



13 March 2012

The Committee of Sponsoring Organisations of
the Treadway Commission (COSO)

www.ic.coso.org/

Re: CLC/HBL/LAN/SHA

Dear Sir or Madam,

Re: COSO Public Exposure on Internal Control – Integrated Framework

FEE is pleased to provide you with its comments on the COSO Public Exposure on Internal Control – Integrated Framework.

Sound corporate governance, including sustainable internal control systems is crucial for companies around the world, as it is a key factor in ensuring and restoring confidence in capital markets through the provision of financial and non-financial information of the highest quality.

To serve the purpose of sound and sustainable internal control systems, the COSO Framework has been widely recognised and has proved its worth as a solid base for the set up and functioning of these systems in companies worldwide. This is beyond the reference in the COSO Framework to the US Sarbanes Oxley Act, Section 404, on effectiveness of internal control.

The societal developments and the financial and economical challenges companies have faced since the inception of the COSO Framework on internal control, and in particular over the last couple of years, have proven the need for a review of internal control frameworks in general. This review should be carried out to ensure that the corporate governance systems as a whole, including the internal control frameworks, are fit for purpose for the future.

Therefore, the review of the COSO Framework for internal control is timely in the context of the large variety of areas that are in focus of policy makers and standard setters around the world. Policy makers and other stakeholders have especially identified the need for strong corporate governance and internal control and risk management are areas where stakeholders are showing increased interest.

In the context of strong corporate governance, external audit forms an important part of the system as a whole. Any improvements to internal control systems of companies should therefore include due consideration as to how the internal control systems of the entity interacts with the other elements of the governance of the entity, including risk management, internal audit, external audit and disclosures about corporate governance, and in particular, the fundamental relationships and obligations between employees, management, board committees, boards, auditors and shareholders at large.

Auditors can add value to companies' corporate governance. Their expertise can be (and is already) provided in a variety of ways, all subject to the relevant ethical and independence provisions. As auditors base their general risk assessment of the company and subsequently design their audit procedures accordingly, on the internal control system, the internal control framework applied by the company is of significant interest to external auditors, in addition to its relevance to internal auditors, risk management departments and to management. This internal control framework goes further than what is referred to under Section 404 of the Sarbanes-Oxley Act, where the assessment and certification only cover the effectiveness of internal control over financial reporting. The International Standards on Auditing (ISAs) also refer to internal control assessments in relation to financial reporting. Therefore, external auditors will be considering the appropriate application of the principles of the COSO Framework for that purpose.

Our general comments on the Consultation Paper that are relevant from the viewpoint of the audit profession with a European or international perspective are summarised below:

1. The COSO Framework should be developed with a global view in mind, as it is widely used globally and could be considered as a world leading framework for internal control. It has a large variety of stakeholders across the world which underpins the need for flexibility in the framework in order to make it applicable for as many users as possible. COSO should note that the International Federation of Accountants (IFAC) is currently working on the same topic and international cooperation is therefore encouraged.
2. The role of the board and of the audit committee could be further addressed, as boards and audit committees play a pivotal role for the monitoring of internal control in companies in addition to the monitoring activities carried out by management and internal audit. Especially the relationship between the audit committee and the auditor and guidelines to enhance the quality of the cooperation between the two parties are of key importance.
3. With regard to the COSO Cube, the objectives should be amended to include strategic processes, and the original 1992 order of the components should be restored to visually highlight that Control Environment is the foundation on which the other components stand.
4. The COSO Framework appears developed with (very) large companies in mind. A proportional approach to internal control has been addressed in the Consultation Paper, but could be further developed to ensure that the framework is applicable to companies of all sizes and with different levels of complexity. Furthermore, it should be ensured that the COSO Framework is sufficiently adapted to allow for new business models, such as internet companies where a different setup of internal control is needed. It should also be taken into consideration that IT technologies are much more widespread today for all companies than they were at the inception of the original COSO Framework.

5. Governance of COSO could be improved. This would include a more representative organisation as well as installing due process measures that entail conducting public consultations of all volumes of the framework and summarising the comments received in feedback statements.

For further information on this FEE¹ letter, please contact Lotte Andersen at +32 2 285 40 80 or via email at lotte.andersen@fee.be from the FEE Secretariat.

Yours sincerely,



Philip Johnson
FEE President

¹ FEE is the Fédération des Experts comptables Européens (Federation of European Accountants). It represents 45 professional institutes of accountants and auditors from 33 European countries, including all of the 27 EU Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 700.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy.

FEE's objectives are:

- To promote and advance the interests of the European accountancy profession in the broadest sense recognising the public interest in the work of the profession;
- To work towards the enhancement, harmonisation and liberalisation of the practice and regulation of accountancy, statutory audit and financial reporting in Europe in both the public and private sector, taking account of developments at a worldwide level and, where necessary, promoting and defending specific European interests;
- To promote co-operation among the professional accountancy bodies in Europe in relation to issues of common interest in both the public and private sector;
- To identify developments that may have an impact on the practice of accountancy, statutory audit and financial reporting at an early stage, to advise Member Bodies of such developments and, in conjunction with Member Bodies, to seek to influence the outcome;
- To be the sole representative and consultative organisation of the European accountancy profession in relation to the EU institutions;
- To represent the European accountancy profession at the international level.

Appendix: Responses to Questions

General comment on the Governance of the COSO organisation

The COSO Framework is widely used globally and could be considered as a world leading framework for internal control.

COSO consists of its five founding organisations: the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), The Institute of Internal Auditors (IIA), and the Institute of Management Accountants (IMA). Each of these five organisations appoints a member to the COSO Board who each determines its own criteria and characteristics for appointing a member (e.g., length of time, staff or volunteer, etc.). The COSO Chair is appointed by the unanimous vote of the sponsoring organisation's members. The term of the Chair shall be three years, renewable for additional years if agreed upon by the Chair and voted upon by COSO's committee members.

In comparison with other international organisations that are charged with setting internationally applicable standards used worldwide², the development of a framework like the COSO Framework on Internal control should be framed by a governance structure of the organisation that supports the public credibility of the framework. Furthermore, a governance structure should:

- Effectively promote the organisation's mission of developing comprehensive frameworks and guidance in the global marketplace on enterprise risk management, internal control and fraud deterrence designed to improve organisational performance and governance and to reduce the extent of fraud in organisations.
- Provide for a standard setting environment that is independent of vested interests, while still ensuring the appropriate accountability to its wide range of global stakeholders.

Therefore, the governance of the COSO organisation could be improved in for instance the following areas:

- Broader diversity, including geographical representation and representation by user groups in the COSO Board. This would balance public interest considerations with the technical expertise needed in the development process of the framework which will also strengthen the global political and technical accountability of the framework.
- Improving the transparency of the appointment process of board members, including setting uniform appointment criteria for board members, such as through a body with supervising responsibilities that includes a nomination committee. In particular, the nomination committee should ensure that board members are appointed from a sufficiently large pool of candidates.
- Ensuring a sustainable funding of the activities.
- Ensuring that the development of the framework is done in a transparent way that is independent of vested interests.

² Such as the IFRS Foundation together with the International Accounting Standards Board (IASB) with regard to financial reporting standards and the International Federation of Accountants (IFAC) together with its independent standard setting boards for auditing, education, ethics, etc.

- Developing a strategy and a uniform due process for all standard setting activities which are appropriately supervised and accountable to the stakeholders which includes public consultation of its work and feedback on such public consultations which will allow stakeholders to obtain an understanding of the reasoning behind the amendments made.

Question 5: The updated *Framework* will help strengthen an entity's systems of internal control

Internal control is an essential part of sound corporate governance which again is essential for high quality audits. In Europe, auditors are already required under European legislation in the Statutory Audit Directive to "... report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process ...". This requirement has been in place since 2006.

Corporate governance has received great interest from policy makers and others, and especially following the financial crisis the focus has been on the competences of boards and audit committees to discharge their monitoring responsibilities. In Europe, this particular issue has been and is intensively debated, in particular in relation to the recent proposals from the European Commission to strengthen the role of the audit committee, including how the audit committee fulfils its monitoring responsibilities. The review of the COSO Framework is therefore timely given this recognition of the need for strong corporate governance in companies.

The COSO Framework should therefore be developed with a global view in mind which is broader than merely focusing on the applicability in accordance with the Sarbanes Oxley Act section 404.

Question 6: The updated *Framework* is internally consistent and logical

Definition and Objectives displayed in the Cube

The definition of internal control in the framework remains unchanged compared to the original 1992 framework. However, to create an even closer link between the definition and the objectives, the definition should also include a reference to the "*strategic process of setting objectives*". This would further align this framework with the 2004 Enterprise Risk Management Framework and would underline that internal control can only be effectively implemented throughout the company when the setting of objectives has been done.

Also, with reference to the part of the definition that addresses compliance control, compliance with policies, procedures and contracts should be added in the part of the definition that refers to laws and regulations.

The International Standard on Auditing (ISA) 315³ includes a definition on internal control that is similar to the definition of the term in the COSO Framework. The main difference appears with regard to the board. The definition in ISA 315 states that the process of internal control is the one “... *designed, implemented and maintained by those charged with governance, management and other personnel...*”. In our view, this underlines the involvement of the board and for instance the audit committee in designing the internal control measures in a clearer way than the COSO definition that states that “*Internal control is a process, effected by an entity’s board of directors, management, and other personnel ...*”

With regard to the objectives and in order to make the internal control concept more robust along the lines of the 2004 COSO Enterprise Risk Management Framework, the following amendments should be made:

- “*Strategic*” should be added as an objective of internal control, since the strategy set by the board needs to be implemented in a well-controlled way by management and the employees in order to having internal control applied consistently throughout the entity.
- Expanding the reference to fraud in the “*Operations Objective*” from “...*safeguarding of assets against loss...*” to also include “... *unauthorised use or disposition.*” This will more clearly capture the risk management assessments that are needed to prevent fraudulent behaviour of employees and management in line with the overall mission of COSO.

Components and Entity as displayed in the Cube

The vertical ordering of the 5 components (Control Environment to Monitoring Activities) has been inverted compared to the original 1992 Cube. We recognise that this aligns the order of the components with the order displayed in the 2004 Enterprise Risk Management Framework.

FEE recommends that the original 1992 order of the components is restored as this will visually underline the Control Environment as the foundation of the internal control framework upon which effective control is built and upon which the other essential components of internal control depend. Therefore, inverting the order back to the original version is visually more intuitive and more comprehensible.

In general, the link with COSO Enterprise Risk Management Framework is not very clear. In order to underline the link between internal control and risk management, risk management should be further addressed in the COSO Framework on internal control.

The different parts of the entity are displayed on the right face of the Cube reaching from “*Function*” to “*Entity level*”. As “*Processes*” is the starting point for the design of internal control, “*Processes*” should be added to the right face of the Cube. This will underline that the COSO Internal Control Framework is also appropriate for designing and assessing effective internal control over business processes.

³ ISA 315 Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment

Monitoring Activities

The definition of internal control refers to the board of directors as the body that effects the processes of internal control. The board will have the ultimate responsibility to set the strategy and to monitor that the strategy set is implemented accordingly. To make a clear link between the board and the processes carried out within the company, we encourage COSO to include a section under “Monitoring Activities“ that provides further detailed guidance on how the board (and any board committee, such as the audit committee or the risk management committee) performs the monitoring on the internal control processes. Including such a section in this framework seems more appropriate instead of including such a section in the Evaluation Volume. This will underline that internal control is under the responsibility of all parties within the company, from the governing bodies to the employees.

Inclusion of such a section on Monitoring by boards and audit committees could clarify the responsibility of audit committees vis-à-vis the board and also specify in more details what the monitoring responsibilities of the audit committee entail in practice. In some European Member States, audit committees are a new concept due to the transposition of the Statutory Audit Directive and these clarifications of their monitoring responsibilities within the COSO Framework could facilitate a more consistent approach as to how audit committees discharge their duties in the various countries. This could also facilitate the presence of non-national members in boards and audit committees.

In this regard, COSO should note that the International Federation of Accountants (IFAC) is currently working on the same topic with the issuance of an Exposure Draft for International Good Practice Guidance on “Evaluating and Improving Internal Control in Organizations” through its standing Professional Accountants in Business Committee in December 2011⁴. International cooperation with regard to the Evaluation part is therefore encouraged.

Although the three-dimensional Cube displays the interaction of the different parts of internal control in an intuitively understandable way, the impact of the monitoring activities on the subsequent (re-design of) control activities is not included. It may therefore be beneficial to display this interaction in the format of a circle showing the interaction of all five components with each other.

The Evaluation Volume and Volume on Internal Controls related to Financial Reporting

In the foreword of the COSO Consultation Paper, it is indicated that the framework is presented in three volumes which is an Executive Summary, the framework itself and an Evaluation Volume. The Evaluation Volume has not been released for public consultation, and it appears that the original 1992 Evaluation Volume will not to be released for public comment before it is finalised.

With the global applicability of the COSO Framework and especially the attention that corporate governance and internal control have received following the financial crisis, FEE strongly encourages COSO to expose its Evaluation Volume for public comment.

⁴ http://www.ifac.org/sites/default/files/publications/files/20111201-PAIB-ED-Internal%20Control-FINAL_0.pdf

A further consideration with regard to public consultation is the large variety of stakeholders and user groups that the COSO Framework has across the world which underpins the need for incorporation of some flexibility in the framework in order to make it applicable for as many users as possible. Also the need for coordinating the approach taken with regard to the monitoring of the governing bodies of the companies with the work subsequently carried out by other parties, such as by the external auditor should be taken into consideration with deciding on public exposure of the Evaluation Volume.

FEE is pleased to note that COSO intends to update and/or provide more guidance with specific focus on Internal Control over External Financial Reporting later in 2012, as this particular volume is of great importance for companies as well as for external auditors. In the current market circumstances, it is essential that financial information provided to users is of high quality taking note of the complexity of financial reporting in order to ensure the credibility of the capital markets.

Question 7: The updated *Framework* is written in a manner that is understandable and provides ease of use

The COSO Framework has proven its quality over the last 20 years. The update now exposed for public comment retains the original approach with some amendments to ensure that the COSO Framework remains fit for purpose.

However, the COSO Framework is comprehensive and although the breakdown in objectives (3), components (5), and entity (4) is clear from the Cube and the additional breakdown into 17 principles provides useful guidance, the further breakdown into 81 attributes makes the framework in itself more complex. With this additional granularity, the framework may not be as easily applied by companies of all sizes and with different levels of complexity.

FEE appreciates the expansion of the guidance on documentation of internal control and the reference to the work of external auditors. Appropriate and high quality documentation from the entity on these matters is essential for the auditor in the design of the relevant audit procedures to be carried out. As COSO may be well aware of, the International Auditing Standard 315⁵ requires the auditor to obtain an understanding of the entity's internal control relevant to the audit, and the COSO Framework therefore works well alongside the ISA standard.

⁵ ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment

Question 8: The updated *Framework* is applicable to organizations of varying legal structures and sizes, and operating in various geographies and industries

Proportionality

Internal control is part of the corporate governance system of the entity regardless of the size and complexity of that entity. FEE appreciates the reference to proportionality of the framework as referred to on pages 20 and 24 of the Exposure Draft and finds it essential that the COSO Framework is easily applicable for all companies. Furthermore, we note the 2006 Framework “Internal Control over Financial Reporting – Guidance for Smaller Public Companies”. FEE finds it essential that the 2006 Framework for smaller public companies (and subsequently for non-listed companies) is updated to reflect the amendments to the COSO Framework that will result of this consultation.

In general, the COSO Framework appears to have been developed with (very) large companies in mind. Although the proportionality principle is introduced in the framework, there may be merit for developing a framework on internal control that from its outset is less comprehensive. Furthermore, COSO should consider whether the current COSO Framework, when retaining the original 1992 approach, is fit for purpose for new and innovative business models in the new economy. Such business models differ from the business models that were common in the early 1990s and for instance, internet companies as well as new IT technologies are much more widespread today for all companies, regardless of their size, structure and business model than they were at the inception of the original COSO Framework. Especially new IT technologies will have an impact on the structure of internal control within the entity and the COSO Framework (all volumes) should be sufficiently flexible to allow for such new business models and internal control systems to develop.