

Comments on
SEC File Number S7-24-06:
“Management’s Report on Internal Control over Financial Reporting”
and
PCAOB Rulemaking Docket Matter No. 021:
“Proposed Standard on Auditing Internal Control over Financial Reporting”

Dear Sirs and Madams,

1. It is a pleasure and privilege to offer these comments on the SEC’s proposed interpretation and the PCAOB’s proposed standard regarding the evaluation and auditing of internal controls. My comments on these documents are combined because those comments are essentially the same and apply equally to both documents and because the SEC and PCAOB indicated that timing of your releases has been coordinated to allow for coordinated public comment. **Answers to specific questions from the SEC are in Appendix A, and answers to questions from the PCAOB are in Appendix B.**

2. I hope these comments will be helpful and provide insights that might not otherwise have been made available to the Commission and Board since my career experience with internal controls has been unusual in its length and concentration. Briefly, that career has focused on internal controls for over 32 years, the first seven with a major public accounting firm and the following twenty-five years with large public companies in several industries where I created, reorganized and directed internal audit departments.

3. It is my firm belief that good internal controls lead to greater operating efficiency, lower overhead, lower administrative and regulatory costs, and better information for management and for financial decision makers. It is therefore unfortunate that the implementation of Sarbanes – Oxley section 404 has thus far resulted in significant and in some cases burdensome costs. These costs arise from a limited understanding of internal control that can and should be corrected with this latest management guidance and revision to audit standards.

4. To understand internal controls, it is important to focus not so much on *what they are* but more importantly on *what they do*. What they *are* is a “process” or “activity” as stated in virtually every definition of internal control over the last 100 years. What they *do* is accomplish business, financial and compliance objectives. Since “process” and “activity” are catch-all terms, *virtually any purposeful action within an organization is a control*. The challenge is finding the *few* actions, activities or processes *that make a real difference in accomplishing the objectives in question* -- Pareto’s law applies here.

5. In virtually every organization or human enterprise there are essentially two processes that form the core of organizational behavior and goal accomplishment. Neither of these has been adequately addressed in the SEC’s proposed guidance or in the PCAOB’s proposed rules. These processes are *motivation and measurement*. Of the two,

motivation is primary. Motivational controls answer the questions, “What’s in it for me?” and “Why should I do it in the first place?” Measurement controls answer the question, “How do I know whether I accomplished what was intended?” and “How do I know when to adjust my actions in order to get closer to achieving the goal?”

6. In most modern organizations people are primarily motivated by three things: 1) keeping their job, 2) making more money, and 3) getting promoted (so they can make more money). Of course intangibles like peer pressure and public recognition are also motivating, but the primary three motivations come first for most people. The processes (and therefore controls) that directly affect these three primary motivations are reporting relationships and compensation systems. In other words, most people are motivated to 1) keep their job by keeping their boss happy and 2) make more money by keeping their boss happy and meeting individual and organizational performance goals.

7. While the last paragraph may be stating the obvious, it is the obvious that has been overlooked in the implementation of Sarbanes-Oxley section 404 and its related rules and guidance. The motivational controls of reporting relationships and incentive/compensation systems more than anything else determine whether financial statements are fairly stated. These controls have not been addressed in the SEC’s proposed interpretation or the PCAOB’s proposed standard.

8. Motivational controls are all the more important in areas where appropriate performance depends upon objective and unbiased judgment. This is the case in financial reporting. As any accountant knows, good accounting is dependent upon objective and impartial judgment. Judgment is required in almost every balance sheet and income statement account. These judgments may take the form of the accounting rules and principles elected, the timing of transactions recorded, the policies, procedures and systems used in recording transactions, the establishment of reserves, the size of reserves, periodic adjustments to reserves, and countless other forms. Each of these judgments should be measured by one standard, “What is the fairest representation of underlying reality?”

9. Unfortunately, current motivational controls, including reporting relationships, compensation systems and incentive systems, force these judgments to be made on an entirely different standard, namely, “What is the representation that *reflects best on management* and company performance (and that we can get away with)?” This judgment bias introduced by current motivational controls is at the root of virtually all financial reporting errors, irregularities and frauds. It was certainly at the root of Enron, WorldCom and other recent financial reporting failures.

10. While motivational controls are entity level controls and key drivers of the control environment, they also can and should be applied on a specific basis to specific control objectives. In the case of financial reporting, they should be applied to the key players in financial reporting. These players are not the auditors, but rather the Chief Accounting Officer, the accounting staff and the members of the Audit Committee. These individuals are most directly responsible for producing fair and accurate accounting and financial

reports. Regulators, auditors and management must begin to recognize that the odds are stacked against fair financial reporting as long as motivational controls introduce bias into the accounting system. Those who are directly responsible for accounting should have motivational controls that *require* their independent and objective judgment in accounting and financial reporting matters. This means that reporting relationships (formal and informal) as well as compensation and incentive systems for these key players should be completely independent of company management and impartial as to company performance.

11. The selection, evaluation, retention and compensation of Audit Committee members should be insulated from management influence either real or perceived and also independent of organizational performance. The Chief Accounting Officer and his/her accounting organization should likewise be independent from management influence either through reporting relationships, hiring, firing, compensation, evaluation or incentives. Instead they should report to the Audit Committee who would be responsible for these activities. Measurements and incentive systems must be developed for both the Audit Committee and the accountants that encourage and reward them for fair, accurate, *objective and impartial* accounting and financial reporting. Only when these basic motivational controls are in place will we have a system that consistently produces fair financial reporting. Until then, we will have periodic financial reporting scandals and numerous errors, restatements and corrections to company financial statements. It should be recognized that companies without appropriate motivational controls have a *material control weakness* in financial reporting.

12. When such controls are established in public and private organizations, surprising things will happen. First, because fair financial reporting will be a naturally occurring activity within our economic system, the cost of effective external auditing, external regulation and external legal proceedings will be significantly reduced. Secondly, the cost of internal accounting will also be reduced and the effectiveness, accuracy and usefulness of this accounting information will significantly increase. Thirdly, we will have achieved a simplified “principles based” rather than “rules based” accounting system, since excessive rulemaking is only necessary when people are motivated to find ways around the rules. Principles based accounting depends upon two things, agreement as to the principles involved (fair and accurate reporting) and the *motivation* to pursue those principles.

13. Finally, my assertion that “good internal controls lead to greater operating efficiency, lower overhead, lower administrative and regulatory costs, and better information for management and financial decision makers” will come to pass in the area of financial reporting. No longer will there be complaints that Sarbanes – Oxley 404 regulations and auditing is too costly. Instead Sarbanes – Oxley internal control requirements will be recognized as a major boon to the free enterprise system, making it more reliable, more trustworthy, more efficient, and more effective in the allocation of capital and in financial and management decision making.

Thank you for your thoughtful consideration of these comments and concepts.

Respectfully submitted,

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Appendix A

Responses to SEC questions regarding the proposed interpretive guidance:

The following are responses to the specific questions raised by the SEC in its proposed interpretive guidance:

- Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process?
Answer: Elements of the proposed guidance are helpful such as top down assessment; decoupling management assessment from auditor assessment, comments on evidentiary matter required, etc.
- Does the proposed guidance allow for management to conduct an efficient and effective evaluation?
Answer: No.
- If not, why not?
Answer: A key element of an effective and efficient control system is not discussed, specifically, motivational controls. See paragraphs 5-10 above.
- Are there particular areas within the proposed interpretive guidance where further clarification is needed?
Answer: Yes.
- If yes, what clarification is necessary?
Answer: Insert guidance regarding the importance of motivational controls. For example, the following might be inserted at the end of the section discussing Entity Level controls:
“Entity level controls that should receive particular attention in the evaluation process are those having to do with the motivation of individuals responsible for financial reporting. These motivation controls include reporting relationships, compensation systems and incentive systems as they apply to these individuals. Fair accounting and financial reporting demands objective and unbiased judgment. Questions such as the following should be evaluated carefully:

- Are Audit Committee members fully independent from management in fact and appearance and independent of company performance in their compensation?
 - Is the Chief Accounting Officer and staff independent from management in reporting relationships and incentive systems? Are they also impartial and objective relative to company performance?"
- Are there aspects of management's annual evaluation process that have not been addressed by the proposed interpretive guidance that commenters believe should be addressed by the Commission?

Answer: Yes.

- If so, what are those areas and what type of guidance would be beneficial?
Answer: Same as the answer to the "clarification" question above. Also see Paragraphs 10-12 above.

- Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted?

Answer: No opinion.

- Will the proposed guidance require unnecessary changes to evaluation processes that companies have already established?

Answer: I do not believe so.

- Considering the PCAOB's proposed new auditing standards, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the Work of Others In an Audit, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance?

Answer: None noted.

- Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?

Answer: Clarification and simplification of three definitions would help:

1. Internal Controls (and Internal Controls for Financial Reporting).

The *essence* of these definitions should be pointed out to the reader, which is that internal controls are simply any "process, action or activity" undertaken to ensure fair financial reporting (ICFR) or, more generally, to ensure efficiency and effectiveness of operations and compliance with laws and regulations. Controls are defined more by their *objectives* than by the "process, action or activity" in question since these are broad, all encompassing terms. Thus any process, action or activity that takes place in an organization that has a purpose

is a control of something. The key is identifying those *few* processes, actions or activities that have *the most impact* on accomplishing the relevant objective(s). In this respect motivational controls and measurement controls usually top the list.

2. **Motivational Controls.** This concept should be defined, explained and illustrated for the reader. Motivational controls are simply processes, actions or activities that effect the motivation of an individual or organization. They include reporting relationships, compensation systems, incentive systems, performance measurement systems, promotions (and related reasons stated and non stated), terminations (and related reasons stated and non stated), job descriptions, long term and short term goals, company bonus and stock option programs, etc.
3. **Material Control Weakness.** This definition is dependent upon the definition of a material error in the financial statements which is nowhere defined in this document. I believe it should be defined here and pointed out to the reader that since a material misstatement is any misstatement or omission that “makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement,” a lack of controls preventing biased accounting judgments of any kind should be considered a material weakness. The reason for this is that biased accounting judgments (no matter how large or small and whether within GAAP or not) are presumably made to influence the judgment of a reasonable person towards the viewpoint of the biased individual(s). Thus motivational controls which insure the independence, impartiality and objectivity of those making accounting judgments and controlling financial reporting are essential to avoiding a material control weakness.

- Will the guidance for disclosures about material weaknesses result in sufficient information to investors?
Answer: No.
- If not, how would you change the guidance?
Answer: See discussion on the clarification of the definition of Material Control Weaknesses above and also paragraphs 10-11.
- Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule.
Answer: Eventually it should be codified as a Commission rule if above comments are addressed due to the fundamental nature and impact of these issues on fair financial reporting.

Appendix B

Responses to PCAOB questions regarding the proposed standard:

The following are responses to the specific questions raised by the PCAOB in its release of the proposed standard:

1. Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?

Answer: Yes, with the exception that the most important controls are not mentioned – motivational controls.

2. Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?

Answer: No, because the most important controls for detecting and preventing fraud are not discussed – motivational controls.

3. Will the top-down approach better focus the auditor's attention on the most important controls?

Answer: Only if the auditor understands the importance of motivational controls and includes these in the analysis.

4. Does the proposed standard adequately articulate the appropriate consideration of company-level controls and their effect on the auditor's work, including adequate description of when the testing of other controls can be reduced or eliminated?

Answer: It is important to consider company level controls but motivational controls should be recognized as the most important company level controls.

5. Does the proposed standard appropriately incorporate risk assessment, including in the description of the relationship between the level of risk and the necessary evidence?

Answer: Yes.

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?

Answer: Yes, but a walkthrough should be understood to be simply the identification and verification of key controls in the process and not necessarily every control. As such a discussion with one employee who is responsible for the operation of that key control may be a sufficient walk through in some cases.

7. Is the proposed definition of "significant" sufficiently descriptive to be applied in practice? Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?

Answer: Yes.

8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or the auditor?

Answer: No. Auditors are not currently recognizing the importance of motivational controls and the material weaknesses inherent in their absence or inappropriate application.

How could the proposed standard on auditing internal control further encourage auditors to appropriately identify material weaknesses when an actual material misstatement has not occurred?

Answer: Since inappropriate motivational controls are at the heart of most material misstatements, a discussion of what they are and how they work to prevent material misstatements should be included in AS2.

9. Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements?

Answer: The proposed definitions will help. However, auditors must learn to identify the root causes of material misstatements and the control mechanisms that remediate these root causes.

10. Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present?

Answer: Yes, however auditors should be required to document why they believe no deficiency exists in these cases. Also an indicator should be added to this list, specifically: "The absence of appropriate motivational controls or the presence of inappropriate motivational controls for the Audit Committee, Chief Accounting Officer, accounting staff and anyone else directly responsible for making accounting judgments, setting accounting policy, making accounting entries or preparing financial statements."

Will this change improve practice by allowing the use of greater judgment?

Answer: Yes, **if** the justification for that judgment is documented, and the motivational control criteria discussed above is added.

Will this change lead to inconsistency in the evaluation of deficiencies?

Answer: Perhaps some but these inconsistency can be corrected through the PCAOB audit review process as long as judgments are documented.

11. Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?

Answer: Yes, refer to all of the discussions above regarding motivational controls, particularly paragraphs 6-12. Once these controls are in place, audit risk, work and testing will be significantly reduced. For that reason a discussion of the importance of effective motivational controls to prevent material misstatements and produce fair and informative financial reporting should be included in AS2.

12. Should the reference to interim financial statements be removed from the definitions of significant deficiency and material weakness?

Answer: No, accurate interim financials are just as important as accurate year end statements. However, it is appropriate that the materiality standard is set at full year reporting levels.

If so, what would be the effect on the scope of the audit?

Answer: No opinion.

13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?

Answer: Yes, some. It is appropriate for auditors to do their own assessment of controls without being required to evaluate management's process, though such an evaluation may be part of the auditor's process if it is likely to lead to less testing and less work for the required level of assurance.

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?

Answer: Yes, I believe so, but see answer to the last question.

15. Will an opinion only on the effectiveness of internal control, and not on management's assessment, more clearly communicate the scope and results of the auditor's work?

Answer: Yes, it will reduce confusion regarding what they are auditing and what they are providing an opinion about.

16. Does the proposed standard appropriately incorporate the value of cumulative knowledge?

Answer: Yes.

17. What are the circumstances in which it would be appropriate for the auditor to rely upon the walkthrough procedures as sufficient evidence of operating effectiveness?

Answer: In lower risk accounts/processes as stated in the proposed rule and in highly automated controls where the computer/system can be relied upon to function the same way every time.

18. Will the proposed standard's approach for determining the scope of testing in a multi-location engagement result in more efficient multi-location audits?

Answer: Yes.

19. Is the proposed standard's single framework for using the work of others appropriate for both an integrated audit and an audit of only financial statements? If different frameworks are necessary, how should the Board minimize the barriers to integration that might result?

Answer: A single framework is appropriate.

20. Does the proposed definition of relevant activities adequately capture the correct scope of activities, including activities that are part of the monitoring component of internal control frameworks?

Answer: Yes.

21. Will requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud, or financial statement misstatements improve audit quality?

Answer: Yes.

22. Is the principal evidence provision that was in AS No. 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

Answer: No.

23. Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing? Will this framework be sufficient to protect against inappropriate use of the work of others? Will it be too restrictive?

Answer: The framework is appropriate and not too restrictive.

24. Has the Board identified the right factors for assessing competence and objectivity? Are there other factors the auditor should consider?

Answer: The right factors have been identified. The same factors should be applied to anyone who has responsibility for accounting or producing financial statements.

25. What will be the practical effect of including, as a factor of objectivity, a company's policies addressing compensation arrangements for individuals performing the testing?

Answer: It is an extremely relevant factor to be considered, but practically speaking it will likely have a limited effect here. Auditor review and supervision of the work performed can have a strong compensating effect for those individuals whose compensation does not encourage objectivity and independence.

26. Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?

Answer: Yes.

27. Is it appropriate for the auditor to use others as direct assistance in performing walkthroughs? Should the proposed standard allow the auditor to more broadly use the work of others in performing walkthroughs?

Answer: Yes, except in those areas where the walkthrough is also the **primary** means of verification and testing that the controls exist.

28. Does the proposed standard on auditing internal control appropriately describe how auditors should scale the audit for the size and complexity of the company?

Answer: Yes.

29. Are there other attributes of smaller, less-complex companies that the auditor should consider when planning or performing the audit?

Answer: These are the major ones.

30. Are there other differences related to internal control at smaller, less complex companies that the Board should include in the discussion of scaling the audit?

Answer: These seem appropriate.

31. Does the discussion of complexity within the section on scalability inappropriately limit the application of the scalability provisions in the proposed standard?

Answer: Not in my opinion.

32. Are the market capitalization and revenue thresholds described in the proposed standard meaningful measures of the size of a company for purposes of planning and performing an audit of internal control?

Answer: It is useful that they are consistent with the SEC categorizations and reporting requirements.

33. Is there other information the auditor should provide the audit committee that would be useful in its pre-approval process for internal control-related services?

Answer: They should describe how the service is NOT in conflict with the requirements of the Act, Board or SEC since it is difficult to conceive of financial related internal control work that doesn't have a potential conflict of interest for auditors.

34. How can the Board structure the effective date so as to best minimize disruption to on-going audits, but make the greater flexibility in the proposed standards available as early as possible? What factors should the Board consider in making this decision?

Answer: No opinion.