

# **Risk Management Advisory Services, LLC**

*Capital markets audit and control*

November 14, 2003

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, D.C., 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008

I am a CPA with 17 years of audit experience, about half in public accounting and half in internal audit. Most of my audit experience has been in performing control audits of business processes and system controls. I am currently working as an independent CPA providing control consulting services. I have no affiliation with any other CPA firms or with any public companies.

My initial reaction to the proposed standard was very positive because the provisions defined a very thorough audit process, coverage of all assertions for all material accounts every year, relying primarily upon the auditor's own work and, most importantly, requirements to audit the controls of the company rather than simply reviewing management's control assessment process.

However, in considering the end result of the proposed process, I question whether the process will add significant value in terms of protecting investors against misstated financial reports because of the inherent limitations of any control audit. The most serious limitation is that control processes can be compromised by "topside adjustments" or other influence and actions by senior management who manage the control system. In fact, if you consider the major accounting problems of recent years (Enron, WorldCom, Tyco, et.al.), the problems were apparently at the top, not in the rank and file.

Furthermore, the cost of the proposed audit process is likely to be high. The proposed standard calls for the auditor to perform a thorough, exhaustive, company-wide audit of internal control. Such an audit is expensive because the auditor must gain a working understanding of so many activities in an organization to be assured that he or she has identified all risks and obtained sufficient evidence of the operating effectiveness of controls.

Therefore, my concern is that the proposed audit standard, despite its excellent value in defining an effective process for auditing internal controls, has the potential to add extensive process and cost without adding corresponding value to shareholders. I think the proposed standard attempts to do too much too broadly while not paying enough attention to the well known and well recognized problems with accounting errors and fraud.

To propose a redirection of the standard, I suggest that the Board consider two categories of corporate accounting control problems: 1) general inattention to controls throughout a company that results in financial misstatements, and 2) deliberate actions, usually by senior officials, to produce a specific financial reporting effect.

I believe that a properly implemented management control assessment process, as defined by Section 404 and the related SEC rules, will fully address the first category. The auditor attestation process becomes an enforcement mechanism to ensure that companies perform this function adequately. Therefore, the standard should define those auditor procedures that are necessary to provide adequate assurance or "enforcement" that management develop, implement, and maintain an appropriate internal control assessment process.

In an attestation role, the auditor need not review internal controls himself or herself but only needs to verify that management performed a thorough and complete assessment. I believe a rigorous process is appropriate, but the focus should be on evaluating management's annual control assessment. The auditor should reperform some of management tests on a sample basis to obtain sufficient evidence. The auditor should hold management to high standards of documentation for its assessment process, including the risk assessment, identifying all assertions for all material accounts, documenting the control design, planning review procedures and tests, documenting findings, reviewing test results and findings, corrective actions, and final conclusions. This approach puts the primary burden and the cost of assessing internal controls upon management.

For the second category of accounting control problem – deliberate actions to obtain a specific but inappropriate financial reporting effect – a corporate-wide control assessment process will not provide much benefit. To address this problem, the standard should define a process for the auditor to look specifically for evidence of earnings management or other attempts to manipulate the financial statements. For example, the process should include forensic audit techniques and procedures to look at adjusting entries, unusual transactions, decisions regarding accounting treatment, presentation materials and minutes of board and senior management committee meetings, interviews with participants of board and senior management committee meetings, handouts and minutes of meetings to review the accounting close, interviews with persons involved in the accounting close, and similar procedures to provide coverage of areas of possible accounting manipulation.

The process should require the auditor to present his or her findings and conclusions regarding any indication of accounting manipulation to the audit committee. The auditor then should be provided safe harbor if the Board-defined procedures are carried out effectively.

In conclusion, I ask the Board to consider fine tuning its auditing standard to put more focus on known problems (deliberate accounting manipulation) and scale back on the audit requirements that address the broad corporate wide procedures, leaving the main effort for maintaining and assessing corporate wide controls in the hands of management.

I have provided comments on other aspects of the proposed standard in responses to the Board's questions in the attached document.

Sincerely yours,

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I have used the term "attestation review" to designate an auditor process to evaluate management's internal control assessment process and other focused procedures to look for evidence of accounting manipulation.

1. Is it appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting as the audit of internal control over financial reporting?

Response: No. I would suggest "the attestation review of management's annual internal control assessment."

2. Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?

Response: No. I believe that Sarbanes Oxley mandates that if a financial statement audit is being performed, the auditor attestation cannot be a separate engagement. However, if no financial statement audit is being performed, the attestation report should be qualified to reflect that the attestation report is normally completed in conjunction with a financial audit, that the financial statement audit might have identified issues that reflect upon the effectiveness of controls, but that no financial statement was performed.

3. Rather than requiring the auditor to also complete an audit of the financial statements, would an appropriate alternative be to require the auditor to perform work with regard to the financial statements *comparable* to that required to complete the financial statement audit?

Response: No. I believe a qualified opinion is a better alternative. It would be difficult to establish a "comparable" process, especially one which did not require a signed auditor certification.

4. Does the Board's proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at, small and medium-sized issuers?

Response: No. The proposed integrated audit process will require much adaptation for small and medium-sized issuers. An attestation review would be naturally scalable to the size of management's control assessment process. Thus, an attestation review would be fairer to small and mid-sized companies and not hold them liable to the interpretive judgments of their auditors in applying the standard.

5. Should the Board, generally or in this proposed standard, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively? For example, it would be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.

Response: No. I believe existing standards that require auditor competency prior to accepting an engagement and standards to assign competent staff to assignments are sufficient.

6. Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?

Response: No. This would be redundant and expensive and, in my opinion, provide limited value due to inherent limitations of control audits, particularly that controls might be influenced or compromised by senior officials in a company.

7. Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?

Response: I believe it is appropriate for the Board to require criteria and that additional guidance is necessary. The lack of documentation is probably the largest and most costly area of control remediation for compliance with Sarbanes Oxley. However, references to "lack of documentation," "improving control documentation," and similar references can be confusing and may allow misinterpretation of the auditing standard. Furthermore, not all types of documentation involved in maintaining internal controls at public companies are equally important. It would be very helpful to define standard terminology and provide further guidance concerning the various documentation requirements.

For example, "policy statements" provide direction and guidance, assign responsibilities, and state the firm's view on matters. "Operational procedures" describe work to be performed at a level of detail according to needs of the users of the procedure. "Audit trails" can be defined as documentation of work performed, what was done, who did it, when it was done, conclusions, who reviewed and approved it and when. A "control design" document identifies the policies and procedures that, as a whole, constitute the control structure.

I would suggest that audit trails, a control design document, and working papers for management's annual assessment are required documentation and that the auditor should not affirm a management opinion that controls are adequate if such documentation is lacking. However, I believe there is considerable latitude when it comes to documenting policies and, especially, operating procedures. This is particularly true in smaller companies, where owner and senior management involvement in many activities can effectively compensate for the lack of documented policies and operating procedures.

My general concern is that companies might perform expensive documentation exercises that add little value to the management and control of the company simply for the sake of "having documentation."

**Internal Control Statements** – As a separate matter regarding documentation, would it be helpful or practical to require management to define in a single document a summary of its internal control over financial reporting?

Existing attestation standards require management to produce and provide to the auditor a specific document of its statements and assertions. The independent auditor then performs procedures and tests to form an opinion regarding management's statements. I suggest that the internal control audit process would be greatly enhanced by a similar requirement.

A summary statement of internal controls puts the burden upon management to identify its key controls. A summary statement provides a tangible starting point for assessing the design of controls and identifying areas to test operating effectiveness. If the Board pursues the proposed integrated audit approach, a summary statement also would enhance the control opinion by identifying the specific statements and assertions that the auditor evaluated in forming his or her opinion.

A standard format might be organized according to the control environment, risk assessment, control activities, information and communication, and monitoring. Each component could include standard subcomponents, such as a code of conduct, an employee reporting process, a self assessment process, the company's risk assessment process, controls over initiating transactions, review processes, approvals, segregation of duties, data input controls, general computer controls, various reconciliations between internal systems and independent external records, specific monitoring activities, and similar information. Other format standards could tie to major lines of business or to major financial statement categories. If the Board defined a standard format, most companies could provide a summary statement of internal controls in a document comparable in size to their financial statements.

8. Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?

Response: This question illustrates my comment in the previous question about vague references to documentation. I believe the auditor should evaluate the significance of all deficiencies in the context of the specific facts and circumstances at the company. However, it would be helpful for the standard to provide a discussion of the different types of audit documentation and the effect on the overall control structure of the lack of each type of documentation.

9. Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?

Response: Yes. Walkthroughs should be strongly encouraged to be performed by the persons conducting the internal control assessment.

10. Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

Response: No. I think that walkthroughs should be performed by the party that is performing the actual internal control review, which I believe should be management rather than the auditor.

11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

Response: Yes. Management should review and test controls for all relevant assumptions for all significant accounts each year. One might argue for more limited testing if management could determine there have been few or no changes since the prior year. However, there are many things that change (or can change) internally and externally that could cause or allow a significant control deficiency. It would be difficult, if not impossible, to examine and rule out all the possible changes in or around a business function. Therefore, all relevant assumptions should be tested each year.

12. To what extent should the auditor be permitted or required to use the work of management and others?

Response: In an attestation review, the auditor should rely solely upon his or her own work.

13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?

Response: No. These categories and provisions are unnecessary if the auditor performs an attestation review. However, if the process requires categories, I would suggest two categories. Category one would include the work described in paragraphs 104 and 105, including work related to accounts involving significant judgments and estimates. Category two would include work related to controls over routine processing.

14. Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

Response: No. there is not enough recognition of internal audit competencies and value as one of management's primary tools for maintaining internal controls. This would be remedied by

adopting an attestation review approach, at which point management would be able to assign internal audit a wide range of roles in its annual control assessment process.

15. Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (for example, reperform tests of all significant accounts or reperform every test performed by others that the auditor intends to use)?

Response: Yes. Reperformance should be an important part of the attestation review. However, some additional guidance probably would be needed regarding the extent of reperformance and evaluating the results such as found in Example B-3.

16. Is the requirement for the auditor to obtain the principal evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor?

Response: Yes, in that the auditor must rely mostly upon his or her own work in an attestation review.

17. Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

Response: Yes. The definitions regarding likelihood, such as “more than a remote likelihood,” are helpful. The distinction between “material to the financial statements” and “material to an individual account” is helpful. However, the standard doesn’t seem to add much to existing guidance, which includes a great deal of situational judgment, regarding the definition of “material” itself.

18. Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commenters could suggest that would provide further interpretive help?

Response: Yes, the examples are generally helpful. However, the materiality is defined in each example and the examples are constructed so that each situation falls clearly into one category or another. The examples do not address the more challenging task, which is to determine materiality of a particular transaction or balance. At some point, it would be good for the Board to review standards and guidance regarding materiality.

19. Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?

Response: Yes. It is necessary in order to identify those that are significant. This is true whether in an attestation review or the proposed integrated audit.

20. Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?

Response: For the proposed integrated audit, I believe this seems reasonable to help ensure that the auditor and management pay attention to all weaknesses. I don’t think this is necessary if an attestation approach is adopted.

21. Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such?

Response: No, not all are appropriately classified. I agree that the first two bullets (restatements and the auditor finding a material misstatement) are “strong indicators” of material control weakness. However, I would not agree that the other bullets necessarily

correlate with material misstatement of the financial statements. I think some companies actually have strong controls over financial reporting and good financial reports in spite of a weak audit committee, internal audit department, or regulatory compliance department. Fraud by an individual, if immaterial to financial reporting, could be completely unrelated to financial misstatement. Similarly, the amount of time that a deficiency is outstanding is a factor in determining if it is a material weakness, but each situation should be assessed based on the individual facts and circumstances.

If the purpose of including these circumstances (bullets 3 through 7) in this list is to apply maximum visibility on these conditions to influence change, then another way to handle this would be to label these situations as significant matters subject to SEC disclosure requirements. Or, the Board could include provisions for disclosure of these situations in the internal control reports. At best, I would suggest that bullets 3 through 7 are "indicators" rather than "strong indicators."

22. Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

Response: No. The audit committee can be an important part of a company's control process; therefore, it is important to review its effectiveness. However, there is a major potential conflict of interest problem in having the auditor assess the audit committee.

The audit committee approves the hiring of the auditor, the fees paid to the auditor, and any non-audit projects to be performed by the auditor. In other words, the audit committee has a great deal of influence over the livelihood of the auditor. In general, the audit committee will get the benefit of the doubt more than is warranted. In the face of a true problem, this arrangement has the potential to create a significant conflict of interest problem for the auditor.

If audit committee effectiveness is important, the Board should consider some other means of evaluation rather than this arrangement which is might fail in the very situation where it would be most needed. For example, the Board might require companies to obtain an assessment of audit committee effectiveness by a different CPA firm, or perhaps by a law firm. The standard would include provisions to ensure the independence of the firm performing the audit committee assessment, such as restrictions on performing other work at the company.

23. Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?

Response: No. See response to 22.

24. If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the audit engagement?

Response: No, I do not think that withdrawal should be mandated. I believe each situation must be evaluated according to the facts and circumstances of the situation, the impact on controls over financial reporting, and the impact on the auditor's ability to plan and perform the audit. For example, an audit committee's ineffectiveness might not necessarily impede the auditor from obtaining information, performing planned audit procedures, and developing an informed and professional opinion regarding controls over financial reporting at a company. If an audit committee exercises undue influence or allows management to exercise undue influence or obstruct the audit, then the auditor should withdraw.

As an observation, it appears that the Board believes that audit committees have (or will have) much more control and influence over financial reporting than I have seen in practice.

25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?

Response: No. I believe that it would be more informative to investors for the auditor to have the option of either a qualified opinion or an adverse opinion. This is important if the Board is going to strongly encourage the rating of material weakness on matters that (in a specific company at a specific point in time) may not have a direct effect on financial reporting in companies where controls over financial reporting are otherwise adequate.

26. Are there circumstances where a qualified "except for" conclusion would be appropriate?

Response: Yes. I believe there are can be material weaknesses (a weakness with a potential impact that is material to the financial statements) where the potential impact would be limited to a defined area of the financial statements or disclosures. For example, if the effect of a material weakness is limited to a particular disclosure while controls over the income statement, balance sheet and other financial statements are adequate, I think it would be more informative to investors to issue a qualified opinion.

27. Do you agree with the position that when the auditor issues a nonstandard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated?

Response: No. I think the public to be better served if the auditor restricts his or her comments to the adequacy of management's control assessment.

28. Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard?

Response: No. I think the standards are sufficient as stated. However, I support the future study of this issue by the Board, especially to include reviewing actual practice in this area.

29. Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?

Response: Yes. As noted earlier, I believe the assessment of audit committee effectiveness should be performed independently from the internal control audit and the financial statement audit. Otherwise, the lists of prohibited consulting activities found in the SEC Final Rule appear adequate. However, I support the Board's plans to review independence matters in the future.

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?

Response: Yes. I think the responsibilities are appropriate for interim quarters as well as the fourth quarter.

31. Is the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting appropriate?

Response: Yes. I believe these provisions, in that they are substantially similar to existing responsibilities for interim financial reporting, are appropriate.