



**The Committee of Sponsoring Organizations of
the Treadway Commission**

Request for Proposal to Develop Additional
Application Guidance on Monitoring, Including
Tools and Techniques

October 17, 2006



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the Treadway Commission

REQUEST FOR PROPOSAL

**Development of Additional Application Guidance on Monitoring,
Including Tools and Techniques**

Table of Contents

I.	Project Summary.....	1
A.	Definition of Project.....	1
B.	Brief Background and COSO Discussion of Monitoring	1
C.	Goals and Objectives	3
II.	Proposal Guidelines	4
A.	Schedule of Proposal Activities.....	4
B.	Schedule of Project Activities	5
C.	Notice of Intent to Respond.....	5
D.	Requests for Clarification	5
E.	Proposal Format	6
F.	Submission of Proposal	7
G.	Evaluations	7
H.	Interviews	7
I.	Written Agreement.....	7
III.	Appendix – Special Issues or Items	8

I. Project Summary

A. Definition of Project

The U.S. Sarbanes-Oxley Act of 2002 (SOX) was enacted in response to a series of business failures, beginning with Enron in 2001. Failures in internal control, particularly over financial reporting, were among the specific concerns addressed by SOX. Section 404 of SOX, together with the SEC's related rules, requires public companies to assert to the effectiveness of internal control over financial reporting using a suitable internal control framework as a basis for the attestation. Because the *COSO Internal Control – Integrated Framework (IC Framework)* is the most commonly recognized framework in the U.S., essentially all U.S. public companies are using it as the basis for their assertions.

During the past several years, public companies and particularly smaller public companies have struggled with how to comply with these new legal and regulatory requirements in a cost effective manner. One key factor in making the 404(a) assessment more efficient and effective is the proper understanding of, and implementation of, the monitoring component of the *IC Framework*.

Through discussions with management, internal and external auditors, and regulators, COSO believes that the monitoring element of the *IC Framework* may not be well understood. Further, we believe that companies have not explored the basic linkage of effective monitoring to the evidence needed by management to support its assertion regarding the effectiveness of internal controls over financial reporting as required by 404 (a). Many management accountants, financial executives, internal auditors, and external auditors, have come to believe that the 404(a) assessment needs to be a process in addition to (or layered on top of) the effective implementation of the *IC Framework*. COSO believes that the proper implementation of the *IC Framework* can serve as a basis for management's assertion regarding the effectiveness of internal control over financial reporting.

As a result, COSO has expressed a desire to engage a guidance developer (“developer”) to assist the COSO Board in researching, writing, and preparing COSO guidance that would:

1. Describe the objectives of the monitoring component of the *IC Framework*, the linkage between monitoring and management's assessment of internal controls over financial reporting, the monitoring component of internal control, and how monitoring of the controls differs from other “monitoring” activities that may be conducted by management (e.g. monitoring organizational performance).
2. Provide guidance as to how “ongoing” and “separate” (or point-in-time) monitoring can meet the objectives of SOX 404(a).
3. Provide cost-effective monitoring examples directed to large and small public companies.
4. Include monitoring tools and techniques that will help large and small companies with their evaluation and assessment.

B. Brief Background and COSO Discussion of Monitoring

Chapter 6 of the 1992 *Internal Control – Integrated Framework* states in part:

Monitoring ensures that internal control continues to operate effectively. This process involves assessment by appropriate personnel of the design and operation of controls on a suitably timely basis, and the taking of necessary actions. It applies to all activities within an organization, and sometimes to outside contractors as well.

Evaluating a system of internal control is a process in itself. While approaches or techniques vary, there should be a discipline brought to the process, and certain basics inherent in it.

The evaluator must understand each of the entity activities and each of the components of the internal control system being addressed. It may be useful to focus first on how the system purportedly functions, sometimes referred to as the system design. This may involve discussions with entity personnel and review of existing documentation.

The evaluator must determine how the system actually works. Procedures designed to operate in a particular way may over time be modified to operate differently. Or, they may no longer be performed. Sometimes new controls are established but are not known to persons who described the system and are not included in available documentation. A determination as to the actual functioning of the system can be accomplished by holding discussions with personnel who perform or are affected by controls, by examining records on performance of the controls or a combination of procedures.

The evaluator must analyze the internal control system design and the results of tests performed. The analysis should be conducted against the backdrop of the established criteria, with the ultimate goal of determining whether the system provides reasonable assurance with respect to the stated objectives.

Monitoring the effectiveness of already designed and implemented internal controls is an integral part of the *IC Framework*. A properly designed and structured internal control process should provide feedback through monitoring as to whether the control system is operating effectively to achieve the organization's control objectives.

Section 404(a) states:

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

(a) **RULES REQUIRED.**—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall: (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Because Section 404(a) requires an evaluation and assessment as of a point in time (i.e. the year-end balance sheet date) management needs to better understand how to make use of “ongoing monitoring” controls as well as “separate evaluation-type monitoring” and how this evidence can be brought together in a cost effective manner to support management's assertion regarding the effectiveness of internal control over financial reporting. There appears to be a misconception that some control activities are monitoring controls

when, in fact, they are complementary controls¹. Merely reviewing someone else's work effort is not consistent with COSO's view of monitoring as one of the five components of the *IC Framework*. Monitoring, taken together with those other elements, is designed to provide reasonable assurance that material misstatements (whether caused by error or fraud) are prevented or detected and corrected.

C. Goals and Objectives

COSO has established the following parameters for the goals and objectives of the proposed guidance project:

1. Focus on monitoring of controls over financial reporting and assist COSO in better articulating the monitoring concept and how it is distinguished from other performance monitoring activities. Further, provide examples and tools that will help management more thoroughly understand the monitoring component of the *IC Framework*.
2. Demonstrate how monitoring controls integrates with management's responsibility to perform a 404(a) assessment and help management comply with this provision in a cost-effective manner.
3. Be consistent with the *IC Framework* as outlined in COSO's *Internal Control: Integrated Framework Guidance (1992)* and *Guidance for Smaller Public Companies (2006)*.
4. Be consistent in its application with the SEC's 404(a) guidance, including the pending management assessment guidance (ED expected in late 2006 or early 2007). In addition, consider other guidance, including that of the PCAOB, that likely will be issued by spring of 2007.
5. Provide examples of best practices of both "ongoing" and "point-in-time" monitoring of controls. COSO understands that companies can and will monitor their controls in a number of different ways and that professional judgment should be used in choosing the monitoring controls. While illustrative tools are requested as part of this guidance, those tools should enhance the thinking of management and outside providers, in regard to creative ways to better implement monitoring in their organizations. Therefore, the examples should not be so prescriptive as to create a checklist approach. When applicable, the guidance might illustrate where management's review of key performance indicators could lead to monitoring of controls.

¹ For example, a common situation the COSO Board has observed is in regard to management's development of key performance indicators (KPI's) as a basis to monitor an organization's operational and financial performance. A KPI may indicate a problem with either company performance or a problem with the company's internal controls. The KPI does not monitor the effective operation of controls. Rather, the KPI may signal a need to investigate certain control processes for a deterioration in their operation. The actual investigation of the control operations is an application of the monitoring component of the *IC Framework*. Further, the KPI's cannot, by themselves, constitute monitoring because there could be a deterioration in the operation of controls with no changes in KPI's. The COSO Board is cognizant that a deterioration of internal controls does not necessarily lead to errors in financial reporting; rather it increases the risk that errors could occur and not be detected to a level that is unacceptable.

II. Proposal Guidelines

Any organization submitting a response to this RFP agrees to all proposal guidelines contained herein. All materials submitted shall become the property of COSO. The proposal guidelines are presented below.

The COSO Board is flexible as to the exact format of the final delivered project and the timetable below reflects that flexibility. Traditionally, COSO projects are presented as one deliverable, but with separate volumes for guidance and the tools/techniques. The SEC has informally stated that it plans to develop management guidance in the form of a Final Rule by mid-year 2007, preceded by an exposure draft *this* calendar year. The COSO Board has a strong preference for the project to be completed in two phases:

- **Phase 1: White Paper**

A “whitepaper” that expresses the project team’s preliminary views on monitoring. The whitepaper may better articulate the monitoring component of the *IC Framework* and provide examples that facilitate understanding and potential implementation of monitoring by public companies. We also believe that it would be useful to describe the relationship of monitoring, as one of the five components of the *IC Framework* and distinguish it from other forms of monitoring that might be conducted by management. We anticipate that this “whitepaper” would be due early spring, 2007, for timely review by the COSO Board, the SEC, and others.

- **Phase 2: Full Document.** The final document will include the guidance concepts developed in the whitepaper, along with an identification of tools, examples, and best practices.

Although the above represents the Board’s initial thinking on the outcome of the guidance, we are receptive to other alternatives that may be presented by the project team after considering the issues identified in the appendix to this RFP.

It is anticipated that the full document will be issued only after a “due process” period that includes public exposure and comment. COSO is publicly committed to full transparency in its guidance processes and believes that public exposure is critical to reflect market input and feedback. Schedule A below contains an ambitious but achievable project timetable which we believe properly balances this need for transparency with the need to bring value to regulators and to provide guidance to management and auditors toward more effectively implementing and evaluating internal control over financial reporting.

A. Schedule of Proposal Activities

Information will be received and evaluated according to the following schedule:

Activity	Date
Distribution of Request for Proposal	October 17, 2006
Notice of Intent to Respond is due	November 1, 2006
Deadline to receive written questions	November 6, 2006
Distribution of responses to questions	November 10, 2006
Proposals due	November 21, 2006
Invitation to oral presentations	November 30, 2006
Presentations to COSO Board	December 14, 2006
Selection and Notification to Project Team	December 20, 2006
Project start	January 1, 2007

B. Schedule of Project Activities

Activity	Date²
Planning session with full COSO Board	January 15, 2007
Outline of whitepaper document submitted	February 28, 2007
Approval of outline by COSO Board (Concepts Whitepaper)	March 15, 2007
Draft of deliverables – full document	June 15, 2007
Draft of examples and tools	June 30, 2007
Resolution of comments with COSO Board	July 15, 2007
Approval for public disclosure	July 30, 2007
Public comment period ends	September 30, 2007
Summary of comments to COSO Board	October 15, 2007
Resolution of comments with COSO Board	October 30, 2007
Revised draft to COSO Board	December 1, 2007
Issuance of final document	December 22, 2007

C. Notice of Intent to Respond

Organizations intending to respond to this RFP must e-mail a Notice of Intent to Respond by November 1, 2006 to:

Dr. Larry Rittenberg, COSO Chairman
 University of Wisconsin
 975 University Avenue
 Madison, WI 53706
lrittenberg@bus.wisc.edu
 Ph: 608-262-2267

D. Requests for Clarification

Questions and other requests for clarification concerning this RFP should be e-mailed no later than November 6, 2006, and should also be directed to Dr. Rittenberg. All clarifications to the RFP will be distributed in writing only to those organizations that have received the RFP and submitted a Notice of Intent to Respond. Response to questions will be emailed by November 10, 2006. The source of any inquiry for clarification shall not be disclosed in the broad memo, but specific comments also will be provided upon request to the submitting organization. It is also acceptable to simply call Dr. Rittenberg for any issues a responding organization would like to discuss in more detail. Any information provided after distribution of the RFP is for clarification purposes only, and shall not be considered part of the RFP document.

² See timing issues described in appendix A

E. Proposal Format

The proposal should contain the following basic elements:

1. Name(s) and organizational affiliation of principal researcher(s) including resumes or vitas. Vita should not exceed three (3) pages in length and should include only information relevant to the RFP.
2. Narrative sections covering the following topics:

Project Objectives	Describe your understanding of the project objectives and articulate any concerns you have about achieving the project objectives. Describe any changes you might suggest to the project objectives as articulated above.
Project Deliverables	COSO has described its vision of the project deliverables above. Describe any recommended changes to the project deliverables and the rationale for the changes.
Work Plan	Discuss how you intend to carry out the project. Include specifics on organization, methodology, staffing, resources, scope, and procedures. Also discuss commitment to the project, approach and solution, implementation plan, and expectations and requirements from COSO personnel.
Personnel	Discuss specific expertise, experience, and interest and accomplishments relating to the proposed project. Highlight organizational affiliation of team members if more than one organization is represented on the project team. Identify the amount of time each person will be able to spend on this project ³ and the organization’s commitment to completing the project on a timely basis.
Schedule	List specific tasks and planned completion in terms of months from start date. Note any restrictions on start date or completion after starting.
Budget	COSO is a volunteer committee with limited resources. Typically, the COSO Board has reimbursed developers for out-of-pocket expenses only (e.g., reasonable travel and administrative costs). The business benefit to the developer is that the developer is identified directly with the COSO end-product as part of the globally recognized COSO brand. Additionally, an agreed upon number of copies of the final product will be made available to the developer at no cost. With that said, a project budget is requested by major component (e.g., travel and administrator expenses) and days/weeks to be expended by the developer project team (the equivalent of chargeable hours). The COSO Board needs a definite “yes/no” on the compensation expectations outlined above.
Special Issues or Items	See appendix

A corporate official, owner, partner, or other person who has been authorized to commit the organization and negotiate a contract with COSO must sign the proposal.

³ The COSO Board wants to know explicitly the following:

- Each individual committed to the project,
- The ability of the organization to complete the project in the timetable identified above, and any reservations the organization may have about the ability to achieve the project objectives in the time identified,
- The percentage of time that each person is committed to the project during the time period of the project and how the organization intends to monitor the time availability. **Note:** a statement from the organization’s CEO committing sufficient time and resources to complete the project in the timetable laid out and with the quality anticipated by both COSO and the research team is important.
- An identification of any constraints that the organization may have regarding its ability to complete the project. An example might be an internal constraint of total budget internally developed for the project.

F. Submission of Proposal

The organization's proposal should be e-mailed to Dr. Rittenberg at the address indicated above no later than November 21, 2006. COSO will not consider late submissions.

G. Evaluations

Evaluation of proposals will be performed by the COSO Board using pre-established criteria. To facilitate the evaluation of each individual RFP, at a minimum, the categories and evaluation criteria below will be considered during scoring.

- A demonstrated understanding of the project and its objectives.
- The research approach, including the ability to identify tools and techniques, as well as best practices for both smaller and larger public companies (with special emphasis on smaller companies).
- Expertise on subject matter and dedication of key resources to the project.
- Experience on similar projects.
- Presentation.
- Cost.
- Proposal content.
- Ability to meet project milestones.

COSO reserves the right to reject any and all responses received as a result of this RFP, or to negotiate separately with any source whatsoever in any manner.

H. Interviews

COSO will interview the top candidates. These interviews will be in the form of a formal presentation tentatively scheduled for December 14, 2006, in Washington D.C., but no later than December 15, 2006.

I. Written Agreement

COSO will negotiate a final written agreement for this project. It should also be noted that the final publication will be the property of COSO.

COSO intends to own and copyright the publication. COSO requires the selected organization to obtain copyright releases for any materials that they obtain from copyrighted sources.

The organization's responding proposal and submitted materials, along with the original RFP, and an implementation schedule shall become part of any agreement.

It should be noted that COSO will not pay or reimburse any organization for any costs incurred by the organization prior to the signing of the development agreement.

III. Appendix – Special Issues or Items

The following are items that have been identified as significant or important factors that should be considered in responding to the RFP:

Timing Issues

Many non-accelerated 404 filers are expected to file their first 404(a) internal control report starting with the December, 2007, reporting year. To enhance timeliness, the COSO Board will be receptive to proposals that address the possibility of a conceptually based white paper to be issued in the spring of 2007. The white paper could be used to expose the conceptual thinking regarding monitoring.

The SEC has committed to rule-making to provide management guidance on 404(a). The timing of the project must be attuned to SEC developments. The rule-making process may hinder some of our ability to receive effective feedback on concepts from the SEC.

COSO Board and Task Force

The COSO Board understands the importance of its project and has committed to meeting monthly with the project team. In addition, the COSO Board will appoint a small task force, with one additional member from each of the sponsoring organizations, to include those with experience with monitoring controls, and who have committed to work effectively with the project team to meet the timing objectives of the project. In addition, the COSO Board anticipates asking both the SEC and the PCAOB to appoint an observer to the project as we believe it is important to work with both of these organizations in drafting guidance. The ultimate decision to issue the guidance rests with the COSO Board.

The Board anticipates that the project meetings will be run by the project team leader. COSO will work with the project team to identify appropriate meeting places, including the technology needed to provide updates on the project and to discuss conceptual and methodological issues as they arise.

Other Issues

The COSO Board has discussed a number of conceptual issues that relate to monitoring. However, we feel that we have only scratched the surface of these issues. We expect the project team to identify other conceptual issues as the project is developed. There is no need to include the conceptual issues in the project proposal, but we suggest that the project team engaged be cognizant of both conceptual and practical issues related to the guidance. Examples of issues that might be addressed during the course of the project include:

- Determining how monitoring evidence (ongoing and separate) is to be used in the management assessment and evaluation process so that there is no, or at least, minimal duplication of effort.
- Determining how the effectiveness of monitoring may be documented such that it may provide evidence that can be utilized by outside attestation entities, e.g. the external auditor.
- Determining the nature of monitoring controls that could be applied in the smallest of public companies where there is not sufficient segregation of employees to avoid monitoring one's own work. Does a smaller business need to engage outside service providers to effectively implement monitoring, or more pointedly, how can management achieve effective monitoring without (or with) outside assistance?

- How does management test the design and operating effectiveness of its monitoring controls?
- The Board of a public company plays an important role in governance and control. Particularly in smaller companies, the board may have an active role to mitigate the risk of management override. From a conceptual point of view, can the results of the external integrated audit provided to the board and to management be feedback/evidence as to the effectiveness of monitoring?
- How does a company monitor its controls over the year-end financial statement closing process?
- Under what circumstances, and to what extent, does monitoring entail the testing of controls?
- Are there any independence issues that need to be considered in determining the design effectiveness of monitoring? For example, is control self-assessment sufficient as a monitoring tool? Under what circumstances might it not be sufficient?
- What role do IT general controls play in monitoring; i.e., IT controls over security and access?
- Since the 404 assertion is as of year-end, to what extent must the point-in-time monitoring be concentrated toward the end of the year?