

Accounting and Financial  
Management Division

October 30, 1992

Mr. Robert L. May  
Chairman  
Committee of Sponsoring Organizations  
of the Treadway Commission  
1211 Avenue of the Americas  
New York, NY 10035-8775

Dear Mr. May:

We appreciate your September 11, 1992, briefing on the final report, Internal Control - Integrated Framework, by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. We are disappointed that the final report is not responsive to our major concerns provided to you on March 16, 1992, in our comments on the draft report. We believe that the final report does not underscore the importance of internal controls, falls short of meeting the expectations of the Treadway Commission for management's reporting on the effectiveness of internal controls, and misses opportunities to enhance internal controls oversight and evaluation.

In general, the report's message does not advance the status of corporate governance and may actually encourage management to lessen its attention to internal controls. In particular, the report:

- does not advocate public reporting on internal controls for financial reporting and fails to encourage evaluation of other controls such as those for laws and regulations,
- excludes safeguarding of assets from financial reporting controls, which is actually a step backwards from those controls long associated with financial reporting,
- does not recognize the important role that an entity's external auditor can play in evaluating internal controls,
- misses the importance of comprehensive evaluations of internal controls,
- does not provide specific guidance for an effective audit committee role, and

-- encourages limited reporting of internal controls deficiencies.

The COSO report provides a framework and criteria for evaluating controls, but given its shortcomings is less likely to be effective than the more comprehensive treatment of controls provided by the FDIC Improvement Act. Further, if COSO's weak approach to controls affects the behavior of the regulators, the benefits of the act's internal control and corporate governance reforms will not be fully realized.

#### PUBLIC REPORTING ON THE EFFECTIVENESS OF CONTROLS

The Cohen Commission, the Financial Executives Institute (one of the five sponsoring organizations of COSO), and the Treadway Commission have at one time or another since the late 1970s recommended reporting on internal controls. On two separate occasions the Securities and Exchange Commission (SEC) has proposed rules for reporting on internal controls by securities registrants. The FDIC Improvement Act requires such reporting for federally insured banks and thrifts with assets of \$150 million or more for fiscal years beginning after December 31, 1992. Moreover, according to COSO, one of every four public companies, and 60 percent of the Fortune 500 companies, already voluntarily report on internal controls in some fashion.

COSO represents organizations with both responsibility for and an interest in internal controls. COSO is in a position to provide an important service to the investing public and others by strongly supporting public reporting on internal controls as a means to better ensure that they are in place and working effectively.

COSO did not follow our recommendation that it strongly support public reporting in its final report. COSO stated that it was not expressing a position on public reporting on internal controls for financial reporting. COSO stated that "public reporting on internal control is not a component of, or criterion for, effective internal control." We disagree. As effective internal controls are clearly management's responsibility, public reporting enhances management's stewardship and accountability to shareholders and other interested parties. Public reporting encourages management to be proactive and pay attention to the effectiveness of internal controls rather than reacting when weaknesses lead to serious corporate problems.

We also recommended that COSO encourage more comprehensive reporting on internal controls, including controls over compliance with laws and regulations. Our work as well as

others has underscored the serious nature of noncompliance with laws and regulations by insured depository institutions and other organizations. The FDIC Improvement Act requires reporting on noncompliance with safety and soundness laws and regulations designated by the regulators. These requirements resulted from the frequent finding of violations at institutions that failed. Also, federal agencies are required to consider controls over compliance with laws and regulations when evaluating and reporting on internal controls under the Chief Financial Officers Act of 1990 and the Federal Managers' Financial Integrity Act of 1982.

COSO's final report stated that management reporting on internal controls over compliance is an evolving area and that the criteria provided in its report could be used for reporting on compliance controls. COSO pointed out that a threshold for measuring the severity of controls deficiencies, perhaps similar to the material weakness concept for financial reporting, would need to be identified. COSO also believed that focusing on the controls system would better address the underlying objective of preventing non-compliance than reporting instances of non-compliance. We believe that both are important. The effectiveness of controls both from their design and in actual operation needs to be determined. As with management reporting on the effectiveness of controls for financial reporting, public reporting on compliance enhances management's stewardship and accountability for compliance.

#### EVALUATION OF INTERNAL CONTROLS FOR FINANCIAL REPORTING

In commenting on COSO's draft report, we pointed out that COSO referred to safeguarding of assets as primarily an operations objective. We expressed concern that if management excluded safeguarding of assets from the financial reporting controls objectives, then the reporting suggested by COSO would be more limited than the scope of the system of controls addressed by the Foreign Corrupt Practices Act (FCPA), and sends the wrong signal about what constitutes effective internal controls. For example, FCPA requires SEC registered companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that (1) transactions are executed in accordance with management's authorization, (2) transactions are recorded to maintain asset accountability, (3) access to assets is permitted only with management's authorization, and (4) recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action taken with respect to differences. COSO's limited definition of financial reporting controls would encompass

only the second and fourth internal controls objectives as defined by the FCPA.

Also, Generally Accepted Auditing Standards (GAAS)<sup>1</sup> focus audit work on internal controls for financial reporting that parallel those of the FCPA. For example, GAAS defines the broad objectives of internal accounting controls to provide management with reasonable assurance that assets are safeguarded from unauthorized use or disposition and that financial records are reliable to permit the preparation of financial statements. GAAS lists the specific objectives, as stated in the FCPA, as necessary to achieve the broad objectives.<sup>2</sup>

The significance of COSO's narrow definition of financial reporting controls objectives is illustrated by an example from its final report regarding commercial bank lending activity. The report's example assumes that controls exist to ensure credit files contain current customer credit histories and performance data. However, the bank's lending officers do not use that information in making credit decisions. Instead, approvals of draw downs against existing credit lines, and even increases in limits, are made intuitively. Financial management periodically conducts thorough reviews to determine appropriate levels of loan loss reserves. COSO states that under this scenario, controls over operations have significant weaknesses, whereas controls over financial reporting do not. The effect of such distinctions for management reporting on internal controls is that management's evaluation of the effectiveness of financial reporting controls would only include controls intended to ensure that any loan losses are accurately reported. The cause of those losses would not be included in management's evaluation as the breakdown in internal controls would be considered a breakdown in operation controls. COSO has distinguished between financial and operation controls in a way that would make any reporting on financial controls much less meaningful.

We believe that COSO's narrow definition of financial reporting controls is a serious step backward to evaluating

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<sup>1</sup>Statement on Auditing Standards No. 30, Reporting on Internal Accounting Control

<sup>2</sup>The AICPA Auditing Standards Board's April 29, 1992, proposed statement of standards for attestation engagements Reporting on an Entity's Internal Control Structure Over Financial Reporting would supersede SAS 30. In commenting on the proposed standard, we recommended on August 14, 1992, that the Board include the basic concepts that are implicit in the internal control structure.

and reporting on the effectiveness of these controls. This step could encourage management to lessen its attention to internal controls and may discourage more expansive public reporting on controls now being made by some companies who deal with controls for the safeguarding of assets from loss or misappropriation. Also, shareholders and other interested parties are likely to be misled by such reports. Under COSO's definition of financial reporting controls, management would be reporting on the reliability of controls to accurately tally the losses and not on the deficient controls that lead to the losses.

The COSO report also downgrades the importance of discrete annual evaluation of controls as compared to ongoing monitoring of controls by management. COSO states the greater the degree and effectiveness of ongoing monitoring, the less need for separate evaluations. Further, the frequency of separate evaluations necessary for management to have reasonable assurance about the effectiveness of the internal controls system is a matter of management's judgment. We agree with COSO that the design and operation of internal controls needs to be monitored on a timely basis as an entity's operations change over time and can reduce the effectiveness of internal controls. What is important is that internal controls are comprehensively reviewed at least annually and that the results of both monitoring and separate evaluations of the effectiveness of controls accomplish that result. Implementing the COSO report may result in management being unable to make a comprehensive statement about the effectiveness of controls at a point in time.

#### ROLE OF THE EXTERNAL AUDITOR

COSO did not revise its final report to address the essential role that external auditors play with respect to internal controls as we recommended. GAAS requires external auditors to gain an understanding of an organization's internal control structure and to assess its control risk. GAAS also provides guidance and procedures for reporting on internal controls. The FDIC Improvement Act requires management of banks and thrifts to annually report on the effectiveness of financial reporting controls and for its external auditor to report separately on management's assertions. As evidenced by the internal control weaknesses that contributed significantly to bank and thrift failures, an independent review of management's internal controls assertions is needed to ensure such weaknesses are identified and corrected before significant losses have been incurred.

COSO stated that external auditors' involvement with public management reporting on internal controls is being

considered by various public and private sector bodies, but it is an issue beyond the scope of its report. However, as previously stated, COSO took the position that public reporting is not a component of effective internal controls. We believe that such a position may discourage public reporting, and it could very well lead to inadequate management attention to the effectiveness of internal controls. Public reporting especially with auditor attestation will lead to stronger internal controls.

#### ROLE OF THE BOARD OF DIRECTORS AND AUDIT COMMITTEES

COSO in its draft report stated that the chief executive officer is ultimately responsible for the overall internal control structure, but recognized that management can override controls, enabling a dishonest management to intentionally misrepresent results to cover its track. We recommended that the final report should also make clear that the board of directors and its audit committee have oversight responsibility for ensuring that internal controls are functioning properly and that management properly supervises the controls and does not override them. We also urged COSO to comprehensively delineate the duties and responsibilities of boards of directors and audit committees for internal controls and to set forth the independence and competence requirements for audit committee members.

Statutes and other authoritative sources do not comprehensively delineate all the specific internal controls responsibilities of boards of directors and audit committees, nor are the qualifications necessary to successfully discharge those responsibilities fully addressed. Our report, Audit Committees: Legislation Needed to Strengthen Bank Oversight (GAO/AFMD-92-19, October 21, 1991) reported the results of our survey of chairmen of large banks' audit committees (assets of \$10 billion or more) in which many respondents stated bank audit committees lack the independence, expertise, and information on internal controls and compliance with laws and regulations necessary to properly oversee bank operations.

COSO's final report added a discussion emphasizing the important role of board of directors and audit committees for effective internal controls. In that respect, the report states they must possess an appropriate degree of management, technical and other expertise coupled with the necessary stature and mind set so that they can adequately perform the necessary governance, guidance and oversight responsibilities that are critical to effective internal controls. The COSO report also states that because a board



must be prepared to question and scrutinize management's activities, present alternative views, and have the courage to act in the face of obvious wrongdoing, it is necessary that the board contain outside directors.

We believe that COSO's final report is responsive to our concerns that the important role of the board of directors and its audit committee be explained. However, COSO did not define the necessary expertise and independence necessary to successfully fulfill the board or audit committee's responsibilities for effective internal controls. The FDIC Improvement Act requires that bank and thrift audit committees be independent from management and that committees of large institutions have members with certain expertise. We believe the act sets forth a good example. It should be noted that COSO's report implies that "outside directors" bring the necessary independence to scrutinize management's activities. Obviously, personal and economic factors that could affect a director's independence must also be considered.

#### PUBLIC REPORTING OF INTERNAL CONTROLS DEFICIENCIES

We advised COSO that its draft report was unclear how uncorrected internal controls weaknesses should be reported--notwithstanding that COSO did not advocate public reporting on the effectiveness of internal controls. We recommended that uncorrected weaknesses should be reported, even when management is making a good faith effort to correct them. We believe that such matters are important to an appraisal by the shareholders and other interested readers of management's report on the quality of financial reporting controls maintained by the business.

COSO's final report limited public reporting of uncorrected internal controls deficiencies related to financial reporting to those judged by management to be material weaknesses. COSO used the GAAS definition defined as a condition in which:

"...the design or operation of the specific internal control structure elements do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions."

GAAS also provides a broader threshold for deficiencies called "reportable conditions," which are "significant deficiencies in the design or operation of the internal

controls structure, which could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements."<sup>3</sup>

By limiting public reporting of controls deficiencies to material weaknesses, the COSO report will discourage reporting of significant impediments to a business' ability to record, process, summarize and report relevant financial data. The result may well be "empty" management reports on internal controls when deficiencies such as reportable conditions exist. Such reporting will not provide a fair picture of the status of financial reporting controls. The future of a business may well be jeopardized by financial controls deficiencies, but these conditions will not be revealed by the kind of controls report proposed by COSO. We believe shareholders and other interested parties would be better served by reporting of uncorrected reportable conditions with those weaknesses judged to be material identified as such.

COSO also advocated point-in-time reporting (as of one day during the year) rather than period-of-time reporting (for an entire year). COSO concluded that point-in-time reporting was preferable because it meets the needs of security holders and is less costly and provides an environment conducive to identification and correction of controls deficiencies. An obvious concern of such reporting is that it reports on the effectiveness of internal controls on a given day (generally year end) and does not address the effectiveness of internal controls for the other 364 days of the year. COSO's solution to this was to suggest that management's report include a statement about the existence of mechanisms for system monitoring and responding to identified controls deficiencies.

A reference in management's report to self-monitoring mechanisms may well provide misleading assurances if such mechanisms are not effective and certainly they are not an equal substitute for period-of-time reporting. As a minimum, we believe point-in-time reporting is a further supporting argument for reporting uncorrected reportable conditions and a strong argument for reporting all "reportable conditions" identified during the year to give

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<sup>3</sup>Management's assertions that underlie an entity's financial statements concern the existence or occurrence of assets, liabilities and ownership interests; completeness of recognizing transactions; rights (assets) and obligations (liabilities) of the entity at a given date; appropriate valuation or allocation of assets, liabilities, revenue and expense components; and presentation and disclosure.



the report user some idea of how monitoring mechanisms are working.

EFFECT ON ACHIEVING BENEFITS  
OF THE FDIC IMPROVEMENT ACT

The FDIC Improvement Act provides a structure to strengthen corporate governance of banks and thrifts and to facilitate early warning of safety and soundness problems. These reforms address deficiencies that significantly contributed to the failure of banks and thrifts and the depletion of the insurance funds. The reforms include corporate governance, accounting, and regulatory reforms.

Regarding internal controls, the act requires banks and thrifts with assets of \$150 million or more to annually report to the federal regulators on their financial condition and management for fiscal years beginning after December 31, 1992. The report is to include a statement of management's responsibilities for preparing financial statements, establishing and maintaining an adequate internal controls structure for financial reporting, and complying with laws and regulations relating to safety and soundness which are designated by the FDIC or the appropriate federal banking agency. The report also must include management's assessment of (1) the effectiveness of the institution's internal controls structure and procedures, and (2) the institution's compliance with the designated laws and regulations. The act requires the institution's external auditor to report separately on management's assertions.

The act also requires the institutions to have an independent audit committee entirely made up of outside directors who are independent of institution management. For large institutions, the act provides that audit committees shall include members with banking or related financial management expertise, have access to the committee's own outside counsel, and not include any large customers of the institution.

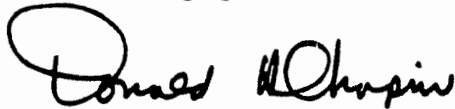
We believe the COSO model for internal controls evaluation does not measure up to the FDIC Improvement Act model. The regulations to implement the act are not finalized and many critical terms need to be defined that will play a key role in determining the success of the reforms. If the COSO guidance is adopted by the regulators and becomes the criteria for internal controls evaluation and reporting for the act, the benefits of the act's internal control and corporate governance reforms will not be fully realized.

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In conclusion, we believe that the COSO report does not meet the Treadway Commission promise of reform. After a number of years of discussion, and attempts to advance the state of internal controls and corporate governance, the COSO report in effect calls for a retreat from the public interest. This is especially disheartening as the COSO report has sponsorship and general acceptance by most important private sector interests. We believe that COSO has failed to respond effectively to the recognized need for strengthened corporate governance.

Congress responded with the FDIC Improvement Act to address the breakdowns in internal controls and other areas of corporate governance in the banking industry. We plan to continue to advocate the model set forth in the act to Congress and others who may affect how internal controls issues are finally resolved. We believe that applying that model will strengthen internal controls and provide a more comprehensive approach to strengthen corporate governance and public accountability. Clearly, action beyond the COSO report such as legislation is needed to further protect investors and our nation's government.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "Donald H. Chapin". The signature is fluid and cursive, with a large initial "D" and "C".

Donald H. Chapin  
Assistant Comptroller General