1991

Comment letters on the exposure draft, "Internal Control — Integrated Approach," Volume 1

Committee of Sponsoring Organizations of the Treadway Commission

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

May 1, 1991

To: **Vincent M. O'Reilly, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Advisors

Gentlemen:

Here is the first batch of seven comment letters on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Tom

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

May 1, 1991

To: **Vincent M. O'Reilly, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
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Gentlemen:

Here is the first batch of seven comment letters on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Tom

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

March 26, 1991

Kmart Corporation
International Headquarters
3100 West Big Beaver Road
Troy MI 48084-3163

Comm. of Sponsoring Orgs.
of the Treadway Commission
1211 Avenue of the Americas
6th Floor, New York, NY 10036-8775

Dear Sirs:

First, I do not feel comfortable with the proposed definition of internal control (page 3 of the Exposure Draft dated March 12, 1991) because of its tone of emphasis and the ability to evaluate certain components as follows:

> By placing emphasis on the first two components (employee integrity, ethical values and competence... and management philosophy) as the foundation components, the definition implies that the presence of these two has more weight than other components. A case in point could (would) be an excellent ethics environment should override a lack of segregation of duties environment.
>
> Since the above components are proposed as the foundation, it would seem logical that an auditor should be knowledgable in evaluating the degree of presence of the first two components. Not only do I believe that most auditors are not equipped or trained in this area, but also (even if knowledgable) they could (should) not rely upon their comfort level as an alternative compromise during a "significant event" of the auditee.
>
> In summary, I have no problem with the nine components. My concern is the undue emphasis placed on the first two components.

Second, internal auditors spend more of their productive time on addressing internal controls than any professional group in the business world. I was surprised that although internal auditors were responsible for submitting 16% of the Commission's questionnaires (B-4), only one internal auditor (B-3) was interviewed. This imbalance should be addressed.

Finally, I was impressed with the layout of Appendix C. Although verbose, I'm sure my staff will consider this checklist as a useful tool in evaluating control aspects on future audits.

Robert B. Rito

Robert B. Rito
Director of Internal Audit

RBR/ja
3518e

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varian

April 5, 1991

Committee of Sponsoring Organization
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

To the Committee,

I have reviewed the Exposure Draft dated March 12, 1991. Here are my comments on the report:

1. Definition

   I agree with the definition.

2. Components

   The nine components appear to adequately address all aspects of internal control. I cannot recommend any additions or deletions.

3. Evaluation

   I believe we plan to use the tools as a supplement in our organization in evaluating internal control. However, I was unclear about a specific area in the Appendix C Exhibit C-16 Reference Manual. The letters "O, F, C" in the "Category" column were not explained. What do they stand for?

4. I believe guidance material is helpful for companies publishing reports on internal control because:

   a. It gives management a frame of reference, a place to begin.

   b. It helps to provide an industry standard so that reports from different companies can be more easily compared to each other.

I hope my comments have been helpful.

Sincerely,

Gina Harney

Gina Harney
Internal Auditor

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Post Office Box 4545
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Georgia Power
the southern electric system

April 5, 1991

The Committee of Sponsoring Organization
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, N. Y. 10036-8775

Dear COSO:

We have reviewed the Internal Control Exposure Draft and herewith submit the attached comments for your consideration.

Should you have any questions, please call me at (404)526-6782.

Sincerely,

L. D. Vaughn

L. D. Vaughn
Manager, Internal Accounting
Controls

LDV:jhu

Attachment

INTERNAL CONTROLS - INTEGRATED FRAMEWORK

COMMENTS

OVERALL

- The definition of Internal Controls is too long.

  Internal Control is the process to help ensure the achievement of the entity's operating and reporting objectives. Its foundation is integrity, ethical values and competence.

PART I - EXECUTIVE BRIEFING

- Internal control is not necessarily part of effective and efficient operations. Internal Control cannot prevent bad management decisions or ineffective and inefficient operations. (page 4)

- Management does consider the work done by external auditors a substantiation and evaluation control. As such, they **are** part of the control system. (page 21)

- Methodology: What part does compliance play in assessing reliability of financial reporting? (page 38)

- The chapter on risk assessment almost completely addresses business profitability risk. This may just be good management of the business and can only be reviewed in hindsight. (page 91)

PART II - DEFINITION, COMPONENTS

- These sections are not essential to the draft and serve primarily to contribute to its length and redundancy.

PART III - MANAGEMENT REPORTING TO EXTERNAL PARTIES

- Report calls for review to cover a period of time or point in time. In a footnote it says "From a practical standpoint, an evaluation will not be done at one point in time. An evaluation program may be carried out at various times through the year, and updated from the time of evaluation procedures to the point in time of the report." (page 180)

  This is not practical. The time to update the evaluation or even perform a complete evaluation every year would be cost prohibitive. Rather, the evaluation should be ongoing. Management should only make a statement that they maintain a system of internal controls and continually monitor and evaluate those controls. Otherwise, one could build in an expectation that all major controls are effectively working at the time of the report. This is impossible to achieve.

INTERNAL CONTROLS - INTEGRATED FRAMEWORK

COMMENTS

- The draft seems to avoid the issue of when to report that the company has a material weakness. (page 157)

  A company should probably report the major control weaknesses and the actions being taken. This should be done in general terms. Also, they should state the effect on the financial statements.

GENERAL COMMENT

The report is **too long** and contains some redundancy. As a result, its usefulness will be limited.

harsco
CORPORATION

April 10, 1991

"COSO Committee"
1211 Avenue of the Americas
New York, NY 10036

Gentlemen:

Regarding Mr. P. Norman Roy's correspondence of March 12, 1991 concerning the exposure draft "Internal Control - Integrated Framework," please be advised of the following responses:

Question 1.

Should the definition "internal control" encompass management controls that extend beyond financial reporting, as proposed in the draft?

- Yes, for both operating and compliance purposes.

Question 2.

Would the proposed framework of components and evaluation tools be useful to you in developing a self-assessment of your internal controls?

- Yes.

Question 3.

What additional guidance would you suggest be provided to assist management in developing a self-assessment of a company's internal control structure?

- None, at this time.

If you have any further questions, please contact me accordingly.

Sincerely,

L. W. Brick
Vice President and Controller

A1/F6-15

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717/763-7064

E/AC/CFB/PNR

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Donald G. Perry
Certified Public Accountant

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April 18, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
Sixth Floor
New York, NY 10036-8775

Re: Internal Controls-Integrated Framework Exposure Draft

Dear Sirs:

Chapter 2 of the Report of the National Commission on Fraudulent Financial Reporting in Section 7 Guidance on Internal Control says "The Commission recommends that the organizations sponsoring the organization work together to integrate the various internal control concepts and definitions and to develop a common reference point." This recommendation would seem to require a definition of internal control that would be useable by companies and other financial reporting organizations in their assessment in reporting on internal control. I have not been able to find such guidance in the Integrated Framework Exposure Draft which was issued on March 12th, 1991.

Not only does the Exposure Draft, comprising 163 pages plus extensive appendencies, seem overly cumbersome and full of irrelevant comments and discussion, the core definition on Page 51 seems to me to be basically flawed. Integrity, ethical values and competence as well as risk assessment and information systems are not components of internal control, they are rather factors to be considered in evaluation of internal control. It would seem to me that internal control consists of "interrelated components with the control environment serving as the foundation for the other components which are establishing objectives, control procedures and monitoring." Communication and managing change could be considered although they also seem to be somewhat extraneous to the definition of internal control.

I have a number of detail comments on the content of the exposure draft which I will put together and send to COSO later. If the others receiving copies of this letter are interested, I will be glad to send copies of my comments to them as well.

Very truly yours,

Donald G. Perry

Donald G. Perry

cc: National Association of Accountants
Instiitute of Internal Auditors

ARMCO

ARMCO STEEL COMPANY, L.P.
703 Curtis Street • Middletown, Ohio 45043-0001

P. J. PICCIONI
Vice President-Finance
and Chief Financial Officer

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April 24, 1991

COSO Committee
1211 Avenue of the Americas
New York, New York 10036

To Whom It May Concern:

I would like to forward on to you my views concerning the exposure draft on internal controls. On the key issues my comments are as follows:

1. Should the definition of "Internal Control" encompass management controls that extend beyond financial reporting, as proposed in the draft?

   Yes

   Reasons:

   - Individuals view internal controls as financial related matters when, in fact, strong business controls not only benefit the company but also strengthen the reliability of the financial statements.

   - Control issues relate to process reliability and being able to evaluate any process within the business.

   - Internal control is everyone's business.

2. Would the proposed framework of components and evaluation tools be useful to you in developing a self-assessment of your internal controls?

   Yes

ARMCO

Reasons:

- it would help raise the level of internal control awareness

- it would augment the work done by external auditors

- it would help all management be more aware of the credibility of their system

- if done properly, would probably add value to the business once completed

3. What additional guidance would you suggest be provided to assist management in developing a self-assessment of a company's internal control structure?

   - Perhaps a video summarizing the importance and value added with internal controls, plus some real live horror stories when structures fail.

One additional note, maybe we need to consider changing the term "internal control" to shed the old assumption that it's financial related. Just a thought!

P. J. Piccioni

PJP:jo

P. J. Piccioni
FEI Member
Dayton Chapter

7

Robert A. Wettle, CIA, CMA, CFE
2246 Angel Avenue
Toledo, OH 43611-1654
April 25, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Internal Control - Integrated Framework
Exposure Draft - March 12, 1991

Below are some recommended revisions for consideration prior to issuance of the final report:

Page	Paragraph	Line	Recommended Revision
20	1	2	Change "egregious" to BLATANT ("egregious" is not a frequently used word)
57	3	1	Change "between" to AMONG (3 categories are referenced)
60	2	2	Add COMMA after "all"
80	2	2	Change "enabler" to FACILITATOR ("enabler" is not a valid form of the word "enable")
89	Chart of Accounts Question 3		 Change "narrative" to NEGATIVE (Assuming that this is what the author intended)
144	3	1	Change "between" to AMONG (3 categories are referenced)
161	3	8	Change "egregious" to BLATANT ("egregious" is not a frequently used word)
C-22	Question 32		Change "narrative" to NEGATIVE (Assuming that this is what the author intended)

RAWettle

R. A. Wettle

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

May 20, 1991

To: Vincent M. O'Reilly, Coopers & Lybrand
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Advisors

Gentlemen:

Here is the next batch of comment letters (there are six) on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Tom

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

cc: Richard M. Steinberg

HARRIS
TECHNOLOGY GROUP

30 April 1991

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Dear Sirs:

After studying your exposure draft "Internal Control - Integrated Framework," I have the following suggestions which I hope will assist you in preparation of the final document.

Benefits

I do not believe the exposure draft adequately outlines the benefits of improved internal control. As stated, the "primary" objective is to "help management . . . . better control their organizations' activities." How is this study or a common definition of internal control going to "help" control their organizations? The exposure draft assumes the readers understand this connection.

I suggest that, first, the exposure draft legitimize the point that the lack of internal control is costing corporations money, lots of money, each year in lost productivity, missed economic opportunities, fraud, theft, etc. Surely, one of the internal control studies done prior to this exposure draft estimated the cost of internal control deficiencies. If not, I propose your first job is to determine a rough cost, otherwise you have not convinced the reader that they need to be concerned with internal control. Having established that their is a cost associated with deficient internal control, the exposure draft should then briefly explain how a common definition and list of components of internal control can improve the internal control within an organization which will then lead to increased productivity and profit.

I believe this will establish the value of this study in the readers mind. Without establishing a legitimate need and benefit from this project, the project could be dismissed an "academic" study whose results will have limited practical value.

Objectives

The stated objectives are to improve management's control over enitities' activities and to provide a single, common definition of internal control. I strongly support approaching this project from a broad perspective so as not be limited to financial issues, but the exposure draft has taken so broad a view as to ignore some meaningful specifics.

As stated above, deficient internal control has a legitimate dollar cost to society in lost productivity, fraudulent regulatory and financial reporting, etc. An objective of the study of internal control must be the reduction of these costs through improvements in organizations' internal control. The listing of the reduction of the costs to society as an objective will not narrow the focus to the study, but will clearly define the benefits of the study in the reader's mind.

Definition

I suggest the definition be changed to

> Internal control is . . . obtain **acceptable** levels of assurance as to the achievement of specified objectives **and representations made to interested outside parties**; . . .

While I do not particularly recommend the work "acceptable," I prefer it to "reasonable" for two reasons. First, "reasonable assurance" is a disclaimer term used by public accountants to indicate that they have not examined a company's records in detail and, therefore, can only give limited assurance on the financial statements. The connotation left with the reader is of "limited" assurance. While sufficient for confirmation of financial data, is the impression of "reasonable" assurance enough when the systems in question are of a more critical nature. Would a reader perceive this "limited" or "reasonable" assurance adequate for the internal control systems governing the screening of blood for HIV virus or the dependability of the space shuttle life support systems? Using the term "reasonable" when describing internal controls for these processes would give the public less assurance than they would require.

Secondly, it is possible to establish a internal control procedure to guarantee virtually 100% compliance with the procedure. While the cost may be prohibitive, the point is that it can be done. The word "reasonable," however, implies some single, average level. Another term is needed to indicate that an internal control system can ensure various levels of assurance given the cost restraints.

In addition, I have added a reference to representations made to outside parties because it was the issue of fraud and misrepresentation to outside parties that brought about this study. It must, therefore, be recognized that satisfying the external reporting requirements is an important responsibility of all organizations as well as a cost to society that must be reduced. Further, all internal control systems are designed to ensure the generation of accurate data whether it be that a particular part meets the required specifications or that balance sheet accurately reflects operations. To ensure the equal treatment of both, the external data reporting issue needs to be included in the definition and can not simply be addressed as one of the "specified objectives" that management is trying to achieve.

Internal Control in meeting objectives

Several times in the report, it was stated that internal control systems provide "no more than reasonable assurance that an entity's objectives will be achieved." I propose that an internal control system is designed to test compliance to procedures, rules and guidelines and provides absolutely no assurance as to the achievement of an entity's objectives other than those related to internal control compliance. The internal control system and objectives are related but only indirectly. They are indirectly related because it is supposed that the rules and guidelines to which internal control is testing compliance have been written with the goal of achieving certain objectives.

It appears, however, you have left this link out of your discussion. For example, in order to achieve an objective of 18% return on equipment investments, a system can be designed to authorize only equipment with estimated returns exceeding 18%. If no proposals exceed 18%, the control system would correctly reject every proposal. The objective has not, however, been reached even though the system has 100% compliance. Thus, I suggest you make the relationship between internal control and meeting objective clearer.

I hope these suggestions will be useful in the publications of the final document. If you have any questions regarding my comments or suggestions, contact me at (402)476-2811.

Sincerely,

Michael D Roe

Michael D. Roe
Financial Consultant

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Donald G. Perry
Certified Public Accountant

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May 1, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
Sixth Floor
New York, NY 10036-8775

Dear Sirs:

On April 18, 1991, I sent you my original comments on the Exposure Draft of Internal Controls-Integrated Framework. Enclosed are my comments on the detailed part of the Exposure Draft itself. Should you wish further discussion of these comments, please feel free to contact me.

It is obvious that there has been a good deal of effort extended in the Exposure Draft and I commend those involved in drafting it. Please accept my comments in the same vein.

Very truly yours,

Donald G. Perry

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INTERNAL CONTROL-INTEGRATED FRAMEWORK
EXPOSURE DRAFT MARCH 12, 1991
COMMENTS OF DONALD PERRY

The guidance sought by Treadway implicitly looks for a concise definition of internal control. This Exposure Draft is not concise nor does it guide but rather provides extensive alternatives to be followed in internal control. The core definition seems to be basically flawed. Integrity, ethical values and competence as well as risk assessment and information systems are not components of internal control, they are rather factors to be considered in evaluation of internal control. It would seem to me that internal control consists of "interrelated components with the control environment serving as the foundation for the other components which are establishing objectives, control procedures and monitoring."

On Page 9 in Chapter 1 there is a statement "An effective control system requires an ultimate owner, the CEO." A better ultimate owner would be the Board of Directors. In addition, there should be other organizations recognized such as non-profit, joint ventures, partnerships, etc.

Page 13 states "Expectations differ regarding what control systems can be expected to accomplish." It seems to me that the guidance being addressed in this Exposure Draft should remove such differences.

In Chapter 2 the Prudent Person Concept implies the controls are always dependent on a prudent person. In my opinion controls can be spelled out in procedures and policies and exercised by any clerk who need not be a prudent person.

"Management override can occur for any number of reasons." I feel that a good control system should preclude effective management override.

Chapter 3 "Senior managers in charge of organizational units have oversight responsibility for internal control related to their unit's objective." This does not really pertain in well-run entities where the system can be spelled out to preclude senior managers from having such responsibility.

"The CFO (is) central to the way management exercises control." The Board of Directors, the Audit Committee, the CEO are certainly more central to the way management exercises control than the CFO. As later stated "All Board Committees, through their oversight roles, are an important part of the internal control system."

Chapter 4. The statement under "Scope and Frequency" "Integrity and ethical values are practical at all levels of the organization and its people are competent," would seen to be obviated by the statement "control procedures are established to ensure policy compliance in addressing risks related to achievements of the activity objectives."

What does "Entity-wide and activity objectives and related implementation strategies are established" mean?

Page 35 in discussing limits on evaluation of internal control systems says "only one category of objectives, such as those relating to the reliability of financial reporting" might be evaluated. Rather, it should be limited to an area, such as payroll, revenue, accounts payable, etc. A category of reliability of financial reporting encompasses all functions.

The Evaluation Process puts Understanding the Internal Control System separate and ahead of Testing. One cannot fully understand without going through the testing process; therefore the evaluation should combine Understanding and Testing.

In Chapter 6 there is a statement "Integrity is a prerequisite for ethical behavior in all aspects of an enterprise's activities, not just those related to internal control." I agree with that statement and therefore integrity is not really a component of internal control. As it states on Page 62 "Organizational factors can influence...ethical behavior." Further, " reducing these incentives and temptations can go a long way in diminishing undesirable behavior...within the context of sound and profitable business practices." I.e., a good system of internal control; or "a well controlled operational and financial reporting system can serve as a safeguard against temptation to misstate performance." This does not sound like a component but a result of internal control.

Chapter 7 contains "since no two operating divisions or foreign or domestic subsidiaries are managed in the same way, it is unlikely that their control environments will be the same." This should be the goal of an internal control system and a result of the control environment and the "tone at the top."

In Chapter 8 the objectives covered do not involve controls; good control is an objective itself. "Increase coop allowances by 10 percent" is not an internal control. As stated at the bottom of Page 81, "goals and controls differ." The financial reporting objective examples again are not controls. These seem to be derived from AICPA literature, not internal control definition. The bullets on Page 83 are almost ridiculous for a discussion of internal control. Page 85 says "When objectives depart from past practices...this should lead to different-and tighter-controls." This does not follow since past practice could have been based on poor controls which should not be perpetuated.

Chapter 9. The second paragraph of this chapter states, "The process of identifying, analyzing and managing risk is an on-going itertive process and is a critical component of an effective internal control system." In fact, it is a means to identify critical components, not an end in itself. As stated on Page 95 "Once the significance and likelihood of risk has been assessed, management needs to consider how the risk should be managed," in other words, after assessing risk, internal controls can be considered.

Chapter 10. This chapter seems concerned strictly with electronic data processing systems. There are other systems as well. As Paragraph 2 says, "Control procedures include the procedures to insure the information systems provide reliable information," not that information systems are a component of control. Again, Page 109, "The quality of information available to management depends largely on the functioning of control procedures."

Chapter 11. This chapter too heavily emphasizes the information system from the prior chapter. The discussion of Entity Specific factors on Page 119 should be covered in Control Environment, not here in Chapter 11.

Chapter 12. This is the "Tone at the Top," not a component of control in itself. The means of communication again speaks of control procedures, not components.

Chapter 13. This chapter overall is too detailed for this publication.

There is a cross-reference to Chapter 10 under the caption Identification/Modification Process that I cannot locate in Chapter 10.

Under the Caption "Mechanisms" is a discussion stating that "a standard for effective internal control is the existence of mechanisms to opportunely identify changes." I do not agree that this is a standard for internal control.

Chapter 14. I have no comment.

Chapter 15. The chapter is obviated by the comment on the top of Page 144 "It should be recognized that public management reporting on internal control is not a component of, or criterion for, effective internal control."

The comments under "Timeframe" are counter to the conclusions to Chapter 1 that "point-in-time reporting is most appropriate."

The statement on Page 154 that "No internal control system can guarantee reliable financial reporting" negates the entire exposure draft and Treadway report.

The illustrative report on Page 156 would seem to require that this document accompany any such report.

The section headed "Effectiveness" seems to cancel out the preceding 156 pages of the exposure draft.

TIAA CREF

Teachers Insurance and Annuity Association
College Retirement Equities Fund

730 Third Avenue
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Craig P. Miller, CPA
Second Vice President
and Auditor
212 916-4707

May 2, 1991

COSO Committee
1211 Avenue of the Americas
New York, New York 10036

Dear Sirs:

Thomas Jones, member of the Financial Executives Institute and my manager, had requested my input to the exposure draft, "Internal Control - Integrated Framework." The following are my summary observations:

. In my view, extending the definition of internal control beyond the confines of financial reporting is most appropriate. The more encompassing definition is a necessary extension of the more traditional and narrower view of what comprises a good internal control system framework.

. The evaluation tools provided by COSO serve as a good starting point for evaluation of a company's internal control system. With the necessary tailoring, the proposed guidelines should serve most companies' purposes well.

. I would be less concerned with the "unwarranted regulation", which management seems to fear the COSO report may bring. Any regulation forthcoming (and there will be) would more likely be lessened by a more proactive management.

. The exposure draft is quite extensive ... more so then I would have anticipated. My concern is that the sheer volume of material provided may discourage reference and use by management rather than "help management of businesses of other entities better control their organizations' activities".

Perhaps, presentation in a two booklet format may be more practical: one with an executive summary, followed by the background and theory; the other with evaluation guidelines for the corporate internal control structure.

I thank you, in advance, for considering the above.

Sincerely,

Craig P. Miller

cc: CCR Committee
Thomas Jones

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JOHN R. SCHUYLER
PLANNING & EVALUATION TECHNOLOGY™
RISK AND DECISION ANALYSIS - BUSINESS MODELING - SHORT COURSES
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May 4, 1991

Committee of Sponsoring Organizations of
the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Colleagues:

I have examined sections of the exposure draft, "Internal Control - Integrated Framework" (March 12, 1991). I was hoping to find appropriate recognition of decision analysis techniques as an integral facet of internal control. This is not present in the document, and I strongly urge you to add appropriate mention of these techniques to the final report.

By **decision analysis**, I'm referring to the techniques to assist analysts and managers in making wise determinations under conditions of risk and uncertainty. The principal calculation techniques are decision tree analysis and Monte Carlo simulation. Probability is the language of uncertainty, and I found no mention of even using probabilities in the exposure draft (there is a veiled reference on page 94). Decision analysis is the only logical and consistent approach for recognizing risks and uncertainties in an analysis. How could this have been omitted in a document about control risks?

Among the places to address decision analysis:

- Objectives section. The company's **preferences** (values, beliefs, and attitudes) should be expressly recognized. I advocate segregating preferences into three groups:
  - different objectives
  - time value of money
  - attitude about risk

  Unless these preferences can be represented in the analysis, it is impossible to logically analyze decision (e.g., control) alternatives.

- Risk Assessment section. Risk analysis is often used as a synonym of decision analysis; many practitioners make a distinction, but that is not critical. What is important is that assessments about the outcomes of chance events be quantified and used logically in the analysis.

- Communications section. Subjective and word qualifiers about risk are inherently imprecise. Alternatively, a probability distribution completely and unambiguously represents an expert's judgment about a parameter or event of concern. A decision analysis provides a framework for an analysis or decision problem; it facilitates communication among the analysis team and other interested parties. It appalls me that most business projections are still being made with deterministic models when certain input parameters should be represented by probability distributions.

I would like to see you release a credible, responsible document. The exposure draft needs a lot of work to correct the deficiencies I've touched upon. If your committee would like to incorporate decision analysis concepts into the revised document, I would be glad to lend a hand.

Sincerely,

John R. Schuyler

John R. Schuyler, P.E., C.M.A.

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CENTRAL LOUISIANA ELECTRIC COMPANY, INC.

T. J. Gauthier
Manager, Internal Audit &
Management Consulting

May 9, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Dear Sirs:

Enclosed are my comments on the exposure draft "Internal Control - Integrated Framework" which you issued March 12, 1991.

Overall, I believe this document to be seriously flawed in several respects - as I explain on the attached detailed comments. The fundamental problems have to do with ambiguities, qualifications and stretched conceptualizations.

Your definition of internal control is reminiscent of the classic definition of an elephant given by several blind men - it was obviously put together to mollify several different constituencies. It is obviously a definition by committee.

Your control components are a mixture of philosophical abstractions and concrete principles. A couple of them are also subdivided to make two were one will suffice.

Finally, the whole documented is tainted by the AICPA's primary mechanism for avoiding responsibility for audit failure - reasonable assurance. This infamous concept threads its way throughout the document to such an extent that it renders it useless as a management concept.

Sincerely,

T J Gauthier

2030 Donahue Ferry Road, P. O. Box 5000, Pineville, LA 71361-5000, Telephone 318-484-7400

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INTERNAL CONTROL - INTEGRATED FRAMEWORK

DETAILED COMMENTS

THOMAS J. GAUTHIER

1. **Reasonable Assurance**

This is an excessively broad and vague term. It is also objectionable because its use by CPA firms has come to mean a way they can evade responsibility for audit failures. In has come to imply that responsibility for failure can be avoided under its all encompassing guise. In the vernacular, the term is "weasel words".

The whole concept of good management implies taking responsibility. Therefore, we should not undermine the idea of management responsibility with the the backsliding concept of reasonable assurance.

If we have to have the concept of assurance in the definition, and I believe we must,then lets make no bones about it and just say "Assurance" without qualification. Of course, we will have to be prepared to face the consequences of failure. That is a basic responsibility managers owe to shareholders, owners, contributors or taxpayers. Nothing short of taking responsibility for the functioning of the organization should suffice.

2. **Integrity, Ethical Values and Competence**

The concepts of integrity and ethical values too philosophical in nature to be control components; they are better suited as guiding principles. Control components should have some objective standard of measurement in the ordinary course of business. Integrity and ethical values are vague concepts that do not have such standards. The can, in fact, only be measured in the negative sense - the results which occur when they are obviously lacking.

Competence, on the other hand, can be measured in both the positive and negative sense. We can define generally accepted qualifications for each position in an organization. We can measure if incumbents possess these qualification and if they do not. Competence is, therefore, a true control component in that it can be measured positively and negatively.

Integrity and ethical values, however, cannot be measured positively. The only positive evidence of their existence within an organization is management assertions. Never let it be forgotten that the scoundrel always clothes himself in the rhetorical fabric of integrity and ethics.

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Integrity and ethical values should be put forth as guiding principles for all well run organizations; philosophical underpinnings of good management. Weaving them into the definition as control components adds an unacceptable element of ambiguity to it.

3. Control Environment

This concept is excellent, but it is not fully defined.

The idea of management philosophy is, like integrity and ethics, an ambiguous concept that is more suited as a guiding principle. Mixing it into a solid component is not appropriate.

Control environment should include the plan of organization, system of record keeping, and procedures and practices management has installed to ensure goals are achieved efficiently and effectively. The last duet is of vital importance to the concept of control environment. All of the practices and procedures and record keeping should be designed not only to achieve goals, but to achieve them efficiently and effectively. Any definition of control environment which fails to mention this duet is deficient.

4. Control Procedures

This is a subset of the control environment component. It should be covered by the procedures and practices part of the control environment definition. It need not have a separate status as a component.

Control procedures are also like information systems, below, in that they are tools effective management uses. Tools are not components.

5. Information Systems

This is one of those items included in the definition of internal control to mollify someone, probably the IBM representative.

This is not a control component, it is a management tool. The organization's information system is a tool used by management to control the organization. This does not make it a control component. An organization can have state-of-the-art information technology that is absolutely useless because management does not know how to use it to control the organization. The information system, by itself, does not add an element of control. Its use by competent management does. Therefore, it is only a tool.

6. **Corrective Action**

The concept of corrective action is missing from your list of control components. It may be the most important. If something goes wrong, mechanisms must be in place to fix it. Whatever those mechanisms are, they fall under the concept of corrective action.

7. **Scope of Reporting to External Parties**

Why do we want to set out a comprehensive framework of internal control then ignore it when it comes time to report to external parties?

As presented, this section adopts the CPA's limited view of internal control. It gives the definite impression that all of the foregoing is simply window-dressing.

Yes, investors want to be given assurance that financial statements are prepared under a sound system of control. But, don't they also want to be assured that the organization is operating efficiently and effectively? Exceptionally good financial controls in an organization that is operating inefficiently and ineffectively will produce financial statements that are good representations. However, they tell the investor nothing about how the organization is operating.

We need a two part reporting process. One citing financial controls and the other citing the administrative and operating controls that foster efficient and effective operations.

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Imperial Tobacco Limited/Limitée

Committee of Sponsoring Organizations
1211 Avenue of the Americas,
6 th floor
New-York,
NY 10036 8775

April 26, 1991

RE: COSO Exposure Draft

I found your summary of the exposure draft on Integrated Framework of Internal Controls - Its Significant to Executives interesting. I would like to obtain a copy of the COSO Exposure Draft. Please send me one to my business address appearing herein.

Also, once your entire report entitled Internal Control - Integrated Framework will be available, I would like to obtain a copy. I find this type of quality material helpful in explaining to our company's managers the essence of internal controls and the role of internal auditors in assessing the quality of our organization's internal and business controls. I also intend to discuss this report with our Audit Committee of the Borad.

Thank you,

Internal Audit Manager

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

May 30, 1991

To: **Richard M. Steinberg, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Advisors

Gentlemen:

Here is the third batch of comment letters (there are six) on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Tom

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

Transok, Inc.

P.O. Box 3008
Tulsa, Oklahoma 74101
918-561-9300

Marjo N. Miller, CPA
Vice President
Corporate Services

May 9, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
Sixth Floor
New York, NY 10036-8775

To Whom it May Concern:

Having worked in internal auditing for fifteen years and developed some of their standards, I looked forward to the COSO document on internal control. It is a difficult subject that has many applications. All of the organizations which contributed resources to undertake the study are to be commended.

My suggestions fall into three categories. I believe changes to the draft document would make the final report more useful to the business community.

Duplicative Components

If internal control is to be reported on, which several groups are currently pushing, then internal control criteria need to be clear.

This document would be more easily used if the nine internal control elements were reduced to eliminate overlaps. For example, the Control Environment and Control Procedures could be combined. These items could even be combined with a broader discussion of Risk Assessment. Two other items which could be combined are: Information Systems and Communication; the foregoing is simply one form of communication.

Another suggestion which would increase readability would be to shorten the executive summary to less that 10 pages. It will be a rare CEO who reads a 47 page "summary".

Emphasis on Financial Activities

This document emphasizes internal control as it relates to financial activities. Internal control concepts are equally applicable to operational activities. COSO should broaden their approach to this internal control definition so it can be used by all who must control the many aspects of business. I think that presently the public and laymen are being mislead that this COSO internal control document presents an all-encompassing way to prevent fraud when in reality it addresses financial activities only.

Cost of Compliance

Particularly with the narrow financial scope of this document, and its overlapping and duplicative elements, the cost to comply with this internal control approach would increase audit fees 10% - 20%. It is well-known that businesses are finding the rapidly escalating audit fees unacceptable.

Thank you for the opportunity to comment on this document.

Sincerely,

Marjo N. Miller

Marjo N. Miller

MNM:mw

c: Representative Ron Wyden
2452 Rayburn House Office Building
Washington, DC 20515-3703

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THE MICRO PRODUCTS CO.
20 NORTH WACKER DRIVE
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TLX - 283545

M. PAUL HUNT
PRESIDENT

May 16, 1991

The Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Subject: Internal Control - Integrated Framework, Part 1
Executive Briefing, Exposure Draft, March 12, 1991

Reference: Page 12 - Management Integrity

Dear Sirs,

Ideally, "a strong active board" could provide the controls that this study is hoping to establish, but if "absolute control" is the object of this study, there must be recourse above the board. I wish I could help, but integrity is rare.

- The government has demonstrated its brand in the "Keating Five".
- Educational institutions demonstrated their brand in the "allocation of costs" assigned to grants from the government.
- Our public auditing firms are themselves under attack.

Perhaps the news media is the ideal choice to expose abuses in business practice, and unless or until a better alternative is found, it will be the "control" of choice.

Sincerely,

M. Paul Hunt

M. Paul Hunt
President

MPH:jo

Enclosures

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OBSERVATIONS

Some of the more important observations gained in the conduct of this study are:

- Management Integrity. Management usually is in a position to override other controls and ignore or stifle communications from subordinates, enabling a dishonest management which intentionally misreports results to cover its tracks. There are certain controls which can help to compensate for this. They include effective upward communication channels to the board of directors, coupled with strong internal audit and legal functions with direct access to the board. A strong, active board is likely to be in the best position to identify and correct such a problem.

- Diverse Views--Common Framework. Throughout the study, a tremendous diversity of views and of convictions on the subject of internal control were evident, pointing up the critical need for all parties to understand each other. To facilitate mutual understanding it is important that the different parties talk the same language. Once the language "gap" was bridged by participants in this study, it became evident that despite the diversity of needs and perspectives, most of the differences are reconcilable.

  For example, internal control is viewed broadly by some as encompassing virtually all activities of a business. Others see it from a more narrowly focused perspective, dealing primarily with the reliability of published financial statements. One view is not "better" than the other. Each is appropriate in terms of serving different needs. However, it is possible--with a broad definition of internal control--to accommodate both views without compromising substance or principle. The framework presented in this report facilitates management's view of controls from the broad perspective of running an enterprise, while it enables a directed focus on narrower areas.

  Although there are diversities of view--many reconcilable, though some requiring a definitional decision--it's important that a framework provide common ground on which mutual understanding and language can be built. The Committee of Sponsoring Organizations of the Treadway Commission[3] believes that this report should serve as that framework. The intent is to provide a starting point for implementation by individual entities, for education, and for assessments of internal control. It is suggested that other interested parties also use this framework for initiatives on internal control that may follow.

3/ These organizations are the American Accounting Association, American Institute of Certified Public Accountants, Financial Executives Institute, Institute of Internal Auditors, and National Association of Accountants.

THE WALL STREET JOURNAL. MONDAY, APRIL 22, 1991 B1

MANAGEMENT

While Outside Directors' Pay Increases, Independence From Managers May Fade

By JOANN S. LUBLIN
Staff Reporter of THE WALL STREET JOURNAL

Lots of people gripe about the pay for part-time jobs, but Donald P. Jacobs is no whiner: Last year, he made $198,000 serving on the boards of five big companies.

That's about $50,000 *more* than his full-time salary, as dean of Northwestern University's Kellogg School of Management.

The sweet deal may soon become sweeter still. Next Monday, Unocal Corp. shareholders are expected to approve a plan to give Mr. Jacobs and other outside directors restricted stock once a year. The shares would come on top of their cash retainers and fees for attending meetings and running committees, which for Mr. Jacobs totaled $48,750 last year.

Unocal, like much of corporate America, is fattening compensation packages for outside directors because liability worries and increased duties make good board members harder to find and to keep. But critics fear the increased compensation could reduce directors' independence.

Unclear Impact

"If your bread is heavily buttered by one company, it's going to be a lot harder" to quit over poor management, says Sarah Teslik, executive director of the Council of Institutional Investors in Washington, D.C. Besides, nobody knows whether compensating directors better makes them or their companies perform any better.

Directors' pay is rising faster than consumer prices and even managers' salaries. Last year, retainers and attendance fees jumped an average of 6.3% to $32,352, according to a survey of 352 companies by Korn Ferry International, executive recruiters. This represents an hourly rate of $352, Korn/Ferry says.

Equally important, more businesses are expanding executive-style perquisites for non-management directors beyond the usual free travel and free products (at General Motors Corp., a new car every six months; at American Telephone & Telegraph Co., free domestic long-distance service; at Hewlett-Packard Co., use of a laptop personal computer). Increasingly popular perks include not only long-term incentives such as stock grants and stock options but also retirement plans, deferred compensation, life insurance and medical coverage. There's even talk of annual bonuses for directors.

The hottest perk, offered by more than two dozen major corporations, allows board members to bequeath money—an average of about $1 million—to charity at no cost to their estates. Companies finance a legacy by taking out an insurance policy on a director's life.

Compensation From Multiple Board Seats

Donald P. Jacobs
Dean, Northwestern University's Kellogg School of Management

CORPORATE BOARD MEMBERSHIPS	1990 CASH AND STOCK COMPENSATION
Commonwealth Edison	$40,500*
First Chicago	$40,000 plus 200 shares
Hartmarx	$25,900
Unocal	$48,750
Whitman	$42,675 plus 200 shares
Total	$197,825 plus 400 shares

*Assumes 95% attendance record, based on 1990 board average

Roger Smith
Retired chairman and chief executive officer, General Motors

CORPORATE BOARD MEMBERSHIPS	1990 CASH AND STOCK COMPENSATION
Citicorp	$54,250*
International Paper	$44,000 (estimated)
Johnson & Johnson	$45,000
PepsiCo	$60,000 plus annual stock grant in July 1990 valued at $18,000
Total	$203,250 plus stock grant valued at $18,000

*Assumes 75% attendance record, based on 1990 board average

"The idea is to attract the most qualified and able people that exist in this world," says William W. Warrick, a senior vice president of American Express Co., which provides both the legacy perk and stock options. "It is a very competitive marketplace, trying to get people to become directors."

In particular, American Express officials believe stock options enable directors to think more like stockholders and to be rewarded for their performance—mirroring a pay trend for managers. Bigger equity stakes also give outsiders a greater financial inducement to protect shareholder value by holding chief executives accountable, proponents say.

Representing Holders

"Stock ownership is a reminder that you are there representing shareholders, not management," says Thomas Neff, president of SpencerStuart & Associates, another executive-search firm. He learned the lesson firsthand in 1986, when British media magnate Robert Maxwell was bidding for U.S. publisher Macmillan Inc. Mr. Neff, a Macmillan board member, had to choose between the Maxwell offer and a leveraged buy-out proposal backed by Macmillan management.

At the time, Mr. Neff owned about 5,50[illegible] Macmillan shares because he had insiste[illegible] on being paid entirely in stock. The holding reinforced his view that a board must "d[illegible] what's best for the company, not for man[illegible]agement." Mr. Maxwell ultimately snare[illegible] Macmillan with a sweetened offer—a[illegible] Mr. Neff pocketed about $496,000.

But few directors choose to be pai[illegible] stock, and even fewer companies pay t[illegible] entirely in shares. More common is for [illegible]rectors to receive shares as a pay supp[illegible]ment. One-quarter of the companies in t[illegible] Korn/Ferry survey provided stock opt[illegible] in 1990—triple the proportion in 1986.

Whether they're getting extra cas[illegible] shares or other perks, many corpora[illegible] rectors reject the notion that a riche[illegible] package might crimp their independe[illegible] "I don't think [higher compensation] [illegible]ters one bit," says Hicks Waldron, re[illegible] chairman and chief executive of A[illegible] Products Inc., and now chairman of B[illegible] room Consultants Inc. "Once you pa[illegible] first nickel, there's a risk."

Indeed, Mr. Waldron says directors [illegible] aren't "getting paid what they are w[illegible]

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Directors' Pay Rises, But Independence May Be Diminishing

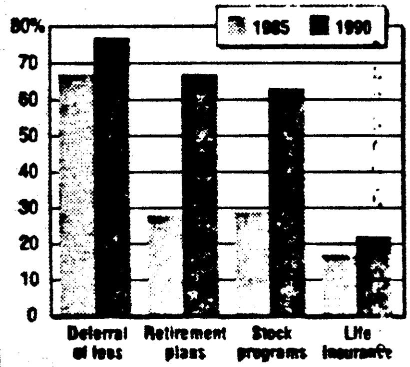
Continued From Page B1

for overseeing multibillion-dollar enterprises. He earns $200,000 to $220,000 a year from board seats on four big companies, where outside directors dominate all the committees. "Most of the boards' work gets done" in committees these days, he says. "We're taking our jobs much more conscientiously" by challenging management harder, he adds.

For instance, Mr. Waldron serves on two of the four board committees at Ryder System Inc., a vehicle-leasing firm based

Spreading Perks

Percentage of Fortune 100 industrial companies offering outside directors these benefits



Source: Hewitt Associates

in Miami. The compensation committee at Ryder and elsewhere used to rubber-stamp executive pay plans, Mr. Waldron says. But today, committee members "are simply not accepting [management recommendations] at face value," he says. Ryder's board and committees meet for two days six times a year. Ten or 20 years ago, a board typically had just two committees, committees met once or twice a year, and many committee members were insiders, Mr. Waldron adds.

Other corporate directors say their potentially huge legal liability for not representing shareholders' interests will overcome any reluctance to bite the hand that's feeding them better. Though most companies provide liability insurance, it doesn't provide complete coverage. "The fear factor outweighs the greed factor by a wide margin," says Lester Korn, chairman of Korn/Ferry and a director of Hillhaven Corp., a nursing care-center operator in Tacoma, Wash.

Mr. Jacobs, the Northwestern dean, agrees. "There are enough [potential] plaintiffs out there that would attack" a director for failing to act independently, he says. He adds that he has so little interest in compensation that he doesn't know how much his directorships pay or the specifics of Unocal's restricted stock proposal.

Critics remain unconvinced. "A CEO runs a board by overpaying them," says Robert Monks, a shareholder-rights activist seeking election next month to Sears, Roebuck & Co.'s board. "The phenomenon of the independent director is being diluted to the point of illusoriness."

Besides the possible loss of independence, the appearance of self-dealing by directors as pay packages get richer concerns critics. Outside directors generally control the compensation committees that concoct board-member pay deals, subject to the full board's approval.

Even some directors worry. "I can see the potential for being accused of [horse] trading between directors and the management," which wouldn't be in shareholders' interests, says Charles Locke, chairman and chief executive of Morton International Inc., a salt and chemical company in Chicago. "You could visualize management directors saying [to outside directors]: 'OK, if you double my options, I will give you this many options' " in return.

The scenario distresses Mr. Locke. "The first time you start compromising a director to management, you have destroyed his effectiveness," he says.

The Morton chairman, who sits on four other boards, tried and failed to block Avon from introducing a retirement plan for outside board members in 1988. "People's eyes just glazed over" at the objections, he remembers. His own company still doesn't give outside directors pensions or stock options. But he feels he's losing his battle against such executive-style perks. "I am more and more a dinosaur," he sighs. "It's happening all over."

—*Amanda Bennett contributed to this article.*

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First Executive Top Officials Protected Their Income While Troubles Mounted

By FREDERICK ROSE
Staff Reporter of THE WALL STREET JOURNAL

LOS ANGELES—As First Executive Corp.'s financial condition was worsening, top officers of the troubled insurance holding company took extraordinary steps to safeguard millions of dollars of their own income, despite frequent statements that the company could ride out the storm.

Chairman and Chief Executive Fred Carr, the main beneficiary of the moves, had $10.7 million of his deferred compensation guaranteed in February by a new First Executive affiliate that is beyond the control of California insurance regulators. In November 1990, he sold partnership interests in First Executive's headquarters building back to the company for $2.7 million—interests he apparently bought over time for $1.5 million.

On Thursday, California's insurance commissioner, John Garamendi, took control of Executive Life Insurance Co., First Executive's largest unit. The seizure marks the nation's biggest insurance failure and the beginning of a rescue effort that must cover more than $28 billion of eventual insurance and annuity liabilities owed to hundreds of thousands of policyholders. Loans and policy redemptions have been suspended, and it's still unclear how large eventual losses might be for investors or holders of various Executive Life financial instruments.

First Executive has a number of units in addition to Executive Life, most of them small. In all, First Executive and its units had $46.11 billion in insurance in force at Dec. 31. The second-largest unit, Executive Life Insurance Co. of New York, hasn't been seized by regulators in that state, although such a step may be taken this week. The New York unit, roughly a third the size of the California unit, is believed to be in somewhat better financial condition. Three insurance units in Nebraska were taken over by regulators last week.

The actions by Mr. Carr and others to protect what had been tax-sheltered deferred compensation and to take profits on an investment at a cost to First Executive were disclosed in filings with the Securities and Exchange Commission. They raise questions about whether First Executive's top officers were gloomier about future prospects than some of the company's own statements implied.

A spokesman for First Executive said that the deferred compensation guaranteed for Mr. Carr and others as well as the partnership interests in the company's head office were in lieu of a company pension or retirement program. The spokesman said that Mr. Carr's apparent gains from the sale of his partnership interests were more than offset by $3.8 million losses on the sale of First Executive stock last year. Mr. Carr sold the partnership interests in part to pay off a 1969 borrowing to buy company stock.

Even while reporting losses totaling $1.14 billion in the past two years, First Executive has issued news with a positive twist. Last summer, for instance, the partial contents of actuarial studies distributed by the company were deemed proof that it was on firm ground. The full studies proved to be limited and less conclusive.

Only a week before the takeover, the company issued a set of questions and answers apparently prepared for sales personnel, assuring clients that "your policy/contract is safe," emphasizing that the company had $1 billion in cash equivalents and government securities, and describing a state-takeover as "only a possibility at this time and . . . a worse-case [sic] scenario."

Despite these assurances, nearly two months earlier First Executive officials took steps to protect a total of $11.3 million in deferred compensation that was owed by Executive Life mostly to Mr. Carr, but with nearly $600,000 spread out among 10 other employees. The amount of deferred compensation isn't a surprise, since it was reported each year; much of it was accumulated when First Executive was reporting hefty earnings. But the compensation was at risk if the insurance company failed, insurance industry officials say, because such claims would rank with unsecured creditors. The industry officials also expect parent First Executive to file shortly for protection under federal bankruptcy law.

The sheltering action was taken through Rhodes Financial Inc., a Delaware company apparently controlled by another Delaware company, Evergreen Acceptance Corp., a non-insurance regulated concern with a 50% interest in Rhodes. The remaining interests are held through two other First Executive units: Lincoln Liberty Life Insurance Co., with 18%, now under regulators' supervision in Nebraska; and First Delaware Life Insurance Co., with 32%.

Rhodes Financial was capitalized with $22 million last year and, according to First Executive's 10K annual report filed with the SEC, was supposed to set up a new insurance business to supplant Execu-

Please Turn to Page A6, Column 3

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Top Officials of First Executive Took Steps To Protect Income

Continued From Page A3

tive Life's junk bond-based operation. "Newco," as it was called, was to be a back-to-basics insurance company, putting money into investment-grade securities.

This February, Rhodes Financial, though its prospects in the insurance business were apparently dim, signed an agreement with Executive Life, pledging the $11.3 million—or a little over half its capital—to guarantee deferred compensation owed by Executive Life. According to the guarantee document, the purpose was to retain the services of Mr. Carr and others, who were "to provide the necessary expertise to operate Newco."

First Executive's spokesman said that the possibility of Newco's operating as an insurance company isn't dead. He said that as recently as a week ago, prior to California's intervention at Executive Life, Altus Finance, 60%-owned by Credit Lyonnais S.A. of France, had talked about using Newco as a part of a revitalization effort for First Executive's insurance operations.

But Rhodes may soon have to make good on its pledge. According to Mr. Carr's deferred compensation agreement with Executive Life, his money is payable at the termination of his employment with that company, among other things. Mr. Carr stepped down as the top officer of Executive Life last week, when it was taken over by regulators. First Executive's spokesman said that no payment has yet been made and that exercise of the Rhodes guarantee is subject to approval by First Executive's board, of which Mr. Carr remains chairman, chief executive officer, and one of six members.

Among other things, the guarantee agreement calls for Rhodes to pay all legal expenses if payment of the guarantee is disputed.

Separately, five former insurance customers of First Executive operations sued top officers and directors for alleged misleading statements about the financial health of the company. The suit, filed in state court in Los Angeles, seeks class action status for all purchasers of insurance products from First Executive companies between Jan. 1, 1984, and last Thursday, when Executive Life was seized by regulators.

In addition to company officers, the suit names Deloitte & Touche, First Executive's former auditors; and A.M. Best Co., Dun & Bradstreet Corp.'s Moody's Investors Service Inc. unit, and Standard & Poor's Co., three prominent rating agencies, which couldn't be reached for comment.

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May 17, 1991

GrantThornton

Accountants and
Management Consultants

The U.S. Member Firm of
Grant Thornton International

Committee of Sponsoring Organizations
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Gentlemen:

This letter is submitted in response to your request for comments concerning the proposed Integrated Internal Control Framework.

Grant Thornton appreciates the thoroughness and comprehensiveness of the work performed under COSO's sponsorship. However, we have serious concerns about the proposed Framework, particularly as it relates to mid-size and smaller entities.

For one thing, the proposed definition of internal control and the accompanying framework are far too broad. Pursuant to these guidelines ("the process by which an entity...achieves reasonable assurance as to...(its)...achievement of specified objectives") the inability of an entity to achieve any of its objectives, including those relating to growth and profitability, could be considered an internal control failure. This serves no useful purpose.

Except for the forgoing, the proposed Framework may be appropriate for the largest public companies, but it is much too lengthy and complex for mid-sized and smaller companies. Few middle market entrepreneurs or busy executives have the time to wade through all this, and we believe that few such entities could implement it on a cost effective basis. Accordingly, the adoption of the Framework in its present form would do a disservice to such companies and impose an unfair burden on their management.

We also call attention to the following:

1. Enhanced internal controls would undoubtedly lead to improved financial reporting. However, except perhaps for the largest entities, a system of internal control is not likely to prevent fraudulent financial reporting when "management fraud" is involved. For most companies, management has the ability to circumvent even the toughest system, if so inclined. Accordingly, we believe COSO should ensure better understanding of this and direct attention to those measures that might help prevent or detect such management fraud.

2. COSO should also seek to enhance understanding that internal controls are not necessarily an effective means of ensuring the reliability of management judgements, or the determination of appropriate accounting estimates (e.g. allowances for uncollectible accounts, loan insurance and loss reserves etc.). This is because it is inherently more difficult to "control" the quality of judgements than to prevent or detect quantitative mistatements.

3. We are, of course, aware that the COSO study does not take a position on the merits of public reporting on internal control systems by management and/or independent auditors. However the study presents useful guidance for situations when such reports are prepared and we urge that this guidance require that any such reports contain a clause pointing out that the (current) assessment of the entity's controls cannot be assumed to pertain to future periods. (At the present time, we do not favor requirements for such public reporting because we believe that until our profession can obtain greater public understanding of the objectives of an audit and of the limitations of a system of internal control, unnecessary additional audit costs will be incurred and undue reliance will be placed on such reports.)

We hope you have found the forgoing comments helpful and would be pleased to discuss any of these matters with you further.

Very truly yours,
GRANT THORNTON, by,

Howard Groveman

National Director of
Accounting and Auditing

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COLLEGE OF BUSINESS ADMINISTRATION
THE UNIVERSITY OF TEXAS AT AUSTIN

The Charles and Elizabeth Prothro Regents Chair in Business
Department of Accounting · CBA 4M.202 · Austin, Texas 78712-1172 · (512) 471-3632

May 17, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Committee Members:

Re: Internal Control - Integrated Framework

The Exposure Draft identifies two principal purposes of the study and four sets of questions for readers. Below are my comments on the achievement of purposes, responses to three of the four sets of questions raised, and comments on the basis for the authors' conclusions.

I. Purposes:

The two principal purposes of the COSO-sponsored study are: "to provide a common ground for mutual understanding of internal control by all interested parties," and "to provide criteria against which all entities can assess . . . internal controls."

The study does provide a possible "common ground" for understanding internal control. The Exposure Draft discusses many relevant concepts and some of their implications for the design, implementation and evaluation of internal control. However, the 163-page textual presentation is lengthy and is not sufficiently specific for practical understanding. In places, treatment of the subject matter is almost academic in that it makes only stylized reference to actual company experiences. Internal control failures led to the creation of the Treadway Commission. Are there common threads as to how managements and others went wrong? Would following the guidance championed in the Exposure Draft have prevented or detected these problems? If so, how?

The draft *does not* provide objective standards or "criteria" by which an entity's internal controls can be judged. Some of the "nine essential components" are vague and need not be in place for all companies. Also, as outlined under II. below, some of the nine components simply don't make sense for self-reporting by public companies.

II. Response to questions raised by COSO:

Definition (Chapter 1 and 5) The Exposure Draft defines internal control as "a process." Presumably, management would assert that they have a process that conforms to standards and auditors would report on its conformance. This definition is in contrast to existing definitions that refer to a condition or state. For example, under AICPA

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definitions, management can assert that there is low risk that material misstatement would arise and not be detected by internal controls on a timely basis. There is experience with assertions of low risk of material misstatement. But can management assert that it has an adequate *process*? If management makes such an assertion about a process, then can it be audited? As to components, can an auditor meaningfully verify top management's "integrity, ethical values and competence," or its "management philosophy and operating style"? I don't see how, and the authors of the study don't offer any suggestions for guidance.

Components (Chapters 1 and 5 through 14) The nine components identified are important in an academic discussion of internal control and its effectiveness. Most will agree that the ideas expressed under Information Systems, Control Procedures, Communication, Managing Change, and Monitoring are useful. However, the four remaining components present difficult issues in regard to public reporting by management.

The Integrity, Ethical Values and Competence, Control Environment, Objectives, and Risk Assessment components are important for control and important for *auditor reliance*. However, it is unreasonable to expect that the Integrity and Control Environment components be part of a self-reporting system by top management. What is the value of top management's assertion that it has "integrity, ethical values and competence," or a "good management philosophy and operating style"? Also, the Exposure Draft is vague about how to evaluate the Objectives and Risk Assessment components.

Management Reporting to External Parties (Chapter 15) The proposed reporting system utilizes an assertion by management that the company meets the COSO standards. Pages 156-157 present a "clean report" from management. Several questions arise:

> Will stockholders, governmental officials and others believe that management would ever indicate that it doesn't meet the COSO standard due to top management's lack of integrity, ethical values or competence?
>
> Will auditors ever take exception to management's "clean report" assertion due to lack of integrity or to an inadequate management philosophy or operating style? How could an auditor who wishes to take exception demonstrate such deficiencies by top management? That is, are these two "most critical components" [p. 69] auditable?
>
> What does management's report mean? Does it mean that the risk of material misstatement is low even before the audit? Does it mean that there will be low risk of material misstatement in unaudited interim financial statements? In short, how can a user gain useful information from the proposed management report?

In my view, the reporting system simply won't work because the nine component criteria aren't enforceable.

<u>III. Basis for Exposure Draft Conclusions:</u>

The study describes its methods as reading or scanning numerous sources, interviews, questionnaires, and follow-up meetings with various groups. These methods may provide useful input. However, they do not form an adequate basis for a policy recommendation on internal control standards to be applied by all public companies.

Some relevant questions about the methods of the study are:

Did respondents to the questionnaire frequently mention the nine components?

What alternative guidance was considered? Why were the alternatives rejected by the authors?

Would the control procedures and other elements mentioned in the Exposure Draft have prevented the failures that led to the creation of the Treadway Commission?

Have the recommendations of the study been pilot-tested to see whether they are feasible? If so, are they cost justified?

Would implementation of the recommended control components by all public companies be cost effective?

The FDA doesn't allow new drugs to be sold without product tests. I believe that COSO should not allow less for a new internal control product that may be broadly applied. The authors of the study simply have not provided adequate justification for their conclusions.

To summarize my views, there is no harm in publishing the Exposure Draft discussion to provide a common ground for understanding internal control concepts. However, it is not clear that the study is more useful or better presented than the internal control guidance of other public accounting firms, textbooks or other sources.

I believe that there is considerable *danger* in adopting the Exposure Draft discussion as a standard by which internal controls of public companies can be judged. There is no demonstration that the guidance will work and certainly no indication that it will be cost effective for firms, or indeed, in the public's interest. I urge COSO not to warrant that the Exposure Draft discussion provides adequate criteria for evaluating internal control of public companies.

In closing, I appreciate the opportunity to comment on the exposure draft. Please contact me if you have questions about this letter.

Sincerely,

William R. Kinney, Jr.

William R. Kinney, Jr.

db

First Union Corporation
Charlotte, North Carolina 28288
704 331-6697

Howard L. Arthur, Jr.
Senior Vice President
Corporate Director of Audit

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May 21, 1991

*Committee of Sponsoring Organizations of the
Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775*

RE: Exposure Draft: Internal Control - Integrated Framework Dated March 12, 1991

I appreciate the opportunity to comment on this exposure draft. My observations will follow your suggested format.

Definition

The definition is cumbersome and too long. Perhaps the components can be separated from a main definition.

For example, I believe an implied function of internal control is to limit losses to an acceptable level of business risk. Under the definition, this would have to be a specific objective of management rather than an implicit function of internal control.

I do feel the final definition must remain broad.

Components

Components and their criteria are acceptable. However, see suggestion under Definition.

Evaluation

There needs to be greater discussion on the control objectives to be achieved, the adequacy of the design of the control system and expansion of the conclusion as to whether the control system is adequate and operating as intended.

Management Reporting to External Parties

Chapter 15 appears to be the focal point to which the integrated framework builds. This is confusing because my analysis of the Treadway Commission's recommendation for this research does not lead me to believe public reporting was intended to be incorporated.

Management Reporting is a worthwhile topic for research and for an authoritative paper, but it has no place in this framework.

General Comments

This research provides valuable and needed information on the topic of internal control. However, redundancy adds bulk and therefore the presentation is difficult to get your arms around. The "executive summary" for example, is too long to expect top executives, CEO's and members of Boards of Directors to read as an overview.

Sincerely,

H L Arthur Jr

HLAjr:pc

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May 22, 1991

Committee of Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Committee:

I appreciate the opportunity to comment on the exposure draft of "Internal Control-Integrated Framework", dated March 12, 1991. My comments are as follows:

First, regarding definition in Chapter 1, Page 9, the last paragraph discusses ownership and states "The only truly effective owner of the control system is the Chief Executive Officer." This statement appears to mean that if the CEO does not support the internal control system, then it (an internal control system) does not exist in the organization. Because of this, I disagree with the statement that the CEO must be the owner of the internal control system. I think that if an ultimate owner is necessary for an internal control system to exist, then that ultimate owner must be the Board of Directors or, if there is one, the audit committee of the Board of Directors. I agree that the CEO sets the tone within the organization for organizational norms, but an internal control system must go beyond organizational norms, and in fact, be above those norms.

Therefore, if the CEO is not a strong proponent of internal controls (for example an entrerpreneur type person who prefers to operate in a loose environment) then it is up to the Board to ensure that internal controls exist. This is especially true if the definition as proposed on Page 1 is going to be used because this definition states that "Internal control is the process by which an 'entity's Board of Directors', management and/or other personnel obtain reasonable assurance as to achievement of specified objectives;....." In this definition, it is the Board of Directors mentioned first, not the CEO. This then would assign ownership responsibility to the Board, in my understanding.

I am not objecting to the definition of internal control as a process. What I object to is assigning ownership of this process to the CEO rather than to the Board of Directors. I firmly believe that ownership of the process must be assigned at the highest possible level.

Second, under "Components" I question the use of "information systems" as one of the nine components. I feel that many organizations have effective internal control systems without adequate information systems. I think that the definition that is being discussed here is irrelevant.

Timely information must flow to management, but that can be covered under the Communication heading rather than having a separate component called "Information Systems." My reasoning is that information systems infers an electronic data processing system. As a matter of fact, many companies refer to their EDP Departments as Management Information Systems (MIS) Departments. With the advent of the PC, of course, even small companies have some sort of electronic data processing but still do not have effective information systems under the definition that is suggested here.

Also under "Components" I especially like the discussion regarding "management of change" whereby it isn't going to look at internal control systems as static, but rather suggests that "mechanisms need to be in place to enable the entity to identify, communicate, evaluate and respond to change on a timely basis." I think that this is critical to a good internal control system.

My final comment under "Components" is the last component of "monitoring", where it discusses the fact that "monitoring includes carrying out routine procedures as well as reacting to input from auditors, regulators and other parties." I suggest that Internal Audit as a function should be prominent in this discussion. I think that using the all encompassing "auditors" rather than differentiating between internal and external auditors is paying short shrift to the Internal Audit function. I believe that, as is noted on Page 12, "a strong internal audit function with direct access to the Board is necessary in a good internal control system." And I believe that this should be discussed under "Components".

On Page 136 of your report there is some discussion regarding the use of audit findings. Once again I do not believe that this gives a strong recommendation for the use of the Internal Audit function. In Chapter 4, internal auditors are mentioned on Page 36 under "Who Evaluates", but this statement does not give a strong recommendation for an internal audit function either, but states rather that "internal auditors normally perform internal control evaluations as part of their regular duties,....". It then goes on to say "Because of their training and objectivity, internal auditors often play an important role in the context of an overall evaluation program." I feel a stronger statement could be made here for the Internal Audit function.

The internal auditor is a control specialist and as such is trained in the evaluation of internal controls. This is one of their primary reasons for existence. Therefore, the committee should give the Internal Audit function more credibility and/or clout with management by taking a stronger stance in the discussion of "Who Evaluates".

A statement should be inserted such as, "Because of their training, internal auditors are called on to perform internal control evaluations as part of their regular duties, or upon special request of Boards of Directors, senior management or subsidiary or divisional executives. They play an important role in the context of an overall evaluation program. While it should be recognized that the Internal Audit function does not....as some people believe....have primary responsibility for establishing or maintaining the internal control system. That, as noted, is management's responsibility. But internal auditors evaluate the effectiveness of control systems and, thus, contribute to ongoing effectiveness. Because of organizational position and authority in an entity, and the objectivity with which it carries out its activities, an Internal Audit function often plays a very significant role in effective internal control." Therefore, by combining the sentences on Page 36 and Page 27, it will give a stronger position for the Internal Audit function.

I hope these comments have been helpful to the committee and I would be willing to discuss them in further detail at any time.

Sincerely yours,

William E. Grieshober

William E. Grieshober
Vice President/Controller
Spring Hill Nurseries

WEG/neh

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

June 6, 1991

To: **Richard M. Steinberg, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Auditors
Jack Albert, Securities & Exchange Commission
Louis Bisgay, National Association of Accountants

Gentlemen:

This is the fourth batch of comment letters (there are eight) on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

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ROHM AND HAAS COMPANY

May 21, 1991

The Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036

Subject: Comments on the Internal Control-Integrated Framework Exposure Draft

Gentlemen:

The definition of internal control and the guidelines for evaluating these controls as detailed in the report represent a theoretical ideal. Application of these concepts to industry, which operates far from this ideal, would be a great burden adding significantly to the responsibilities of internal audit departments and external audit fees while adding nothing to the competitiveness of American industry.

This is not a practical document. The theoretical guidelines presented in the report imply warranties that cannot possibly exist. There is a great danger that these guidelines, once in the public domain, will provide the basis for unwarranted liability and regulation at great cost to industry.

Internal control should not be a business goal in itself but part of a much broader goal of improving a company's ability to meet customer needs. A better way to approach internal control would be to strive for quality as defined by the Malcolm Baldridge Award. An effective system of internal control is necessary to achieve this goal and the ultimate reward is increased competitiveness.

Sincerely,

Fred W. Shaffer
Vice President and
Chief Financial Officer

FWS:mjm

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May 22, 1991

The Committee of Sponsoring
Organizations of The Treadway
Commission
1211 Avenue of the Americas 64
New York, New York 10036-8775

Subject: Exposure Draft of Internal Control --
Integrated Framework dated March 12, 1991

Dear Sirs:

I have one overall comment with regard to the above referenced Exposure Draft: The entire approach, of the Exposure Draft, seems to be from the point of view of large, publicly held companies and their accounting firms (normally "Big Six").

Perhaps you should get some input from, and redirect your thrust to include, smaller, proprietor managed firms which are not publicly held.

One source of information, that I think you might find helpful, would be the Private Companies Practice Section of the AICPA's Division for Firms.

I am not surprised at the approach that you took, in the Exposure Drafts, since the individuals who gave input are either all with large, publicly held companies or with national CPA firms. However, there are a significant number of proprietor operated audit clients out there, who prepare financial statements only for their own use, or for submission to financial institutions, who have have relatively simple, unsophisticated control structures and which do not need an elephant gun to shoot a mosquito.

Very truly yours,

Sherman Rosenfield

SLR/djg

VICTOR Z. BRINK, PH.D., C.P.A., C.I.A.
MANAGEMENT CONSULTANT

May 28, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
New York, NY 10036-8775

Gentlemen:

The writer has reviewed in some detail the Internal Control - Integrated Framework (ICIF). It is a voluminous and impressive statement and this reviewer can do no more than offer some very broad comments, as follows:

The major problem is that ICIF unduly takes over the total management process, whereas internal control is essentially a supportive activity and only a portion of the entire management process. Internal control provides its supportive service in two ways a) as a built-in feature of the various components of the management process - to the extent practicable - and b) as deliberate post-operational audit activities, provided by internal and external auditors.

Here I might add that internal auditors begin as a protective type service - such as compliance, verification, detection of fraud, etc. - and then build on the protective services to provide betterment - such as greater effectiveness of policies and procedures and increased profitability. External auditors begin normally with independent assurance of proper financial statements and then can go on to provide management assistance. The external auditor can also provide other services on a special engagement basis.

The second related major problem is that ICIF does not sufficiently focus on the audit dimension of internal control.

Here I might add that the management process begins with resources. Managers take these resources- as they exist in a particular situation - establish goals and objectives and work toward the realization of those goals and objectives via strategies, policies, implementing actions, reporting, evaluation, and controls. The latter, as previously stated, includes built-in qualities at all stages and in all portions of the management process, plus supplemental audit activities.

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VICTOR Z. BRINK, PH.D., C.P.A., C.I.A.
MANAGEMENT CONSULTANT

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All of the foregoing adds up to the truth that what internal control is all about is to make management activities as economical, productive, and effective as is practicable.

Everything in Parts 1 and 2 of ICIF is useful and relevant but what I think is needed is an introductory base to set the stage and to show more clearly how all of your present material fits in. Additionally the treatment of the Monitoring segment needs to focus more substantively on internal auditing - how it provides both a) meaningful evaluation of existing internal control and b) betterment potentials everywhere in the management process.

As respects Part 3, I think it would be better if that subject was dealt with at another time and place. Its inclusion now unduly complicates an already difficult blending of the management process and the internal control process.

I hope that my comments will be helpful

Sincerely,

Victor Z. Brink

cc: Thomas E. Powell
Director of Professional Services
The Institute of Internal Auditors

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State Auditor

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23

May 24, 1991

Mr. Thomas E. Powell
Director of Professional Practices
The Institute of Internal Auditors
249 Maitland Avenue
Altamonte Springs, Florida 32701-4201

Dear Mr. ~~Powell~~: Tom

We have reviewed the exposure draft entitled, "Internal Control-Integrated Framework," issued by the Committee of Sponsoring Organizations of the Treadway Commission. The exposure draft contains a broad definition of internal control that encompasses all aspects of controlling an organization: controls over financial reporting, compliance with laws and regulations, and operating activities. It also defines nine inter-related components of internal control that must function in order to have an effective internal control system.

While the focus of the exposure draft is toward a business in the private sector, it has general application to government entities as well. In your letter dated April 30, 1991, you proposed five questions for which you wanted specific comments. We have attempted to address each of the questions as follows:

<u>Question</u>

1. Do you agree with the proposed definition of internal control, including its nine components? Is it appropriate, understandable, and useful in the evaluation of control?

Answer

The exposure draft establishes the following definition of external control: "Internal control is the process by which an entity's board of directors, management, and/or other personnel obtain reasonable assurance as to achievement of specified objectives; it consists of nine interrelated components, with integrity, ethical values, competence, and the control environment, serving as the foundation for the other components, which are: establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring."

Internal control is an elusive concept that holds different meanings for management, accountants, auditors, and regulators. A principal objective of the exposure draft is to integrate various existing internal control concepts into a common framework in which a common definition is established and control components and their relationships are identified and defined.

We occur with this board definition of internal control because it addresses significant control issues that are applicable to state government in Texas. The big picture integrated system approach to internal control is clearly a significant and important change in the traditional view of internal control and closely parallels a management control methodology that we have developed and are using to evaluate management controls at the 30 largest agencies in the State of Texas.

The proposed definition is important because it stresses an outcomes-driven approach tied to the mission, goals, and objectives of the organization. Such an integrated system, which is a living part of any organization, is the only way that those who lead organizations can have early warning signals early enough to take corrective actions before a crisis situation occurs.

Question

2. Do you believe that the control concepts presented in the exposure draft will be useful in helping managers improve control over their activities in your organization?

Answer

Yes, the control concepts presented are critical to any organization. Highly developed skills in each of these areas is essential to good management as well as good government.

These elements tie very closely to current issues concerning management of government agencies in the State of Texas. The need for adequate mission statements, strategic planning processes with measurable goals and objectives, adequate information systems, managing change, and the need for more effective monitoring and evaluation processes tie very closely to the elements presented in the exposure draft.

The exposure draft makes two very important points, the first that management is responsible for the state of their management control systems and the second is the emphasis on the fact that people are the critical factor in the success of any control system.

Question

3. Do you believe that the evaluation tools contained in the exposure draft will assist your organization in evaluating the adequacy and effectiveness of internal control? Do you feel that an extended test period is needed to assess applicability across different organizational environments?

Answer

Yes, we see the tools presented in the exposure draft as useful guidelines for performing an organization-wide evaluation of internal control. However, they should not be adopted without adapting them to the specific needs of the organization being reviewed.

No, an extended test period is not necessary. We feel that the elements presented in the exposure draft are basic to any comprehensive control system in both government and private sector organizations.

Question

4. Do you feel that a discussion on management reporting to external parties should be an integral part of this study? If not, do you feel that a separate study is suggested?

Answer

From the government perspective, we feel that the citizens have the right to know about the status of management controls within any state agency. There is a great deal of benefit to be derived from a comprehensive study of management controls for any organization. We are, in fact, performing management control audits at the 30 largest state agencies in Texas. Separate management control audit reports will be issued for each of these reviews.

The issue of the external reporting, especially controls over compliance with laws and regulations, may be more of a concern for private sector organizations.

Question

5. Do you feel that the length of the report is appropriate? Should additional material be added or certain material be removed? What changes would you suggest to the current presentation?

Answer

We commend this initiative and believe that it goes a long way to ward achieving the Treadway Commission recommendation calling for development of a common definition of internal control that can be used by operating and financial management, internal and external auditors, audit committees, regulators, and others. We believe the criteria provides a reasonable framework for organizations to use to evaluate the effectiveness of internal controls. The committee has provided a valuable service with this study. From an internal audit perspective, we believe this document will be a valuable resource to state agency internal auditors in their evaluations of control systems within their agencies.

Thank you for facilitating the comment process for this very important study.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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BayBanks

May 29, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Gentlemen:

I was pleased to review the draft results of the study conducted by your group. The study and resulting redefinition of internal controls effectively brings together some of the concepts and ideas that those of us in the internal auditor's community have been talking and writing about for years.

I would like to propose; however, that serious consideration be given to addition of another component of internal control. After reading the document, I see very little, if any, mention of education of managers and employees regarding internal controls. In fourteen years of internal auditing, I have found the absence of a sound understanding of internal control concepts to be a common weakness with many managers. As a practicing internal auditor, it remains a continuing source of frustration to have to educate some managers regarding control concepts while attempting to provide a useful service that the same managers don't think they need.

Fundamentally, internal control concepts should be, and are to some extent, taught in colleges and universities. However, I think it is equally important for corporate training programs to emphasize control and to instruct managers "how to" control.

As one of the two primary stated purposes of your study is to help improve internal controls, I believe education, and/or training, regarding control concepts is an important issue to be considered. I would hope that your group would consider the issue of education as an additional component, or within the framework of one of the other components, and document the Committee's thoughts on this subject.

Please contact me if I can be of any assistance.

Sincerely,

Scott D. White

Scott D. White, CIA, CBA, CISA
Audit Manager

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KPMG Peat Marwick

Certified Public Accountants

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New York, NY 10153

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May 31, 1991

Mr. Gaylan N. Larson
Chairman
Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, New York 10036-8775

Dear Mr. Larson:

KPMG Peat Marwick agrees with the guidance in the exposure draft of the report, *Internal Control—Integrated Guidance*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO report), as a broad framework for management to evaluate the effectiveness of internal controls. We support the efforts of COSO in developing internal control guidance, and we believe the reliability of published financial statements will be enhanced by management reporting on the effectiveness of internal controls over financial reporting. Although management has been evaluating the effectiveness of internal control systems for many years, we believe the COSO report is an excellent tool that can provide additional guidance for management. However, we have the following comments that we believe would improve the guidance.

Objectives of the Study

The COSO report states that the primary objective of the study is to help management better control their business. However, we believe that the COSO report should state in chapter 1 that one objective of the report is to provide guidance for evaluating the effectiveness of internal controls over financial reporting as well as to help management control their business. By stating this as an objective of the study, the private sector takes a leading position in this initiative. Also, the cover letter to the COSO report states that the report was produced as a direct result of the Treadway Commission (Commission) recommendations which emphasized the need for an effective system of internal control to prevent fraudulent financial reporting. The suggested change will clarify that the objectives of the study are consistent with the recommendations of the Commission.

We believe that the COSO report also should emphasize in chapter 1 that the report is a framework which may be used by management of individual entities to develop specific programs to evaluate the effectiveness of internal controls over financial reporting. For example, a manufacturing entity will have to develop specific steps in its evaluation process that are different from those used by a financial institution.

Definition of Internal Control

We believe the definition of internal control should be modified to exclude the nine components. Those nine components are simply one of many ways subparts of internal control may be classified; the classification scheme, in and of itself, is not important to the definition. Our suggestion for the definition is as follows:

> *Internal control comprises the environment, plans, policies, systems and procedures established, executed and monitored by an entity's board of directors, management and other personnel to foster achievement of the entity's objectives in a prudent, cost-effective manner.*

This definition has the following advantages:

- It retains the broad concept of internal control as a process synonymous with management control of an entity's resources and activities, along with the concept that management is responsible for internal control even though many internal control activities are conducted at lower levels of the organization.

- It retains the concept that internal control is objectives oriented and implies that internal control design should start with defined objectives.

- It embodies the concept that internal control fosters achievement of an entity's objectives rather than provides absolute assurance that defined objectives will be achieved.

- It embodies the concept that internal control should be considered in light of costs and benefits.

This suggested definition may be applied to specific objectives within an entity, for example, objectives relating to financial reporting, in the same manner as is contemplated elsewhere in the study.

Components

As noted above, we regard the nine components of internal control discussed in the study as one of many ways the subparts of internal control may be classified. We believe that any classification scheme is simply a means to organize the discussion and consideration of those subparts. For example, the definition of internal control proposed in the COSO report (and the alternative definition we suggest in this letter) is essentially the same as the broad definition that appears in the professional auditing literature. The only difference is that the subparts in the auditing literature are classified into only three subparts—the control environment, the accounting system, and control procedures.

Regardless of the classification scheme used, as one works with the concepts of internal control, it becomes apparent that an entity's control activities may be classified in more than one way. For example, procedures applied by management to follow up on variations from an entity's business plan are covered by all three subparts referred to in the auditing literature.

Recognizing the purpose and inherent limitations of any classification scheme, our preference would be to reduce the number of classification categories to the following six:

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KPMG Peat Marwick

- Commitment to Control
    - Management integrity and style
    - Corporate culture and ethical values
    - Corporate oversight (board/audit committee)
    - Organizational structure
    - Self-assessment mechanism
- Planning
    - Goals and objectives
    - Risk assessment
    - Change management
- Communication
- Personnel
- Monitoring and Feedback
    - Information system
    - Internal audit
    - Outside sources
    - Response mechanisms
- Control Procedures

We believe that reducing the number of categories makes it easier to work with the document and the concepts more understandable. We recognize that the classification of control activities is not as important as whether control objectives are met in a cost-effective manner.

Material Weaknesses

We agree that the material weakness concept is the best measure for determining the effectiveness of internal controls over financial reporting. However, we believe that the cost/benefit concept should not be considered in determining whether a deficiency is a material weakness as implied on page 160. We also believe that chapter 15 should be amended to state that management should not issue an unqualified opinion on the effectiveness of internal control over financial reporting if a material weakness exists.

The points of focus in Appendix C have been presented to assist management in developing a program to review the effectiveness of an entity's internal control system. However, in order to enhance the usefulness of the guidance presented in Appendix C, we believe that there should be a clear link between the points of focus in Appendix C and material weaknesses which should be the threshold for measuring effectiveness of internal control.

Management Reporting to External Parties

We agree with the COSO report that there should not be external reporting on the effectiveness of internal controls over operations or compliance with laws and regulations.

We do not believe that adequate criteria for evaluating the effectiveness of internal controls over these categories of controls has been developed. We also believe that the reasons for not proposing public reporting on internal controls over operations and compliance with laws and regulations should be included in the final COSO report. The Treadway Commission's recommendation for management to report on the effectiveness of internal controls was not intended to include reporting on such internal control objectives.

We agree that both annual and interim financial statements should be included in the scope of the management report to clarify which financial statements are covered by management's report. Further, in order to ensure that user's expectations do not exceed the scope of management's assertion on the effectiveness of the internal control system included in its report, a caveat should be included in management's report for inherent limitations of internal controls.

On page 152, the COSO report states that a reader of the management report "... might justifiably assume an internal control system or certain components of the system considered to be effective at a point in time will continue to be effective in the future." We believe that the COSO report should more clearly state that the conclusions in the management report with respect to effectiveness of internal controls over financial reporting cannot be projected to future periods.

Other Comments

The COSO report appears to be directed primarily towards large, publicly-owned corporations rather than smaller entities. Some of the discussion of the components would not apply to smaller entities. For example, few small entities have an internal audit function, a formal code of conduct, or an audit committee. Also, the formal evaluation process as described in the COSO report would be disproportionately time consuming and costly for the smaller entities. There are other examples throughout the report that may prove difficult for the small entity to implement. We believe the COSO report should address the needs of the small entities separately and recognize that the same level of controls may not be necessary for small entities.

The COSO report refers to but does not include the audit committee guidelines contained in the Treadway Commission report. We believe such guidance should be included in an appendix to the COSO report.

* * * *

We would be pleased to discuss any comments that you may have concerning our letter.

Very truly yours,

KPMG Peat Marwick

KPMG PEAT MARWICK

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June 1, 1991

Committee of Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York City, New York 10036-8775

Dear Sirs:

I am writing to comment on the recently exposed document entitled, Internal Control-Integrated Framework (hereafter, "the document"). My concerns about the document are described below. However, I must preface these descriptions by noting that, despite the KPMG Peat Marwick letterhead, I am writing as a member of the academic community. Specifically, effective this fall I will be leaving my temporary position with KPMG and returning to the University of Illinois at Urbana-Champaign where I hold a permanent position as Professor of Accountancy.

As a member of the academic community, I am especially concerned about the nature of many of the conclusions drawn in the document given the research program which was the apparent basis for them. I would characterize the research as an opinion survey (coupled with a literature review). From such a survey one can learn a number of valuable things--especially what persons' perceptions are. For example, this type of research program is especially useful for learning that there are many diverse views of what internal control is and who owns it. However, this type of research program is not very good for drawing conclusions about actual real-world relationships-- for example, determining what actually causes internal control failures or what makes a control system effective. Field studies or experimentation would seem to be more appropriate if the objective is to address real-world empirical phenomena. Unfortunately, the comparative advantages and disadvantages of the research program are not adequately reflected in the document especially not in the conclusions drawn therein.

I also think that the role of incentives is not adequately considered within the document. Indeed, the document virtually ignores incentives. This, of course, is in substantial contrast with the scholarly accounting literature and is in contrast with much of the popular business press. As I see it, incentives can be viewed as an alternative to control in the traditional sense. Indeed, adopting this alternative would provide a much more positive frame for the whole project relative to that currently in place. That is, in modern business environs, people are viewed in a positive light, but are recognized as economic animals who will respond to economic incentives. They are, therefore, empowered to "get the job done" within a setting in which it will be in their interest to do so. This frame contrasts with the more traditional view-- people are viewed as inherently "evil" and in need of control.

In addition, I have several concerns related to the definition of internal control. First, I am concerned about aspects of the notion of "reasonable assurance" and about the operationalization of this notion in terms of the so-called "prudent person" and in terms of "cost-benefit analysis." Specifically, consistent with considerable prior literature, the document states that internal control provides reasonable rather than absolute assurance. Further, we are told that reasonable assurance envisions that persons will act prudently and (implicitly) that controls should be instituted to the extent that they are cost beneficial. These are not new notions. Nevertheless, I have some concerns about the extent to which they actually can be used in practice to guide the appropriate establishment of controls which in turn (as the document notes) is intended to ensure reliable financial reporting. Consider the following example-- Company X could establish control A at a cost of $1,000,000.00. If control A were established, Company X would save $1,001,000.00 (i.e., a return on the investment of .1%). Thus, from the cost -benefit perspective presented in the document, it seems that control A should be established. However, if Company X were to invest $1,000,000.00 to expand its production capacity (instead of establishing control A), it would earn a return of 15%. Should Company X be expected to make the investment in the control?

This example points our that the opportunity cost of funds potentially invested in internal controls must be considered. However, there still are other issues which complicate practical application of these concepts. To illustrate, it is not clear how even when alternative uses of funds are considered, focussing on control costs and benefits necessarily will result in the optimal level of reliable financial reporting?? Similarly, considerable academic research has reported that people generally do not have a good understanding of how much they know. Consequently, I am puzzled about the description of a prudent person as someone who is " . . .aware of his or her own ignorance . . . " Also, it would seem more appropriate to characterize the level of ability of the prudent person as at least the average ability of those in his/her profession. This discussion suggests that the notions of reasonable assurance, the prudent person and cost-benefit analysis are not sufficiently developed for the purpose of guiding practice with respect to internal control system design within US companies. Such a concern becomes exacerbated if one recognizes that many US companies are multinational in character and that there may be substantial differences amongst nations in terms of how these notions are operationalized.

Lastly, the role of ethical values in the internal control definition remains something of a dilemma to me. On the one hand, I can see the value of discussing the need for businesses to encourage employees to do what is "right" as opposed to what is allowed by regulation or legislation. On the other hand, however, this seems inevitably to lead to a quagmire. To illustrate, doing what is right seems to require one to articulate a philosophical perspective which provides the basis for evaluating actions. However, since no one philosophical perspective can be shown to be better than another and since each could lead to different notions of what is right, it is not clear that anything will be gained by this (i.e., since any behavior can be shown to be consistent with some philosophical perspective). Nevertheless, management will be forced to articulate their philosophy and, perhaps this is the benefit-- once it is articulated, it is open for scrutiny. Irrespective of the value of such articulation, I find that the statement in the accompanying discussion that "ethics pays" is somewhat gratuitous and overly simplified. Clearly, the popular press is full of instances (e.g., firms selling chemical weapons to countries like Iran and drug companies selling AIDS drugs at very high prices) in which this may not be the case unless one is willing to take an extremely long-term perspective or adopt a very unusual philosophical perspective.

Sincerely,

Ira Solomon

Ira Solomon
Professor of Accountancy
University of Illinois at Urbana-Champaign

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DEKALB GENETICS CORPORATION

3100 Sycamore Road
DeKalb, Illinois 60115
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June 3, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
New York, New York 10036-8775

Dear "COSO":

I appreciate the effort that went into generating the Internal Control exposure draft. There is very much in the draft which will be useful. Understanding a total framework of internal control is a large task which grows in dimension when trying to write it down. I have not undertaken such a task, so I feel a bit presumptuous commenting on one that others have done. None-the-less, I have one comment and one concern associated with the draft.

THE CONCERN

Having provided something which is reputed to be "everything you ever wanted to know about internal control", we are likely to have some regulatory or legislative body attempt to codify it. Then, instead of having something which is useful in guiding and evaluating our businesses, we will have something which will be burdensome because it will not quite fit when it is written in law or regulation.

THE COMMENT

Throughout the draft, it appears that there is confusion about what is internal control and what is "process". In this statement I define "process" as the steps necessary to produce an on-spec product or service. For example, if we want to make a piece out of bar stock, the "process" defines all of the steps necessary to:

-purchase the proper material and get it to the machining line.
-machine the piece, including appropriate speeds and feeds and other machining instructions necessary to produce the proper specifications a predictable percentage of the time (presumable very close to 100% of the time).
-handle the piece in the processing line and subsequently until the customer receives the piece and is happy with it.

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In my opinion, internal control is what you need to do to ensure that the "process" does what it is supposed to do and is followed. The same separation of definitions works in the finance area. The process defines all of the steps necessary to (for example) properly close the books. Internal control is what you need to do to assure that the process works and that you actually did what you have previously defined as the way to properly close the books. Clearly, even though internal control may be separate from process, the two must be closely integrated to benefit from timely feedback.

Thank you for an opportunity to comment on such a large undertaking.

Very truly yours,

A D Skouby

Alan D. Skouby

mjh

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

June 12, 1991

To: **Richard M. Steinberg, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Auditors
Jack Albert, Securities & Exchange Commission
Louis Bisgay, National Association of Accountants

Gentlemen:

This is the fifth batch of comment letters (there are six) on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Tom

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

MDU RESOURCES
GROUP INC.

400 North Fourth Street
Bismarck, ND 58501
(701) 222-7900

May 29, 1991

COSO Committee
1211 Avenue of the Americas
New York, New York 10036

Subject: **Internal Control - Integrated Framework Exposure Draft**

I recently reviewed the Exposure Draft (ED) and found the publication to be a very good reference document for effective internal controls. The primary objective of the study was to help management of businesses and other entities better control their organization's activities. I believe the document will be helpful to managers, and that it does provide a starting point for implementation by individual entities, for education and for assessments of internal control. However, much of the ED duplicates practices and evaluations we already complete at our company, and the document is lengthy and duplicative within itself.

I agree with the fundamental concepts in the ED definition of internal control and that the definition should remain broad to encompass all aspects of controlling a business. The scope of Internal Auditing includes examining and evaluating the adequacy and effectiveness of the system of internal control. This is to determine whether the system provides reasonable assurance that the organization's goals and objectives will be met efficiently and economically, and that the system is functioning as intended. We review controls regarding operations and financial reporting, and compliance with contracts, company policies and procedures, laws and regulations. Accounting, administrative and operational controls have an important impact on the scope of our work and toward achievement of management objectives.

The ED definition of internal control contains nine components essential to effective internal control. I agree these components are important for effective internal control, and discussion regarding each of these items is necessary toward development or assessment of internal control systems. However, I do not believe all of these components belong in a definition of internal control. Many of the components simply repeat the various functions of management, which makes the definition of internal control unnecessarily long. Internal controls are simply whatever process, actions taken, or system is used to plan and direct accomplishment of management objectives. They can include manual or automated controls, be preventive or detective controls, and encompass various means and methods.

The control environment provides the foundation for and influences the internal control system. If any components remain in the definition of internal control, I would limit the components to the management environment, along with the need to establish objectives and control procedures to achieve the objectives. Objectives must be identified before internal controls can exist. Control procedures provide reasonable assurance of their achievement. Each of the other components discussed in the ED are again basic functions of management, or in my opinion, are part of the above components. Strong, effective controls result from proper planning, organizing and directing by management personnel.

There are nine chapters in the ED which describe each of the components. Appendix C to the ED includes numerous questions relevant to each of the components. The Appendix also contains a detailed reference manual which identifies objectives, potential impediments, and control focus points for various organizational activities. I found these chapters and the Appendix to be very informative, and to provide a good understanding of the criteria for effective internal control. However, the chapters are quite duplicative and do not provide any new evaluation tools for our company. They do provide a good reference for educating people about each of the basic control concepts.

I expect the final draft will be a good reference document for management personnel, and that it will be useful in helping managers to understand and improve controls regarding their activities. The evaluation tools contained in the ED are helpful but do not provide anything new to our organization. We have already included these questions and evaluation tools in current internal auditing procedures, as part of a management controls environment questionnaire we complete annually for our external auditors, or as part of the self-assessment questionnaire we completed in conjunction with the Treadway Commission report. The tools in the ED would therefore be used only as a supplement to our existing evaluations.

The ED also includes a chapter which discusses management reporting to external parties. I think it is a good idea to include this discussion in the document for those who need direction in developing a management report. We currently include in our Annual Report a management report which addresses internal accounting controls as well as specific elements discussed in the ED chapter. These elements include the audit committee, written management policies and procedures, organizational structure, selection and training of personnel, a code of conduct, and an internal auditing program.

I hope these comments will be helpful and I appreciate the opportunity to respond to the ED.

Sincerely,

Daryl Splichal

Daryl Splichal
Internal Auditing Manager

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May 31, 1991

Committee of Sponsoring Organizations
1211 Avenue of the Americas - 6th floor
New York, NY 10036-8775

To Committee Members:

"Internal Control - Integrated Framework" is a very comprehensive and well-prepared document. We at A. T. Cross have always understood the importance of strong internal controls. Our systems relate not only to accounting, but to all operational aspects of our Company. We make strong use of both our external and internal auditors in reviewing our financial and operating areas.

As you state in your introduction, "legislators and regulators gave internal control significant attention as a result of the Watergate revelations of illegal domestic, political contributions and questionable or illicit payments". This resulted in enactment of the Foreign Corrupt Practices Act and, ultimately, the National Commission on Fraudulent Financial Reporting (the Treadway Commission).

Since that time, there has been a concern that if the private sector did not take the initiative to control itself, the government would mandate. However, we must not overreact to potential government interference. As an example, lack of internal controls may have contributed to the S & L crisis. But, the main problem was a lack of ethics in a very few number of key executives. It is very unlikely that a strong system of internal control would have prevented the S & L crisis.

With that in mind, I offer the following comments:

- It is extremely important that the cost/benefit of strong internal controls be a <u>primary</u> concern in any proposed internal control framework. While your document addresses this area, it is one among many issues included. Because of this, it is possible that any final framework may result in companies incurring significant additional costs in order to meet, what could ultimately be, governmental reporting requirements. As we enter the competitive 1990's, American business does not need any additional costs that will put us further out of line in a worldwide economy.

- If a management report is ultimately proposed, it is important that such reports be as of a point in time rather than for a period of time. This will allow companies to reduce the ultimate cost of making certain that a proper system of internal control is in place. Individuals that have the proper integrity will spend the time and money to develop/maintain a system of internal control and, therefore, such a report would be redundant. Unfortunately, individuals that do not have the proper level of integrity will not put in the necessary controls, but will still have no problem signing a report. Since the Treadway Commission's concern is fraudulent financial reporting, people who are intent on committing fraud will find a way to circumvent any system of internal control.

The bottom line is that any company's operations revolve around the people involved in the company. As long as the board of directors and the top managers are committed to a strong, controlled environment, one will exist. If the commitment is not there, any framework will be irrelevant.

Thank you for this opportunity to comment on the proposal and you can be assured that A. T. Cross will support any final proposal.

Sincerely,

Bradford R. Boss
Chairman

be

cc: Mr. Barry Rogstad
President
American Business Conference
1730 K Street, NW
Suite 1200
Washington, DC 20006

3.

NORGES HANDELSHØYSKOLE
Norwegian School of Economics and Business Administration

INSTITUTT FOR REGNSKAP OG REVISJON
INSTITUTE OF ACCOUNTING AND AUDITING

June 3, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Committee Members:

Attached is the report from the American Accounting Association's Auditing Section Committee to Respond to the COSO Exposure Draft Entitled: *Internal Control - Integrated Framework*. I hope that our comments will be helpful in your deliberations on this important document.

If you have any questions concerning our report, I can be reached at the University of Florida at (904) 392-8882 after June 17.

Sincerely,

W. F. Messier Jr.

William F. Messier, Jr.
Professor of Accounting and
Committee Chairperson

cc: R. Knechel
W. Kinney
D. Ward

COMMITTEE REPORT ON

INTERNAL CONTROL - INTEGRATED FRAMEWORK

by

The Auditing Section Committee to Respond to
the Committee of Sponsoring Organizations of the Treadway Commission
Exposure Draft Entitled: *Internal Control - Integrated Framework*

Members: William F. Messier, Jr., Chairperson (University of Florida)
William R. Kinney, Jr. (University of Texas)
W. Robert Knechel (University of Florida)
D. Dewey Ward (Michigan State University)

June 3, 1991

COMMITTEE REPORT ON
INTERNAL CONTROL - INTEGRATED FRAMEWORK

This committee of the Auditing Section of the American Accounting Association was charged with responding to the exposure draft entitled *Internal Control - Integrated Framework* prepared for the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. In preparing our comments on the exposure draft, we considered the two principal purposes cited by COSO for the study:

1. To provide a common ground for mutual understanding of internal control by all interested parties, and

2. To provide criteria against which all entities can assess and, where necessary, identify areas where they can improve internal controls.

In addition, our Committee considered the two primary objectives cited in Chapter 1 (p. 3). These objectives are:

1. To help management of businesses and other entities better control their organizations' activities, and

2. To integrate various internal control concepts into a framework in which a common definition is established and control components are identified.

The discussion starts with some overall comments that have a pervasive effect on the document. Our remaining comments are categorized according to the four issues raised on pages 2 and 3 of the letter from COSO.

OVERALL COMMENTS

The following comments represent issues that have a pervasive effect on the document:

1. In discussing objectives in the Executive Summary (pp. 4-5) and in Chapter 8, the study states that objectives fall into three categories (operations, financial reporting, and compliance). In reading the document, the financial reporting objective seems to dominate the discussion and examples. If this document is intended for a variety of "interested parties," more emphasis should be given to the operations and compliance objectives. We cite specific instances of this bias in the following comments.

2. The document contains a large number of unsupported statements or conclusions with the reader left to judge their veracity. This is not just a research methodology comment. (Note that the Committee does feel that the study suffers from serious research methodology weaknesses. However, these issues will not be addressed in our comments.) The authors of a document of this import have an obligation to provide support for their conclusions. The study refers in Appendix A to the earlier work done by Mautz, et al. (*Internal Control in U.S. Corporations*) and by Mautz and Winjum (*Criteria for Management Control Systems*). The Mautz, et al. study provided detailed data to support their conclusions and recommendations. The second study (Mautz and Winjum) made specific reference to the data from the first study. It seems appropriate to provide at least some data to support the study's findings and conclusions. Again, we note a number of these unsupported statements or conclusions in our discussion of relevant sections of the document.

3. Our Committee does not believe that management reporting to external parties should be included in the document. However, if it is included a number of issues need to be addressed. In Chapter 15 (Management Reporting to External Parties), under the heading of "New Report Guidelines," the authors state "This study's report presents a definition, criteria and guidelines. *Reference in internal control reports to this report* will enable report issuers and readers to have a common understanding of what is being communicated, and limit the need for explanatory passages (p. 155, emphasis added)." This statement suggests that this document serve as ***the* benchmark** for reporting on internal control. If this is to be the case, the document needs to set a high standard in terms of the two purposes cited by COSO. We discuss specific situations in the document where the benchmark issue is particularly relevant.

DEFINITION (Chapters 1 and 5)

The following definition for internal control is provided in the document:

> Internal control is the process by which an entity's board of directors, management and/or other personnel obtain reasonable assurance as to achievement of specified objectives; it consists of nine interrelated components, with integrity, ethical values and competence, and the control environment, serving as the foundation for the other components, which are: establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring.

Given the importance of this project, the definition of internal control is critical to its success. We have two major comments related to the proposed definition. First, the document contains the following quote. "Although different definitions may be used by different parties, any particular definition *must be precise enough to avoid misunderstandings and unwarranted expectations* (p. 50, emphasis added)." Our Committee feels that the proposed definition for internal control is too broad. We realize that internal control is a complex issue and subject to different interpretations. However, without a more precise and operational definition, "misunderstandings and unwarranted expectations" are likely to occur. This is particularly important since it is suggested in Chapter 15 that this document can serve as the benchmark for management reporting on internal control. Second, the definition of internal control should not contain the nine components. In our opinion, the nine components represent the "model" of internal control and should be discuss outside of the definition.

Additionally, the definition contains the term "reasonable assurance." There is a one paragraph discussion on p. 6 and casual reference on pp. 51-52 to this concept. Given the importance of the concept of reasonable assurance, more discussion seems warranted. The discussion on p. 6 is very similar to the presentation in SAS No. 55. This concept has always caused some difficulty for auditors, managers, investors, and other third parties. The authors could make a major contribution to the internal control literature by providing a more detailed discussion and clarification of the reasonable assurance concept.

COMPONENTS - (Chapters 1 and 5 through 14)

The components of internal control, as mentioned above, represent a model of internal control and should not be included with the definition. In addition, there are a number of issues related to the components that need to be addressed. First, how were these components derived? Were they derived logically from the definition or developed from the empirical research conducted by the authors? Some support should be provided for the inclusion of each component. Second, how do we know that this list of components is complete? The authors state that "the nine components constitute a total system of internal control (p. 56)." Some justification should be provided for this statement. Third, we have some concern over the relationships among the components. Since many people will only read the Executive Summary, Figure 5-1 should be move forward. Additionally, it would be helpful to add a section in the Executive Summary and/or a chapter that specifically addresses how the components relate to each other.

Chapter 15 contains an interesting idea concerning the relationships among the nine components that should be given further consideration. On p. 147, the authors make the following statement: "These four components of the internal control system -- objective setting, risk assessment, information systems and control procedures -- referred to as the infrastructure, are considered together." This idea should be explored further since we believe that it may provide a clearer picture of the intended relationships among the nine components.

The authors also argue on p. 8 that all nine components are critical. Then, five components are selected as being particularly important to control failures. No reason is given for excluding the other four components. It is easy to construct internal control failures for the other four components. One way to justify the nine component model would be to argue that different types of deficiencies can occur in each of the nine components. The authors' arguments that these five components are somehow more important undermine their belief in the model.

Following are comments that relate to specific components. These comments arise from the Executive Summary and the related chapters.

Integrity, Ethical Values and Competence

Integrity and ethical values are indicated by the authors as the foundation for the internal control model. However, they represent rather complex philosophical concepts. While it may be appropriate to use a dictionary definition of integrity in the document, recommendations regarding behavior (see the first two paragraphs on p. 64) should be supported by more authoritative evidence.

In Chapters 6 and 12, the study mentions how management can communicate the entity's values and behavior. It would be very helpful to potential users if the authors provided more specific suggestions or information on issues such as: How many organizations used formal versus informal methods for communicating values and behavior? How effective are these methods perceived by the organizations?

We are troubled by the comment that management override can occur for *proper* reasons (p. 19 and p. 61). How can a system be designed to allow legitimate override and reject illegitimate override? What type of control procedures would be required? If an entity needed to override existing controls it is probably due to failing to "manage change" properly. We suggest that this comment be removed from the document.

Control Environment

There is some degree of redundancy in the material contained in Chapters 6 and 7. For example, the discussion on pp. 62-63 concerns issues related to the control environment and concentrates mainly on financial reporting. We believe that the discussion in Chapter 6 probably should be broader in nature.

On p. 69 the document contains the following quote: "Integrity, ethical values and competence, coupled with the entity's control environment, represent the *most critical* internal control components (emphasis added)." While many readers may agree with this statement, it may be better to refrain from placing a relative value on each component. To simply state that all of them are an integral part of good internal control should be sufficient.

The "tone at the top" is viewed as particularly important to the control environment. However, only two questions are devoted to this issue at the end of the chapter and in the related section of Appendix C. We recognize that the questions in Appendix C are to be viewed as only a starting point, but it does seem that more coverage should be included in order to stress the importance of this issue.

While we realize factors that make up the control environment may vary, the document should provide more specific guidance for each variation. If this document is to serve as a benchmark for management reporting on internal control (Chapter 15), this presentation may confuse potential readers.

While this document must go beyond traditional internal accounting control (i.e., financial auditing), some mention should be made of the control factors discussed in SAS No. 55. The Committee believes that existing standards, especially standards that are so new, should be incorporated into this chapter.

Objectives

The definition of internal control contains the term objectives and then objectives are included as a component. The authors use the terms "objectives," "subobjectives," and "goals" interchangeably. Internal control should probably be defined to include the "establishment of appropriate objectives." In fact, the authors suggest that this is the case when they state "Hence setting objectives....is both a prerequisite and enabler of internal control (p. 80)." Perhaps the term "mission of the entity" should be used. The mission would be agreed to, and put in motion, by the Board and senior management. The objectives would emanate from the mission statement, with internal control insuring that such objectives are achieved.

Risk Assessment

The discussion of risk assessment could be improved and clarified. First, the document should provide more examples and details on how to assess risk. The discussion on p. 93 provides little guidance to potential users of the document. Second, the conclusion on p. 94 that "sophisticated statistical techniques can be applied, but in many cases good judgment is sufficient" can not be supported. There is a vast body of literature which indicates that individuals are not very good at assessing risks. Third, the chapter contains a discussion of material that seems more related to objectives. For example, on p. 91, the study states "In a number of areas of performance, an entity often does not set explicit entity-wide objectives because it considers its performance to be acceptable." How can the entity know that performance is acceptable if it is not compared to some benchmark (objective)? This type of discussion is confusing to the reader. Maybe this issue should be addressed in the objectives chapter instead of the risk chapter.

Information Systems

The document discusses information systems in a very broad context. This is appropriate given the nature of the document. However, we suggest that the authors provide a formal definition of information systems. The last paragraph on p. 103 appears to be a good starting point. We suggest the following changes:

Information systems include all the processes that identify, move, assemble, classify, record, report and store information that is needed by the entity to plan, monitor and execute actions needed to meet the entity's operations, financial reporting and compliance objectives.

This definition ties the information systems directly back to the three categories of objectives.

Although the authors state that information systems serve operational, financial reporting, and compliance purposes, there is no discussion of the compliance aspects of information systems.

This chapter contains a number of unsupported, and perhaps unwarranted, statements. Three examples can be found on p. 107.

> Currently, there is normally less linkage among different systems than one would hope, since operations systems are not always linked to the financial systems. In the JIT environment--where such linkage makes a lot of sense and would improve operations--such integration often does not exist.
>
> While highly integrated systems have numerous organizational benefits, studies have demonstrated that there is sometimes a heavy toll exacted from systems users....
>
> Despite the challenges of keeping up with the revolution in information systems technology, it is a mistake to assume that newer systems provide better control just because they are new....

For example, did the conclusion that highly integrated systems sometimes exact a heavy toll from systems users come from the interview or questionnaire data?

Control Procedures

The authors make it very clear in this chapter that control procedures must be evaluated in conjunction with objectives. However, there appears to be inconsistencies between the coverage and focus of objectives in Chapter 8 and the control procedures in Chapter 11. First, there is substantial discussion of operations, financial reporting and compliance objectives in Chapter 8, but very little corollary discussion in Chapter 11. Second, Chapter 8 addresses entity-wide and activity objectives while Chapter 11 does not mention them. For example, one would expect a strong relationship between control procedures and activity objectives.

The document discusses five examples of types of controls and states that "These are presented to illustrate the range and variety of control procedures, not to suggest any particular categorization (p. 112)." The Committee believes that one of the integrated framework's purposes should be to reduce the range and variety of control procedures, and propose a specific categorization scheme. This is particularly important given our overall comment about this document being used as a benchmark for external reporting on internal control.

Why are information processing controls singled out for discussion to the exclusion of the other four types of controls? Are they more important or are they just easier to discuss from an audit perspective?

The Committee recommends that the use of the terms general and application controls be removed. While these terms may still be used in practice, they are no longer a part of auditing standards (refer to SAS No. 55). For an integrated framework, it may be more appropriate to use more generic terms. One suggestion would be for the authors to think of the following analogy.

Control Environment => General Controls
Information Systems / Control Procedures => Application Controls

An alternative view might be to consider the following relationships: The categories of "top level reviews" or "direct activity management" could include some of the general controls over EDP system design and implementation. The category of "information processing" controls could include many of the application controls. The "physical controls" category could be broadened to include access controls. As presented, there is a great deal of detail on EDP controls but it is discussed as if it is something totally different from "types of controls."

One of the strong points of this chapter is that the authors note the relationship between the risk assessment, objectives and control procedures. This relationship should be developed even further in the chapter. In addition, the evaluation tool (Exhibit C-6) should provide more information than just a format.

Communication

Should communication be a separate component? Perhaps the ideas included in this chapter can be folded into the control environment and information systems components. The authors have not adequately justified a need for communication to be a separate component. For example, the discussion starting at the fourth paragraph on p. 124 sounds more like examples based on "tone from the top." Similarly, the example on p. 123 suggests a mispecified control procedure rather than a communication problem.

Managing Change

The authors should added some specific examples of how organizations are managing change. This would help users of the document to better evaluate their own procedures. Perhaps the data from the interviews and questionnaires would be helpful here.

This chapter also contains a number of unsupported statements. For example, there is no support for the situations discussed under the headings "New or Revamped Information Systems," "Rapid Growth" and "Corporate Restructuring" on pp. 130-131.

Monitoring

The authors properly point out that monitoring is an ongoing function that should be subjected to separate evaluations on a periodic basis. Ongoing monitoring is the "feedback" mechanism that provides management with information on the effectiveness of internal control. Separate evaluations are discussed in Chapter 4 (Executive Summary) and ongoing evaluations are discussed in Chapter 14. We suggest that the order of discussion be reversed. Since we view the ongoing monitoring to be the more important, it should be discussed first.

EVALUATION - (Chapters 4, 6 through 14 and Appendix C)

The evaluation part of the document could be improved. Appendix C is presented as a guide and its use is not mandatory. The authors explicitly recognize that entities may modify the tools included in Appendix C or use entirely new approaches. Further, the document makes it clear that Appendix C does not cover all issues, is not appropriate in all circumstances, and is to serve as a starting point. These are important and necessary caveats. The problem here is that without some alternative suggestions, users of the document are likely to viewed this approach as the "suggested or required" approach. The Committee recommends that other approaches, including their advantages and disadvantages, be presented.

The evaluation process described on p. 37 sounds very much like the external auditors' evaluation of internal control structure. It is not clear that this approach is suited for all nine components. For example, how does one test the integrity, ethical values and competence, risk assessment, communications, and managing change components? We would suggest that a quite different type of methodology might be needed for such components.

MANAGEMENT REPORTING TO EXTERNAL PARTIES - (Chapter 15)

It is not clear to the Committee that management reporting to external parties should be addressed in this document. We consider such a reporting requirement to be outside the purposes cited by COSO and the objectives listed in Chapter 1. The authors provide little *objective* support from potential users on the demand for such reporting and we are not aware of any significant demand. Additionally, it is not apparent that such reporting can be justified on a cost/benefit basis. Thus, our suggestion is to remove discussion of management's reporting on internal control to external parties from the document.

However, we also recognize that there is a potential concern that legislative action may be taken to require reporting on internal control. If the authors decide to keep the discussion of management reporting to external parties in the document, we believe that the following comments should be considered.

Requirement to Report

The report states on p. 143 that it does not express a position on whether reporting on internal control should be required and that this chapter is intended to only provide guidance to entities that do report. Given the potential for Congressional initiatives, why not be proactive and take a stance in favor of reporting on internal control? It would be better if a private sector group suggested a requirement for such reporting rather than waiting until Congress mandates it.

Scope of the Report

The report recommends limiting management reports on internal control to the entity's published financial statements. This recommendation is based on the following unsupported statement "This coincides with the needs of securityholders and other external parties who may look to internal control reports for assurances on the process by which management develops the published financial statements (p. 144)." Further justification is stated to be (1) it puts an appropriate fence around internal accounting control, (2) it is recognized that reporting on controls over financial reporting are far more advanced, and (3) a cost/benefit argument. These reasons do not adequately justify limiting reporting to published financial reports. It is very likely that external users are interested in control issues related to operations and compliance objectives.

Additionally, limiting the reporting in this way is inconsistent with using the document as a benchmark. The paragraphs suggested for the report on internal control (p. 156) make a direct reference to this document including all nine components. Thus, reporting on internal control should cover all objectives of internal control.

Time Frame

The authors argue for limiting the reporting to a point in time. They state that this "meets the needs of securityholders and other report readers, yet provides an environment conducive to identification and correction of deficiencies (p. 151)." There is no support provided for this statement and it is inconsistent with the arguments for a continuous monitoring environment. An argument can be made that users are interested in whether material weaknesses occurred and were corrected <u>during</u> the year. The recommended reporting requirement should not be limited to a point in time.

SUMMARY

This document goes a long way towards meeting its purposes and objectives. However, as mentioned in our report, there are a number of issues that need to be clarified before the document should be issued in final form. In particular, the three pervasive issues cited must be addressed if this document is to completely achieve its purposes and objectives. Finally, the Committee believes that this internal control framework should be subjected to some form of field testing prior to issuing the final document.

Corning Incorporated
Controllers Division
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Corning, New York 14831
607.974.8313

Richard B. Klein
Senior Vice President
Controller

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June 4, 1991

CORNING

Committee of the Sponsoring
Organizations of the Treadway
Commission
1211 Avenue of the Americas, 6th Floor
New York, N.Y. 10036-8775

Dear Sir/Madam:

I'm writing in response to your request for comments on the Internal Control - Integrated Framework exposure draft dated March 12, 1991.

The stated objectives of the report (pg. B-1) were to "assist management in improving their entities' internal control systems and to provide a common understanding of internal control among interested parties".

The report provides a comprehensive definition of internal control which, if used universally, should lead to "a common understanding of internal control among interested parties". It also provides a common ground against which the entity can assess the effectiveness of its' internal control system and identify areas where improvement is needed.

The report and executive summary are extremely detailed. If the report or the executive summary are to be read and supported by Management and the Board of Directors, a more concise version should be developed. This concise version should focus on the objectives of the report and include only a brief description of the basic topics.

* I agree with the comprehensive definition of internal control as presented in chapter 1 with the following exceptions:

> "Internal control is the process by which an entity's board of directors, management **and/or** other personnel...". The "other personnel" of any entity should and do play an important role in the internal control system. Removing the "/or" from the sentence would prevent misunderstanding and place the responsibility of maintaining an effective internal control system on all parties involved.
>
> The responsibilities and importance of the role of the board of directors is emphasized throughout the exposure draft, yet the roles and responsibilities of "other personnel" is not. The board of directors does play an important oversight and directive role in internal controls but an effective internal control system is driven by management and "other personnel". The emphasis on the board of directors vs. "other personnel" should be re-evaluated.

* The description of the nine components of internal control should be integrated into the definition section of the report. The definition would be more complete and understandable if the description of these nine components followed the definition directly as opposed to being in a separate section of the report.

* The evaluation tools presented in the exposure draft would be useful in **supplementing** the evaluation of internal controls in an organization. The tools are extremely specific and would have to be modified by any organization. The fact that any number of methodologies and techniques can be useful in an evaluation process should be emphasized. What is important is that a logical methodology be applied when evaluating a particular component of an entity's internal control system. It should be clearly stated that the tools provided are **suggestions** and not the only way to evaluate the effectiveness of an internal control system.

* The guidance material on management reporting to external parties is both relevant to the users of management's report and flexible enough to be implemented. Management's reporting must remain flexible so that companies can deal with forthcoming SEC reporting requirements and still include information that is relevant to the readers of the report.

As noted above, the exposure draft should emphasize that it is a guide and should not imply that companies must follow the report to the letter when designing, evaluating or reporting on internal control systems. Flexibility within the system is part of the key to an effective system.

I hope these comments are helpful. If you have any questions about the comments, please call Ann Schading, Manager of Internal Audit at 607/974-8759 or Kathy Asbeck, Director of Accounting at 607/974-8242.

Sincerely,

Richard B. Klein
Senior Vice President and Controller

cc: J. R. Houghton, Chairman and CEO
V. C. Campbell, Vice Chairman

J. W. McAllister
Vice President
Internal Audit

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COMPANIES

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People Pledged to Excellence

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Homewood Suites, Inc.

June 4, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Gentlemen:

We have the following observations on the March 12, 1991 Exposure Draft of "Internal Control-Integrated Framework."

Overall, the document does not communicate effectively. It is extremely burdensome to read, and, practical, usable insights are almost totally absent. The document has minimal value in its present form and should not be published.

The definition of internal control does not communicate and does not appropriately define internal control. The proposed definition is too long and is not helpful. Since the definition fails, the rest of the document lacks credibility.

It seems that an alternative that is much more meaningful would include a short, clear internal control definition and practical "how to" information. For example, a definition and following approach might be:

> Internal Control is defined as the measures an organization uses to maintain the integrity of its resources. The "organization" in the definition includes the various stakeholders of an entity. "Resources" include reputation, employees, programs, property, community, customers, etc.
>
> Commentary following this definition would be focused on how internal control is achieved through an analysis of risk. The risk analysis discussion should include many factors, e.g., organization changes, profit pressures, human capabilities, character of asset flows, remoteness of operations, etc.
>
> Once risk is appropriately defined, measures should be discussed as to how to reduce the risk. Such measures might be segregation of duties, dual control, daily reporting, locks, ombudsman, etc. Certainly, a part of this discussion would be the importance of the "tone at the top."

We disagree with a number of the premises in the document. Just a few examples follow:

While integrity and ethical values are very important, they are not the primary elements to internal control that the document conveys. There is an argument that strong internal control can exist in an unethical environment. Also, a very ethical environment will, unfortunately, occasionally include a dishonest individual who will convert resources, absent management's understanding of risk and consequent development of controls that are visible and are enforced. Internal controls are designed to create an environment that will enable most people, bad or good, to behave most of the time. Ethics are important, but not primary to internal control. Accordingly, the statement that internal controls cannot rise above the integrity and ethical values of the people who create, administer and monitor them is a questionable statement.

Ethics and integrity are not easily defined and; therefore, are not objectively measurable. Basing internal control on a subjective foundation is not appropriate.

Ethics and integrity should be outside the primary document, perhaps in an appendix.

We do not subscribe to the premise in Chapter 5 that management, auditors, legislators, and regulators have different perspectives of internal control. Our experience is that there is generally common agreement. The only real difference is one of the degree of control to be implemented.

The document is also centered on "specified objectives." This focus in the definition and discussion is more esoteric than practical. There are varying and evolving objectives found from one entity to another and there is a very real problem that many important objectives may not be formally stated in a business environment. Overall, the emphasis on objectives in the document is poorly developed and unpersuasive. Certainly, understanding objectives is important to establishing internal controls; however, the document's discussion does not adequately place objectives in the proper perspective. The direction of the discussion should be on the risk that programs to achieve objectives will not achieve their purpose, how this risk is identified and how controls are developed to mitigate the risk.

Risk analysis is a secondary element in the control hierarchy established by the document. Risk analysis is the primary element in the development of effective internal control measures and deserves much more emphasis and expansive treatment in the document. This is a major deficiency of the document.

The document gives little attention to the need for management understanding and accountability for risks and controls and the consequent value of training. There is also a lack of emphasis on the importance of controls at the transaction level of a company.

The "certain fundamental concepts" at page 4 of the document contain inappropriate and vague statements. For example, the statement that internal control cannot be expected to provide more than reasonable assurance is misleading. Internal control can provide absolute assurance, if cost is not a factor. In certain cases, absolute assurance is necessary, particularly in our business (casinos). The statement would be better if it indicated that internal control is necessarily subject to cost benefit analysis and absolute control may not always be practical. The last statement that internal control consists of interrelated components is unconsequential and should be deleted. The statement contained in the second statement that internal control is not effected by policy manuals and forms is not correct.

The emphasis on information systems contained in the document is inappropriate. Information systems can be an important part of the control procedures and information systems can present risk. However, information systems are a tool used by the entity and should be subject to user risk assessment and consequent controls just as, for example, the marketing tools would be similarly treated. Making information systems a point of emphasis in the hierarchy is not justified.

Finally, although there are numerous points of disagreement, some of which are outlined in the preceding discussion, there are elements of the document that are good. For example, Chapter 12 on communication is a meaningful discussion. Also, the periodic assertion that control is built into the management process and not a separate function is an important emphasis.

Sincerely,

J. W. McAllister

JWM:jw

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AFFILIATIONS
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ASSOCIATED REGIONAL
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June 7, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Sirs:

We are pleased to submit for your consideration the following comments related to the exposure draft titled Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Report).

We believe the COSO report can become a first step in the development of a framework that an entity's management may use to evaluate and report on the effectiveness of an entity's internal control structure over financial reporting. However, we feel that certain changes must be made before the report can be useful to all public companies. Our recommendations are arranged by topic.

Definition of Internal Control

The proposed definition of internal control is too broad. To include all entity activities in the definition of internal control will lead to inappropriate expectations about the role of internal control in an organization. It could appear to third parties that all business failures are the result of a deficiency in an entity's internal controls.

We recommend that the definition of internal control exclude entity wide objectives and similar managerial functions.

Components

Many of the nine components of an effective internal control structure as set forth in the COSO report overlap. Also, the components appear to address the framework for large companies without considering medium or small companies.

We recommend that the nine components be reorganized into fewer components and that additional guidance be added to enable small and medium sized companies to adopt the framework to their sized entity.

Reporting to External Parties

Management reporting to stockholders was one of the specific recommendations of the Treadway Commission. The COSO study which resulted in this exposure draft was undertaken because of Treadway recommendations. However, as stated on page 143, the COSO report does not express a position on the issue of management reporting to external parties.

We recommend that the Committee of Sponsoring Organizations take a position on this issue in order to respond to the specific recommendation of the Treadway Commission.

Management's Report

The third paragraph of management's report presented on page 157 of the COSO report presents management's belief.

We recommend that management's report be a positive declaration of management's assessment. The third paragraph could be worded as follows:

> Based on management's assessment, at December 31, 19xx, the company maintained an effective system of internal control over the preparation of its published financial statements.

* * * * * * * *

If you would like to discuss these comments, please contact Richard A. Jones at (817) 332-7905.

Weaver and Tidwell

Weaver and Tidwell

/cm

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

June 14, 1991

To: **Richard M. Steinberg, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Auditors
Jack Albert, Securities & Exchange Commission
Louis Bisgay, National Association of Accountants

Gentlemen:

This is the sixth batch of comment letters (there are ten) on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Tom

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

DAYTON HUDSON CORPORATION

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612/370-6948

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May 31, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Re: Exposure Draft: Internal Control - Integrated Framework

Dear Sirs:

Dayton Hudson Corporation, a diversified national retailer, is pleased to respond to the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's Exposure Draft, Internal Control - Integrated Framework. Our comments are structured in response to the four specific matters for comment (Definition, Components, Evaluation and Management Reporting) highlighted on pages two and three of the Exposure Draft. We have also commented on one additional overall concern.

Definition

The Exposure Draft defines "internal control" in a broad sense, with which we concur. This broad definition provides a framework which enables all types of organizations to review and analyze their own unique internal controls.

However, the Exposure Draft focuses primarily on financial information and financial reporting, while the fundamental internal control concepts and objectives described in the Exposure Draft discuss broad operations/objectives. We believe the Exposure Draft would be improved if there was consistency between the definition and the remaining framework.

Components

The components of internal control as defined in the Exposure Draft are generally addressed in some form within Statement of Auditing Standards No. 55, Consideration of the Internal Control Structure in a Financial Statement Audit. SAS 55 provides an understanding of internal controls through three elements of a control structure, those being control environment, accounting system and control procedures. While we believe the Exposure Draft could elaborate on the SAS 55 elements, we encourage the COSO to utilize the structure of internal control outlined in SAS 55.

We believe the Exposure Draft's nine internal control components should be streamlined and reconsidered in light of the structure outlined in SAS 55. Integrity, ethics and competence are an integral part to any control environment and should be considered as such. Communication and managing change are pervasive and should be included in the consideration and evaluation of other components.

Although objectives will be considered during the evaluation of internal controls, they are not a component. Risk assessment is also a factor to be considered in evaluating internal controls, but is not a component of internal control.

While important to an entity and its evaluation of internal controls, these five factors should be considerations within other elements of the control structure, but not separate components.

Evaluation

Dayton Hudson Corporation currently conducts an annual comprehensive evaluation of its internal controls. This process is similar to the evaluation described in the Exposure Draft. Accordingly, we would not replace our current system of evaluation, but would use the Committee's suggestions as a reference tool in reviewing the adequacy of our internal control evaluation process and enhancing it, if necessary.

Management Reporting

Dayton Hudson Corporation is firmly committed to the concept of management reporting and responsibility. Since 1979, we have included a "Report of Management" in our Annual Report to Shareholders. This report focuses on management's responsibilities relative to our financial statements and our systems of internal controls.

The Exposure Draft discusses a management report which focuses solely on internal control. A report of this type may be useful, but lacks a direct association with financial information. Our report on internal controls is structured within the context of financial reporting and it therefore is an integral part of our Annual Report to Shareholders. For the suggested report to be most useful, we believe it should be placed in the context of an annual report on financial statements.

Further, the Exposure Draft's sample management report refers to the COSO's final report as a frame of reference in a manner that appears to be authoritative. We believe our report has been complete and understandable without such reference, and we do not believe a need exists for such reference to be included in effective management reporting (see attached copy of our 1990 management report).

Additional Concern

We are concerned that the Committee of Sponsoring Organizations of the Treadway Commission may appear as an authoritative body relative to the accounting profession. This may lead to establishing another authoritative body, which we do not believe is necessary.

As a result of the Treadway Commission, various existing authoritative bodies have adopted standards and regulations. Our suggestion is that this Framework be used as a reference tool. Requirements for important features such as management reporting could be promulgated by various existing authoritative bodies, without adding another.

The comments and suggestions contained within the Internal Control - Integrated Framework Exposure Draft are timely and helpful. They should not provide the genesis for another authoritative body.

* * * *

As a responsible corporate entity, we appreciate the efforts of the Treadway Commission. The increased focus on responsibility, controls and corporate actions has been a positive force within the business environment. To that same extent we also recognize the efforts of the Committee of Sponsoring Organizations of the Treadway Commission in preparing Internal Control - Integrated Framework. This document will prove to be a valuable reference tool and source of discussion within the corporate community.

We are pleased to provide our comments on this important issue.

Sincerely,

Karol D. Emmerich
Vice-President, Treasurer and
Chief Accounting Officer

Attachment

REPORT OF MANAGEMENT

The following financial statements and other information presented in this Annual Report have been prepared in accordance with generally accepted accounting principles. Management is responsible for the consistency, integrity and presentation of the information in the Annual Report, which necessarily includes some amounts based upon our judgment and best estimates.

To discharge this responsibility, we maintain comprehensive systems of internal controls designed to provide reasonable assurance that assets are safeguarded and transactions are executed in accordance with established procedures. The concept of reasonable assurance is based upon a recognition that the cost of the controls should not exceed the benefit derived. After judging the cost and benefit factors, we believe our systems of internal controls provide this reasonable assurance.

The Board of Directors exercises its oversight role with respect to the Corporation's system of internal financial controls primarily through its Audit Committee, which is composed of seven independent directors. The Committee oversees the Corporation's systems of internal controls, accounting practices, financial reporting and audits to ensure their quality, integrity and objectivity are sufficient to protect shareholders' investments. Their report appears on this page.

In addition, our financial statements have been audited by Ernst & Young, whose report appears on page 33. As a part of its audit, Ernst & Young develops and maintains an understanding of the Corporation's internal accounting controls and conducts such tests and employs such procedures as it considers necessary to render its opinion on the financial statements. Their report expresses an opinion as to the fair presentation, in all material respects, of the financial statements and is based on an independent audit made in accordance with generally accepted auditing standards.

Kenneth A. Macke
Chairman of the Board and
Chief Executive Officer

Stephen E. Watson
President

Willard C. Shull, III
Senior Vice President,
Finance

Karol D. Emmerich
Vice President, Treasurer
and Chief Accounting Officer

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New York City
Transit
Authority

370 Jay Street, Brooklyn, N.Y. 11201

June 3, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, N.Y. 10036-8775

Subject: Comments on Exposure Draft on Internal Control

Dear Sirs:

We reviewed the draft on internal control. The purpose of our review was to provide general comments on internal control and specific comments on areas where the draft's contents were different from the internal control standards applicable to the New York City Transit Authority (Transit Authority). We used the following sources for our review:

- the State Comptroller's internal control standards followed by New York State (NYS) agencies and public authorities in establishing and maintaining systems of internal control as required by the NYS Governmental Accountability, Audit and Internal Control Act of 1987; and,

- Generally Accepted Government Auditing Standards (GAGAS) issued by the U.S. Comptroller General, (the yellow book) revised July 1988 and effective January 1, 1989 for audits of governmental organizations, programs, activities and functions.

We also referred to the Transit Authority's Departmental Guidelines for Evaluating and Reporting on Internal Control Systems issued February 1991. These guidelines were prepared to comply with the NYS Comptroller's internal control standards and the NYS Governmental Accountability, Audit and Internal Control Act of 1987. Our comments are arranged in the order suggested in the exposure draft.

Based on our review, we believe that the contents of the exposure draft were consistent with the standards of internal controls being implemented at the Transit Authority. However, as indicated below, we do express some concern regarding the components identified in the definition of internal control.

1. Definition of Internal Control (Chapters 1 and 5).
   We generally agree with the exposure draft's definition of internal control because it encompasses the concepts discussed in the State Comptroller's standards. Such definition will change, however, if the recommendations proposed in item 2 are accepted.

2. Components (Chapters 1 and 5 through 14).
   A. The draft identifies nine components of internal control. It also combines integrity, ethical values, and competency as one component. Integrity and ethical values are moral issues while competency refers to abilities and knowledge. The State Comptroller's internal control standards present competency as a general standard for all internal control systems. It further states that managers and employees must maintain a level of competence that allows them to accomplish their assigned duties, as well as understand the importance of developing and implementing good internal controls.

      We believe that competency is a very significant element of good internal controls. Not only must personnel attain a certain level, they must be periodically trained and retrained to keep the system effective. Therefore, we recommend that competency be removed from the combined component and be developed as a separate component of internal control.

   B. The draft also identifies information systems and communications as separate components of internal control. We recommend that the two components be merged since effective information systems will provide good communications for internal activities and external factors.

We would appreciate you providing us a copy of the final report when completed. If we can be of further assistance, please advise.

Very truly yours,

John J. Fernandes

John J. Fernandes
Vice President and General Auditor
New York City Transit Authority

The Business Roundtable

36

Drew Lewis
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Samuel L. Maury
Executive Director

June 3, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th floor
New York, NY 10036-8775

Gentlemen:

The Accounting Principles Task Force of the Business Roundtable appreciates the opportunity to express our views on the Committee of Sponsoring Organization's Exposure Draft (ED), "Internal Control - Integrated Framework". We endorse the approach taken by COSO in the document, and we believe the study focuses on the appropriate issues and includes pertinent observations and recommendations on this important subject.

As CEOs and the individuals most responsible for the stewardship of our companies, we want to emphasize that we consider internal control to be an integral part of the infrastructure of an organization. Companies must ensure that their internal control systems are effective and constantly evolving with the dynamic business environments in which they operate. The nine elements of internal control identified in the ED are the basic tenets of good business practice, reinforcing the concept that internal control cannot be "built on" but rather should be "built in" to an organization. In times of economic stress, CEOs must rely even more heavily on their internal control systems to ensure that appropriate business actions are taken and that these actions are accurately reported for internal and external reporting purposes. We agree with COSO that senior management must have an active role in developing, modifying, evaluating and monitoring the operation of internal control within their organizations.

While we believe the ED is an important study on the subject of internal control, we have reservations concerning the level of detail contained in the document and the emphasis on a standardized approach to evaluation and reporting. We believe the document should be reorganized into a succinct, thought-provoking statement of principles. Without such a change in focus, the document will be relegated to the CEO's bookshelf and will represent a lost opportunity to encourage senior management involvement. The extensive reporting guidelines and evaluation tools should be presented as a separate volume and characterized solely as guidance material, directed primarily at companies that do not already have sophisticated internal control systems. Senior management should be given the maximum flexibility to design the evaluation tools which best suit their organizations, and to tailor their management report to the needs of their shareholders and other readers of financial statements.

Very truly yours,

John S. Reed
Chairman, Accounting Principles Task Force

cc: Drew Lewis, Chairman, The Business Roundtable
William L. Lurie, President, The Business Roundtable
Members of the Accounting Principles Task Force

THE UNIVERSITY OF ARIZONA
TUCSON, ARIZONA 85721

COLLEGE OF BUSINESS AND
PUBLIC ADMINISTRATION
DEPARTMENT OF ACCOUNTING

WILLIAM L. FELIX, JR.
PRICE WATERHOUSE AUDITING PROFESSOR
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June 4, 1991

The Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Committee Members:

Thanks very much for this opportunity to comment on your very important project. Given the objectives for the study included in your letter of March 12, 1991, I am not at all satisfied with the contents of the Exposure Draft. The definition of "internal control" and the discussions of it do not provide a common ground for mutual understanding of internal control. I will comment on the definition further. In addition, the nine components of internal control do not provide criteria against which all entities can assess their internal controls. To elaborate, the definition of internal control provided is not, in my view, a definition. How can a process be a definition? What's more, how do the nine elements define a process? As an auditor interested in financial reporting controls, it is not at all clear how the so-called definition accommodates or includes controls for financial reporting. It would be especially essential in a successful draft for the components of internal control on page 6 and the definition of internal control to be clearly and specifically linked. The so-called definition is really a description of internal control as a process. The components seem to be necessary conditions or activities for the process to occur, but are not described as such nor is it made clear conditions under which all or parts of the nine components are essential.

The Exposure Draft claims that reporting on internal control is not a component or a critical criterion for effective internal control. It would appear that reporting on internal control may create enough of an incentive for good control practices in public companies to be just as significant as or more significant than the other components.

Finally, for the Exposure Draft to be clear, an effective definition of "control failures" is needed. This definition should distinguish between the effects of over-ride or collusion and the effects of poor design or ineffective operation. This point is based, in part, on the discussion of reasonable assurance on page 6.

There are a number of components of the Exposure Draft that are quite useful. The task you have set yourself is a difficult one and any progress you make will be significant.

Sincerely yours,

William L. Felix, Jr.

WLF/ml

DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VIRGINIA 22304-6178

OFFICE OF THE DIRECTOR

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07 JUN 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Your exposure draft, "Internal Control - Integrated Framework," dated 12 March 1991 reflects a significant and positive effort on your part to heighten awareness of the importance of an entity's internal control system. I share your view that improved criteria are needed for improving understandings of internal controls and for assuring that systems are sufficient to provide a reasonable basis for reliance.

In response to your request for comments on the exposure draft, we offer the following:

Exposure Draft: Chapter 3 indicates that external auditors are not part of the entity's internal control system.

Comment: External auditors may be a part of the entity's internal control system. This occurs when the engagement agreement specifically requires tests or other functions for the purpose of internal controls. For example, an external auditor may be engaged to perform tests which might otherwise be assigned to an internal auditor. Also, where the engagement permits internal auditors to have access to external audit working papers, the internal auditor may extract information from the financial statement audit which serves a dual function as an element of the system of internal controls. As mentioned below, a coordinated audit plan may integrate the various audit tests for multiple purposes.

Exposure Draft: Chapter 4 "Evaluation of Controls" states that "often evaluations take the form of self-assessments, where the person responsible for a particular unit or function will determine the effectiveness of controls for their activities."

Comment: Self-assessments will clearly help management in evaluating internal controls. However, because of the very nature of self-assessments a question may arise as to their credibility. This conclusion is based on the natural tendency to overlook one's own faults.

We recommend that the coverage in the exposure draft be modified to encourage a control feature; e.g., have either the internal or external auditors test the self-assessments. This would increase management and external confidence in the final assertion.

Exposure Draft: Chapter 14 acknowledges the roles of internal and external auditors in monitoring systems of internal control.

Comment: The effectiveness of interaction between internal and external auditors may be enhanced by having a formal program of coordination. By coordinating the audit planning process, comprehensive coverage of critical elements of internal controls is more likely and undesirable duplicative audit effort may be avoided. Sharing audit analyses and observations will often benefit the risk assessments and conclusions of the separate audit organizations. Consequently, we recommend that you encourage companies to include specific provisions in their engagement letters with external auditors requiring coordinated audit planning and the sharing of audit analyses and observations. When there are government auditors involved, as in the government contracting environment, similar coordination and sharing arrangements should also be encouraged. We have observed that more effective audits of internal control systems are achieved at less cost when all auditors engage in coordinated auditing.

Exposure Draft: Chapter 15 recommends that point-in-time reporting is most appropriate since management's focus should be identification and correction of deficiencies and not on disclosing deficiencies that were identified during the year and promptly corrected.

Comment: The exposure draft is silent on disclosure of the subsequent discovery of facts existing at the date of the management report. Auditing standards require disclosure of significant subsequent events. We recommend that the exposure draft be revised to encourage the same disclosure with respect to internal controls. As in financial reporting, internal control problems can come to the attention of management after year-end. To the extent these deficiencies are significant and are not corrected as of the date of the report, full disclosure should be made.

Exposure Draft: Chapter 15 recommends that the report content include management's conclusion on the effectiveness of the internal control system. The Chapter equates the concept of internal control effectiveness with the term "material weakness."

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07 JUN 1991

Committee of Sponsoring Organizations
of the Treadway Commission

Comment: Statement on Auditing Standards No. 30 requires that for an internal control procedure to be considered effective it must be in place for a time sufficient to test for compliance. The exposure draft infers that if management has implemented corrective action the system is effective. We recommend that the exposure draft be revised to specify that corrective action must be in effect for a time period sufficient for testing. If this is not the case, disclosure of the deficiency and corrective action should occur.

Exposure Draft: Chapter 15 indicates that the management report should focus specifically on controls over published financial statements. This coincides with the needs of security holders and other external parties who may look to internal control reports for assurances regarding the process by which management develops the published financial statements.

Comment: As noted by the exposure draft, two of the three internal control objectives -- financial reporting, and compliance with laws and regulations -- are standards imposed by parties external to the entities. The COSO, however, proposes reporting only on controls over financial reporting. It is our opinion that external users of the management report also want assurances that the entity has controls to help ensure compliance with laws and regulations. Therefore, we recommend that the exposure draft be modified to also require reporting on internal controls over compliance with laws and regulations.

Exposure Draft: The merits of public reporting on internal control are being addressed by public and private sector bodies with responsibility for, or interest in, this issue. On page 9, the report states that it does not express a position on the issue.

Comment: Appendix A notes that legislative activity on public reporting of the effectiveness of a public company's internal controls has intensified since 1985. Although no legislation or regulations containing these requirements have been enacted or issued, the frequency with which they are being introduced highlights the increasing emphasis that governmental bodies are giving to the reporting of internal controls. We recommend that the COSO should take a leadership role on the requirement for reporting of internal controls. Private sector leadership and action could effectively eliminate any need for legislation or regulation.

William H. Reed

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Director

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ACCOUNTING DEPARTMENT
WALTER O. BAGGETT, Ph.D., CPA

10 June 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Gentleman,

I am pleased to respond to your March 12, 1991 Exposure Draft of Internal Control - Integrated Framework.

I have had a long standing interest in the subject of internal control, both as a practitioner and as an academician. A number of years ago I published an article on the subject. I am enclosing a copy because it reinforces some of the thoughts I have on this draft.

I have read the draft and reviewed the appendices.

I will provide you in this letter a list of my general, overall impressions of the draft. I will append a list of detailed comments on specific passages.

First, the report clearly reflects a good deal of work. If it were a document designed to elicit general discussion in the business community, it would possibly achieve that objective.

Unfortunately, the stated purpose of this document is to develop a general framework around which a consensus can be built. It does not do this because nine components do not comprise a viable working model. Instead, they are merely component that have been lumped together.

There are a number of reasons this is apparent. First, you have clearly not looked at the broad control literature such as is found in management and engineering (not to mention the biological and physical sciences). This general systems framework defines control systems in terms of inputs, outputs and feedback mechanisms. I would also urge you to examine the reliability literature, as that appears to be useful in understanding internal control.

Another reason this framework is untenable and will not serve as the basis of a viable general framework, is your inability to convert it into anything approaching quantifiability. While I realized many people are most comfortable in cloaking themselves in the robes of judgement, unless someone is willing to say how much is enough, and be able to prove it, the framework will not work.

In fact, this first and second reason merge. The well thought out and used models developed in other fields can be quantified. If you were to follow those models, not only would you have a more readily understood and accepted model, you would have one that could be quantified.

I realize, there is a strong temptation to go headlong into issuing this document with only cosmetic changes. I would strongly suggest you do not. To try and float a ship that is doomed to sink could well set back the goal of developing a long range consensus on internal control.

I appreciate your efforts in developing this project and would like to thank you for this effort to comment on them.

Very truly yours,

Walt O. Baggett

Walter O. Baggett
MBA, Ph.D., CPA

APPENDIX TO

Comments on

Internal Control - Integrated Framework

Page 3-4 DEFINITION OF INTERNAL CONTROL

1. I am not certain internal control is a process. It may be a number of concepts and even concrete facts, but to lump it all into a concept does not seem quite right.

2. In bullet two you refer to people. I tend to see it more specifically as peoples, their attitudes and values as demonstrated by their actions.

Page 6 COMPONENTS

The last sentence of the Objectives bullet. I think besides being reasonable attainable, they must be measurable.

Page 8 Your five bullet list of the five components whose failure leads to the failure of control. I am not convinced as to how you came up with this list. I think you need to explain why the failure of these components is critical.

Page 9 Paragraph 3. The ownership of the control system by the CEO is an issue that you push here and through out the document. I find this unacceptable, particularly in light of the concern over the competitiveness of U.S. industry. Clearly there needs to be a measure of control near the top, but you are fooling yourself if you believe that control is an indispensable element of the top position.

Page 11 Last two paragraph. Your discussion of the need for a definition of material weakness versus reportable condition starts here. It continues through a number of places in the study. This is a very real need as the literature is unclear. Once again this is an argument not only for a better framework but one that can be quantified, perhaps along a number of dimensions.

Page 12 Second paragraph and bullet. I agree there is a language "gap" in need of bridging. The unfortunate part of this report is that it was written from the perspective of accountants and does not seem to include the vocabulary of management and other business sciences.

Page 13 First paragraph, second sentence. Suddenly the words "control systems" appear. Where do they come from? What do they mean? This is common usage that you seem to ignore. I suggest you look into these words.

Page 13 Second bullet, second paragraph. I have a great deal of difficulty with the built-in versus built-on distinction. Most control frameworks are constructed by grafting new mechanisms on and pruning away old and unhelpful practices. Some controls, such as the annual external audit, are purposely left as external and not intrinsic to the organization. This appears to be an invalid distinction.

Chapter 2 This chapter, in particular, invoke the notion that you need to look at reliability engineering. Why do things fail? There are not necessarily a "cause." Instead, "normal" stress and stain tend to lead to things wearing out. You need to realize that even a well construct system will eventually fail just through ordinary use.

Page 47 First paragraph, second sentence. Internal control clearly does not represent all aspects of controlling a business. The management literature would never recognize this terminology. For the accounting profession to believe that its ill-conceived wording would be used on a broad basis makes no sense. Internal control has always had to do with anything that improved the financial reporting process. Some of those things are, in fact, control systems. Other have nothing to do with controls. Things like changes in the economy and technology, law and government, cultural mores and folkways. These may have something to do with business policy, but they clearly do not fall under the rubric of "controlling a business."

Page 48 Third paragraph. As you have figured out by now, looking in the dictionary for a definition of control just will not do it. You **must** examine the authoritative literature on control.

Page 50 Paragraph two, sentence three. What the writers either do not know or do not seem to believe is important is that the FCPA defines internal control using language lifted verbatim from the now superceded section 320 of U.S. GAAS. In fact Congress took the profession at its word, literally. And now we are turning our backs on them, saying the definition was inadequate. This is clearly a problem that the profession must face.

Page 54 Paragraphs three, four and five. As I indicated earlier, I believe the process conceptualization of internal control is unworkable. These paragraphs confirm that belief. I find them to be a nice group of platitudes that mean nothing. I would like to see some concrete examples to prove that you are correct.

Page 62 The reference at the bottom of the page is unclear. Who published the work by Kenneth A. Merchant. I think you need to do a better job of spelling these things out.

Page 69 Paragraph three, first sentence. I do not see the difference between integrity, ethical values and competence and the control environment factors you are coupling them with. I think there is a significant conceptual overlap here, which is a problem.

Page 80 Paragraph four, third sentence. I have a problem with the concept of "inherent objectives." It gets you into a whole host of problems. Perhaps you should think about using a term like "externally motivated" demands on the entity.

Page 83 Bullets four through eight. A classical case of the unquestioning lifting the auditing literature. It is widely recognized that while the auditing standards recognize five assertions, they leave out two: cutoff and mechanical accuracy. If you don't believe me check out you own book, Montgomery's Auditing, eleventh edition, college version, page 150.

Page 92 The two bulleted lists of internal and external factors. Where did these lists come from? Are they exhaustive? You need to reference your source. If you just pulled them out of the air, I suspect you are in trouble. Please motivate your position so we know what authority you are speaking on.

Page 130 First bullet. Control procedures that address change make no sense. I think there is a lack of the understanding of change here. Once again, I think you need to talk to experts in the field. You are dealing with a dynamic factor and can not predict the controls that need to be in place. Management must take a role in recognizing the changes and respond by developing the controls that are needed. You can not put a control in place before you know what you are controlling.

Chapter 15 Your entire discussion was hard to follow. There seemed to be a number of fuzzy proposals on the table here. I would like to get a better feeling through more examples of specific wordings and types of reports. It would be particularly helpful if you gave examples of reporting when there are problems. It is easy to report when everything is fine. The real skill is in dealing with bad controls. I think you must address this issue.

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Internal Control: Insight From a General Systems Theory Perspective

WALTER O. BAGGETT*

Internal control is one of the most significant topics in current auditing and accounting literature. Yet there is much confusion over what internal control is. This article contends that internal control is more than just control itself or the total accounting/information system. Instead internal control appears to include these and an element of systems reliability.

Auditors have long recognized the importance of internal control in easing the burden of their audit work. By testing the system of internal co

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first the auditing literature and then general systems theory.

The Classical Approach

One of the earliest definitions of internal control is found in Section 320. Paragraph 9 of the Auditing Standards:

> Internal control comprises the plan of organization and all the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote opera-

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The author would like to thank David T. Stamford and David Small of Kent Process Control. Inc. for their assistance in developing the ideas in this article.

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ROBERT L. PLANCHER
SENIOR VICE PRESIDENT AND
CHIEF ACCOUNTING OFFICER

June 10, 1991

The Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, Sixth Floor
New York, New York 10036-8775

Gentlemen:

We appreciate the opportunity to respond to the Internal Control-Integrated Framework Exposure Draft issued March 12, 1991. Excepting those items noted below, we concur with the conclusions reached by the Committee and commend the Committee on the in-depth and qualitative manner in which it has dealt with what is clearly a complex issue.

Of concern to us is the potential clouding of the role of the Board of Directors and over-riding of management authority and discretion that could result from a literal interpretation of the conclusions drawn. As you know, the law of most states requires the business and affairs of a corporation be managed by or under the direction of its board of directors. This role encompasses, but is not limited to:

A. Accuracy of financial statement and other public disclosure documents;

B. Maintenance of control against loss of assets and assurance of compliance with law.

While we fully support and agree with the position that the definition of internal control should encompass financial as well as administrative controls, the positions on objectives and managing change as put forth by the Committee, could lead to a second-guessing of Board and management decision-making and ultimately, an unwieldy and unmanageable bureaucracy.

We further believe that given the litigious environment which exists today, an additional concern emerges; namely, the possibility that a letter of the law interpretation could become legislated standards. If such an overzealous approach were to be taken, the costs and organizational resources that would be required to achieve compliance would be both onerous and costly. The inevitable conclusion of such action would be a strangulation of the organization with a program that would add little value to the overall control effectiveness, efficiency and profitability of the nation's business.

Since we subscribe to the premise that broadly worded negative criticism to detailed and specific expositions lead to non-productive results as opposed to constructive change, we have attached for your consideration a "memorandum of specific matters for comment" that we hope will permit the document, as finally released, to achieve the full extent of your, and incidentally, our objectives.

We urge the Committee to stay the course on defining internal control more broadly, but temper the position as currently proposed. If we can be of any further assistance in this effort, please let us know.

Very truly yours,

Robert L. Plancher

COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION

INTERNAL CONTROL - INTEGRATED FRAMEWORK EXPOSURE DRAFT - MARCH 12, 1991

SPECIFIC MATTERS FOR COMMENT

DEFINITION OF INTERNAL CONTROL

Proposed Definition:

> Internal control is the process by which an entity's board of directors, management and/or other personnel obtain reasonable assurance as to achievement of specified objectives; it consists of nine interrelated components, with integrity, ethical values and competence, and the control environment, serving as the foundation for the other components, which are: establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring.

Commentary: We suggest that the definition of internal control be modified to read as follows:

> Internal control is the process by which an entity's board of directors, management and/or other personnel obtain reasonable assurance that business is conducted in accordance with managements' general or specific authorization; it consists of interrelated components, with integrity, ethical values and competence, and the control environment serving as the foundation for other components which are: risk assessment, information systems, control procedures, communication, managing change, and monitoring.

Our key concern here is the issue of objectives. As currently proposed, the definition of internal control could be interpreted to expect the control environment to provide assurance that the "right" decisions are made as opposed to assuring that decisions, good or bad, are made in accordance with defined authorizations and authorities. While establishing objectives is crucial to overall business success, the setting of objectives is not a control issue, but rather a prerogative and responsibility of management which can and should only be evaluated at the Board of Director, shareholder and government level.

In large part, the position put forth here represents a blurring of Board of Director corporate governance with traditional financial and operational control. This represents a potentially dangerous encroachment on American business and given today's litigious society, could have serious consequences if adopted.

In summary, we support the notion that the definition of internal control should encompass both financial and administrative control. We would, however, urge that the definition of internal control be tightened to preclude the possibility of an unintended or inappropriate expectation of the function or purpose of internal control.

COMPONENTS OF INTERNAL CONTROL

Integrity, Ethical Values, and Competence. Internal control is only as effective as the integrity and competence of the people who develop, administer and monitor the controls. Integrity must be accompanied by ethical values, and both must start with the chief executive and senior management and permeate the organization.

Commentary: Agree

Control Environment. Factors in the control environment include management's philosophy and operating style, the way it assigns authority and responsibility and organizes and develops its people, and the attention and direction provided by the board of directors.

Commentary: Agree

Objectives. Objectives must be set at an entity-wide level and linked to objectives set at the functional or unit level. These established objectives provide the organization's targets, and strategies provide the directions for getting there. Objectives and strategies must be clearly communicated, and reasonably attainable, or control breakdowns can occur.

Commentary: While we would agree that setting clear and defined objectives is important to organizational success and can impact internal control, we are concerned that this component as currently defined could lead to an inappropriate encroachment on management prerogatives and responsibilities. Should this component stand, we believe the effort of the Committee will result in more confusion than clarity. Specific matters which we believe would bog down the achievement of a strong internal control environment would include:

. Clarifying and defining the level to which objectives would need to be defined.

. Establishing a monitoring process for certain objectives which may add little value to the system of internal control or the management process.

. Defining who would decide the adequacy and completeness of the process by which objectives are established. Would the auditors, either internal or external, assume responsibility for this effort? If not, then whom? Net, net--complying with this component could deteriorate into a wide-ranging bureaucratic effort.

It would be our suggestion that this component be revised to "clearly defined lines of authority and responsibility". Verbiage accompanying this component could read as follows: specific responsibility for the performance of duties must be assigned to specific individuals if the system of control is to operate effectively and work is to be properly performed. If a duty is not adequately performed, it is then possible to place responsibility with the person who did the work. The one assigned is thus motivated to work carefully, and corrective action by management is made possible.

Risk Assessment. Every entity faces risks to its success, from external and internal sources. To be in control, risks potentially affecting achievement of an entity's objectives must be identified, analyzed, and acted upon.

Commentary: We support the inclusion of risk assessment as a component of internal control. We would suggest, however, that emphasis on this point be modified to remain more in line with the AICPA's standard for evaluating risks. Specifically, we would suggest that risk assessment be a component of evaluating inherent risk, control risk, and audit risk.

Information Systems. Management at all levels must have relevant and timely information about both internal activities and external factors.

Commentary: Agree

Control Procedures. Control procedures must be established throughout the organization and in all functions. They include a wide variety of activities, including approvals, authorizations, verifications, reconciliations and reviews of operating performance.

Commentary: Agree

Communication. Effective communication must occur--down, across, and up an organization--as well as between the entity and outside parties. The exchange of information--as well as an environment that fosters open discussion of issues, problems and concerns--is essential.

Commentary: Agree

Managing Change. Reality is that economic, industry, regulatory, and operating environments change, and entities' activities evolve--bringing new risks and opportunities. Mechanisms need to be in place to enable the entity to identify, communicate, evaluate and respond to change on a timely basis.

Commentary: Without question, change more often than not represents the greatest challenge to maintaining an appropriate and sound system of internal control. While we support its inclusion as a component of internal control, we believe that the focus within this category must be more narrowly defined and should be limited to considering the impact of change on internal control and the potential need for supplementing the process or revision of existing control practices and procedures.

We must zealously ensure that the focus within this component does not become one of second-guessing management. As a specific example, evaluating managements' reaction to changing competitive pressures in the marketplace would not be deemed an appropriate exercise within the context of a system of internal control responsibilities. Ensuring that programs and procedures were in place to maintain current awareness of government laws and regulations would be.

Monitoring. The system must be monitored to assess both the current performance of controls and their adequacy over time. Monitoring includes carrying out routine procedures as well as reacting to input from auditors, regulators and other parties.

Commentary: Agree

EVALUATION OF CONTROLS

Commentary: We fully agree with both the need for evaluation of controls and your commentary provided in Chapter 4 of the Exposure Draft regarding methodologies to be employed.

MANAGEMENT REPORTING TO EXTERNAL PARTIES

Commentary: As a corporation which provides a report of management in our company annual report, we endorse the concept of management reporting to external parties. We fully concur that such public management reports on internal control should continue to address only controls over financial reporting. We also agree with the proposed guidelines regarding what should be included in the report.

Schering-Plough

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June 10, 1991

Committee of Sponsoring Organizations
1211 Avenue of the Americas
New York, New York 10036

Gentlemen:

We appreciate the opportunity to express our views on the exposure draft of March 12, 1991, "Internal Control - Integrated Framework". We commend those who participated in the study and those who drafted the report. Internal control is an important subject and Schering-Plough is concerned with the potential impact these concepts may have.

The exposure draft defines internal control as the process by which an entity's board of directors, management and/or other personnel obtain reasonable assurance as to achievement of specified objectives; it consists of nine interrelated components, with integrity, ethical values and competence, and the control environment, serving as the foundation for the other components, which are: establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring".

Appended to the definition, however, is an extensive list of detail requirements which we believe are excessive and not cost justified to implement. It would be more useful if basic control standards were covered in the proposal with specific procedures tailored to each company.

Secondly, we are concerned that this definition will shift the emphasis of the independent accountant's responsibility from a financial statement opinion basis to a report on a company's internal control system and its weaknesses. We believe the auditors opinion on the financial statements remains the correct focus.

We are also concerned with the de-emphasis of financial statement reporting which is the basis of our current system of internal control. Internal control as defined in the report is viewed as not only accounting controls but other controls and functions. This change in definition creates additional control implementation problems and difficulty with its overall implementation due to its broad implications. Schering-Plough's emphasis has been in support of the Foreign Corrupt Practice Act definition which states:

> Internal accounting control provides reasonable assurance regarding the achievement of certain objectives, dealing with: execution of transactions in accordance with management's authorization; recording transactions to permit financial statement preparation in accordance with generally accepted accounting principles and to maintain asset accountability; permitting access to assets only with management's authorization; and comparing assets with accounting records.

We believe that the above objectives should continue to be the focal point of an internal control definition.

We agree with the objective to establish a "common-ground" definition of Internal Control, but one that would not be construed as a binding, strict and extensive checklist which must be complied with in detail. We prefer a definition that allows flexibility to custom tailor it to the individual company environment.

We have the following specific comments concerning certain areas of the exposure draft:

- Integrity and Ethical Values

  The draft proposal indicates that integrity and ethical values are critical components for good internal control. Unfortunately, we believe this statement is a philosophical truism that cannot be installed or designed into a system. We do not think it is practicable to develop a system that would measure or compare one organization's integrity and ethical values to another; and if this hypothetically could be evaluated by an auditor how would recommendations be effected? Essentially, in this area, we believe the proposal is into theoretical philosophy that cannot be effectively measured and applied by an organization attempting to comply with the proposal. As such, this can be stated in a philosophical overview aimed at CEO's, but should not be part of an application guide.

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As the report itself indicates on page 64, integrity and ethical values are highly subjective and difficult to evaluate. For example, on pages 62 and 63, the authors are trying to create an "ideal" atmosphere by suggesting that the existence of high performance dependent awards, bonus plans, etc., encourages fraud. Furthermore, the report states removing or reducing these incentives and temptations will go a long way in diminishing undesirable behavior. While these views may or may not have merit, performance incentives have in fact been highly successful in many instances in motivating managers in a positive way.

o <u>Control Environment</u>

We agree that the control environment establishes the foundation for the internal control system and concur with the five factors discussed in chapter 7. We believe, however, that the list should be expanded to include two more elements which are important aspects of the control environment and would be beneficial to most entities. These factors are the existence of effective (1) internal and external audit functions and (2) management methods for monitoring performance, i.e., reporting, meetings, seminars, etc. We recommend these be added to the report.

o <u>Establishing Objectives</u>

The objectives which are categorized as Operations, Financial Reporting and Compliance are too broad in scope. We agree that establishing a list of objectives is necessary for good control, however, all companies have a multitude of objectives throughout their organizations, which are separated into sub-objectives. The report suggests controls be established for all of the company's objectives. We disagree with developing objectives and controls for all company functions and disagree with the list in Appendix C, showing the potential objective and defining the control procedure for each. This checklist approach goes too far in establishing a useful framework. The following examples taken from Appendix C provide examples where the report goes beyond constructive internal control system guidelines.

- Human Resources department is expected to maintain employee turnover at an acceptable level, maintain confidentiality of records, compare compensation and benefits with those offered by other companies, and maintain appropriate candidate identifications, screening and hiring practices, etc.

- The Sales department should communicate market strategies to sales personnel, retain qualified and experienced sales staff, monitor effectiveness of each, etc.

- The Planning Department would be required to review and test the validity of assumptions.

The list in this section of the report includes similar information covering 114 pages. We are concerned with the effort needed to evaluate each function and department by a list of objectives. We find it very difficult to accept the evaluation suggestions and controls in Appendix C as tools to improve internal controls.

We recommend a more general approach to establishing objectives. Those objectives that are more important to a company should be identified and monitored for internal control purposes. Others would be considered at the company's option. In no instance should these objectives and controls be used for auditing purposes.

o Risk Assessment

Schering-Plough also views risk assessment as a critical component of an effective internal control system. We concur with the report that risk assessment is an ongoing process to identify, analyze and manage risks. We also feel that a fundamental part of risk analysis includes the cost and benefit determination. The chapter correctly begins by emphasizing the importance of "considering. . . the cost and benefit of mitigating" risks and "what degree of risk is acceptable as prudent business risk." The risk analysis section, however, ignores cost/benefit determination as a part of the risk analysis process. The chapter instead only briefly mentions in the next section that this determination and the resulting residual risk are in existence. We are of the opinion that cost/benefit analysis deserves more emphasis and, specifically, that it should be included in this chapter prior to the discussion of identification and implementation of alternatives.

The definitions of "Preventive" and "Displacement" actions on page 95, appear to describe control procedures. These definitions should be enhanced and better examples showing the difference between action and control procedures should be included. For example, on page 95, implementation of a disaster recovery plan is considered an action which would require an internal control procedure to ensure that it is appropriately designed and implemented. We believe that the disaster recovery plan is itself an internal control procedure rather than an action that needs to be controlled. This section should be revised as it is confusing.

- <u>Information Systems</u>

  We recognize and appreciate the positive impact that effective and efficient information systems have on internal control. We concur with the opening section (pages 103-104) of chapter 10 which adequately describes how information systems effect control. We suggest, however, that the two subsequent sections (Scope and Integrated Systems) are unnecessary. The discussion of the Scope and Integration of systems need not be detailed here as these concepts are already well understood. This chapter should be short and concise in describing the critical effect that adequate information systems have on internal control; the linkage with other control components, and; evaluation techniques of reassessing the effectiveness and efficiency of information systems. This chapter should perhaps also be considered for inclusion as a subset of the Control Procedures chapter rather than a stand alone component.

  Information systems are generally not acquired or implemented by an entity solely to enhance internal control. The systems instead contain operating procedures which require control. In addition, the report should include a more detailed discussion on system security issues/controls. The fact that these controls are necessary is only mentioned in chapter 10 and briefly discussed in chapter 11.

- <u>Control Procedures</u>

  While we believe this is one of the most useful chapters in the report, we continue to believe that financial control is the critical focal point which should be emphasized.

Also the controls discussed in this chapter are covered in chapter 14 - Monitoring. We suggest combining both chapters to eliminate much of the redundancy. For example, counting inventories and comparing to perpetual records are covered in this chapter and also in monitoring.

- <u>Communication</u>

  We agree that effective communication is important to the success of an internal control system, however, we believe that communication is a critical aspect of the control environment and not reduced to simply a <u>component</u> of the internal control system. Communication is a method of providing for the successful implementation of an internal control system. Whether the communication is written or verbal, internal to an organization or external to shareholders and others, it is critical in the implementation of entity's objectives. It is more appropriate to include communication in the definition of the control environment.

- <u>Managing Change</u>

  Although we agree that any entity needs to have a process to manage change, we do not necessarily agree that this process is an exclusive component of internal control. We instead view this practice as a comprehensive on-going process affecting all aspects of our business. As such, we consider the management of change to be a pervasive factor that affects the entire organization and not simply a component of the internal control system.

  This chapter would prove more useful if it provided a brief example of a mechanism used to enhance the effectiveness of internal control in each of the conditions identified as requiring special attention. Mechanisms in place at Schering-Plough, for example, include special reviews by internal auditors to assist management in assessing the impact in various areas of a potentially significant change.

- Monitoring

  Monitoring includes many financial controls such as comparing physical assets with the books, reconciliations, etc. Other monitoring aspects include training seminars, planning sessions and other meetings to provide feedback to management as to whether controls are working. There is no specific mention in this section on cost benefit consideration in the monitoring of internal controls. Due to the broad scope of this report, it would be difficult to assess control in an area without doing a cost benefit analysis. We recommend that more emphasis be put on expansion of cost/benefit considerations in the evaluation of the entity's effectiveness.

- Management Reporting

  On the subject of public management reporting on internal control, we believe the report is correct in focusing on issues related solely to internal control impacting the reliability of an entity's financial statements. Schering-Plough also agrees that it is important to ensure that the reasonable expectations of Annual Report readers are matched with the scope of the management report, which in our case is on the effectiveness of the controls over financial reporting.

  Although there are common-ground guidelines which are well conceived and useful, a problem arises with respect to the chapter's intended objective. **It's goal is to establish this document as "the standard against which the internal control system is measured".**

  Schering-Plough cannot at this time concur with this objective. Because of the concerns we have documented above in our discussion of the report's conception of internal control, including its definition and components, we do not support the report as an authoritative standard. We are of the opinion that the report requires modification and cannot ratify it without appropriate changes being made.

In summary, based on our recommendations, the internal control system would include four interrelated components (versus nine), with the control environment serving as the basis for the others which are: establishing objectives, risk assessment and control procedures/monitoring techniques. As noted earlier, the report is very broad and difficult to use as a tool by management. By reducing the number of components as suggested, and developing more useful information, this document could become a document for good internal control. Also, we suggest adding a statement of flexibility in the definition to custom tailor it to each entity. We strongly support the issuance of a Management Report which should be tailored to each company as opposed to a standardized boilerplate statement. We do not believe that auditor involvement or comment on the management Report should be required.

We have a concern with this report that is not relevant to Schering-Plough. Our concern relates to the very serious problem of fraudulent financial reporting. Many of these problems have appropriately been highlighted in the business press and we believe that this report should go beyond defining what internal control is and how to evaluate it. A section should be added specifically on the subject of fraudulent financial reporting that indicates how implementation of the recommendations can be expected to reduce the risk of fraudulent financial reporting. We believe this is necessary to show that this whole effort is responsive to the fundamental issue which is fraudulent financial reporting.

Schering-Plough has over the years improved upon its internal control system, and recognizes that this is an ongoing process of reviewing, evaluating and modifying in order to effectively deal with continuing change. Schering-Plough supports a strong internal control environment. For your information, we have attached a write-up of our internal control system.

We appreciate the efforts of the individuals who tried to deal with this difficult subject. We would be pleased to provide additional information should the committee desire.

Very truly yours,

Robert G. Weiss

Robert G. Weiss,
Senior Vice President,
Financial Control

RGW:jc

cc: CCR Committee
FEI
P.O. Box 1938
Morristown, N.J. 07962-1938

LJ040401.P0Z/14G

Schering-Plough Corporation

Internal Control System

- **Operating Plans and Approval Authorization System**

  Schering-Plough has a formal operating plan process against which actual performance is measured. In this process there are clearly defined lines of authority for spending based on an approval authorization system. This system is an effective mechanism to control the level of spending through delegation of authority throughout the company. The system is designed to permit spending levels within defined parameters to carry out duties and responsibilities.

- **Financial and Administrative Policies and Procedures**

  The Finance Manual and Corporate Administrative Policies and Procedures have been distributed throughout the corporation. These policies are continually updated and provide the basis for control and guidance. They are used by the independent and internal auditors to verify that practices at the various sites are in compliance with approved policies. The Finance Manual policies encompass areas of accounting, reporting, planning, auditing, systems, tax and treasury operations. The Corporate administrative polices provide guidance to selected activities of various functions throughout each operating unit. Information covering Business Conduct, New Product Development, Employee Relations, etc. are disseminated to appropriate supervisors for implementation.

- **Internal Control Standards**

  A formal set of internal control standards are maintained and distributed throughout the company. These standards provide a basis for good internal control to ensure that transactions and functions are adequately controlled; that proper and complete records are maintained; that assets are safeguarded and their physical existence periodically compared with the accounting records. Compliance with these standards is a matter of routine audit review by both the independent auditors and Corporate audit department.

- **Evaluation of Internal Controls**

  Control Plan, Control SET (Study and Evaluation Techniques) and Internal Control Evaluation Questionnaires are methods used at Schering-Plough to evaluate internal controls. Control Plan is a computerized evaluation system designed for large operations. Control Set and Internal Control Evaluation Questionnaires are used in smaller operations.

The evaluation techniques are designed to provide in-depth analysis, evaluation and documentation of existing controls and to identify weak or missing controls. The absence of any significant weakness indicates that the control environment is adequate to provide reasonable assurance that company assets are safeguarded from loss or misappropriation and that such assets are utilized in the conduct of company business in accordance with the extent and direction of management. Compliance testing with Control Plan, Control SET or the condensed Internal Control evaluation, is a required function of the internal and external auditors.

- Internal and External Audits

  The control environment at Schering-Plough is constantly under review and evaluated by the staff of Corporate Auditors and by the independent auditors, Deloitte and Touche and has repeatedly been found to be free of serious weaknesses. All recommendations for improvements made by the auditors have been carefully reviewed according to our policy and, in the majority of instances, have been implemented. In a relatively few instances recommendations are not implemented if the control risk is low and the cost of implementing high. All actions taken are approved in accordance with policy by those with direct responsibility, and by the Vice President, Corporate Audits and the Vice President and Controller.

- Code of Conduct

  The company provides business conduct information to all employees on specific criteria for conducting business activities with business and political associates and others where a conflict or interest may arise. Compliance with Business Conduct as set forth by Schering-Plough is periodically tested by the internal and independent auditors.

- Audit Committee

  The Audit Committee is totally comprised of independent directors whose duties have been prescribed in a written "Statement of Responsibilities" approved by our Board of Directors. They review various issues of internal control matters routinely and are kept informed of any significant issues.

- External Reporting

  We submit a report by management to shareholders in our Annual Report on Management's responsibility for the integrity of the financial statements and the maintenance of and reliance on a system of internal accounting controls.

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ROADWAY
SERVICES, INC.

1077 GORGE BOULEVARD
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AKRON, OH 44309-0088
(216) 384-8184

June 10, 1991

Committee of Sponsoring Organizations of the Treadway Commission
1211 Avenue of The Americas, 6th Floor
New York, NY 10036-8775

I am the director of internal auditing for Roadway Services, Inc. I am a certified public accountant and worked in public accounting before moving to industry. I am a member of the Ohio Society of CPA's, the AICPA, and the NAA/IMA. I serve on the Board of Governors of the Cleveland/Akron Chapter of the IIA and am president of the National Association of Motor Carrier Auditors.

I have read much, but not all, of the internal control exposure draft of March 12. The general comments below are my opinions, not formal company positions. Accompanying are some specific comments.

The core concepts of the report are satisfactory. The report contains information useful in providing guidance on evaluating and improving internal controls.

The nine identified components of control seem to be complete in encompassing control elements, and the concept of their interrelationship as necessary for effective control is valid. The definition of internal control is satisfactory.

Yet overall the report is unsatisfactory. It is cumbersome and repetitive, with much convoluted, drawn-out writing. It suffers from a minimum of simple, direct statements. Drastic condensation is essential for this to be a usable, handy reference source that does not demand too much time on the part of readers. An effective condensation would significantly reduce the wording while improving the report clarity and utility.

The report presents much general or background information but lacks specificity of certain key control elements. For example, the coverage in Chapter 7 (Control Environment) of organizational structure and assignment of authority and responsibility does not discuss segregation of duties, long recognized as a key control element.

Exposure Draft - Internal Control

It is obvious and appreciated that there has been a major effort by COSO in researching internal controls and in preparing the exposure draft. The materials will provide visibility to the need for effective internal control and stimulate discussion. The fundamental concepts presented are solid and will provide guidance and a framework for understanding and evaluating internal controls.

I would suggest, however, that the Exposure Draft be considered an interim step and that another report, more direct and concise, be developed.

Respectfully,

Gerald R Roush

Gerald R. Roush
Director - Audit

cc: Institute of Internal Auditors
249 Maitland Avenue
Altamonte Springs, FL 32701-4201

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of The Americas, 6th Floor
New York, NY 10036-8775

SPECIFIC COMMENTS ABOUT THE EXPOSURE DRAFT OF MARCH 12, 1991

The following comments address specific points in the Exposure Draft. I did not evaluate all chapters of the Draft.

CHAPTER 1 - SUMMARY

DEFINITION OF INTERNAL CONTROL

P. 4 - Fundamental concepts:

The report states "Internal control is effected by people. It's not policy manuals and forms, but people ...." While policy manuals and forms are part of internal control systems; the above seems to exclude them. Consider deleting the second quoted sentence, or perhaps rewording to not exclude policy manuals and forms: "It is not only policy manuals and forms ...", or "In addition to policy manuals and forms ..."

COMPONENTS

P. 8, 9 - Linkage, Ownership:

This section points out that the CEO is the "ultimate owner" of an effective control system. Since controls involve all levels or activities of an entity, consider a statement that all managers have ownership of controls for their areas of responsibility. Also consider a statement discussing ownership by the Board of Directors.

MANAGEMENT REPORTING TO EXTERNAL PARTIES

This section could be interpreted as specifying requirements; I believe this entire section should offer guidance, not specify requirements. COSO was chartered with the task of providing guidance.

P. 9 - Introductory paragraphs:

The first two paragraphs of this section state conditions as they exist today but which may soon change. These paragraphs will be quickly dated unless the introductory wording is less specific to today's situation.

P. 11 - Future periods:

What is the real point of this section? If not rewritten more directly to whatever is the point, consider eliminating in its entirety.

Why include this section if as stated on page 10 "point-in-time reporting is most appropriate"?

The final sentence of the second paragraph states "whether internal changes occurred that affected ...", a past-tense phrase, when discussing future periods. Should this be written to discuss possible future changes?

SELF-ASSESSMENT

Many entities have effective ongoing self-assessment through their external and internal audit and quality improvement processes. This should be mentioned as an alternate to the self-assessment contemplated by this section of the report.

Reliance on external and internal audit and quality improvement efforts, and on ongoing regular management reporting, makes control evaluation a continuing rather than a one-time or occasional effort. I believe that such ongoing review is preferable to any chief executive self-assessment.

A strengthening of the internal audit function and quality improvement process may be more effective than a special control study by/for an entity's chief executive. Where an effective internal audit function exists, the suggested self-assessment would be redundant.

CHAPTER 2 - LIMITATIONS OF INTERNAL CONTROL

COSTS VERSUS BENEFITS

This is a simple concept that is overkilled by the detailed explanation.

BREAKDOWNS

Second paragraph would seem more appropriate as the final paragraph of the "Prudent Person Concept" section.

CHAPTER 4 - EVALUATION OF CONTROLS

Entire section too rambling, wordy, general. Is difficult to ascertain the intended point(s) or to develop useful specific information.

EVALUATING INTERNAL CONTROL

P. 34 - Scope and Frequency:

It is unlikely in any medium or large entity that a decision would be made to evaluate the entire internal control system other than as part of an internal audit review cycle.

P. 35 - Scope and Frequency

"Integrity, ethical values, and competence, and the control environment ... should be formally evaluated on a regular basis." Sounds good, but is this too subjective to be really possible?

REPORTING DEFICIENCIES

P. 44 - Forms of Reporting

"Typically, ongoing monitoring activities are reported orally to direct superiors." This varies with companies and in many entities written reports (period/monthly activity reports, audit reports, charts, graphs) are more likely to be used than oral reports.

CHAPTER 7 - CONTROL ENVIRONMENT

The coverage of organizational structure and assignment of authority and responsibility does not discuss segregation of duties, long recognized as a key control element.

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BARBARA HACKMAN FRANKLIN
PRESIDENT

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June 11, 1991

Committee of
Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
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New York, NY 10036-8775

Gentlemen:

I appreciate the opportunity to comment on the March 12, 1991 exposure draft, "Internal Control - Integrated Framework" prepared for the Committee of Sponsoring Organizations of the Treadway Commission.(1)

I chair or am a member of audit committees of the boards of directors of seven large public companies. Therefore, I am inclined to be supportive of anything giving directors and shareholders more assurance about the integrity of the company's internal controls. I applaud the purposes of this study: "to provide a common ground for mutual understanding of internal control... and to provide criteria against which all entities can assess and, where necessary, identify areas where they can improve internal controls." It is apparent that a great deal of effort has gone into this report.

However, the draft raises several serious concerns:

<u>First, the proposed definition of "internal control" is much too broad.</u> As stated in Chapter 1:

> "Internal control is the process by which an entity's board of directors, management and/or other personnel obtain reasonable assurance as to achievement of specified objectives; it consists of nine interrelated components, with integrity, ethical values and competence, and the control environment, serving as the foundation for the other components, which are: establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring."

---

(1) American Institute of Certified Public Accountants, America Accounting Association, the Institute of Internal Auditors, National Association of Accountants, Financial Executives Institute

As defined here, "internal control" is the virtual equivalent of "management"; I do not think this is correct or appropriate. For example, internal control does not provide "reasonable assurance as to the achievement of specified objectives," as the definition suggests. That is what the management process should do. Internal control cannot be synonymous with nor a substitute for the process of management. Rather, it is one part -- a very important part -- but one part of that process.

The nine components cited in the definition are too many. The evaluation of many of them, e.g., managing change, risk assessment, by their nature, will be subjective. There is a pitfall: the results of such evaluation will be far less meaningful than the high-sounding language suggests, and this could create another "expectation gap." Users of financial statements may assume more assurance about the efficiency of the internal control system than is the fact. Worse still, users may think a sound internal control structure guarantees the achievement of certain financial results, when, in fact, it does not.

I, therefore, suggest a major rethinking of the proposed definition of internal control.

Secondly, the requirements for management reporting on internal control lack clarity. Chapter 15 indicates that management's reporting should focus on internal control over the reliability of an entity's published financial statements. From "Scope of Report" on Page 144:

> "Focusing reports on controls over financial reporting puts an appropriate fence around internal control reporting. If the scope of reports were to extend to other objectives, efforts and related costs would increase. It also recognizes that reporting on controls over financial reporting is far more advanced and must be mastered before venturing into reporting in other areas. For these reasons, it is the controls over the public financial reporting process that are, and should continue to be, addressed in public internal control reports."

I concur that this "fence" is appropriate. But, this is not what the chapter, taken as a whole, seems to imply. For example, on Page 156, the second paragraph of the "illustrative report" to be signed by the CEO and CFO:

> "Management assessed the Company's system in relation to criteria for effective internal control presented in a report of the Committee of Sponsoring Organizations of the Treadway Commission. Those criteria consist of interrelated components, with integrity, ethical values and competence, and the control environment, serving as the foundation for the other components, which are: establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring."

To be sure, Page 157 indicates that management may modify or expand on this language. But, one is clearly left with the impression that all nine components in the overly-broad definition of internal control should be reported upon. This is confusing. At the very least the second paragraph of the illustrative report should be reworded to make it consistent with Page 144 -- to say that management is to report only on internal controls over financial reporting. Then, the remainder of the chapter needs to be restructured so that it supports "Scope of Report" on Page 144.

Thirdly, the implications for audit committees and their work are profound. Currently, an audit committee, on the board's behalf, through its oversight process, seeks to ensure the integrity of the corporation's financial statements, its financial reporting process, and its system of internal control related to financial reporting. However, if management -- either explicitly or implicitly -- is expected to report on internal control as broadly defined in this draft, the work of the audit committee will increase correspondingly. Since the report's definition of "internal control" equates to management, the audit committee would be placed squarely in the position of overseeing the entire management process. That, in turn, would mean an increase of exponential proportions in the audit committee's responsibility to the board and the shareholders. I take this potential very seriously, and would want to be very clear about what this added responsibility would mean.

Audit committees would undoubtedly also want the opinion of the outside auditor about whether management's report on its internal control system is accurate. This would entail further work on the part of the outside auditor.

Additionally, a question must be raised about the role of the internal auditor under this overly-broad definition of internal control. His/her work and responsibility would escalate accordingly; the audit committee looks to him/her as the guardian of the system of internal control.

This draft report addresses none of these issues, all of which are potentially very important and very serious. The crux of the problem, it seems to me, lies with the overly broad definition of "internal control" and the lack of clarity about what management is to report about and why.

Beyond all of this is the question of cost. The additional work will cost more. How much more is difficult to say, but the amount could be considerable. The question is: will the added work and additional cost create enough benefit in terms of increased assurance for shareholders and other users of financial statements? This question has neither been addressed nor answered, and until it is, this report ought not be finalized and published.

Fourthly, this report, its definition, and its reporting suggestions could become the basis for legislation or regulation involving internal control reporting. To my knowledge, no major study on internal control has ever been done. Thus, this treatise -- if it is finalized -- will be the only such document available. This may not have been fully understood when the study was begun; but, circumstances change and that is now the situation. Therefore, the five co-sponsoring organizations bear a much greater burden to ensure clarity and workability than if this were strictly a set of guidelines for private sector use. If getting this document right takes a good deal more time, energy and effort, then it must be done. In fairness to shareholders and the public interest, you are, I believe, obligated.

Sincerely,

Barbara Franklin

Barbara Hackman Franklin
President

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BARBARA HACKMAN FRANKLIN
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BRIEF BIOGRAPHY OF
THE HONORABLE BARBARA HACKMAN FRANKLIN

Barbara Franklin is President of Franklin Associates, a Washington-based management consulting firm she founded in 1984. The firm specializes in solving problems, which requires knowledge of both business and government, for corporate clients.

Franklin serves on the boards of directors of seven large public corporations: Aetna Life & Casualty Company, The Dow Chemical Company, Westinghouse Electric Corporation, Black & Decker Corporation, Automatic Data Processing, Inc., Nordstrom, Inc., and Armstrong World Industries, Inc. She serves on the audit committee of each company and chairs the committees at Aetna and Dow.

Franklin is also a public member of the Auditing Standards Board Planning Committee and is a former public member of the board of the AICPA.

In October 1990, she was cited by the American Management Association as one of America's 50 most influential corporate directors.

June 1991

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

June 17, 1991

To: **Richard M. Steinberg, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Auditors
Louis Bisgay, National Association of Accountants

Gentlemen:

The attached is the seventh batch of comment letters (there are ten in this batch) on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

The Black & Decker Corporation
701 East Joppa Road
Towson, Maryland 21204
301 583 3573

Nolan D. Archibald
Chairman, President and Chief Executive Officer

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BLACK&DECKER®

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Members of the Committee:

We are responding to your exposure draft dated March 12, 1991, "Internal Control - Integrated Framework". On balance, we feel that the Commission should be commended for performing an in depth study and for developing a thorough definition of internal control. In particular, the comments dealing with managements' responsibility for the control system and the fact that internal control should be part of the organization's infrastructure are particularly relevant. The concepts of "cost/benefit" and "prudent person" are also necessary to convey the business purpose of internal control.

Our major concern with the exposure draft is in the area of public management reporting on internal controls. At Black & Decker, we endorse the concept of public reporting on internal controls and include such a report in our annual report to shareholders. The exposure draft states that it does not express a position on public reporting but rather intends to provide guidance for those entities that do or intend to report on their internal control systems. Although guidance may be helpful, the extensive commentary on the subject, coupled with the inclusion of the evaluation tools in Appendix C, give undue emphasis and structure to this portion of the exposure draft.

Given the current environment, various legislative and regulatory agencies may misinterpret the intent of the guidance provided in the exposure draft and consider the evaluation tools as the minimum procedures necessary to report on the internal control system. We are also concerned that if legislation is passed requiring external auditors to opine on management's report, the auditors will be obligated to audit management's completion of the evaluation tools. This could have a significant impact on audit fees without a corresponding benefit. At a time when American business is facing increasing competition from abroad, we do not believe that incurring additional costs for this kind of activity would be beneficial. Accordingly, we feel that the report would be improved if the evaluation tools contained in Appendix C were removed from the final report.

With respect to the sample report on internal controls presented in chapter 15, we feel that the report should focus on the process for maintaining an effective system of internal control and not just the effectiveness of the system when the financial statements were prepared. It is not possible to give assurance that the internal control system will be effective in future periods; however, we feel that the shareholders should be informed as to whether a process is in place at the time of the report to maintain an effective control system. The third paragraph of the sample report should be modified along the following lines:

> "The Company maintains a system of internal control which in the opinion of management provides reasonable assurance that the financial records are reliable in all material respects for preparing financial statements. The system of internal control is reviewed, modified and improved as changes occur in business conditions and operations."

* * * * *

We appreciate this opportunity to comment on the exposure draft and hope that our suggestions prove beneficial to the Committee.

Yours very truly,

Nolan D. Archibald

Nolan D. Archibald
Chairman, President
and Chief Executive Officer

45-

Ashland

ASHLAND OIL, INC. • P.O. BOX 391, ASHLAND, KENTUCKY • 41114 • (606) 329-3333

June 7, 1991

PAUL W. CHELLGREN
Senior Vice President and
Chief Financial Officer
(606) 329-3024

Committee of Sponsoring Organizations
of the Treadway Commission (COSO)
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Subject: Comments on Internal Control -
Integrated Framework
Exposure Draft - March 12, 1991

One of the recommendations of the Treadway Commission was a call for the sponsoring organizations to work together to develop a common definition for internal control and to provide guidance on judging the effectiveness of, and improving, internal control. We believe that the Exposure Draft developed by COSO substantially achieves that recommendation of the Treadway Commission. Our comments on specific matters are summarized below:

Definition of Internal Control
We agree that the definition of internal control should be broad enough to cover the management control process, as currently reflected in the Exposure Draft. Executive, operating, and financial managements have a joint responsibility in developing effective integrated control systems.

We also concur that compliance with applicable laws and regulations should not be part of the core definition of internal control. While it is Ashland Oil, Inc.'s philosophy that its employees comply with all applicable laws and regulations and adhere to the highest ethical standards, we believe that compliance in itself is viewed as one of many key management objectives and not part of the process of achieving such specified objectives.

Components of Internal Control
We believe that the integrity, ethical values, and competence component is an integral part of the control environment component. Therefore, these two components should be combined.

Evaluation Methods and Techniques
Overall, the framework of components and related evaluation questions and tools will be a useful supplement to Ashland Oil, Inc. in our self-assessment of internal controls.

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Management Reporting to External Parties

The final report should expand on the discussion of why public reporting on controls over compliance with laws and regulations and over operations is inappropriate. Without this explanation, legislators or regulators could attempt requirements of reporting on controls over compliance with all laws and regulations and over operations without understanding the subjectivity of and costs associated with management reporting publicly on such controls.

We agree with the recommendation that management reports, if issued, should include the assessment of effectiveness of internal control over the preparation of its published financial statements.

Paul W. Chellgren

Paul W. Chellgren
Senior Vice President and
Chief Financial Officer

mja

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The Coca-Cola Company

COCA-COLA PLAZA
ATLANTA, GEORGIA

PATRICK M. WORSHAM
VICE PRESIDENT AND CONTROLLER

ADDRESS REPLY TO
P. O. DRAWER 1734
ATLANTA, GA. 30301
404 676-4696

June 7, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
Sixth Floor
New York, NY 10036-8775

Members of the Committee:

This letter expresses the views of The Coca-Cola Company concerning the Committee's Exposure Draft, Internal Control - Integrated Framework. Our general comments on the Exposure Draft and our comments on the four major issues outlined in the Committee's introductory letter are presented below.

GENERAL COMMENTS ON THE EXPOSURE DRAFT

We commend the Committee on the significant progress made in developing an integrated internal control framework for business managers to use in establishing or enhancing internal control systems. We believe this framework can provide a valuable benchmark against which companies can measure the effectiveness of their present systems of internal control.

The Exposure Draft contains considerable detail on internal control issues and provides illustrative examples of specific control procedures. While this level of detail may assist managers attempting to establish a basic internal control process, we feel most companies with existing processes will use the document as a measuring device to assess the thoroughness of their present systems. Accordingly, we believe the final document would be more effective if the following changes were made:

- o reduce the Executive Briefing to a high level (five to ten pages) summary of the full document.

- o eliminate all but the most critical illustrative examples of specific control procedures from the full document. The examples retained should only be those necessary to clarify a complex internal control issue.

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o include the evaluation tools in a separate reference publication.

Consideration should also be given to making the final document as "user friendly" as possible to non-financial operating managers. Reducing the document's overall length and structuring it in a clear, crisp fashion will encourage managers to read it.

We are concerned that the Exposure Draft does not address which organization will retain "ownership" of the management reporting standard once the Committee has issued its final report. Therefore, we believe that the framework should become the ongoing responsibility of an appropriate organization that will ensure it is continually adapted to the changing business environment.

DEFINITION

We agree with the Committee's conclusion that the definition of internal control should encompass management controls extending beyond financial reporting. However, the definition in the Exposure Draft could be improved by identifying the specific objectives of an effective internal control system and by removing the list of nine components.

We believe the following definition better communicates the benefits provided by an effective internal control system:

> "Internal Control is the process by which management obtains reasonable assurance, at an appropriate cost/benefit relationship, that assets are safeguarded and that transactions are authorized, recorded and properly reported. The process also provides reasonable assurance that management is aware of the extent of achievement of other specified objectives."

COMPONENTS

The Committee's final document should be a model for managers to use when developing, enhancing or evaluating internal control systems. The nine components listed in the Exposure Draft are all relevant to internal control systems. However, the final document should combine certain components, thereby eliminating redundancies in the Exposure Draft and making the final document much easier to read and use.

We believe the concepts embodied in the nine components would be more clearly and concisely expressed if combined as follows:

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1. Control Environment
   - Control Environment
   - Integrity, Ethical Values and Competence
   - Communication
   - Managing Change

2. Setting Objectives and Risk Assessment
   - Objectives
   - Risk Assessment

3. Systems and Procedures
   - Information Systems
   - Control Procedures

4. Monitoring

EVALUATION

The evaluation tools are comprehensive and could be an effective benchmark in measuring the adequacy of existing evaluation methodologies or developing new ones. **However, we believe the evaluation tools should not be mandatory.** As acknowledged in the Exposure Draft, circumstances vary considerably from company to company and industry to industry. A mandatory "cookbook" approach would not be cost beneficial.

To provide value to the broadest constituency, some of whom have existing methodologies, we believe the tools should be included in a separate reference publication. Business managers may then elect to utilize these separate guidelines to supplement existing evaluation methodologies or to develop new ones.

MANAGEMENT REPORTING

We agree with the guidelines for management reporting included in the Exposure Draft. We believe reporting should be as of a point in time; however, any deficiencies existing at year end, but corrected before issuance of the Management Report, need not be reported.

The Exposure Draft correctly points out that Management Reports should address only controls over financial reporting, and that "if the scope of reports were to extend to other objectives, efforts and related costs would increase." We believe the final document should more thoroughly explain why public reporting on controls over an entity's compliance with laws and regulations and over operations is inappropriate.

4 6

While not addressed in the Exposure Draft, earlier proposals on management reporting have suggested that a company's independent accountant have varying levels of involvement with management's report. We believe that the role of the independent accountant should be limited to its existing responsibilities under generally accepted auditing standards, and not be extended to require an opinion on the effectiveness of the internal control system or management's evaluation thereof.

Finally, the last sentence of the illustrative Management Report should include the concepts of reasonable assurance and materiality. Accordingly, we recommend the following language:

> "Based on our assessment, it is management's opinion that the system of internal control as of December 31, 19XX is effective in providing reasonable assurance that the published financial statements are free of material misstatement."

* * * *

We appreciate this opportunity to present our views to the Committee on this matter.

Sincerely,

/llg

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U.S. Department
of Transportation

**Maritime
Administration**

400 Seventh Street, S.W.
Washington, D.C. 20590

June 7, 1991

Mr. Robert L. May
Chairman
Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Mr. May:

We are pleased to present our observations on the exposure draft Internal Control - Integrated Framework.

The Maritime Administration (MARAD) has numerous contracts for the operation, maintenance and repair of various types of vessels the Agency owns as well as other significant contracts. All contracts are subject to the provisions of the Federal Acquisition Regulation (FAR) which requires certain capabilities of the contractor's accounting system, particularly internal controls, as they relate to contract cost accounting.

We commend you and the Committee on emphasizing and clarifying the importance of an internal control integrated framework which effectively addresses all aspects of an entity's endeavors. Our major reservation with the draft is with the limited scope of the Management Report compared with the comprehensive approach as presented in the rest of the draft. We believe that the scope section regarding the Management Report should foster and encourage the incorporation of the major internal control aspects which are vital to the viability of a company.

The current "Scope of Report" on page 144 states:

> "Focusing reports on controls over financial reporting puts an appropriate fence around internal control reporting. If the scope of reports were to extend to other objectives, efforts and related costs would increase. It also recognizes that reporting on controls over financial reporting is far more advanced, and must be mastered before venturing into reporting in other areas. For these reasons, it is the controls over the public financial reporting process that are, and should continue to be, addressed in public internal control reports."

We believe that government contractors and regulated companies who are required to maintain internal controls in order to preserve their contractual or legislated status should, at a minimum, be encouraged to incorporate in the Management Report internal control compliance with the appropriate regulations such as compliance with the FAR for government contractors and compliance with The Comptroller of the Currency regulations for National Banks.

We would prefer that the draft be consistently comprehensive by a more positive approach requiring that the thrust of the Management Report encompass the key internal control elements which assures the viability of the particular company and tailoring the report to such elements. While we also recognize that it is important to address internal controls over financial reporting, such an assurance could primarily be handled in a standardized paragraph. Furthermore, we believe that stockholders would be as interested, if not more so, in whether a company is successfully maintaining its contractual and legislated status through effective controls versus whether controls are effective over financial reporting.

As recognized by the Committee, an effort should be made to meet the expectations of governmental and commercial entities which rely on a company's internal controls to meet specified contractual as well as regulatory requirements. In the same vein, we are also in the process of addressing the AICPA's auditing standards board's proposed draft "Reporting on Management's Report on the Effectiveness of the Entity's Internal Control Structure." Our major objective is the establishment of a standardized practice for CPA firms to provide an attestation on a contractor's compliance with the FAR provisions; thus, eliminating the need for DCAA audits and other governmental reviews. Accordingly, we believe that there should be consistency and interchange between the two drafts to reinforce this effort.

We urge the Committee to reconsider its position and take a leadership role in this matter.

In reviewing the draft we also noted the following:

1. Regarding the characteristics of effective objectives, a direct linkage should be made between the compensation for all levels of management staff to their utilization and promotion of internal controls. Wherever responsibility for specific internal controls is clearly assigned, the compensation of the individuals involved should be dependent on their compliance and contributions to effective internal controls. The tying of internal control performance to salaries should provide adequate incentive. (Refer to page 5 of draft.)

2. While we agree that "public management reporting on internal control is not a component of, or a criterion for effective internal control," such reporting reinforces effective internal control through the public disclosure process. (Refer to page 9 of draft.)

3. We agree with the assertion that "Personnel should understand the need to resist pressure from superiors to participate in improper activities, and channels outside of normal reporting lines should be available to permit reporting of such circumstances." As a practical matter an effective system of safeguards needs to be in place protecting such individuals, thus facilitating their reporting. (Refer to page 28 of draft.)

4. We believe that the cited example for compliance objectives needs to be changed since it is not a reasonable objective. "For example, occupational safety and health regulation might cause a company to define its objectives as, 'Have no lost time due to work-related accidents.'" To require such an absolute objective is nonproductive and outside the control of management. Accidents, by their nature, occur in spite of controls. A proper and more effective example would include the approach to "establish and/or improve controls which would effectively minimize and/or reduce lost time due to work-related accidents." (Refer to page 84 of draft.)

5. Regarding the reliance on management reports for future periods, we believe that the report should be issued annually coinciding with the issuance of the audited financial statements. Furthermore, the degree of reliability on management reports for future periods would largely depend on the track record of past management reports to subsequent periods. (Refer to page 152 of draft.)

In summary, we support the Committee and believe that it has the opportunity to initiate needed assurances on key internal controls. Accordingly, it should not limit the scope of the Management Report but should focus the report on key internal controls which are needed to maintain the viability of an entity; such as compliance with the FAR for government contractors. On the governmental side of this issue, we at MARAD would like to assure you that we are fostering the utilization of CPA firms rather than governmental audit groups to verify the adequacy of relevant internal controls.

My staff and I are very interested in your deliberations and would appreciate being informed of your progress. Accordingly, we are available to discuss with you and the Committee any aspect of our comments or to provide additional information. For your information we will also be sending a copy of these comments, along with other suggestions to the AICPA's Auditing Standards Board regarding "Reporting on the Effectiveness on Management's Report on the Effectiveness of the Entity's Internal Control Structure." Please contact Mr. Richard McDonnell for specific inquiries on 202-366-5868.

Sincerely,

James J. Zok

JAMES J. ZOK
Deputy Associate Administrator
for Maritime Aids

48

The Dow Chemical Company

Roger L. Kesseler
Vice President and Controller

The Dow Chemical Company
2030 Dow Center
Midland, Michigan 48674
517 · 636-5250

June 7, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Gentlemen:

We are pleased to comment on the exposure draft (ED) "Internal Control - Integrated Framework." I am familiar with the unpublished draft of September 12, 1990 that used a comprehensive definition of internal control to include control over:

1. financial reporting
2. operations
3. compliance with laws and regulations

The March 12, 1991 Exposure Draft correctly stated that public reporting include only controls over financial reporting. Our main concern is that legislators and regulators will use the final document to expand public reporting to include controls over operations and compliance over laws and regulations. We recognize that the current ED contains the same comprehensive definition used in the September 12 edition and that surely could lead the legislators/regulators toward an inappropriate expansion of the definition to be opined on by the independent accountants in the company's financial statements. To do so would greatly increase our audit fees and internal costs in a way that would further erode a United States based company like ours to compete in world markets. I would recommend making a stronger and more complete statement on the rationale of limiting the public reporting to only financial controls.

We continue to believe the standard setting process should remain in the private sector and our company will always be proactive in improving the reliability of financial reporting in our country. This private sector initiative to define internal control is an important first step to codify the definitions and will be an important document in building the body of thought on this important subject. However, we need to be careful that this effort does not evolve into a "cookie-cutter" approval to implementing and evaluating internal controls.

The effectiveness of a system of internal controls starts with the "tone-at-the-top." However, a top quality and effective internal control system will not guarantee a successful enterprise. The goal is to have reliable financial reporting for public purposes and no more. The responsibility for the ultimate success of the enterprise remains with the management and the Board of Directors (BOD) to which it is accountable. Today reasonable control systems are in place to hold managers and BOD's accountable for their internal decision making consistent with their risk exposure and the fundamental economics of their businesses. We can't legislate or regulate against failed decisions or incompetent decision makers.

At The Dow Chemical Company, we know our internal control systems are not perfect, but we feel they are effective and produce reliable financial statements for our users in the public arena. Basically we are satisfied with what we have today, but will never be complacent by maintaining the status quo. The committee of sponsoring organizations have provided a service to private enterprise by adding the internal control definition to the body of thought on this subject.

Sincerely,

Roger L Kesseler

49

CHARTER MEDICAL CORPORATION

JOHN R. DAY
Controller

June 10, 1991

Committee of Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, Sixth Floor
New York, New York 10036-8775

Gentlemen:

I appreciate the opportunity to comment on the exposure draft entitled Internal Control-Integrated Framework. I am supportive of this project undertaken by the Committee of Sponsoring Organizations and believe this document will help top management and audit committees evaluate the effectiveness of their internal control systems. The following are my specific comments:

Definition of Internal Control (page 3) - I agree with this definition of internal control, particularly the emphasis placed on integrity, ethical values, competence and the control environment serving as the foundation for the other components of an internal control system.

Chapter Six - I want to emphasize the need for a written code of conduct. The CEO may have very high integrity and ethical standards, but this may not be clearly communicated or known in all levels of a multi-unit business organization. In fact, unit managers may have an entirely difference understanding of what ethical conduct is acceptable based on their day to day dealings with managers above them. I recommend you include examples of codes of conduct.

Control Environment (page 75) - I don't think enough is said in this chapter on the need for proper segregation of duties, particularly in a multi-unit organization that has a decentralized accounting function. The questions under the caption "attitudes towards accounting and data processing" are very pertinent to this point.

P. O. BOX 209 • 577 MULBERRY STREET • MACON, GEORGIA 31298 • (912) 742-1161

I believe the methods and techniques used to evaluate internal controls (chapters 4, 6 through 14 and appendix C) would be helpful. The methodology is similar to a methodology called Transaction Flow Analysis which I used when I worked with Arthur Andersen & Co.

Management Reporting to External Parties (chapter 15) - I found the guidance in this chapter to be helpful. This section provides an overview of reporting issues. I believe more examples of reports are needed, particularly those dealing with "material weaknesses".

Very truly yours,

John R Day

JRD:ja

50

Hershey Foods

Hershey Foods Corporation
Corporate Administrative Center
14 E. Chocolate Ave.
P.O. Box 814
Hershey, Pennsylvania 17033
Phone: (717) 534-7586 Telex: 842317

JOHN B. STILES
Vice President and Controller

June 10, 1991

The Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Sirs:

We have reviewed the Exposure Draft entitled "Internal Control - Integrated Framework" dated March 12, 1991 issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). We believe that the authors of this study have done a thorough job of examining the elusive concept of internal control; something that takes on added importance and difficulty in a rapidly changing world.

With respect to the specific issues that you asked be addressed by comment letters relative to this exposure draft, we are not troubled by the concepts or conclusions contained in the Definition or Components sections. The Evaluation process discussed and illustrated in Chapters 4, 6 through 14 and Appendix C is similar to the Arthur Andersen & Co. Transaction Flow Analysis methodology which Hershey Foods has used over the last decade to document and evaluate its system of internal controls. Accordingly, we would not anticipate using the Integrated Framework tools as a substitute or supplement to our present methodologies as to do so would be duplicative. We believe that management reports in Annual Reports should address factors which are critical to the preparation of public financial statements as enumerated in the sixth paragraph of Chapter 15. Therefore, we are strongly opposed to the inclusion in the Annual Report of a signed, separate statement related to internal control.

While we believe it is critical that financial executives and financial statement users have a clear understanding of what comprises a proper internal control environment and that internal control systems be adequately evaluated and scrutinized, we feel that the added focus afforded by such letters is, at best, redundant and, at worse, prone to building false expectations on the part of financial statement users relative to what a proper system of internal controls can provide. It also moves us dangerously closer to regulatory inputs to internal control systems and the then inevitable reporting by independent public accountants on internal controls.

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Hershey Foods Corporation, along with many other Fortune 500 companies, reacted negatively to the Wyden Bill introduced in 1990 because of a belief that the requirements for such reporting by independent public accountants added unnecessarily to the cost structure of American industry. There are clearly many misunderstandings about what an audit conducted in accordance with Generally Accepted Auditing Standards can do to provide assurance to a financial statement user as to the accuracy of financial statements, but it is similarly clear that a separate, signed report on internal controls by management, the Chairman of the Audit Committee (as recommended by the Treadway Commission), or by the independent public accountants, will only serve to increase the financial statement user's expectation without any measurable increase in the quality of the financial statements.

Sincerely,

JBS/bls
L4/1085

51

GENCORP

175 Ghent Road
Fairlawn, Ohio 44313-3300

Tel: 216-869-4212
Fax: 216-869-4227

Celeste C. Michalski
Vice President and
Controller

June 11, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, New York 10036-8775

Committee Members:

The "Internal Control - Integrated Framework" exposure draft, prepared by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, provides a useful, comprehensive internal control framework. It will serve both financial and operational personnel. The document appropriately emphasizes the importance of people. It sets integrity, ethical values and competence as the bedrock of the entire internal control process. By defining internal control very broadly, it integrates operating controls, administrative controls and financial reporting controls into one topic. We commend the authors of this document.

Our comments on the exposure draft are discussed below. We hope that our views will be of value to the COSO.

1. We believe provision should be made for a separate condensed document or pamphlet directed at expanded readership. The document as currently written is comprehensive by necessity. Unfortunately, it probably will not be read or used by most financial or nonfinancial people because of its length and complexity. We believe that a more succinct version would be very useful throughout most business organizations. Such a version would be an excellent tool to convey internal control concepts and each employee's responsibilities and duties in this regard.

   We believe the document may analyze internal control components further than necessary, which creates unneeded volume. For example, it is difficult to segregate the control environment component from the integrity, ethical values and competence component. These two components are the essence of "corporate culture" and could be combined.

2. We believe "Part 3 - Management Reporting To External Parties" should be separated from this study and given renewed thought. We believe a distinction must be made between the appropriateness of management reporting on internal controls related to external financial reporting and the inappropriateness of management reporting on internal controls related to compliance

and operations. We think an unresolved conflict presently exists between the broad definition of internal control and the suggested reporting on internal controls related only to financial reporting.

The illustrative report on page 156 focuses on controls related to the reliability of an entity's financial statements. The scope of just these particular internal controls is not clear to all readers. The document's broad definition of internal control includes the entire horizon of an entity's affairs. The definition encompasses objectives, risk assessments of internal and external matters, compliance with laws and regulations, managing change, the monitoring process, etc. We are concerned that the illustrative report would be interpreted to apply to the entire horizon, which may include compliance and other issues that are beyond management's current knowledge or control.

Further, when this issue is addressed, we believe discussion should be expanded on why public reporting on nonfinancial controls is inappropriate. This may prevent any future legislative requests that management report on nonfinancial controls, which, in our view, would be costly, inappropriate and in some cases meaningless.

3. We agree that management's report on internal controls should be as of a point in time. We also believe, however, that a material weakness need not be reported if it is corrected before the issuance of management's report.

If you desire further clarification, please contact us at your convenience.

Sincerely,

Celeste C. Michalski

Celeste C. Michalski

CCM:lil

cc: A. W. Reynolds, Chief Executive Officer, GenCorp
J. L. Heckel, Chief Operating Officer, GenCorp
D. M. Steuert, Chief Financial Officer, GenCorp
Ernst & Young

Sheldon Rutstein
Senior Vice President
Controller

Raytheon Company
141 Spring Street
Lexington MA 02173

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Raytheon

June 11, 1991

Committee of Sponsoring Organizations (COSO)
1211 Avenue of the Americas
Sixth Floor
New York, New York 10036-8775

Dear Sirs:

Raytheon Company is pleased to provide comments regarding the Exposure Draft - "Internal Control - Integrated Framework" dated March 12, 1991.

We would like to commend the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and its Project Advisory Council for providing this thorough and important research study concerning internal control practices. We have no major criticisms of the Exposure Draft.

We were asked to comment on the specific matters of definition, components, evaluation and management reporting to external parties. Those comments are attached.

Sincerely yours,

S. Rutstein

/jak
Attachment

cc: John S. Reed, Chairman
Accounting Principles Task Force
The Business Roundtable
200 Park Avenue
New York, New York 10166

RAYTHEON COMPANY

COMMENTS REGARDING SPECIFIC MATTERS

EXPOSURE DRAFT - "INTERNAL CONTROL - INTEGRATED FRAMEWORK"

DEFINITION (Chapters 1 & 5)

We agree with the definition.

COMPONENTS (Chapters 1 & 5 through 14)

The report identifies nine components essential to effective internal control. We agree that all are important segments of an internal control framework.

EVALUATION (Chapters 4, 6 through 14 & Appendix C)

The draft report correctly points out there are many methods and techniques that can be used in evaluating internal control. Methods & techniques will and should vary from company to company. It would be difficult to provide a set of evaluation tools which would provide a standard evaluation process for every company. We have no criticism of the usefulness and adequacy of the approach recommended in the draft report as long as the report remains clear that the tools are presented only as an illustrative approach.

MANAGEMENT REPORTING TO EXTERNAL PARTIES (Chapter 15)

We support the inclusion of a management report that addresses internal control in companies' annual reports. We would recommend that the report be limited to statements that include:

- The company has prepared the financial statements and related data.
- The financial statements are prepared in accordance with generally accepted accounting principles, and reflect judgments and estimates as to the expected effects of transactions and events currently being reported.
- The company is responsible for financial statements and other financial data.
- The company maintains a system of internal controls to provide reasonable assurance that assets are safeguarded and that transactions are properly executed and recorded.
- A description of the components of the internal control system.

Since the above statements fully describe the internal control system, statements as recommended in the Exposure Draft about managements's conclusions on the systems effectiveness and its inherent limitations, appear to be unnecessary and could be confusing to readers.

XEROX

Xerox Corporation
800 Long Ridge Road
P. O. Box 1600
Stamford, Connecticut 06904
203 968-4515

Paul A. Allaire
Chairman and Chief Executive Officer

53

June 10, 1991

The Committee of Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Sirs:

You have requested our views on the Internal Control - Integrated Framework Exposure Draft dated March 12, 1991. We have reviewed the Exposure Draft, which we understand has two principal purposes:

- To provide a common ground for mutual understanding of internal control by all interested parties, and
- To provide criteria against which all entities can assess and, where necessary, identify areas where they can improve internal controls.

We also understand that you have requested public comment on the Exposure Draft in order to help improve the product and build consensus for the final report, and that, following the exposure process and your consideration of public comments, you intend to ask each of the sponsoring organizations to endorse your final report.

With respect to the four specific matters for comment that you have indicated, our views are as follows:

1) Internal Control Definition. The definition of internal control as a process, executed by people, to accomplish specific objectives, goes well beyond the strict internal accounting control definition used in current professional and legal standards and proposes a more operational view. This is desirable in terms of its consistency with the direction we have taken in Xerox to involve operational managers more deeply in our internal control processes. Therefore we agree with the proposed definition.

2) Internal Control Components. We agree that the nine components identified in the exposure draft are essential for effective control. We also believe that the "model", depicting the interrelated nature of these components is helpful in explaining internal control.

3) Evaluation. At Xerox, we are aware of the need to continually evaluate our internal controls, and to do so in a cost-effective manner. We employ self-assessment checklists, periodic internal control representations at all management levels, and we involve operating management in internal control committees in each of our operating units to address internal and external audit problems and recommendations. These activities collectively support our current Report of Management to our shareholders. In view of our reasonably comprehensive internal control activities, we see the tools offered in the Exposure Draft as a means to supplement our current evaluation procedures.

4) Management Reporting to External Parties. We do not believe the document taken as a whole enables us to go beyond our current Report of Management which states "our internal control structure is designed to provide reasonable assurance that assets are safeguarded against loss or unauthorized use and can be relied upon to produce financial statements in accordance with generally accepted accounting principles". This is because the material weakness concept is not sufficiently developed, as is acknowledged by the Committee. In addition, certain losses resulting solely from economic down turns or other external factors could be misconstrued as internal control breakdowns. As shown in the attached examples, external events can cause losses even though management's judgment was sound given the circumstances in the timeframe when decisions were taken.

We believe more work is necessary to establish a clear boundary between losses which result from prudent business risk taking and those evolving out of internal control breakdowns.

In conclusion, we agree with the Exposure Draft's internal control definition and components, and we will supplement our internal control evaluation procedures with some of those in the Exposure Draft. These are clear benefits and we therefore fully support including these aspects in the final report to be endorsed by the sponsoring organizations. However, we need further guidance on the issue of public reporting on the effectiveness of our internal control system. As the appropriate bodies evaluate the material weakness concept, as recommended in the Exposure Draft, we believe a key point to be addressed is that the material weakness concept needs to be refined in order to facilitate clear distinction between material losses resulting from business risk taking vs. those resulting from true internal control breakdowns.

If you would like to discuss this further, please contact Daniel Marchibroda, Assistant Controller, at 203-968-3684.

Sincerely,

Paul A. Allaire

PAA/rd
attachment

Material Weaknesses in Internal Control Structures Versus Sound Business Judgments that Failed

As stated in the accompanying letter we believe that the concept of "material weakness" has not been sufficiently developed to enable most companies to publicly report about the effectiveness of their internal control structures to prevent losses from material weaknesses. As you are aware the need to make business decisions is what management is about. Presumably all decisions are based on sound judgment and utilize all available resources to provide a basis. Due to external economic events, such as competition, etc., sound business decisions can result in failure. As we understand the components of internal control, as articulated in the Exposure Draft, it is apparent that many sound business judgments that ultimately fail could be construed to be a result of material weaknesses in internal controls. We do not believe this should be a conclusion of applying the Exposure Draft's concepts. Furthermore we question if any such conclusions were intended by the Exposure Draft's authors. Two examples, which are representative of our experience and the experiences of many other companies, will illustrate the preceding.

Example 1

Facts: A manufacturing company develops a product which, test marketing confirms, will be extremely competitive in the current market. It builds a large plant to manufacture the projected supply requirements. In the mean time, unprojected foreign competition arrives expanding the supply of product and, more importantly, technological changes slowly start to obsolete the product and hence demand evaporates. (Management had previously concluded that foreign competitors would not enter the market and had evaluated the technological changes as not being critical to this product. In hindsight these judgments were in error.) As a consequence the large plant that was built never operates at capacity and fixed costs are not adequately recovered. Management identifies that an impaired asset exists, studies the situation for several quarters and ultimately closes the plant and recognizes a material shutdown charge at that time.

Relationship to the Components of Internal Control: In the preceding at least three of the nine components of internal control "failed" (managing change, risk assessment, competency). With hindsight, it could have been possible to predict a stronger foreign competitive presence than anticipated. Likewise it could have been possible to predict that an emerging technology would supplant a long established technology/product. While technological innovations sometimes succeed quickly in very profitable ways, many more do not. While management often must grapple with this issue, conservatism may often dictate a decision to stay with an established product or condition. Likewise the extent of a growing foreign presence in an industry has been a consistent problem for the entire U.S. economy. Hindsight allows us to easily determine what could have been predicted. However, decisions are only made with the benefit of informed foresight and are based on management's personal experiences, available capital resources, cost/benefit considerations, etc.. Rarely are future issues clear enough not to require a significant degree of judgment in the final decision. When such decisions ultimately fail, the Exposure Draft's provisions could easily lead to the conclusion that an internal control failure had occurred. In this example the risk assessment was insufficient and change was managed in the wrong direction. Because these failed, presumably management's competency is also questionable.

Example 2

Facts: A money center bank routinely writes loans to third world countries - either directly to local industry therein or through the respective central banks. Incentive to originate the loans varies and the reasons may include some or all of the following: (i) the need to provide funding for local operations of major corporate clients of the bank; (ii) requirements, requests etc. of various U.S. government agencies and departments to assist in third world development; and (iii) loan portfolio diversification. It is recognized that the loans carry a greater degree of risk when originated and to the extent possible this is reflected in the interest rate. Risks include exchange controls, hyperinflation, expropriation, civil war, etc. Management carefully monitors its third world exposures but realistically cannot do much to protect the bank against risk of loss on outstanding loans. Reflecting weakening local conditions on several occasions the money center bank, along with many of its competitors, recorded material loan loss reserves on its third world loans.

Relationship to the Components of Internal Control: In the preceding example at least three of the nine components of internal control "failed" (objectives, risk assessment, competency). Management could be construed to have lost sight of the fact that their primary objective is to maximize shareholder value and not to assist in third world development. Additionally, the risk assessment associated with these loans was obviously deficient because they ultimately resulted in losses. Lastly, because management allowed these actions to happen (especially since these types of writeoffs have been a recurring problem for some years) their overall competency must be suspect. Thus, the writeoff of third world loans can easily be construed, using the Exposure Draft's definition of and components of internal control, as a material weakness because the origination of risky loans ultimately resulted in a loss. However, we believe this example represents a business risk scenario, rather than an internal control weakness scenario. For example, all money center banks effectively have an obligation to the world, including less developed countries, because they take deposits and conduct other business on a world wide basis. Additionally, competition may ultimately force them to accept additional risk because the U.S. headquarters of their corporate clients require a financial intermediary to fund foreign operations. Also, failure to provide funding may conflict with U.S. foreign policy thus risking enmity from regulators. Lastly, management's judgement was in part based on the fact that for years the "experts" have been predicting a turnaround in the third world's fortunes thus making it potentially desirable to "be there now".

Conclusion

We believe these examples make the point that all business failures are not the result of internal control failures. We have also developed scenarios where it is easy to construe that well intentioned actions, based on sound judgment and analysis, that fail for various reasons can almost always be attributable to internal control failures. We believe this is neither a fair nor intended conclusion of the Exposure Draft however such a conclusion appears inescapable from it's provisions. This is not to say that a company's management should not be held accountable for failure; of course they should. However, as the Exposure Draft defines the components of internal control, we believe including in a Report of Management a comment to the effect that a company's system of internal controls is sufficiently effective to prevent material losses will create a false sense of security about the likelihood of material losses. No system of internal controls can prevent all losses and just as judgment is necessary to determine the extent of necessary control features, judgment is also necessary to make most important business decisions. Accordingly, when used in the context of the Exposure Draft's provisions, we do not believe many companies can or should be compelled to publicly make representations about the effectiveness of their internal control systems.

Committee of
Sponsoring Organizations of the Treadway Commission

1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

June 18, 1991

To: **Richard M. Steinberg, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Auditors
Louis Bisgay, National Association of Accountants

Gentlemen:

Attached is the eighth batch of comment letters (there are twelve responses in this batch) on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

NATIONAL ASSOCIATION OF ACCOUNTANTS
10 PARAGON DRIVE
MONTVALE, NEW JERSEY 07645-1760
(201) 573-9000

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June 11, 1991

Mr. Robert L. May, Chairman
Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, New York 10036-8775

Dear Mr. May:

The Management Accounting Practices (MAP) Committee appreciates the opportunity to comment on the Exposure Draft of the study performed by Coopers & Lybrand on Internal Control - Integrated Framework. The MAP Committee speaks for the National Association of Accountants, the world's largest organization of management accountants. NAA's 95,000 members are management accountants and come from public accounting, academe, and industry. Our membership criteria emphasizes management accounting. NAA presently has four research studies underway as a result of our work with the Commission on Fraudulent Financial Reporting. These are:

(1) The Effects of Personal Values and Codes of Corporate Conduct on Fraudulent Financial Reporting
(2) A Study of the Effectiveness of Analytical Procedures for Detecting Management Fraud
(3) A Decision Support Systems Approach for Providing Integrated Guidance to Assist in Developing and Assessing Internal Controls
(4) Improving the Effectiveness of Audit Committees.

Our membership is vitally interested in the subject matter presented in this study.

The request for comments asked that respondents comment on four specific items: (1) definition of internal control; (2) components of effective internal control; (3) evaluation of internal control; and (4) management reporting to external parties. Our responses to these specific issues are covered in Appendix A.

The NAA supports the development of this type of document. Internal control is a very broad subject, which makes it difficult to convey concisely the necessary processes involved in achieving good internal control. This document does make it clear that good internal control cannot be achieved simply by printing a short and simple list of procedures to be followed.

Recognizing that this is an extremely broad subject, we believe that this document needs a substantial amount of additional work to make it a useful tool for management of business enterprises. As presented, the report is much too voluminous, includes irrelevant data, and is often redundant. The executive summary needs to be condensed from 42 pages to a short, concise, three or four page section. The remaining portions of this study, as presently drafted, will defeat all but the most avid manager in pursuit of improved internal controls. We believe that non-accountants will be overwhelmed by the document and will not attempt to absorb the information contained therein.

Furthermore, the document does not help managers differentiate between a material weakness and an insignificant weakness. The document provides little support for the concept that internal control procedures should be justified using normal cost/benefit analysis. Internal control guidelines might recognize that the internal control structure of an organization needs to be compatible with the major facets of the organization's overall business strategy, such as a focus on total quality management. The report also does not recognize that the approach to good internal control in a small organization may involve fewer steps than necessary to achieve the same degree of control in a large organization.

We believe that through COSO, a recommendation should be made from within the private sector that management reports on internal control be issued whenever publicly held companies issue financial statements to external parties. As discussed in Appendix A, management should be allowed flexibility in the preparation of the report. Auditor involvement or comment on the report should not be required although some enterprises may elect to have auditor involvement.

We also believe that the document on evaluation should include case studies of enterprises that have had difficulties with internal control and should attempt to develop a profile of situations that represent a high risk for fraudulent financial reporting because of internal control deficiencies. The business press has highlighted some of the "horror" cases. To what extent would or could the proposed tools have mitigated the situations?

National Association of Accountants • 10 Paragon Drive • Montvale, New Jersey 07645-1760 • (201) 573-9000

Some specific areas regarding possible approaches to the resolution of these deficiencies will be identified in Appendix A.

The Management Accounting Practices Committee would be pleased to elaborate on any of the issues discussed in this letter and is prepared to meet with you if it would be helpful in completing this important project.

Sincerely,

Robert G. Weiss

Robert G. Weiss, Chairman
Management Accounting Practices Committee

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APPENDIX A

MANAGEMENT ACCOUNTING PRACTICES COMMITTEE OF THE NATIONAL ASSOCIATION OF ACCOUNTANTS RESPONSE TO SPECIFIC MATTERS FOR COMMENT INTERNAL CONTROL - INTEGRATED FRAMEWORK

1. Definition of Internal Control. Do you agree with the definition? If not, why not? -

   We believe that the definition can be streamlined by elimination of the internal control components from the definition. The National Association of Accountants, in its Statement on Management Accounting No. 2A, Management Accounting Glossary, dated November 30, 1990, had defined internal control as follows:

   "The whole system of control, financial and otherwise, established by management to carry on the business of the enterprise in an orderly and efficient manner, to ensure adherence to management policies, to safeguard the assets, and to ensure as far as possible the completeness and accuracy of the records."

   We believe that the proposed COSO definition of internal control is consistent with the concepts considered in the development of the above definition. If the proposed definition is retained, we suggest that the following changes in your definition be made:

   a. Delete the phrase ... "and/or other personnel" ... and;

   b. Reconstruct the definition of internal control to include only five interrelated components as opposed to nine. The five components will be discussed in 2. below.

   We believe that the change from nine to five components would add to the usefulness of the document as a whole by allowing the authors to eliminate many redundancies. The more compact structure also would be more clear to the reader.

2. Components - The report identifies nine components essential to effective internal control. Are there others that should be added? Should any be deleted? -

   As mentioned in 1. above, the MAP Committee believes that there are five components essential for effective internal control. These five components are (i) the control environment, which includes integrity, ethical values and competence, communication, and managing change; (ii) establishment of objectives; (iii) risk assessment; (iv)

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control procedures, which includes information systems and (v) monitoring.

Reducing the number of separate components would help streamline the document and help the reader in relating the importance of each component to the overall establishment of good internal control. Also, the five components listed above are more responsive to how business views internal control components and are more in line with Statement on Auditing Standards No. 55.

We firmly concur with the study's conclusion that the foundation for good internal control is the control environment along with the inclusion of a discussion of the items making up a strong control environment. The inclusion of a discussion of the responsibilities of the board of directors should be added to this part of the study. We believe that this discussion should include additional emphasis on the importance of the "tone at the top" in the establishment of good internal control. It should emphasize that to be effective, the "tone at the top" must strongly support the organization's continuous efforts to enhance the control environment. We believe that some instances of fraudulent financial reporting are a result of a poor attitude toward financial controls at the board of directors and executive management level.

3. Evaluation - Compare and contrast the evaluation process followed by your organization with the study's proposal and comment on the adequacy of the recommended approach.

The MAP Committee strongly believes that the methods and techniques for evaluation presented in this report should be separated from this document and dealt with in a separate publication. In addition to streamlining this document, we do not believe that evaluation methods and techniques can be properly presented without extensive utilization of case study material to support the evaluation tools. Although the objectives outlined in Appendix C of the study all lead to well run enterprises, we find it hard to accept the concept that things such as "low-employee turnover" lead to strong internal control. Is this to imply that high turnover is a material weakness in internal control?

The document referred to above should include multiple evaluation tools and a series of case studies. The case studies should include field tests of the evaluation tools included therein and be applied to both small and large companies. The separate publication should include sample checklists that may be used by management and auditors in assisting in the evaluation of internal control. The evaluation tools should recognize that different industries may need different evaluation tools.

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4. <u>Management Reporting to External Parties - Do you believe the guidance material is helpful for companies publishing management reports on internal control? -</u>

We concur with the study's conclusion that any management report on internal control should focus on the relationship of good internal controls and financial reporting. If our comments regarding components of internal control are adopted, the management report will also need to be modified.

We disagree with the presentation of only one illustrative report in this study. We feel that other sample reports should be provided, incorporating illustrations from management reports currently being used, and including management's acknowledgment of responsibility for the financial statements. To have only one illustration in this document will lead to a situation in which this becomes "boilerplate" that all companies will follow.

We agree that the management report on internal control should state that it has been based on management's assessment of its internal control system based on criteria established by COSO or on another set of guidelines. The assessment of internal control must be based on the specific circumstances of each enterprise.

* * *

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Fireman's Fund

Fireman's Fund
Insurance Company

John C. (Jack) Gazlay
Vice President

June 10, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Re: Exposure Draft "Internal Control - Integrated Framework"

Gentlemen:

I had great hopes that the COSO would produce the definitive study of and pronouncement on internal control. While good, Internal Control - Integrated Framework is not yet world class. I hope the final document will be.

The original charge to the Committee was "that the organizations sponsoring the Commission work together to integrate the various internal control concepts and definitions and to develop a common reference point. This guidance would build on the Commission's recommendations, help public companies judge the effectiveness of their internal controls, and thus help public companies improve their internal control systems." I do not feel that these objectives have been achieved. I feel that the help public companies will get is a format for another FCPA-type analysis of controls to sit on a shelf as "Treadway compliance". What is needed is a living, breathing methodology which can be continually evaluated and improved. I encourage you to flowchart the methodology you propose to help public companies establish on-going programs to judge the effectiveness of and improve their internal controls.

<u>Do you agree with the definition?</u>

In the definition of internal control (page 3), I think it is important to identify internal control as "<u>all</u> the process<u>es</u> by which ..." The processes are so diverse they should not be considered all part of one. Also, the definition should not refer to nine or any number of components. The nine identified components are judgmental and provided as a convenience to consider or classify processes, not to define internal control. Also, these captions don't further the definition, understanding, or evaluation of internal control because they are interrelated and overlapping.

1600 Los Gamos Drive, San Rafael, CA 94911 415 492 6202

I have greater expectations for internal control than you do. The report continually cautions that internal control can never do better than provide reasonable assurance.

> "Internal control cannot be expected to provide more than reasonable assurance" (p.4)
>
> "Internal control systems can provide no more than reasonable assurance" (p.5, 13)
>
> "Internal control ... can only provide reasonable assurance" (p.6, 15)

I expect internal control in some areas to produce absolute assurance and believe that it does, e.g. many areas affected by data processing. However, it cannot be expected to provide absolute assurance in every area. I think the report should indicate that internal controls have this capacity for greatness, but cannot be relied upon for absolute assurance.

Are there components which should be added/deleted?

I think the nine components are some of the facets or dimensions of internal control. The document indicates that since there are nine components it is necessary to identify or evaluate all nine to adequately identify or evaluate internal control. It is the myriad processes within these artificial, convenient captions that are the components of internal control, and all are not necessary to identify or evaluate a particular internal control system. Finally, some of the components are environmental and not subject to on-going management e.g. integrity, ethical values, and competence; management's philosophy and operating style; and objectives. These are relatively fixed and part of the environment in which a particular entity's internal controls must operate.

There are additional dimensions to internal control not included in the nine components. External parties enhance internal controls. Employees verify paychecks, customers check invoices, suppliers send bills, people complain. Therefore, I disagree with the paragraph on page 21.

On balance, I encourage you to refer to general/environmental controls and application/specific controls. These classifications were simple and yet elegant in their comprehensiveness. It was possible to present a schematic view of general and application internal controls and thereby transfer the knowledge or awareness of them to management, staff, or other interested parties. The nine components are so interrelated, overlapping, and conceptual that they are only of value to theoreticians.

Would you use the evaluation tools as a substitute or supplement?

Probably not. I would continue to look at internal control as the definition suggests: first from the objective(s), then to the general and application (or objective-related) control standards, and then to the implemented procedures and techniques. Top down and without regard to whether some or all of the nine components were addressed as long as the identified controls are sufficient for the objective(s) being evaluated. Since the evaluation tools are heavily driven by the nine component definition of internal control (with which I differ), they are of little value/use. The evaluation tools remind me of the FCPA tools that were developed and used (at great cost), but which now sit on a shelf untouched, unused, and out-of-date.

Do you believe the reporting guidance material is helpful?

No, for two reasons. It is inconsistent to do point of time reporting on a process. In a snapshot of a process nothing is happening. As indicated on page 11, the key is over what period of time does the reported control condition change? I doubt that internal control changes sufficiently in even a year to change a management report on it.

Also, I believe management reporting is a compliance matter for regulatory definition (as Treadway did) and that the guidance included here is misplaced and will date/limit the document.

Since these are global issues which relate to the overall definition and approach to integrating the concepts of internal control, I have not included all the specific detail comments in the text which relate to these issues. Please feel free to call me for further explanation or discussion of these matters.

Very truly yours,

John C. Gazlay

/bg
AUD138

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PHILLIPS PETROLEUM COMPANY
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COMPTROLLERS

June 10, 1991

Committee of Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Subject: Internal Control - Integrated Framework

Members of the Committee:

We are pleased to see the Committee address the important issue of internal control. In general, we agree with the scope and objectives of the project and feel it will provide useful guidance in evaluating internal control systems and preparing management reports regarding controls over the public financial reporting process. Our comments on the specific issues follow.

INTERNAL CONTROL DEFINITION

We agree that internal control is a process, executed by people at every level of an organization, to obtain reasonable assurance as to achievement of specified objectives. This definition is broad enough to include traditional financial reporting and compliance objectives as well as the specific operational objectives of an individual entity.

INTERNAL CONTROL COMPONENTS

The components of internal control identified in the Exposure Draft represent criteria for effective internal control. The individual components are interrelated in the control process. While reasonable assurance requires that all components be satisfied, it is important to realize that individual components may not function identically, or even at the same level, in different organizations.

INTERNAL CONTROL EVALUATION

The effectiveness of internal controls cannot rise above the integrity and ethical values of the people who create, administer and monitor them. Top management must communicate the entity's values and behavioral standards to its employees. Internal control systems must be monitored on both an ongoing and a periodic basis. We believe the tools contained in Appendix C may be useful in conducting an evaluation of an entity's internal control systems.

MANAGEMENT REPORTING TO EXTERNAL PARTIES

The scope of management reports on internal control should continue to be limited to controls over the public financial reporting process. We agree that point in time reporting is most appropriate. If management has corrected any significant control deficiencies identified during the year, management is in a position to report the existence of an effective internal control system as of year-end.

Very truly yours,

PHILLIPS PETROLEUM COMPANY

James A. Kelly

James A. Kelly
Comptroller

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June 10, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
New York, New York 10036

Re: Internal Control - Integrated Framework
Exposure Draft Comments

Dear Committee of Sponsoring Organizations:

The internal control - integrated framework exposure draft appears to be the product of a comprehensive project based on sound methodology and evaluation tools. Our specific comments regarding the exposure draft are described below.

Internal Control Definition
The definition of internal control most definitely should encompass management controls that extend beyond financial reporting. Internal control is the process by which an organization's directors, management, and other personnel obtain reasonable assurance as to the achievement of specified objectives. It consists of eleven interrelated components in three categories. The proposed definition would be clearer if the interrelated components were separated into three functional categories as follows:

1. The foundation of internal control consists of integrity, ethical values, competence, and the control environment.
2. The strategic systems of internal control consist of established objectives, risk assessment, control procedures, information systems, and monitoring.
3. The message system consists of communication and managing change.

Proposed Framework of Components and Evaluation Tools
The proposed framework of components and evaluation tools would be useful in our organization to enhance the assessment of internal control. Particular emphasis should be placed on people. The link between people's responsibilities and the way in which they are carried out and the entity's objectives is vital to the success of internal control.

The control environment should include accountability in addition to authority and responsibility. Holding management accountable for its responsibilities will enable the control environment to achieve the control objectives.

Formal written internal control procedures must be followed as part of daily routines. Crosstraining of individuals helps improve effectiveness of controls as rarely does one person have enough knowledge of all others job responsibilities. Each employee should feel some responsibility for the control environment.

The monitoring system assesses performance and adequacy of controls. It must have objective feedback channels and corrective action policies. Routine control activities effectively performed provide better assurance than formal evaluations performed less frequently.

We fully agree that the only truly effective owner of the control system is the chief executive officer (CEO). The CEO should set the tone at the top and maintain feedback systems to ensure that the entire organization integrates the control system into its existence.

Management Report Timeframe

It is in the stockholders best interest that the management report to external parties pertain to a period of time. Deficiencies, corrective actions, and the timeliness of detection/correction are indicators of the company's seriousness about internal control. Also, stockholders get a better sense of any significant activities during the year.

It is in the company's best interest that the management report pertain to a point in time as less discussion of deficiencies will be required as companies strive to have effective control at the time of reporting. Since the basic needs of the stockholder are met by point in time reporting and the fact that controls don't change drastically overnight, most companies should adopt point in time reporting.

Point in time reporting to external parties is the least that stockholders should expect as a responsibility of its management.

Summary

The final product of this study will be a welcome resource to many companies as a guide for assessing and improving internal control. We do not believe that unwarranted regulation will result from the use of the report.

Thank you for the opportunity to comment on the exposure draft.

Sincerely,

John W. Poling
Chief Financial Officer

Louise S. Smith

Louise S. Smith, CPA, CMA
Senior Financial Analyst

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June 10, 1991

Dear Sir:

I have taken the opportunity to review the exposure draft entitled "Internal Control-Integrated Framework" and I find it to be well thoughtout and "doable". There are however a few thoughts and ideas which I would like share with you for your considerations.

A. I believe that the term "internal control" as discussed in the exposure draft is too limiting and may be a misnomer in the framework discussed. I think "management control" is not only more applicable but is also best understood by all levels of management and by the audit profession.It also more clearly fixes the responsibility at the management level.

b. The "management control system" could then be described as:

1. A statement of objectives that are defined and meaningful to management.
2. A fromework of managerial policies to give direction to and set the bounds for actions of managers, including assigned responsibilities.
3. A set of performance standards that are consistent with the objectives, policies and assigned responsibilities and that are also useful to managers for evaluating progress towards achieving the objectives.
4. An information and feedback system which provides timely and reliable information on the conduct and results of operations and measures actual conditions.
5. Monitoring devices that relate actual performance to standards.
6. Corrective mechanisms in the form of decision devices that determine actions to be taken and action devices that carry out the decision.

An internal control system is not a separate system within an entity but rather an integral part of a broader "management

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system" used to operate and administer programs and activities.

C. The evaluation of this "management system" would include in addition to the factors outlined in your discussion of the nine interrelated components:

1. The compatibility, appropriateness and applicability of all six components identified under B above.
2. The identification of control objectives which would direct the auditor or evaluator to determine if:
   -What you want to happen is happening, and
   -What you don't want to happen is not happening.
3. Whether control techniques established by management and operating personnel include the necessary standards, feedback and monitoring devices necessary to ensure objectives are satisfied.
4. That such techniques are operative.

I am sorry I could not devote more time to my critique but I hope I hope my comments will be judged useful and constructive. You should be applauded for the fine product you have produced.

Joseph E. Alleo

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June 11, 1991

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor,
New York, NY 10036-8775

Dear Sirs:

Internal Control- Integrated Framework
Exposure Draft, March 12, 1991

The Committee receives our support for the important contribution it has made in addressing the evolving issue of designing, maintaining, assessing, and reporting on internal controls. The Canadian Institute of Chartered Accountants has also embarked on a similar project, entitled Criteria of Control, which addresses control from a different perspective- one which, we believe should be of interest and assistance to COSO.

We are presently working on a concept paper. Attached you find a draft of the Introduction and one of the chapters, entitled "Reporting on Control". This material identifies a number of key concepts, we believe, are required in order for management and users to have a common understanding when preparing and using reports on control systems. We will forward a copy of the final publication, which should be available in the next few weeks.

In the common interest of continuing our respective efforts on this issue, we would be pleased to meet with your representatives to share a wide ranging discussion of views and experiences.

Yours truly,

Edmund Zdyb, CA
Assistant Director
Criteria of Control
Studies and Standards

Table of Contents

CHAPTER 1: INTRODUCTION

"A structure (or theory) is essential if we are to effectively interrelate and interpret our observations in any field of knowledge. Without an integrating structure, information remains a hodge-podge of fragments. Without an organizing structure, knowledge is a mere collection of observations, practices and conflicting incidents. (Page 1-2, "Principles of Systems" by Jay W. Forrester, 1980)

Section 5205 of the CICA Handbook lists the basic components of internal control. They include: plan or organization, recording of transactions, personnel, authorizations, limitation of access to assets, comparisons of accounting records with assets, and management supervision.

The Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants is considering a new standard titled "Reporting on Management's Report on the Effectiveness of an Entity's Internal Control Structure over Financial Reporting." It describes three elements of internal control: control environment, accounting system and control procedures. These are the same three elements described in ASB 55 issued in 1988.

The Auditing Standards Committee will be revising the CICA Handbook in line with the ASB's position.

The recently released exposure draft of the Committee of Sponsoring Organizations of Treadway (COSO lists nine components of internal control. There is already evidence that COSO will be receiving submissions from the auditing profession to combine some of these components to come up with a somewhat shorter list.

In January of this year, the Internal Control Standard Committee of the Supreme Audit Institutions issued a proposed Internal Control Guidelines and Standards. It too adopts a traditional view, listing many of the same components as those contained in the CICA Handbook.

These various listings of the components on internal control represent to a great extent the cumulative knowledge and experience of auditors and accountants. Managers have had relatively little involvement or indeed interest. To a large extent internal control has been seen as the realm of the accounting profession.

The profession, however, has not found a way to bring together the various separate and often conflicting views of practitioners let alone managers and academics. There has been no real attempt to develop a unified structure or theory. No one seems to have come up with a model of an effective system of control.

Without such a model or structure to interrelate facts and observations it has been difficult for the profession to learn from its experience, and it is going to be increasingly difficult to use the past to educate for the future.

The accounting model, based on generally accepted accounting principles, allows preparers and readers to understand the meaning and significance of the myriads of transactions and judgement decisions which constitute the components of financial reporting. Without such a model accounting information would indeed remain a "hodge-podge of fragments".

Directors, managers, auditors, shareholders and regulators need a structure or model to interrelate their observations about control systems. It has been difficult to find a suitable structure. As Forrester says - "If systems are so pervasive, why do not the concepts and principles of systems appear more clearly in our literature and in education? Is it because there has been no need for understanding the basic nature of systems? Or is it because the principles of systems, while sought after, have been so obscure that they have evaded detection? The answer seems to have been each of these in turn."

Because the COSO exposure draft reflects much of our traditional way of thinking about organizations and control it will be referred to periodically. Although the Summary Chapter emphasizes the importance of people and the dynamic nature of systems, much of this thinking is not reflected in the detailed discussion and questionnaires in the balance of the publication. A summary is provided in Appendix A.

Identifying and expressing a body of universal principles that explain and successes and failures of organizations is not an easy task. Without a structure, managers, auditors and other interested parties continue to be overloaded by fragments of knowledge.

Auditors have traditionally used questionnaires to accumulate fragments of knowledge. They have always had difficulty understanding the significance of the answers. Professional judgment of an experienced practitioner seems to have been sufficient in the past. As organizations become larger and more complex it is becoming extremely difficult for even an experienced practitioner with a sound understanding of the industry to assimilate let alone assess a mass (hodge-podge) of facts, observations and impressions. This booklet provides a broad overview of a systems perspective and describe one widely accepted model of control.

The model, together with the accompanying perspective on the nature of systems, provides a structure which can be used by managers to start thinking about how they might assess and report on their systems of control. They also provide a structure which auditors can use when asked for their opinion of control systems.

CHAPTER TWO: REPORTING ON CONTROL

Chartered Accountants are having to respond to a number of questions relating to control. Directors are asking questions such as the following with increasing frequency:

- I would like your opinion on the adequacy of control over credit risk management in our company. What would this involve?

- Can you tell me whether our systems for the administration of trust assets are under effective control?

- Would our control systems prevent the problems which have recently come to light at ABC Company?

These are difficult questions. Auditor's frequently hedge their answers. Even though they are not comfortable providing answers they are reluctant to admit it. Behind these questions is an even more difficult question.

- Will our systems of control be effective tomorrow, as well as today?

After all the only reason people ask questions about control is they are concerned that something will go wrong in the future.

When auditors provide opinions on control systems, as they do more and more frequently, the readers presume that the systems will continue to be effective. It does not matter how carefully they word their reports the presumption remains.

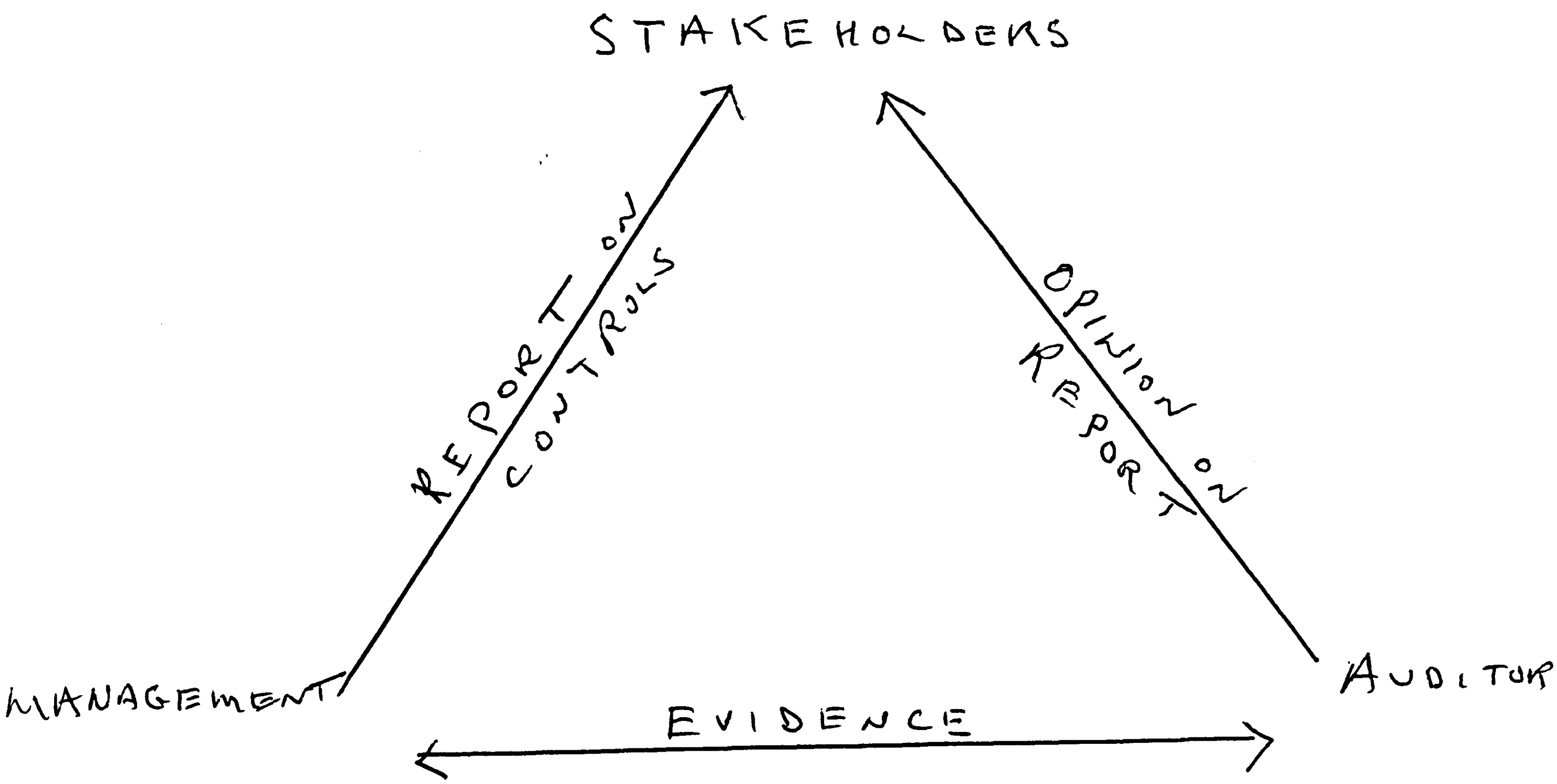
This chapter is based on presentations made by Duncan Galloway and sets out our vision for the future. Our vision has three components:

1. A control reporting framework
2. A control accounting framework
3. Criteria of effective control systems

Like all visions its realization is going to require the creative thinking and hard work of many people. It is our hope that managers, regulators and auditors will join us in making this vision a reality.

Control Reporting Framework

We believe the appropriate reporting framework parallels that which was established many years ago for financial reporting. We believe that such a framework will be acceptable to managers and directors. We believe it will be acceptable to regulators, industry associations and other stakeholders. Finally we believe it will be acceptable to auditors.



It is essential that management report on their control systems. In other words management makes assertions regarding the nature of their systems and the effectiveness of these systems. This is important because the only systems that really work on a day to day basis are those which management perceives as real, the ones that management relies upon. There is a danger that if someone other than management i.e the auditor, identifies and reports on control these reports will include assertions regarding systems that management do not use, do not recognize and perhaps were not even aware of. Ownership by management is essential.

Control Accounting Framework

We also believe it is essential to distinguish clearly between control standards or objectives and criteria of control. This has been a source of considerable confusion. One reason the terms are often confused is that one person's standards may be another persons criteria.

A control standard or objective is a statement of what a control system is designed to achieve, e.g., a control system to ensure computer security.

Standards or objectives are frequently specific to an industry or function. They may in many cases be specified by regulators, industry associations or other stakeholders.

Control criteria on the other hand are the measures by which a control system can be assessed in achieving its objective.

In order to demonstrate the relationship between objectives and criteria lets look at a simplified diagram of the three levels of control in relationship to the banking system.

Parliament wants to maintain a healthy banking system; this is its objective. To do this it passes legislation which includes the appointment of a regulator. The way parliament satisfies itself that its objective will be met is through a regulatory process. This is parliament's criteria. If the regulator says things are OK that is as far as parliament goes.

The regulator sets objectives based in part on the governing legislation. These might include an objective that there be no major bank failures. To achieve this objective the regulator needs criteria regarding the management and control of banks. These are often referred to as control standards eg the standards recently issued in draft form by Canada Deposit Insurance Corporation (CDIC).

These standards become the objectives of the control systems of individual banks. At this level it is possible to appreciate the importance of criteria of control. Without such criteria it would not be possible for either management or the regulator to know whether a bank's systems are indeed achieving the standards or objectives specified by the regulator.

REGULATORY
CRITERIA
STANDARDS OF
SOUND BUSINESS

INDIVIDUAL BANK

INDIVIDUAL BANK'S OBJECTIVE
COMPLY WITH STANDARDS OF SOUND BUSINESS COND[illegible]

BANK'S CRITERIA
GENERALLY ACCEPTED
CONTROL PRINCIPLES
(CRITERIA OF
CONTROL)

SYSTEMS OF INDIVIDUAL
BANK

9A

STANDARDS OR ~~CRITERIA~~ OBJECTIVES

~~VS AND~~

CRITERIA

PARLIAMENT'S OBJECTIVE
HEALTHY BANKING SYSTEM

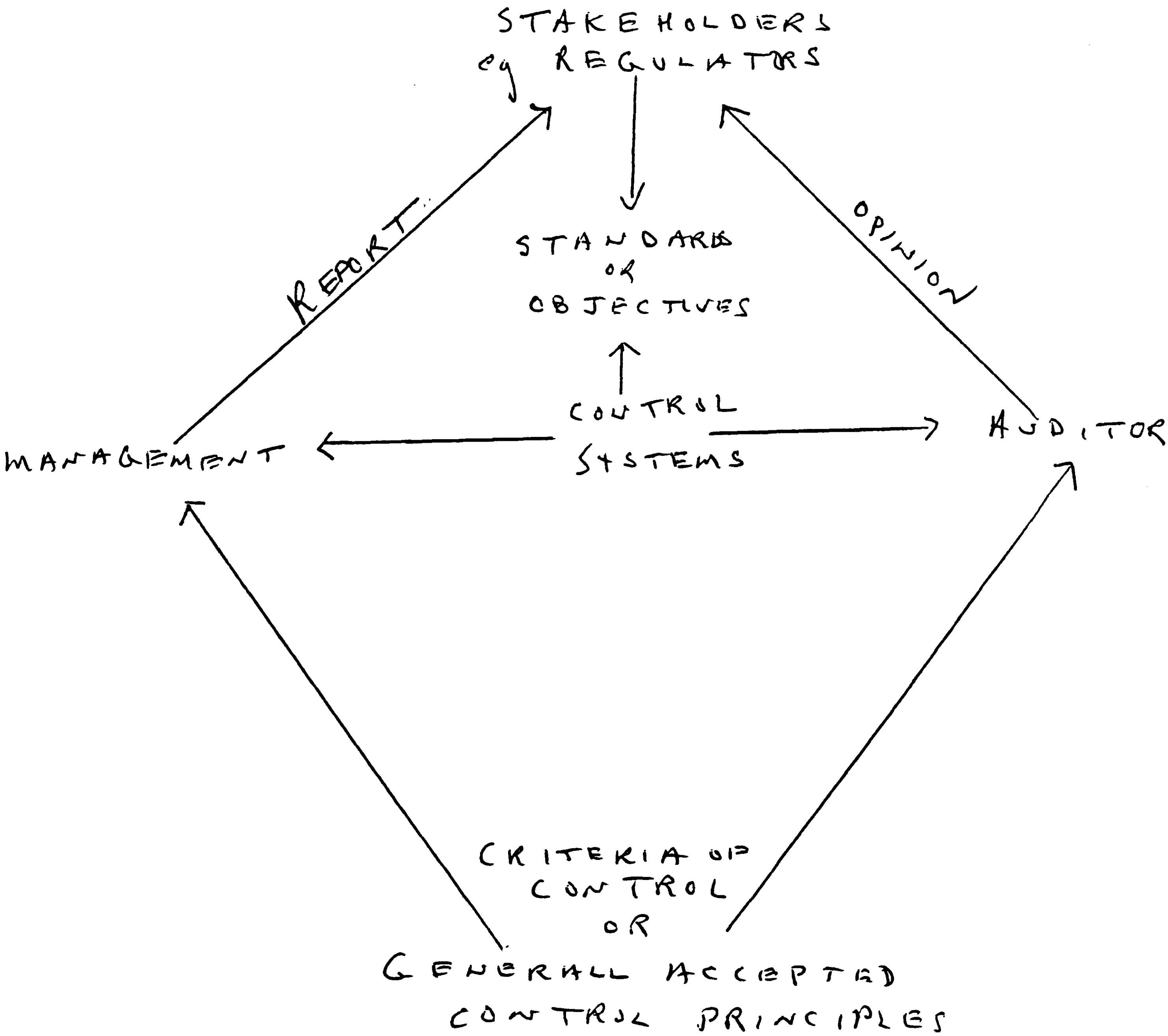
PARLIAMENT'S
CRITERIA
APPOINT A
REGULATOR

BANKING ~~SYSTEM~~ INDUSTRY

REGULATOR'S OBJECTIVE
NO MAJOR BANK FAILURES

Clearly defined and agreed to control standards or objectives are essential. Equally essential are agreed upon criteria of control which we have referred to as generally accepted control principles.

When we have such reporting and accounting frameworks in place it will be possible for management to say "yes our systems are effective in terms of the standards set because they meet these criteria" And it will be possible for the auditor to say "I have examined management's report on their systems and I believe it presents fairly their assessment of their systems in relation to the stated criteria." This can be illustrated as follows:



Criteria of Effective Control Systems

We believe that criteria should be generic. They should be applicable to any control system for any objective.

They should acknowledge the forward-looking presumption that a control system will continue to operate over a reasonable period of time. They should have a sound theoretical base which recognizes certain fundamental laws which apply to all control systems. They must be more than a collection of concepts, observations and experience.

One of the reasons we want the criteria to be generic is that it is impractical to list all of the procedures for every function in every industry. Even listing all the control procedures which might be appropriate for a simple manufacturing company is a massive job as we have seen from the COSO exposure draft.

A second reason for needing generic criteria is that even in the simplest of companies there are many different ways of achieving the same objective. Different management styles and different environments are just two reasons why control systems will be different

The third reason is that without generic criteria both managers and auditors would require a great deal of specialized expertise to understand and evaluate the effectiveness of control systems. Many organizations and many functions within organizations require high levels of technical knowledge. This is the reason we believe that control objectives should be developed by people who have specific industry knowledge, but it is also the reason why control criteria need to be generic..

Because criteria must be theoretically sound we require a model. We are all familiar with the traditional accounting model which incorporates "generally accepted accounting principles."

A model provides us with a common understanding. This is what makes it so useful. A model allows us to move beyond lists of control procedures and environmental factors.. A model allows us to identify our underlying assumptions. It controls us with a way of communicating with each other. What we are seeking is a model of any effective control system which is by definition generic.

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Because a system incorporates feedback loops and other structures to maintain its ongoing viability we can entertain the presumption that a report on control has some element of future oriented assurance regardless of how the report is worded. This is the key characteristic of an effective control system. It is the ability to not fall apart when things change either internally or externally.

To sum up it might be more accurate to say that we need a generic model for effective control systems.

The model which we have identified as meeting our needs is called the "Viable Systems Model" or VSM which was developed by Stafford Beer and has been written about and experimented with for almost 30 years.

One of the features of the Viable Systems Model or VSM which attracted us was that it is a model of a system which will maintain its viability or survival over time. The VSM has been applied to a number of different organizations in terms of size and industry. It has been used primarily for consulting and organizational diagnosis. It was developed out of the field of cybernetics which in turn has incorporated concepts from biology, information theory, mathematics and sociology. Another reason this model is so attractive is that is contains many fundamental laws and theories of control systems.

The VSM and a number of these laws and theories are discussed in this booklet.

The Vision in Practice

Let's look at how our vision might become a reality:

- Regulators, industry associations and other stakeholders identify control standards or objectives for entities in which they are interested

- Management of such an entity decides to prepare a report on how its systems achieve these objectives

- Management prepares a description of its control systems using the criteria for effective control systems. Management may at this point decide to make changes to control systems to achieve compliance with the criteria.

- An external auditor reviews the control systems and managements' description and assesses them against criteria for effective control systems.

- The auditor reports to the stakeholders that he or she has examined management's report on the effectiveness of control systems to achieve objectives a, b, c. The auditor reports that the audit was conducted in accordance with generally accepted auditing standards for such engagements and the effectiveness of the control systems in achieving objectives a, b, c is fairly stated in accordance with generally accepted control principles.

Although our ultimate goal is to establish generally accepted control principles, it will first be necessary to develop a common understanding of the issues and a common understanding of the model for effective control. From this it will be possible to develop criteria which can be published in the form of an exposure draft with sufficient time for experimentation by interested parties. The publication and generally acceptance of control principles will only be possible after there is understanding and support. This issues paper is an early step in the process.

We see the need for a Task Force which would have primary responsibility for undertaking these various steps. We also see the need for case studies and the need for an extensive program of education.

WAB/rn/May 3/91
(Ref.10 & 11)

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Central and South West Corporation

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T. BART EDWARDS
Director of Audits

June 12, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Subject: Internal Control-Integrated Framework Exposure Draft Dated March 12, 1991.

Dear COSO:

Central and South West Corporation (CSW) is a public utility holding company with four electric subsidiary companies. These four subsidiaries provide electricity to more than 4 million people in a widely diversified service area covering 152,000 square miles. This area is one of the largest served by any electric utility system in the United States. In addition to this core business, other subsidiaries include Transok, Inc., an intrastate natural gas gathering and transmission company, CSW Credit, Inc., which purchases the accounts receivable of CSW subsidiary companies and other electric utilities and three other subsidiaries. CSW and its subsidiary companies had 8,377 employees and $9.1 billion in total assets at the end of 1990 and $356 million of net income in 1990.

CSW believes the exposure draft contains a complete and accurate framework of internal controls that provides relevant and useful guidelines to the development and maintenance of adequate and effective internal control systems.

Although there are many different definitions and components of internal controls besides those outlined in the exposure draft, we see no significant related issues with which we take exception. Recognizing these differences, however, we are concerned about the consequences of portraying these guidelines as the single authoritative source for internal control theory. Internal control theory is a continuously evolving subject that can rarely if ever be isolated and presented in one readable document. In this respect, internal control theory is very similar to GAAP in that it is not contained in one single document but is derived from a number of sources. We do not believe that the many standards promulgated by organizations such as the AICPA and the IIA should be ignored in evaluating internal controls. Consequently, the final COSO report should integrate with other subject literature (rather than displace it) and should be used as a basis for this continued development of guidelines for good internal control systems.

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CSW offers the following specific comments pertaining to Chapter 15 - Management Reporting to External Parties.

- We disagree with the statement that public management reporting on internal controls over financial statement preparation is not a component of effective internal control. Such reports, when signed by the CEO, are vital to setting the tone at the top of the organization, and consequently, become an integral part of the control environment. Management reporting can facilitate a greater emphasis on the control environment by forcing executive management to specifically focus on internal controls and go on record as to its adequacy. Therefore, CSW believes that such public management reporting is an important component of effective internal controls, the importance of which is de-emphasized by the presentation method contained in the exposure draft.

- Although the exposure draft correctly states that public management reporting on internal controls over financial statement preparation is not a criterion for effective internal control, CSW believes that, for reasons previously mentioned, such management reports are critical dimensions of the control environment. Consequently, we encourage that COSO add teeth to its final report by recommending mandatory public management reporting.

  The most logical argument against public management reporting is concern over whether the assertions made by management are true. This is a false argument. It is incompatible to issue public financials without sufficient confidence in the related controls over financial reporting. Mandatory reporting requirements would encourage management to focus more on the adequacy of financial reporting controls and improve the user's real and perceived reliance on the integrity of the financial statements.

- The exposure draft accurately recognizes the absence of authoritative public management reporting guidelines. We agree that such guidelines are necessary, and as previously stated, believe that public management reporting should be mandatory. However, the exposure draft emphasis is on restructuring the existing guidelines advocated by the original Treadway Commission Report (Treadway). We believe that this emphasis is misplaced, and rather should be on the needs for authoritative guidelines and mandatory reporting requirements. Further, we believe that the proposed management report contained in the COSO draft tends to weaken the stronger management representations proposed by Treadway and inappropriately limits its reference to the COSO internal control framework rather than the broader body of internal control theory discussed earlier in this comment letter. We therefore strongly prefer the Treadway public management reporting guidelines.

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CSW appreciates the opportunity to respond and to be involved in this worthwhile project. We encourage COSO to carefully consider our recommendations and incorporate them in the final report.

Sincerely,

Glenn D. Rosilier

Glenn D. Rosilier
Senior Vice President and Chief Financial Officer
Central and South West Corporation

Michael D. Smith

Michael D. Smith
Controller
Central and South West Corporation

T. Bart Edwards

T. Bart Edwards
Director of Audits
Central and South West Corporation

cc: E. R. Brooks
Chairman, President and Chief Executive Officer
Central and South West Corporation

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FEDERAL EXPRESS

Malcolm Baldrige National Quality Award 1990 Winner

Frederick W. Smith
Chairman and
Chief Executive Officer

June 12, 1991

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Mr. Robert L. May
Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Dear Robert:

The Federal Express management team has reviewed your exposure draft on Internal Control - Integrated Framework. We have high praise for the businessman's perspective on controls described in the proposed definition. The draft will be used as a platform for training during 1991 to improve our corporate awareness of controls.

However, the proposal for Management Reporting to External Parties drew a great deal of criticism on the following points.

- A routine requirement to assess and report on controls will have substantial cost to the organization in management attention, consulting fees and additional manpower required.

- Any opinion expressed on internal control will be subject to interpretation by the reader. Misinterpretations could unreasonably raise investor expectations and result in avoidable litigation.

- The opinion itself addresses only controls over preparation of financial statements. Many highly publicized control failures resulted from breakdown of other controls. A limited representation provides financial statement users with minimal comfort while carrying the risks outlined above.

We recommend that the movement to require a report on internal control be resisted.

In addition, we suggest that the draft be revised to include a four to five page summary document for distribution to non-financial management.

We appreciate the opportunity to comment.

Sincerely,

Fred W. Smith

FWS/lnc
5757

VIA FEDERAL EXPRESS STANDARD OVERNIGHT LETTER

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Shell Oil Company

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Houston, Texas 77252

M. F. Sullivan
Controller

June 12, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
Sixth Floor
New York, NY 10036-8775

Gentlemen:

Subject: Internal Control - Integrated Framework

We are pleased to comment on the Exposure Draft (E/D), "Internal Control - Integrated Framework", which you issued March 12, 1991.

The E/D brings together relevant ideas in a manner that will enhance the understanding of internal control. In particular, the emphasis on the control environment and on managing change should heighten the awareness of their importance to the internal control process.

The E/D makes a significant start toward building knowledge of the broad scope of internal control. However, the all-encompassing definition raises some important issues which need to be addressed.

-- The proper role of internal controls within the conduct of an entity's operations needs to be clearly delineated.

-- External reporting should only relate to internal accounting controls, which are currently mandated by law and can be more objectively measured.

-- There is a need to minimize the internal evaluation effort and contain audit costs.

Role of Internal Controls

The E/D defines internal control as a process to reasonably assure achievement of objectives. Implicit in that process is the assessment of internal control. The E/D goes on to indicate that meeting objectives is a standard of conduct, to the extent that achievement is within management's control. This leads to a serious question about the role of internal control in the exercise of judgment and the taking of prudent risks necessary to accomplish business objectives. When objectives are not met, does this mean that there is a weakness in internal control or that actions were not in compliance with control standards?

Given the potential consequences of noncompliance, it is important that the role of internal control in the conduct of an entity's operations be made more specific. Accordingly, it is suggested that a next step in the exposure process actively involve the various professions that may meaningfully contribute. To this point, the accounting community has provided most of the input. To adequately develop the role of internal controls as they relate to the total management process requires sufficient participation by the various disciplines affected. This would also enable appropriate focus on the nonfinancial positions in the roles and responsibilities section.

<u>External Reporting</u>

It is recommended that Chapter 15 only relate to internal accounting controls, which are currently mandated by law. There is no justified need for management reports to cover other controls related to financial reporting.

It is important that attention to the accounting control principles critical to reliable financial reporting not be lessened. The fundamental accounting controls from auditing literature and the Foreign Corrupt Practices Act should be reinforced and placed in one chapter of the final report.

Notwithstanding the examples provided in Chapter 15 and Exhibit C-16, a sharper distinction between controls related to financial reporting and those pertaining to operations and compliance is needed. To achieve more clarity, each chapter on components should explain how the subject component will typically pertain to financial reporting.

It is recommended that the illustrative report presented in Chapter 15 be deleted. Including a sample report could result in it becoming a required standard. The suggested content which precedes the illustration in Chapter 15 provides sufficient guidance.

<u>Evaluation</u>

The E/D offers flexibility in the method and the frequency in conducting separate evaluations. A costly evaluation effort can be reduced by sound monitoring practices and focusing on the material activities.

It is suggested that some statements made in Chapter 14 be repeated in Chapter 4. These statements point out that ongoing monitoring not only lessens the need for separate evaluations but is more effective. It is also recommended that emphasis be placed on evaluating the activities of material significance to the entity. More succinct guidance on materiality in Chapter 15 would be helpful in providing the desired focus. In addition, the cost/benefit discussion should be strengthened to provide a sound basis for reducing some control procedures.

Within the context of public reporting, the E/D indicates that the framework can be used to establish a "standard" against which the internal control system is measured. The real value of the framework will lie in the useful guidance it provides for understanding and improving the conditions necessary to cause effective control, not in the establishment of standards. Though beneficial for guidance, many elements of the components do not lend themselves to objective or efficient measurement. Further, there is a possibility that the evaluation tools will be wrongly perceived as standards by third parties. The final report should remove references to standards and make clear the limited purpose of the tools.

Very truly yours,

Mike Sull

M. F. Sullivan

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Telephone 212 819 5000

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Price Waterhouse

June 13, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, New York 10036-8775

Internal Control - Integrated Framework

Dear Committee Members:

We are pleased to respond to your request for comments on the "Internal Control - Integrated Framework" exposure draft. Overall, we found the report to be insightful on concepts of internal control. It presents a sound, objectives-oriented, risk-driven approach. The broad based definition of internal control:

- makes the concepts in the report usable by management, internal auditors, regulators and independent accountants, and
- provides for narrowing the definition to focus evaluation on specific objectives.

Responses to the specific questions asked in the cover letter to the exposure draft and other comments follow.

Definition (Chapters 1 and 5)

The definition of internal control in terms of achievement of specified objectives is flexible for use by a wide range of organizations and for a wide range of purposes. Also, the provisions for focused definitions enable it to be informative to users of evaluation results. It would be improved if it ended after "...achievement of specified objectives," as adding that internal control consists of nine interrelated components (and

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listing them) detracts from the focus on objectives.

Components (Chapters 1 and 5 through 14)

We believe that eight of the nine components identified in the report are elements of internal control and that, taken together, they provide appropriate and useful criteria for evaluation of internal control. The component identified as "Managing Change," however, appears to be a subset of other components as demonstrated by the description of the process that is included at the beginning of the Managing Change chapter:

- Identifying the changed condition

- Analyzing the associated opportunities or risks

- Considering control procedures

- Supplementing controls as necessary

- Determining whether the control works properly

In addition, elevating managing change to the level of a separate component of internal control may lead some to the conclusion that all business adversity could be prevented if management maintained effective internal control. Consequently, we suggest that the information on identifying changed conditions and analyzing the associated opportunities and risks be blended into the chapter on the risk assessment component of internal control; the remaining identified parts of the managing change process are covered conceptually in chapters 10 through 12 and 14.

We also suggest that discussion of identifying and analyzing changed conditions include explicit statements to the effect that:

- The decision to be in business creates risk. Prudent managements take different approaches to operating objectives, and the kind and degree of business risks they accept.

- Internal control is intended to provide reasonable assurance of achieving objectives, but does not result in achieving control over external factors that affect the organization.

- Even when internal control would be considered appropriate under the prudent person concept, errors in execution or in judgment can result in or exacerbate business adversity.

Blending the Managing Change component into the Risk Assessment component would allow the Communication component to be shown on both sides of the pyramid diagram, indicative of the need for communication to occur down, across and up the organization.

We recognize that different components of control could be developed that would also be appropriate and useful. However, we believe the differences would primarily result from differences in emphasis.

We also believe that the relative significance of the identified components varies depending on the circumstances, including the nature of the entity, its business, the specific objective, the risks related to achievement of the objective and the effectiveness of the control obtained from the other components. This view is supported by statements in the section titled, "The Significance of Specific Deficiencies," on page 159 that:

- When a deficiency is noted, the evaluator should look for control strengths in the same or other components that will help to achieve the particular financial reporting objective affected by the deficiency.

- Management may consider controls that are present anywhere in the system in forming a conclusion as to whether the entity's system, taken as a whole, is appropriately designed and operating to achieve each specific financial reporting objective.

Accordingly, although we would agree with statements that "If all nine criteria are satisfied, a conclusion can be reached that the internal control system is effective (page 34)," that "When all of the criteria are met, an effective system of internal control can be deemed to exist (page 56)," and that "Each... must be present for internal control to be effective (page 6);" we also believe that whether each of the elements is sufficiently effective in the circumstances should be evaluated in combination with the other components.

Management Reporting to External Parties (Chapter 15)

We support management's reporting on the effectiveness of internal control over published financial reporting, and believe that if the final report included a statement of support for management reporting as the consensus view of the sponsoring organizations, it would be influential.

The paragraph following the illustrative report (page 157) permits managements to modify or expand on its contents. We believe that management reports will be more informative to readers of the reports, and hence more useful, if they include supportable statements that identify and briefly discuss "cornerstones" of the organization's internal control over published financial statements and of the procedures used by management to assess the effectiveness of the internal control. Tailoring of management's report would give the readers an insight into management's internal control philosophy and priorities. Accordingly, we recommend that the paragraph cited above encourage rather than merely permit expansion of the illustrated report.

We agree with the conclusion in the draft that a material weakness is the appropriate level of internal control deficiency to disclose in management's report. The AICPA's definition of reportable conditions, a concept developed by the profession to increase communication about internal control matters with audit committees to assist them in fulfilling their oversight responsibilities, is not appropriate for management's public reporting on internal control.

Other Substantive Comments

Material Weakness Concept

The draft uses the existence of a material weakness (as defined in the AICPA's professional standards) as the threshold at which management would report a

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deficiency in internal control over the preparation of its published financial statements. The draft also proposes that the definition of a material weakness be evaluated to determine if it needs to be refined, or at least more explicitly defined.

The existing definition has been reasonably useful and has the value of having been used over a period of years, including use for communicating with audit committees and regulators. It is highly desirable that the severity of deficiency to be publicly reported be as objectively determinable as feasible given the nature of the matter. The reason is to promote consistency in reporting among managements and to reduce and resolve differences of opinion (and potential litigation) among individuals with different primary motivations. However, we believe that explanatory material clarifying application of the existing definition would be more productive in this regard than revising the definition itself.

In addition:

- The cost-benefit relationship should <u>not</u> be a factor in determining whether management should report a control deficiency. Although in theory there may be circumstances in which not mitigating a material weakness is justified based on cost-benefit considerations, the potential, justifiable effect on the reader's views of the entity's ability to produce reliable financial statements is not mitigated. Accordingly, the discussion on page 160 should be changed to explicitly state that cost-benefit should not be a consideration in determining whether there is a material weakness.

- Including or referring to the discussion of inherent difficulties related to reporting results of operations for interim periods that is at APB 28, paragraph 4 would add an important perspective to the discussion of "Effectiveness" (on pages 157 through 160).

- The definition of material weakness that is appropriate for management's reporting on internal control over published financial reporting would not also be appropriate for management reporting on internal control over operations or on compliance with laws and regulations.

Small Companies

The usefulness of the report would be enhanced by including more explicit guidance on cost-effective measures that top management of smaller organizations can use to efficiently evaluate and improve internal control. These smaller organizations can be generally characterized as ones in which CEOs and other top management have a more hands-on role in effecting internal control than is likely in larger organizations, and in which a relatively smaller number of people are involved in activities requiring and providing control. Accordingly, in preparing the final report, we suggest that additional consideration be given to whether each of the chapters provides sufficient guidance for management of smaller organizations.

Editorial Suggestions

Page	
	Part 1 - Executive Briefing includes full discussions of limitations of internal control, roles and responsibilities, and evaluation of controls. As a result, it is over 40 pages long. We believe that managements, especially those individuals less versed in internal control concepts, would find the report more useful if the Executive Briefing presented only a concise, executive-level overview.
6	In the first line of the second paragraph move the word "only" to follow rather than precede "provide," so that it reads "can provide only reasonable assurance." The same comment applies to the first sentence of the Chapter Summary on page 15.
13	In the first paragraph under Expectations, repeat the point that even with an effective control system, achievement of operations objectives is not always within management's control.
15	See editorial suggestion for page 6.

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35 Rephrase the last (parenthetical) sentence to read "...distinguishing controls that relate to financial reporting objectives..." in order to maintain the distinction that it is the objective that is important, not the nature of the control.

57 Rephrase the last sentence to read "...distinguishing controls that help to accomplish financial reporting objectives from the other two categories...," for the reason given for the editorial suggestion for page 35.

144 Editorial changes similar to those proposed for pages 35 and 57 should be made to pages 144 through 150.

151 Delete the third sentence of the first bullet, "This means..." as it contradicts the rest of the statements therein.

151 In the second bullet, delete "in financial statements" because readers have a reasonable basis to presume that management's report on the effectiveness of internal control over the preparation of its published financial statements includes at least all of the financial statements in the annual report regardless of where in the annual report the information is located.

156 As the existence of even one material weakness should preclude management's report from containing an unqualified conclusion that the Company maintained an effective system of internal control, modify the second sentence of the third bullet point in the second paragraph to read, "If a material weakness exists, precluding a statement that the system is effective, a description of the material weakness or weaknesses should be included."

159 In the last line, change "that" to "as to whether" to avoid prejudging the issue.

161 In the second sentence of the last paragraph change "unethical acts" to "acts evidencing a breach of integrity" as not

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all acts that would be deemed by some to be unethical also represent a lack of integrity.

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We appreciate this opportunity to comment on the exposure draft. If you would like to discuss or obtain further information about our comments or any other aspect of the exposure draft, please call Ralph Hoffman at (212) 819-4804.

We also express our appreciation to those involved in producing the "Internal Control - Integrated Framework" study. We believe it to be a significant accomplishment.

Sincerely,

Price Waterhouse

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Georgia Gulf

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June 11, 1991

COMMITTEE OF SPONSORING ORGANIZATIONS
OF THE TREADWAY COMMISSION
1211 Avenue of the Americas, 6th Floor
New York, N.Y. 10036

Dear Committee:

I have several observations concerning the exposure draft, "Internal Control -- Integrated Framework", issued March 12, 1991. My comments concern the definition of internal control contained within the exposure draft.

First, the proposed definition seems vague, broad and unachievable. Second, the proposed definition exacerbates rather than alleviates the "expectations gap" which public and internal auditors face with the public-at-large.

A careful reading of the proposed definition of internal control allows the interpretation that the internal control process assures achievement of specified entity objectives. The dictionary defines assurance as "the act of informing confidently with a view of removing doubt" (American Heritage Dictionary). Using this interpretation, internal controls assure the achievement of sales and manufacturing objectives, for example. The use of the word "achievement" implies non-achievement in addition, but for someone not inclined to semantically split hairs, the subtlety does not exist. Undoubtedly the Committee did not intend for this interpretation to arise, but the definition as proposed does allow such an understanding.

Internal controls do not assure achievement of objectives; however, internal controls do provide management with information concerning the achievability of the entity's objectives. Continuing the example from above, internal controls provide management with information concerning the achievement of sales and manufacturing objectives. Using this information, management may make decisions which affect either the achievement of the objective, or changing the objective.

Secondly, the public has a high expectation of internal control. The public believes, rightly or wrongly, that internal controls and auditors eliminate the risk of misleading, erroneous or fraudulent activities occurring. The reasonable assurance phrase contained in the proposed definition does not dispel this notion, and potentially increases the public's misunderstanding. While the dictionary may define assurance as quoted previously, the general public has a stricter definition, meaning informing confidently without the possibility of error or mistake.

By leaving the proposed internal control definition unchanged, two possibilities exist. First, those most responsible in the public's eyes for internal control, auditors, must operate at an impossible standard, perfection. Secondly, whenever management fails in achieving objectives, whether because of external environmental reasons or their own failings, the auditors become accountable for this non-achievement.

I propose a slightly modified definition of internal control as follows: Internal control is the process by which an entity's board of directors, management and/or other personnel obtain appropriate knowledge as to the achievement of specified objectives. This subtle change places more appropriate responsibility with management for the internal control process.

A person unfamiliar with internal control systems in practice, and organizations, will have trouble differentiating between management's normal activities and those activities which are considered part of the internal control process. However, the public's more important concern is that management controls the organization, rather than differentiating between managing and controlling.

The components which form the internal control process remain valid for this definition. Two components, risk assessment and managing change, support this overly broad definition of internal control. While definitely part of the internal control process, these components also belong within the basic management process. Narrowing the scope of these two components as currently defined in the draft would help clarify the distinction between the internal control process and the fundamental management function of managing the organization for the benefit of all stakeholders.

I hope these comments benefit the committee in establishing the final definition of internal control.

Sincerely,

Karl E. Green
Director of Internal
Control and Finance

65

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June 4, 1991

Committee of the Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Dear Sirs:

Re: Exposure Draft of Internal Control -- Integrated Framework, March 12, 1991.

I am completely supportive of the work incorporated in the Exposure Draft of Internal Control -- Integrated Framework ("ED") due to the importance to organizations of internal control both for financial disclosures and for operating effectiveness and efficiency. The importance of control to management in meeting objectives has long been recognized. Chester I. Barnard [The Functions of the Executive, Harvard University Press, 1968; reprint of 1938] said:

> Control relates directly, in conscious application chiefly, to the work of the organization as a whole rather than to executives as such. But so heavily dependent is the success of cooperation upon the functioning of the executive organization that practically the control is over executives for the most part. If the work of the organization is not successful, if it is inefficient, if it cannot maintain the services of its personnel, the conclusion is that its "management" is wrong;...[p.223]

Some modern literature in management has used different terms for the broad concept of internal control used in the ED (for example, see Richard Hammermesh [Making Strategy Work: How Senior Managers Produce Results, John Wiley and Sons, 1986] terms it "administrative considerations"). Regardless of the terminology, the integration of internal control, as defined in the ED, within management processes should be widely recognized. Somehow, a misunderstanding has occurred when some individuals think that internal control considerations for maintaining the integrity of financial disclosures is inherently separable from the need to have control of operating activities.

The ED, therefore, is an important document for executives and accountants. The clear statement of the concept of "built-in, not built-on" in relation to internal control for operating activities, financial disclosures, and compliance with laws and regulations (p.13 of the ED) is important to bringing clarity to the present situation. Having said this, I do have some serious concerns about the ED which are discussed below.

Authority and Responsibility

The terminology in the ED when discussing internal control and its relationship to organizational structure needs to be very precise because of its potential standard setting, regulatory, and legal use. Ambiguity should be avoided wherever possible. The current usage of authority and responsibility (responsibilities) in the ED do not meet this criterion.

Authority[1] is properly defined in one place in the ED (p. 71, second paragraph, next to last sentence). Responsibility[2] is never defined in the ED. Responsibility or responsibilities is used at various places in the ED as a synonym for authority, accountability, and activities (duties). The use of responsibility as a synonym for authority or vice versa is clearly inappropriate. The use of responsibilities as a synonym for activities or duties introduces unnecessary ambiguity.

In addition, one needs to use appropriate verbs with the appropriate noun (authority or responsibility). Thus, delegate[3] should only be used with authority and some other verb, such as assignment, should be used with responsibility. An old Naval adage goes "you can delegate authority, but you can never delegate responsibility." With any delegation of authority goes a responsibility from the individual receiving the authority to the individual delegating the authority, but the individual delegating receives no reduction in responsibility which existed at the time of the delegation.

In the context of the ED, these comments lead to some very specific changes.

1. The verbs needs to be reversed in the first line of the first paragraph on p. 71.

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[1]Webster's New Collegiate Dictionary defines as "the right to govern, control, or command."

[2]Webster's New Collegiate Dictionary defines as "the state of being responsible (answerable or accountable)."

[3]Webster's New Collegiate Dictionary defines as "entrust, empower (one who acts for)."

2. The third from the last sentence in the second paragraph of p. 71 needs to have "authority" substituted for "responsibility."

3. The first sentence of the paragraph entitled "Management's Philosophy and Operating Style" on p. 145 needs to have "authority" substituted for "responsibility."

4. The third bullet at the top of p. 146 needs to be changed to read as "Clarity of the delegation of authority and duties;" since responsibility is covered in the first bullet on that page.

5. The last word in the first paragraph on p. 71 should be "duties" rather than "responsibilities."

6. The word "responsibilities" in the last sentence of the second paragraph on p. 55 should be replaced by "duties."

While I have spent some considerable time reviewing the document, the lack of computerized form prevents my searching for all uses of the words authority, responsibility, and responsibilities in order to make individual determinations about appropriateness.

The ED does not adequately explicitly address internal versus external responsibility or dual responsibility to outsiders in relation to financial disclosures. By internal versus external responsibility, I mean that a single individual may have internal responsibility (sometimes referred to as reporting relationships) within an organization while simultaneously having responsibility outside the organization. This seems especially the case for the chief executive officer (CEO) concerning financial disclosures who responsibility to the board of directors and a responsibility under the federal securities laws. Given this, I don't understand the structure of the discussion at the top of p. 72. Regardless of whether the "accepts" responsibility, the responsibility exists.

By dual responsibility, I mean that more than one individual may be responsible equally to outsiders for the same activity. It seems that the CEO, the members of the board of directors, and the chief financial officer (CFO) have the same external responsibility for financial disclosures. The Securities and Exchange Commission proposal on management reports would seem to extend this to a chief accounting officer also. Note that there are other situations where such dual responsibility exists (for example, the responsibility of commanding officers and officers of the deck on naval ships). Explicit recognition of dual external responsibility. even when one individual reports to another within an organization, would seem to make the discussion of the role of the CFO (chief accounting officer) clearer in Chapter 15.

Objectives and Evaluations/Monitoring of Internal Control

The ED, on page 51, fails to distinguish adequately between setting objectives and providing reasonable assurance that objectives are met for purposes of making an assessment. Some objectives are imposed on an organization from external sources such as the objectives for financial reporting and compliance with laws and regulations. Other objectives are within the purview of management. Internal control for externally imposed objectives requires assuring that management objectives are consistent with the externally imposed objectives in addition to providing reasonable assurance that such objectives are met. Other objectives, those within the purview of management, only require providing reasonable assurance that such objectives are met. The ED assumes that all externally imposed objectives and some objectives within the purview of management are "objectives common to virtually all entities" without guidance on determining whether such consistency of objectives exist or what to do about entities not falling within the scope of "virtually all."

The failure to distinguish adequately between ensuring that objectives of an organization are consistent with externally imposed objectives leads to a deficiency in the discussion of both evaluation and monitoring because determining whether an organization's objectives are consistent is never considered. Given the definition of internal control used in the ED on p. 52, reasonable assurance of compliance with objectives could be obtained without explicitly considering whether such objectives were consistent with financial disclosure requirements imposed under either generally accepted accounting principles or the federal securities laws. This seems to be due to an assumption that these objectives are consistent in the ED on p. 82, third paragraph. Many financial disclosure failures seem to relate to a failure of the consistency of objectives of organizations with the objectives inherent in conformity with generally accepted accounting principles and disclosure requirements of the federal securities laws.

The final comment in this area concerns monitoring and evaluation as used within the ED. Monitoring seems to be a process, more precisely a management process, undertaken on a continuing basis which can provide judgments about whether internal control processes are working (Chapter 14) or operational objectives are being attained (p. 103). Evaluation seems to be a process undertaken at discrete times to determine whether internal control processes are in place and working as designed. I don't think that the authors meant that such a separation should occur. Evaluation should be a part of any monitoring process and specific additional evaluations should occur on an as needed basis. Since I don't believe that this separation was intended, I believe some careful attention needs to be given in differentiating evaluation from the process by which the evaluation occurs, whether monitoring or periodic.

Additional comments

1. The functions by which management meets their responsibility shouldn't be written in such a fashion that it appears to create a different type of responsibility. Thus, I think that p. 22, first line of last paragraph, should not use "have oversight responsibility," instead it could be written as "have responsibility which they meet by exercising oversight."

2. I have great difficulty in separating the writing on page 54 in the first paragraph of the section entitled People from what is commonly referred to as "culture." People seems to refer to their characteristics and competences as separable from how they act in conformance with organizational mores.

3. Autonomous as used on page 72 seems to mean a high degree of delegation of authority, low specificity as to the amount or type of information communicated, and divergence from cultural norms in other parts of the organization. Are all three differences necessary before a separate internal control evaluation is needed?

4. I have some concern with the consistency of the discussion of integrity between the last paragraph on p. 59, the second and third paragraphs on p. 61, and the second paragraph on p. 62. My difficulty seems to be due to the differences between ethical values (which may or may not be stated in terms of economic consequences or even relate to economic consequences), short-run economic behavior, and long-run economic behavior. An example question may assist in understanding my position. Would it be unethical to murder executives of competitor firms even if it was in both the short-run and long-run best economic interests of the firm?

5. Inherent in the term organizational structure as usually used is the designation of organizational units, the designation of positions for people within these units (which usually is thought of as defining duties and authority), and the designation of reporting relationships (which usually is thought of as defining formal communication and the assignment of responsibility). Thus I find it hard to discuss communication, authority, and responsibility separate from the organizational structure (see p.

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72 ff.).

6. I believe that organizations should carry out risk assessment. I believe that it shows a lack of internal control if risk assessment is not carried out by organizations. After making such a statement, I question the purpose of this chapter unless it is identified as defining what is an acceptable or appropriate management activity which meets this requirement. Note also that the term "internal control system" is used in the second paragraph on p. 91 which is both not used elsewhere in the ED and goes against the "built-in, not built-on" definition.

7. I believe the order of the last words on p. 103 should be "plan, execute and monitor" instead of "plan, monitor and execute."

8. I had great difficulty in seeing any reason for having Chapter 12 (Communication) or 13 (Managing Change). The information in the first paragraphs of Chapter 12 can be, and I believe are, covered respectively in chapters on information systems; control environment; control procedures; control procedures; control environment and managing reporting to external parties; risk assessment; control environment and integrity, ethics and competence; control environment; integrity ethical values and competence; and control environment. The remaining discussion could easily be placed in those chapters as appropriate. All of chapter 13 seems to relate either to risk assessment or to evaluation.

9. I believe the third bullet on page 145 should read "Whether the knowledge and skills of accounting personnel are sufficient to properly account for new business lines." so that this bullet stands alone like all the other bullets on that page.

Thank you for you consideration of these comments. Please do not hesitate to call me at (614) 292-6879 before July 1 or (216) 672-2545 after that date if you require clarification.

Sincerely,

Ray G. Stephens
Professor

cc: Alvin A. Arens
Andrew D. Bailey, Jr.

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

June 19, 1991

To: **Richard M. Steinberg, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Auditors
Louis Bisgay, National Association of Accountants

Gentlemen:

Attached is the ninth batch of comment letters (there are twelve responses in this batch) on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

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GENERAL MILLS, INC. • EXECUTIVE OFFICES

Number One General Mills Boulevard • Minneapolis, Minnesota 55426

June 12, 1991

THOMAS P. NELSON
Senior Vice President
and Controller

Mr. Gaylan N. Larson
Chairman
Committee of Sponsoring Organizations of
the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Dear Mr. Larson:

We appreciate the opportunity to review the COSO exposure draft, "Internal Control - Integrated Framework." It is apparent that a significant effort went into preparing this document.

Our overall assessment is that the framework used is appropriate and many important points are made in the process of defining internal control and providing standards against which evaluations can be made. However, we suggest that the final exposure document should be more narrowly focused, eliminating certain general information, to make the exposure draft more effective as a working document.

We believe the stated overall objective of the study "to help management of businesses and other entities better control their organizations' activities" is too broad. Since this project originated from concerns about financial reporting, we would suggest that the focus of the final exposure document be limited to the following aspects of internal control and external reporting.

- Providing reasonable assurance to the Board of Directors, Management, the investing public and appropriate regulatory agencies that the published financial statements are reliable and that the entity polices and procedures concerning its financial records are in place and being followed.

These more focused objectives need not preclude a broader definition of internal control. But once defined in broad terms, leave the more general scope of internal control to later study if appropriate.

Here are some comments relating to questions raised in the FERF comments and in the Exposure Draft:

- Leaving the definition broad, and defining internal control as a process, executed by the entity's people, to accomplish specified objectives, is a good working definition.

- Not including specific reference in the definition to applicable laws and regulations is appropriate. Compliance with laws and regulations is not only implicit in the part covering integrity and ethical values but should also be covered in an entity's objectives detailed in its written policies and procedures.

- While defining nine components of an effective internal control system is one way to describe internal control, there are convenient ways of combining these subjects into a smaller number of separate components.

- The scope of the material covered in the chapters on each component should be limited to the two aspects of internal control listed on page 1.

- The subjects of competence, skills, education, and training are prerequisites for good internal control and can be adequately covered within the two basic elements of Integrity, Ethical Values, and Competence and Control Environment.

- The structure of the exposure draft: Executive Briefing, Definitions, Reporting to External Parties, and Appendices is useful and can be even more so if the material is reduced to the previously noted aspects of internal control. Regarding the potential risk of encouraging unwarranted regulation, we believe that while this is always a concern, there is greater risk from doing nothing.

- Reporting to external parties on the status of internal controls is appropriate to cover in a separate chapter. The focus is suitably narrow, addressing internal control related to the reliability of published financial statements. This focus sets the tone for the previous chapters which would then provide more concise standards for public reporting. Additionally, we believe that COSO should recommend that the SEC require a management report on the effectiveness of internal control over financial reporting in the annual report.

In summary, the structure of the Exposure Draft is good, though the focus should be more narrow and the number of components reduced. The number of definitions and anecdotes could be reduced significantly.

We hope that this input is useful and look forward to seeing the final document.

Sincerely,

Robert E. Northam
Executive Vice President
Chief Financial Officer

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June 12, 1991

Mr. Gaylan N. Larson, Chairman
The Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
New York, N.Y. 10036-8775

Dear Mr. Larson:

Attached is the JCPenney Company's response to the exposure draft on the Internal Control-Integrated Framework.

We acknowledge the contribution the Committee has made in its effort to advance the mutual understanding of internal control. Overall, we endorse the Committee's conclusions in the exposure report, but have four recommendations and four observations to the report as outlined in our response.

Very truly yours,

REN:ps
att.

Customer Service is Our Number One Priority

J.C. Penney Company, Inc. • P.O. Box 659000 • Dallas, TX 75265-9000
Executive Offices • 14841 North Dallas Parkway • Dallas, TX 75240-6760

JCPenney Company, Inc.
Response To The Exposure Draft of Internal Control - Integrated Framework by the Committee of Sponsoring Organizations for the Treadway Commission

The JCPenney Company appreciates the opportunity to review the Committee Of Sponsoring Organization's (COSO) exposure draft on Internal Control - Integrated Framework.

We endorse the study's conclusions as outlined in the draft and agree it will help advance the understanding of internal control and aid management in better controlling their organization's activities. We agree that most organizations should require little or no change in their current control environment in implementing and achieving compliance with the study's conclusions.

The JCPenney Company has always placed a great deal of emphasis in establishing and maintaining a strong internal control environment. The Company's system of internal control is supported by written policies and procedures that are designed to provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with appropriate authorization and are recorded and reported properly. The system is supplemented by a strong controllership function which has personnel in all major operating entities who focus on maintaining an adequate control environment. Additionally, a professional internal auditing staff and independent external auditors continually review, evaluate and make recommendations to strengthen the internal control environment.

The Audit Committee of the Board of Directors is composed solely of directors who are not officers or employees of the Company. The Committee reviews both the internal and external audit plans, scope, and results and the effectiveness of the Company's programs for correcting audit findings. Both the internal and external auditors meet periodically with the Audit Committee to discuss auditing and financial reporting matters.

The JCPenney Company is generally in agreement with the conclusions of the study. However, we do have the following recommendations to the study's conclusions.

Recommendation 1 - In Chapter 4, the minimum standard of documenting the overall internal control environment in organizations should be adopted.

Chapter 4 states: "The nature and extent of internal control system documentation necessary to an evaluation is a matter of the evaluator's judgement. In small companies, or for certain aspects of larger companies' control systems, little or no documentation may be needed."

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This statement is inconsistent with the basics of internal control systems and the lack of any documentation suggests a weakness in the internal control environment. We recommend that documentation standards be established and incorporated into the report to state, at a minimum, that the overall general internal controls within an organization be documented. The current statement that no documentation may be needed, weakens the credibility of the exposure draft.

<u>Recommendation 2 - The scope of Chapter 10 should be enhanced to include systems in general rather than focusing only on information systems.</u>

Chapter 10 on information systems should be retitled "Systems". While we agree that information systems are one of the tools used to ensure an adequate control environment, there are other systems (i.e. manual or informal) that also have an impact on the internal control environment. Singling out information systems does not address the entire role that systems play in the internal control process. Therefore, the scope of this chapter should be enhanced to not only focus on information systems, but systems in general that serve as an integral part of the overall internal control environment.

<u>Recommendation 3 - Chapter 14 should include additional emphasis on Exception Reporting as an effective Management Monitoring Tool.</u>

Chapter 14 states that, "monitoring ensures that internal control continues to operate effectively". We agree that monitoring is an integral part of the control environment and this chapter should place additional emphasis on **Exception Reporting** as an ongoing management monitoring activity. Corporate America has experienced an information explosion in the 1980's and the challenge for management in the 90's is how to get their arms around the truly meaningful exceptions of information, to enable management to identify where the control opportunities exist.

<u>Recommendation 4 - In Chapter 15, Point-in-Time for Management reporting to external parties should be adopted as the standard.</u>

Chapter 15 covers management reporting to external parties. Specifically, the time frame of reports on internal controls is discussed and examples are given regarding period-in-time and point-in-time reporting. The exposure draft adequately illustrates these two types of reports, however, the conclusion reached in the last sentence of the "Time frame" section stating, "Accordingly, point-in-time reporting is most appropriate", does not provide definitive guidance.

The exposure draft explains the benefits of point-in-time reporting over period-in-time reporting, but lacks the authoritative conclusion necessary to establish a standard of such reports. We concur that point-in-time reporting is most appropriate, and that the document should be modified to provide a definite conclusion that "only point-in-time reporting is appropriate for management reporting of internal controls to external parties".

This conclusion is further supported by the exposure draft's guidance given in this same chapter under the heading "New Report Guidelines" where it is stated that, "this study's report presents a definition, criteria and guidelines" and that, "reference in internal control reports to this report will enable report issuers and readers to have a common understanding of what is being communicated". This goal of readers being able to have a complete understanding of what the report is communicating, requires the standardization of the time frame covered by the report.

General Observations

Additionally, we have noted some general observations regarding the presentation and content of the report and make the following recommendations on the overall document's presentation format.

Observation 1 - Providing a condensed Executive Summary will help ensure the information in this document is read by Senior Management.

> As evidenced in the quality of the document, the committee did an excellent job in researching the subject and preparing the document. However, the Executive Briefing (47 pages) includes more detailed information than management will have time to read. As outlined in the document, "The primary objective of the study is to help management of businesses and other entities better control their organization's activities." Providing a more refined executive summary will help ensure senior management of Corporate America takes time to read this important document and accomplish the primary objective of the committee.

Observation 2 - Writing the document in a more conventional, business-style and user-friendly format will help ensure the information is universally understood by all readers.

> Although the document is well written, the style of the report appears to be written as an educational text book rather than as a working tool for management. If this document was written using a more businesslike style of writing and user friendly format, it would help ensure that management would implement the study's conclusions. Additionally, under the current format of the report, information within the document

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is repeated within the various chapters of the document making the information appear redundant.

Observation 3 - Using additional white space and bullets will help improve the eye appeal and ease in reading the document.

In an effort to help ease the reading of the material and improve the eye appeal of the information, we would encourage the use of additional white space and "bullets" to highlight key points within the document.

Observation 4 - Developing an Index of topics within the document will help provide a reference aid for the reader.

Creating an **Index** of terms at the end of the document will help aid the reader by having a consolidated source to reference and locate specific topics within the document.

We appreciate the significant contribution the committee has made in completing the study and preparing this draft document to advance the mutual understanding of internal control within today's business organizations.

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INTERNATIONAL PAPER

ANDREW R. LESSIN
CONTROLLER

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June 12, 1991

Committee of Sponsoring Organizations
of the Trading Commission
1211 Avenue of the Americas
6th Floor
New York, New York 10036-8775

Re: Internal Control - Integrated Framework (March 12, 1991) <u>"The Exposure Draft"</u>

International Paper Company fully endorses the maintenance of effective internal control systems. However, we do <u>not</u> agree with the Exposure Draft definitions of internal control, nor believe that the draft management report is an improvement over that previously recommended by the Financial Executives Institute.

The Exposure Draft's proposed definition of internal control and related components, as set forth below, is too broad and is not susceptible to objective measurement.

> "Internal control is the process by which an entity's board of directors, management and/or other personnel obtain reasonable assurance as to achievement of specified objectives; it consists of nine interrelated components, with integrity, ethical values and competence, and the control environment, serving as the foundation for the other components, which are: establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring."

Many of the elements included in the above definition relate more to good management practices and conduct, rather than to internal control. We believe that internal controls should be more closely defined and focus on safeguarding assets, preparation of reliable financial statements and the integrity of financial analysis.

In addition, we have some reservations about the wording of the suggested (i.e. illustrative) management report:

> First, the initial paragraph contains a caveat that,
>
> > "an effective internal control system, no matter how well designed, can provide only reasonable assurance with respect to the preparation of reliable financial statements; further, because of changes in conditions, internal control system effectiveness may vary over time."
>
> This wording totally vitiates the message you are trying to convey (i.e. the reasonable accuracy of the statements) and leads one to the conclusion that the report has no real substance.
>
> Second, the suggested management report cites the 170 pages of the Exposure Draft's Appendix C ("Evaluation Tools") as the standard by which the adequacy of the internal control system is to be measured. This is contrary to other assertions in the Exposure Draft that represent these as "guidelines" rather than as standards.
>
> Third, the report requires disclosure of material weaknesses if they are deemed to exist. As highlighted by the discussion in the Exposure Draft, "materiality" in this context is a very subjective notion with no defined measurement. It is our feeling that, except in those cases where weaknesses preclude the preparation of financial statements (or the auditor's ability to opine thereon), nothing would be a reported as a "material" weakness. Therefore, it is our judgement that the suggested management report is less meaningful than that which we now include in our annual report.

The control techniques set forth in the Exposure Draft appear to be designed more to limit the liability of public accountants than to furnish a practical framework for a cost effective system of internal controls. The costs of full verifiable compliance with a set of standard control procedures was not adequately discussed. In our judgement, the techniques, if adopted as the standard for adequate internal control, would increase administrative costs substantially without adding any real value.

Although the Exposure Draft did not require that independent accountants opine on the management report, we believe that such a requirement would shortly follow.

We suggest that COSO not rush to publish this large internal control "cookbook" that would, no doubt, be incorporated into "Wyden"-type legislation. Rather, it would be more practical and productive to break this down into digestible segments and to issue a series of discussion memos on each specific area to ensure that each receives the attention it deserves. It is not our intention to be overly critical of this comprehensive document...many parts will be very useful. Frankly, there is just too much data to adequately respond in detail to all of the relevant points in this Exposure Draft.

Very truly yours,

Andrew R Jessin

Johnson & Johnson

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PAUL H. SAAKE
VICE PRESIDENT, INTERNAL AUDIT
CORPORATE STAFF

ONE JOHNSON & JOHNSON PLAZA
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(908) 524-2076

June 12, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
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New York, NY 10036-8775

Comments to the Exposure Draft on Internal Control - Integrated Framework are enclosed for your review, analysis, and consideration. If you have any questions, please contact Mr. Bruce E. Hartman (908) 524-2282 or me.

Sincerely,

P H Saake

P. H. Saake

c: Mr. C. H. Johnson

Attachments

INTERNAL CONTROL - INTEGRATED FRAMEWORK
EXPOSURE DRAFT RESPONSE

The Internal Control Integrated Framework (Framework) is a comprehensive document which encompasses all the concepts associated with a system of internal control. A summary of our recommendations for your evaluation and consideration follows.

Definition

- The definition of internal control should be broad enough to cover the management control process as reflected in the Framework. This definition is also in concert with the Standards for the Professional Practice of Internal Auditing which has promulgated a broad view of control. Some confusion may result from the fact that the business community will be utilizing this broad definition while the auditing profession will be following SAS #55. The elements presented in SAS #55 are covered in the definition presented in the Framework.

- We feel that the explanation of the components on pages 7 and 8 are silent with regard to compliance with applicable laws and regulations but it is addressed under Objectives on pages 51 and 81.

Components

- The nine components detailed in this report meet the objective of the study which is to help management of business and other entities better control their organization's activities.

- In our opinion, more emphasis should be placed on Management Integrity, or "tone at the top", because it is the pinnacle of the system of internal control and serves as a condition precedent to all other components of the system.

- Competence, skills, education, and training are important to a system of internal control, but we feel that they should not be listed in the definition as separate components. These components should be a key part of the Control Environment. Also, training and preventative controls were not emphasized enough in the text. A fundamental principle of any internal control design is prevention rather than detection.

INTERNAL CONTROL - INTEGRATED FRAMEWORK
EXPOSURE DRAFT RESPONSE

- In our opinion, the definition in the Framework should be consolidated into four components of internal control: Management Integrity, Control Environment, Control Procedures, and Information (or Accounting) Systems. The other five components should be considered subsets of two of these groups as follows:

    - Management Integrity

      Management Integrity, or "tone at the top", which encompasses ethical values and competence, is the pinnacle of the system and serves as a condition precedent to all other components of the system. We feel the components of Communication and Managing Change should be subsets or key ingredients of Management Integrity. The system of internal control requires management to be skilled communicators (internal and external) and adept at managing change.

    - Control Environment

      In our opinion, the components of Objectives, Risk Assessment, and Monitoring should be subsets of the Control Environment. Part of the Control Environment is management's approach to assessing and assigning responsibility, as well as monitoring results. The assignment of responsibility, in a competitive environment where resources are limited, has to be accomplished by management through a risk assessment process which reflects top management's philosophy. Additionally, the Framework should explain how achievement of objectives and risk assessment can be measured. It is also management's responsibility to monitor the system of internal control based upon the objectives and risk assessment process.

- A key part of the study is the section on evaluation tools which contain "points of focus", by component. We recommend that these questions be considered as guidelines and not become mandatory.

INTERNAL CONTROL - INTEGRATED FRAMEWORK
EXPOSURE DRAFT RESPONSE

Reporting to External Parties

- Management's reporting to the public and other external parties is a by-product of a system of internal control and should only be mentioned as such in this study. Our opinion is that this area should be considered as a possible subject of another study. The subsequent study should offer concise guidance on the time frame of the required report, content, limitations, handling/disposition of internal control deficiencies discovered and who should sign the report. The report from management to the public should be limited to an assertion on controls over financial reporting. If the scope of these reports were to extend to the nine components, it is our opinion that administrative efforts and related audit evaluation costs would increase for companies that have a strong system of internal control.

Other Observations

- We found the document to be very repetitious which we feel is caused by the overlap and linkage of the nine components.

- We feel that the authors of this document must continue to balance the theoretical with the practical adaptability of the business community, especially smaller organizations.

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Union Pacific Corporation

Charles E. Billingsley
Vice President and Controller

June 12, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Gentlemen:

Union Pacific Corporation appreciates the opportunity to respond to the Committee's exposure draft "Internal Control - Integrated Framework". Our recommendations and comments are attached.

Union Pacific generally agrees with the report, suggesting only minor revisions to the definition and identified components of internal control. The final report should provide a strong base for internal control evaluation.

The major area of concern for Union Pacific continues to be Congressional efforts relating to internal control legislation. Such proposed legislation in its current form will disrupt the continuing private initiatives on internal control, will fail to prevent a future savings and loan type crisis, and will unnecessarily increase audit and administrative costs with little or no commensurate benefits.

Very truly yours,

Charles E. Billingsley

:nbh

cc: Drew Lewis
White Matthews

Martin Tower, Eighth and Eaton Avenues, Bethlehem, PA 18018 • 215 861 3356

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UNION PACIFIC CORPORATION
INTERNAL CONTROL - INTEGRATED FRAMEWORK
POSITION PAPER

Union Pacific Corporation (UPC) generally agrees with the concepts and framework for internal control summarized in the exposure draft prepared by the Committee of Sponsoring Organizations of the Treadway Commission.

We believe that clarifying portions of the definition of internal control and the addition of a tenth component essential to effective internal control will serve to further highlight the concepts already discussed in the exposure draft. In addition, UPC supports the inclusion of a management report containing an assessment of the internal control system in the annual report. However, we do not advocate any expansion of independent public accountant responsibilities to include testing, evaluating or opining on the system of internal control.

DEFINITION - Internal control is defined as a process, executed by the entity's people, to accomplish specified objectives. Do you agree with the definition? If not, why not?

The exposure draft defines Internal Control (IC) as follows:

> Internal control is the process by which an entity's board of directors, management and/or other personnel obtain reasonable assurance as to achievement of specified objectives; it consists of nine interrelated components, with integrity, ethical values and competence, and the control environment, serving as the foundation for the other components, which are: establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring.

Although Union Pacific generally agrees with this definition, we also believe that it is both too general and too specific for much of the interested audience.

The use of the term "specified objectives" results in ambiguity for many interested parties who need greater familiarity with IC and the IC process. To delay identification of the types of objectives that IC addresses serves to reduce the emphasis of the high level benefits of IC. Later in the exposure draft the "specified objectives" are succinctly categorized as operational, financial reporting and compliance objectives. Inclusion of these categories in the definition of IC will appropriately highlight for executives and management (who may not otherwise delve into the detail of the exposure draft) the benefits an effective internal control program will produce.

Continuing this highlighting focus, the inclusion of the nine components of the IC process in the definition combines the purpose of IC and the method or structure of IC into one all-encompassing statement. The inclusion of the specific components clouds the importance of both the purpose (definition) and the process (components) of IC. We support a separation of the components from the purpose of internal control.

A suggested revision to the definition is as follows:

> Internal Control is the process by which an entity's board of directors, management or other personnel obtain reasonable assurance as to the achievement of specific operational, financial reporting, and legislative and regulatory compliance objectives.

The structure of the process (identification of components) should be discussed shortly after the definition, but it is not considered an integral part of the definition of IC.

<u>COMPONENTS</u> - **The report identifies nine components essential to effective internal control. Are there others that should be added? Should any be deleted?**

The nine components identified in the exposure draft are essential to the IC process. The components appropriately integrate a general, business perspective (integrity, ethical values, and competence, communication, and managing change) with a more detail-oriented, activity perspective (control environment, objectives, risk assessment, information systems, control procedures, and monitoring). A proactive emphasis is also apparent in the discussions of information systems, communication, managing change and monitoring. The identified components are individually important in an IC process and, as such, none should be deleted or combined within the framework.

A suggested addition to the component list is "Follow-up: The elimination of identified weaknesses and the minimization of identified risks". Although such follow-up is implied within several components, most strongly in managing change and monitoring, Union Pacific believes separate emphasis of such a component is necessary. In Chapter 12: Communication, a situation is described in which the purpose and performance of a reconciliation process had been misinterpreted. Although new procedures and controls may be identified and implemented within the managing change and monitoring processes, continual follow-up of such implemented changes is necessary until the controls are working properly and as initially planned. Such follow-up procedures may be implied within the process of assessing risk and determining monitoring frequency; however, segregation of the follow-up process into a separate IC component will emphasize the importance of properly functioning controls, ensure understanding of the purpose of new control procedures, and reduce the possibility of a "brush-off" attitude towards control implementation.

EVALUATION - Many methods and techniques can be used in evaluating internal control. This report discusses evaluation, and presents evaluation tools intended to be useful in assessing internal control systems. Compare and contrast the evaluation process followed by your organization with the guidance specified in the study and provide comments on the usefulness and adequacy of the approach recommended in the report. Would you use the tools as either a substitute or a supplement in evaluating internal control in your organization?

UPC is continually undergoing change. For example, during the 1980's Union Pacific Railroad (the "Railroad") adapted to deregulation, acquired three other railroad companies, significantly reduced employees and underwent several changes in senior management. In addition, during this time UPC also acquired its trucking subsidiary (Overnite Transportation Company) and its hazardous waste subsidiary (USPCI, Inc). In order to function effectively within such a changing environment, UPC presently employs many of the methods and techniques described in the exposure draft.

The Railroad benefits from not one, but several audit groups. The UPC audit staff and the external auditors provide review and evaluation of financial processes and information. The Railroad's Planning and Analysis area provides support on current and proposed regulatory requirements affecting the operation. The Railroad and UPC planning, law, and external relations functions evaluate the company's legislative environment and the potential effects of proposed legislation. Further, in 1990 the Railroad organized a quality audit function emphasizing quality procedure compliance in all departments. Another separate financial quality function also exists and was expanded in 1990 to emphasize the importance of quality in the internal operations of the Railroad as well as in its dealings with customers and vendors, and to recognize the resulting competitive advantages through quality improvements.

Because of the structure and processes already in place within UPC, the evaluation methods and tools summarized in Appendix C of the exposure draft would most likely be used as a supplement to existing evaluation tools and processes already an integral part of the operations of the company. The general nature of the points of focus and the questionnaires for each component provide an opportunity for the comparison of the internally generated Union Pacific approach to an external, objective view of the IC process.

<u>MANAGEMENT REPORTING TO EXTERNAL PARTIES</u> - A number of private, legislative and regulatory proposals have been put forth regarding management reporting on internal control as it pertains to financial reporting. Do you believe the guidance material provided is helpful for companies publishing management reports on internal control?

We believe that the exposure draft provides a strong framework for the development of a standardized management report. As discussed below, it provides guidance for the improvement of our own management report and we believe it is useful for companies contemplating the inclusion of a management report on IC in their annual financial statements.

UPC has published a statement relating to management's responsibilities for financial statements for many years (see 1990 statement attached). Our current report includes comments on many of the areas indicated in the exposure draft including organizational relationships, personnel policies, monitoring and communication of policies, the inherent limitations of an IC system, and the roles of the audit committee, internal audit and independent public accountants. Further, the statement is signed by the chief executive, financial and accounting officers as suggested in the exposure draft. However, management's conclusion on the effectiveness of the system, as of a certain date, and the evaluation criteria are not included. We support the inclusion in the annual report of such an assessment, by management, of the system of IC. We agree the assessment should be made as of a point in time (at the end of the fiscal year) to allow for timely response to and correction of situations which will inevitably occur.

However, we continue to be concerned by the Congressional efforts to enact legislation requiring independent public accountants to audit and report on these management assessments, and also to determine compliance with applicable laws. The proposed legislation would preempt initiatives (including this exposure draft) already underway and would be costly to companies, shareholders and the general public.

The Foreign Corrupt Practices Act requires SEC registrants to maintain adequate internal controls. Generally accepted auditing standards also require auditor consideration of control environments. Further, a current SEC proposal requires statements of management's responsibility for and assessment of the internal control system, as well as responses to significant auditor recommendations. The proposed legislation would duplicate and disrupt this continuing progress. In addition, it would also result in increased audit fees and internal administrative costs with no commensurate benefits. A portion of these costs would be passed on to consumers, causing a deeper competitive disadvantage in global markets.

We are also concerned that the legislation may not prevent any future savings and loan type crises (one of its perceived benefits). The legislation primarily affects companies already regulated by the SEC, rather than extending SEC jurisdiction to all companies where there is a public interest in the entity's solvency and the reliability of its financial statements.

Union Pacific shares the concern for adequate internal controls. We support a management statement of responsibility for and assessment of internal controls in the annual report. However, we believe that current professional standards and the continuing private initiatives adequately address auditor responsibilities for review of internal controls and illegal acts. Therefore, we strongly object to any legislation extending auditor responsibilities to these areas.

WLF:alr
6/13/91
Attachment

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Responsibilities for Financial Statements

The accompanying financial statements, which consolidate the accounts of Union Pacific Corporation and subsidiary companies, have been prepared in conformity with generally accepted accounting principles.

The integrity and objectivity of data in these financial statements and accompanying notes, including estimates and judgments related to matters not concluded by year-end, are the responsibility of management as is all other information in this Annual Report. Management devotes ongoing attention to review and appraisal of its system of internal controls. This system is designed to provide reasonable assurance, at appropriate cost, that the Corporation's assets are protected, that transactions and events are recorded properly and that financial reports are reliable. The system is augmented by a staff of corporate traveling auditors supplemented by internal auditors in the subsidiary operating companies; careful attention to selection and development of qualified financial personnel; programs to further timely communication and monitoring of policies, standards and delegated authorities; and evaluation by independent public accountants during their audits of the annual financial statements.

The Audit Committee of the Board of Directors, composed entirely of outside directors as identified on page 46, meets regularly with financial management, the corporate auditors and the independent public accountants to review the work of each. The independent public accountants and corporate auditors have free access to the Audit Committee, without management representatives present, to discuss the results of their audits and their opinions on the adequacy of internal controls and the quality of financial reporting.

Drew Lewis

Chairman and Chief Executive Officer

L W Matthews

Senior Vice President-Finance

Charles E. Billingsley

Vice President and Controller

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Gerald A. White
Vice President
Finance

AIR PRODUCTS

12 June 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Sirs:

We appreciate the opportunity to comment on your exposure draft--"Internal Controls--Integrated Framework". Your efforts should benefit all parties interested in preventing control failures, including the worldwide business community in which Air Products participates as a major international supplier of industrial gases, cryogenic equipment, specialty and intermediate chemicals, and environmental and energy systems with consolidated annual sales approaching $3 billion.

We agree with the general direction and content of the exposure draft. However, we believe certain areas could be enhanced and others modified. These areas include Empowerment, Separate Control Evaluations, Information Systems and Management Reporting. Our detailed comments follow.

Areas of Agreement

We agree that people are the key to an effective control system. It cannot be overemphasized that people must have the highest levels of integrity, ethical values and competence for a control system to work. Without these, no control system is effective.

From a theoretical viewpoint, the definition of internal control is proper. However, this broadened view could have serious future implications. For example, this definition could be adopted by the Securities and Exchange Commission or become part of a law which requires an examination and report by a company's external auditors. The external auditors do not have the expertise to opine on a company's entire internal control system and the cost of such an effort could far exceed any benefits derived.

With one exception discussed later, we also agree with the components of internal control. Additionally, the various evaluation checklists and criteria for assessing internal control are very good and will be useful by companies in evaluating their systems on an ongoing basis.

Areas for Enhancement

Chapter 7, page 71, discusses "Assignment of Authority and Responsibility", i.e., Empowerment. We believe additional discussion is required in this area. Authority, accountability and responsibility are not interchangeable terms and each should be clearly defined. While authority to act and responsibility can be delegated, accountability is inherent in a given job definition and cannot be delegated. Ultimate accountability always resides with top management. Additionally, communication is more important under empowerment. Those who are empowered have a greater responsibility/obligation to communicate upward since top management is no longer in the day-to-day decision making process.

Areas of Disagreement

Chapter 4 recommends a combination of separate internal control evaluations and ongoing monitoring. We believe that separate evaluations are not a cost effective exercise for many companies. Self-assessment of internal control is a continuous process not a one-off project. Management generally knows if its objectives are being met. If integrity, ethical values and competence are in place, continuously monitored and assessed, there is no need for a separate evaluation. Separate evaluations may be appropriate for companies who do not regularly and continuously self-assess their control environment.

Information systems is listed as one of the nine components of internal control. We disagree. Information systems are part of the communication systems, not a separate element of internal control. They can be used to execute a strategy to meet company objectives, but they are not a criteria of internal control. It is apparent that the committee also struggled with including this element as evidenced by the discussion on page 108 regarding information systems linkage with other components. Such a discussion was not necessary for any of the other components of internal control.

Chapter 15 discusses the need for management reporting on internal control. We agree that providing interested parties some assurance concerning the existence of an effective control system is important. Our company's annual report includes a signed management letter addressing our accounting systems and related controls. There has been no pressure for increased reporting on internal control from our shareholders or other interested parties. Additionally, the report format recommended in the exposure draft could give interested parties an unwarranted level of assurance regarding the effectiveness of the company's control system. This would lead to unrealistic expectations and could cause a widening of the so-called expectations gap.

Thank you for consideration of these comments.

Sincerely,

G. A. White

6271V

James V. Phillips
Chief Administrative Officer

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BP AMERICA

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June 13, 1991

Robert L. May, Chairman
Committee of Sponsoring Organizations
of the Treadway Commission (COSO)
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Internal Control -- Integrated Framework

Dear Mr. May:

This letter presents the comments of BP America Inc., an indirect wholly owned subsidiary of The British Petroleum Company p.l.c. (BP), on the draft report entitled "Internal Control - Integrated Framework" (the "Exposure Draft").

BP America supports the COSO in its efforts to lead a private sector initiative to advance a framework for the understanding and implementation of internal controls. We support the principle that internal control should be viewed broadly, within the context of how a board of directors and management runs and controls an entity.

Our comments are, for the most part, intended to clarify certain aspects of the Exposure Draft. We are in substantial agreement with the overall focus of the report.

Managements' Report on Internal Controls

An entity's management is responsible for establishing and maintaining the entire (operations, financial reporting, and compliance with law and regulations) infrastructure of internal controls. This infrastructure should operate continuously and evolve, as necessary, to meet the changing internal control demands within the entity's operating environment.

Accordingly, management's report on an entity's internal controls should indicate management's responsibility for the effectiveness of this infrastructure. The report should confirm, to the best of management's knowledge and belief, that the financial statements present fairly all transactions, and that the company has complied with all significant governmental and regulatory reporting requirements. Many public companies have internal audit functions who review, for the audit committee of the board of directors, the efficacy of operational internal controls. Such functions and reporting relationships could be structured so as to provide relative independence. In cases in which there is an internal audit function, the report should indicate whether the infrastructure of internal controls has been assessed by the entity's internal audit department. The report should be signed by the entity's chief executive officer and by the chairman of the audit committee of the board of directors or, alternatively, by the chief internal auditor (but only if the chief internal auditor does not have primary reporting responsibility to the chief financial officer).

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The scope of the report of independent accountants, however, should be limited to controls over financial reporting. If, however, during the course of the independent accountant's examination of the financial statements and the internal control infrastructure, they become aware of material weaknesses in the non-financial internal controls, these reportable conditions should be reported to the audit committee of the board of directors.

Board of Directors

Based on the references to board of directors contained within the Exposure Draft, it is not clear whether the COSO regards as preferable a board of directors that has a majority of independent, outside members. The only references to "independence from management" are found on page 69 in the main text and on page C-6 of Exhibit C-2 Appendix C. However, even in Appendix C the supporting question number 1 on page C-13, which is intended to specifically elicit information to respond to the aforementioned item on Exhibit C-6, does not mention independence. Additionally, none of the remaining questions on page C-13 regarding boards of directors and audit committees specifically refers to independence. Also, we note that the illustrative questions for assessment of the adequacy of internal controls do not contain a reference to boards of directors' independence or outside members.

We believe that the report should clearly recommend that a majority of the members of the board of directors come from outside the company's management.

Definition

The Exposure Draft's description of components of internal control will assist in arriving at a practical definition that can be understood and implemented on a general basis. However, the specific components are grouped in such a way that may result in a lack of a clear definition. For example, in Chapter 1, on page 9, five components are highlighted as those from which internal control failures often result. Notwithstanding the Exposure Draft's assertion to the contrary, this implies that the other four components (Risk Assessment, Information Systems, Control Procedures and Monitoring) are not as equally important. The COSO should rechallenge its identification of the components into only those categories which are critical to the structure, and relegate the remaining components to subsets of the critical ones.

General Comments

Chapter 3 -- Roles and Responsibilities

Legislators and regulators initiate, amend, repeal and enforce laws that provide protection for investors and consumers. They must carry out this role responsibly by guarding against intrusive control over transactions that generally are best left to the dynamics of free markets and free people. For the most part, the Securities and Exchange Commission, along with various federal and state agencies have, in general, participated in a way that has offered protection to the public without impairing free market activities. Certain statements in the Exposure Draft, however, make distinct inferences that we believe go beyond reasonable oversight.

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The first paragraph appearing on page 30 states in part, "[legislators and regulators] establish rules that provide the impetus for management to ensure that internal control systems meet the requirements." The modifying term "minimum statutory/regulatory" should be inserted before the word "requirements." Otherwise, the tone suggests that an entity's management would see no merit in effective internal control apart from the efforts of legislators and regulators. This implication is inaccurate. In fact, there are many entities whose executives and staff are committed to internal control systems that exceed government mandated rules. This is enlightened business and good management practice. This message should not be lost in the Committee's conclusions.

Chapter 6 -- Integrity, Ethical Values and Competence

The last sentence of the first paragraph on page 61 should read: "For example, providing an essential product (petroleum, lumber or food) may necessitate some environmental change." The present wording is pejorative.

Chapter 8 -- Objectives

The Exposure Draft (page 83) indicates an entity's financial statements rest on a foundation consisting of five assertions supported by internal controls. These five assertions are identified in literature by the AICPA as existence or occurrence; completeness; rights and obligations; valuation or allocation; and presentation and disclosure. However, the supporting discussion of the five assertions fails to clearly state that amounts in financial statements are sometimes estimates and that management is responsible for developing appropriate processes of estimation that are verifiable. This point needs to be emphasized.

* * *

We are available to discuss further our comments and recommendations with the Committee.

Sincerely,

James V. Phillips

JVP:llc

cc: J. H. Ross
R. F. Chase
J. A. Rahilly
M. P. Bohan

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Mobil Corporation

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ROBERT C. MUSSER
CONTROLLER

June 13, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas - 6th Floor
New York, New York 10036-8775

INTERNAL CONTROL -
INTEGRATED FRAMEWORK

Dear Committee Members:

We are pleased to have the opportunity to comment on the subject exposure draft entitled "Internal Control - Integrated Framework" (the Report). It is very desirable, in our opinion, for the private sector to be taking this initiative. We are, however, concerned with the overly broad definition of internal control adopted in the draft. Unless the Report's scope and emphasis are substantially changed, we believe it has the potential, in the current environment, to do a significant disservice to the private sector.

In our opinion, the Report has obscured the line between internal controls and other tangentially related management practices, which the Treadway Commission identifies as the corporate control environment. We certainly agree with the Treadway Commission that "the overall corporate control environment, together with the internal accounting controls, comprise the internal controls that can prevent and detect fraudulent financial reporting."

However, by including the components of this corporate control environment in the internal control definition, the Report can potentially be misunderstood by non-audit/accounting laymen and result in unintended consequences. We therefore believe that the Report's definition of internal control should be narrowed to comprehend only the internal accounting and financial reporting control systems and mechanisms. We would suggest, therefore, a restructuring of the Report which would both change the emphasis and substantially shorten it.

DEFINITION AND COMPONENTS

This section of the Report should achieve its stated objectives of establishing a common definition of internal control. It should be a definition that can accommodate the viewpoints of all constituencies, including management, the auditing profession, and legislative bodies.

There can be honest debate on whether such elements as risk assessment, objectives setting, or managing change are internal control issues. Certainly, we at Mobil support and actively participate in each of these activities. However, it is considerably more precise and useful to view them as responsible management practices that provide a framework for an effectively operating internal control system.

This perspective will encourage acceptance of the Report by experienced and responsible managers, whereas the broader definition is likely to confuse those interested parties and impede acceptance of this important report. Furthermore, the broad definition invites broader regulatory intervention. There has been evidence of this tendency in the past.

The Foreign Corrupt Practices Act as enacted in 1977 included a revision in the Securities Exchange Act of 1934 to require all registrants to maintain a system of internal accounting control as defined in the auditing standards of that time. We see a danger that, if the Report's broad definition of internal control is adopted, it may affect the interpretation of the current 1934 Act definition. If the private sector offers a ready-made definition, the regulator or the courts, or both, are likely to take it up, as given. Codification of the broad definition used in the Report would inappropriately limit management discretion and burden industry with unnecessary and otherwise avoidable compliance standards.

Consequently, we believe it desirable the Report be restructured and the definition of internal control revised to include only internal accounting and financial reporting controls. It should be divided into two major sections - Financial Reporting Controls and Supportive Management Practices.

Financial Reporting Controls

This first section should be the primary focus of the Committee. The definition of internal control would be primarily those controls that are normally identified as "internal accounting controls" and would include such elements as competence and integrity, segregation of duties, execution of duties within authorized scope and limits, accuracy and timeliness in recording transactions, limiting access to assets, and monitoring compliance with policies and procedures. We believe that a definition including these elements would be widely accepted. We would add to the definition an element that would include reasonable assurance that there are no known violations of laws or regulations that materially affect the financial statements or are not disclosed in the notes to these statements.

Supportive Management Practices

This part of the Report should be characterized as part of the environment necessary to support effective financial reporting controls. While management practices should not be considered as internal control processes, they contribute to an effective control system. Effective management practices would include risk assessment, objectives setting (including compliance with laws and regulation), and managing change. The Report should be very clear that these practices are different among different companies and industries. They involve discretionary management decision making and therefore are not amenable to the application of codified compliance standards.

Excluding management practices from the definition of internal control, but recognizing their necessity will encourage a wider acceptance of the Committee's conclusions. Also, emphasizing that these practices require business judgment and are subjective will help legislators and regulatory bodies better understand the elusive concepts of internal control.

MANAGEMENT REPORT

The objective of this section of the Report should be to provide an understanding of the purpose of management's reporting to external parties and why management's report can only address financial reporting controls.

We strongly endorse the Committee's recommendation that the management report only address financial reporting controls. If the definition of internal controls is revised as we suggested, it will be much easier to support this position.

The language in the proposed management report tends to be confusing because the scope of the report is not identified until the last sentence. Reference to the components of internal control should be eliminated. We think that the report should be similar to the SEC's proposed amendment to Title 17, Chapter II of the Code of Federal Regulations (see Attachment).

Finally, we suggest the Committee explain why the management report covers only financial reporting controls. This should also be easier under our suggested revised definition. At a minimum, we recommend that you discuss the following:

- There are thousands of complex laws and regulations, both U.S. and foreign, that would be impossible to report compliance with. Therefore, industry, on a practical basis, can only report on compliance where a material adverse impact on the financial statements is involved.

- Many U.S. rules are implemented via regulations issued years after enactment with retroactive effect, which makes concurrent compliance impossible.

- The identification of those laws and regulations requiring compliance would have to be defined, because some countries' laws cannot be complied with by U.S. companies (e.g., boycott laws).

- Controls over operations vary with the type of business, by industry and with specific entities and management practices. Measurement standards that would be appropriate for all entities and situations cannot be developed.

CONCLUSION

In conclusion, we see the definition of internal control contained in the Report to be impractically, and in a sense, dangerously broad. We suggest it should be limited to financial reporting controls, as we have defined them. We agree that all of the components discussed in the report are necessary for effective management. However, we would not characterize all of them as internal control components in a document that may be used as a basis to enact legislation. The Committee would better serve its constituency by being sensitive to this environment and not approach the topic with the same conceptual objectives as might be involved in developing a textbook on internal controls.

Very truly yours,

Bob Musser

Robert C. Musser

Attachment

Title 17, Chapter II of the Code of Federal Regulation is proposed by the SEC to be amended as follows:

229.703. (Item 703) Report on management's responsibilities.

(a) Financial information. Furnish a description or statement of management's responsibilities for the preparation of the registrant's financial statements in accordance with generally accepted accounting principles, the determination of the estimates and judgments used therein, and the preparation of other financial information included in a document containing the registrant's financial statements.

(b) Internal control system. Furnish a description or statement of management's responsibilities for establishing and maintaining a system of internal control directly related to, and designed to provide reasonable assurance as to the integrity and reliability of, financial reporting. Include an assessment as of the registrant's most recent fiscal year end of the effectiveness of the registrant's system of internal control that encompasses material matters, and state how management has responded to any significant recommendations concerning the system of internal control made by its internal auditors (or those performing an equivalent function) and independent accountants.

(c) Signatures. The report required by paragraphs (a) and (b) of this section shall be signed on the behalf of the registrant by its principal executive officer or officers, its principal financial officer, and its controller or principal accounting officer.

Instruction. When furnishing its report, management may include other information it considers appropriate. In making its assessment of the effectiveness of the system of internal control, management must consider any information necessary to prevent its report from being misleading. This includes information coming to management's attention subsequent to year end but prior to the date of the filing of the report with the Commission or distribution to security holders.

Frederick W. Burford
Vice President
Treasurer and Controller

PROMUS
COMPANIES

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People Pledged to Excellence

Harrah's
Embassy Suites, Inc.
Hampton Inns, Inc.
Homewood Suites, Inc.

June 13, 1991

Committee of Sponsoring Organizations
of Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Gentlemen:

This letter is in response to your exposure draft entitled Internal Control - Integrated Framework.

Definition of Internal Control. The definition is broad and I believe it properly defines the way in which well managed companies operate. It is through the management process that objectives are set and results are monitored and evaluated. There should be a clear distinction between financial controls and the management control process. Without this distinction the definition is too broad and confusing. Perhaps the exposure draft should be titled The Management Control Process - Integrated Framework to reflect its broader scope.

Reporting Controls vs. Operating and Compliance Controls. This document should take a strong position on why it is inappropriate to report on controls over operations and over compliance with laws and regulations. If this is not addressed in the final document, the regulators and legislators could use this document as a basis for requiring expanded reporting and auditing of public companies. This would be extremely expensive to companies and therefore its owners. It would take away from management's time for running the business (which is what the owners expect from management) to comply with regulators and it would increase the audit scope and therefore the audit expense.

There is a wide body of literature that provides specific guidance to the auditors for evaluating and reporting on financial controls, but not on the broader internal control definition used in the document. The auditor is not trained for a broader role and there is little established criteria for reporting on controls over operations and compliance with laws and regulations. Furthermore to evaluate the effectiveness of the objective setting process, to assess the ability of the company's management to respond to change, to determine management's ability to assess business risk, and to a lesser extent analyze the other components of internal control as defined in the exposure draft, would require the auditors to have more insight into business operations than can be reasonably expected.

After all, the financial statements and the related footnotes are the report card for the operating results. Further the regulators do a thorough job of monitoring non-compliance with laws and regulations, and through assessing the need for disclosure under SFAS No. 5, liabilities for non-compliance with laws and regulations are reviewed on a regular basis by management and the external auditor. Auditors are trained in evaluating financial controls and in this role add value.

Components of a Control System. The nine components of the internal control definition do not make the distinction between the components of financial control and the components of compliance and operating controls. SAF No. 55 defines the elements of financial control and discusses the assessment of control risk. Management, investors, and auditors are familiar with these definitions and procedures which are effective when properly utilized. Therefore they should not be changed and should be reaffirmed in this document to emphasize the distinction between financial controls and the broader concept of management controls.

Reporting to External Parties. It is appropriate for management to take responsibility for the financial statements and to report same to the investors. However, it is inappropriate for management to report on compliance and operating controls. The management control process is important to running the business but is not the main concern of an investor. An investor is concerned that adequate control procedures are in place to allow the auditor to give reasonable assurance as to the fair presentation of the financial statements and with the business prospects outlined in management's discussion of the business. The most effective control system cannot compensate for poor management strategy and decision making nor will reporting on internal controls give insight into the future prospects of the company.

By having a separate chapter on this topic, too much emphasis is placed on public reporting on internal control. The Management Reporting to External Parties chapter should be modified to emphasize public reporting on financial controls and be placed as an appendix to the document. This appendix would provide useful guidance to companies that are not currently reporting on financial controls. This placement would reduce the risk that legislators and regulators might use this guidance to mandate management reporting on compliance and operating controls without understanding the cost and usefulness.

Conclusion. The document was structured broad enough to encompass the management control practices which are essential to operating a successful business. In its current form the document can only be used by the most sophisticated professional. It needs to be modified for use by the less sophisticated manager.

I strongly urge you to refocus the document to make it a useful tool for all businesses, especially those where management has not been trained in sound business practices, and to eliminate the risk that business will be burdened with another set of rules and regulations.

Thank you for the opportunity to provide comments for your consideration. Please let me know if I can provide any additional detail on the comments.

Sincerely,

Frederick W. Burford

Frederick W. Burford

FWB/jhf

cc: C.A. Ledsinger
E.A. Minbiole

ITT

ITT Corporation

World Headquarters

Raymond H. Alleman
Senior Vice President
and Controller

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June 14, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas - Sixth Floor
New York, NY 10036-8775

Subject: Exposure Draft: Internal Control - Integrated Framework

The Committee did an extraordinarily thorough job of reviewing and organizing concepts and points-of-view concerning internal control. The Exposure Draft (ED) provides a comprehensive discussion of important control issues; the final report can become a valuable reference, particularly for internal control measures under discussion by regulators and Congress. Discussions in the ED of the reasonable-assurance and prudent-person concepts are authoritative reminders of the practical limits of proper controls.

Our recommendations on specific aspects of the Committee's proposal are described in the following sections:

I Overall Views

The ED provides a broad definition of internal controls, covering almost all of the management function, with a supporting framework that reflects this broad definition. We believe that the broad scope pushes the concept of internal control beyond practical boundaries, and would lead to evaluating controls through attributes that can only be assessed subjectively.

It is important that the final report include a process that is workable, both because of the need for objective affirmation that controls are in place, and because the report could have an important influence on legislation or regulation that may be proposed. We recommend, therefore, that the definition be narrowed, and linked with a brief explanation of the principal aspects of control to form a framework that is definitive, but flexible enough to fit the characteristics of individual entities.

... Continued

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II Recommendations

A. Definition - The essence of the definition of internal control in the ED is "... the process ... (to) obtain reasonable assurance as to achievement of specified objectives." Attesting or affirming such a broad concept would be difficult and costly. We recommend this definition for internal controls:

> Internal control is the process that provides reasonable assurance that assets are safeguarded, that transactions are executed in accordance with management's authorization and are properly recorded, and that financial records are accurate.

B. Components of Internal Control -- We recommend that the internal control framework include these five components: control environment, risk assessment (applicable to controls, not to the general business risks described in the ED), control procedures, communications, and monitoring. Our recommendation eliminates four components that were included in the ED's "nine components":

- Objectives (applicable to general management).
- Managing change (include in the "control environment" component).
- Integrity, ethical values, and competence (these are essential responsibilities of management; internal controls, however, must be designed to handle the values and countervailing pressures that exist -- for control systems, these values and attributes should be considered part of the "control environment").
- Information Systems (not a stand-alone component -- part of "monitoring" and "communication" components).

C. Evaluation Tools -- The ED includes one hundred and sixty-eight pages of points-of-focus, questions, and an illustrative reference manual and filled-in evaluation. The concept of evaluation tools has useful application at the entity level, but it is virtually impossible for the Committee's report to include more than a broad illustration of the evaluation process, because entities' circumstances vary so broadly. We recommend that the tools be narrowed to the definition of internal control cited in this letter, and that they be presented separately, simply as an illustration, not authoritative guidance.

D. Management Reports on Internal Controls -- The coverage in the ED is useful because it clarifies that the management report should cover only internal controls over the preparation of published financial statements -- a much narrower scope than used in the rest of the ED. The ED is helpful also in noting that public management reporting on internal control is not a component of, or a criterion for, effective internal control. We recommend brief coverage of management reports in the Committee's final document, only to make the points just cited. The Committee's report should refer to recommendations in the Treadway Commission's Report, which provided a more complete format for the management report than the example in the ED.

RH Alleman

R. H. Alleman

RHA:MRA

BELLSOUTH

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June 14, 1991

Committee of Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas
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Ladies and Gentlemen:

BellSouth supports both the intent and the effort placed in the exposure draft of Internal Control - Integrated Framework dated March 12, 1991. Internal control should be evaluated consistently throughout an entity. BellSouth is in favor of having management acknowledge its responsibility for both the financial statements and the company's internal control structure as well as assessment of the effectiveness of the internal controls. Self-assessment is the most economical and effective means of internal control evaluation. We agree that the five components listed on page eight are essential in preventing internal control failures. Chapter three appropriately specifies that management has the direct responsibility for the internal control system.

This document needs to be useful to management in performing the evaluations necessary to monitor these internal controls. In our opinion, an evaluation based on these guidelines, either internally or externally, would not add value to either an entity's management or its owners/shareholders. We have four major concerns with the framework as described in this exposure draft: the lack of relating controls to business risk, the inability to meet the needs of the modern business entity, its structure is impractical for effective internal control evaluation, and its ultimate use.

Relationship of Controls to Business Risk

Internal controls are needed and should be designed to minimize business risks. Risks must be identified prior to developing internal controls and, as a result, risk is not a component within the internal control process. This draft assumes that an existing internal control system will meet business needs indefinitely by the mere fact that controls are present. However, control systems must be a product of relevant risk assessment in order to be effective. Many savings and loans, for example, failed because they were not able to relate the controls they had in place to the business risks involved.

Without understanding the relationship of business risks to controls, there is no way to measure the effectiveness of controls. For example, safeguarding of cash is an objective of processing funds. The risk that funds will be lost prior to recording, such as coin telephone collections, warrants costly investments in physical security of vehicles and counting centers. This investment, essential to effective control for this process, would not be appropriate unless loss of unrecorded funds was a major risk.

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Modern Business Entity Needs

Today's businesses cannot separate manual from programmed procedures in an effective evaluation of internal controls. Since information systems represent programmed procedures, they should not be an independent component. Therefore, to meet the needs of the modern business entity, we recommend integrating manual procedures with programmed procedures for an effective internal control evaluation at the application level. Input can be both electronically transmitted and manually keyed for the same control system. On-line edits are not effective if computer operators do not respond properly. Computer reports are ineffective if the people do not respond to the information presented. Many of our employees cannot perform their jobs without interacting with a mechanized system throughout the day.

Practical Evaluation of Internal Control

We believe this exposure draft will be ineffective for internal control evaluation for several reasons. First, strict adherence and reporting to the guideline would not be a viable alternative to the approach BellSouth has already adopted. In 1989, BellSouth adopted a methodology from Coopers & Lybrand which is in direct opposition to the use of checklists and the separate evaluation of programmed and manual procedures. Our approach is two-fold:

1) the linkage between significant business risk and an entity's internal control environment and

2) a control theory which evaluates internal control systems regardless of the level of mechanization in a particular function.

BellSouth Internal Auditing has adopted this approach to audit all systems, regardless of the level of mechanization. Additionally, groups of operational personnel are also using these concepts to design internal control systems.

Second, responses to many questions listed in the appendices could be impeded. Some areas of the checklist (e.g. integrity, ethical values, control environment, communication, and managing change and monitoring) contain questions which do not lead to the identification of evidence needed to support a negative response. For example, violations of the "right thing" and "cutting corners" as noted on page C-8 cannot be objectively determined. Proving the existence or impact of a manager's "hidden agendas" as suggested on page C-22 may require extensive investigation.

In addition, these components are very subjective and difficult to substantiate as proposed in the exposure draft. It is ineffective for internal personnel and/or external auditors to evaluate the competency and integrity of upper management without appropriate support. As discussed in the draft, upper management plays a key role in setting the "tone" for the organization. Once that tone is set, evaluations must be made based upon identifiable weaknesses or it is one person's word against another's.

Third, it is not practical for management to use the draft in its present structure. A more concise edition would encourage greater use by operating managers who might not understand the importance of studying over 340 pages on internal control. The suggestions noted in the last 169 pages need to be streamlined for effective and consistent use throughout a business entity of any size.

BellSouth agrees with the purpose and principles included in this document. However, we cannot support this draft unless the evaluation process is strengthened. This can be accomplished with three changes. First, the definition of internal control noted on page 50 must be expanded to include identification of risks in achieving the entity's objectives. To be effective, the actions taken minimize these risks within acceptable bounds. Second, the evaluation process should be designed to examine the effectiveness of manual and programmed procedures working together for each business system to reduce these risks. Finally, the checklist approach must be replaced with a dynamic thought process that will apply in every business system. Management reports on internal control without an effective evaluation process would be of no value.

We recommend the use of effective methods already implemented to obtain the evaluation process. Responses to this exposure draft indicating measurable systems in place should be tested in other entities. The strengths of each approach can be combined with the foundation outlined in this draft into an effective evaluation process.

Our approach to control evaluation has enabled operating management to improve the quality of the internal control systems designed and to focus on true business risk. Under this approach, internal auditors have been able to improve the quality of recommendations to management and focus substantive testing on critical high risk areas. On the enclosed attachment are our replies to the specific matters for comment as requested on pages 2-3 of the exposure draft. We have responded by listing the terms and concepts we have found effective during the last three years. Feel free to contact us for more detailed information.

Ultimate Use of Framework

Recent legislative efforts proposed that an assessment of internal control by external auditors be required. We agree that an assessment of internal control based on standard guidelines is needed. BellSouth believes that a self-assessment based on this framework, which incorporates the aforementioned changes, with possible attestation of management's assessment by external auditors would be a more effective and efficient alternative. This alternative would satisfy the need for additional legislation and is consistent with the Security and Exchange Commission's support of management's reporting on internal control. This method would also be less burdensome on smaller entities who may not have a large internal auditing department.

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If you have any questions or comments regarding our response please call Pat Casey (404-249-2900) or Vic Jarvis (404-249-3150).

Sincerely,

Patrick H. Casey
Vice President & Comptroller

V.E. Jarvis
Assistant Vice President
Chief Corporate Auditor

Attachment

BellSouth Replies to Specific Issues

Definition of Internal Control

The draft states that operations, financial reporting, and compliance are the three categories of control objectives. The internal controls which operate the business contain substantial risk which requires more focus than this draft suggests. Financial institutions failed because of the lack of controls regarding which loans were granted. The failures were not prevented by complying with the various regulatory authorities or accurately reporting the reserve balances.

We use the categories listed in Standard 300 of the <u>Standards of Professional Practice of Internal Auditing</u>. These categories expand financial reporting to include all processing and reporting of information and separate operations into safeguarding of assets, economical and efficient use of resources, and accomplishment of established objectives and goals for operations or programs. Failure to minimize the risks in any of these three operating categories can bring financial ruin regardless of the financial controls. Their importance to operations along with the distinct differences involved warrant individual categories.

Once business risks have been established, all significant information which needs to be controlled should be identified in order to minimize those risks. Therefore, we would alter the proposed definition of internal control to reflect the objective of internal control. This objective is to reduce or eliminate identified business risks:

> Internal control is the process by which an entity's board of directors, management and/or other personnel obtain reasonable assurance as to the achievement of specified objectives. Internal control is defined as a system of manual and programmed procedures working together to minimize business risks. The performance of these procedures should reduce risks identified under one or more of the five specified business objective categories.

This definition allows unbiased measurement. All significant information has or has not been identified. Procedures controlling this information do or do not minimize business risk within acceptable bounds. Procedures are or are not being performed as designed. (These acceptable bounds are determined based on cost benefit. Material weakness is based on a financial concept that is neither understood or appropriate in operational environments.)

Components of Internal Control

Based on the changes to the concept and definition of internal control noted above, objectives and risk assessment should be removed from the nine components. These components represent the basis needed prior to designing specific systems of internal controls. As previously mentioned, information systems represents the programmed procedures and should be combined with manual control procedures to form one component. The remaining components represent general controls over manual procedures. The relationship and impact of these general controls to the application's manual procedures are not developed. Another necessary component is the general controls over the programmed procedures. The significance of these omissions impacts the evaluation of internal control as discussed below.

Evaluation of Internal Control

The structure of the components noted in the draft does not facilitate evaluation of internal control. The purpose of evaluation is to determine if there are procedures in place (any combination of manual or programmed) which minimize the business risk such that management, owners/stockholders, etc. can be reasonably assured that business objectives will be met. This evaluation involves a duo-focus. First, procedures that are actually being performed today (application controls) must be evaluated. Second, the likelihood that the procedures evaluated will be performed consistently (general controls) through time must be evaluated.

The application controls we use are completeness of input and update, accuracy of input and update, authorization, continuity and timeliness. BellSouth has taken these application control objectives originally designed for information systems and redefined the concepts to include compliance with policies and plans, safeguarding of assets, efficient and effective use of resources, and accomplishment of management's objectives as well as reliability and integrity of information. Our internal audits measure the effectiveness of both the manual and programmed procedures in each control system to minimize the risks in each of the five control categories.

The general controls over programmed procedures used at BellSouth are program implementation, computer operations, physical security, software security, data security and program security. The general controls over manual procedures are organization structure, policies and procedures, segregation of duties, supervision and review, and staff training. The general controls measure the level of reliance that can be placed on the results of the application control evaluations through time. Manual procedures are performed consistently when staff training, supervision, etc. are adequate.

Programmed procedures perform consistently if software is adequately installed, program changes are properly implemented, etc. In our evaluations of control systems, general controls which control the manual and programmed procedures in the application are evaluated separately. The results of both application and general control evaluations for each control objective are combined to determine overall adequacy of the control system.

Management Reporting to External Parties

BellSouth believes the management reporting guidance given can be helpful and completes the assessment process. This information does not add value for BellSouth since our reporting process to external parties is well developed. BellSouth has had internal controls and procedures in place to provide reasonable assurance that our financial statements are in conformity with generally accepted accounting principles since our incorporation in 1983.

BellSouth includes a management report in its annual report to shareholders. Our management report is in compliance with both the National Commission of Fraudulent Financial Reporting ("Treadway Commission") recommendations and the Securities and Exchange Commission's ("SEC") proposed Item 703 of Regulation S-K. It describes management's responsibilities for the preparation of the financial statements and other information, management's responsibilities for the system of internal control and management's assessment of its effectiveness. The report is signed by both our Chief Executive Officer and our Principle Accounting Officer.

BellSouth believes most SEC registrants' reports include this same information as well and that the guidelines provided just reiterate what is already in practice through the recommendations of the Treadway Commission and the SEC.

ERNST & YOUNG

■ 2000 National City Center
Cleveland, Ohio 44114

■ Phone: 216 861 5000

June 12, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
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New York, New York 10036-8775

Exposure Draft on Internal Control—Integrated Framework

We are pleased to provide our comments on the exposure draft (ED), *Internal Control—Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Following are our more significant comments on the ED.

- We commend this private-sector initiative and believe it goes a long way toward achieving the objective of the Treadway Commission recommendation — private sector development of a common definition of internal control that can be used by operating and financial management, internal and external auditors, audit committees, investors, regulators, and others.
- We believe the internal control criteria provide a reasonable framework for organizations to use to evaluate the effectiveness of internal controls and to report publicly on the effectiveness of controls over financial reporting if they choose to do so or if required to do so by legislative or regulatory action. The ED observes that many existing management reports discuss what the system is designed to do, but do not clearly say whether the system is operating effectively. We agree with the recommendation that management reports, if issued, should address effectiveness. We also believe the proposed framework would be appropriate for auditor reporting on management reports should that be required by legislative or regulatory action.
- The ED correctly points out that public reporting is only appropriate for reporting on controls over financial reporting, and is not appropriate for controls over compliance with laws and regulations or over operations. We believe the final COSO report should expand its discussion on the rationale for this so that legislators and regulators do not inappropriately seek management reporting on controls over compliance with laws and regulations or over operations.

The remainder of this letter provides our views on the four broad issues on which COSO requested specific comments.

Definition of Internal Control

We agree with the broad definition of internal control — to cover the management control process — because it is the most efficient way for management to design and implement controls that are important to their business. We believe this generally is how management views internal controls and it enables the development of integrated control systems that accomplish multiple objectives of an organization. It also has the positive effect of bringing operating personnel into the internal control process.

Evaluation Methods and Techniques

Recognizing the Different Sources of Information Affecting Account Balances

We believe the final report would be improved if additional emphasis were given to the different characteristics and related risks inherent in the different sources of information that affect financial information and how management can respond to such risks. The accumulation and recording of financial information is affected by sources of information with different characteristics as follows:

- *Accounting estimation processes* reflect the numerous judgments, decisions, and choices made in preparing the financial statements. Examples include estimating the allowance for doubtful accounts, the allowance for loan losses, and warranty reserves.
- *Routine data processes* are the accounting applications that process detailed information about frequently occurring transactions. For example, in a manufacturing company, routine data processes would include accounting applications, including relevant portions of information systems for sales and accounts receivable, cash receipts, purchasing and accounts payable, cash disbursements, payroll, and inventory and cost of sales.
- *Non-routine data processes* are less frequently applied processes used in conjunction with the preparation of the financial statements. Examples include counting and pricing physical inventories and calculating income tax expense.

Routine data processes generally are subject to more formalized controls because of the volume of the information processed. Because estimation processes and non-routine data processes are performed less often, and estimation processes are affected significantly by judgment, the risk of error often is greater. These processes may have controls but they are usually not at the same level of formality and often are influenced significantly by the control environment.

Smaller Organizations

We also believe the final report should discuss issues specific to documentation and evaluation of internal controls by smaller organizations and include appropriate implementation tools in the appendix.

Documentation

The last section of Part 3 of the ED relative to documentation should specifically mention that, in addition to the material included in Exhibit C, other forms of documentation (narratives, flowcharts, checklists, policy manuals) are equally acceptable consistent with the complexity, size, and diversity of the organization.

Management Reports

Scope of Management Report

We believe the final report should expand on the discussion of why public reporting on controls over compliance with laws and regulations and over operations is inappropriate. Our concern is that legislators or regulators could inappropriately seek management reporting on controls over compliance with all laws and regulations and over operations without understanding the subjectivity of and costs associated with management reporting publicly on such controls.

Evaluating and reporting on controls over financial reporting are well developed. There is agreement on the objectives (that is, the financial statement assertions) and the criteria for evaluating their achievement is accepted (that is, the concept of material weakness). As a result, criteria related to financial reporting controls provide consistent measurement and comparison among different organizations.

Unlike the criteria related to financial reporting controls, the criteria for controls over compliance with laws and regulations and over operations are not developed. Also undeveloped is how the concept of material weaknesses could be adapted to apply to compliance and operations objectives. In addition, there are other reasons why it is not appropriate to publicly report on internal controls over compliance with laws and regulations and operations that are unique to each of these areas as discussed below.

- *Controls Over Compliance with Laws and Regulations* — The number and complexity of laws and regulations to which organizations are subject make it extremely difficult to establish criteria that would provide for consistent measurement and meaningful reporting. In addition, how the concept of reasonable assurance — rather than absolute assurance — would be applied to controls over compliance with laws and regulations is not developed.

For these reasons, we do not believe public reporting on controls over compliance with all laws and regulations is appropriate.

- *Controls Over Operations* — Management is responsible for establishing objectives over operations which are necessarily entity specific. As a result, there are no criteria to provide for consistent measurement among entities. Therefore, although important for management to address on an entity-by-entity basis, public reporting by management on controls over operations would not be meaningful.

Contents of Management Reports

The ED's guidelines for the contents of management reports should increase the consistency of management reports, if issued, and thus enhance reader understanding. We believe that, in addition to those items specifically called for in the ED, the management report should include the following information:

- A discussion of management's responsibility for the preparation of the financial statements, including the other financial information included in the annual report, and how such information has been prepared.
- Identification of whether the report covers controls over the preparation of annual financial statements or both annual and interim financial statements (see discussion below under *Interim Financial Information*).
- More specific language to ensure that readers understand that management's opinion on effectiveness is in the context of the system of internal control providing reasonable assurance that the financial statements are free of material misstatement.

The appendix to this letter includes an illustrative management report that includes the items called for in the ED plus the additional items listed above that we believe also would improve upon communications in the management report.

Point-in-Time Reporting

We agree that management's report on internal controls should be as of a point-in-time. However, we believe that a material weakness that existed at year end but is corrected and sufficiently tested by management (see following paragraph) prior to the issuance of the management report need not be reported.

Also, we believe the final report should clarify that any changes in controls to correct an ineffective internal control system must be sufficiently tested before management can conclude in a report as of a point-in-time that controls are effective.

Interim Financial Information

The ED points out that it is not necessary to explicitly state in the internal control report that the interim reporting process is covered. We disagree. We believe management's report should clearly state if the internal control process over interim financial information is covered. And we believe it is appropriate for the management report to address internal controls over the preparation of interim financial information only if the document that contains management's report (for example, the annual shareholders report) includes the interim financial information.

Number of Internal Control Components

When evaluating controls over financial reporting, it often may be more efficient for companies to combine some of the identified internal control components. Internal and external auditors as well as management have been evaluating internal control following the three internal control structure elements — control environment, accounting system, and control procedures — set forth in Statement of Auditing Standards No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. We do not believe the internal control framework included in the ED should necessarily change that.

We believe that the integrity, ethical values, and competence component is so integral to the control environment component that the two components should be combined. We believe that objective setting and risk assessment, while integral to the process of designing internal controls and evaluating their effectiveness, are not really internal control components. Instead, objectives are the basis of what is being evaluated for purposes of assessing risk and determining the controls necessary to reduce identified risks. While objectives are essential to the process and need to be considered, they are not a criterion for effective internal controls. Similarly, risk assessment relates to the process of identifying potential errors in relation to established objectives so that appropriate controls can be put in place that will prevent or detect material errors.

We also believe there is confusion in the ED about whether all nine components need to be achieved in order to conclude that controls are effective. We believe it should be clear that the evaluation of the effectiveness of internal controls is based on whether reasonable assurance exists that the criteria in the aggregate provide for the achievement of the objectives (that is, prevention or timely detection of errors that could be material to the financial statements). This confusion also would be further minimized by combining the components as discussed above.

* * * * *

We would be pleased to discuss our comments with members of the Committee.

Very truly yours,

Ernst + Young

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Appendix—Illustrative Management Report on Financial Reporting

This illustrative management report incorporates the items called for in the ED plus the additional items (identified by italics) we believe improve upon communications as discussed on page 4 of this letter under *Contents of Management Reports*. In addition, the sample report in the ED includes a list of the nine internal control components; we do not believe it is necessary to include this list and have omitted this in our illustrative report.

Report of Management

The management of ABC Company and its subsidiaries has the responsibility for preparing the accompanying financial statements and for their integrity and objectivity. The statements, which include amounts that are based on management's best estimates and judgments, have been prepared in conformity with generally accepted accounting principles and are free of material misstatement. Management also prepared the other information in the annual report and is responsible for its accuracy and consistency with the financial statements.

Management of ABC Company maintains a system of internal control over the preparation of its published *annual* [*and interim*] financial statements. It should be recognized that even an effective internal control system, no matter how well designed, can provide only reasonable assurance with respect to the preparation of reliable financial statements; further, because of changes in conditions, internal control system effectiveness may vary over time.

Management assessed the Company's system of internal control in relation to criteria for effective internal control *over the preparation of its published annual* [*and interim*] *financial statements* developed by the Committee of Sponsoring Organizations of the Treadway Commission. Based on its assessment, it is management's opinion that its system of internal control as of December 31, 19X2 is effective *in providing reasonable assurance that its* published *annual* [*and interim*] financial statements *are free of material misstatement.*

Chief Executive Officer

Chief Financial Officer

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

June 20, 1991

To: **Richard M. Steinberg, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Auditors
Louis Bisgay, National Association of Accountants

Gentlemen:

Attached is the tenth batch of comment letters containging sixteen responses on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Tom
jmy

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

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SunTrust

William P. O'Halloran
Senior Vice President
and Controller

SunTrust Banks, Inc.
Post Office Box 4418
Atlanta, Georgia 30302

June 3, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
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New York, New York 10036-8775

Gentlemen,

SunTrust Banks, Inc. appreciates the opportunity to comment on Internal Control - Integrated Framework (the Document), the product of the Internal Control Research Project sponsored by COSO. SunTrust, with assets of $33 billion, is a bank holding company with extensive operations throughout Florida, Georgia and Tennessee.

We believe the Document is an outstanding treatise on the subject of Internal Control. It can provide valuable guidance and will provoke creative thinking on the part of management as controls are established or evaluated. At the same time, we have a significant concern about seeking public comment on the Document, the product of a research project. Our concern stems from our belief that public exposure is normally associated with due process and due process is associated with standard setting. As mentioned, we believe the Document provides much useful guidance but also firmly believe it would be totally unsuitable as a standard. We are not aware of any action on the part of the AICPA or any other group to make the Document a standard. However, we are aware of comments from accounting professionals, politicians and others urging the AICPA to have a standard on internal control in place against which auditors can measure and render opinions on their clients' internal control.

The Treadway Commission recommended its sponsoring organizations cooperate in developing guidance on internal control. The Document fulfills that recommendation. We believe the Document should be accepted for what it is, the product of research. Detailed comments and alternative opinions are inappropriate unless given within the context of a formal standard setting process. If in the future, action is taken by the AICPA or others to adopt the Document as a standard, we will at that time provide detailed comments on why we believe the Document is unsuitable.

Very truly yours,

W. P. O'Halloran

ONTARIO
BLUE CROSS

150 Ferrand Drive, Don Mills (Toronto), Ontario M3C 1H6 Tel: 416-429-2661 Fax: 416-429-0105

June 5, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, New York
10036-8775 U.S.A.

Dear Sirs:

As a follow-up to the suggestions in your **Integral Control - Integrated Framework - Exposure Draft, March 12, 1991**, the Finance Department of Ontario Blue Cross is pleased to provide commentary on this document.

We have organized our response into general comments, and specific comments related to: (a) Definition, (b) Components, (c) Evaluation and (d) Management Reporting to External Parties.

General Comments:

Links to Strategic Management:

As the document highlights, most individuals generally view Internal Controls from an operational perspective and relate Internal Controls in the narrowest sense, to accounting controls. In our opinion, the model which is described in this document presents the components from a Strategic Management perspective and therefore goes well beyond just accounting and safeguarding controls.

Recently the Senior Finance Team within Ontario Blue Cross has been engaged in the exploration of new approaches to Strategic Management. The model which is represented here (developed by Strategic Decision Group of California) clearly illustrates the components of Strategic Management and consists of: Strategic Development, Change Management, and Operations Management. The model reflects the importance of leadership as the glue which binds and strengthens all of these aspects.

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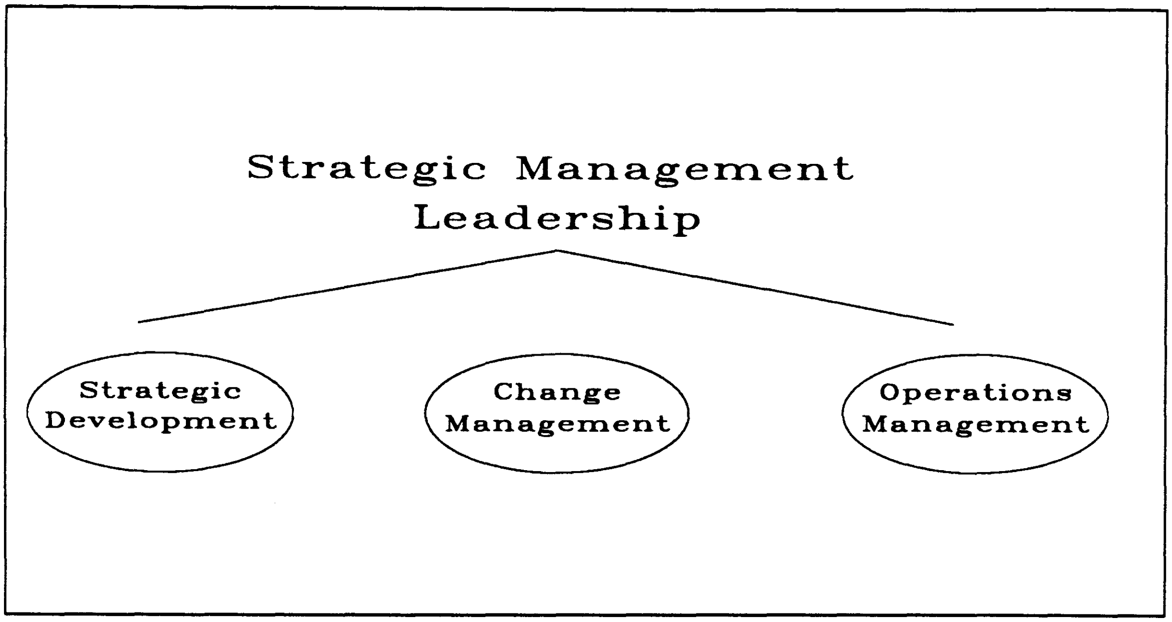

The Strategic Decision Group defines strategy development *as an assessment of the current business situation, and its environment, identification of alternatives, evaluation of actions based on possible outcomes as well as an assessment of risk.*

The final step in this process includes the selection of a strategy to follow as well as the identification of the necessary steps to manage the change and activate the initiative in operations.

From our perspective the **Internal Control - Integrated Framework** is built on a number of similar concepts. It is also important to note that the Strategic Decision Group believes that a complete strategy includes an effective project plan consisting of a specific objective, key activities, milestones, and a budget.

Link Internal Control to Strategic Management

This framework also includes as an element of Operations Management, the development of policies and procedures which are defined as *"the documentation of the good business decisions made in the past for reference purposes".*

Many organizations today are both functional and hierarchical in form. The implementation of the approaches as advocated in the internal control framework correspond with the need to develop initiatives which cross these functional boundaries and therefore create impacts at the entity level.

This frame of reference describes how the Internal Control Concepts can be "Built-In" as part of the management process as opposed to "Built-On".

We recommend that the Internal Control Framework be modified to clearly explain the linkage with the organization's Strategic Management process. By doing this an organization ensures that fundamental internal control objectives become integrated and entrenched into the fabric of an organization.

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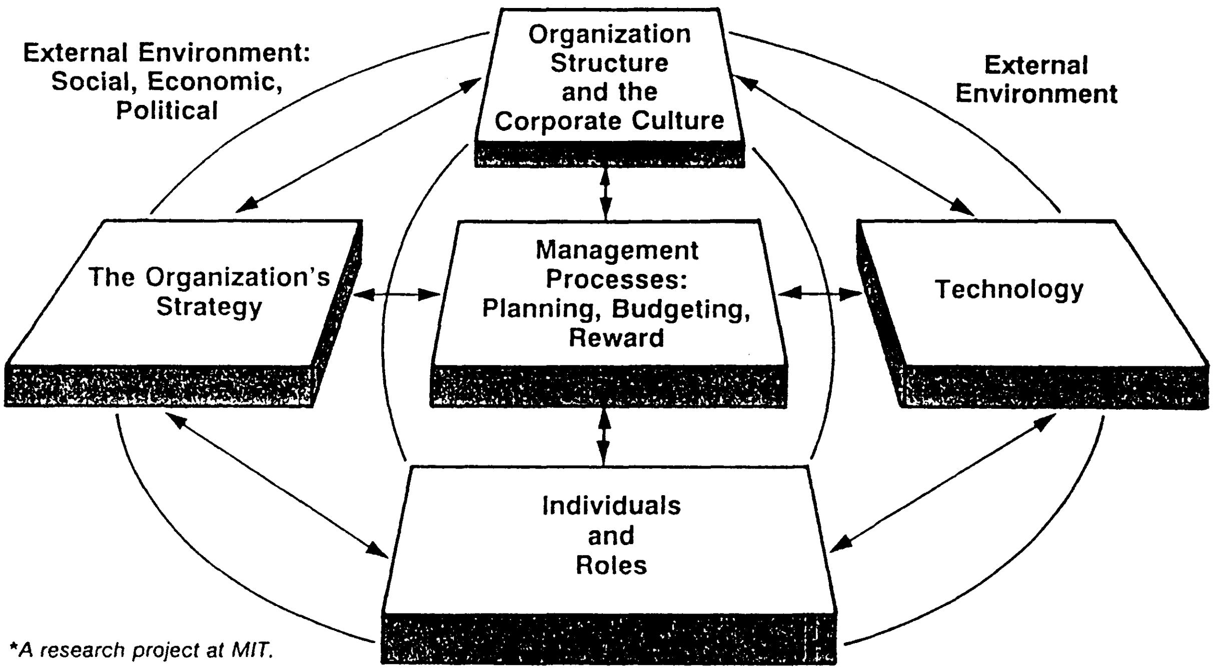
Internal Controls as a Dynamic Process:

Maintain Balance: deal with issues rather than symptoms

The internal control components are mutually supportive.

However, it is important to recognize that these elements must function in a state of equilibrium. The dynamic interrelationship model identifies many of the same components. It shows that if any of the elements are changed or modified then the other elements must also be adopted to ensure that the organization returns to a steady state. It is essential to identify breakdowns in the internal control framework and deal with the broad issue rather than correcting symptoms of the larger problem.

EXHIBIT 3
Management in the 1990s: A Research Framework*



*A research project at MIT.

Many of the nine components are synonymous with prudent business practices and it is also important to recognize that these elements are essential to the implementation of "Continuous Improvement Programmes".

Specific Comments:

Definition:

We accept the definition of Internal Control as outlined by the Committee of Sponsoring Organizations:

"The process by which an entity's board of directors, management and/or other personnel obtain reasonable assurance as to achievements of specific objectives; it consists of nine interrelated components, with integrity, ethical values and competence, which are: establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring."

In coming to this conclusion we are aware that this definition of internal control is dependent upon a number of implicit assumptions such as: (a) internal control is a process, (b) it is affected by people, (c) it only provides reasonable assurance not absolute control, (d) it consists of a number of interrelated components and (e) it is geared to the achievement of the entity's objectives.

Components:

In the past we have worked from a narrower definition of Internal Control as outlined in an earlier publication.

"Internal Control comprises the plan of organization and all the co-ordinate systems established by the management of an enterprise to achieve management's objective of ensuring, as far as practical, the orderly and efficient conduct of its business, including the safeguarding of assets, the reliability of accounting records, and the timely preparation of reliable financial information."

This definition of Internal Controls identified the key elements as follows:

1. **Organizational Controls**
   - Honest and competent employees
   - Segregation of functions
   - Overall plan of organization
   - Accounting/finance organization plan

2. **Systems Development and Change Controls**

3. **Authorization and Reporting Controls**
   - General authorization, specific authorization, and approvals.
   - Budgets, responsibility reporting, management information systems

4. **Accounting Systems Controls**
   - Ensuring that transactions are initially recorded
   - General Ledger and chart of accounts
   - Journals, sub-ledgers, balancing routines
   - Document design
   - Cost Accounting

5. **Additional Safeguarding Controls**
   - Restricted access
   - Periodic count and comparison
   - Protection of records
   - Insurance

6. **Management Supervisory Controls**

7. **Documentation Controls**

All of these elements are subsumed in the broader definition.

However, Information Systems is an area which is currently undergoing tremendous change and the technical aspects, create additional challenges for Senior Management.

This component of the Integrated Framework could be strengthened by more clearly defining the major activities included in the management and control of Information Systems.

Relevant activities could include:

- Development of Information Systems Strategy and Policies
- Assignment of responsibilities and appropriate separation of duties
- Application Systems Development
  (Project Management, Systems Investigation, Systems requirements analysis and initial design, Systems development, Testing including string/unit testing, System and User Acceptance Testing, Systems implementation, Systems maintenance and change control)
- Security:
  (Standards, Administration, Monitoring of hardware, software and the EDP environment)
- Data Base Administration:
  (User Support, Data Integrity and Security, Performance Monitoring)
- Production:
  (Production Scheduling - data entry/conversion and control, data resource management)
- Operations:
  (Data Centre Operations including data control, output distribution and telecommunication networking)
- Facility Planning:
  (Physical space planning, Environmental conditions)
- Application Support:
  (User Interface, New Systems Support)
- Processing Support:
  (Hardware/Software support, Capacity Planning)

The Institute of Internal Auditors Research Foundation has recently issued a comprehensive document on Systems Accountability and Control which could prove to be a valuable source of additional information on this subject area.

Definition of Roles and Responsibilities:

Another important aspect which needs further highlighting is the definition of roles and responsibilities for Information Systems.

In our view, *Users* of information systems should be responsible for data integrity, the accuracy and propriety of data processing and the identification of needs and opportunities; while *information systems staff* provide the service capability to meet the needs of users. We also believe that *Internal Audit* must play a high profile role and be responsible for quality assurance and monitoring of compliance with organizational policy and procedures.

Evaluation:

The Internal Control - Integrated Framework states that the evaluation of controls can occur in two ways:

> *"through routine activities, referred to as ongoing monitoring, and through separate evaluations."*

We agree with this concept, but would suggest that more emphasis be placed on the responsibility of management for the organization's internal control. An ongoing process should exist that allows a department or division to identify its objectives as well as assess the controls in place to achieve these objectives. In this way the evaluation of controls would be a bottom-to-top process that would focus efforts on the important nine components listed in this study's definition of internal control.

Traditionally, the conventional approach to evaluation reinforces the idea that the internal auditor is in charge of controls. Under this new methodology, the auditor would ensure that management is adequately identifying control weaknesses and that the information is presented to senior management and the audit committee. Also, the auditor would assist management by examining areas where control is considered unacceptable and identifying effective practical solutions. Internal Audit, then, with its objectivity and independence, becomes the source of separate evaluations.

The extensive evaluation tools presented in Appendix C are useful as guidelines in establishing the existence of the nine components in the company as a whole or in each division of the organization. As emphasized in the document, these tools must be adopted to the changing control environment and not remain as static, fixed devices.

In our organization we will use these tools to supplement our current approaches to evaluating internal control. The tools, as stated above, do help in forming a comprehensive overview of internal control. However, at times the use of other tools, such as root cause analysis, process mapping, or walk-through tests, results in additional information regarding the state of internal control. As underlined in the introduction to Appendix C, no set of tools is all inclusive and readers *"may wish to modify these tools to meet their particular needs, develop different evaluation tools, or use methodologies utilizing other evaluative techniques."*

Management Reporting to External Parties:

Any type of external reporting is a sensitive matter. Management reporting on internal control represents a report card on the effectiveness of management in a particular organization.

While we agree with the importance and need for a report of the nature described in the document, it is imperative that the report not become a report without any substance.

The need for consistency in the format of such a report is critical in order to establish a basis for evaluation between and within industries. Freedom to describe the control environment and actions taken by management can then be detailed within the framework. Certainly as described in the document the materiality of specific weaknesses will have greater or lesser significance depending on the nature of the organization and the industry within it operates.

We are of the opinion that for management reports on internal control to be effective management must place a greater emphasis on describing (a) Integrity, Ethical Values and Competence, (b) Management's Business Philosophy and Operating Style, and (c) How the Organization Manages Change.

These items represent the core business practices and principles followed by management. The mechanisms to communicate and monitor those practices and principles could then be discussed from an effectiveness perspective (i.e. Role of Audit Committee, Establishing and Communicating Within Policies, the Role of Internal Audit) within the report.

We also agree that a period of reference, CEO and CFO signatures are required as well as a statement describing the general effectiveness of the systems of internal control.

A management report on internal control should not preclude management from discussing other aspects of the operations in a Management Discussion of Operations also to be included in regular external reporting documents.

Overall Conclusions on Document:

We believe that the **Internal Control - Integrated Framework** is a comprehensive and very useful document.

Within our organization we have already begun to communicate the components of Internal Control from this integrated perspective.

We believe that the linkage and emphasis on the establishment of reasonable objectives within operating plans is an area which will have the greatest influence on our operations. We also plan to employ the evaluation techniques during the conduct of future internal audit assignments

We trust you will find our input of interest and we would be pleased to respond to any questions that you might have.

Yours sincerely,

J.G. Wilson
Vice-President Finance

JGW/mf

cc: Editor, Financial Executive Magazine
H.D. Russel, President & CEO
L.S. Jenkins, Corporate Controller
M. Pock, Director Internal Audit
L. Bowers, Director Administration & Special Projects

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POB

Public Oversight Board

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June 7, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th floor
New York, NY 10036-8775

Dear Committee Members:

The Public Oversight Board is preparing a comment letter on the March 12, 1991 exposure draft of "Internal Control - Integrated Framework." The Board believes that the study's conclusions are extremely important to increasing the public's awareness and understanding of internal control and is therefore dedicating substantial time to evaluating them and formulating our response. However, because of the schedule of Board meetings, we will be unable to finalize our comment letter until about July 12 and we hope that you will be able to give consideration to it in finalizing the report.

Sincerely,

Jerry Sullivan

Jerry D. Sullivan
Executive Director
/ma

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June 10, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

SUBJECT: Comment Letter

Gentlemen:

The purpose of this letter is to offer comments on the March 12, 1991 Exposure Draft of "Internal Control-Integrated Framework". I have read the draft and offer the following comments:

SPECIFIC COMMENTS:

Page 24, para.3--When I first read this paragraph I was left with the impression that internal audit was being labeled as having a narrow focus. On re-reading I can see that this is being addressed to the CFO. Perhaps there is some way to reword for greater clarity.

Page 25--Audit Committee "they are not universally required, nor are their specific duties and activities prescribed." While this statement may be true it tends to diminish the full importance and responsibility of the audit committee. Expectations are not always reduced to legislative dictates but it has been evident for many years, and is becoming more evident, that much is "required" of audit committees. This expectation, which I believe is tantamount to legal requirements, should be emphasized in the final form of this document.

Page 55, Quality. Spelling should be Baldrige, not Baldridge.

GENERAL COMMENTS:

Overall, I am pleased with the Exposure Draft. There are many clear cut (unequivocal) statements that leave very little doubt as to what

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is expected of management, the independent public accountant, internal audit, and so forth. Some key concepts that are noteworthy are:
(a) That control is an integral part of the management process and is pervasive, permeating all activities of an entity.
(b) That the elements (9) of control are entwined; therefore if the objective is to ensure an adequate control environment then all elements will need to be addressed.
(c) The chapter summaries are an excellent idea, particularly on the nine elements. These summaries do a nice job of stating succinctly the importance of the element.
(d) Appendix C is welcomed particularly since the "Points of Focus" more directly address the issues. Too often these issues, which I believe are crucial to an adequate control environment, have been sidestepped or addressed in vague or general terms. These issues need to be addressed squarely and this portion of the document will go a long way toward that goal.

In conclusion, I commend the Committee of Sponsoring Organizations, the Project Advisory Council, and Coopers and Lybrand for their work on this most important project. Those of us who work daily in the audit and control environment realize that internal control is not magical nor is it scientific or awesome. It is noting more than good common sense and sound business judgement.

Very truly yours,

QUAKER STATE CORPORATION

Robert L. Gabler

Robert L. Gabler
Manger Internal Audit

RLG/mlc

UNITED TECHNOLOGIES

United Technologies Building
Hartford, Connecticut 06101
203/728-7000

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June 11, 1991

The Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Internal Control-Integrated Framework -
Exposure Draft March 12, 1991

We have read the *Internal Control - Integrated Framework*, exposure draft dated March 12, 1991, and appreciate the opportunity to be able to review and comment. We believe this is an important initiative. The establishment of effective internal controls is paramount to increasing public confidence in the integrity of the financial reporting process. Our comments and observations follow.

Executive Briefing

The executive briefing is too lengthy and detailed for its intended audience. These individuals (chief executives and other senior executives, members of boards of directors, legislators and regulators) should already have a basic understanding of the internal control process and sufficient knowledge of the issues discussed. A short high-level summary would more likely be read than the present version, which covers over 45 pages.

However, we do find the level of detail included in the exposure draft to be appropriate. We agree that the audience, who may be expected to use the broader working document, would require more explanation and detail so that there would be no misunderstandings as to definition or intent.

Evaluation of Controls - Reliance on External Auditors

At UTC, we place the responsibility for the evaluation of the internal control process with management. The Chief Financial Officer (CFO) of each entity is required to conduct an annual comprehensive survey and review of the system of internal accounting controls. The review may be conducted by qualified employees under his direction and control. However, because the review is in fulfillment of the CFO's own responsibility, the engagement and reliance upon outside accountants or other consultants, or reliance upon regular reviews by Internal Audit or UTC's independent public accountants, is not viewed as an appropriate means of meeting this requirement. The review can and usually should be conducted by or with the participation of those senior financial personnel of the entity who are responsible for various areas of financial activity, including the internal controls in each area.

The exposure draft states that "management may use the work of external auditors in considering the effectiveness of internal controls." At UTC, we stress that management is responsible for the annual evaluation of controls. Our internal auditors and independent public accountants help to validate management's annual evaluation based on the results of their compliance tests.

When conducting the annual audit, the external auditors evaluate the internal controls of the corporation for the purpose of determining the level of reliance which can be placed on the systems of internal controls. The better the internal control structure, the less substantive testing will be required. The external auditors require management's assistance to identify and define the internal control systems. If the corporation were to rely on its external auditors to determine the adequacy of our internal controls, we might find that management would become less familiar with their own internal control systems than the external parties. That would be unacceptable!

We believe the exposure draft should be modified to permit the results of the external auditors' work be used only to assist management in the evaluation of the effectiveness of established internal controls. The practice of management self-assessment has been a UTC requirement since the enactment of the Foreign Corrupt Practices Act in 1977. Our approach, although strict, places full responsibility for the establishment and evaluation of internal controls with management.

Management Reporting to External Parties

The UTC Annual Report includes a brief statement of Management's Responsibility for Financial Statements (copy attached). In this statement, management acknowledges full responsibility for the financial statements and all other information included in the Annual Report. Management also indicates it is responsible for establishing and maintaining accounting systems and practices adequately supported by internal accounting controls, which management believes provide reasonable assurance that --

- the Corporation's assets are safeguarded,
- transactions are executed in accordance with management's authorizations, and
- the financial records are reliable for the purpose of preparing financial statements.

We believe that a brief discussion is most appropriate. Attempting to communicate to the unsophisticated Annual Report reader on the inherent limitations of internal control systems can only further serve to undermine the public's trust in the reliability and integrity of Corporate America. Providing more detail without such a qualification would only serve to give the financial statement reader a false sense of assurance (i.e., beyond that of reasonable assurance). As such, the present level of detail provided to our financial statement readers seems both prudent and appropriate.

Comparison with UTC Approach

Many of the concepts and approaches to internal control enumerated in the exposure draft are quite similar to practices currently followed by UTC. Outlined below are some of our thoughts which may be useful during your final deliberations.

Management Integrity

We agree that management integrity is an important aspect of internal controls. The exposure draft recognizes that management integrity is a strong influence in the functioning of internal controls, as they have the ability to override and ignore certain controls or stifle communications from subordinates, enabling a dishonest management, which intentionally misreports results, to cover its tracks.

We compensate for this type of activity with strong upward communication to the Board of Directors, as well as a strong Internal Audit influence which regularly reports to an Audit Review Committee made up of five directors who are not officers or employees of UTC. Additionally, we maintain a strong upward confidential feedback mechanism, which allows employees to report any suspected dishonest or fraudulent behavior by management while maintaining anonymity.

Self-Assessment

As previously mentioned, the UTC approach to internal controls stresses an annual self-assessment by each entity CFO. The exposure draft also adopts this approach, which ensures that internal controls are periodically challenged and updated to reflect a continuously changing environment.

Strong Influence of Internal Audit and Audit Review Committee

UTC maintains a strong centralized internal audit function, which is required to review management's annual internal control evaluation. The review considers the adequacy of management's responses as well as compliance testing of management's representations.

Internal audit findings require management to establish corrective action plans, which are reviewed for both appropriateness and completeness. Significant findings are also reported to the Audit Review Committee on a regular basis.

This strong influence helps to ensure that establishing and maintaining sound internal accounting controls is perceived by everyone throughout the corporation as being of utmost importance.

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In summary, we would suggest the following:

- A more condensed and less detailed Executive Briefing.
- A more limited role for the external auditors in the evaluation process.
- Not expanding management reporting to external parties beyond current practice.

Once again, we appreciate the opportunity to comment on this exposure draft and hope that our input will be helpful.

John A. Rolls
Executive Vice President & Chief Financial Officer

JAR:cbp

Attachment

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GULF STATES UTILITIES COMPANY

POST OFFICE BOX 2951 • BEAUMONT, TEXAS 77704
AREA CODE 409 838-6631

BOBBY WILLIS
Vice President and
Controller

June 13, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Gentlemen:

Gulf States Utilities Company (GSU or the Company) submits the following comments in response to the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Exposure Draft (ED) on "Internal Control--Integrated Framework." GSU is an investor-owned utility company primarily engaged in the business of generating, transmitting, and distributing electricity to over 570,000 customers in a 28,000 square mile area of Southeast Texas and South Central Louisiana.

Comments

GSU appreciates COSO's efforts to follow up on the Treadway Commission's recommendation to develop needed guidance for all parties interested in the vital area of internal control. An integrated framework for internal control should benefit the accounting profession by providing a bedrock upon which to build future authoritative pronouncements on internal control. The Company notes that a similar conceptual framework issued by the Financial Accounting Standards Board has already been utilized in the development of a number of extremely important recent accounting standards such as Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." Therefore, due to the important nature of this ED, the Company is pleased to be able to offer the following comments.

With respect to the definition of internal control, the Company finds itself in substantial agreement with the ED. Although the ED definition of internal control is certainly broad, it captures the essential components of internal control. Additionally, as stated in the ED, it can accommodate more specific subsets of internal control.

Included in the ED definition of internal control is a listing of nine interrelated components of internal control. The Company concurs that all of these components seem to be important and relevant. However, it should be noted that the degree of relevance of these components, especially the component of objectives, seems to be at least partially dependent on the extent of decentralization of an entity. In a highly decentralized entity, the amount of interaction

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between the core entity and its subunits may be extremely limited. Such limitation may be due to valid business reasons. Therefore, GSU believes that COSO should consider the question of decentralized entities and the establishment of entity-wide objectives in its final release.

The Company already has in place many of the evaluation procedures and processes outlined in the ED and believes this would be true of most large business entities. This section of the ED would seem to provide an appropriate and valuable codification of evaluation tools.

With respect to management reporting to external parties, the Company believes that the guidance and illustration provided in the Exposure Draft will provide a valuable reference point. However, GSU notes that individual companies will need to tailor such guidance to their specific situations. As such, the ED guidance will be a supplement to, but not a replacement for, management judgment.

GSU appreciates the opportunity to respond to this ED.

Sincerely,

BJWillis

DC/jb

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Pacific Gas and Electric Company

77 Beale Street
San Francisco, CA 94106
415 973-2691

Gloria S. Gee
Controller

June 13, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY. 10036-8775

Dear Sir or Madam:

Pacific Gas and Electric Company (PG&E) is a regulated public utility under the California Public Utility Code and serves gas and electricity to more than 11 million people in Northern and Central California.

PG&E appreciates the opportunity to comment on the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) exposure draft, Internal Control - Integrated Framework.

Our comments on Part 2 of the COSO exposure draft are as follows:

I. DEFINITION - We believe that the definition of Internal Control proposed in this draft report is too general. The proposed definition states that "Internal control is the process by which an entity's board of directors, management, and/or other personnel obtain reasonable assurance as to achievement of specified objectives" (p. 51). The objectives of internal control, which are specified in official publications of professional organizations such as the American Institute of Certified Public Accountants and the Institute of Internal Auditors should be stated, thereby leaving no doubt what such objectives are.

The subject of the COSO study is internal control and the definition should address "control objectives." A definition which could be considered is: "Controlling comprises a network of processes that involves people acting in a cost-effective manner that (a) reduces the organization's exposure to loss or failure to an acceptable level of business risk, and (b) increases the likelihood that the following five generally accepted control objectives will be achieved:

- o Significant financial, managerial, and operating information reported externally and internally are accurate, reliable, and timely,
- o Employee's actions are in compliance with policies, operating standards, plans, and procedures and the laws and regulations of the land,
- o Resources are adequately protected,
- o Resources are acquired economically and used efficiently (or in the case of not-for-profit organizations, cost effectively), and
- o The organization's plans, goals, and objectives are achieved."

II. CONTROL ENVIRONMENT - We agree that "the internal audit department should report to a senior officer who is not directly responsible for preparing the company's financial statements and has sufficient authority to ensure appropriate audit coverage and to follow up on findings and recommendations" (p. 70). In addition, internal auditing should have direct access to the Audit Committee of the Board of Directors as well as the Chief Executive Officer and other senior management, as necessary and appropriate. The ability to report independently on internal control matters to corporate senior management is the critical feature in the reporting process. To be effective, internal auditing must maintain its independence and objectivity by having unrestricted access to, and support of, senior corporate officials.

PG&E currently provides in its annual report on a voluntary basis a report on management's responsibility for financial statements. This report includes a discussion of the Company's internal accounting controls and the roles of the internal auditors, external auditors and the audit committee. (We have included as an attachment a copy of PG&E's 1990 report.) Our comments on the proposed guidelines on management reporting to external parties contained in Part 3 are as follows:

1) The category of controls being addressed (controls over the reliability of the entity's published financial statements):

PG&E

We do not agree that the category of controls being addressed should be limited to controls over the reliability of the published financial statements. We feel that a broadened discussion to cover internal accounting controls, which includes financial reporting controls, would be more useful to the shareholder in his or her assessment of the integrity of the financial information. Further, Section 13(b)(2) of the Securities Exchange Act of 1934 already requires that broader objectives of internal accounting controls be met. Therefore, we recommend that the scope of the report be expanded to cover internal accounting controls and that the illustrative report be modified accordingly.

2) A statement about the inherent limitations of internal control systems:

We agree that a statement should be made regarding the inherent limitations of internal control systems since decisions must be based on the recognition that the cost of the systems should not exceed the benefits to be derived.

3) A frame of reference for reporting--that is, the standard against which the internal control system is measured:

Although we agree that a frame of reference for reporting should exist, the identification of the nine interrelated internal control components in the illustrative report would be confusing to the average shareholder. We recommend that this section of the illustrative report be rewritten and simplified so that it is more understandable to the average financial statement user.

4) Management's conclusion on the effectiveness of the internal control system:

We do not agree with the wording contained in the illustrative report, "the Company maintained an effective system of internal control over the preparation of its published financial statements..." (p. 157). Under Section 13(b)(2) of the Securities Exchange Act of 1934, companies subject to Securities and Exchange Commission jurisdiction must devise and maintain a system of internal accounting controls sufficient to provide <u>reasonable assurance</u> that certain objectives of internal accounting controls are achieved. Maintaining that the internal controls are effective goes beyond what is required by the 1934 Act. We believe that wording such as "controls are adequate to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce the records

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PG&E

necessary for the preparation of financial information" provides shareholders with the appropriate level of comfort as to reliability and integrity of the financial information.

5) The date as of which management's conclusion is made:

   We do not agree that management's conclusion should be dated as of a point in time. The requirements under Securities Exchange Act Section 13(b)(2) (as noted above) imply that adequate internal accounting controls exist over a period of time. A conclusion as of a point in time would be inappropriate since some financial statements cover a period of time. In addition, concluding as of a point in time may also cause the reader to question whether the financial information prepared during an earlier part of the year is reliable.

6) Signed report:

   We agree that the report should be signed by the chief executive officer and the chief financial or accounting officer since they are ultimately responsible for the internal accounting controls.

7) Additionally, we believe that a discussion of management's responsibility for the financial statements and the roles of the internal auditors, external auditors and the audit committee also should be required to be included in the management report.

Sincerely,

Gloria S. Gee

GSG:cd

Attachment

ATTACHMENT 84

Responsibility for Financial Statements

Pacific Gas and Electric Company

The responsibility for the integrity of the financial information included in this annual report rests with management. Such information has been prepared in accordance with generally accepted accounting principles appropriate in the circumstances, and is based on the Company's best estimates and judgments after giving consideration to materiality.

PG&E maintains systems of internal accounting controls supported by formal policies and procedures which are communicated throughout the Company. These controls are adequate to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce the records necessary for the preparation of financial information. There are limits inherent in all systems of internal control, based on the recognition that the costs of such systems should not exceed the benefits to be derived. The Company believes its systems provide this appropriate balance. In addition, the Company's internal auditors perform audits and evaluate the adequacy of and the adherence to these controls, policies and procedures.

Arthur Andersen & Co., the Company's independent public accountants, review and evaluate the Company's internal accounting control systems to the extent they consider necessary in order to support their opinion on the consolidated financial statements. Their auditors' report contains an independent informed judgment as to the fairness, in all material respects, of the Company's reported results of operations and financial position.

In a further attempt to assure objectivity and remove bias, the financial data contained in this report have been reviewed by the Audit Committee of the Board of Directors. The Audit Committee is composed of six outside directors who meet regularly with management, the corporate internal auditors and Arthur Andersen & Co., jointly and separately, to review internal accounting controls and auditing and financial reporting matters.

The Company maintains high standards in selecting, training and developing personnel to ensure that management's objectives of maintaining strong, effective internal controls and unbiased, uniform reporting standards are attained. The Company believes its policies and procedures provide reasonable assurance that operations are conducted in conformity with applicable laws and with its commitment to a high standard of business conduct.

Georgia-Pacific Corporation

133 Peachtree Street, N.E.
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Atlanta, Georgia 30348
Telephone (404) 521-5220

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T. Marshall Hahn, Jr.
Chairman of the Board and
Chief Executive Officer

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, New York 10036-8775

June 13, 1991

Re: Internal Control - Integrated Framework, "The Exposure Draft" (March 12, 1991)

Gentlemen:

We appreciate the opportunity to review and comment on your Exposure Draft publication entitled Internal Control - Integrated Framework. We support the efforts of the Committee of Sponsoring Organizations (COSO), believe this type of document is long overdue and offer the following recommendations:

The Committee of Sponsoring Organizations of the Trading Commission should:

- **Clarify the intent of this document.**

  Consider this publication as a resource to reference and clarify internal control principles and guidelines rather than a standard to follow as a mandatory requirement.

- **Reorganize this document into four modules and make presentation improvements to it by condensing key issues, eliminating redundancy, balancing its substance in terms of content and examples and summarizing information.**

  The document in its current lengthy form is cumbersome. Reorganize the document into four modules and make presentation improvements to it as follows:

  - Executive Summary: Contains key principles

  - Internal Control Reference Manual: Contains detailed narrative of the current document but eliminates redundancy of content and examples. This section needs to balance the emphasis on internal control aspects for ALL business activities instead of only emphasizing financial reporting and accounting activities

  - Appendix: Contains reporting guidelines and evaluation tools that currently exist in the Exposure Draft

  - Glossary and Index: To facilitate understanding and locating information quickly

  This structure would provide a flexible means of briefly referencing various topics within the subject of *"Internal Control"*. Corporations and individuals could select the module they need as a resource rather than be engrossed in one lengthy document.

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- **Revise the definition of *internal control*.**

  The adoption of a general control-component definition, evaluation methods and external reporting requirements as a standard would result in a significant increase in administrative costs without adding value.

  The committee should focus on providing a definition with specific and measurable control objectives (e.g., stated in the "Codification of Standards for the Professional Practice of Internal Auditing" Section 300.05) as a better basis to evaluate the effectiveness of and report externally an opinion about an internal control system. The definition as written is a means to manage a control environment which is subjective and immeasurable.

- **Determine who will continually maintain and revise this document.**

  Business operates in a dynamic environment that continues to change. One of the internal control components is "Managing Change". Taken from this context, "Conditions external to and within this *Internal Control-Integrated Framework* will continue to change and mechanisms need to be in place to identify and effectively deal with the changes". Changes to this document need to be anticipated and revised as necessary if the intent is for it to be maintained as a valid resource of internal control guidance.

- **Indicate who is specifically responsible for monitoring internal controls in an operation.**

  The Exposure Draft seems to be inconsistent on who is specifically responsible for monitoring controls. For example:

  - Page 23: "**Management** establishes the control environment, ensures it effective communication, institutes mechanisms to manage changes affecting the entity and **sets up monitoring procedures**"

  - Page 23: "Financial Officers. Of particular significance to **monitoring are finance and controllership officers** and their staffs...

  - Page 24: "The importance of the role of the **chief accounting officer** in preventing and detecting fraudulent financial reporting was emphasized in the Treadway Commission report: As a member of top management ... is responsible for implementing and **monitoring the company's financial reporting system...**"

  - Page 36: "An appropriate mix of **ongoing monitoring and separate evaluations** can be extremely effective... Often, evaluations take the form of self-assessment, where **persons responsible for a particular unit or function** will determine the effectiveness of controls for their activities.

  Clarification in this area would be helpful.

Again, we appreciate the opportunity to express our views.

Sincerely,

T. Marshall Hale, L

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American Paper Institute, Inc.
260 Madison Avenue, New York, N.Y. 10016-2499
(212) 340-0600 • FAX: (212) 689-2628
cable address: AMPAPINST New York

Office of the President

June 13, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Re: Internal Control - Integrated Framework (March 12, 1991)
Exposure Draft

Gentlemen:

The American Paper Institute (API) is pleased to provide comments on the above Exposure Draft.

API supports efforts to advance the understanding of internal controls and fully endorses the maintenance of effective internal control systems.

Identification of major concepts is a useful first step, but we believe the definition is too broad and the control components too imprecise to fully achieve the document's second stated purpose of providing useful criteria against which all entities can assess and identify areas where they can improve internal controls. For purposes of accountability, we believe that internal controls should be more narrowly defined and should focus on safeguarding assets and on preparation of reliable financial statements.

The suggested management report refers to an extensive set of "evaluation tools" in Appendix C to measure the adequacy of the internal control system, and would require the use of considerable and costly internal resources for documentation. In our opinion, this proposed management report would be less meaningful and useful than those that now appear in many of our members' annual reports. These current management reports appropriately reflect the unique structure and characteristics of the reporting entity, while providing reasonable assurance of the integrity of financial statements and assessment of the company's system of internal controls.

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In our view, this Exposure Draft is and should remain in the form of a conceptual framework document. However, in order to enhance its value for the different management levels within corporations, consideration should be given to separating the major components of this document into two or three distinct segments. An executive summary should present principles or goals, and a separate section should include the evaluation tools and guidelines, for use as a reference source. These evaluation tools and guidelines, in turn, should be maintained and revised over time, in order to retain their value as a dynamic resource.

General Comments and Recommendation

The evaluation tools and reporting criteria should be viewed as guidelines rather than standards, and corporate managements should be allowed flexibility in the use of this document for the assessment and maintenance of their own internal control systems, and for the development of their management report.

We appreciate this opportunity to express our views.

Very truly yours,

Red Cavaney

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Bell Atlantic
1600 Market Street
Philadelphia, Pennsylvania 19103
215 963-6800

William L. Bardeen

Vice President -
Finance and Controller

June 13, 1991

Mr. Robert L. May, Chairman
Committee of Sponsoring Organizations (COSO)
1211 Avenue of the Americas, 6th Fl.
New York, New York 10036-8775

Dear Mr. May:

In response to your request, Bell Atlantic Corporation wishes to offer comments on the Committee of Sponsoring Organization's (COSO) draft on "Internal Control-Integrated Framework." Bell Atlantic commends COSO for its extensive work on this project. We do believe, however, that there are several areas of concern in the exposure draft where the report could be more effective. Specifically, we wish to highlight the following areas for reconsideration:

1. <u>The definition of internal control needs to be better focused so that it does not encourage various interpretations. It also needs to be reconciled to the SAS No. 55 and IIA definitions.</u>

   a. Specifically, we have difficulty with the words "... achievement of specified objectives." This is very broad language that seems to run counter to the goal of establishing a common definition. Each reader of a management report would be free to read in his own notion of what is meant by "specified objectives."

      We believe the definition of internal control should be more focused and convey, on a stand-alone basis, that internal control and all of its components are critical because internal controls have the potential to impact the accuracy and reliability of financial statements.

   b. The relationship of the proposed definition to the current definitions of internal control contained in the AICPA Statement On Auditing Standards No. 55 and the IIA Statement on Internal Auditing Standards No. 1 is not clear.

Is the COSO definition intended to replace these definitions by which external and internal auditors currently assess controls? If the COSO definition is published in some final form and a large number of companies adopt it for external reporting, how will this impact external audit fees?

The SAS No. 55 definition is complete and is operable currently. By suggesting a definition that goes beyond controls related to financial reporting, we may be creating an unnecessary conflict with SAS No. 55 definition. Moreover, an entity's independent auditor, who is currently guided by SAS No. 55, might have to redefine its activities resulting in unneeded expanded auditing procedures and fees.

We believe the interrelationship with existing definitions of internal control should be resolved.

2. <u>The proposed framework of components and evaluation tools, while helpful, is very broad and is neither company nor industry specific. Therefore, the evaluation tools should be clearly marked as tools and should not be given undue attribution as "the standard."</u>

Bell Atlantic recognizes the difficulty in creating an evaluation tool that can be useful to all. At Bell Atlantic, we would use the evaluation tool as a reference guide, a textbook, to supplement our existing industry and company specific control documents. And we would continue to supplement our internal control efforts with an active internal auditing function performing independent evaluations of our company's internal controls. Individual companies trying to use the evaluation tools will find that the exposure draft goes into more detail than may be useful to every entity.

The proposed framework of components and evaluation tools is helpful if used as a reference. However, COSO's work could become the basis for broader congressional or regulatory mandates. It, therefore, may need to be tailored so that an assumption is not made that all parts of the evaluation tools are relevant to every business and so that any guidance that regulators or legislators might take from the document is practical and adequately focused.

3. <u>There are some additional items that could be made part of the self-assessment to support maintenance of good internal controls.</u>

The most important is an internal auditing function performing independent appraisals on the systems of internal control and providing effective communication to senior management. Additional items that could be included are obtaining management representation letters from operating units within a company, follow-up internal audits on problem areas, and internal audits on the completion of self-assessments.

4. <u>We are not in agreement with the suggested structure of the management report because it suggests segregation of internal control reporting from financial reporting and implicitly references COSO (a voluntary organization) as the authoritative source of internal control.</u>

Unlike the Treadway Report, the exposure draft does not express an opinion on the reporting of internal control. Yet guidance is provided for those companies reporting or considering reporting. We are not in agreement with the suggested format in the illustrative report. A particular concern is the second paragraph of this report which is self-serving by its reference to Treadway and COSO.

We question whether it is appropriate to completely separate comments on internal control in a management report from comments on financial controls as recommended in the sample letter. We believe the very reason for focus on internal controls is to ensure accurate current financial reporting. Comments on internal control, therefore, should be inextricably interrelated to comments on financial reporting controls.

Additionally, the inclusion of this illustrative report could result in this report as drafted leading to its adoption as a "standard" reporting requirement. Therefore, the sample report should be improved to accommodate an appropriate linkage to financial reporting so that, if adopted, the definition of internal control and its relationship to financial reporting is clear.

We appreciate very much the opportunity to comment on the exposure draft and sincerely hope that our views are helpful. If we can clarify our views or if you have further questions of us, please call me or Dennis Jacobs, AVP Corporate Auditing on (215) 963-6147.

Sincerely,

W. L. Barden

The St. Paul Companies, Inc.
385 Washington Street, St. Paul, Minnesota 55102
Telephone (612) 221 7911

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The St. Paul
Companies, Inc.

June 13, 1991

COSO Committee
1211 Avenue of the Americans
New York, New York 10036

Dear Sirs:

The purpose of this letter is to comment on the Internal Control - Integrated Framework Exposure Draft. You requested comments on four areas:

- Definition
- Components
- Evaluation
- Management Reporting

Definition of Internal Controls

We, at The St. Paul, agree with the broad definition of internal controls and the development of a common definition that can be used by operating and financial personal, internal and external auditors, audit committees, regulators, investors, etc. However, we believe internal control is not a "process" but rather is a "system" designed to provide reasonable assurance that specified objectives are achieved. A "process" is too narrow a term, it implies a beginning and end and sometimes is synonymous with procedures. On the other hand, a "system" is a broader term that implies various components that continuously function together to accomplish objectives.

Components

We recommend combining several of the components. We believe the total control environment includes three components that should not be separated: integrity, ethical values, and competence; control environment; and communication. These components are pervasive and together provide the environment within which specific controls operate. Information systems and control procedures should be combined because almost all procedures are integrated with computer systems. Finally, managing change and monitoring are not separable because you must monitor to identify changes.

Evaluation

The methods presented in the ED are similar to our current methods. We will use the tools and techniques outlined in the ED as a supplement in evaluating internal control at The St. Paul.

Management Reporting to External Parties

We support the concept of management reporting. We agree with the ED that the scope of reporting should be limited to financial reporting controls at this time. Methods for evaluating financial reporting controls are well developed. However, methods for evaluating and reporting on the broader system of internal controls are not well developed and therefore reporting would not be meaningful.

We feel that the ED's guidance on management reporting will promote greater consistency in reporting. We agree with the conclusion that management should express an opinion on the effectiveness of the control system.

Sincerely,

H Dalton

Howard Dalton
Sr. Vice President and Chief Accounting Officer

cc: Financial Executives Institute

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KERR-McGEE CORPORATION
KERR-McGEE CENTER • OKLAHOMA CITY, OKLAHOMA 73125

June 13, 1991

JOHN C. LINEHAN
SENIOR VICE PRESIDENT

Robert L. May, Chairman
Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Re: *Internal Control - Integrated Framework* Exposure Draft

Dear Mr. May:

Kerr-McGee Corporation appreciates the opportunity to comment on the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) Exposure Draft *Internal Control - Integrated Framework* (ED).

As requested, we have commented on the issues raised in the ED's introductory letter.

1. Definition of Internal Control

We agree with the idea of a broad definition of internal control. However, we believe the definition can be simplified and still represent an industrial company's views as well as those of the sponsoring organizations'. An alternative definition is:

"Internal Control is the process by which reasonable assurances can be obtained that specified goals and objectives are achieved. These processes involve the entity's culture, management actions to achieve goals and objectives and systems with adequate control procedures established within those systems. All these processes form the entity's internal control environment."

The above definition does not specify components of internal control. It does, however, acknowledge the entity's culture (integrity, ethical values and competence mentioned in the ED), management actions (establishing objectives, risk assessment, communication, managing or responding to change, and monitoring, all mentioned in the ED), and systems and the control procedures established within those systems (also mentioned in the ED).

2. Components

As stated above, we do not believe internal control (a conceptual process) should be discussed as nine components. We do agree that a discussion of certain aspects of internal control is needed in the document. However, redundant aspects of internal control are presented as separate components in the ED, i.e., we believe that control procedures include such things as monitoring and managing change. We also believe objective setting and risk assessment, while inherent to the internal control design process, are not actual "components" of internal control. Additionally, controls should be components of information systems, but we do not necessarily view information systems in all instances as components of control.

3. Evaluation

We believe that the evaluation process discussed in Chapter 4 is a valid one. Kerr-McGee uses certain of the same or similar tools to evaluate internal controls as presented in Appendix C. However, Appendix C and the entire evaluation discussion throughout the ED presents the same tools for management controls and financial controls. The evaluation tools presented do not work for evaluation of management controls. Culture (integrity, competency and ethics) and change management, etc. are not appropriately evaluated by checklists or the "activity objectives, risk assessment and control procedures" tool presented in Exhibit C. More emphasis is needed to discourage a "cookbook" evaluation of internal controls from Appendix C of the ED. Kerr-McGee urges the COSO to extend the tests of the ED's evaluation tools across different organizational environments. We believe that the COSO might consider a separate publication for these and other evaluation tools after an extended test period.

4. Management Report on Internal Controls

We do not agree with the management report included in the ED. We do not believe that a need exists for a standard report on internal controls. Kerr-McGee has long included its own statement regarding controls in its annual report. In addition, we believe that the report on financial internal control as presented in the ED contradicts the rest of the document dealing with the broad nature of controls. While we understand that the COSO is responding to Congressional and SEC reaction to the savings and loan crisis, we do not believe that the ED with its management report on internal controls is going to solve this situation. A strong internal accounting control system is already required by the Securities and Exchange Act of 1934 and the Foreign Corrupt Practices Act of 1977. We believe that the last thing industry needs is more reporting. Finally, we do not believe that it is necessary to reiterate the ED's components of internal control in a management report. We believe instead that management's responsibility for annual reporting is what should be emphasized as we do in our Annual Report.

5. Lastly, the ED itself is much too long. The writers state that they hope all levels and types of management will read and use the report. However, a 163-page document with appendices in excess of 180 pages does not present an invitation to a reader who questions the need for additional reporting requirements.

The above comments are respectfully submitted and we hope the COSO will give due consideration to them in the deliberations.

Sincerely,

Joe Eickert

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Allied Signal

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J. Thomas Zusi
Vice President and Controller

June 14, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Dear Sirs:

We appreciate the opportunity to comment on the March 12, 1991 Exposure Draft ("ED") on "Internal Control - Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Our primary concern is that the study's focus on internal control at the macro level may diffuse many of the critical issues that are better and more effectively addressed at a micro level.

Our expectation was that the additional guidance provided on internal control, as discussed and recommended in the Report of the National Commission on Fraudulent Financial Reporting ("Treadway Commission Report"), would focus primarily on internal controls which are critical to the prevention and detection of fraudulent financial reporting.

This expectation was based on the fact that the Treadway Commission Report indicates that fraudulent financial reporting continues to occur despite adequate internal accounting controls and concludes that internal controls broader than the internal accounting controls contemplated under the Foreign Corrupt Practices Act are necessary to reduce the incidence of fraudulent financial reporting.

The ED sets forth a broad definition of internal control which covers operations, financial reporting and compliance with laws and regulations. The ED indicates that "quite simply, the primary objective of the study is to help management of businesses and other entities better control their organization's activities." The ED does not focus specifically on internal controls which are critical to the prevention and detection of fraudulent financial reporting.

We agree that it is important to emphasize that internal control pervades all activities of an organization and therefore, as a first step, a broad definition of internal control is required. We do feel, however, that as a second step, which should be the primary objective of the study, the subset of internal control which is critical to the prevention and detection of fraudulent financial reporting should be emphasized and presented in a focused, comprehensive manner.

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Our primary concern is, therefore, that the ED's emphasis on the broad definition of internal control may tend to diffuse the issue relative to fraudulent financial reporting and may therefore not accomplish what we consider to be the primary objective of the study.

In addition to our primary concern, we also find the ED to be too theoretical and therefore of limited practical use. This focus on the theoretical could create a false sense of security. Internal control is not and cannot be a cure-all. It is, however, only through a comprehensive presentation and discussion of the practical applications that one comes to fully understand and appreciate the facts that: no internal control system is completely effective or fail safe and cost/benefit considerations are critical.

Our comments on the Specific Matters for Comment, as requested in the ED, follow:

Definition

We do not disagree that internal control is a process, executed by the entity's people, to accomplish specified objectives. Given that internal control is being broadly defined to include operations, financial reporting and compliance with laws and regulations, we do not feel that the use of the phrase "reasonable assurance", as part of the definition, is appropriate in this context, particularly as it relates to operations.

Internal control can promote efficient operations. It cannot provide reasonable assurance as to the achievement of operational objectives. The ED acknowledges that the achievement of operational objectives is not always within the entity's control. There is no internal control system which can provide a reasonable guarantee that, for example, a sales objective will be achieved. What the system can do is provide reliable information which is used for making critical business decisions as it relates to operations. Given that internal control, in this context, promotes operational efficiency, the process merely serves to enhance the likelihood that operational objectives are achieved; the process does not provide reasonable assurance.

Internal control should, however, provide reasonable assurance that certain objectives - those relating to financial reporting and compliance with laws and regulations - are being achieved.

We are of the opinion that the following broad definition may solve this dilemma:

> Internal control is the process by which an entity's board of directors, management and/or other personnel safeguard the entity's assets, obtain reasonable assurance as to the accuracy and reliability of the entity's financial information and compliance with laws and regulations, and ensure adherence to prescribed managerial policies.

As you will note, this definition is a modification of the first authoritative definition of internal control issued in 1949 by the American Institute of Accountants (now American Institute of Certified Public Accountants). There is nothing inherently wrong with this definition. For management purposes, this very broad, inclusive definition works well. Since this definition was too broad for the independent public accountant's purpose, over time, the definition has been divided to focus on "accounting control" and "administrative control" separately.

What we now need to do is merge the two components rather than create a new definition. It should be noted that our suggested definition merely serves to specifically define the objectives which are inherent in the ED's proposed definition. Since one purpose of this study is to educate, this specificity is critical to a full understanding of the pervasive nature of internal control.

We agree that the statement concerning the nine interrelated components should be incorporated as part of the definition. We feel that such a statement of criteria is also critical to a full understanding of internal control.

Components

The nine components, though described somewhat differently, appear to be similar to categories typically included as part of the elements of an internal control structure. Though one could argue that the control environment should be listed first, this rearrangement is not critical given that the focus will be on the substance of the components and not necessarily their order.

The nine components constitute the criteria against which an internal control system is to be measured. The ED indicates that all nine criteria must be satisfied in order to conclude that an effective system of internal control exists. The ED further indicates, however, without elaboration, that some trade-offs may exist between components.

The focus should be on the subset/subsets of internal control which are critical to the prevention and detection of fraudulent financial reporting. Additional discussion and clarification should be provided as to the trade-offs between components relative to this specific subset. This additional information is needed in order to more fully understand the integration of the nine components, effectively implement the framework and be able to reach a conclusion relative to effectiveness. This is of primary importance given that the illustrative report in Chapter 15, "Management Reporting to External Parties", requires a statement as to whether or not the system of internal control over the reliability of an entity's published financial statements is effective.

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In elaborating on these trade-offs, cost/benefit considerations and judgements should be discussed as well as mitigating controls. It must be recognized that the costs of internal controls should not exceed the benefits to be derived. If there are minimum standards for effective control systems, the ED should so indicate this or explain why there are none.

Another issue which should be addressed relates to small businesses and whether or not owner/management direct involvement serves as a counter balance and therefore eliminates the need for such an elaborate framework which could potentially stifle entrepreneurial spirit.

Evaluation

Consistent with our view that the primary objective of the study should be internal controls necessary to the prevention and detection of fraudulent financial reporting, we do not believe that the evaluation methods and techniques contained in the ED address this primary objective.

The "points of focus" and the related illustrative questions center around controls that "help management of businesses and other entities better control their organization's activities".

If one is to evaluate a system of internal control designed to prevent and detect fraudulent financial reporting, one must evaluate the system of internal control as it relates to the various transaction cycles (e.g., cash receipts, revenues, inventory, procurement). It is axiomatic that a system designed to prevent/detect fraudulent financial reporting must be built on a bedrock of a properly functioning system of internal accounting controls.

While this aspect of the evaluation is briefly presented as part of the evaluation methods/tools for criteria (3) Objectives, we feel that there needs to be a focused, comprehensive presentation and discussion of the evaluation methods/tools for all nine criteria relevant to the issue of preventing and detecting fraudulent financial reporting.

Here at Allied-Signal, our evaluation of the system of internal accounting controls, which provide reasonable assurance as to the integrity and reliability of our financial statements, is a combination tops-down, bottoms up process. We periodically have all of our locations complete an accounting transaction cycle based internal control evaluation. Included in this process are both financial and operating management given that we consider operating management to be a critical component of the control environment. This process not only identifies areas where improvement may be needed, but it also requires that if a weakness is identified, a plan of corrective action is developed. Our evaluation process, at this level, also includes testing of the systems, including a review of the responses to the questionnaire, by our auditors, both internal and external.

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In addition to the transaction cycle evaluation, our process includes periodic meetings with managers, both financial and operational, of the various business units within the organization so that Corporate and Sector staff have a clear understanding of the problems and opportunities facing the units. This understanding is then utilized during the oversight review of the financial results. Critical to our evaluation is an assessment of the control environment. We consider the following as elements of the control environment:

- Management Philosophy/Style
- Organizational Structure
- Audit Committee of the Board
- Management Control Methods
- Internal Audit Function
- Personnel Policies and Procedures
- External Influences.

The Company, long before the Treadway Commission and the Foreign Corrupt Practices activities, recognized the need for strong internal controls and instituted a system to insure the integrity of its financial statements. The Company, with the full support of management, has a strong Corporate ethical climate strengthened by a written code of conduct ("Code"). Employees with "key" functions are required to sign annually a document stating that they have read the Code and indicating whether or not they have complied with its provisions. Other internal control initiatives include a strong and active Audit Committee of the Board of Directors which is comprised solely of outside directors. The Company also maintains an internal audit department and has a close working arrangement with the Company's independent auditors. The auditors, both internal and external, meet with the Audit Committee at least quarterly.

We are of the opinion that the subset of internal controls which are critical to the prevention and detection of fraudulent financial reporting includes internal accounting control, an effective internal audit function and an informed, vigilant and effective audit committee. The ED should focus on this subset and provide evaluation guides/tools relative to the nine components vis-a-vis this subset.

<u>Management Reporting to External Parties</u>

Chapter 15 appears to be the only chapter dealing specifically with financial reporting. We agree that public management reporting on internal control is not a component of, or criterion for, effective internal control. We do feel that some of the guidance material provided is helpful for companies publishing management reports on internal control. However, as discussed under the heading <u>Components</u>, definitive, measurable criteria must be provided to evaluate the effectiveness of the internal control system over financial reporting before such a requirement is incorporated in any report.

The illustrative report describes the category of controls being addressed as controls over the preparation of published financial statements. Use of the word "over" is not appropriate if internal control is to be defined as a process. A process is a series of actions or operations conducing to an end. The end, in this instance, is the integrity and reliability of financial statements. This process extends beyond the preparation of the statements per se and incorporates the entire system of financial reporting. The first sentence in the illustrative report should therefore read:

> XYZ Company maintains a system of internal control that provides reasonable assurance as to the integrity and reliability of its financial statements.

The remainder of the report should be modified in light of this change.

In conclusion, we fully appreciate the importance of this study and are convinced that private sector actions and initiatives have the greatest likelihood of producing cost beneficial improvements in internal controls. We therefore hope that our comments will prove useful in the development of a document which will educate and provide guidance to companies in judging the effectiveness of, and thus improving, their internal control systems.

Very truly yours,

J. Thomas Zusi

J. Thomas Zusi

JTZ/ml
SF30004

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WANDA A. WALLACE, PH.D., CPA, CMA, CIA
Deborah D. Shelton Systems Professor of Accounting

June 14, 1991

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1211 Avenue of the Americas, 6th Floor
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Re: Comments on the Exposure Draft Entitled Internal Control--Integrated Framework

I have shared detailed comments on earlier drafts of the document and many of those ideas continue to apply to the COSO document. However, I will focus on the primary concerns I continue to have regarding the content and plausible usefulness of the current Exposure Draft.

I believe that a "floor" of essential control components is needed as guidance to those professionals who are represented by COSO. An operational set of criteria would facilitate comparison of two organizations and reasonably consistent implications as to whether that floor was met by each entity. I have repeatedly requested an exemplary applications-oriented set of guidance that would clarify an unacceptable setting, an acceptable setting, and a desirable setting. Such a continuum, structured around critical control components in my view would be invaluable. However, no such guidance is presently available in the document.

In my past research and that with which I am familiar in the public domain, there is no evidence that a public report on internal controls is either demanded by users or would be value added. Indeed, my work when the 1979 proposal was made indicated that many users felt that a boiler plate mandatory report in the public domain would erode information available in management letters and special-purpose reports for which contracting parties could negotiate. The costs associated with public reports on control are perceived to be significant and the benefits appear arguable at best. The COSO document's position on the public report fails to admit the prevalence of evidence at odds with the proposed additional disclosure and implicitly endorses the concept. Importantly, the business environment is changing quickly, the information age will likely alter the form that controls will and should take, and any sort of boilerplate approach to reporting would appear at direct odds to the increasingly "tailored to the consumer" strategy evolving in markets. Moreover, the quality assurance thrust in the economic sector would seem at odds with a "sufficient control" mentality. Hence, the three-way continuum I request above becomes increasingly important--how can we improve even if we meet the minimum floor?

I believe that a document addressing useful control guidance for implementation by varied constituencies needs to present an "audit trail" of what was considered, why certain ideas were discarded, and what evidence

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supports conclusions drawn. The present document fails on each of these needs. Generalities prevail, footnotes are inadequate, and logical explanations of choices are absent. A new, shorter, more on-point document in the form of a Discussion Memorandum such as those put forth in the more formal standard setting community is needed. The current document does not invite commentary, because the choices and alternatives are not delineated.

To be more detailed in citing some examples underlying these concerns I have outlined, I will provide some references to the final COSO document:

o p. 2 makes it sound as though "specified objectives" being accomplished is the definition of control; this would mean that when Keating accomplished his objectives, controls were present! Surely that is not intended but is implied

o p. 2 refers to nine components being "essential" yet the possible substitution among components is implied elsewhere and what magnitude of each component meets the "essential" criterion is not developed

o p. 8 when referring to the control environment should integrate competence in an explicit manner (in my judgment, this is an example of the manner in which comments have been an "add-on" rather than an integration; while the notion of competence was added, as I and others had requested, it is not an integrally coordinated facet of the exposition)

o p. 9 the scope of report discussion could be misleading since most of us would contend that a set of financial statements can be fairly presented despite a poorly controlled environment

o p. 10 refers to a "current report" being needed; is this "annually" or ?

o p. 11 refers to the material weakness concept and a need to perhaps have others refine or better define the ideas; why not elaborate on what the issues are--is it not the case that this would be one of the expectations of the COSO guidance?

o p. 12 in referring to COSO seems to state that the organizations believe the exposure draft provides the framework envisioned by Treadway; I believe that characterization is at odds with the debates I have observed and in which I have been involved--better and clearer guidance would seem essential to meet the goals of the Treadway Commission

o p. 13 refers to built-in versus built-on and then asserts "To do so only means costs"; surely sometimes "built-on" is essential, has benefits, and would be preferred to inaction!

o p. 15 speaks to the cumulative and redundant nature of controls reducing risks; yet, redundancy can create bureaucracy, apathy, and ignoring of controls and this possibility deserves recognition

o p. 16 speaks to "An appropriate balance" yet provides no direction as to w such a balance is achieved o p. 17 introduces the idea of "the general average of the community"; to what community is COSO referring? I understand that recent litigation has tried to separate the concepts of GAAP and GAAS from some "higher standard" expected from a particular local "community"; this approach seems an operational nightmare in the sense of not achieving consistency and consensus as to "floors" of controls and related issues

o p. 18 has a quote from Justice Learned Hand with no citation

o p. 20 seems to make management override and fraud equivalent; I strongly disagree with such a characterization and believe such blurring of distinctions in terminology will confuse rather than enlighten

o p. 21 states that "The chief executive officer is ultimately responsible and should assume "ownership" of the control system." I believe this sentence is interpretable in a manner that grants excessive power to the CEO and could even induce a legitimacy implication for management override. The ownership of controls is at a corporate governance level, with societal responsibilities.

o p. 24 describes board of directors' responsibilities and refers to how the board "can confirm its expectations through its oversight activities"; what if these expectations are low?

o p. 24 refers to the nominating committee's role through identification of qualifications of prospective board members; note that the objectivity and independence of the members, particularly as a balance on the CEO's role, is a facet of that committee's evaluation of directors (this is similarly needed as a dimension of the highlighted summary on p. 25)

o p. 25 should mention the frequency of meetings issue and the necessity of access to internal audit report files on a routine dissemination basis

o p. 26 why not elaborate on examples of other committees and their setting, such as the regulatory setting faced by defense contractors

o p. 26 the footnote #1 is incomplete; note place and year

o p. 28 the lines of reporting need to be more explicitly developed, e.g., should internal auditors be required to share findings with external auditors; should external auditors require copies of all reports by internal auditors?

o p. 28 the external auditor discussion needs rewritten from a COSO perspective

o p. 28 the next to last paragraph about "Some believe..." could be dangerously misleading since it implies a basis exists for this, whereas the observation is clearly a misperception; reword to label the belief a misperception and to alter the "Others believe" to "Others are under the erroneous assumption that..." the declarative statement at the end of the paragraph is too late and the other sentences could easily be read out of

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context and mislead

o p. 36 Where is the CEO's self-test? Members of the FERF advisory group requested a self-test for CEOs that could allow them to evaluate their entity on the sort of continuum I request above; no such guidance has been included as yet

o p. 36 in the last paragraph presumes certain characteristics of internal auditors, yet their role must assume that the organizational structure is conducive to the objectivity of internal auditors and should be an explicit point

o p. 39 "A word of caution is needed. When comparing internal control systems, consideration must be given to differences that always exist in objectives, facts, and circumstances."; such a phrasing is indicative of the generality of discussion, the absence of an operational definition, and the possible loose interpretation by Keating and others that due to their objectives, their control is appropriate...

o p. 41 refers to deficiencies; what should be clear here, rather than garbled is that at least five possibilities exist: (1) opportunity for improvement, (2) desirable control, (3) deficiency in control, (4) minimal floor achievement, and (5) material weakness (below floor). Where are these delineations and where is the operational guidance to place a given control system along such a continuum?

o p. 41 refers to reports from external sources but fails to clarify what constitutes "carefully considered" and what control procedures are expected to ensure availability of such feedback

o p. 42 states "However, condoning personal use of the entity's money might send an unintended message to employees." Talk about an understatement of the decade! Why not TALK STRAIGHT!

o p. 43 line 3 states "usually to at least one level of management above the directly responsible person"; why the delimiter of "usually"; if this is not a prescription, what ensures that a check and balance is invoked?

o p. 43 the exclusion to "significant findings" can limit effective oversight, particularly given the report's position that material weakness as a concept is not sufficiently developed; why not call for full disclosure on a FYI basis?

o p. 44 add that internal auditors should report to audit committees, who, in turn, should ensure disclosure to external auditors, to close the information loop

o p. 44 the wording of footnote 1 sounds restrictive in the choice of the word "include"; state that reportable conditions not only include all material weaknesses but also...

o p. 47 give full cites for footnotes 1 and 2

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The above examples of phrasing problems, content exclusion, and confusing expositions are indicative of what can be found upon continued reading of the COSO document.

I urge COSO not to endorse the document as presented and to rethink a more useful condensation of a continuum of controls that clearly sets forth a minimal floor and a goal to which to strive.

Sincerely,

Wanda A. Wallace

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GRAHAM D. STALEY
Vice President and Controller

June 14, 1991

Committee of Sponsoring Organizations of the
Treadway Commission
1211 Avenue of the Americas
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New York, New York 10036-8775

Dear Sirs:

On behalf of Holiday Inn Worldwide, I am submitting comments on the Exposure Draft, "Internal Control - Integrated Framework."

Overall, the Draft is well thought out and well presented and addresses the whole idea of internal control very comprehensively. We do have some observations on the section on "Management Reporting", but it should be noted that these are made from the perspective of a British owned company operating in the United States.

If you wish to discuss any of the points made, I shall be pleased to do so, and I hope that it will be possible to receive an update on the feedback received from other respondents.

Yours sincerely,

Graham D. Staley
Vice President and Controller

GDS/dlc
Attachment

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"Internal Control - Integrated Framework"
Exposure Draft
March 12, 1991

Comments From Holiday Inn Worldwide

Background

The comments below are made from the perspective of a division of a British company with its Worldwide headquarters in Atlanta, Georgia.

The ultimate parent company is U.K. based and publishes its accounts in accordance with the statutory requirements of that country. Divisions are allowed to act with a high degree of autonomy and group activity is coordinated by an Executive Committee which meets every two weeks in London, England. Divisional Chairmen are members of that committee and the Board of Directors.

1. Definition of Internal Control

   The definition is sufficiently broad to establish the full scope of internal control and does not limit it to financial control only. On the other hand, it is concise and easily understandable.

2. Components of Internal Control

   The graphic pyramid of internal control on page 58 is an excellent representation of the relationship of the nine components. The definition establishes "Integrity, Ethics and Competence" as the foundation of the other components but does not attempt to clarify the relationship of the other eight. This would be difficult to do whilst maintaining brevity.

   To overcome this, perhaps it would be possible as a matter of course to include the graphic and its associated description with the definition.

   No changes are suggested for the components themselves.

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3. Evaluation Techniques

To a large extent, the evaluation tools are already in use in our organization, although the users of the tools and the timing of their use differ.

The main factors in determining the users are objectivity and independence. A divisionally structured company like ours is able to use a variety of internal and external sources for the review of internal controls. Divisional Internal Audit will review departmental controls, with Group Internal Audit taking responsibility for the review of Divisional controls and whether these controls meet Group objectives. At a higher level, external consultants may be used and at the unit level, individual departments will carry out their own SWOT analyses.

The main factors determining timing are rate of change, degree of decentralization and risk of system failure.

4. Management Reports

U.K. quoted companies must include a statement by the External Auditors in their Annual Report stating that the accounts give a "true and fair view of the state of affairs of the Company." Where this is not possible, the auditors must state the reason and the accounts are termed "qualified."

Qualifying accounts is a serious decision for the external auditors and is not made lightly. When it occurs, protracted discussions will have taken place with the company to agree a remedy if at all possible and the consequences are at least strained client relationships resulting in the ultimate test of objectivity and independence.

Bearing this in mind, we have serious doubt about the integrity and objectivity of voluntary reporting on internal controls by Internal Audit or some other department. The primary role of internal audit is to report to Management on internal control. The relationship with management, which is necessary to create an effective internal audit function, would be difficult to maintain if external reporting responsibilities were added to the scope of the

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department. To achieve any degree of objectivity and independence, it will be necessary for the external auditors to prepare the statement and unless they increase the work considerably, they will not obtain sufficient detail to make a confident statement.

The choice would appear to be, therefore, between an expensive, reliable source provided by an external party or a potentially suspect source provided from inside the company. The overall objective of providing a statement of the level of internal controls is praiseworthy, but in practice may be difficult and/or expensive to deliver.

Unilever

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June 14, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
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New York, NY 10036-8775

Dear Sirs:

You have asked for comment on the exposure draft (ED) entitled "Internal Control - Integrated Framework".

Our broad reaction is to welcome the ED as a worthwhile initiative and useful addition to the literature on the subject. Our preliminary views on the four specific matters on which you have requested comment are as follows:

1. Definition of internal control. We agree with the broad definition proposed.

2. Components. We would not add to the list proposed. We see scope for simplification, in particular, by the combination of the first two components since we see integrity, ethical values and competence as integral to the control environment.

3. Evaluation methods and techniques. With respect to the need for evaluation, we agree completely. We would note, however, that the self-assessment can take several forms, all of which can be acceptable in achieving the purpose of such a review. In our Concern, as for many others, control evaluations are performed by the Internal Audit Department who report directly to our Chief Executive.

   With respect to the evaluation tools, we feel they have value as a wide-ranging check list but to be useful, as the ED makes clear, they will need to be tailored to the needs of the individual organization. We think that they bring little immediate added value to the effective control of large, well managed, businesses.

4. Management reporting to external parties. We think the guidance provided helpful and such as to be likely to increase the consistency, and usefulness, of management reports to external parties.

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We have a number of more detailed comments and they are set out in the attachment to this note.

Yours truly,

Thomas I. Dolan

T. I. Dolan
Vice President and General Auditor

Michael A. Fox

M. A. Fox
Vice President - Finance

MAF:nb
Attachment
0129

ATTACHMENT

DETAILED COMMENTS ON THE EXPOSURE DRAFT "INTERNAL CONTROL - INTEGRATED FRAMEWORK"

Chapters 1 and 4

The ED is communicating the message that management should initiate its own self-assessment of internal control through the use of multifunctional teams. While we feel that this type of self-assessment can and should be considered, we do not feel that organizations should consider only this type of approach. Where there is an on-going program of self-assessment performed by a qualified internal audit group reporting independently to senior management, it seems to us that internal audit itself is a self-assessment team, and should be confirmed as such in the ED.

Chapter 3

Page 24 Delete the reference to "internal audit" from the last sentence of the third paragraph.

Perhaps inadvertently the current wording suggests that it is normal for Financial Officers to be responsible for the internal audit function. We do not believe that this is, in general, the case but in any event it is an organizational structure which weakens internal audit's independence and effectiveness.

Page 26 Delete "components" from the first paragraph of the discussion of the role of Internal Auditors.

As drafted the sentence suggests that internal auditors have been using the conceptual framework provided by the ED prior to its existence!

Pages 28/29 The final paragraph on Page 28 confirms, inter alia, that the external auditor does not give an opinion on the internal control system. The discussion on Page 29 risks conveying a contrary message. You may wish to consider strengthening the limitations on the external auditors responsibilities in this area.

Chapter 6

Page 64 A template for a corporate code of conduct, which companies can tailor to their own needs, might be a useful contribution.

Page 65 Under "Codes of Conduct" the third and fourth questions clearly overlap and might be combined by deletion of the third and addition of the words "and acknowledged by all employees?" to the fourth.

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Chapter 7

Page 77 Under "Performance Appraisals" consider adding:

"Are performance appraisals performed periodically for all employees?"

"Are performance appraisals documented in sufficient detail for employees to be aware of how they have performed against management's objectives?"

And consider deleting:

"Is ethics/integrity a criterion in performance appraisals?" Reasoning that their absence would be cause for dismissal, rather than part of a performance appraisal.

Page 78 What is meant by "behavioral standards" in the second question?

Chapter 8

Page 89 We are unclear as to the meaning of "relevant standards" in the context of the second question, and the intention behind the third question. Both could usefully be clarified.

Chapter 11: Control Procedures

Suggested changes in this chapter include the following:

- The chapter emphasizes controls over information systems but skims over operational controls and procedures. It might be helpful to expand on operational controls and procedures (i.e., supervisory review, bank reconciliations, etc.).

- The chapter could usefully expand on the development of policies and procedures as important controls.

June, 1991
0132.doc

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

June 20, 1991

To: **Richard M. Steinberg, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Auditors
Louis Bisgay, National Association of Accountants

Gentlemen:

Attached is the eleventh batch of comment letters containging thirteen responses on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Tom
jmy

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

J. B. Farrell
19759 Wells Drive
Woodland Hills, Ca. 91364

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June 9, 1991

COSO
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

I have two sets of problems with the March 12, 1991 Exposure Draft: "Internal Control--Integrated Framework".

The first set of problems has to do with the objectives discussed in Chapter 8:

(a) Operations objectives -- Apparently, one would conclude that an internal control system would not be designed to provide assurance that "operations objectives" are being achieved. In the Summary Chapter, page 5, the first sentence reads as follows: "An internal control system should provide reasonable assurance that certain objectives--those relating to financial reporting and compliance with laws and regulations--are being achieved." Why just these two?

(b) Financial reporting objectives -- apparently these are to be defined by reference to management's needs for internal reporting and for external financial reporting. Have the objectives of internal reporting been defined anywhere in the authoritative literature? Are the objectives of external financial reporting to be defined differently from those identified in the FASB's Conceptual Framework?

(c) Compliance objectives -- ranking this objective on the same level of importance as the first two apparently means that compliance with laws and regulations should be of foremost concern in designing an internal control system. With this kind of primary emphasis, chances are that internal control systems will tend to be bureaucratic and regulatory in focus.

Possibly because of my difficulty in fully understanding these objectives, I came away with the impression that this document was intended as an encyclopedia of internal control concepts and ideas. To group all of these ideas into "...nine interrelated components..." and then state that: "Each is crititcal and must be present for internal control to be effective." (page 6) (underlining supplied) is to create a maze of ideas which can be interpreted in as many ways as there are evaluators. How does one implement an encyclopedia?

My second set of problems has to do with the baggage we have accumulated over the last forty-years as the public accounting profession has tried to keep more than an arm's length distance away from being charged with the responsibility of evaluating the effectiveness of management control systems.

If we accept the premise that the financial viability and profitability of an enterprise are directly related to management's ability to plan and control the activities of that enterprise, why does it not follow that all parties are really interested in evaluating the strengths and weaknesses of the "management control systems"?

Isn't it about time that we put aside the term "internal control" (which has a long history of confusion of "internal accounting control" and "administrative control")?

Shouldn't all parties be concerned with identifying and describing all those activities which would fall within the definition of "management control systems?

And at the same time shouldn't we acknowledge that understanding the effectiveness of management control systems has to be based on an understanding of:

(a) <u>the nature of the operations/activities of a enterprise,</u> and

(b) <u>the constraints imposed on the particular enterprise by the business/economic/regulatory environment in which it operates.</u>

Once we have become used to the idea that all those interested in "adequate internal controls" are really interested in "adequate management controls", perhaps we can acknowledge that "management controls" over an enterprise's activities will vary significantly with the type of activities engaged in. Both accounting and auditing have evolved under the basic premise that manufacturing activities provide the common grounds for determining "generally accepted" principles.

We are now beginning to recognize that "generally accepted accounting principles" are no longer relevant to many industries. The proliferation of accounting guides (and auditing guides, statements of position, etc.) is evidence that one set of general principles will <u>not</u> adequately measure and report on <u>all</u> of the information necessary to "<u>fairly present</u>" the financial affairs of companies in <u>widely differing</u> industries operating under <u>diverse</u> business environments. Accounting and financial reporting principles must be tailored to the operating facts and circumstances which are unique to the many specialized industries which have evolved in the last few decades.

I believe we should also recognize that the management control systems appropriate to a bank (or a savings and loan association, or to a motion picutre company, or to an oil company, etc.. etc., etc.) are significantly different from those of a manufacturing company.

In summary, the exposure draft is deficient because it fails to recognize:

(a) the importance of understanding the implications of modern management control systems

(b) the significance of management control systems that are unique to specific industries, (e.g., the production control system in a manufacturing company, the loan approval system in a bank, the cash management system of an amusement park , etc.), and

(c) the significance to financial reporting of communicating information about changes in the external business environment which have an impact on the financial viability and profitability of a particular enterprise.

To continue the charade that "internal control" is something different and apart from "management control" will only reinforce a long-held belief by auditors that they do not have to understand management control systems. The notion that "internal accounting controls" have an importance separate and apart from "administrative controls" is a delusion that has existed for too many years. If one focuses on "internal accounting controls", one evaluates effectiveness of control by determining whether a foreman's approval appears on time cards. If one focuses on "management controls", one evaluates the effectiveness of budgetary controls over labor costs and the degree to which several layers of management are monitoring significant differences between actual and budgeted labor costs.

Sincerely,

J B Farrell

J. B. Farrell

CC to:

Shaun F. O'Malley-Managing Partner, Price Waterhouse
Charles A. Bowsher-Comptroller General of the United States

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Automatic Data Processing, Inc.
One ADP Boulevard
Roseland New Jersey 07068-1728
201 994-5000

June 10, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Gentlemen:

Thank you for the opportunity to comment on the March 12, 1991 Exposure Draft of "Internal Control - Integrated Framework".

We believe there is a legitimate need for a common framework for public companies reporting on their system of internal control as it relates to the preparation of published financial statements...but we respectfully submit that the issuance of a 340 page "cookbook" document is the wrong way to accomplish this goal. Unless more narrowly focused we believe that this document will end up requiring costly and onerous documentation procedures while providing limited value to its users. This burden of costs with little benefit would contribute towards making U.S. companies and capital markets less competitive than they are today.

We believe that the exposure draft is flawed principally in the following areas:

- To be useful the final report should be narrowly focused on financial reporting and those areas of internal control directly impacting financial reporting. The exposure draft deals broadly wih the concept of internal control and then somewhat illogically shifts to a more narrow focus on control over financial reporting. It also does not differentiate on the overlaps between operational and financial controls.

- Appendix C contains a substantial amount of detail on evaluation tools regarding certain areas of internal control. However, since the business facts and circumstances and the resultant internal control systems will appropriately vary significantly from company to company, there is no set of procedures...no matter how detailed...that can have universal applicability. While these pages may be intended to be illustrative, they seem more like unnecessary clutter.

In summary - the need for broad guidance for public companies reporting on the internal control systems behind their financial reporting is real. In order to effectively do this, however, the document must be narrowly focused on the area of financial reporting...while at the same time broadly dealing with those general principles that have universal applicability.

Sincerely yours,

Arthur F. Weinbach
Senior Vice President
Finance & Administration

Richard J. Haviland
Corporate Controller

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The Goodyear Tire & Rubber Company

Akron, Ohio 44316-0001

EXECUTIVE VICE PRESIDENT

June 10, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas - 6th Floor
New York, New York 10036-8775

Dear Committee Members:

We are pleased to respond to your request for comments on the Exposure Draft, INTERNAL CONTROL-INTEGRATED FRAMEWORK. It is our opinion that the study has made a valuable contribution in understanding internal control.

The draft report requested comment on four specific points. Our comments are as follows:

Definition (Chapters 1 and 5). Internal control is defined as a process, executed by the entity's people, to accomplish specified objectives. Do you agree with the definition? If not, why not?

Components (Chapters 1 and 5 through 14). The report identifies nine components essential to effective internal control. Are there others that should be added? Should any be deleted?

> We believe the definition of internal control is a process to accomplish specified objectives, we do not agree that it should contain all of the nine components. The definition as published in the study is too broad and therefore the underlying concepts would be difficult to effectively disseminate throughout a business entity.

Evaluation (Chapters 4, 6 through 14 and Appendix C). Many methods and techniques can be used in evaluating internal control. This report discusses evaluation, and presents evaluation tools intended to be useful in assessing internal control systems. We would like you to compare and contrast the evaluation process followed by your organization with the guidance specified in the study and then provide comments on the usefulness and adequacy of the approach recommended in this report. Would you use the tools as either a substitute or a supplement in evaluating internal control in your organization? Please explain.

In our Company we would not benefit significantly from the content of the exposure draft. For the most part, the tools and techniques recommended consist of questions to be used in evaluating specific areas. We might refer to the evaluation questions but would not use the evaluation tools in their entirety. Also, the content of the draft report is too long and theoretical to serve as an effective teaching tool.

We suggest that the report be summarized into the format of a questionnaire not exceeding 8-10 pages.

Management Reporting to External Parties (Chapter 15). A number of private, legislative and regulatory proposals have been put forth regarding management reporting on internal control as it pertains to financial reporting. This chapter provides guidance on the subject, and presents an illustrative management report. Do you believe the guidance material is helpful for companies publishing management reports on internal control? Please explain.

Last year we expressed our opinion with regard to HR5269 (the Omnibus Crime Bill). Our opinion is that management reporting on internal controls in annual reports is not in the best interest of Goodyear and other U.S. multi-national corporations. We continue to have that opinion and therefore support the comments on page 155 of the Exposure Draft:

"...identifying these deficiencies in the report may cause report readers to second-guess management's overall assessment of internal control or question the appropriateness of its actions in dealing with the deficiencies. All in all, the arguments against reporting these matters outweigh those for it."

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We appreciate the opportunity to comment on the exposure draft. We are confident that the final report will be a significant contribution for improving financial internal control.

Very truly yours,

Oren G Shaffer
jlf

TEXAS INSTRUMENTS

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June 10, 1991

Committee of Sponsoring Organizations
of The Treadway Commission
6th Floor
1211 Avenue of the Americas
New York, NY 10036-8775

Gentlemen:

We appreciate the opportunity to comment on this project. Following are our comments provided in the suggested format:

Definition of Internal Control (Do you agree with definition? If not, why not?)
Nine Components in the Internal Control Definition (Are there any that should be added or deleted?)
After reviewing this draft document, we reread Statement on Auditing Standard No. 55, which was issued in 1988 and is the current text on elements and review of internal control. Frankly, we find No. 55 adequate and in no need of change. Our internal and external auditors have developed an efficient and effective cooperative program to regularly review our internal control. While we appreciate the Committee's efforts on this project and understand the document defines internal control overall and not just related to financial information, we are aware of no demonstrated need to expand the internal control definition and the related evaluation checklists and questionnaires. Given the regulatory history in this country, we think issuance of this document will inevitably lead to increased and unnecessary bureaucratic requirements for internal control reviews and representations.

We are concerned the primary impetus for this project is a reaction to the current difficulties of financial institutions and the related legislative response. Unfortunately, this project is not focused on the problem, financial institutions, but instead is a board brush extending over all companies. We believe this is inappropriate.

We think the document is a solution in search of a problem. We suggest it either be withdrawn or refocused on the problem: financial institutions. We believe to do otherwise, i.e., to issue the document as is, will further saddle American industry with unnecessary, and competitively harmful, compliance costs.

Guidance for Evaluation (Compare and contrast the evaluation process followed by your organization. Is the material helpful? Would you use the tools as a supplement or substitute?)
Since we do not advocate expanding the definition of internal control, we see no need for the "Guidance for Evaluation." The checklist and questionnaires we have been using to evaluate internal control have proven to be adequate and cost efficient.

Management Reporting to External Parties (Do you believe the guidance material is helpful?)
Notwithstanding our basic comment that this document should be withdrawn or refocused, we have several concerns about a management report on internal control. First, we believe a report on internal control in the annual report is basically redundant. Our external auditors certify as to the accuracy of our financial statements. We do not think the management representation/opinion adds anything, other than perhaps litigation protection for those auditors.

We also object to the thrust in this draft whereby management would opine on the effectiveness of the control system, versus the current practice of discussing what the system is designed to do. We are concerned an annual management opinion on effectiveness of the control system will require excessive and cost inefficient reviews and documentation.

The effort could be especially onerous given this draft's guidance that such opinion should cover quarterly report preparation. Contrary to the draft's conclusion that the opinion as to effectiveness would only be as of year-end, we think it could be interpreted to require quarterly reviews, i.e., a virtual continuous and expensive evaluation process.

Specifically, on page 157, the draft management representation notes that the company "maintained" an effective system of internal control "over the preparation of its published financial statements." And, as noted on page 151, "this means the report covers the preparation of quarterly financial information contained in the year-end financial statements." Contrary to the commentary on that page that this does not mean that internal control was effective at each quarter-end, we think it may mean exactly that. At least, we think there is a clear risk that regulators or the courts will interpret it that way.

We think the management report section should be substantially revised to eliminate the "effectiveness" opinion. Further, we suggest the draft management opinion be revised to clearly exclude quarterly information.

Although this draft document does not call for external auditor review of the management report, this could be the ultimate result of including an internal control report in the annual report to stockholders. Any additional layer of review merely increases the audit fee we must incur, without providing any additional benefit to the company's stockholders or the investing public. Increasing the audit fee for U.S. corporations, for a cost-inefficient requirement, will contribute further to the uneven playing field advantage that some foreign corporations enjoy.

And finally, in an overall sense, we are concerned about the cost inefficiency of a management report on internal control, whether requiring continuous or point-in-time review and whether requiring external auditor review or not. We frankly think this draft report is remiss in not explicitly addressing this issue.

This concludes our comments. We would be pleased to provide additional information if appropriate.

Sincerely,

Gerald R. Pierce

Gerald R. Pierce
Vice President, Corporate Staff
Director of Corporate Audits

GRP/jrm

98

STATE OF MONTANA

Office of the Legislative Auditor

STATE CAPITOL
HELENA, MONTANA 59620
406/444-3122

LEGISLATIVE AUDITOR:
SCOTT A. SEACAT

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DEPUTY LEGISLATIVE AUDITORS:

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Operations and EDP Audit

JAMES GILLETT
Financial-Compliance Audit

JIM PELLEGRINI
Performance Audit

June 10, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Dear Members of the Committee:

Enclosed is our response to the Exposure Draft dated March 12, 1991, Internal Control - Integrated Framework.

As stated in the response, we believe the guidance offered on internal controls will be beneficial to all users of the document.

Thank you for the opportunity to contribute to the report. If you have any questions, please contract us at (406) 444-3122.

Sincerely,

Rebecca Dorwart

Rebecca Dorwart
Senior Auditor

Enclosure

RD/v/c2.ltr

Internal Control - Integrated Framework
Exposure Draft - March 12, 1991

Your report on an integrated internal control framework will provide the necessary guidance for management, board of directors, internal and external auditors, legislators, regulators and other parties in understanding and applying internal control. We believe the report effectively addresses and explains the components of the internal control structure. We have identified some areas for your consideration as you prepare your final draft.

As an overall comment, your editor should consider eliminating some of the passive voice used throughout the text and replace it with active voice. The use of passive voice detracts from the presentation and makes the concepts more difficult to understand. The following are specific comments on the draft.

Chapter 1 - Summary

Page 3 - Proposed Definition of Internal Controls
The wording and punctuation used in the definition make it difficult to understand. If the definition is to be useful, it must be easy to understand and remember. Complicated sentence structure is a "road block" to attaining a universal definition.

Page 4 - Fundamental Concepts
The description of the elements of internal control effectively presents the concepts individuals must understand when addressing internal controls.

Page 6 - Control Environment
The wording of this component is difficult to understand. Parallel phrasing may make this more understandable. (i.e. management's philosophy, operating style, assignment of authority and responsibility, organization, and personnel development; and the Board of Director's attention and direction.)

Page 9 - 3rd Paragraph
The report ably addresses the common misconception that the internal control system is the responsibility of the accountants, when in fact, it is the responsibility of top management.

Page 9 through 11 - Management Reporting to External Parties
This subject is explained in detail in the final chapter of the report. If the summary chapter is a brief overview of the report this extensive discussion of management reporting to external parties may not be necessary, especially since the final chapter contains similar, if not duplicate, information.

Chapter 2 - Limitations of Internal Control

Page 15 - Chapter 2 Summary
The summary adequately addresses the limitations of any internal control system through the use of examples.

Page 17 - Prudent Person Concept
This section provides a helpful analysis of the cost/benefit relationship of internal controls by addressing what a prudent person would do in a similar situation.

Chapter 3 - Roles and Responsibilities

Page 22 - 3rd Paragraph
The use of the term "CEO" is generally accepted and used in the business community, but is it a term generally accepted and used by all users of this document? The writer could place "CEO" in parenthesis after using the term "Chief Executive Officer" for the first time in this section. The writer may then use "CEO" in the text without confusion.

Page 23 - final Paragraph
Same comment as above pertaining to the use of the term "CFO"

Page 25 - 4th paragraph
This paragraph leaves the reader wondering what are the "general guidelines" related to the audit committee. Should these be explained here? Is this reference to the Treadway Commission necessary?

Page 27 - 2nd paragraph
This sentence is long and confusing. It is unclear what the point of the sentence is. By breaking it up into several smaller sentences, the point may become more evident.

Page 27 - 4th paragraph
The section ably points out that the design and implementation of an internal control structure is the responsibility of management, not the internal auditor. The internal auditor's role is to evaluate the effectiveness of the systems.

Page 27 - Other Entity Personnel
The concept of effective internal controls being the responsibility of all personnel is excellent. All personnel should be aware of their roles in internal controls. This ties back to the concepts of Integrity, Ethics and Competence as well as to the importance of communication.

Chapter 4 - Evaluation of Controls

No comments

Chapter 5 - Definition

Page 51 - Definition
Same comments as Chapter 1 page 3 regarding the definition.

Page 54 - 1st indented paragraph
The writer should define the term "value chain" since it is not a universally used phrase.

Page 54 - People Section
This section explains the realities of the people responsible for internal controls and points out they are the driving force behind internal controls

Page 56 - Chart of Components and Criteria
The chart effectively explains the relationship between the components of internal control and the criteria for effective internal controls.

Page 57 - Linkage and Model
The narrative and visual model will help the reader recognize the interrelationship of the components of internal control. If one section of the pyramid is missing or weak, the whole system collapses.

Page 57 - 5th paragraph
Is "Iterative" the word you wish to use? It seems out of context with the rest of the paragraph. Should this be "interrelated" as described in the remainder of the paragraph?

Chapter 6 - Integrity, Ethical Values and Competence

Page 62 and 63 -Reducing Incentives and Temptations
This section describes the factors that influence individuals in engaging in questionable behavior. This is an excellent reminder for management not to set unrealistic goals for themselves or employees. It also points out the dangers of weak internal controls. The bottom line is "don't place your employees in a situation where they will not be able to resist temptation."

Chapter 7 - Control Environment

No comments.

Chapter 8 - Objectives

Overall the section effectively identifies the relationship between objectives, goals, controls, and assertions.

Page 84-86 Reasonableness of Objectives
This section should be helpful in establishing an entities objectives and related controls

Chapter 9 - Risk Assessment

Page 91 - Chapter Summary
The chapter summary introduces the concept of "risk management."

Page 91 - Risk identification
The concept of explicit versus implicit objectives is an important point. It is important for management to ensure all parties interpret the implicit objectives correctly to adequately assess the risk associated with achieving that objective.

Page 96-97 - Integrating Risk Assessment
The section stresses importance of doing risk a assessment and not the "how." Management must be more cognitive of its responsibility in this area (risk assessment). The guidance this chapter contains should provide management with the necessary impetus.

Chapter 10 - Information Systems

Page 103 - 3rd Paragraph
"information Systems. . .used by people."

Page 107 - 4th Paragraph
"employees may no longer. . .feeling of usefulness and worth"

Overall, this chapter should more clearly identify and/or emphasize the necessity of human interactions and response to information systems.

Chapter 11 - Control Procedures

Page 117 - Relationship between General and Application Controls
This section states "If there are inadequate general controls, it may not be possible to depend on application controls. . ." We believe it is not possible to depend on application controls in this situation because the "umbrella" under which applications function is "leaking." Application controls

cannot be strengthened enough to compensate for ineffective/nonexistent general controls.

In general, this chapter provides useful definitions and examples of control procedures.

Chapter 12 - Communication

Overall the chapter effectively promotes the concept that communication is the responsibility of all players -- management and staff.

Chapter 13 - Managing Change

Pages 130 to 131 - Circumstances Demanding Special Attention

This section provides good examples of circumstances demanding change.

Chapter 14 - Monitoring
no comments

Chapter 15 - Management Reporting to External Parties

Page 160 - Footnote 5
The correct title of the SAS is Reporting on Internal Accounting Control.

Page 161 - Tailoring the Judgement
The examples provided are a good idea. They are helpful to individuals identifying material weaknesses.

v/c2.mem

June 11, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of The Americas, 6th Floor
New York, NY 10036-8775

Gentlemen:

I have reviewed the draft of the Internal Control - Integrated Framework document and I offer the following comments for your consideration.

1.A Definition of Internal Control (Summary, page 3; Chapter 5, page 51)

Recommend substituting the term "dynamic system" for "process". "System" is more suitable because it implies a broad structure that has integrated elements which include a variety of inputs, processes and outputs. Indeed, the draft states that "the nine components constitute a total system of internal control" (page 56). Furthermore, the system of internal control is not static but dynamic, changing as conditions demand.

1.B. Components of Internal Control (Summary, page 3; Chapter 5, page 56)

Recommend portraying the control environment as the umbrella of the control system. The environment is composed of two elements. First is the macro-perspective: the external social, political and economic influences which affect the entity. This element involves the attitudes and expectations of the public, including investors, creditors, customers and suppliers. The second element is the micro-perspective conditions, which includes the value system, motives, style and competence of the entity's management and leadership.

The value system is the set of ethical standards which guide the behavior of management and sets the tone, influencing the collective behavior of the entity. This ethical code includes character traits of honesty, integrity, morality, loyalty, etc.

Functioning within, or under, this umbrella of the control environment is the control structure. The structure includes all plans, policies, procedures and other mechanisms which direct the entity's progress.

Following is an outline of the relationship of control components as I interpret them.

INTERNAL CONTROL COMPONENTS

1. Control Environment
   a. Macro-External Conditions
      - social, political, economic influences and risks
   b. Micro-Management Tone
      - value system, motives, competence and style of management

2. Control Structure
   a. Management Controls
      - planning, staffing, organizing, directing
   b. Operational Controls
      - policies, procedures, standards, supervision
   c. System Controls
      - input, process, output, storage, access
   d. Communication
      - accountability, information, coordination, measurement, feedback

2. I think the concepts are not presented clearly and concisely enough to preclude confusion among various potential readers. I would not expect line or middle management to wade through the document on their own, nor be able to apply the concepts having done so. I also don't think senior management would spend much time or effort on this. This document is largely academic theory that would be helpful as a classroom reference text, the basis for discussion of specific elements or a research tool.

3. The evaluation tools, (Appendix C) may prove useful to an internal audit staff in identifying control objectives, risks and procedures. I don't think management would be inclined to use them. I think additional time is needed to assess the applicability of the evaluation tools and, for that matter, the entire document.

4. Management reporting to external parties is an adjunct issue that should be mentioned but does not warrant development to the extent found in the draft. In fact, on page 9 the document states external reporting "is not a component of, or criterion for effective internal control." The content of any external report is an issue to be addressed by the regulatory entity which requires it. A separate study of external reporting would be appropriate.

5. The document is excessively wordy. Even the summary is longer than necessary. The draft needs general editing to eliminate redundancies, wordy phrases and unneeded information.

I recommend the following changes.

A. The evaluation tools should be modified to integrate the appropriate questions into the related points of focus.

B. The reference manual should include definition of the category codes O, F & C.

C. Specify CEO and/or owner has the primary responsibility for establishing the right tone (page 9).

D. Self-Assessment (pages 13-14) should include mention that the internal audit function is the primary resource that senior management should look to.

E. Costs versus benefits example (page 15) should indicate that control must be adequate to assure availability for production.

F. Management override examples (page 19) should include intent to enhance operational performance or meet production requirement.

G. Word of caution (1st paragraph, page 39) phrase "distinction between" requires a second element of comparison.

I. Insurance Company question (page 138) should be generalized for any sales situation.

Thank you for the opportunity to express my opinions. I hope my comments are helpful in preparing the final version of the Internal Control document.

Sincerely,

Kenneth Winter, CIA, CPA
Director, Audit Administration
Service Merchandise Company

cc: Tom Powell

/475

100

THE UPJOHN COMPANY

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June 11, 1991

Committee of Sponsoring Organizations of
the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Gentlemen:

The purpose of this letter is to respond to the Exposure Draft (ED) of the Committee of Sponsoring Organizations of the Treadway Commission.

We support the recommendations of the Treadway Commission. In concept, we also support the efforts of the Committee of Sponsoring Organizations in carrying out the Commission's recommendation to "integrate the various internal control concepts and definitions and to develop a common reference point." However, we were quite dismayed by the broad scope and lack of clarity of the ED.

We have voluntarily included a Report of Management in our Annual Report to Shareholders since 1980, as recommended by the Financial Executives Institute (FEI). That report has always referred to "systems of internal accounting controls," which is a well understood concept and the one used by FEI. We believe the ED's omission of the concept of internal accounting controls is inappropriate given the fact that this concept is commonly used and has served preparers and auditors of financial statements well for many years.

Also, we are concerned about the costs to implement the ED. Both auditors and preparers of financial statements currently use an established framework recently updated by Statement on Auditing Standards No. 55 (SAS 55), the related audit guide published by the AICPA, and established documentation and review methodologies to carry out their respective responsibilities for internal accounting controls. The ED does not address how it relates to this existing literature and methodologies. The Treadway Commission's charge was to integrate proven concepts, not create a need to revamp all prior literature.

Finally, we have grave concerns about the ED which stem from the fact that it deals primarily with a broad range of internal controls, including operations and compliance with laws and regulations. We are concerned that the document could be misconstrued as suggesting that the accountant, the auditor and the audit committee have the ability and the responsibility to implement, monitor and oversee this full range of internal controls as contrasted with the system of internal control over the preparation of published financial statements.

The balance of this letter provides more detail relative to our concerns.

SCOPE OF THE EXPOSURE DRAFT
In our opinion, the primary focuses of the ED should be on internal accounting controls and on the related management report. We believe the ED's inclusion of operational controls and compliance with laws and regulations is confusing, because throughout the text it intermingles these controls with internal accounting controls. We do not deny that these controls exist, but the extensive discussion of them in this context is not necessary.

This country has a long history of financial controls and auditing. To broaden, either intentionally or unintentionally, the audit requirement to include operational controls and compliance with laws and regulations is inappropriate without the full range of due process that such a major change in emphasis deserves.

The private sector in the U.S. faces stiff competition from overseas. A new bureaucracy to document and administer a broad definition of internal controls only heightens the competitive disadvantage. To set guidelines for the lowest common denominator penalizes the businesses which are well managed.

INTERNAL ACCOUNTING CONTROL PRINCIPLES
It seems appropriate to develop linkage between the ED's principles of internal controls and current accounting and auditing literature. We feel that the ED should reconcile its approach to SAS 55. SAS 55 outlines the "elements of an internal control structure" for the accounting and reporting process in paragraphs 6 through 15. These include; a) the control environment, b) accounting systems, and c) control procedures. In addition, these "elements" are further elaborated upon in an audit guide "Consideration of the Internal Control Structure in a Financial Statement Audit" published by the AICPA.

Specifically, we feel a chapter should be added to apply the ED's "principles" to the existing accounting and auditing literature on internal accounting controls. Otherwise, unnecessary costs could be incurred to implement the ED.

It also seems appropriate to include in the ED an exhibit similar to 9-1, which would include financial controls for each business cycle from the accounting and financial reporting literature. This would establish the conceptual scope for the financial reporting objective.

INFRASTRUCTURE FOR EVALUATION OF NONFINANCIAL OBJECTIVES
It should be noted that there is not a formal infrastructure for evaluation of non-financial objectives. Accountants have generally only superficially explored evaluation of other control objectives. These evaluations seem to be concentrated in the areas where there is an overlap between operational, financial and/or regulatory objectives.

The Upjohn Company has had experience in adapting certain fundamental audit tools of third party review/audit to various regulatory processes. It is difficult, but possible, to establish an audit-type function where other disciplines are involved. The audit approach does seem to be adaptable, but it is a long, slow process requiring education of the other disciplines.

We would be pleased to discuss our views with you or provide additional information if requested.

Sincerely,

Frederick J. Hirt

Frederick J. Hirt

FJH:rem

Monsanto

LAWRENCE B. SKATOFF
Vice President-Finance

Monsanto Company
800 N. Lindbergh Boulevard
St. Louis, Missouri 63167
Phone: (314) 694-8405

June 12, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, New York 10036-8775

Gentlemen:

Monsanto supports the issuance of the report on an integrated framework of internal control. A strong, cost-effective system of internal control is a must in today's business environment. Business and other organizations will be served well by having a general guide that addresses the importance of internal control and the related components.

We agree with the report's emphasis on the total system of internal control, not just the system of internal control related to financial reporting (hereafter referred to as "financial control"). To be effective, the total system of internal control must be addressed by the entire organization, not just the finance organization. Therefore, the chief executive officer should emphasize strongly the importance of internal control to the entire organization.

We also agree with the report's suggestion that management should report externally on only its system of internal financial control. While management should emphasize to employees the importance of the total system of internal control, in our opinion, investors are concerned principally with the system of internal financial control because of its effect on the financial statements. The procedures to understand and evaluate the system of internal financial control are better defined than are the procedures for other types of internal control (referred to hereafter as "administrative control"). Because of the lack of generally accepted definitions for internal administrative control due to its more subjective nature, organizations should not be required to report externally on them.

We offer the following suggestions for consideration in the final report:

1. The report should caution readers that a strong system of internal control is not a substitute for "sound decision-making by management." A sound internal control system will not preclude business failures resulting from management decisions. For this reason, the report should discourage attempts by legislative groups to proclaim a good system of internal control as a cure-all to any type of future business failure, such as the current savings and loan crisis.

2. The report states that "no two entities will, or should, have the same internal control system." However, given the recent attempts by certain politicians to legislate the adoption of good systems of internal control, we suggest that the report place greater emphasis on the fact that a single system of internal control cannot be established as the standard for all businesses. Just as businesses appropriately have many different management styles and philosophies, businesses must have the freedom to select those procedures that managements believe are most cost-effective in achieving reasonable systems of internal control.

3. The exposure draft does not discuss the impact of external forces (including the relationships with customers and suppliers) on an organization's system of internal control. Understanding the relationships between employees and external forces is important in establishing a company's control procedures and, therefore, we believe this impact should be discussed.

4. The 47 page executive summary of the principal issues should be condensed significantly to increase the likelihood that executives will read it.

The attachment addresses other specific questions or issues raised by the report.

Sincerely,

L. B. Skatoff
Vice President - Finance

Attachment
cc: Mr. R. J. Mahoney
Mr. F. A. Stroble
Mr. John S. Reed - The Business Roundtable

/01

June 12, 1991 Attachment

The following questions or issues were raised either directly in the exposure draft or indirectly by commentators on the exposure draft. Our responses are indicated below.

Do you agree with the definition of internal control as a process executed by the entity's people to accomplish specific objectives? Should the definition of internal control encompass controls that extend beyond financial reporting?

We agree that the purpose of a system of internal control is to accomplish a set of objectives. We also believe that a system of internal control should encompass the entire organization and should not restrict itself to only one group (such as the finance organization) or one set of control (such as financial control).

The report identifies nine components essential to internal control. Are there components that should be added or deleted?

The nine components are appropriate, and we do not have any suggestions for additions or deletions.

Compare and contrast the evaluation process followed by your organization with the guidance specified in the study. Provide comments on the usefulness and adequacy of the approach recommended in this report.

The process of evaluating the system of internal financial control described in the exposure draft is similar to the process used at Monsanto to evaluate the system of internal financial control. Organizations trying to strengthen their control should benefit from the definitions and procedures described in the report. For Monsanto, the report provides a confirmation of issues considered in the establishment of our system of internal financial control.

Our procedures for documenting and evaluating the system of internal administrative control are not as formalized as those related to the system of internal financial control because of the numerous separate and sometimes unrelated disciplines involved. Further, administrative control is more subjective than financial control. This subjectivity inhibits the ability to determine the effectiveness of the evaluation of overall control. Because of this subjectivity, we question whether generally accepted definitions ever will be developed that might enable a company to evaluate and report externally on the effectiveness of its overall system of internal control.

June 12, 1991 Attachment

Is the guidance material helpful for companies publishing management reports on internal control?

The guidance should be helpful. Also, we concur that a management report should be limited to the system of internal financial control. However, a strong system of internal financial control is not a guarantee that a business will avoid a future business failure. A good system of internal financial control is not a substitute for "sound decision-making by the management." The management report should not be misinterpreted as a "fail-safe" mechanism that would prevent a future business failure.

Would the proposed framework of components and evaluation tools be useful to you in developing a self-assessment of your internal controls?

The report could be a useful document. However, the usefulness of the report will depend upon the willingness of companies to use the concepts described in the report when developing their systems of internal control.

What additional guidance would you suggest be provided to assist management in developing a self-assessment of a company's internal control structure?

We believe that the self-assessment:

- should encompass the entire organization, not solely the finance organization. All disciplines within the organization must have an understanding of internal control concepts and must be self-assessed.
- is an ongoing process in order for the system of internal control to continue to be effective.
- should include the impact of external forces (including the relationships with customers and suppliers). An understanding of the relationships between the employees and the external forces is important in establishing a company's control procedures.

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June 12, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
New York NY 10036-8775

California Society Certified Public Accountants

Dear Sirs:

The California Society of Certified Public Accountants' Accounting Principles and Auditing Standards (APAS) Committee is pleased to submit, for your consideration, the following comments related to the exposure draft titled "Internal Control -- Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report).

The APAS Committee is the senior technical committee of the California Society of Certified Public Accountants representing some 29,000 California CPAs. The 1990-1991 committee is comprised of 40 members, of which 20% are from national CPA firms, 55% are from local or regional firms, 15% are sole practitioners in public practice, 3% are in industry and 8% are in academia.

The APAS Committee commends the Committee for its decision to expose the COSO report to interested parties. As a result of the exposure process, management and others have an opportunity to provide valuable insights. The APAS Committee also believes the COSO report contains good guidance for an entity's management to use in evaluating the effectiveness of the entity's internal control structure over financial reporting.

We have some suggestions that we believe would improve the usefulness of the COSO report for management and their accountants.

Objective Criteria

The COSO report generally provides reasonably objective criteria to enable managements of large companies to report on the effectiveness of internal control structures over financial reporting. We have a concern that such criteria may not be useful for small to medium-sized entities. Most small to medium-sized entities may, for example, possess the integrity, ethical values and competence component without the formal use of written codes of conduct, an active board of directors and other devices larger companies use in their evaluation of this component. The APAS Committee, therefore, believes that the guidance could be improved by adding a separate chapter to the report that would describe how the criteria for the larger companies explained in the COSO report could be modified and applied to smaller entities, including closely-held, owner-managed entities.

Definition of Internal Control

The process of managing an entity has traditionally included planning, directing, staffing and controlling an entity's activities. Internal control has been one element of this process but is not the entire process as this report seems to imply. This broad definition of the internal control part of the management function may well lead to inappropriate expectations about the role of internal controls in an organization so that every business failure will be viewed as a result of deficiencies in the entity's internal controls.

As an example of this all-encompassing nature of the definition of internal controls, Chapter Eight states that setting objectives, including entity-wide objectives, is key to the definition of internal controls. We agree that this is an important part of the management function but do not agree that it is part of internal control. Internal control policies and procedures are needed to see that the entity's objectives

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are attained but the setting of such goals are necessary as a precedent condition to setting up the internal controls.

On page six and in other places in the report there is an indication that all of the nine components espoused by the report must be present for the internal control to be effective. The APAS Committee believes that many smaller entities may not have formal methods of assessing whether they have each of the nine components outlined in the report but still maintain an effective internal control structure over the financial reporting of the entity.

There appear to be several areas of overlap between many of the components and, while page six states that each element need not have equal importance, there is little indication in the rest of the report that this unequal status is recognized. For example, Chapter Nine on Risk Assessment and Chapter 13 on Managing Change appear to fit in with Chapter Seven, Control Environment. In another example, there appears to be a great deal of overlap between Chapter 14, Monitoring, and Chapter eleven, Control Procedures.

Managing Change

This is an important management function but the APAS Committee does not feel that it is an element of internal control. It is difficult for an entity to manage internal change and all but impossible to manage external change. The airlines, for example, had no control over the change in fuel costs and availability resulting from the Persian Desert war. The discussions in Chapter 13, however, seem to imply that as long as an entity manages change, it will continue as a going concern.

Public Reporting by Management

Chapter 15 proposes public reporting on the effectiveness of an entity's internal control structure over the financial reporting but not over operations and compliance with laws and regulations. Since the whole report, and the components of internal control advocated by the report encompass all three areas -- operations, financial reporting and compliance with rules and regulations -- it seems to us that readers of this report will see no difference and that adequate criteria have been established for the evaluation of all three areas. Because there is no discussion of, or criteria for, the applicability of these components for small to medium-sized entities we do not believe there is a basis for management reporting on any of the areas.

If there is to be public reporting, we believe that there should be a statement in Chapter 15 indicating that any material weakness in the internal control structure over financial reporting precludes management from asserting that the entity maintains an effective internal control structure. Page 150 implies that management could report an effective internal control structure existed at the date of their report even though a material weakness had previously existed. Guidance is needed in this area which requires that the new controls instituted to correct the weakness must have been in place and operating for a reasonable time.

The APAS Committee believes that the report is a good conceptual analysis of internal controls in terms that are understandable for executives of large entities but falls short when applied to most of the business and not-for-profit entities in the country.

Thank you for the opportunity of submitting these comments.

Douglas L. Blensly, Chairman
Accounting Principles and Auditing Standards State Committee

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4500 Cypress Knee Drive
Boca Raton, FL 33487
June 12, 1991

The Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

There are times when compromise destroys the original concept. You have expanded the definition of an Internal Control System to include what seems to me to be the definition of a Management System. When the Internal Control System is confused with the Management System, the management process clouds the purpose and effectiveness of Internal Controls.

Specifically, on page 4 of the Draft, Internal Control is referred to as "geared toward achieving ... objectives". Later on page 13, it is stated that Internal Controls provide reasonable assurances that an entity's objectives will be achieved. I strongly disagree! Internal Controls are tests of the achievement of objectives. Management establishes policy which is implemented through procedures and practice. The accomplishment of policy is achieved by setting appropriate (and measurable) goals. Internal Controls test whether those goals have been achieved. A business could run (although not prudently) without Internal Controls, and Internal Controls are useless without existing objectives against which to measure performance. However, the Internal Controls are evaluation and feedback mechanisms, not the entire system.

I have assumed managerial responsibility of departments which lacked Internal Controls. While they were disorganized and inconsistent, they were producing a product valued by senior management. The implementation of appropriate Internal Controls facilitated improved efficiency and provided feedback as to the performance of the entity. However, the Internal Controls are not the end product. They are a very small, though often overlooked, part of the overall management process.

The most important point you can make is that for a small incremental investment in Internal Controls, significant improvements in efficiency usually can be achieved. When you bury the Internal Controls in the entire management system, improvements in efficiency seem to be related to the design and implementation of major systems. Thus, it would seem that huge investments in machine and human resources must be made before results can be achieved. It is not necessary to have a sophisticated system. A simple one which has clearly stated measurable goals can have Internal Controls.

I strongly urge you to narrow the scope of your definition of Internal Controls.

On page 9 of the Draft Report, you state that the owner of the control system is the CEO. In my opinion that statement is a blueprint for failure. The CEO has ultimate responsibility for the effective and efficient operation of the entity but is the individual lease likely to have the available human resources to implement and administer a control system. I recommend that the COSO recommend the formation of Internal Control Committees, which would report to the CEO and the Audit Committee. The purpose of an Internal Control Committee is to facilitate the delegation of authority for implementation of Internal Controls from the CEO to appropriate levels of senior management. The Internal Control Committee would meet regularly to evaluate the effectiveness of existing controls, review control problems and recommend the implementation of additional Internal Controls.

I appreciate the significant contribution the Committee of Sponsoring Organizations will make to the Accounting Profession which is due to the effort of many people. I wish to thank all those who have contributed their talents and time to this worthwhile project.

Yours Truly,

Dr. Raymond P. O'Connor, CFE

Dr. Raymond P. O'Connor, CFE

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United States
Office of
Personnel Management

Washington, D.C. 20415

In Reply Refer To: Your Reference:

JUN 12 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Gentlemen:

I am a training specialist with the U.S. Office of Personnel Management, and have been involved in training managers and staff personnel in management control systems and evaluations for about three years. We have made significant changes to our training based on audit findings of the U.S. General Accounting Office and efforts of the President's Office of Management and Budget to reinvigorate management controls in the federal government.

Since my office does not establish federal policies on management controls, the views expressed in the enclosure should be considered my own. Nevertheless, I offer them in the spirit of cooperation in our shared goal of enhancing accountability and integrity in all our organizations.

Sincerely yours,

Robert A. Grossman

Robert A. Grossman, Program Manager
Management Sciences Training
Office of Washington Training
and Development Services
Washington Area Service Center

Enclosure

CON 114-24-3
June 1988

Enclosure

Comments on Exposure Draft: Internal Control--Integrated Framework

Title

Instead of "internal controls," I suggest the use of "management controls." The latter denotes managements' responsibility for control systems. "Internal control" does not denote anyone's responsibility, and many managers associate internal control exclusively with finance or accounting.

Definition

I don't agree with your definition because it is too procedurally oriented rather than output oriented, and is not particularly meaningful to non-financial managers. Management control is action taken by management to enhance the likelihood that goals and objectives will be carried out effectively, efficiently, economically--in accordance with applicable laws and regulations. It should focus on creating results with high quality, reasonable costs, and integrity, as follows:

> Management control is action taken by management to enhance the likelihood that an organization's goals and objectives will be carried out with high quality, reasonable costs, and integrity.

Evaluation

The chapter on Monitoring should give more attention to testing of controls by managers. It states that control systems monitor themselves to some degree, and that separate control evaluations are also needed. The chapter should emphasize the need for managers to be involved in conducting critical tests of their controls, apart from separate evaluations. It should also emphasize the need for tracking and follow up to correct weaknesses in the control system.

Evaluation Tools

I think that the tools are an improvement over earlier checklists, but that the emphasis in evaluation should be more integrated with risk assessment. Based on the results of the risk assessment, management should choose the type of evaluation that is most appropriate. I understand that the U.S. Army, which has an extensive array of "internal control checklists," found that only six percent of their material weaknesses were identified through the use of checklists.

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JAMES RIVER CORPORATION
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DAVID J. McKITTRICK, C.P.A.
Senior Vice President, Group Executive
Finance, Transportation & Risk
Chief Financial Officer
(804) 649-4270

June 12, 1991

The Committee of Sponsoring Organizations of
the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Re: Internal Control - Integrated Framework

Gentlemen:

We fully support the Committee's efforts to promote a mutual understanding of internal control and to provide criteria against which entities can assess and improve controls. We offer the following concerns for your consideration in improving the effectiveness of the document. A more detailed discussion of these and other concerns is attached.

The definition of internal control and the breadth of its recommended application greatly surpass traditional concepts of internal control and go well beyond addressing the internal control failures which have triggered the current legislative focus. As a result, the document may be counterproductive if it becomes the reference manual used by Capitol Hill for internal control mandates. Because of its breadth, the document may create unnecessary and unachievable expectations, does not provide sufficient tools to help meet them (even in the traditional areas), and may divert attention from the essential control of transactions and financial reporting activities. In addition, the cost of full, verifiable compliance with the framework may be prohibitive, yet receives little if any consideration in the document.

The value of management reporting is unproven and has generally been overstated in the financial press. Legislation requiring management reporting and attestation of such may result from the unwarranted emphasis it receives in the document. This would result in substantial incremental cost with very little benefit. Accordingly, we believe that less importance should be attributed to management reporting.

We appreciate the opportunity to respond to the issues raised in the Integrated Framework and hope that our concerns are addressed in the final document.

Sincerely,

David J. McKittrick

David J. McKittrick

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JAMES RIVER CORPORATION

COMMENTS & OBSERVATIONS

INTERNAL CONTROL INTEGRATED FRAMEWORK

GENERAL OBSERVATIONS

Each component of internal control included in the definition is an essential aspect of a well run business. However, the breadth of the definition and the stated intent of using it to evaluate controls over the achievement of an entity's objectives in all areas goes well beyond traditional definitions of internal control. In so doing, the definition and the document becomes a blueprint on how to run a business.

This may be viewed as unnecessary by CEOs, the "ultimate owners" of internal control systems. We are also concerned that in attempting to address all components of the definition, for all Company activities, that resources and attention will be diverted from the essential control of day to day transactions and activities contemplated in more traditional definitions of internal control.

In its present form, the document could be counterproductive if it becomes "the" reference manual used by Capitol Hill to mandate public reporting on internal control or other internal control initiatives. It may create unnecessary and unachievable expectations, does not provide sufficient tools to help meet them, and goes beyond addressing the internal control failures which have triggered the current legislative focus. The cost of full, verifiable compliance with the framework may be prohibitive, yet receives little if any consideration in the document.

The document clearly states that the framework is to serve as "a starting point for implementation ..., for education and for assessments of internal control." However, in our view, it does not do enough to facilitate practical application. While we do not expect the document to be an "off the shelf" solution, more explicit detailed guidance and tools with which to perform risk assessment, define control objectives, evaluate existing controls, and select and implement appropriate control procedures would be beneficial.

Despite the breadth of the definition, and the diversity of the sponsoring organizations, the document has a public accounting financial statement/financial controls slant to it. We believe the document overstates the external auditors' role and ability to impact internal controls, especially since the definition is to be applied to nonfinancial controls. Yet, given the document's need to provide more extensive practical tools for implementation, American business may again be besieged by a marketing blitz from the public accounting profession.

EXECUTIVE BRIEFING

We believe the document underestimates the time demands on CEOs and may overestimate the interest level in the subject matter. The Executive Briefing is over 50 pages long, and the document exceeds 300 pages. At this length, we question whether it will receive sufficient attention by CEOs for them to understand and embrace their roles as the ultimate owners of internal control systems. We recommend that a considerably briefer summary be provided to direct their attention to specific action items.

MANAGEMENT REPORTING

Considerable discussion is devoted to management reporting on internal control, yet as the document states, reporting on internal control is not a component of, or a criterion for, effective internal control. From that standpoint, management reporting is not consistent with the charge to the sponsoring organizations "to develop a common definition of internal control and to provide guidance on judging the effectiveness of, and improving internal control."

The attention devoted to management reporting puts the cart before the horse. Let's not concern ourselves with reporting until agreement has been reached on the definition and its practical application. At this stage, discussion of management reporting is analogous to teaching the form and content of accountant's reports before students have been exposed to and digested the concepts of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards.

Management reporting in and of itself is not a value adding exercise, and although its focus on financial reporting is appropriate, it is inconsistent with the broad thrust of the framework. Accordingly, we would prefer that management reporting on internal control be excluded from the document. If management reporting remains in the document, less space should be devoted to its discussion in the Summary. Ideally, it should be addressed solely as an appendix to the main report. External reporting is an ancillary issue which may detract from the main thrust of the document.

We have the following concerns about the document's discussion of management reporting:

> The discussion of reportable conditions dwells on the public accounting concept of "material weakness". This is a poor operational criteria for internal use in evaluating internal control. Self evaluation should be governed by a concept of cost benefit. Controls should be implemented to address risks

and assist in meeting goals and objectives whenever it is cost effective to do so. While cost effectiveness is addressed throughout the document, the emphasis within the reporting section on material weakness may create a contrary impression.

Further, the discussion does not indicate whether entities should be concerned with individually material weaknesses or with the collective impact of individual weaknesses.

The discussion on reporting does not address a significant component of the equation: the audience for such reports. This audience is at least partially composed of unsophisticated individual investors, and the document does not address the educational effort necessary to educate the audience. Without such effort, there is risk that the existing expectation gap will be widened.

CHAPTER 11 - Control Procedures - Types of Controls - Page 112

This section presents five categories of controls (top level reviews, direct functional or activity management, information processing, physical controls, performance indicators). To quote the document, these categories are presented "to illustrate the range and variety of control procedures, not to suggest any particular categorization." We believe this reluctance to propose a common set of terminology and control concepts is a significant shortcoming.

The true test of this framework will be if it serves as an impetus to strengthen controls. The litmus test for improvement will be at the control procedure level. No matter how theoretically sound the definitional framework is, if procedures aren't implemented, the definition will not be met.

The document should propose a common lexicon of control concepts, control objectives in standard functional areas, control techniques and terminology. It should also illustrate the relative effectiveness of different types of controls in various circumstances and present minimum control expectations in common areas. Although it is beyond the <u>stated</u> intent of the document, a compendium of control objectives and techniques that goes well beyond the "reference" would improve the practical utility of the document.

The discussion should address concepts such as completeness and accuracy controls, preventive and detective controls, segregation of duties, compensating controls, physical safeguard controls, management controls, etc. etc. Chapter 11 contains a four page discussion of categories of EDP controls, yet devotes considerably less attention to basic control concepts and techniques.

NONTRADITIONAL WORK ENVIRONMENTS

The document does little to acknowledge or assist in dealing with the impact of various current trends in American business. Adoption of the philosophy of W. Edwards Deming and other trends such as high performance work teams, sole source procurement, Just In Time (JIT) management, Electronic Data Interchange (EDI), End User Computing (EUC), etc. are having significant impacts on traditional organizational structures and control techniques. For the most part, the document is based on traditional structures.

MANAGEMENT OVERRIDE

The concept of management override is an important one, and while the discussion in the document is sound, we believe this issue should receive more attention. It should be tied more strongly and explicitly to Integrity, Ethical Values and Competence, tone at the top, and ultimate ownership by the CEO. More examples should be presented to illustrate the subtle unintentional nature of some override and how it can undermine the intended tone at the top and adversely impact adherence to prescribed controls by organization members.

INTERNAL AUDIT

We do not feel that the document gives enough credit to or sufficiently explores the role of modern internal audit functions in monitoring and improving internal controls and in educating management about their importance. In many organizations, internal auditors are <u>the</u> control "experts", yet the document seems to understate their importance, especially in comparison to external auditors.

EXECUTIVE BRIEFING - Limitations of Internal Control - Collusion (page 20)

This one paragraph discussion is insufficient to address the issue, and no attempt is made to discuss control procedures to make collusion more difficult to carry out. This is a prime example of the need for the document to provide more illustrations of practical control concerns and techniques.

CHAPTER 4 - EVALUATION - Action Plan - Page 40

The fourth suggested step in the action plan, prioritization by unit, component, or otherwise, of the higher risk areas that warrant attention, is a specific area where the document should provide more detailed "how to" guidance. Although the document defines risks in each of the components of internal control, it stops short of integrating the discussions into a recommended risk assessment approach or methodology.

For entities to approach evaluation in an appropriately prioritized manner, more guidance is needed to assist in comparing and ranking the very diverse risks that must be addressed to comply with the broad definition of internal control. Further, all relevant risks are not easily quantifiable. The authors appear to have fallen into the trap of thinking of internal control as encompassing only financial statement risk.

CONTROL PROCEDURES (Chapter 11) - "Built-in versus Built On"

This chapter should have reinforced the concept of built in versus built on controls, instead it is silent on the subject. In particular, the discussion of computer controls should strongly emphasize the need to focus on controls and not just functionality when developing application systems. We also would have expected the document to come out more forcefully in favor of the use of standardized systems development methodology. More emphasis should also be placed on the common control pitfalls of end user computing and systems development and maintenance by end users on a decentralized basis.

SEGREGATION OF DUTIES

The document contains very limited discussion of the importance of segregation of duties, a critical concept and a practical problem in this age of corporate downsizing.

EVALUATION TOOLS - REFERENCE MANUAL (page C-50)

The "generic business model" and Reference Manual on control procedures are not all inclusive, and the disclaimers to that effect are insufficient. Further, the format of the Reference Manual seems inconsistent with the definitional framework in approach, format and terminology.

The headings in the Reference Manual are Objectives, Potential Impediments and Points of Focus for Control Procedures. It would seem more natural and consistent for the headings to more closely mirror the relevant components of the document's definition of internal control, i.e., Control Environment, Objectives, Risks, and Control Procedures. This approach would better link the reference with the remainder of the document.

CONTROLS OVER INFORMATION SYSTEMS (page 114)

The discussion does not effectively integrate computerized control concepts with manual control concepts and techniques. It is anachronistic to discuss them separately. The document should clearly indicate that both manual and EDP controls must generally be in place to achieve specific control objectives and should illustrate the fact that computer controls do not obviate the need for manual user controls or management review of computer generated information.

INFORMATION SYSTEMS (page 103)

While one can not argue with including information systems as a component of internal control, the component and the discussion is so intuitively obvious as to be meaningless. Its linkage with the other components is not strong, the discussion is overly general and tends to only touch briefly on current developments and their impact on controls.

The document makes reference to the IIA Systems Auditability and Control project, which is widely considered to represent the state of the art in the evaluation of computer controls, yet does not recommend or endorse it directly as a tool for use in the evaluation process.

MANAGEMENT REPORTING (Chapter 15, page 162)

In the example on potential warranty claims, why is it suggested that Internal Audit correspond with customers at year end? Internal controls and financial reporting are managerial responsibilities, not audit responsibilities. Responsible management should have a mechanism in place to capture and analyze warranty related information. The mechanism and the information itself would be subject to periodic internal or external audit scrutiny, but certainly internal audit should not be that mechanism.

SUPPLEMENTAL RESOURCES

Given the considerable research that went into development of the framework, and because the end result is not a stand alone, self-contained "solution", we would suggest that the document present a bibliography of suggested reference sources to assist in the evaluation process it recommends.

/06

Chesapeake
CORPORATION

John W. Kirk
Corporate Controller

June 12, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Re: Internal Control - Integrated Framework (March 12, 1991)
"The Exposure Draft"

Gentlemen:

Chesapeake Corporation, a Fortune 400 company, is an integrated paper and forest products company with headquarters in Richmond, Virginia. This letter is our response to the "Internal Control Integrated Framework" exposure draft.

The exposure draft, in a very broad way, accomplishes its stated purpose of providing a common ground for the mutual understanding of internal control. The nine components are worthwhile practices to consider, but are somwhat vague in truly defining internal control. The definition should be more specific as to what objectives should be achieved. The exposure draft's length, broadness and redundancy causes us to doubt its value in achieving its second stated purpose of providing a useful criteria against which all entities can assess and identify areas where they can improve internal controls.

We disagree with the idea that the CEO is the primary person responsibile for internal control. While the ultimate responsibility may belong to the CEO, it is hard to imagine a CEO, in anything other than a small, centralized company, spending any time dealing with internal control issues. Management of specific operating groups or functions, as well as their subordinates, should be responsible for internal control within their designated areas. The CEO relies on these persons to manage control and on internal and external auditors for verification.

While we realize that the management report included in the exposure draft is for illustrative purposes, we feel it signals improper thoughts in regard to assessment of internal control. Its chief problem is the references and tie to the exposure draft itself. The exposure draft should be a guide rather than a standard. There are other ways to effectively assess internal control and provide reasonable assurance. We feel our present report, included in our annual report to stockholders' since 1980,

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is superior to the report in the exposure draft. Our report (see attached), similar to many other companies' reports, comments on the existence, continuing refinement and monitoring of internal accounting control in relation to the integrity of the financial reports, policies and procedures and the roles of management, the board of directors and internal and independent accountants. This overview provides the same reasonable assurance without limiting entities to specific measures.

We at Chesapeake fully support the manintenance of an effective internal control system as a part of good management practices. The exposure draft does a generally good job of getting this point across. However, we feel the exposure draft could be improved by narrowing its focus, while allowing entities flexibility in the assessment and maintenance of their internal control systems.

Sincerely,

John W. Kirk

Attachment

RESPONSIBILITY FOR FINANCIAL STATEMENTS

Chesapeake Corporation is responsible for the manner of presentation, the determination of accounting policies and the integrity of the financial information contained in this report. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles and necessarily include some amounts based on management's best estimates and judgments.

To fulfill its responsibilities, Chesapeake maintains and continues to refine a system of internal accounting controls, policies and procedures to provide reasonable assurance that the company's assets are safeguarded, transactions are executed in accordance with proper management authorization, and financial records are reliable for the preparation of financial statements. This system of internal controls, policies and procedures is evaluated regularly by the company's internal audit staff to confirm it is adequate and is operating effectively.

As indicated in the report of independent accountants, Coopers & Lybrand performs an annual audit of Chesapeake's consolidated financial statements for the purpose of determining that the statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles. The independent accountants are appointed annually by Chesapeake's Board of Directors based upon a recommendation by the Audit Committee, and the appointment is ratified by Chesapeake's stockholders.

The Audit Committee of the Board of Directors, composed of outside directors, meets periodically with the company's management, internal auditors and independent accountants to review internal accounting controls and financial reporting practices and the nature, extent and results of audit efforts. The independent accountants and the internal auditors have direct and independent access to the Audit Committee.

Committee of
Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor, New York, NY 10036-8775 Telephone (212) 575-6656

June 21, 1991

To: **Richard M. Steinberg, Coopers & Lybrand**
Howard Siers, Consultant
Project Advisory Council to COSO
P. Norman Roy, Financial Executives Institute
William G. Bishop, Institute of Internal Auditors
Louis Bisgay, National Association of Accountants

Gentlemen:

Attached is batch twelve of comment letters containing fourteen responses on the exposure draft, "Internal Control -- Integrated Approach.

Sincerely,

Tom

Thomas P. Kelley, CPA
Group Vice President
Professional

TPK:jmy
Enclosure

SARA LEE CORPORATION

107

Three First National Plaza
Chicago, Illinois 60602-4260
312 558 8613

Richard G. Rademacher
Senior Vice President-
Chief Accounting Officer

June 10, 1991

Committee of Sponsoring Organizations of the
Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, NY 10036-8775

Gentlemen:

This letter contains the views of Sara Lee Corporation regarding the Committee of Sponsoring Organizations' draft report on the integrated framework of internal controls. Sara Lee is a diversified manufacturer and processor of food and consumer products with annual sales of approximately $12 billion.

Sara Lee is supportive of the work performed by the Committee and is in general agreement with the findings as detailed in the Exposure Draft. We offer the following specific comments on the contents of the Exposure Draft.

Definition of Internal Control

We concur with the broad definition of internal control which covers the management control process. This definition mirrors the way in which Sara Lee views internal controls as well as our philosophy of integrating internal controls into the complete management process from the Board of Directors down to the production worker.

We also believe that this broad definition properly accommodates subsets of internal control such as financial reporting, compliance with laws and regulations, and separate operating entities which exist in highly decentralized organizations such as ours. Therefore, we see no need for the definition to be more specific in this area.

Components of Internal Control

Each of the nine items identified as components of internal control is critical in establishing and maintaining an adequate system of control. As such, we believe it is appropriate for all nine to be mentioned in the report. However, we do believe the number of components could be reduced, in the interest of simplicity and brevity, since some of the nine are definitely subsets of other components.

For example, we view integrity, ethical values and competence, and communication as being the indispensable infrastructure of the control environment and internal control system. We strongly agree with the supporting comments and discussion of these concepts but do not believe they are separately identifiable components of internal control.

We also do not view risk assessment as a separate component of internal control. Rather, risk assessment is the integral process underlying the establishment of the system of control and the specific control procedures to be implemented.

Our concept of the overall system of internal control approaches information systems as being an integrated part of all processes and a key element in the control system. We agree that information systems is appropriately identified as a component of internal control; however, the discussion of information systems should be expanded to clarify that both manual and automated portions of the management process are included.

As an intangible benefit, we would suggest that a reduction in the number of identifiable components might improve the readability of the report and, in turn, assist management in understanding the overall concepts.

Evaluation

Our approach to the evaluation of the system of internal control has been developed and refined over the years and encompasses all of the concepts included in the Exposure Draft but is, of course, tailored to our specific needs, risks, and environment. We believe this is true for the majority of large, publicly-owned corporations and, as such, the evaluation process and tools included in the Exposure Draft would serve more as research sources for these companies rather than as practical aids. However, for smaller organizations or companies without an established evaluation system, the methods and techniques suggested should provide a solid framework for establishing an evaluation process.

Reporting to External Parties

Sara Lee Corporation currently reports on internal controls over financial reporting in its annual report to stockholders. This level of reporting is appropriate and does not need to be expanded.

The exposure draft should make a stronger statement that public reporting on compliance with laws and regulations and on operations is not appropriate. While public reporting on financial reporting has been researched and the relevant issues discussed, there has not been adequate discussion or research into public reporting on other areas. A stronger statement and explanation of this area might assist in precluding premature suggestions by regulatory bodies for an expansion of public reporting.

We concur that point-in-time, rather than period of time, reporting is appropriate. We also agree that there is no need to separately address interim financial reporting in management's reports. The exposure draft properly indicates that users of financial statements "have a reasonable basis to presume that an accompanying internal control report implicitly covers controls over the interim data's preparation" and that inclusion in management's report of wording specific to interim reporting should be optional, if at all.

Summary

In summary, Sara Lee strongly endorses the findings and concepts expounded in the Exposure Draft. Further, we believe the document accomplishes the stated objectives of assisting businesses in controlling organizational activities and providing a common framework for internal control. We would support any efforts on the part of the Committee to condense and simplify the executive briefing. The current length and complexity could potentially prevent ready acceptance of the important contents of the report.

Very truly yours,

R Rademacher

Richard G. Rademacher

RGR:ch

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BURLINGTON NORTHERN INC.

777 Main Street
Ft. Worth, Texas 76102

June 10, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
New York, New York 10036

Gentlemen:

As requested we have reviewed the exposure draft Internal Control - Integrated Framework and offer the following comments.

Summary

While we concur with the general content and concepts expressed, we have three primary observations and concerns regarding the issuance and application of the Internal Control - Integrated Framework document:

- We anticipate the framework guidance will quickly evolve into standards with sanctions for non-compliance. This is troublesome given the broad definition of Internal Control followed in the study.

- The framework may erroneously perpetuate the belief that business management, judgment, integrity and competence can be universally described, measured and verified.

- An economic cost in the form of both increased audit fees and internal administration to prove compliance with sound business practices will be imposed on organizations indiscriminately.

Conclusion

To be effective we urge that the report be segmented and issued by Control Category; i.e., Financial, Compliance and Operations, at a minimum, so as to recognize the disparate purposes for which it will be used. While we agree that an integrated approach to internal control is desirable, the pragmatic impact in terms of how the document will be used must be considered. Since it will likely represent the primary source of authoritative literature on the topic of internal control, it is reasonable to assume that all parties; i.e. regulators, legislators, shareholders, etc., interested in guidance will refer to it. Yet as noted throughout the document itself, there are varying needs of these parties requiring such guidance in this area. If the authors are unable to segment the report by control category, it is not reasonable to expect the various users, who are seeking guidance, to make such distinctions. The result is then likely to be the codification and application of a much broader definition of Internal Control than would be appropriate for each specific purpose. This would extend the framework's impact inappropriately beyond the stated purpose . . ."to provide a starting point for individual entities for education and assessments of internal controls."

Notwithstanding our concerns, the need for a comprehensive study in the area of internal control is clear. The draft document is thoughtful and well prepared. Properly implemented it can be a meaningful tool for management as we execute our responsibilities to the various stakeholders involved with the multitude of enterprises to which this framework applies.

Sincerely,

Don S. Snyder

Don S. Snyder
Vice President - Controller
and Chief Accounting Officer
Burlington Northern Railroad Company

cc: Mr. Gerald Grinstein
Mr. Robert F. McKenney
Mr. Frank Green
Mr. Ken Evans - Coopers & Lybrand

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UJB FINANCIAL

UJB Financial Corp
301 Carnegie Center
P.O. Box 2066
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609 987-3200

John R. Haggerty
Senior Executive Vice President

June 11, 1991

Mr. Robert L. May, Chairman
Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
6th Floor
New York, New York 10036-8775

Dear Mr. May:

We have reviewed the exposure draft of the report, Internal Control-Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO report), and agree that it provides a broad framework for management to evaluate the effectiveness of internal controls. We support the efforts of COSO in developing internal control guidance, and we believe the reliability of published financial statements will be enhanced by management reporting on the effectiveness of internal controls over financial reporting. However, we do have some comments which we feel would improve the guidance.

DEFINITION OF INTERNAL CONTROL

We concur with the broad definition of internal control - to cover the management control process - because it is the most efficient way for management to design and implement controls that are important to their business. We believe this generally is how management views internal control and it enables the development of integrated control systems that accomplish multiple objectives of an organization. It also has the positive effect of bringing operating personnel into the internal control process.

We do not believe that the nine components should be an integral part of the definition. We would suggest the following definition:

> Internal control comprises the environment, plans, policies, systems and procedures established, executed and monitored by an entity's board of directors, management and other personnel to foster achievement of the entity's objectives in a prudent, cost-effective manner.

COMPONENTS

We believe the nine components presented offer a reasonable framework. We do not agree that all nine must always be present for internal control to be effective. The size, structure, and complexity of an organization must be considered and evaluated to determine which components are appropriate.

EVALUATION

We believe the evaluation tools could be useful in developing or enhancing an existing self assessment of internal controls.

The COSO report appears to be directed primarily towards large, publicly-owned corporations rather than smaller organizations. The formal evaluation process, as described in the report, would be disproportionately time consuming and costly for the smaller organizations.

MANAGEMENT REPORTING

We agree with the COSO report that the external reporting on the effectiveness of internal controls should be limited to financial reporting and should not encompass operations or compliance with laws and regulations.

We do not believe that adequate criteria for evaluating the effectiveness of internal controls over operations or compliance with laws and regulation has been developed. We feel such criteria would be very subjective and cannot be developed in a cost effective manner. We also believe that the reasons for not proposing public reporting on internal controls over operations and compliance with laws and regulations should be included in the final COSO report.

We agree that both annual and interim financial statements should be included in the scope of the management report to clarify which financial statements are covered by management's report. The management report should clearly state if the internal control process over interim financial information is covered.

We believe that, in addition to those items specifically called for in the exposure draft, the management report should include the following information:

° A discussion of management's responsibility for the preparation of the financial statements, including the other financial information included in the annual report, and how such information has been prepared.

- More specific language to ensure that readers understand that management's opinion on effectiveness is in the context of the system of internal control providing reasonable assurance that the financial statements are free of material misstatement.

We appreciate the opportunity to comment and would be pleased to discuss any questions that you may have concerning this letter.

Very truly yours,

J H Haggerty

cc: W.J. Healy
E.C. Weiss, Jr.
A.M. D'Augusta
K.K. Calaiaro
W.C. Pasko

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GTE Corporation

Bruce E. Haddad
Vice President - Controller

One Stamford Forum
Stamford, CT 06904
203 965-2000

June 12, 1991

The Committee of Sponsoring Organizations of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Sirs,

GTE appreciates the opportunity to provide comments on the Exposure Draft on "Internal Control - Integrated Framework."

The maintenance of a strong internal control environment is a top priority with GTE just as it is with other corporations in the United States. We consider it fundamental not only with respect to our ability to fairly and accurately report our financial results, but it is also imperative that we have a well controlled environment in order to effectively manage our various businesses.

For these reasons we have policies and procedures to ensure that internal controls are in place and are operating effectively. Our progressive internal audit function regularly reviews the operations and provides management with an overall assessment of our internal controls. We have a code of ethics, a conflicts of interest policy and a commercial guidelines policy all which require adherence to prescribed norms of conduct for all employees.

From a public reporting standpoint,we have included a management letter in our annual report to shareholders which clearly states that management takes responsibility for internal accounting controls. This statement along with the report of the independent public accountants underscores the reliability of the financial data presented in the annual report.

We agree fully that the integration of internal control concepts into a framework will be useful in order to define, organize, develop and maintain a strong internal control environment within an organization. Internal control is clearly the responsibility of management and the actions taken to foster an appropriate internal control environment should be included in a report accompanying the financial statements. Since such a framework has not existed in the past, financial statement users have been left to draw their own conclusions regarding the internal control environment and the responsibility for it.

By documenting the definitions of internal control and its various components, describing standards for the issuance of management reporting to external parties and providing guidance for evaluating internal controls, the exposure draft on Internal Control - Integrated Framework provides a comprehensive framework against which standards of internal control can be measured and reported.

We particularly applaud this effort as GTE believes strongly that this is a subject for which the private sector has responsibility and needs to ensure that it is addressed on a progressive and professional basis.

Our responses to the four specific matters for comment as well as some general comments are contained in the attachments to this letter.

Ben E. Hubbard

BEH:RPA

Attachments

Attachment A

Responses to Questions:

The following represents our responses to the four matters requested by the Committee of Sponsoring Organization to be specifically commented upon:

1. Internal control is defined as a process executed by the entity's people, to accomplish specified objectives. Do you agree with the definition? If not, why not?

While we agree with the definition, we believe that it could be less vague. There are other definitions that might add greater specificity, clarification and meaning. For example, the following definitions taken from the Committee of Auditing Procedures of the AICPA, which GTE has adopted, and the NAA respectively, might better serve the purpose:

> *"Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies."*
>
> *"Internal control is the whole system of control, financial and otherwise established by management to carry on the business of the enterprise in an orderly and efficient manner, to ensure adherence to management policies, to safeguard the assets, and to ensure as far as possible the completeness and accuracy of the records."*

Utilizing the above definitions, we would recommend that the definition be reassessed to determine if more specificity could be built into the wording.

2. The report identifies nine components essential to effective internal control. Are there others that should be added? Should any be deleted?

The nine components adequately address the areas of concern in evaluating internal controls. However, we believe that there are only five components essential for effective internal control. These five components are (i) The control environment which includes integrity, ethical values and competence, communication and managing change; (ii) establishment of objectives; (iii) risk assessment; (iv) control procedures which includes information systems and (v) monitoring.

By reducing the number of separate components, this will help streamline the document and we believe also help the reader relate the importance of each component to the overall establishment of good internal control. Also, the five components listed above are more responsive to how business views internal control components and is more in line with the Statement on Auditing Standards No. 35.

3. Many methods and techniques can be used in evaluating internal control. This report discusses and presents evaluation tools intended to be useful in assessing internal control systems. We would like you to compare and contrast the evaluation process followed by your organization with the guidance specified in the study and then provide comments on the usefulness and adequacy of the approach recommended in this report. Would you use the tools as either a substitute or as a supplement in evaluating internal control in your organization?

We would use the tools as a supplement in evaluating internal control within GTE. Based on a comparison of the document against our own internal procedures, we find we already have an effective and established system which consists of three separate efforts.

First, is a policy which requires all reporting locations to formally respond to an evaluation of their internal controls. This policy requires the reporting locations to answer specific questions relating to their organizations, hiring and training, auditing, policies and procedures, management information systems, management support and monitoring. Following this, the locations are required to complete a representation letter on the adequacy of their internal controls which is required to be signed by the chief operating officer and chief financial officer.

Second, we have an extensive internal audit function which regularly assesses internal controls and reports to management (including the Audit Committee) on their effectiveness. It does this by reviewing on a regular basis, all major business cycles, functions and control objectives which are ranked by relative importance with a weighting assigned to each of them. Within the objectives, controls elements are stated along with internal control techniques which should be present in order to satisfy the objectives.

Finally, the independent accountants provide management with observations related to any control deficiencies or recommendations to improve internal control during their normal audit activity.

As an added comment, the Appendix C "Evaluation Tools" might better serve its purpose as a separate document. The evaluation methods and techniques contained in this section deal more with the implementation or assessment techniques related to internal controls as opposed to a document focused on definition or structure.

In addition, this section would be greatly enhanced it if contained real life examples and case studies. This would greatly enhance the understanding and usefulness of the evaluation process, particularly in a smaller company environment. Further emphasis should also be placed on the fact that these techniques are very comprehensive and many of them are not necessary in evaluating the control environment in smaller organizations.

4. A number of private, legislative and regulatory proposals have been put forth regarding management reporting on internal control as it pertains to financial reporting. This chapter provides guidance on the subject, and presents an illustrative management report. Do you believe the guidance material is helpful for companies publishing management reports on internal controls? Please explain.

The material in chapter 15 is helpful provided that it is limited to internal accounting controls over financial statements. It may be useful to provide examples of existing management letters which serve the same purpose in order not to imply that the statement provided is the standard which is to be followed.

The exposure draft includes three broad categories of controls: financial reporting, compliance with laws and regulations and operations (which relates to the effective and efficient us of resources). We would emphasize that the internal accounting controls are the only matter which is to be commented upon in the management letters. As stated in the exposure draft: "If the scope of reports were to extend to other objectives, efforts and related costs would increase. It also recognizes that reporting on controls over financial reporting is far more advanced, and must be mastered before venturing into reporting in other areas." As indicated above, we would strongly support this position and believe that it should be emphasized in the document.

The GTE management letter, which is signed by our chairman and chief executive officer as well as our chief financial officer, may serve as another example of an effective statement. This management letter is as follows:

> *"The management of GTE is responsible for the integrity and objectivity of the financial and operating information contained in this Annual Report, including the consolidated financial statements covered by the Report of Independent Public Accountants. These statements were prepared in conformity with generally accepted accounting principles and include amounts that are based on the best estimates and judgments of management.*
>
> *The company has a system of internal accounting controls which provides management with reasonable assurance that transactions are recorded and executed in accordance with its authorizations, that assets are properly safeguarded and accounted for, and that financial records are maintained so as to permit preparation of financial statements in accordance with generally accepted accounting principles. This system includes written policies and procedures, an organizational structure that segregates duties, and a comprehensive program of periodic audits by the internal auditors. The company also has instituted policies and guidelines which require employees to maintain the highest level of ethical standards.*
>
> *In addition, the Audit Committee of the Board of Directors, consisting solely of outside directors, meets periodically with management, the internal auditors and the independent public accountants to review internal accounting controls, audit results and accounting principles and practices, and annually recommends to the Board of Directors the selection of independent public accountants."*

Attachment B

Other Comments

The following are our other comments on the exposure draft:

• We find the document extremely cumbersome. At times it contains irrelevant and often repetitive data. We do recognize that it covers extensive subject matter, however, as currently formatted, we have found most readers rapidly lose interest. Although the material contained in the report is appropriate and valid for the subject, a reformatting and condensation of the document would greatly enhance its usability and effectiveness as a tool to further the understanding and implementation of enhanced internal controls.

As an example, it includes repetitive and irrelevant data. The nine components are discussed on pages 6-9, 34-36, 55-58. There is then an entire chapter on each of them. Additionally, the evaluation section of each chapter lists questions which are repeated in the appendices. These should be deleted from the chapter material. We recommend that a restructuring of the document be undertaken for this purpose.

No example is provided in Chapter 15 - Management Reporting To External Parties, on wording that might be suggested for a management report where management has identified a material deficiency in internal controls. It would be extremely useful to provide suggested approaches to dealing with this type of situation.

• The executive briefing, which currently consists of 47 pages of material, should be significantly modified. In order to provide a tool that can be utilized as a true executive overview, this section should be compressed into no more than 3-5 pages of succinctly worded material. In its current format, it will deter any but the most persistent reader from gaining a quick overview of the subject matter.

• Although the report states that objectives must be clear and measurable, examples do not always reflect that. For example, in Exhibit 9-1 each business should establish defined objectives by quantifying the number of days for "slow-moving merchandise" and state what percent is the "acceptable turnover level" for employees. We would recommend that measures should be added wherever possible in order to make the exhibits more useful to the reader.

• The document currently does not provide guidance as to what constitutes a material weakness in control. Although necessarily subjective in nature, guidance on assessing and differentiating between control weaknesses that would require some qualification in a management report versus control weaknesses which would not require such disclosure, would be extremely helpful.

Warner-Lambert Company
201 Tabor Road
Morris Plains, New Jersey 07950
201 540-2913

Ernest J. Larini
Vice President & Controller

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WARNER LAMBERT

June 12, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Dear Sirs:

Thank you for the opportunity to comment on the draft issued by COSO of Integrated Guidance on Internal Controls (document). We fully support its intent and anticipate that it will result in a useful document for industry. However, the document as currently written appears to be of questionable value to most companies for the reasons indicated below.

The following is a summary of our response including recommendations followed by more specific comments in Appendix A:

- **Definition of internal control** - Use of the term "specified objectives" in the definition could be interpreted to mean one, two, or all three objectives listed under the definition (i.e., operations, financial reporting, and compliance with laws). It would be overly ambitious to include all three objectives in the definition now and would lead to confusion if industry were required by Federal legislation to include audited management letters in their annual reports, e.g., the most readily recognized standards or tools for establishing, monitoring, or auditing internal control relate to financial reporting control objectives.

  We believe that internal control should be defined for now as only the financial reporting control objective. However, the definition could be expanded later through a careful evolution process which might include actual results derived from field testing different companies.

- **Document needs streamlining** - The document at 332 pages is long enough to discourage many people from reading it. The Executive Briefing at 44 pages is many times longer than a briefing should be and is a good example of the verbosity used throughout the manual. The document does not present an innovative approach and instead describes in broad, rambling, textbookish narrative the theory of business activity at most large established companies. It is not well

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organized or user friendly with significant redundancies and overlapping material throughout the document.

We believe the entire document should be shortened. The nine internal control components could be condensed and combined to perhaps five. Appendix C Evaluation Tools as currently written should be deleted. Practical tools available in text books or other sources (e.g., the AICPA Internal Control Questionnaire covering financial reporting control objectives) should be referred to or more practical tools developed.

- **Management Report section** - Much of industry is concerned about recent proposed U.S. legislation that may lead to a statement in an audited Management Report on the effectiveness of broadly defined internal control. The concern is that if certain legislation is passed, the majority of U.S. public companies may have to incur substantial additional work and expense which, in a competitive global environment, would result in little or no value to companies, investors, or regulators and may produce a report which may mislead investors. All of this is possible merely because some government officials are hopeful that the incidence of financial or management frauds would be diminished. The document surprisingly does not take a position on whether a report should be included or a perspective on whether it should be audited.

  We believe the document should serve as an advocate of industry by clearly setting forth the strongest consensus for what companies can do effectively, realistically, and at a reasonable cost, i.e.:

  - Revise the example given of the management report to clarify that only financial reporting objectives of internal control are covered and take a firm position that it should be included in annual reports of published companies.

  - Recommend that the management report not be audited.

While these comments would result in significant changes to the document, they were made with a sincere purpose to develop the best framework document for U.S. industry. We hope all of the above comments will be considered in the final draft of the document and suggest that after this round of changes, a second draft be exposed for comment, at least on some limited basis, and field tested. See Appendix A for more specific and editorial comments supporting the above general comments.

Sincerely yours,

E J Larini

Ernest J. Larini

EJL/sjk
Attachment

APPENDIX A

Chapter 3 - Roles and Responsibilities

We recommend that this Chapter include a discussion of responsibility for safeguarding assets which appears to be mentioned only in an example in Chapter 8. That example appropriately mentions that operations staff are responsible for the efficient use and protection of the asset while the controller is responsible for ensuring that any such asset losses are properly reflected in the entity's financial statements.

Chapter 4 - Evaluation of Controls

- As the document requested, we will outline the evaluation process followed by Warner-Lambert Company for comparison with the process presented in the document.

  - Accounting Controls - Each of our affiliates is responsible for assessing their internal accounting controls yearly. A questionnaire (ICQ) tailored to Warner-Lambert is used as a tool to complete the review during the year. One-third of the ICQ is required to be addressed each year. At year end, the financial head of every affiliate is responsible for signing an internal control compliance letter (patterned after the letter in the 1987 Treadway Commission Report) which should list any major internal control weaknesses identified with plans to correct. We follow up on weaknesses as appropriate.

  - Legal Compliance - Senior management at every location is responsible for signing Management Integrity letters affirming compliance with Foreign Corrupt Practices Act laws, including applicable local laws.

  - Other Controls - Examples include: Corporate Human Resources staff review local affiliates' compliance with policy; the Security Department requires an annual review of the security function at each location. We are currently looking for appropriate ways to evaluate controls of other administrative and operating departments.

In addition to the above, our Internal Audit staff independently evaluates the effectiveness of the control system and compliance with certain laws and regulations. I hope the above brief description of our control environment meets your needs. Our other comments on Chapter 4 follow.

- Page 35 of the document indicates that a monitoring of financial controls should focus on interim reporting as well as year-end reporting. The statement in the management letter covers "published financial reports" which includes 10K's (and quarterly data in the annual report) and 10Q's. We believe it would be a misrepresentation to imply that controls can be monitored as precisely as each quarter.

///

The actual review should be done during the year and the assessment made as of a point in time at year end.

- We recommend that the focus of this chapter be structured by type of main objective. For example:

  - Financial reporting objectives - A description of a model self-assessment program should be suggested here including ideas on how to construct a company questionnaire, referencing questions to key policies and procedures, and the need for an annual compliance letter to be completed by affiliates and other units. A discussion could also include: (a) how to coordinate the evaluation with operating, compliance and other administrative personnel who may have responsibilities overlapping accounting functions and (b) what follow up is appropriate for various types of findings.

  - Compliance with laws and regulations objectives - While we recommended earlier that this control objective not be included in the definition of internal control now, its inclusion may evolve later. A separate evaluation program may be wise in the future but only for companies which may have substantial risks inherent in a company's industry (e.g., oil, mining, waste handlers, financial services, etc.) The discussion would focus on who would be responsible for the evaluation process, points on developing a questionnaire, and how to deal with changing laws.

  - Operating objectives - Again, we recommended that this control objective not be included in the internal control definition now. However, it too may evolve. Page 38 indicates that because a number of people may be involved in an internal control system evaluation, it is important to bring the team together to plan the evaluation process and ensure a coordinated effort - sessions, work programs, etc. are mentioned. This implies that an extensive effort may be needed which we do not think is warranted for companies with "built in controls" and perhaps would apply primarily to new or rapidly developing companies.

- Page 41 introduces the term "reporting deficiency" as a condition worthy of attention representing a shortcoming. This would be a good place to contrast this new term with related terms mentioned elsewhere in the document and also used in professional literature - "reportable conditions" and "material weaknesses".

<u>Chapter 6 - Integrity, Ethical Values and Competence</u>

Page 61 mentions that "American" management increasingly has accepted the view that "ethics pays" - that ethical behavior is good business. While there are many examples of good ethical behavior in U.S. industry, we suggested deleting the word "American" since the sentence could imply that foreign companies may not be as ethical.

/ / /

Chapter 13 - Managing Change

The implication in this chapter is that as long as management has controls in place to manage change that the company will be under control and achieve its objectives. This can be misleading to investors because there can be changes in business which are so major as to be beyond management's control (e.g., manual typewriter industry, slide rule industry, companies impacted by the 1991 Gulf War, etc.). Isn't managing change really a management activity and not internal control? We suggest deleting this chapter.

Chapter 15 - Management Report

- The document indicates that it is appropriate for the CEO and CFO to sign the management report. We agree, since both now sign the 10K which legally covers the entire document and would therefore have the same legal commitment. However, signing the report would impress on management their ownership of the control system.

- The exposure draft argued both for and against reporting on control deficiencies (major weaknesses) in the management report. We believe it would be a mistake to include deficiencies in the report because of their subjective nature, e.g., there is no way to measure consistently what a major weakness is thereby putting some companies at a disadvantage.

- The Federal Government may impose legislation which would require that management reports be audited. We believe such a requirement would be inappropriate, not cost effective and would impact U.S. business attempt to be competitive. The document should discuss the rationale for why audited management reports should not be required. The rationale could include:

  - There can be such a wide variety of opinion as to what are adequate controls for any particular company that it would be subjective for external auditors to judge what are effective controls.

  - Audited reports would impose another layer of bureaucracy at significant cost to many companies thereby frustrating our efforts to compete in the global marketplace.

  - Financial fraud will occur regardless of the controls in place in the presence of management override of controls or because of collusion. There is no sure audit defense against either. Therefore, audited reports would give investors the impression of a guarantee by management and auditors against financial fraud. In fact, financial fraud is rare in relation to the number of companies registered with the SEC.

  - Most importantly, a dishonest management determined to commit a fraud would not be deterred by an audited management report. Therefore, the financial frauds which occurred in the last twenty

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years which triggered the interest in internal control (by others - management has always been interested) would continue to occur thereby widening the expectation gap. If the threat of substantial penalties does not deter dishonest management, we cannot expect that an audited report would.

The document should include an example of a report appropriately worded with caveats about the limitations of internal control and emphasize that there is no guarantee to investors. We understand that many people argue that a management report has no value in an annual report. Such an argument has some merit. However, it would be an indication by industry of a good faith compromise to suggest a management report and since many companies already do much of the required work, there would be little added cost.

APPENDIX C - Evaluation Tools

The general tone of the document as currently drafted is at its worst in the Tools and Reference Manual Sections in Appendix C (i.e., the section that industry may use to evaluate their internal control). For example:

- o Page C96 explains that an objective of the Plan is to "Develop plans that are realistic". The solution offered is to "Review and test validity of assumptions".

- o Page C92 explains that an objective to managing legal affairs is to "Ensure the entity complies with all laws and regulations". The solution offered is "Retain legal counsel with applicable industry experience".

- o Page C91 explains that an objective of managing risks is to "Prevent and reduce potential for accidents". The solution offered is "Identify hazardous jobs, activities, or locations".

Much of the C Section of the document is similar. The tone of such an evaluation process is so obvious and so general that the credibility of the entire document is undermined. Clearly, these tools would not add any value to a company's review process and they would not be used.

The presentation and organization of the Value-Chain activities, infrastructure activities, and subactivities in the C Section is very confusing and not user friendly. It is not clear how a company would use these charts to address specific departments. Further, one column on the charts in the Reference Manual section is headed O,F,C but there is no explanation nor purpose.

We recommend that information be gathered from all comment letters and less theoretical more practical evaluation tools be developed or referenced. For example:

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- o Financial reporting objectives - Refer to the AICPA internal control questionnaire and suggest that companies tailor it to suit their own environment.

- o Compliance with laws objectives - Present a few examples of actual companies form various industries (environmental issues, financial services issues, etc.) and include types of controls followed. For example, some companies have checklists of critical environmental laws, corporate policies, etc.

Frank J. Borelli
Senior Vice President &
Chief Financial Officer

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June 13, 1991

MARSH & McLENNAN COMPANIES

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Sirs:

With respect to the Exposure Draft dated March 12, 1991 concerning Internal Control-Integrated Framework (the "Document"), I commend you on the thoroughness exhibited in your approach to this subject. The views expressed herein are those of Marsh & McLennan Companies, Inc., a New York Stock Exchange listed company with significant interests in insurance broking, reinsurance broking, consulting and investment management. The Company has over 24,000 employees worldwide.

Concerning the Document, Marsh & McLennan Companies has the following observations and suggestions:

> The definition of internal control appears much too broad, particularly concerning the proposed Operations portion of the objective which states the view that internal control includes an "effective and efficient use of an entities resources." This is clearly well beyond the scope of what would normally be considered internal control. A more appropriate definition would be that <u>internal control is the process by which an entity, through its board of directors and management, provides reasonable assurance that transactions are executed in accordance with proper authorization and are in compliance with applicable laws and regulations, that the resources of the entity are safeguarded and that accurate and reliable financial records are maintained</u>.
>
> In that regard, we would suggest that the number of components of internal control should be reduced considerably. The cornerstone of internal control is the (1) integrity, ethical values and competence of management and the employees of the organization. In addition, the

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control environment and control procedures are legitimate components of internal control. However, the other elements noted including objectives, risk assessment, information systems, communication, managing change and monitoring are, at best, sub-systems of the three (3) components mentioned above and in certain respects are beyond the scope of internal control. They should be included within those three components or eliminated as gratuitous or redundant.

Finally, we disagree with the stated position that for those entities which include a management report in their published financial statements, such report should focus specifically on controls over published financial statements if, by that, the Committee is suggesting that companies report only on that aspect of internal control. Although we agree that such report should include reference to the financial statements, it should also state that the system of internal control provides reasonable assurance that transactions are executed in accordance with management's authorization and that the resources of the entity are safeguarded.

I trust that these comments and suggestions will assist you in finalizing the Document.

Sincerely yours,

F. Bouch

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Bechtel

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June 13, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Gentlemen:

On behalf of Riley P. Bechtel, this is to let you know that we have read with great interest the exposure draft dated March 12, 1991, entitled "Internal Control - Integrated Framework", which was prepared by your Committee.

Obviously, dealing with a subject as complex as Internal Control at the macro level, as this report does, was a challenging task. The Committee is to be commended for a job well done. We believe this framework should be a useful tool for any enterprise in understanding and assessing where it stands in this critical area.

To make the application of the principles embodied in this report even more effective, we would suggest consideration of the following in preparing the final report:

- Provide a more concise, hard-hitting summary of the main points of the report, to help ensure that the CEO and others in executive management
    - get a clear appreciation of the importance of this subject
    - better appreciate their leadership role and responsibilities in this area.
- Increase the emphasis on the benefits of a periodic evaluation of internal control from the standpoint of the enterprise as well as its various constituencies. The summary mentioned above could be one place where this might be done.
- Shorten the report wherever possible and improve its overall readability.

We hope that the foregoing comments will be helpful in completing your report. We look forward to seeing the final version.

Sincerely yours,

V. P. Unruh

V. P. Unruh
Vice President and Controller

Bechtel Group, Inc.

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Union Camp Corporation

J.F. Haren
Assistant Comptroller

1600 VALLEY ROAD, WAYNE, NJ 07470 TELEPHONE (201) 628-2384

June 12, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th floor
New York, NY 10036-8775

Re: Internal Control - Integrated Framework

Gentlemen:

We appreciate the opportunity to comment on the issues raised in your Exposure Draft - "Internal Control - Integrated Framework". We recognize that the study is a response to the Treadway Commission's recommendation to develop needed guidance on internal control. In general, we believe that this objective has been achieved. The study is an excellent reference document on internal control, however, the definition of internal control needs to be refined. Also, in its present form we believe it will be inappropriately elevated beyond its stated purpose of guidance to that of a required standard.

More specific to your request for comment on the issues within the Exposure Draft we offer the following opinions:

The proposed definition of internal control is too broad. It is more a prescription on how to succeed in business than an internal control framework. Beyond this, several of the specified components of internal control are too subjective in nature. Competence, Managing Change and Communications are certainly essential elements in an ongoing business enterprise, however, can we expect companies to have the knowledge and ability to fairly assess themselves in these areas? How can a company assess itself against components which do not have enough measurable characteristics to result in an objective determination? How comparable will these assessments be between companies?

The study also focused on the presentation and content of management's report on internal controls. The proposed wording of the report includes a requirement to measure these controls against criteria provided in this document. In substance, this requirement inappropriately raises these guidelines to internal control standards.

Management's representations on the adequacy of its internal control system will require the use of considerable internal resources to make these assessments. In addition, the basis for these assessments will have to be fully documented even by those companies that already have sophisticated internal control systems. At a time when U.S. enterprises are being challenged to be cost effective this added cost burden must be questioned.

The document is also too lengthy in its present form. This will dissuade many from familiarizing themselves with it. The opportunity for positive and constructive insights will be lost to many potential readers. We recommend an approach which recognizes the different audiences which have varying interests in this subject.

Very truly yours,

John F. Haren

J. F. Haren
Assistant Comptroller

cc: R. E. Moore - Vice President and Comptroller
J. M. Reed - Executive Vice President and Chief Financial Officer

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PEPSICO INC.

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June 13, 1991

ROBERT L. CARLETON
SENIOR VICE PRESIDENT
AND CONTROLLER

Mr. Gaylan N. Larson
Chairman
Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas
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New York, New York 10036-8775

Dear Mr. Larson:

PepsiCo Inc. appreciates the opportunity to respond to the Exposure Draft entitled Internal Control - Integrated Framework (the "Framework").

Overall, the Framework effectively integrates the diverse concepts of internal control, and meets the primary stated objective of the report: to help management better control its business. We are concerned, however, that this broad definition of internal control might be misconstrued as encouraging public reporting standards well beyond those contemplated by the Treadway Commission, whose focus was fraudulent financial reporting.

Many companies presently meet the necessary criteria to provide reasonable assurance that fraudulent financial reporting has not occurred. These companies have found a meaningful and cost effective way of meeting the objectives of the Treadway Commission. The Framework seems to "raise the bar" with its varied and broad internal control criteria. From a financial reporting perspective, the added benefits may be minimal while the additional costs may be onerous. This certainly was not an objective of the Treadway Commission.

Reporting on controls over operations and compliance with laws and regulations may not be meaningful because criteria for effectively measuring results against the related objectives are not well developed. Even if measurable, deficiencies in either of these areas do not necessarily impact financial reporting.

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Therefore, we believe that the Framework's definition and components should put primary emphasis on internal controls over financial reporting. The report should clearly state that its primary objective is to provide guidance for evaluating the effectiveness of internal controls over financial reporting, with a secondary objective of helping management control its business. The operational and compliance aspects of internal control may still be an integral part of the Framework, but it must be clear to legislators, regulators, investors, creditors and auditors that only financial controls should be subjected to potential public reporting requirements.

We would be pleased to discuss our comments with you.

Sincerely,

Robert L Carlton

AICPA

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June 13, 1991

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Robert L. May, Chairman
Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Dear Mr. May:

This letter presents the views of the Internal Control Task Force (the "Task Force") of the Industry Committee of the American Institute of Certified Public Accountants (the "AICPA") on the exposure draft entitled "Internal Control - Integrated Framework" (the "Exposure Draft") of the Committee of Sponsoring Organizations of the Treadway Commission (the "Committee"). The Industry Committee represents the AICPA members employed in business and industry. The Task Force is comprised of four AICPA members from industry.

Generally, the Task Force supports the overall content of the Exposure Draft. We support the Committee's intention that the resultant document should serve as a starting point for implementation by individual entities, as an educational tool and an evaluation tool to assist in assessing internal controls. In addition, we commend the Committee for emphasizing the principle of cost-effectiveness and for recognizing informal controls in the establishment and operation of an internal control system.

We offer the following comments for consideration by the Committee:

<u>Chapter 1 - Summary</u>

<u>Definition</u>

Three Task Force members are somewhat concerned that the use of the term reasonable assurance within the definition of internal control does not obscure management's ultimate responsibility for the internal control system. A fourth Task Force memeber believes that management's responsibilities for internal control are adequately detailed in the exposure draft. We all agree that the importance of the definition of internal control in this document cannot be overstated. If this document achieves its purpose of providing a guide for implementation of internal control systems, this definition will be seized upon and cited by a large number of business managers and other interested parties.

The committee should consider retaining the definition as is currently drafted but in the discussion sections surrounding it (and indeed throughout the Exposure Draft) add more emphasis on management's responsibility for the internal control system. We suggest that the Committee should consider incorporating language similar to that used at the top of page 72 in Chapter 1 and throughout the Exposure Draft.

Components

The components of internal control as described in the Exposure Draft assist in arriving at a practical definition that can be understood and implemented on a broad spectrum. However, the specific components were grouped in a couple of instances in such a way that may result in a lack of a clear definition. For example, in Chapter 1, on page 8, five specific components are distinguished as those from which internal control failures often result. Notwithstanding the Exposure Draft's assertion to the contrary, this implies that the other four components (Risk Assessment, Information Systems, Control Procedures and Monitoring) are not as equally important.

We suggest that the other components are important, but perhaps not to the same extent. Is it possible that Risk Assessment, Information Systems, Control Procedures and Monitoring are subsets of the Control Environment? With respect to Risk Assessment, our view is supported by the third paragraph on page 71 appearing under the caption Assignment of Authority and Responsibility which suggests that Risk Assessment is fundamental to empowering and risk acceptance, which are elements of the Control Environment.

We recommend that the Committee consider grouping the Exposure Draft's components of internal control into five core components:

- Integrity, Ethical Values and Competence
- Control Environment
- Objectives
- Communication
- Managing Change

The remaining four components would be treated as critical subsets of the core components.

One Task Force member disagrees with the above proposal for regrouping the core components. In this Task Force member's view, the Exposure Draft's nine components of internal control provide for a solid identification of the basics of what constitutes good management information, control and evaluation of a business operation. This framework approach allows for variable functional emphasis when applied to specific situations. In short, they provide a good set of tools to be used as necessary and they should not be made an unwieldy group of multipurpose tools which cannot be used with precision when the situation requires it.

People (Board of Directors)

A strong control environment can be bolstered through a board of directors that includes members who are independent from management of the entity (hereinafter, the terms "independent" and "independence" are used in the sense of "being apart from management" rather than in the sense of "independence of attitude"). The Exposure Draft makes frequent mention of boards of directors, but gives little and late attention to the virtue of independence. In particular, boards of directors are cited as important features of internal control on pages 12 and 24, with no mention of the independence feature. The commentary in the second paragraph on page 62 alludes to an objective board of directors but makes no specific reference to "independence" nor to "objectivity." The first, and only, direct reference to a director's independence in the main text appears in the final paragraph on page 69.

The only other reference that we found to a director's independence is in the second paragraph of Exhibit C-2 on page C-6 of the evaluation tools appendix. However, even here the illustrative question number 1 on page C-13, which is intended to specifically elicit information to respond to the aforementioned item on page C-6, does not mention independence. Additionally, none of the remaining questions on page C-13 regarding boards of directors and audit committees specifically refers to independence.

We recommend that, at a minimum, the final document more clearly and strongly state the case for independent directors representing a sufficient portion of a board's membership so that their views cannot be ignored. This should be a guideline, at a minimum, for publicly-held entities.

Chapter 3 - Roles and Responsibilities

Legislators and regulators initiate, amend, repeal and enforce laws that provide protection for investors and consumers. They must carry out this role responsibly by guarding against intrusive control over transactions that generally are best left to the dynamics of free markets and free people. For the most part, the Securities and Exchange Commission, along with various federal and state agencies have, in the aggregate, participated in a way that has offered protection to the public without impairing free market activities. However, certain statements in the Exposure Draft make distinct inferences that we believe go beyond reasonable oversight.

The first paragraph appearing on page 30 states in part " They [legislators and regulators] establish rules that provide the impetus for management to ensure that internal control systems meet the requirements". The modifying term "minimum statutory/regulatory" should be inserted before the word "requirements." Otherwise, the tone suggests that an entity's management would see no merit in effective internal control apart from the efforts of legislators and regulators. This implication is inaccurate. In fact, there are many entities whose executives are committed to internal control systems that go beyond government mandated rules. This is enlightened business and good management practice. This message should not be lost in the Committee's conclusions.

We are concerned that management reports and external auditors' reports thereon may grow to a scope beyond the expertise of external auditors and beyond the scope contemplated by the Committee. Specifically, out of the three categories of internal control objectives - operations, financial reporting and compliance - the first and third categories should not be within the scope of management reports and subject to the attest function of external auditors. We recommend that the final document clearly limit the scope of management reports to financial reporting and certain compliance reporting objectives. In support of the proposed limitation, we note that page 5 of the Exposure Draft indicates that achievement of operations objectives is not always within the control of management. This limitation should be expanded upon early in the document. At present, the clearest statement of this limitation is contained in Chapter 15 -- this comment must be made earlier.

External auditors should not be required to examine and express an opinion as to the effectiveness of an entity's planning and management process. Similarly, external auditors should not focus their audit on productivity of people, disciplinary actions and effectiveness of specific management personnel. The tools set out in Appendix C to focus on these elements of internal control primarily consist of open ended and subjective questions. There may be no correct or definitive answers to those questions, and the meaning of the answers are subject to broad interpretation. Only management is in the position of doing an appropriate cost-benefit analysis of such operating controls. The benefits from such controls are subjective and do not involve public policy/investor related issues. However, if during the course of the independent accountants examination of the financial statements, they become aware of material weaknesses in the operating or compliance controls, such weaknesses should be reported to the audit committee and or the board of directors.

While we appreciate the Committee's attempt to categorize the "objectives" appearing in Appendix C as "operations," "financial reporting" and "compliance," it would be more useful to categorize Appendix C's "points of focus" in this fashion. The categorization of points of focus is particularly important in those cases in which the broad objective covers more than one category. If not categorized to this level, there will likely be debates as to which points of focus were viewed by the Committee as purely operating and compliance oriented (and not to be covered by the contemplated management report) and which were viewed as financial reporting oriented (and potentially subject to the contemplated management report). We are available to provide specific examples, if they are desired by the Committee.

Chapter 6 - Integrity, Ethical Values and Competence

This section addresses the "Tone at the Top" concept of the Treadway Report as it applies to integrity and values. The Treadway Report frames the Code of Corporate Conduct issues with a discussion of management's obligations on the question of fraudulent financial reporting and internal control. In Chapter 6, the concepts of oversight, self governance and monitoring and enforcement are absent. The Treadway Report is specific on the importance of these concepts.

The discussion on pages 60 and 61 focuses on the difficulties of establishing integrity and ethical values and consequences of negative (or lack of) values. The concepts of balance and obligation to society are a strong focus. Any discussion, however, of societal values should take into consideration that a sense of pride, fairness and rationality about a decision is dependent on cultural bias. This country is not only a melting pot, but its businesses are increasingly foreign owned. In addition, more discussion on the values for the customer, the investor, the employee, and the supplier would underline the importance of ethical values for business success.

The evaluation tools outlined on pages 65 to 67 and included in Exhibit C-1, Appendix C are a mix of the objective and subjective. The objective questions of, is there a code, is it adequate, do employees acknowledge, etc., can be reasonably answered by management and auditors. The subjective questions may be unanswerable. For instance, the question of, "Do employees feel peer pressure to do the right thing, or cut corners to make a 'quick buck'?" can never be answered with certainty. If anyone answers "yes" to the former, this answer will hold only until the first actual contrary instance comes to light. As another example, the question of, "What concern has the board shown for integrity and ethical values?" may never have a documented trail. The evidence of "concern" is elusive at best.

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Chapter 7 - Control Environment

The section on control environment leads through a discussion of managerial authority which is easily understood in the context of internal controls. However, when the evaluation tools on pages 73 to 78, and included in Exhibit 3-2, Appendix C are reviewed, some of the questions will be difficult to answer, and, as such, questionable as to value. As noted in our comments regarding Chapter 3, such questions as, how involved is the board in, and what steps have they taken to ensure appropriate, "tone", can lead to considerable conjecture.

Chapter 8 - Objectives

The discussion of objectives provides an underpinning for understanding the company's internal control design. The evaluation tools on pages 88 and 89 and included in Exhibit C-3, Appendix C may have little to do with instituting or assessing internal controls. Most relevant questions on budgets and chart of accounts can be covered in the functional questionnaires on finance and accounting. The other questions, if asked at a high level may be impossible to evaluate in large companies. The establishment and achievement of management objectives is a considerable topic of management theory, and a broad brush question very likely would prove of little value.

An entity's financial statements rest on a foundation consisting of a series of assertions supported by internal controls. These assertions, which the Exposure Draft (page 83) indicates are identified in literature by the AICPA, are as follows:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

The supporting discussion in the Exposure Draft fails to clearly state that amounts in financial statements are sometimes estimates and that management is responsible for developing appropriate processes of estimation that are verifiable. This point needs to be emphasized.

Chapter 9 - Risk Asssment

Page 93 of the Exposure Draft contains the illustration of a high quality fashion merchandise business. The various risks that are listed are impressive, however it excludes the major risk--market acceptance. It may be better to leave the illustration out or to limit the risk to major areas such as market acceptance, stable suppliers, economic conditions and governmental regulations (e.g., environmental).

Chapter 10 - Information Systems

An entity must maintain systems that effectively assemble and report various pieces of information for analysis in order to support decision-making. This fact is clear in the Exposure Draft. However, there is another vital aspect of information and supporting systems that need further mention. We recommend that timeliness of information be highlighted as a critical aspect. For example, the following modifications might be made to the text (additions are underscored, deletions are struck over):

Page 104, the first full paragraph

> "Systems <u>that</u> produce the reports <u>on a timely basis</u> containing operational and financial information ~~that~~ make it possible to run the business."

and

Page 105, the third full paragraph

> "To be effective...and report it <u>in time for it to be</u> ~~in a way that is~~ useful in controlling the entity's activities."

Appendix C - Evaluation Tools

We believe the following modifications to the reference manual portion of this appendix should be made in order for the manual to be more practical:

- Page C-57

  include freight verification as part of inbound activity.

- Page C-57 Objective #1

  Receiving needs to be advised of purchases to be received but it is not necessary to forward material requirement summaries to them.

- Page C-58 Objective #4

  "Do not accept materials not properly ordered" - this is unreasonable and could cause production problems. Delivery is normally taken and then the quality/appropriateness of the material and/or paperwork needs to be determined and, if not satisfactory, then appropriate action taken.

- Page C-67 Objective #13

  Independent verification of shipping document information is not always feasible "before shipment."

- Page C-109 Objective #2

  It is not practical to expect to receive an employee signature for each and every receipt of a paycheck. In fact, a growing number of entities pay employees through "direct" or "automatic" deposits -- obtaining employee signatures would delete the efficiencies gained from such automatic payment systems.

. . .

We are available to discuss further our comments and proposed recommendations with the Committee.

Sincerely,

Eric L. Schindler
Chairman
AICPA Industry Committee

Michael P. Bohan
Internal Control Task Force
Chairman
AICPA Industry Committee

MPB/ELS/cpp

cc: Thomas P. Kelly - AICPA
Internal Control Task Force
Members

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June 13, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Gentlemen:

The Accounting Principles and Auditing Standards Committee of the Florida Institute of Certified Public Accountants (Committee) has considered the exposure draft (ED) entitled "Internal Control - Integrated Framework" in a recent committee meeting. The following are written comments based on our deliberations. The written comments address the "Specific Matters For Comment" identified on pages 2 and 3 of the ED.

General Comments

In general, the Committee believes that the ED is a significant step forward in integrating an authoritative discussion of the subject of internal control. However, as noted in several of the comments below, we believe that the guidance in this ED pertaining to some of the internal control components may be difficult to measure in practice and may not be susceptible to independent attestation.

As discussed below, we believe that the guidance concerning reporting on internal controls over the financial reporting process (Chapter 15 of the ED) should be expanded in a separate integrated framework document.

Definition (Chapters 1 and 5)

The Committee was unable to reach a consensus about whether the definition of internal control is satisfactory. This inability to reach a consensus resulted primarily from the concerns of some committee members that (1) the definition of internal control is too broad to be effective as authoritative guidance, and (2) the definition of internal control should not include the components.

Despite the concerns expressed about the general definition, the consensus of the Committee was that the special-purpose definitions shown on pages 52 and 53 of the ED are acceptable. The Committee also believes that the use of "components" of an internal control system is a useful means of clarifying the specific nature of various aspects of internal control, and that the three categories identified in the ED -- operations, financial reporting and compliance -- are proper distinctions.

Components (Chapter 1 and 5 through 14)

As stated previously, the Committee believes that the aspects of internal control identified as components in the ED are all essential to effective internal control. However, in our view, certain of these components are subsets of other components and certain components overlap several of the other components identified. See specific comments below.

The Committee believes that the framework would be improved if the number of components could be reduced and most of the overlap eliminated.

a. Integrity, Ethical Values and Competence

We agree that integrity, ethical values and competence form a foundation upon which other components and aspects of an internal control system are based. However, we question the desirability of segregating these concepts from the control environment concept except as a means of emphasizing the absolute importance of integrity and ethical behavior as a basis for internal control; we view these concepts as factors in the control environment that are very closely associated, if not inseparable, from the factor of management's philosophy as a part of the control environment.

In addition, we believe that the concepts of integrity, ethical values and competence may be too subjective to be reasonably measured or to be susceptible to attestation. For example, we question the measurability of Items 7, 8, 9, 10, 12, 14, 17, 19, 20, 23, 26 and 31 on pages C-4 and C-5 of Appendix C of the ED.

b. Control Environment

In our view, the factors listed in Chapter 7 as factors of the control environment are, for the most part, more measurable than the factors of integrity, ethical values and competence identified in Chapter 6. However, as previously noted, we believe that the factors identified in Chapter 6 could be included as factors of the control environment.

c. Objectives

The Committee believes that effective internal control requires that objectives be established. However, the establishment of objectives may be a management process that precedes and is not a part of the internal control system.

Also, in terms of specific objectives, it may not be possible to attain reasonable assurance of control for operating objectives (see discussion and examples on page 81 of the ED).

We noted that the ED identifies internal control as a process referred to as an "internal control system". This is inconsistent, in our view, with recent authoritative pronouncements of the Auditing Standards Board, especially Statement on Auditing Standards No. 55, in which internal control is identified as a "structure" as opposed to a "system". This inconsistency may result in difficulty integrating the authoritative guidance which will result based on the integrated framework with existing authoritative literature, some of which only recently redefined this particular aspect of the concept of internal control.

d. Risk Assessment

Some members of the Committee question whether risk assessment should be shown as a separate component of internal control. They believe that risk assessment pervades all internal control components (especially monitoring) and, therefore, should not be identified as a separate component. Some committee members also believe that questions 9 through 16 on page C-15 of Appendix C of the ED do not specifically relate to risk assessment as a component of internal control.

e. Communication

Some committee members question whether communication should be shown as a separate component of internal control. They believe that communicate pervades all other components of internal control and, therefore, should not be shown separately.

The Committee believes that the delineation of factors of communication identified on pages 126 and 127 of the ED are clear and relevant to the subject of communication in internal control.

f. Managing Change

The Committee expresses doubt whether the component of managing change can be assessed only at a point in time because the factors and concepts of this component imply the measurement of change over a period of time. In light of the discussion of "time-frame" on pages 10 and 150-151 of the ED, the Committee believes that the application of a "point in time" report for the managing change component should be clarified.

g. Monitoring

The Committee questions whether monitoring should be identified as a separate component of internal control. The activities identified on pages 136 and 137 of the ED, which we believe are relevant, seem to fit other components of internal control.

Management Reporting to External Parties (Chapter 15)

As stated previously, guidance on the subject of an integrated framework on reporting on internal controls over the financial reporting process should be expanded in a separate document. An example of the types of expanded guidance which we believe would be helpful are various sample reports showing the wording that should be used in a report by management if departures from the standard report are deemed necessary. Particularly, it would be helpful to have an example report showing the wording that would be used if a material weakness has been encountered.

The Committee also believes that the only reportable condition that need be mentioned in the management report on internal controls would be in the case of a material weakness.

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* * * * *

We appreciate the opportunity to provide comments in response to this ED. Representatives of our committee are available to discuss these comments with the Board or its representatives at their convenience.

Sincerely,

COMMITTEE ON ACCOUNTING PRINCIPLES AND
AUDITING STANDARDS - FLORIDA INSTITUTE
OF CERTIFIED PUBLIC ACCOUNTANTS

Gary L. Holstrum RPR

Gary L. Holstrum, PhD, CPA, Chairman
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Task Force to Coordinate the Committee Response:
Gary L. Holstrum, PhD, CPA
Richard P. Reid, CPA

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INTERNAL CONTROL - INTEGRATED FRAMEWORK
RESPONSE TO EXPOSURE DRAFT OF MARCH 12, 1991
L. E. Burnham, Phillips Petroleum Company

As a member of the Consulting Panel for this study, I commented extensively on it. Those comments are documented in the files of the authors (C&L) and elsewhere. This response will summarize what I consider to be the "fatal flaws" in the document which should prevent its publication. I believe COSO should send the effort to achieve an "integrated" and broadly-usable definition of internal control back to the drawing board.

There is lack of support or opposition by many of those closest to the project. The Consulting Panel appeared to be the most representative and knowledgeable on the subject of internal control of any of the bodies which participated in the project, but its views were given little weight by the authors. Further, the authors filtered and buffered those views and they did not effectively reach the Steering Committee or COSO. Some Steering Committee members and key people in the COSO bodies are dissatisfied with the process and its result, but find it hard to mount effective opposition. It is appalling to see this failed project that, nevertheless, could become accepted by default. It seems to have acquired a great deal of momentum from the authors' drive and the difficulty of now killing it, in the face of the expectations and uninformed support generated by the recent public exposure and its attendant publicity). See comments on "due process."

The proposed definition falls far short of being "integrated." The proposed definition does not reconcile or contain sufficient recognizable elements of existing definitions (AICPA, GAO, IIA, FCPA, etc.). The authors' original definition, in the project proposal, did so. But that original definition was replaced by a new and different concept based on "components"--stated as philosophical principles--rather than on the control objectives which serve as the basis of most existing definitions. See below for comments on this contrast and the impracticality of applying "components" to implementing, monitoring and evaluating controls.

The research, development, and exposure of this study (and new definition) do not represent "due process." There are at least three "fatal flaws":

- The literature search, other research, and the purported "integration" process, are not documented adequately. There is no "audit trail" or other analysis to demonstrate how they led to the resulting document drafts. Most of the text was written independently, and in advance, of the research, interviews, workshops, etc. Some concepts and language appear to be <u>in spite of</u> available literature and research.

- In the questionnaire/interview processes, and in seeking other input, the authors did not provide adequate background. Sources could not give informed and balanced views. If asked, "Do you agree this is a good concept?" or "Is this an acceptable definition?", one should have a context and alternatives to compare with what is being proposed. Those were not provided during development and now there is not an adequate discussion memorandum to give context to the exposure draft.

- An integrated definition and the supporting concepts should have been given broad exposure (with discussion of alternatives), and consensus obtained, <u>before</u> the rest of the document was written. The authors refused to follow repeated suggestions of that obviously necessary sequence. The representation of consensus in the exposure draft is dishonest and misleading.

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In substance, the exposure draft pays only lip service to a broad management perspective. The definition and accompanying discussion describe elements of the management control process, but leave out some essentials. For example, the passive concept of ". . . obtain reasonable assurance. . . ." does not describe management control. Management "exerts purposive influence" (contained in the original source from which the authors took the concept for their new definition) or "take actions designed to ensure compliance/achieve objectives" (IIA/GAO). Omission of compliance with applicable laws, regulations, and ethical standards is unrealistic in the management control context. There are many other detailed examples which could be cited. The "cookbook"/ICQ approach to evaluation tools, as well as the appearance that the logical culmination of the internal control process is financial reporting and/or public reporting on controls, certainly detract from the the management control perspective.

The "components" are comforting platitudes but are impractical both to define workable controls and to evaluate compliance. It is easy to agree with each of the components in principle and accept them as desirable characteristics, but it is difficult to get beyond that point. The definition should be able to stand on its own, but requires chapters of elaboration before anything useful takes shape.

Many proposed alternatives do a reasonably good job of broadening and integrating existing definitions and are workable. This is because they describe management actions and are fairly specific as to objectives whose achievement can be reasonably measured or judged. They stand on their own, incorporating criteria/objectives such as "transactions are executed in accordance with management's general or specific authorization," "actions designed to achieve . . . reliability and integrity of information," "cost-effective protection and use of resources," and others which can be readily subjected to judgment by a "reasonable man."

Contrast those alternatives with the "components": How do you implement and measure achievement of the principles of "ethical values" or "competence" or "control environment" or "managing change" or "information systems"? Even with all the chapters of elaboration and explanation, the proposed definition is unworkable because it is empty, generalized and subject to widely-differing interpretations. The authors failed in their attempts both to apply the definition to cases of business failures (e.g., Which "components" were lacking and how could they have been applied as preventives?) and to apply it to a hypothetical case. The implementation tools may be useful to some, but do not flow logically from any or all of the "components" and cannot be cited as evidence of practical application. It is unfair to inflict this on the general public and expect them to do what the authors cannot.

The "components" overlap and are not of the same stature. This results in unnecessary repetition which clutters and confuses the entire document. For example, information systems and communication, or monitoring and managing change, are too much alike to merit separate consideration. The authors, while maintaining at one point that all the components are essential, admit elsewhere that some are more equal than others and that compensating strengths in some could overcome absence of others. All this is easily demonstrated and was pointed out, early and repeatedly, but the nine components acquired sacred status (probably because their detailed chapters were written prematurely and thus cast in concrete).

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There is danger that the definition, and possibly the entire document, will be incorporated into legislation. Because of the problems pointed out above, of both concept and application, the definition should not be available as a standard for legal or regulatory purposes. It will not stand the test of litigation and is not usable as a basis implementation, evaluation, public reporting, or auditor attestation. It was not necessary or desirable to produce such a document to serve as a basis for public reporting on financial controls and/or auditor attestation. It would be much better to make minor revisions to the FCPA definition (perhaps adding a point on compliance with applicable laws and ethical standards), for incorporation into legislation or SEC rules.

Discussion of public reporting on internal controls, and possible formats for it, have no place in this document. This project had as its primary (sole?) purpose to "develop a common [integrated] definition of . . . and provide guidance . . .on judging effectiveness and improving . . . internal control." Much of the recent discussion of public reporting in relation to this project has centered on (or had as a hidden agenda) the pros and cons of the issue. That is irrelevant. Regardless of their merits, public reporting and related issues are significant political issues which need to be resolved in the appropriate political forums (by Congress, the SEC, professional bodies, and the affected companies and other entities). By not divorcing it from the central purpose of the project, the COSO bodies will become a witting or unwitting partisans on issues on which they should be neutral with respect to defining and describing internal control. This partisan position would be improper.

I know of many who hold views similar to mine, but who for various reasons, will not respond to you. Others would hold those views if they had enough background for informed judgment.

I sincerely hope COSO will not publish this document. It does not represent an improvement. At best it is a particular view of internal control principles and implementation methodology which might be published separately, without the authority and recommendation for adoption of COSO.

There needs to be another attempt at finding a broadly-applicable, integrated definition.

Thanks for listening . . . .

L Burnham

L. E. Burnham
June 12, 1991

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AT&T

Roger F. Davis
Vice President and Controller

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June 14, 1991

The Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Gentlemen,

We have reviewed the Exposure Draft (ED) on Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our comments are provided below. We endorse the development of a common definition and framework for internal controls and appreciate the difficulty in obtaining a consensus from a divergent group.

This comprehensive treatise on Internal Controls contains valuable guidance for all levels of managers in various types and sizes of companies. COSO and all of the individuals who have contributed to this study should be congratulated for their quality work on this product.

In particular, we found the sections which discuss Roles and Responsibilities and Limitations of Internal Controls informative and feel it will be useful to managers in many disciplines and not just to auditors and financial people. Also, we believe the guidance in Part 2 on how to establish, maintain, and evaluate internal controls for each of the nine components can be of significant value.

The format of the ED makes it readable but lengthy. Condensing the content would be helpful, although we recognize that it may be difficult to make the final version more concise since this document will be used by various groups and companies of different sizes and types. One suggestion would be to separate the Evaluation Tools section contained in Appendix C from the final document. The Evaluation Tools section would be more helpful as a separate document to guide implementation than as part of the framework itself. The framework would not suffer by having this section as a separate and distinct document since much of this information is contained in Part 2 in the evaluation section for each of the components.

The flow charts in Appendix C (Exhibits C-11 thru 15) could be improved if the design and symbols were changed to help visualize the path through each process, as well as loops, data access points and other reference points. Also, we believe this would make it more readily usable by finance and operations managers in companies of all sizes.

As requested listed below are comments related to the following issues:

- We agree with the <u>definition</u> that internal control is a process, executed by the entity's employees, to accomplish specified objectives. However, we believe that the definition of "objectives" could be strengthened by dividing the definition into categories (operations, financial reporting, and compliance with laws and regulations). In a stand-alone mode, the meaning of the word <u>objectives</u> is subject to different interpretations. We realize that this improvement will lengthen the definition but it is important to be precise.

- We concur with the report in the identification of the nine <u>components</u> which are necessary for effective internal control. This report appears to have the correct amount of emphasis placed on each of the components.

- The <u>evaluation</u> approach recommended in the report is useful and depending on the type and size of a company it may be adequate. We will utilize information from the evaluation tools in conjunction with our monitoring and review process. The evaluation tools section contained in Appendix C should be a separate and distinct document from the framework as mentioned previously. Many managers would find a ready reference useful and this section could be the basis for a handbook on internal controls for daily use and guidance in both established and start-up companies.

- The guidance given in the <u>management reporting to external parties</u> section regarding reporting is adequate. However, additional discussion is needed up front which makes clear how internal controls on the financial statements are specifically defined, consistent with the currently accepted definition of accounting control. The discussion should also emphasize that management reporting on internal controls made in connection with the issuance of financial statements should be specifically restricted to the internal controls over preparation of financial statements.

  The illustrative management report should be dropped since this report will need to vary to fully reflect each company situation.

AT&T is pleased to provide comments on the Exposure Draft. Please contact us if there are questions regarding these comments.

Roger F. Davis

Roger F. Davis

Aetna

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June 14, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, New York 10036-8775

Gentlemen:

Aetna Life and Casualty Company (Aetna) is pleased to have this opportunity to comment on the draft "Internal Control - Integrated Framework." We believe that your draft represents a significant first step in developing a useful standard for internal control. We support continued efforts at refining this preliminary proposal so that useful, practical guidelines on what constitutes an effective internal control system will result. To that end, we offer the following suggestions for your consideration:

Scope of the Report - We believe that the scope of the discussions in the document should be clarified. Part II is very broad in defining internal control and describing the nine components of operational, compliance, and financial reporting controls. Part III is very specific in describing Management Reporting to External Parties on only financial reporting controls. The transition between the general and specific discussions is confusing. We believe that the general discussions of components (Part II) and evaluation tools (Appendix C) should be clearly focused on financial reporting controls. This would better support the later specific discussions of management reporting on the adequacy of the financial reporting controls.

Components of Internal Control - We agree that all nine components identified in the report are part of an effective system of internal control. However, we believe that some components identified in the draft can be combined into broader components and that the evaluation of certain components is highly subjective. For these reasons, we believe that the providers of opinions on control adequacy and readers of these opinions will be confused by the draft. The Committee can clarify the report by continued work to simplify and clarify the components and to reduce subjectivity from their evaluation.

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For example, the Integrity, Ethical Values and Competence component is not easily evaluated and is difficult to subject to an opinion by management (or their independent auditors). An adequate system of internal control must be based on sound ethical values; however, the evaluation methods described in the exposure draft are too subjective for management to meaningfully form and express an opinion thereon. Also, the principles considered in Managing Change are part of the Risk Assessment component and those included in the Communication component are redundant with the Control Environment component.

Management Reporting - We concur that the adequacy of the system of financial reporting controls should be addressed in public reports. We believe that the Committee should take a stronger position on public reporting and make a specific recommendation to that effect.

We have the following suggestions on the management report suggested in the report:

- **Opinion** - The report suggested on page 156 of the draft explicitly states that the company has an effective system of internal control over the preparation of its published financial statements. By also including the paragraph preceding the opinion paragraph which specifically mentions the COSO report and the nine components, Aetna believes that the report also implicitly states that the company's entire system of internal control is the subject of management's opinion. The limitation of the management opinion to financial reporting controls should be explicitly clear to the reader of the report.

- **Point in Time** - Aetna believes that the report does not clearly limit the opinion to control adequacy at a specific point in time. We believe that the opinion should state that "the Company had an effective system of internal control at December 31, XXXX for the preparation of its financial reports." The suggested wording of "the Company maintained an effective system of internal control over the preparation of its published financial statements," does not clearly limit the opinion to a specific point in time.

Material Weakness - One of the critical issues in establishing a practical standard for internal control is developing a useful definition of a material weakness in an internal control system. Management cannot report meaningfully on the adequacy of financial reporting controls without a precise definition of what constitutes a material weakness in that control system. The Committee acknowledged this issue by stating that the "material weakness concept should be evaluated by the appropriate bodies to determine if it needs to be refined, or at least more explicitly defined." We also believe that an explicit definition of a material weakness is needed. We believe that the Committee cannot meet its objective of establishing an internal control standard without such a definition.

Since this report represents a comprehensive standard for internal control and may be looked to by the standard-setters, legislators and regulators as a basis for their future efforts in this area, we believe that the Committee should assume a leadership role in developing a comprehensive definition of material weakness. We will support activities of the Committee in leading and coordinating the efforts of the AICPA and others in this endeavor.

Appendix C, Evaluation Tools - We believe that the inclusion of evaluation tools is inappropriate for this document. As the body of the report illustrates, internal control systems are dependent on an organization's structure, systems, and control environment and must be specifically tailored for each entity. It follows that control system evaluation tools need to be specifically tailored as well. This is not the impression given by inclusion of a generic questionnaire.

We suggest that the Committee consider replacing the generic questionnaire with a reference manual that provides information about possible internal control processes and procedures in a format that facilitates easy reference by operational areas on specific functions (e.g., accounts receivable controls, general ledger controls, etc.). This would enhance the general usefulness of the report and better fulfill the second stated purpose of the document; to provide criteria against which all entities can assess and improve (if necessary) internal controls.

Due Process - We are unclear about the significance of the final COSO report. It is unclear if the final report is to become part of authoritative accounting literature and represent a consensus of the U.S. accounting community. Further, we are unclear of the procedures to be used by the committee to obtain individual sponsoring organization endorsement of the report (i.e., entirely democratic or one or more organizations retains "veto" power over issuance).

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The COSO operating procedures and policies should be clarified and disclosed to the public. We believe that this document should be subject to full "due process" procedures similar to those followed by the FASB and AICPA. Those procedures should include public testimony, public discussions of the comments received on the draft and changes proposed by the Committee and, if the draft is changed substantially, re-exposure to the public for comment. The Committee should also conduct a comprehensive field test of the standard before it is finalized.

Adoption of due process procedures will help ensure the usefulness and practicality of this standard and increase acceptance and credibility of the final report.

We appreciate the opportunity to express our views on the draft. We applaud these early efforts and support your continued work toward defining a useful standard for internal control. We believe that your future plans should provide for another exposure draft, and most importantly, include a comprehensive field test of the standard before it is finalized. This would provide an opportunity to test the usefulness and practicality of the standard and increase its credibility.

If you have any questions, please do not hesitate to contact me.

Very truly yours,

P. W. Kenny

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John M. Nimons
Vice President—Controller

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Champion
Champion International Corporation

June 10, 1991

Committee of Sponsoring Organizations
of the Treadway Commission
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Gentlemen:

Re: Internal Control - Integrated Framework Exposure Draft Dated March 12, 1991

We have compiled comments from individuals in our Control and Internal Audit areas regarding your exposure draft ("ED"). While the tone of our comments may seem critical, we appreciate the difficulty in developing a framework for internal controls.

The ED states as its two principal objectives:

- o To provide a common ground for mutual understanding of internal control by all interested parties, and

- o To provide criteria against which all entities can assess, and, where necessary, identify areas where they can improve internal controls.

In an attempt to achieve these objectives, the ED developed very general definitional guidelines which provided little concrete assistance to the reader. In an apparent effort to reach consensus among the COSO members, the ED strayed from the clear, concise and specific format of the Treadway Report. The following comments address our most significant concerns.

Definition of Internal Control

The ED defines internal control as a process, executed by an entity's board of directors, management and/or other personnel, to achieve specified objectives. These objectives fall into three areas - operations, financial reporting and compliance. No mention is made of the need to safeguard an entity's assets - probably the primary purpose of internal controls. In fact, the need to safeguard assets is only hinted at throughout the ED.

Limitations of Internal Control

This chapter was generally well written, except for the two page discussion from the Law of Torts on the "Prudent Person Concept". This legalistic digression illustrates the lack of focus and conciseness running throughout the ED.

Reporting Deficiencies in Internal Control

The Treadway Report made specific recommendations to public companies, independent public accountants and the SEC regarding the action steps for various reporting deficiencies. The ED makes no such recommendations, addressing this issue in a general fashion, and reaching no conclusion. For example, under the topic of to whom to report deficiencies, the ED states: "To whom to report information on control deficiencies depends on the nature and significance of the information and its source." Some general comments follow which provide no additional guidance to the reader. We recommend that this area be dropped from the final report, unless the Committee feels it can enhance the original recommendations of the Treadway Report.

Management Reporting on Internal Controls to Third Parties

The ED recommends that reports on internal controls include the following:

1. The category of controls being addressed.
2. A statement about the inherent limitations of internal control systems.
3. A frame of reference for reporting (i.e., the COSO report).
4. Management's conclusion on the effectiveness of the internal control system.
5. The date as of which management's conclusion is made.
6. The names of the report signers.

We do not believe that point three above requiring that the COSO report be the frame of reference for reporting (i.e., the standard against which the internal control system is measured) is appropriate at this time. Other laws and standards currently exist which address the assessment of the adequacy of internal controls over the preparation of financial reports. We believe that a reference to generally accepted standards would be a more appropriate frame of reference, such as, "management assessed the company's system in relation to generally accepted professional standards of internal controls."

The illustrative report that conforms to your recommended guidelines (page 156) appears to place too much emphasis on the inherent limitations of internal control systems. As a result, the reader is left with the impression that the primary purpose of the Management Report is to absolve management from any responsibility for the preparation of financial statements which are not reliable.

In the Management Report on Internal Controls included in our 1990 Annual Report, we state: "The company maintains a system of internal controls designed to provide reasonable assurance that assets are safeguarded, transactions are executed and recorded in accordance with its authorizations, and financial records are maintained so as to permit the preparation of reliable financial statements." By stating that our controls "provide reasonable assurance" we alert the reader that there are inherent limitations in our internal control systems, but more clearly state the purposes of these systems.

<u>Appendix C - Evaluation Tools</u>

Pages C-1 to C-49, which provide a set of questions each entity should answer in evaluating each component of its internal control system, were very well done. These pages, which nicely summarize your nine components of internal control, represent the most significant contribution of the ED. We recommend that this Appendix be given more prominence when the final report is issued.

Thank you for giving us the opportunity to furnish you our views and recommendations on the ED. If you have any questions or comments relative to this letter, we would be pleased to furnish further assistance.

Sincerely,

John M. Nimons

John M. Nimons

JMN:hb