EXPERT PROCESS SOLUTIONS LLC

PO Box 2005
DAVIDSON, NC 28036

March 31, 2005

Mr. Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: File Number 4-497 FILED ELECTRONICALLY (rule-comments@sec.gov)

Sarbanes-Oxley (SOX) Act §404 Auditing Standard No. 2 (AS-2) and COSO Framework analysis can result in more efficient and effective businesses. I have been the information officer of a $1b public company, reengineered whole companies and functions, managed supply chain operations, and personally mapped all business processes and controls in dozens of companies. The accumulation of my experience is offered in business cases and examples in this comprehensive commentary and white paper.

Reengineering companies has proven that fast, effective and comprehensive change efforts to produce results require company-wide system design and integration architecture, engineering and planning. This same approach is expressed by the PCAOB in AS-2 and COSO framework requirements so companies can achieve better strategic and business controls. Key Processes and Business Controls in Significant Accounts are a key focus of AS-2. Interdisciplinary analysis and holistic design of Key Processes and Business Controls can eliminate operational bottlenecks and assure management that their objectives are carried out. AS-2 demands this method.

The approach of COSO and AS-2 demand a higher level approach. Results of the piecemeal and costly projects of the past and current audits:

- Methods, processes, accounting, and systems fail to indicate to management in a timely fashion where and how to improve company performance.
- Management methods and tools have not been effective in driving business performance to new levels. Investors (including 401-K) realize little, no or slow appreciation in value.

It has been estimated that $40 billion was spent on Y2K without measurable return. Strategic and Business Controls were overlooked in Y2K conversions run by large auditor/accounting/consulting firms. Also missing was the treatment of processes, methods and accounting concurrently and holistically throughout the whole business. As stated in AS-2, "…not all controls relevant to financial reporting are Accounting Controls; …controls that materially affect the reliability of financial reporting are part of internal control including…effectiveness and efficiency of operations and compliance with laws and regulations."

A common statement discussing this with audit committee, compliance and financial executives is "Well that looks like what the law requires, but we have to do what our audit firm wants us to do." or "We need to do what our Big Four firm (implied expertise) tells us to do to avoid material deficiencies." **Nowhere does it say auditors run businesses, define competitive advantage, or determine the effectiveness of Key Processes and Business Controls in driving management's strategy.**

While large accounting firms are competent in many of the facets related to financial reporting, audit and advice, they are not by pedigree necessarily equipped to address the full theatre of Business Controls called for by SOX 404. Their ability to review and attest to the quality of internal documentation (as seen in support of an audit) is not the question. The challenge being proffered here is whether auditor/advisor firms can evaluate (in somewhat a vacuum) the broad organizational scope in evaluating Management's Assessment of enterprise risk and mitigating controls and whether organizations can rely largely on the

accounting silo of the organization (internal and external) as the only ones needing to fully embrace/fulfill SOX requirements.

The axis of auditor/advisor firms and the finance silo are costly to businesses, investors and workers alike. Loss in brand and competitive values in certain manufacturing companies follows outsourcing of skilled workers. Unemployment within computer science programmers is at an all time high due to outsourcing IT, a source of competitive advantage (Porter). Exhibit B shows that outsourcing workers based on "acceptable" accounting practices instead of facts produced no measurable results for one company, even though 42% of the workforce was eliminated. This is an example of management's lack of understanding of Key Processes and Business Controls as they relate to the execution of strategic objectives and not just global need "prudent" outsourcing.

Auditor/advisor firms stood by and watched this happen without raising alarms except for their consulting arrays. The SEC should act to change the audit/advisor relationship along with the procurement and response mechanisms of companies that hire them. The attached paper suggests ways to break this costly and ineffective link.

The COSO framework and AS-2 standards contain easily executable instructions in the hands of people who know their businesses, know Key Processes, know Business Controls and know what they are doing. Further definitions, however, are needed to advance the audit profession.

If anything, the **SEC should redefine the term "Internal Controls" to mean Key Process and Business Controls to mitigate enterprise risk** along with fiscal responsibility and training for senior audit professionals to understand these principles. Accounting, audit, IT and other lower level controls emphasized by auditor/advisors in the form of their "control matrices" should be the exclusive purview of internal audit. A statement about these controls from internal audit should suffice. After all, these were be automated years ago. Why are they micromanaging these? What purpose is it to check the obvious if only to run up a tab and provide a nice façade to shareholders?

David R. Eshleman

David R. Eshleman, President

Finding Value in the Sarbanes-Oxley Act §404 Certification Process

David R. Eshleman

Expert Process Solutions LLC
March 31, 2005

Introduction

This comment is an evaluation of how the COSO Framework and Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2 – An Audit of Internal Control Over financial Reporting Performed in Conjunction with An Audit of Financial Statements (AS-2) can make Management's Assessment and the certification process efficient. This comment supports the principles in the PCAOB Standards and SEC Rules concerning Management's Assessment and process audit. Examples show that the rules and standards, applied correctly by knowledgeable practitioners, can improve business operations and performance by applying sound business concepts and the principles at the front end.

Corporate in-house improvement/reengineering projects, were generally accomplished in a matter of months, produced significant cost savings and improved Business Controls because the problem solving approaches used the same principles now expressed in rules and standards of the SEC and PCAOB. Conversely, 404 certification projects, just as in Y2K, judging from the comment letters, periodicals, and company interviews: took too long, had excessive navel gazing recommendations from internal staff and audit firms, took too many resources, and were extremely costly.

The examples and business cases herein show that if the standards and rules are correctly followed, the combination of operational improvement and compliance can produce savings that substantially outweigh expenses.

In order to achieve substantial levels of savings, a more interdisciplinary approach must be taken to realize benefits. Company leadership must employ skills outside finance or accounting to reduce costs. Operations, functional leaders, industrial and computer engineers to validate transactional flow, systems and interfaces, with accounting to check the numbers provide a balanced mix to assure effectiveness and efficiency of Business Controls. Key Processes must be regulated by the CEO and the management team to be sure that business objectives can be met. The right people and skills must be employed.

The certification process should work as shown in the table below, described in COSO ***Internal Control – Integrated Framework***, "**Evaluation Tools.**" The current practice is piecemeal, just like Y2K projects, and missing the cross-functional, holistic analysis that reduces costs and improves performance.

Order	COSO Framework; AS-2	Order	Current Practice
1	Enterprise Financials	1	10-K Enterprise Materiality
2	Functional Materiality	2	Functional Materiality
3	Material Transaction Flow	-0-	Missed
5	Business Risk and Control Assessment	-0-	? / Not addressed
4	Key Process Workflow	3	Detail on all Processes
6	Automation/Remediation	4	"Generic Control Matrix"
7	Testing of Controls	5	Testing of Controls

Again, just like in Y2K, a relatively simple task has evolved into a costly nightmare because of a failure to apply the principles in the left hand side of the table and to involve individuals with the necessary skills, abilities, knowledge, and experience to truly reengineer the business with a decent payback, on-time and under budget. Failure to apply sound business concepts and principles and the right skills at the front end is a systemic problem, so no one should be surprised at the amateurish "performances" that result.

There are four sections in this report and two supplementary exhibits at the end.

1. Benefits of §404 Standards and Rules

Key Processes and Business Controls

Corporate improvement projects detailed in Section 2 came about because of weaknesses in Key Process and/or ineffective Business Controls that negatively affected the business. The projects were initiated and driven by the division or company CEO using a "framework" to assess the business and its controls. Each project began with a transaction flow diagram to identify Key Processes and Business Controls then a "Management's Assessment" analysis to identify "material weaknesses" that caused excessive cost or working capital or fines to the business (terms in quotes correspond to those in AS-2). The table below illustrates 3 of the 7 Key Processes in companies:

3 of the 7 Key Business Processes	% of Total Business Activities	Operational Efficiency & Effectiveness	Potential for Control Issues
Orders to Cash (including DC/FG Shipments)	41%	50%	med
Procure to Payment	12%	58%	low-med
Accounting Operations and Financial Reporting	9%	81%	low

Operational Effectiveness and Efficiency percentages in the above table reflect current operating capabilities in $100 million to $4 billion companies. Business volumes, business controls that are manual or semi-manual, and customer demands all contribute to weaknesses in operational capabilities. For example, weak Business Controls in Orders-to-Cash cause performance issues in order fill and on-time delivery. Ineffective Business Controls are a root cause of poor delivery performance.

Some examples of Business Controls in Key Processes listed above are:

- Orders to Cash (including DC or Finished Goods Shipments): order/line fill triggers; on-time delivery controls; contract management; + other real-time business-specific controls
- Procure to Payment: automated buying triggers; procure to contract; contract coordination and management; product rationalization plan; + other real-time business-specific controls

Other key processes include raw materials to manufacturing, sales and marketing, supply chain management, product marketing to manufacturing. These all have Business Controls unique to the operational and strategic requirements of a particular business.

Improving Business Performance

A typical Action Plan to improve Business Controls listed above:

1. Understand the Key Processes by mapping the material transaction types from origin to the ledger, then the P&L and Balance Sheet. Collect data and perform statistical analysis.
2. Check if the transaction types had significant financial and statistical accounts set up to trigger exception notices and provide the appropriate month end reporting.
3. Perform a contract review to be sure that contract provisions were reflected in procedures and pricing disciplines and maintained in orders.
4. Do a top-to-bottom framework analysis to map relationships to customers or suppliers, determine financial materiality to the business entity, and map the cradle-to-grave transaction flow through functional activities, then do a risk and control activities assessment to find bottlenecks/weaknesses.
5. Design and implement a system and controls to automate Key Processes to improve effectiveness and efficiency of operations and Business Controls to reduce cost and improve service.

The plan steps 1-4 are identical to Key Process documentation, Management's Assessment with the COSO framework analysis and other elements from AS-2. The functional assessment, focus on Key Process and Business Controls and the AS-2 process mapping work are the same techniques used in effective change management that improves the business. For a $1b business, the process in steps 1-4 to analyze the two Key Processes described in the prior examples can be accomplished by a three person team in about 2-3 weeks. Item number 5, if properly designed from the activities of 1-4, should save more money than it costs.

Better Business and Internal Control is not just Finance and Accounting

Concerning the Internal Control over Financial Reporting, the SEC Final Rule on Section 404 of the Act stated that the COSO framework identifies three primary objectives of internal control:

- Efficiency and Effectiveness of Operations – orders-cash, procure-pay, etc. (6 Key Processes)
- Financial Reporting (Accounting to Financial Reporting Key Processes)
- Compliance with Laws and Regulations

PCAOB AS-2 states that "Management is required to base its Assessment of the effectiveness of internal control …on the COSO Framework" (Auditing Standard #2, Paragraph 13) and that "…not all controls relevant to financial reporting are Accounting Controls; …controls that materially affect the reliability of financial reporting are part of internal control including…

- Effectiveness and Efficiency of Operations
- Compliance with Laws and Regulations" (Auditing Standard #2, paragraph 15)

From the Key Process table, the Accounting and Financial Reporting Key Process is less than 10% of all the sub-processes in a business. Successful improvement projects were launched by considering and evaluating the three COSO objectives in an assessment format that focused on issues outside of accounting and finance. In fact, accounting and finance should be highly automated and integrated with all business operations. If not, this in itself indicates weak controls, especially in larger global companies.

A holistic approach in evaluating the three objectives is vital to any significant, sustainable operational and internal control improvement in any business. Here are the symptoms of not using this approach:

- Methods, processes, accounting, and systems fail to indicate to management in a timely fashion where and how to improve company performance.
- Management methods and tools have not been effective in driving business performance to new levels. Investors (including 401-K) no longer realize benefits to share ownership.

The focus by the PCAOB in improving both operations and controls in Auditing Standard No. 2 should be reinforced by the Commission for the benefit of business and investors.

2. Driving the Cost-Benefit Equation

Successful Change Requires Intelligent Leadership and Framework

A sample of corporate improvement project examples below illustrate the benefits of using a Management's Assessment Process like the approach required by AS-2 described in the previous section.

1. $550 million Tool and Supplies Company. The task was to reengineer the supply chain Key Process and design new Business Controls. The framework approach, transactional mapping, and functional assessment enabled a key system to be re-implemented in 6 weeks. The next quarter, the change resulted in the best quarter-end performance in 22 months, with 15% inventory reduction for the quarter. A critical customer's line fill and on-time delivery increased from 70% to 98%. (2002)
2. $125 million Manufacturer. A Team change of business processes and implementing new systems in three months resulted in a 6% cost reduction. (1998)
3. $500 million Gas Marketing Division. A $10 million fine for a pipeline imbalance required new operational real-time processes for energy trading, with Business Controls and derivative management systems. To forestall immediate risk, back office systems were developed and installed in two trading locations in 6 weeks. The initial risk and controls assessment led to a framework analysis to map business operations and develop a link to systems tied to Oracle™ revenue and accounting. (1994)
4. $900 million Distribution Company. New leadership was brought in to turnaround a failed and over budget project. Systems design, programming and implementation of an order processing and inventory management system was seriously behind. This system covered the business operations of 10 distribution centers and 300+ branch offices. A holistic approach, a cross-functional team,

systems engineering methods, and Business Controls framework helped reengineer the turnaround in just over a year. As a result, $3 million/year was saved in development and on going costs. (1993)

5. $100 million Construction Company. Using a holistic plan view of the business and functional activity diagram, all business processes and Business Controls were improved and converted to the new system. At the same time the construction company was converted to JD Edwards job cost, contract management, and accounting systems, 35-40 companies in a $200 million real estate development company in the same family of businesses were also converted to property management and accounting systems, all in 5 months. The result was elimination and consolidation of two legacy systems and a complete automation of all accounting systems and the IT function. The IT staff was reduced 90% and the accounting staff 80%. Payback was in about 6 months. (1991)

The experience with extreme change as illustrated above shows that change management processes very similar to those in the Rules and Standards can be profitable for identification and remediation of weak Internal Controls and significantly improving business operations. The work done by the PCAOB on producing AS-2 was good work and the team should be congratulated. **Management's Assessment and Certification and the Process Audit should be considered as high value tasks by management, and assigned to the hands of experienced and knowledgeable practitioners as described below.**

A Framework with Right Leaders Solve Problems

After performing an analysis using a framework, functional processes were designed to maximize performance and automate Business Controls. Using high-level Functional Activity Maps, Key Process design, risk assessment and Business Controls became the subject of senior management selection and direction; establishing the "tone at the top." Once the functional design was completed, project discipline and control was established to execute the changes. This problem solving approach, led by an expert practitioner, was no different than that required by Auditing Standard No. 2: Management's Assessment, consisting of the COSO framework analysis and Risk/Control Activities Assessment.

Since the standards and rules were unknown at the time, one might consider this as an independent proof of the effectiveness of the SEC and PCAOB rules for Management's Assessment. The specific approach used in these projects was identical to the one presented in the COSO publication "Internal Control – Integrated Framework: Evaluation Tools," September 1992 in the "Reference manual" section of the publication. This was the second manual in the set on the COSO framework.

Unfortunately, in the introduction of the COSO "Tools" manual, it states that the "tools are presented for *purely illustrative* purposes" and "not an integral part of the *Framework*…" Maybe the COSO team lacked specific examples like the business cases presented here. However, the Reference Manual shows how the "Framework" should be implemented. The "Framework" can be applied to both process improvement and internal control certification as the examples here attest. The "Evaluation Tools – Reference Manual" approach should be strengthened by the SEC.

3. Leveraging Cost Benefits

§404 AS-2 Certification Done Right: Fast, Effective, and Good Business

Speed. All the projects in the previous section accomplished objectives in a short timeframe because of dedicated, high performance teams of 3-5 persons. After a focused, holistic analysis using a framework, including use of Six Sigma methods, process solutions were "engineered", meaning the application of a broad range of disciplines and approaches from all functions, including accounting and finance. As a result, operations were streamlined and controls strengthened in a condensed timeframe. These projects used the identical problem-solving approach advocated in the COSO Evaluation Tools Reference Manual and methods required by Auditing Standard No. 2. Sound business concepts and principles were applied at the front end. The project was planned and executed accordingly.

Internal Controls are Business Controls. Business Controls result from Entity and Functional Activity Risk and Control Activities Assessments. This is a strategic business "system" analysis that seeks to establish integrated and automated controls in the internal and external structure of the business. "Business Controls" regulate management's objectives and strategies relating to customers and markets to reduce risks to the company's business. An example of a just one element of this approach is the

analysis of the 7 Key Processes. To meet the requirement of the AS-2 Standard, Business Controls in all seven Key Processes must be identified and assessed. Again, sound business concepts and principles were applied at the front end.

Balanced Skills. The reported costs of compliance are excessive. Jobs posted for §404 work have all been accounting related in education, background, and experience, reporting to a Controller or Internal Audit. Most Business Control issues are in the 90% of total business operations that are outside of accounting and finance. Operations personnel and other disciplines along with accounting and finance in teams of no more than 3-5 individuals should be working and controlling the compliance process. Everything required by AS-2: process mapping, systems design and analysis for business controls and streamlining, and change management are MBA, systems, industrial and computer engineering and accounting are not exclusively accounting skills. Right people and skills are required for right results.

Avoid Sub-Optimization and High Costs. A "systems engineering" (not IT) interdisciplinary and holistic approach would expand the compliance initiative to involve other skills and experience on certification teams would improve both business operations AND Business Controls. This view of improved operations and controls mirrors what the PCAOB and SEC have expressed in preliminary documents and comments on Internal Controls issues. The Rules and Standards as currently written, bear this out.

How to Improve the Current Certification Process In Companies

Considering Customers, Suppliers, Key Operational processes, Business Controls and Significant Accounts as a complex "system" then all company processes must be "engineered" at the same time to assure optimum performance and accomplish objectives. Systems Engineering is a interdisciplinary holistic process based on business, finance, science, statistics and probability. It evolved from early Air Force space projects and was refined in repetitive operations of these programs that can best described as production operations. Space launch operations are similar in scope and complexity to global supply chain, final assembly, distribution and logistics in manufacturing/distribution.

AS-2 and the COSO framework analysis represent a balanced, systemic (or "Systems Engineering") approach, requiring a business to be examined end-to-end, or holistically (origin of transaction to P&L and Balance Sheet), to determine if material weaknesses exist and design a fix. Risk assessment is also required. Every key or material process that drives the business must have documented Business Controls to make sure the legitimate objectives of management are carried out, that management has designed these controls, and that they are operating successfully. The rules say that the business must provide documented evidence to auditors, and auditors must be able to trace material business transactions from customer/supplier to the P&L and balance sheet and verify that controls are in place.

The question is whether Auditors have the interdisciplinary skills necessary to do a competent audit of business processes in company operations and also evaluate Management's Assessment. Obviously, a process walkthrough can be a training exercise in itself if processes are documented well. If Management does an Assessment of its Internal Controls and includes its business objectives and strategies, can an auditor effectively evaluate whether management objectives are indeed carried out in Business Controls?

4. Conclusions

Strategic Objectives and Business Controls Up; Costs Down

Operational Business Controls. The sub-processes in the Accounting and Financial Reporting Key Process are less than 10% of all types of processes in a company. When multiple facilities and functions are considered, the percentage is actually 5% or less. Business Controls that management requires for control are almost exclusively outside of accounting and operations, more noticeably in the very largest public companies. Many of these Business Controls are manual or semi-manual in operation, which shortchanges executives charged with managing the company and providing return to investors. Multifunctional teams (operations, IT, accounting) most familiar with these processes led by operations should document and test these controls. Knowledgeable people make the SOX Act certification efficient.

Accounting Business Controls. Key Accounting and Financial Reporting Processes were automated years ago. Operational systems outside of accounting should have automated feeds to the general ledger. If they this is not the case, a controls or significant weakness may exist.

Key Process Documentation and Assessment. From Key Process diagrams, Business Controls can easily be assessed and compared to the Strategic Objectives of Management. When this assessment and an enterprise view is provided to the CEO, an Enterprise Risk Management (ERM) assessment can easily be completed. This is Management's Assessment of Internal Controls. Key Process documentation and assessment can be easily accomplished by a team of 3 individuals per division in 6 weeks or less and only needs to be done once and quickly updated on a quarterly or annual basis as required by AS-2.

Right Knowledge and Skills Lowers the Cost. Having competent people with the right skills and cross-functional knowledge to use the PCAOB Rules and Standards to improve the business is a more cost effective approach. This means designing and implementing new methods and controls to reduce the cost of doing business while at the same time providing the evidence for certification. The "systems engineering" interdisciplinary problem solving approach (the business operations and its customers and suppliers are "systems") that is currently imbedded in the PCAOB rules and Management's Assessment is the only effective way to offset and reduce the cost of compliance and audit. Read the Manuals.

General and Business Controls Can Only Be Assessed at 30,000 Feet. If System Engineering principles are used to carry out the PCAOB mandate, the job is simplified and management has a 30,000 foot view of the way things work which can be validated by detailed process walkthroughs. CEOs and the Management Team need an aerial view of the business, to have an overarching view of Operations and Business Controls. Both the business and the controls can then be improved at the same time, with selection and direction from the top. This gives management greater control over the achievement of strategies and objectives.

The Rules Are Reasonable. So the SEC and PCAOB rules and standards are good, consistent with a systems engineering problem-solving approach. The current Rules and Standards are well thought out and in the right hands can produce real and significant cost saving improvements with Business Controls that help the CEO drive his objectives throughout the organization. As written, they make the task relatively simple. With the right leaders and practitioners, and the return should be greater than the cost. There is a clear distinction between auditor and company tasks. However, unqualified humans can overcomplicate what can be an effective change process and make compliance costly and slow.

Shareholders Need Fast, Accurate, Inexpensive Auditors

Management Needs Better Business Controls. To accomplish the Management's Assessment task efficiently and effectively, the Audit firm's opinion about how the firm should work and run must be removed from the process. Management should define the strategy, then specify General and Business Controls to be sure management's objectives are carried out, just as the framework specifies. The SOX Rules and Standards were written to help company management have better controls, not enrich auditors.

Business Controls are the stuff of strategic execution; everyone in an organization is responsible, not just accounting and finance. Appropriate communication vehicles MUST ALSO BE EVIDENT throughout the organization so as to instill this sense ... and empower individual managers to undertake tactical decision-making compatible with management's authorized conduct of business

Audit and Accounting Firms Need Restrictions. Audit Firms should be restricted from consulting services to non-attest clients. Business process mapping, systems integration and design and Business Controls identification and assessment should be accomplished by competent professionals. Audit Firms should be restricted from providing these services, in spite of the fact that the AICPA Professional Ethics states that auditors can provide these services. Process mapping is industrial engineering and can be accomplished internally by individuals trained in Six Sigma or business process mapping methods. For strategic business processes and controls, education or experience in business strategy, business controls design, computer science, computer engineering, industrial engineering, or systems engineering is required. An effective procurement process designed by management with HR involvement will help assure the right resources are working on a 404 project.

Auditor Independence and Selection Process. PCAOB Rules should require that members of an audit firm disassociated from the audit process are prohibited from contact with board members or company management. Only the audit professional leading the project on-site with responsible charge should have senior management and board contact. The SEC/PCAOB could help this process by assigning Audit Firms to companies through a lottery process and capping their hourly rates. Audit professionals must

have total charge and independence concerning the audit at hand to be sure the investing public is protected. The PCAOB should also develop a report card format to periodically grade audit teams on their performance and make this rating public.

In the past, arguments have been made that changing auditors frequently will drive up costs because the new auditor will have a learning curve. This is not the case with AS-2. Companies should have already mapped their processes in a straightforward, understandable way. The only specialized training audit professionals need in a new situation is how to perform audits efficiently so costs are minimized for the client. There should be some kind of business process and controls test to make sure they are qualified by knowledge and intelligence to perform an audit in a new situation.

Save MONEY! There is no justification for high internal and external costs of §404 SOX certification. Application of the COSO framework, Management's Assessment, and Auditing Standard No. 2 should result in improving and automating the accounting function, better Business Controls, and significant cost savings that outweigh costs of compliance. If managements are unable to achieve this goal, their boards should remove them.

David R. Eshleman
PO Box 2005
Davidson NC 28036

Phone: 704-892-6112

Supplementary Information in Exhibits A and B

Exhibit A shows that Auditing Standard No. 2 fits a pattern of good business practices and principles as compared to a longstanding, accepted practice. Evidence shows that the bigger audit firms have neither strengthened nor supported the COS Framework and AS-2. No material weakness means clear evidence that Key Process effectiveness and efficiency to Financial Reporting is driven by Business Controls that are designed, put in practice, made operational and tested by Management directives, not auditors.

Exhibit B is an example of ineffective General and Business Controls. Auditors did not inform senior management that the General and Business Internal Controls were ineffective and did not indicate to management that its cost down strategy was not working. Effective Business Controls means that management objectives are carried out and kept in line by the methods, processes, accounting, and systems of the company and these indicate to management in a timely fashion where and how to improve performance.

Exhibit A: COSO Framework/AS-2 Requirements; Audit Firm Recommendations

The table below shows the concepts and requirements derived from the COSO framework and AS-2 on the left hand column. These concepts are consisted with a "Systems Engineering" or holistic approach to problem solving in business that breaks down complexity and creates viable and profitable solutions. Company responses are derived from interviews.

COSO Framework and AS-2	**Audit Firm/Company Response**
Definition of Internal Controls	
1. A Process: Designed by the CEO and effected by the Board of directors	
2. Concurrent Key Process Management's Assessment, Controls & F.S. Audit	Management's Assessment not emphasized or clarified to client
3. High level assessments for management and process audit to improve Business Controls	Only Accounting skills required for AS-2
4. Holistic, systemic, interdisciplinary approach is implied and required	
Leadership – CEO/CFO has responsibility for operation – Framework of execution is a priority for Management's Assessment	CFO only, COSO Framework not executed at all or well
Risk Assessment – Required for <u>all</u> significant activities – Factors analyzed to determine efficiency / effectiveness of unique Business Controls – Includes Operational, Financial Reporting, and Regulatory Compliance Risk	Risk Assessment narrowly focused on accounting/ finance; non-significant micro areas covered also, limited organizational participation to help limit scope to areas of significance
Disciplines – <u>Interdisciplinary</u>: all functional activities with Key Processes of significant transaction flows and significant accounts – Detailed knowledge of operational, financial, material and performance issues – Professional teamwork required	Accounting and finance driven, little/no operational and professional skills for process mapping or controls work
Goals – Benefit investment community and shareholders (organization/investors) – Annual and quarterly reporting – Proactive Risk Identification/Management – Maximum Flexibility for Business Control	Management goals and business performance are not a part of compliance
Scope – Broad throughout, covers all functions – Integrated processes/products – Balanced life-cycle – Single focused project	Business Controls and Key Process improvements are not the emphasis
Timeframe/Execution – Concurrent execution with change initiatives helps maintain competitiveness – Efficient synthesis of controls solutions with improvement lowers cost – Focused goals from knowledge – Short, forced timeframe	Concurrent business improvement with controls is not recommended (similar to Y2K restrictions on business improvement)

Exhibit B: Ineffective Strategic Business Control Example

An example of weak Business Controls is the dilution of the value of accounting practices and controls in large public firms to adequately inform management of the results of their actions. Ineffective controls defeat the objectives of management in operational effectiveness and efficiency. Nowhere is this more obvious than in the outsourcing of millions of jobs that have value to American manufacturing and distribution businesses. In many cases, the return to shareholders has been minimal for these vogue programs. In outsourcing, a management team may have a goal to eliminate unions and reduce cost. Company accounting and not-so-independent auditors may justify management's goal in internal allocations of costs that show manufacturing labor as overly costly to the business, when in fact a total and/or lifecycle costing approach may show otherwise.

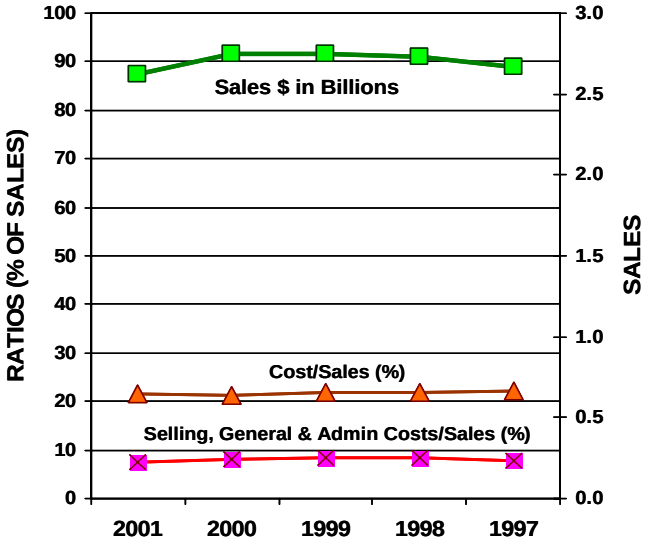
Consider the following public company's performance data. In this manufacturing company example, the CEO rolled out an outsourcing strategy. The results of this program are shown below. The source of information is the company's 10K filings from 1997 to 2001.

	2001	1997
Number of US Employees	7,000	12,000
Number of Foreign Employees	7,400	6,000
Total Employees	14,400	18,000
Outsourcing Reduction in US Jobs 1997-2001	-42%	(5,000)
Foreign Employees – jobs gained	23%	
Total Jobs Lost/Gained	-3,600	

The job loss chart above indicates a 42% outsourcing job loss over a five year period. Over 5,000 jobs were permanently lost. In some cases foreign vendors replaced manufacturing jobs, which accounts for reduction in the "Total Employees" numbers. Did this produce financial benefit to the company? The following chart shows the financial results for this same period. Sales are flat, and cost and SG&A ratios are flat.

Why do the numbers show such poor results, even though American workers were replaced by cheaper Chinese labor? If a framework analysis like in COSO is correctly performed by this company, the real risks of this strategy are revealed:

- Overhead had been unfairly "allocated" to production workers on division P&Ls
- Labor cost for most products was less than 8% of base product cost, while overhead was often well over 90% of the total cost.
- Company accountants calculated internal cost allocations monthly – these were not publicly reported, but were used for internal decision making by management.
- Outsourcing to China produced unwanted competition. Now knock-offs from China of key products are being showcased by key high-volume customers.
- The intelligence and skill base used to produce safe, useful and quality products is gone, decreasing the company's (and investor's) brand value.



The company's auditors did not alert the CEO, board and shareholders that a potential inaccurate picture created by overhead allocations presented a risk to the company and its investors. This went on for more than 5 years. Many companies have outsourced their workers. Have millions of jobs have been lost, even though external reporting is attested as accurate by the company's auditors, because end results have questionable value due the misapplication of internal accounting in allocations? If a Management's

Assessment of Internal Controls over Financial Reporting had been performed with the Objective of Efficiency and Effectiveness of Operations, this oversight might have been discovered.

Were internal controls designed and in place? Did they govern the effectiveness and efficiency of operations? The audit firm should have at least recognized the lack of control that could undermine long term investor value. While this example is about good controls over performance and investors loosing value when a skilled workforce is lost, it also unfairly caused loss to the workers and their families. Practices such as these can work against management's strategy to reduce overall costs and accomplishment of long term objectives.