reporting led the Commission to conclude that any initiatives encouraged by its recommendations should permeate the undergraduate and graduate business and accounting curricula. The Commission first recommends that business and accounting students gain knowledge and understanding of the factors that cause fraudulent financial reporting and of the strategies that can lead to a reduction in its incidence. To enable students to deal with risks of such fraud in the future at public companies, the Commission recommends that business and accounting curricula convey a deeper understanding of the function and the importance of internal controls and the overall control environment within which financial reporting takes place. Students should realize that practices aimed at reducing fraudulent financial reporting are not simply defensive measures, but also make good business sense.

In addition, part of the knowledge students acquire about the financial reporting system should be an understanding of the complex regulatory and law enforcement framework that government and private-sector bodies provide to safeguard that system and to protect the public interest. As future participants in that system, students should gain a sense of what will be expected of them legally and professionally when they are accountable to the public interest.

The Commission recommends that the business and accounting curricula also foster the development of skills that can help prevent, detect, and deter such fraud. Analytical reasoning, problem solving, and the exercise of sound judgment are some of the skills that will enable students to grapple successfully in the future with warning signs or novel situations they will encounter in the financial reporting process.

Furthermore, the ethical dimension of financial reporting should receive more emphasis in the business and accounting curricula. The curricula should integrate the development of ethical values with the acquisition of knowledge and skills. Unfortunately, the lack of challenging case studies based on actual incidents of fraudulent financial reporting is a current obstacle to reform. The Commission therefore recommends that business schools give their faculty a variety of incentives and opportunities to develop personal competence and suitable classroom materials for teaching about fraudulent financial reporting. Business school faculty reward systems should acknowledge and reward faculty who develop such competence and materials.

Professional Certification Examinations and Continuing Professional Education

The Commission makes two additional recommendations relating to education. Both professional certification examinations and continuing professional education should emphasize the knowledge, skills, and ethical values that further the understanding of fraudulent financial reporting and promote a reduction in the incidence of such fraud.

Five-Year Accounting Programs and Corporate Initiatives

The Commission makes no recommendation with regard to the much-discussed proposal to expand the undergraduate accounting curriculum from 4 to 5 years. Rather, the Commission offers a number of observations based on its research and deliberations. Similarly, the Commission outlines some of the numerous opportunities for public companies to educate their directors, management, and employees about the problem of fraudulent financial reporting.

Fraudulent Financial Reporting: 1987-1997- An Analysis of U.S. Public Companies

This study was commissioned to look at the extent of fraudulent financial reporting that had been identified during the period of 1987 – 1997. The universe for the study was SEC Enforcement Actions taken against companies during that decade. It was a decade before the dot.com bubble. The study focused on 200 actions taken against public companies by the SEC during that time period.

From the 200 financial statement fraud cases, the finding were grouped by the authors into five categories to describe the nature of the companies involved, the nature of the control environment, the nature of the frauds, issues related to the external auditor, and the consequences to the company and the individuals allegedly involved.

Nature of Companies Involved

- Relative to the population of all public registrants, companies committing financial statement fraud were <u>relatively small</u>, well below $100 million in total assets, in the year preceding the fraud. Most companies (78 percent of the sample) were not listed on the New York or American Stock Exchanges.

- Downwards trends in net income and upward trends in net income in periods preceding the first fraud were common among most companies. As a result, the frauds were designed to reverse the downward spirals or to preserve the upward trends.

Nature of the Control Environment
(Top Management and the Board)

- In 83 percent of the cases, either the CEO or CFO or both were involved in the fraud. Other individuals involved include controllers, chief operating officers, other senior vice presidents, and board members.

- Most audit committees of the companies involved met only once a year and some companies did not have audit committees at all. Twenty five percent did not have audit committees whereas those companies that did, 65 percent did not appear to be certified in accounting or have current or prior work experience in key accounting or finance positions.

- Boards of Directors were dominated by insiders and "gray" directors (i.e. outsiders with special ties to the company or management) with significant equity interest and little experience serving as directors of other companies.

- Family relationships among directors and/or officers were fairly common, as were individuals who apparently had significant power.

Nature of the Frauds

- Given the relatively small size of the companies committing fraud, the cumulative amounts of frauds were rather large. The average financial statement misstatement or misappropriation of assets was $25 million and the median was $4.1 million. While the average company had assets totaling $533 million, the median company had total assets of only $16 million.

- Only 14 percent of the frauds were isolated to a single fiscal period while the average period of fraud extended over 23.7 months.

- Over half of the frauds involved recording premature or fictitious revenues, with many occurring at the end of the period. While the remaining half involved overstating assets by understating allowances for receivables, overstating the value of inventory, property, plant and equipment and other tangible assets, and recording assets that did not exist. *Thus, while there was a breakdown at the tone at the top, the fraud also was facilitated by a lack of control at the detailed processing level.*

Issues Related to the External Auditor

- All sizes of audit firms were involved. Fifty six percent of the sample fraud companies were audited by a Big Eight/Six auditor during the fraud period.

- Fifty five percent of the audit reports issued in the year preceding the fraud period were unqualified opinions. The remainder were qualified due to issues related to auditor's substantial doubt about going concern, litigation and other uncertainties, changes in accounting principles and changes in auditors between fiscal years comparatively reported.

- Financial statement fraud occasionally implicated the external auditor. Twenty nine percent explicitly names individuals for alleged involvement in the fraud or for negligent auditing. Also most of the auditors implicated were non-Big Eight/Six.

- Just over 25 percent of the companies changed auditors during the time frame beginning with the last clean financial statement period and ending with the last financial statement period. Many changes took place during the fraud period and it was often a change from one non-Big Eight/Six to another.

Consequences for the Company and Individuals Involved

- Over 50 percent went bankrupt or experienced a significant change in ownership following the fraud disclosure. While 25 percent were delisted by a national exchange.

Fraudulent Financial Reporting: 1987-1997

An Analysis of U.S. Public Companies

Research Commissioned by the

Committee of Sponsoring Organizations of the Treadway Commission

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Fraudulent Financial Reporting: 1987-1997
An Analysis of U.S. Public Companies

I. Executive Summary and Introduction

Fraudulent financial reporting can have significant consequences for the organization and for public confidence in capital markets. Periodic high profile cases of fraudulent financial reporting raise concerns about the credibility of the U.S. financial reporting process and call into question the roles of auditors, regulators, and analysts in financial reporting.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) sponsored this research project to provide an extensive updated analysis of financial statement fraud occurrences. While the work of the National Commission on Fraudulent Financial Reporting in the mid-1980s identified numerous causal factors believed to contribute to financial statement fraud, little empirical evidence exists about factors related to instances of fraud since the release of the 1987 report (NCFFR, 1987). Thus, COSO commissioned this research project to provide COSO, and others, with information that can be used to guide future efforts to combat the problem of financial statement fraud and to provide a better understanding of financial statement fraud cases.

This research has three specific objectives:

- To identify instances of alleged fraudulent financial reporting by registrants of the U.S. Securities and Exchange Commission (SEC) first described by the SEC in an Accounting and Auditing Enforcement Release (AAER) issued during the period 1987-1997.
- To examine certain key company and management characteristics for a sample of these companies involved in instances of financial statement fraud.
- To provide a basis for recommendations to improve the corporate financial reporting environment in the U.S.

We analyzed instances of fraudulent financial reporting alleged by the SEC in AAERs issued during the 11 year period between January 1987 and December 1997. The AAERs, which contain summaries of enforcement actions by the SEC against public companies, represent one of the most comprehensive sources of alleged cases of financial statement fraud in the United States. We focused on AAERs that involved an alleged violation of Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 17(a) of the 1933 Securities Act given that these represent the primary antifraud provisions related to financial statement reporting. Our focus was on cases clearly involving financial statement fraud. We excluded from our analysis restatements of financial statements due to errors or earnings management activities that did not result in a violation of the federal antifraud statutes.

Our search identified nearly 300 companies involved in alleged instances of fraudulent financial reporting during the 11 year period. From this list of companies, we randomly selected approximately 200 companies to serve as the final sample that we examined in detail. Findings reported in this study are based on information we obtained from our reading of (a) AAERs related to each of the sample fraud companies, (b) selected

Form 10-Ks filed before and during the period the alleged financial statement fraud occurred, (c) proxy statements issued during the alleged fraud period, and (d) business press articles about the sample companies after the fraud was disclosed.

Summary of Findings

Several key findings can be generalized from this detailed analysis of our sample of approximately 200 financial statement fraud cases. We have grouped these findings into five categories describing the nature of the companies involved, the nature of the control environment, the nature of the frauds, issues related to the external auditor, and the consequences to the company and the individuals allegedly involved.

Nature of Companies Involved

- **Relative to public registrants, companies committing financial statement fraud were relatively small.** The typical size of most of the sample companies ranged well below $100 million in total assets in the year preceding the fraud period. Most companies (78 percent of the sample) were not listed on the New York or American Stock Exchanges.

- **Some companies committing the fraud were experiencing net losses or were in close to break-even positions in periods before the fraud.** Pressures of financial strain or distress may have provided incentives for fraudulent activities for some fraud companies. The lowest quartile of companies indicate that they were in a net loss position, and the median company had net income of only $175,000 in the year preceding the first year of the fraud period. Some companies were experiencing downward trends in net income in periods preceding the first fraud period, while other companies were experiencing upward trends in net income. Thus, the subsequent frauds may have been designed to reverse downward spirals for some companies and to preserve upward trends for other companies.

Nature of the Control Environment (Top Management and the Board)

- **Top senior executives were frequently involved.** In 72 percent of the cases, the AAERs named the chief executive officer (CEO), and in 43 percent the chief financial officer (CFO) was associated with the financial statement fraud. When considered together, in 83 percent of the cases, the AAERs named either or both the CEO or CFO as being associated with the financial statement fraud. Other individuals named in several AAERs include controllers, chief operating officers, other senior vice presidents, and board members.

- **Most audit committees only met about once a year or the company had no audit committee.** Audit committees of the fraud companies generally met only once per year. Twenty-five percent of the companies did not have an audit committee. Most audit committee members (65 percent) did not appear to be certified in accounting or have current or prior work experience in key accounting or finance positions.

- **Boards of directors were dominated by insiders and "grey" directors with significant equity ownership and apparently little experience serving as directors of other companies.** Approximately 60 percent of the directors were insiders or "grey" directors (i.e., outsiders with special ties to the company or management). Collectively, the directors and officers owned nearly 1/3 of the companies' stock, with the CEO/President personally owning about 17 percent. Nearly 40 percent of the boards had not one director who served as an outside or grey director on another company's board.

- **Family relationships among directors and / or officers were fairly common, as were individuals who apparently had significant power.** In nearly 40 percent of the companies, the proxy provided evidence of family relationships among the directors and / or officers. The founder and current CEO were the same person or the original CEO / President was still in place in nearly half of the companies. In over 20 percent of the companies, there was evidence of officers holding incompatible job functions (e.g., CEO and CFO).

Nature of the Frauds

- **Cumulative amounts of frauds were relatively large in light of the relatively small sizes of the companies involved.** The average financial statement misstatement or misappropriation of assets was $25 million and the median was $4.1 million. While the average company had assets totaling $533 million, the median company had total assets of only $16 million.

- **Most frauds were not isolated to a single fiscal period** Most frauds overlapped at least two fiscal periods, frequently involving both quarterly and annual financial statements. The average fraud period extended over 23.7 months, with the median fraud period extending 21 months. Only 14 percent of the sample companies engaged in a fraud involving fewer than twelve months.

- **Typical financial statement fraud techniques involved the overstatement of revenues and assets.** Over half the frauds involved overstating revenues by recording revenues prematurely or fictitiously. Many of those revenue frauds only affected transactions recorded right at period end (i.e., quarter end or year end). About half the frauds also involved overstating assets by understating allowances for receivables, overstating the value of inventory, property, plant and equipment and other tangible assets, and recording assets that did not exist.

Issues Related to the External Auditor

- **All sizes of audit firms were associated with companies committing financial statement frauds.** Fifty-six percent of the sample fraud companies were audited by a Big Eight/Six auditor during the fraud period, and 44 percent were audited by non-Big Eight/Six auditors.

- **All types of audit reports were issued during the fraud period.** A majority of the audit reports (55 percent) issued in the last year of the fraud period contained unqualified opinions. The remaining 45 percent of the audit reports issued in the last year of the fraud departed from the standard unqualified auditor's report because they addressed issues related to the auditor's substantial doubt about going concern, litigation and other uncertainties, changes in accounting principles, and changes in auditors between fiscal years comparatively reported. Three percent of the audit reports were qualified due to a GAAP departure during the fraud period.

- **Financial statement fraud occasionally implicated the external auditor.** Auditors were explicitly named in the AAERs for 56 of the 195 fraud cases (29 percent) where AAERs explicitly named individuals. They were named for either alleged involvement in the fraud (30 of 56 cases) or for negligent auditing (26 of 56 cases). Most of the auditors explicitly named in an AAER (46 of 56) were non-Big Eight/Six auditors.

- **Some companies changed auditors during the fraud period.** Just over 25 percent of the companies changed auditors during the time-frame beginning with the last clean financial statement period and ending with the last fraud financial statement period. A majority of the auditor changes occurred during the fraud period (e.g., two auditors were associated with the fraud period) and a majority involved changes from one non-Big Eight/Six auditor to another non-Big Eight/Six auditor.

Consequences for the Company and Individuals Involved

- **Severe consequences awaited companies committing fraud.** Consequences of financial statement fraud to the company often include bankruptcy, significant changes in ownership, and delisting by national exchanges, in addition to financial penalties imposed. A large number of the sample firms (over 50 percent) were bankrupt/defunct or experienced a significant change in ownership following disclosure of the fraud. Twenty-one percent of the companies were delisted by a national stock exchange.

- **Consequences associated with financial statement fraud were severe for individuals allegedly involved.** Individual senior executives were subject to class action legal suits and SEC actions that resulted in financial penalties to the executives personally. A significant number of individuals were terminated or forced to resign from their executive positions. However, relatively few individuals explicitly admitted guilt or eventually served prison sentences.

Summary of Implications

The research team analyzed the results to identify implications that might be relevant to senior managers, board of director and audit committee members, and internal and external auditors. The implications reflect the judgment and opinions of the research team, developed from the extensive review of information related to the cases involved. Hopefully the presentation of these implications will lead to the consideration of changes that can promote higher quality financial reporting. The following implications are noted:

Implications Related to the Nature of the Companies Involved

- The relatively small size of fraud companies suggests that the inability or even unwillingness to implement cost-effective internal controls may be a factor affecting the likelihood of financial statement fraud (e.g., override of controls is easier). Smaller companies may be unable or unwilling to employ senior executives with sufficient financial reporting knowledge and experience. Boards, audit committees, and auditors need to challenge management to ensure that a baseline level of internal control is present.

- The national stock exchanges and regulators should evaluate the tradeoffs of designing policies that might exempt small companies, given the relatively small size of the companies involved in financial statement fraud. A regulatory focus on companies with market capitalization in excess of $200 million may fail to target companies with greater risk for financial statement fraud activities.

- Given that some of the fraud firms were experiencing financial strain in periods preceding the fraud, effective monitoring of the organization's going-concern status is warranted, particularly as auditors consider new clients. In addition, the importance of effective communications with predecessor auditors is highlighted by the fact that several observations of auditor changes were noted during the fraud period.

Implications Related to the Nature of the Control Environment (Top Management and the Board)

- The importance of the organization's control environment cannot be overstated, as emphasized in COSO's *Internal Control – Integrated Framework* (COSO, 1992). Monitoring the pressures faced by senior executives (e.g., pressures from compensation plans, investment community expectations, etc.) is critical. The involvement of senior executives who are knowledgeable of financial reporting requirements, particularly those unique to publicly-traded companies, may help to educate other senior executives about financial reporting issues and may help to restrain senior executives from overly aggressive reporting. In other cases, however, board members and auditors should be alert for deceptive managers who may use that knowledge to disguise a fraud.

- The concentration of fraud among companies with under $50 million in revenues and with generally weak audit committees highlights the importance of rigorous audit committee practices even for smaller organizations. In particular, the number of audit committee meetings per year and the financial expertise of the audit committee members may deserve closer attention.

- It is important to consider whether smaller companies should focus heavily on director independence and expertise, like large companies are currently being encouraged to do. In the smaller company setting, due to the centralization of power in a few individuals, it may be especially important to have a solid monitoring function performed by the board.

- An independent audit committee's effectiveness can be hindered by the quality and extent of information it receives. To perform effective monitoring, the audit committee needs access to reliable financial and non-financial information, industry and other external benchmarking data, and other comparative information that is prepared on a consistent basis. Boards and audit committees should work to obtain from senior management and other information providers relevant and reliable data to assist them in monitoring the financial reporting process.

- Investors should be aware of the possible complications arising from family relationships and from individuals (founders, CEO / board chairs, etc.) who hold significant power or incompatible job functions. Due to the size and nature of the sample companies, the existence of such relationships and personal factors is to be expected. It is important to recognize that such conditions present both benefits and risks.

Implications Related to the Nature of the Frauds

- The multi-period aspect of financial statement fraud, often beginning with the misstatement of interim financial statements, suggests the importance of interim reviews of quarterly financial statements and the related controls surrounding interim financial statement preparation, as well as the benefits of continuous auditing strategies.

- The nature of misstatements affecting revenues and assets recorded close to or as of the fiscal period end highlights the importance of effective consideration and testing of internal control related to transaction cutoff and asset valuation. Based on the assessed risk related to internal control, the auditor should evaluate the need for substantive testing procedures to reduce audit risk to an acceptable level and design tests in light of this consideration. Procedures affecting transaction cut-off, transactions terms, and account valuation estimation for end-of-period accounts and transactions may be particularly relevant.

Implications Regarding the Roles of External Auditors

- There is a strong need for the auditor to look beyond the financial statements to understand risks unique to the client's industry, management's motivation towards aggressive reporting, and client internal control (particularly the tone at the top), among other matters. As auditors approach the audit, information from a variety of sources should be considered to establish an appropriate level of professional skepticism needed for each engagement.

- The auditor should recognize the potential likelihood for greater audit risk when auditing companies with weak board and audit committee governance.

July 1994 Edition
In Two Volumes

INTERNAL CONTROL – INTEGRATED FRAMEWORK

- Executive Summary
- Framework
- Reporting to External Parties

September 1992

- Addendum to "Reporting to External Parties"

May 1994

Committee of Sponsoring
Organizations of the
Treadway Commission

Executive Summary

Senior executives have long sought ways to better control the enterprises they run. Internal controls are put in place to keep the company on course toward profitability goals and achievement of its mission, and to minimize surprises along the way. They enable management to deal with rapidly changing economic and competitive environments, shifting customer demands and priorities, and restructuring for future growth. Internal controls promote efficiency, reduce risk of asset loss, and help ensure the reliability of financial statements and compliance with laws and regulations.

Because internal control serves many important purposes, there are increasing calls for better internal control systems and report cards on them. Internal control is looked upon more and more as a solution to a variety of potential problems.

What Internal Control Is

Internal control means different things to different people. This causes confusion among businesspeople, legislators, regulators and others. Resulting miscommunication and different expectations cause problems within an enterprise. Problems are compounded when the term, if not clearly defined, is written into law, regulation or rule.

This report deals with the needs and expectations of management and others. It defines and describes internal control to:

- Establish a common definition serving the needs of different parties.
- Provide a standard against which business and other entities—large or small, in the public or private sector, for profit or not—can assess their control systems and determine how to improve them.

Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

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

The first category addresses an entity's basic business objectives, including performance and profitability goals and safeguarding of resources. The second relates to the preparation of reliable published financial statements, including interim and condensed financial statements and selected financial data derived from such statements, such as earnings releases, reported publicly. The third deals with complying with those laws and regulations to which the entity is subject. These distinct but overlapping categories address different needs and allow a directed focus to meet the separate needs.

Internal control systems operate at different levels of effectiveness. Internal control can be judged effective in each of the three categories, respectively, if the board of directors and management have reasonable assurance that:

- They understand the extent to which the entity's operations objectives are being achieved.
- Published financial statements are being prepared reliably.
- Applicable laws and regulations are being complied with.

While internal control is a process, its effectiveness is a state or condition of the process at one or more points in time.

Internal control consists of five interrelated components. These are derived from the way management runs a business, and are integrated with the management process. Although the components apply to all entities, small and mid-size companies may implement them differently than large ones. Its controls may be less formal and less structured, yet a small company can still have effective internal control. The components are:

- *Control Environment*—The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.
- *Risk Assessment*—Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.
- *Control Activities*—Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.
- *Information and Communication*—Pertinent information must be identified, captured and communicated in a form and timeframe that enables people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about

external events, activities and conditions necessary to informed business decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders.

- *Monitoring*—Internal control systems need to be monitored—a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.

There is synergy and linkage among these components, forming an integrated system that reacts dynamically to changing conditions. The internal control system is intertwined with the entity's operating activities and exists for fundamental business reasons. Internal control is most effective when controls are built into the entity's infrastructure and are a part of the essence of the enterprise. "Built in" controls support quality and empowerment initiatives, avoid unnecessary costs and enable quick response to changing conditions.

There is a direct relationship between the three categories of objectives, which are what an entity strives to achieve, and components, which represent what is needed to achieve the objectives. All components are relevant to each objectives category. When looking at any one category—the effectiveness and efficiency of operations, for instance—all five components must be present and functioning effectively to conclude that internal control over operations is effective.

The internal control definition—with its underlying fundamental concepts of a process, effected by people, providing reasonable assurance—together with the categorization of objectives and the components and criteria for effectiveness, and the associated discussions, constitute this internal control framework.

What Internal Control Can Do

Internal control can help an entity achieve its performance and profitability targets, and prevent loss of resources. It can help ensure reliable financial reporting. And it can help ensure that the enterprise complies with laws and regulations, avoiding damage to its reputation and other consequences. In sum, it can help an entity get to where it wants to go, and avoid pitfalls and surprises along the way.

What Internal Control Cannot Do

Unfortunately, some people have greater, and unrealistic, expectations. They look for absolutes, believing that:

- Internal control can ensure an entity's success—that is, it will ensure achievement of basic business objectives or will, at the least, ensure survival.

  Even effective internal control can only *help* an entity achieve these objectives. It can provide management information about the entity's progress, or lack of it, toward their achievement. But internal control cannot change an inherently poor manager into a good one. And, shifts in government policy or programs, competitors' actions or economic conditions can be beyond management's control. Internal control cannot ensure success, or even survival.

- Internal control can ensure the reliability of financial reporting and compliance with laws and regulations.

  This belief is also unwarranted. An internal control system, no matter how well conceived and operated, can provide only reasonable—not absolute—assurance to management and the board regarding achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the collusion of two or more people, and management has the ability to override the system. Another limiting factor is that the design of an internal control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

Thus, while internal control can help an entity achieve its objectives, it is not a panacea.

Roles and Responsibilities

Everyone in an organization has responsibility for internal control.

- *Management*—The chief executive officer is ultimately responsible and should assume "ownership" of the system. More than any other individual, the chief executive sets the "tone at the top" that affects integrity and ethics and other factors of a positive control environment. In a large company, the chief executive fulfills this duty by providing leadership and direction to senior managers and reviewing the way they're controlling the business. Senior managers, in turn, assign responsibility for establishment of more specific internal control policies and procedures to personnel responsible for the unit's functions. In a smaller entity, the influence of the chief executive, often an owner-manager, is usually more direct. In any event, in a cascading responsibility, a manager is effectively a chief executive of his or her sphere of responsibility. Of particular significance are financial officers and their staffs, whose control activities cut across, as well as up and down, the operating and other units of an enterprise.

- *Board of Directors*—Management is accountable to the board of directors, which provides governance, guidance and oversight. Effective board members are objective, capable and inquisitive. They also have a knowledge of the entity's activities and environment, and commit the time necessary to fulfill their board responsibilities. Management may be in a position to override controls and ignore or stifle communications from subordinates, enabling a dishonest management which intentionally misrepresents results to cover its tracks. A strong, active board, particularly when coupled with effective upward communications channels and capable financial, legal and internal audit functions, is often best able to identify and correct such a problem.
- *Internal Auditors*—Internal auditors play an important role in evaluating the effectiveness of control systems, and contribute to ongoing effectiveness. Because of organizational position and authority in an entity, an internal audit function often plays a significant monitoring role.
- *Other Personnel*—Internal control is, to some degree, the responsibility of everyone in an organization and therefore should be an explicit or implicit part of everyone's job description. Virtually all employees produce information used in the internal control system or take other actions needed to effect control. Also, all personnel should be responsible for communicating upward problems in operations, noncompliance with the code of conduct, or other policy violations or illegal actions.

A number of external parties often contribute to achievement of an entity's objectives. External auditors, bringing an independent and objective view, contribute directly through the financial statement audit and indirectly by providing information useful to management and the board in carrying out their responsibilities. Others providing information to the entity useful in effecting internal control are legislators and regulators, customers and others transacting business with the enterprise, financial analysts, bond raters and the news media. External parties, however, are not responsible for, nor are they a part of, the entity's internal control system.

Organization of this Report

This report is in four volumes.* The first is this *Executive Summary*, a high-level overview of the internal control framework directed to the chief executive and other senior executives, board members, legislators and regulators.

The second volume, the *Framework*, defines internal control, describes its components and provides criteria against which managements, boards or others can assess their control systems.

The third volume, *Reporting to External Parties*, is a supplemental document providing guidance to those entities that report publicly on internal control over preparation of their published financial statements, or are contemplating doing so.

The fourth volume, *Evaluation Tools*, provides materials that may be useful in conducting an evaluation of an internal control system.

* The COSO report was issued in September 1992 as a four-volume set. An addendum to *Reporting to External Parties* was issued in May 1994. In this 1994 edition, the first three volumes and the addendum are combined and printed in one volume and *Evaluation Tools* in a second one.

What to Do

Actions that might be taken as a result of this report depend on the position and role of the parties involved:

- *Senior Management*—Most senior executives who contributed to this study believe they are basically "in control" of their organizations. Many said, however, that there are areas of their company—a division, a department or a control component that cuts across activities—where controls are in early stages of development or otherwise need to be strengthened. They do not like surprises. This study suggests that the chief executive initiate a self-assessment of the control system. Using this framework, a CEO, together with key operating and financial executives, can focus attention where needed. Under one approach, the chief executive could proceed by bringing together business unit heads and key functional staff to discuss an initial assessment of control. Directives would be provided for those individuals to discuss this report's concepts with their lead personnel, provide oversight of the initial assessment process in their areas of responsibility and report back findings. Another approach might involve an initial review of corporate and business unit policies and internal audit programs. Whatever its form, an initial self-assessment should determine whether there is a need for, and how to proceed with, a broader, more in-depth evaluation. It should also ensure that ongoing monitoring processes are in place. Time spent in evaluating internal control represents an investment, but one with a high return.
- *Board Members*—Members of the board of directors should discuss with senior management the state of the entity's internal control system and provide oversight as needed. They should seek input from the internal and external auditors.
- *Other Personnel*—Managers and other personnel should consider how their control responsibilities are being conducted in light of this framework, and discuss with more senior personnel ideas for strengthening control. Internal auditors should consider the breadth of their focus on the internal control system, and may wish to compare their evaluation materials to the evaluation tools.
- *Legislators and Regulators*—Government officials who write or enforce laws recognize that there can be misconceptions and different expectations about virtually any issue. Expectations for internal control vary widely in two respects. First, they differ regarding what control systems can accomplish. As noted, some observers believe internal control systems will, or should, prevent economic loss, or at least prevent companies from going out of business. Second, even when there is agreement about what internal control systems can and can't do, and about the validity of the "reasonable assurance" concept, there can be disparate views of what that concept means and how it will be applied. Corporate executives have expressed concern regarding how regulators might construe public reports asserting "reasonable assurance" in hindsight after an alleged control failure has occurred. Before legislation or regulation dealing with management reporting on internal control is acted upon, there should be agreement on a common internal

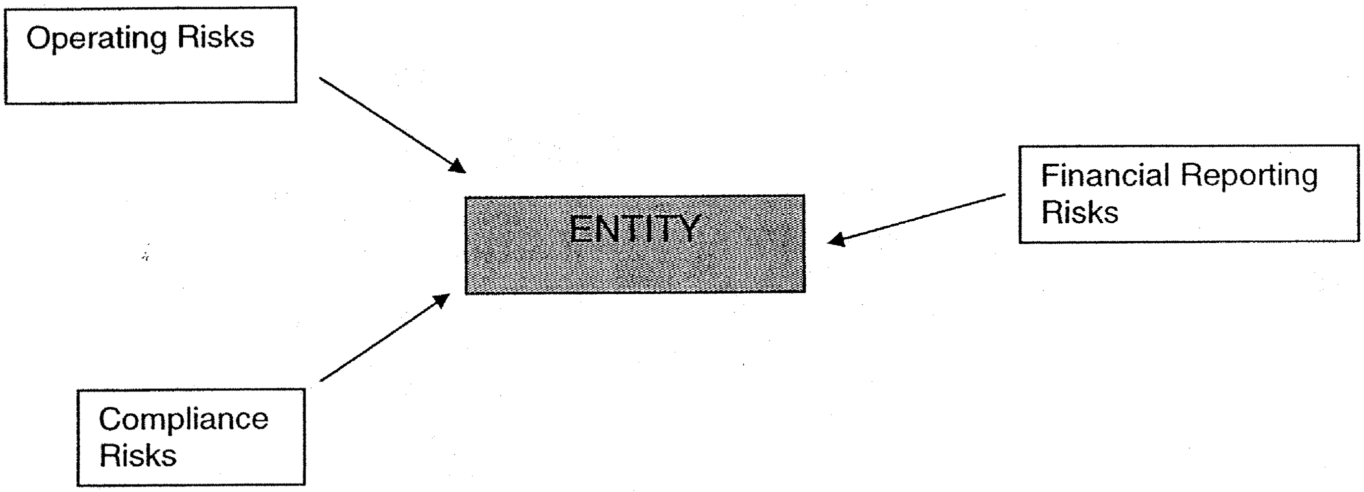
control framework, including limitations of internal control. This framework should be helpful in reaching such agreement.

- *Professional Organizations*—Rule-making and other professional organizations providing guidance on financial management, auditing and related topics should consider their standards and guidance in light of this framework. To the extent diversity in concept and terminology is eliminated, all parties will benefit.
- *Educators*—This framework should be the subject of academic research and analysis, to see where future enhancements can be made. With the presumption that this report becomes accepted as a common ground for understanding, its concepts and terms should find their way into university curricula.

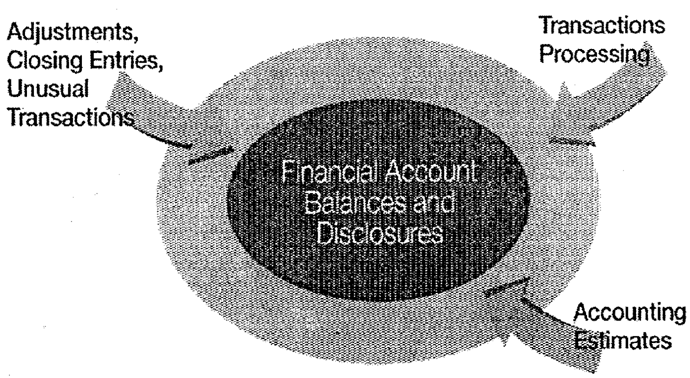
We believe this report offers a number of benefits. With this foundation for mutual understanding, all parties will be able to speak a common language and communicate more effectively. Business executives will be positioned to assess control systems against a standard, and strengthen the systems and move their enterprises toward established goals. Future research can be leveraged off an established base. Legislators and regulators will be able to gain an increased understanding of internal control, its benefits and limitations. With all parties utilizing a common internal control framework, these benefits will be realized.

The COSO Internal Control Integrated Framework

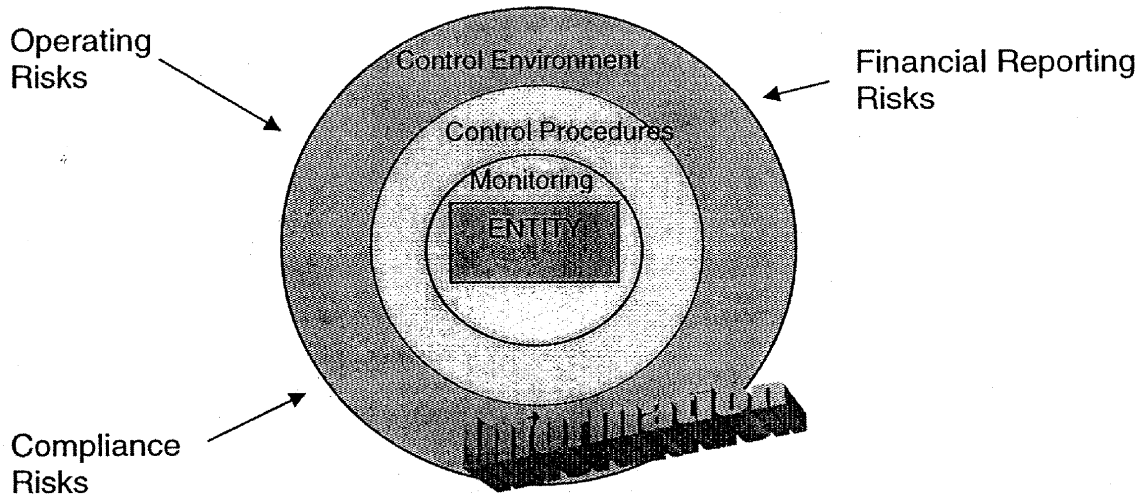
Underlying Concepts



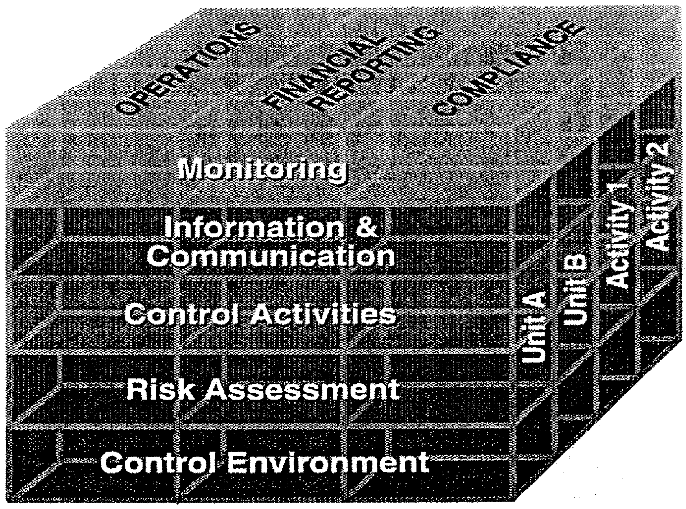
Understanding Sources of Risk



CONCEPTUAL MODEL
INTERNAL CONTROLS PRESENT LINES OF DEFENSE TO MITIGATE RISKS



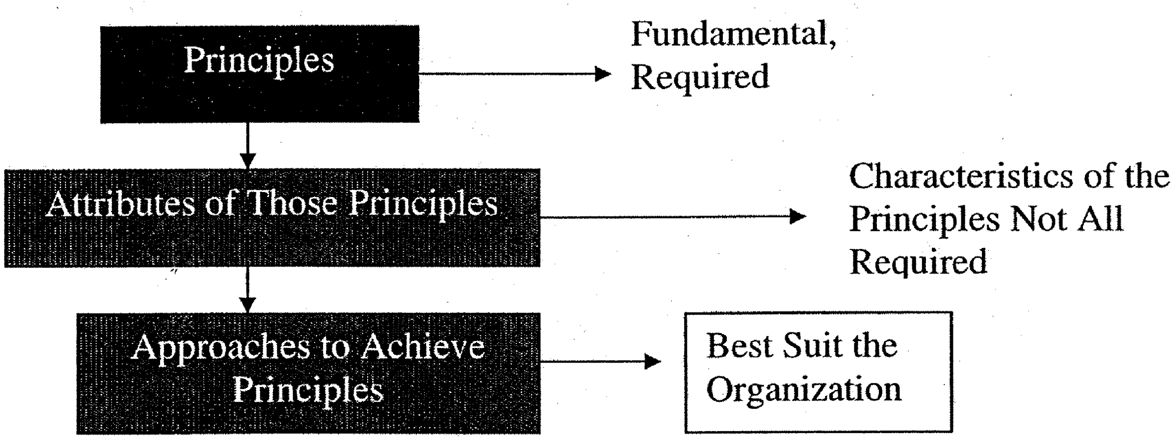
The COSO Model



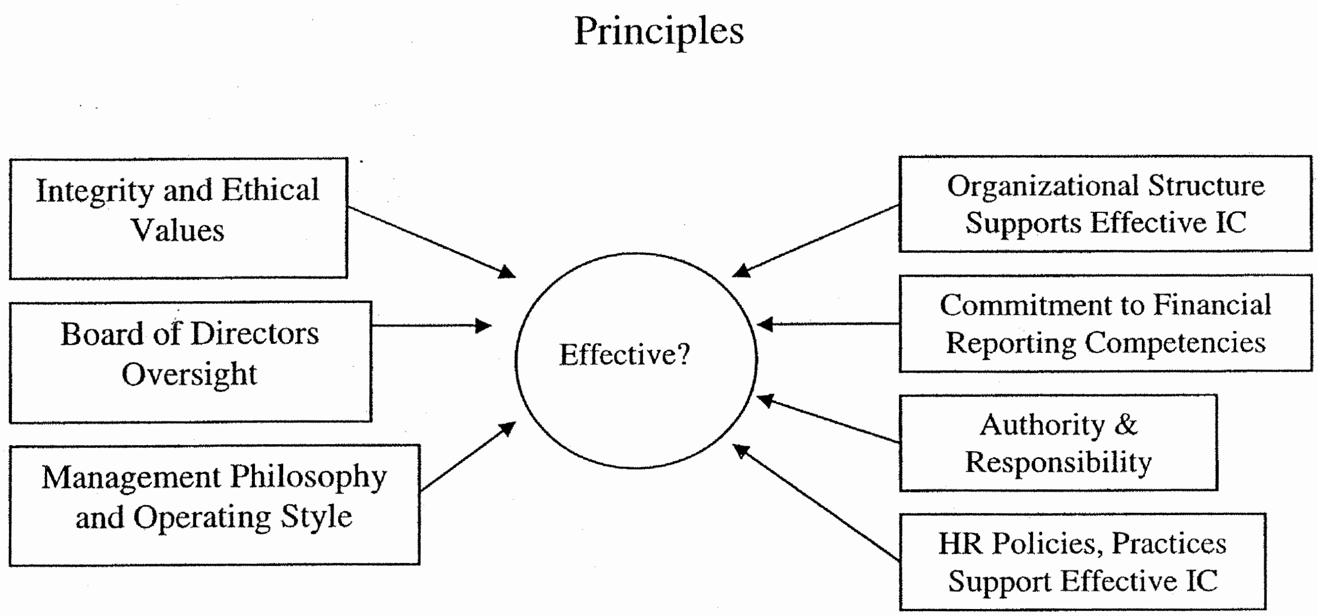
Guidance- Principles-Based

- Each element needs to be present and working.
- Evaluation is based on the whole, not the individual components.
- Focus on Financial Reporting
- Each element is based on:
    - Fundamental Principles
    - Attributes of those Principles
    - Approaches to implement the controls

STUCTURE OF GUIDANCE
COSO Guidance for Smaller Businesses



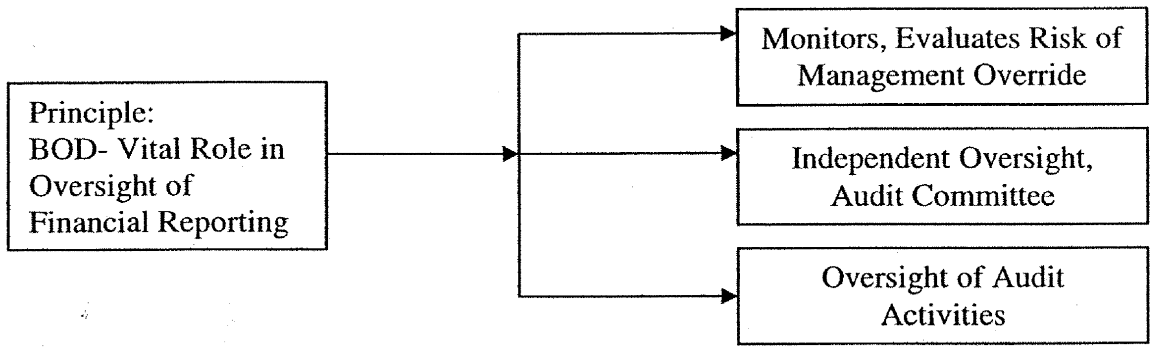
Example: Control Environment

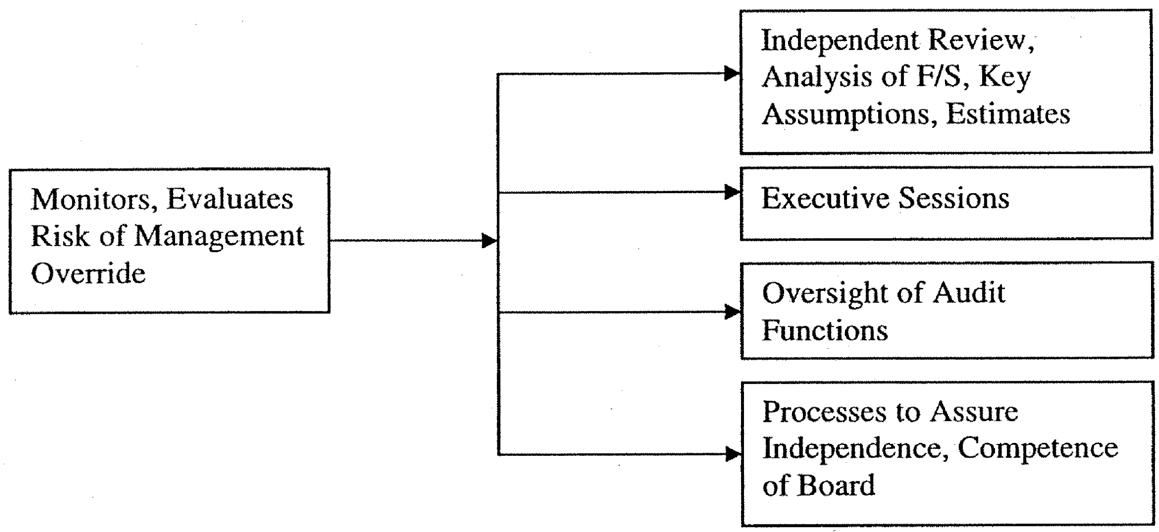


Consider Ethics

- Principle: Ought to have commitment to ethical values:
- Attributes
  - Clearly articulated statement of values
  - Communicated
  - Understood
  - Monitored
  - Actions taken

CONTROL ENVIRONMENT





B. Implementation of principles

The following control matrix is one possible tool, but not the only tool, that may be used in determining whether the organization has effectively implemented all key principles included in this guidance.

	Effective	Attributes	Control Activity	Evidence of Control
Control Environment				
1. **Integrity and Ethical Values** - *Sound integrity and ethical values, particularly of top management, are developed and set the standard of conduct for financial reporting.*	Yes/No	*Developed* *Communicated* *Reinforced* *Monitored* *Deviations Addressed*		
2. **Importance of Board of Directors** - *The board of directors understands and exercises oversight of financial reporting and related internal control.*	Yes/No	*Evaluates and Monitors Risk* *Oversees Quality and Reliability* *Oversees Audit Activities* *Independence of Audit Committee* *Independent Critical Mass* *Financial Expertise* *Frequency*		
3. **Management's Philosophy and Operating Style** - *Management's philosophy and operating style support achieving effective internal control over financial reporting.*	Yes/No	*Set the Tone* *Articulate Objectives* *Select Principles and Estimates*		
4. **Organizational Structure** - *The company's organizational structure supports effective internal control over financial reporting.*	Yes/No	*Establishes Responsibility* *Maintains Structure* *Maintains Processes*		
5. **Commitment to Financial Reporting Competencies** – The *company retains individuals competent in financial reporting and related oversight roles.*	Yes/No	*Identifies Competencies* *Retains Individuals* *Evaluates Competencies*		
6. **Authority and Responsibility** - *Management and employees are assigned appropriate levels of authority and responsibility to facilitate effective internal control over financial reporting.*	Yes/No	*Board Oversees Financial Reporting Responsibility* *Defined Responsibilities* *Limit of Authority*		

Control Environment – continued				
7. Human Resources - *Human resource polices and practices are designed and implemented to facilitate effective internal control over financial reporting.*	Yes/No	*Establishment of Human Resource Policies* *Recruiting and Retention* *Adequate Training* *Performance and Compensation*		
Risk Assessment				
8. Importance of Financial Reporting Objectives - *A precondition to risk assessment is the establishment of objectives for reliable financial reporting.*	Yes/No	*Meet Generally Accepted Accounting Principles* *Financial Statement Assertions* *Materiality*		
9. Identification and Analysis of Financial Reporting Risks – *The company identifies and analyzes risks to the achievement of financial reporting objectives as a basis for determining how the risks should be managed.*	Yes/No	*Potential Risks* *Include Business Processes* *Include Information Technology* *Internal and External Factors* *Involve Levels of Management* *Estimate Impact and Likelihood* *Triggers for Reassessment*		
10. Assessment of Fraud Risk - *The potential for material misstatement due to fraud is explicitly considered in assessing risks to the achievement of financial reporting objectives.*	Yes/No	*Evaluates Potential for Fraud* *Integral Part of Risk Assessment* *Incentives and Pressures* *Considers Risk Factors* *Considers High-Risk Areas* *Audit Committee Oversight*		

Control Activities				
11. Elements of a Control Activity - *Control activities are the policies and procedures established and communicated throughout the company, at all levels and across all functions, that enable management directives to be carried out.*	Yes/No	*Policies and Procedures* *Cascade into the Company* *Criteria for Accomplishment* *Monitored* *Track Implementation* *Documented* *Ownership*		
12. Control Activities Linked to Risk Assessment - *Control activities are actions taken to address risks to the achievement of financial reporting objectives.*	Yes/No	*Inherent in Business Processes* *Include Significant Points of Interest into the Company's General Ledger* *Mitigate Risks* *Risk Based* *Encompass Information Technology* *Continued Relevance*		
13. Selection and Development of Control Activities - *Control activities are selected and developed considering their cost and their potential effectiveness in mitigating risks to the achievement of financial reporting objectives.*	Yes/No	*Range of Activities* *Preventive and Detective* *Segregation of Duties* *Compensating Controls*		
14. Information Technology - *Information technology controls, where applicable, are designed and implemented to support the achievement of financial reporting objectives.*	Yes/No	*Application Controls* *General Computer Controls* *Consider End-User Computing*		

Information and Communication				
15. **Information Needs** – *Information is identified, captured and used at all levels of a company to support the achievement of financial reporting objectives.*	Yes/No	*Use to Effect Control* *Operating Information* *Internal and External Sources*		
16. **Information Control** - *Information relevant to financial reporting is identified, captured, processed, and distributed within the parameters established by the company's control processes to support the achievement of financial reporting objectives.*	Yes/No	*Formality* *Exception Reporting* *Updated* *Quality Review* *Capture Data*		
17. **Management Communication** - *All personnel, particularly those in roles affecting financial reporting, receive a clear message from top management that both internal control over financial reporting and individual control responsibilities must be taken seriously.*	Yes/No	*Program Development* *Communications Programs and Approaches* *Relevant information* *Frequency*		
18. **Upstream Communication** - *Company personnel have an effective and nonretributive method to communicate significant information upstream in a company.*	Yes/No	*Enhance Control* *Secondary Channels* *Compliance*		
19. **Board Communication** - *Communication must exist between management and the board of directors so that both have relevant information to fulfill their governance and to financial reporting roles.*	Yes/No	*Open Channels* *Timely* *Information Needs* *Access to Information*		
20. **Communication with Outside Parties** - *matters affecting the achievement of financial reporting are communicated with outside parties.*	Yes/No	*Open Channels* *Secondary Channels* *Value Sharing* *Monitored* *Independent Assessment*		

Monitoring				
21. Ongoing Monitoring - *Ongoing monitoring processes enable management to determine whether internal control over financial reporting is present and functioning.*	Yes/No	*Built-in* *Feedback* *Indicator of Control Effectiveness*		
22. Separate Evaluations - *Separate evaluations of all five internal control components enable management to determine the effectiveness of internal control over financial reporting.*	Yes/No	*Objective* *Knowledgeable* *Feedback* *Scope and Frequency*		
23. Reporting Deficiencies - *Internal control deficiencies are identified and communicated in a timely manner to those parties responsible for taking corrective action, and to management and the board as appropriate.*	Yes/No	*Timely Action* *Findings Reported* *Deficiencies Reported*		
Roles and Responsibilities				
24. Management Roles - *Management exercises responsibility and ownership for internal control over financial reporting.*	Yes/No	*Top Management Responsibility* *Finance and Accounting Officers Monitor and Provide Oversight*		
25. Board and Audit Committees - *The board of directors, directly and through the audit committee, has processes that provide directors with information needed to perform their oversight responsibilities regarding the achievement of effective internal control over financial reporting.*	Yes/No	*Governance, Guidance, and Oversight* *Audit Committee*		
26. Other Personnel - *Objective testing of internal control over financial reporting, often performed through an internal audit activity, is performed by competent and objective personnel.*	Yes/No	*Senior-Level Accountability* *Objective Assessment* *Everyone's responsibility*		