



The Committee of Sponsoring Organizations of the Treadway Commission

May 16, 2006

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Mr. Christopher Cox
Chairman
Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549

Mr. John White
Director of the Division of Corporate Finance
Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Cox and Mr. White:

During the SEC and PCAOB Roundtable on Internal Control Reporting and Auditing Provisions last week, a question was raised regarding the current project undertaken by COSO. The purpose of this letter is to provide you with additional information with respect to the question raised.

In January of 2005, COSO began a project to provide additional guidance in the application of its *Internal Control – Integrated Framework*. This additional guidance is based on fundamental principles of internal control that were included in COSO's original framework; principles which COSO believes are applicable to all organizations.

In October of 2005, an exposure draft of this guidance, *COSO Control Guidance for Smaller Businesses* was published for public comment. Many comments and constructive suggestions were submitted in response to this exposure draft. After careful consideration of all the comments and revision of the exposure draft based on these comments, COSO is finalizing the document and planning for publication, both in printed version and on our website by June 30.

In the process of considering the comments received during the exposure period, issues raised by the SEC's Advisory Committee on Smaller Public Companies were considered and addressed. I address the issues raised by that committee in an appendix to this letter. We do feel that the forthcoming guidance addresses the comments raised by the Advisory Committee.

This new COSO guidance will be published in three documents – each designed for a specific purpose and audience. The volumes are:

- Executive Overview – intended for all users, but especially management, CFO's, and boards.

- Small Business Guidance: Principles and Attributes of those principles. This is hands-on guidance for each of the COSO internal control components with examples of how small businesses are implementing effective internal control.
- Implementation Tools. These are tools that small businesses might utilize to organize information about internal control.

Additionally, the guidance provides mechanisms for more efficient bases for internal control assessments than we have seen in the past two years. For example, the guidance points out that once a company establishes effective internal control the monitoring component of the framework might be used for management's continued assessment of control effectiveness.

We believe this guidance will be helpful to smaller organizations in establishing effective internal control over financial reporting. This guidance, while providing many useful tools and examples, does not provide a specific checklist for management to follow in order to evaluate its internal control. Rather, the guidance requires management to use informed judgment in establishing and evaluating its internal control, i.e. do the controls achieve the objective of providing reasonable assurance regarding the preparation of reliable financial statements.

COSO was established because the sponsoring organizations were concerned about fraudulent financial reporting. Our recommendations contained in the *National Report on Fraudulent Financial Reporting* (1987) shows our commitment to improving transparent financial reporting and closely parallel the actions taken by Congress in the Sarbanes-Oxley Act. COSO believes that all companies - public or private, large or small, US domiciled or foreign domiciled - should commit to implementing effective internal controls to ensure that their financial statements are free from fraud or other material misstatement. The objectives oriented approach in the forthcoming guidance reiterates that simple proposition and provides guidance to achieve those objectives with management making cost-benefit decisions as to the appropriate set of controls to implement.

COSO remains committed to working with all constituents, domestically and globally, to promote the achievement of effective control and risk management across all organizations. To that end, the COSO board has approved a strategic planning process that will begin immediately to explore more effective ways for COSO to achieve its objectives, including input from the SEC and other constituent organizations.

Sincerely,

Larry E. Rittenberg
Chair, COSO

c.c.

Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
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COSO RESPONSE TO SEC ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES

May 16, 2006

The Advisory Committee issued its report on April 23, 2006. In that report, the Advisory Committee makes a number of statements, all in the same tone, and generally framed as:

“unless and until a framework for assessing internal control over financial reporting for such companies [smaller businesses] is developed that recognizes their characteristics and needs” (p. 6).

That statement is then followed by a series of recommendations supporting some relief for smaller public companies. The implication is that the COSO *Internal Control, Integrated Framework (the Framework)* does not recognize the characteristics and needs of such companies.

We address the nature of the COSO *Framework* in this appendix and further espouse the basis for our belief that the framework is applicable to all businesses - large or small, public or non-public, domestic or foreign registered. We believe the recommendations made by the committee are issues that the Commission rightfully addresses and therefore we are silent on the merits of the recommendations other than stating that COSO believes that fraudulent financial reporting is not the unique province of larger companies¹. Further, as stated in my letter, COSO believes that all companies ought to commit to a system of internal control that provides reasonable assurance that financial reports are free of material fraud or other misstatements and can be reasonably relied on by users of those statements.

A Brief Overview of the COSO Framework

In its basic elements, COSO views internal control as a process that evolves over time as business practices change and as the nature of an organization changes. The *Framework* starts with the setting of objectives, i.e. *effective internal control over financial reporting should provide reasonable assurance that financial statements prepared by management are free of material fraud or other misstatements*. The internal control components follow in a logical pattern:

¹ See for example, Beasley, Mark, Joe Carcello, and Dana Hermanson, *Fraudulent Financial Reporting, 1987 – 1997: Analysis of US Public Companies*, 1987, New York, sponsored by COSO. That study focused on SEC actions against companies. The primary findings were:

- The companies committing fraud were generally small,
- In 72% of the cases, the CEO was involved in the fraud,
- Most of the companies had weak boards and/or non-existent audit committees,
- A significant portion retained substantial ownership by the founders and/or board members,
- The consequences of the fraud were strong, including bankruptcy in many cases.

- **Risk Assessment.** The organization should identify the major risks to the achievement of the objectives. For smaller businesses, those risks relate primarily to the recording (misrecording) of transactions, estimates, or adjustments; management override of controls and processing; and errors or fraudulent transactions that are usually mitigated by segregation of duties in larger companies.
- **Control Environment.** The control environment represents the “tone at the top” of the organization and is an important mechanism to mitigate risks. A strong board, with sufficient resources, for example is a strong line of defense against management override. A strong ethical culture and a commitment to financial reporting competencies represent reasonable responses by all businesses to mitigate the risks of misstatement or fraud.
- **Control Activities.** All organizations need to implement policies and procedures to ensure that all transactions are accurately recorded. Without such controls, it will be difficult to make informed management decisions, or even to ensure that the organization properly bills all its services and collects cash.
- **Information and Communication.** Stated simply, a company needs basic information to run the enterprise and to gain knowledge that its major processes, including financial reporting, are working.
- **Monitoring.** Once companies establish effective internal control, they should develop processes to monitor the control system to determine that it continues to operate effectively. Monitoring can include such things as management reports or random testing. Management can, and should, use monitoring as a basis for their continued assessment of internal control once it has established effective internal control.

The *Framework* is scalable. The specific activities that are chosen to be implemented can vary with the size or complexity of the organization. Our forthcoming guidance provides numerous examples and approaches that are currently utilized in a cost-effective manner by small businesses to achieve their control objectives related to financial reporting. Because the *Framework* is scalable, we believe that it does consider the unique needs and circumstances of smaller businesses. For example, we recognize that smaller businesses have challenges in achieving segregation of duties. However, the juxtaposition of another framework does not eliminate or even reduce the risks associated with inadequate segregation of duties. Rather, specific controls, such as management knowledge of the business and review of periodic reports, or management review of important reconciliations may be very effective in mitigating those risks. *The amount of risk is the problem, not the framework. Management needs to respond with the most cost-effective way to mitigate those risks.*

Effectiveness of Internal Control

The forthcoming *Guidance for Smaller Public Companies* (the “*Guidance*”) is very explicit that judgments about the effectiveness of internal control are made in relationship to the achievement of the financial reporting objectives. The internal control components, as well as the principles

discussed in our *Guidance*, serve to facilitate the achievement of those objectives. Based on our review of the comment letters issued in response to our exposure draft, it appears that many readers viewed the exposure *Guidance* as potentially burdensome because we did not focus as explicitly on the achievement of the objectives. Rather, we focused on the principles underlying the components of internal control, such as the elements of a strong control environment. Those principles are both important and necessary, but they may be achieved in many different ways for smaller businesses than for larger businesses. Our forthcoming *Guidance* has clarified this particular issue. We are also clear that good internal control is not based on a “check the box” approach that is the same for all companies. Rather, good internal control is based on choosing the most appropriate set of control activities to reduce risks to reliable financial reporting. Our *Guidance* suggests approaches to consider in making the decisions on choosing controls.

Specific Issues Raised in Advisory Committee Report

The COSO *Framework* is a support structure to achieve effective internal control. It is important to note that the *Framework* does not specify particular controls; rather a company is encouraged to determine which controls best address the financial reporting risks that the organization faces. In that sense, a control framework always requires management judgment. Further, we believe the nature of those judgments ought to be discussed with parties independent of management, such as the board and potentially outsiders, such as auditors, so that all parties understand the judgments and can objectively discuss those judgments in achieving the control objectives. Some of the major concerns of the Advisory Committee were:

- Inadequate resources to achieve segregation of duties,
- The risks of management override,
- Changing nature of smaller businesses (dynamic processes),
- Sufficiency of guidance regarding what is “adequate” internal control, and
- Costs of documenting, assessing, auditing internal controls.

Segregation of Duties and Management Override

The Advisory Committee Report noted that smaller public companies may have limited resources, which may preclude a smaller public company from creating the more traditional internal control processes that segregates responsibility for authorizing transactions, performing control activities related to recording and processing transactions, monitoring those control activities, maintaining accounting records, and having physical access or custody of assets or key records/documents. The Report also notes that smaller companies processes are dynamic and not suited to a “documentation and process” oriented approach to internal controls.

We specifically address management override and the lack of adequate segregation common among smaller public companies. We first ask the specific risk questions suggested by the COSO Framework:

1. What is the risk to reliable financial reporting of management override and how might that risk be mitigated in a smaller business?

2. What is the risk to reliable financial reporting of inadequate resources that generally results in segregation of duties in larger companies and how might that risk be mitigated in a smaller business.

We suggest that risks to reliable financial reporting do not go away with a different framework or a pass on management's need for effective internal control. Rather, we suggest that organizations use innovative approaches to minimize these risks. The question is how this can be done (addressed in our *Guidance*).

Our *Guidance* suggests that smaller public companies can better leverage the intimate knowledge of the business and day-to-day monitoring of activities that is typical of the management of smaller public companies [and, in many instances, those activities may adequately compensate for lack of segregation of duties]. We suggest approaches in which management can utilize their business knowledge to “ask the right questions”, identify deviations from expectations, and to identify the existence of material errors or fraudulent activity in a smaller business. Management might also review, or perform, selected reconciliations, to address the risk of misstated financial statements due to human error or fraud². In many small companies managers already are performing these and other procedures supporting reliable reporting, and credit should be taken for their contribution to effective internal control. As companies grow, it may be more efficient and cost effective from a management time consideration to segregate processing duties.³

To address the concerns of management override, we have recommended the active involvement of the Board of Directors as a means to strengthen the control environment at smaller public companies. In the smaller company environment, it is imperative that the appropriate tone at the top be set and management exemplifies strong ethical behavior. While it is true that management of smaller public companies have increased opportunity to override controls, active involvement by the Board of Directors and the Audit Committee helps mitigate this risk and through their oversight, enhances the control environment as it relates to financial reporting. We point out where the board may utilize other resources as a check against management; for example, request an outside auditing firm to review significant adjustments and estimates that were entered or approved by management.

Adequate Internal Controls

The Advisory Committee Report expresses concern regarding the lack of clarity about what constitutes "adequate" internal controls for smaller companies. During the development of our *Guidance*, our Task Force members concluded that the objectives of effective internal control are

² Other activities suggested in our guidance include, but are not limited to managers' reviewing system reports of detailed transactions; selecting transactions for review of supporting documents; periodically conducting counts of physical inventory, equipment or other assets and comparing them with accounting records; and reviewing reconciliations of account balances or performing them independently.

³ Our review of practice reiterates that there are not many companies in the “smaller” definition suggested by the Advisory Committee that will not have, as a matter of good business practice, adequate segregation of duties. For example, a company with \$100 million in annual revenue generated through the sale of product will most likely have the billing and collection function segregated in practice and through the computer applications they use.

the same for smaller companies as for larger companies⁴. Thus adequacy is determined by whether the internal control components, taken as a whole, achieve the objectives of preparing reliable financial reporting. In doing so, the task force recognized that smaller businesses may place greater emphasis on some components of the control framework, e.g. more on computerized control activities, less on a formal risk identification process, more on management monitoring, and more on the actions of an effective board of directors. We do not say, for example, that every organization, large or small, should have a separate human resources department that documents every policy and procedure regarding affecting their function. Rather, we say that a company must have a mechanism in place to ensure that it deals with its human resources in a way that it complies with applicable federal and state regulations and it has mechanisms to ensure that its employees are paid properly and that relevant tax-statement reports are made to the applicable jurisdiction. In other words, the assessment is based on achieving the objective, not on a documented checklist.

Our guidance is explicit in stating that effective internal control does not necessarily mean a “gold standard” of control is built into every process. There can be classes of transactions for which a deficiency in one component is mitigated by other controls in that component or in another component strong enough such that the totality of control is sufficient to reduce the risk to reliable financial reporting to an acceptable level.

Dynamic Nature of Small Businesses and Processes

It has been asserted that the nature of small businesses require that processes be dynamic and change as the organization changes. We could not agree more. The *COSO Framework* simply states that those processes should continue to be guided by the objective of achieving reliable reporting. That reporting will enhance management decision-making and increase the probability of the company succeeding. The scalable nature of the *Framework* encourages companies to embrace new and efficient ways to accomplish effective internal control.

Effectiveness of the “Guidance for Smaller Public Companies”

The Advisory Committee Report questions the effectiveness, especially the cost-effectiveness, of the guidance contained in our exposure draft. We have carefully considered the comment letters, including the comments by the Advisory Committee and have adjusted clarified our report in many aspects.

One of the challenges hurled at the Task Force was to identify “significant cost savings” for smaller businesses. Good internal control provides significant benefits beyond public reporting. It results in better information for management decision-making. It helps assure that resources flow into the organization based on sales. It helps assure that resources are not inappropriately siphoned off for individual management enjoyment, or for employee enjoyment through fraudulent activities. Those benefits do not come cost-free. The challenge is to achieve those benefits while minimizing any additional cost – one we strongly believe can be overcome.

⁴ The task force was constructed such that the membership was predominantly drawn from smaller businesses, or served smaller businesses. In addition, the majority of the project team from PricewaterhouseCoopers was drawn from their small business practice.

One cost is related to documentation and was extensively discussed by our Task Force. The *Guidance* discusses both formal and informal approaches to documentation. Smaller businesses may have less formal documentation of activities. We discuss a more pedestrian example to illustrate the point: small businesses may not want to have each employee sign a code of conduct; rather it may enhance its ethical environment by prominently displaying its code within the office, the factory floors, or on the shipping dock. It is the actions that are taken to ensure that ethics is ingrained in every activity of each employee that is the concern; it is not the documentation. We suggest that an entry into a calendar that shows management follow-up to an issue or management discussion with employees constitutes documentation. The nature of the documentation should reflect the sophistication and formality of the systems. As we stated earlier, an effective system does not have to be the “gold standard”.

One criticism we saw in the comment letters focused on the number of principles and attributes contained in our exposure draft. We have clarified by stating that the principles relate to achievement of objectives; the principles are not an end in themselves. We sought to reduce the cost of compliance by addressing how the components of the COSO framework could be applied in the most cost-efficient manner for the smaller public company. We have further refined the number of principles in our exposure draft from 26 to 20 and have reduced the number of attributes of those principles substantially. The guidance does not suggest that a company need to document each and every attribute of every principle; rather it suggests that the attributes should be considered by companies that want to achieve effective internal control.

We also believe that our guidance is effective in communicating the principles embedded in the original Framework⁵. One consideration is the format in which it is written. The principles have been written in a concise outline format with specific attributes associated with each principle. This allows a reader to focus on the concepts surrounding each principle. We follow up each discussion of principles with approaches that a smaller business can take to implement these principles within their organization. The approaches are then followed by relevant examples of how a company could implement the principle. Each example was developed by practitioners based on relevant experiences with smaller businesses. They are not intended to be best practices, but rather illustrative principles that will provide the user with the concepts needed to implement internal control over financial reporting in organizations of any size.

COSO Commitment to Internal Control and Improved Financial Reporting

We continue to believe that there are effective and efficient ways of implementing good controls in every organization. Furthermore, we believe that the market place is best served by the use of the same internal control framework for both large and smaller companies. Having a single, principles based model, as opposed to the rules based guidance some constituents have called for, allows the capital markets to benefit from knowing that all companies have applied an equal standard and quality of internal control over financial reporting regardless of their size. We strongly believe that a Framework specific to smaller companies is not necessary or desirable. It

⁵ The guidance does not change the 1992 COSO Internal Control, Integrated Framework. Rather, our guidance further explicates the underlying principles contained in that framework to provide greater guidance to businesses in implementing the framework.

is through the modification to the approach and variation in the relative importance of each component of the *Framework* that a smaller company can tailor the means by which it demonstrates effective internal control unique to its environment.

Evolution of Controls and Practices

As noted in the covering letter, COSO is committed to a strategic planning process that will likely result in a more inclusive, robust organization than we currently have to work. As chair of COSO, my vision is that the organization will work on harmonizing control frameworks globally and become more nimble in providing guidance where needed. Our structure will likely be different and better funded. We look forward to meeting those challenges.