

# Michael J. Ramos

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To The Public Company Accounting Oversight Board

### **Rulemaking Docket Matter No. 008**

I found your proposed auditing standard on internal control reporting to be extremely thoughtful and thorough and possessing a clarity of thought and expression that is difficult to achieve in such a complex document. The work of the Auditing Standards board, upon which a good portion of your document is based, was equally impressive. But I feel that you have build substantially upon that earlier work in ways that will benefit the auditors, financial statement issuers and others who will be affected by the final standard. In particular, I believe that you have shown a genuine sensitivity and responsiveness to the issues raised by financial statement issuers about the burdens of complying with the internal control reporting requirements of Sarbanes-Oxley Section 404. I have no doubt that many financials statement issuers will continue to raise strong objectives about the cost of compliance, but I think that even these critics will be impressed with your willingness to consider alternate points of view.

Thank you for considering my comments, which I offer in response to the questions you asked in the proposed standard.

#### *Integrated Financial Statement and Internal Control Audit (Questions 1 – 3)*

It is appropriate to refer to the auditor's "attestation" of internal control as an "audit" because the meaning of the term "audit" is more widely understood. To continue to refer to it as an "attestation" would be confusing for the general public. I agree that the auditor should be prohibited from performing an audit of internal control without also performing an audit of the financial statements. Imagine a situation where the internal control audit and financial statement audit were performed by two separate auditors, and the company fails. In trying to determine who should be held accountable, auditor A's defense is "I only audited internal control—I didn't see the financial statements." Auditor B's defense is "I only audited the financial statements." The auditor should be held accountable, and the only way to do that is to require the same auditor to perform both audits.

The suggestion that the internal control auditor could perform work "comparable to that of an audit" seems problematic to me. As a practical matter, what would that work be? Would the general public be able to distinguish between an "audit" and "work comparable to an audit?" It seems that this approach would create more problems than it would solve.

#### *Evaluation of Management's Assessment (Questions 6 – 8)*

It is absolutely appropriate that the scope of the internal control audit should consider both management's process for evaluating internal control and the auditor's own evidence relating to internal control. I have always considered that the audit of internal control is analogous to the

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auditor's consideration of an accounting estimate, in that both require the auditor to come to conclusions about subject matter that is primarily subjective in nature. Because of this subjectivity, the auditor should be required to gather evidence from several different sources. Additionally, by requiring the auditor to consider the evaluate management's process, you reinforce the point that management has the primary responsibility for evaluating the company's internal control.

It also is appropriate for the Board to provide criteria that the auditor should use to evaluate the adequacy of management's process, including the supporting documentation. Without this criteria, there would be too much variation in practice, which would undermine the overall effectiveness of the internal control reporting requirements. Moreover, without concreted guidance on what management should include in its process and documentation, the considerable uncertainty over compliance, which currently exists among issuers and auditors, will only persist and fester.

However, I would like to make a suggestion about the guidance that the Board has provided in paragraph 41. In that paragraph, the standard makes reference to controls "on which other controls are dependent." Does the Board intend that the control environment be included in that description? My interpretation is that the term does include the control environment. I base that interpretation on paragraphs 51, 53, and 54, which make reference to controls that have a "pervasive effect" on internal control and to "company-level controls." If my interpretation is correct and the Board does intend for management's process to include an evaluation of the control environment, then the clarity of that guidance may be improved by either making explicit reference to the control environment in paragraph 41, replacing "controls on which other controls are dependent" with "controls that have a pervasive effect..." or both.

#### *Obtaining an Understanding of Internal Control (Questions 9 – 10)*

The objective to be achieved in performing a walkthrough is important. Before an auditor can perform an effective and efficient test of the operating effectiveness of internal control, he or she should have a good understanding of what *actually is* happening at the company. Reviewing documentation is insufficient because documentation is a representation of what *should be* happening at the company, which in some cases will be different from what actually occurs on a daily basis. Thus, after reviewing the documentation, an intermediate step is required before the testing of operating effectiveness commences.

I believe that walkthroughs are one way, but not the only way of achieving this objective. For example, I have seen examples where a facilitated focus group with company personnel can be a highly effective way to clarify one's understanding of the way in which documented policies and procedures are "operationalized" at the company. Additionally, it seems that walkthroughs may be rather limited in some situations. Paragraph 80 requires the auditor's walkthroughs to encompass more than just controls activities, but I am having difficulty understanding a walkthrough can be used to address many of the control environment components such as integrity and ethical values, philosophy and operating style, etc.

For these reasons, I thought that the document placed too much emphasis on walkthroughs. I believe that the auditor should be required to accomplish the objectives described as bullet points in paragraph 79, but that the way in which the auditor achieves those objectives should be left to judgment, with walkthroughs being an example of a procedure that may be performed.

#### *Testing Operating Effectiveness (Question 11)*

It is appropriate to require the auditor to obtain evidence of the effectiveness of internal control *every year*. Business conditions can change dramatically in a short period of time, and from a

practical standpoint, it would seem much easier to require testing every year rather try to provide guidance on the conditions under which the auditor can rely on previous year's testing.

Regarding this general subject matter, I would like to comment on the guidance provided in paragraph 96 relating to interim tests. In addition to the four bullet points listed, I believe that the relative effectiveness of company-wide controls, especially monitoring, also should be considered when designing tests of controls during the "rollforward" period.

*Using the Work of Management and Others (Question 12 - 16)*

I found your guidance in this area to be excellent. On first reading it, my initial reaction was that it was far too restrictive, in that it did not allow the auditor to rely enough on the work of the company. But upon further reflection, when I really thought through the practical implications of the guidance, I ultimately came to the conclusion that auditors will be able to rely on management's work to a significant degree—though not inappropriate level.

*Evaluating Results (Question 17 – 24)*

The definitions of "significant deficiency" and "material weakness" will provide for increased consistency because the phrase "more than a remote likelihood" is more consistently understood than the phrase it replaced, "relatively low level of risk."

However, I am somewhat concerned about unintended consequences of this change in terminology. All of the practitioners I have spoken with about this matter believe that "remote likelihood" is a lower threshold than "relatively low level of risk." That is, more deficiencies will be considered to be material weaknesses under the new definition than under the previous definition. I am finding people to be resistant to this change.

I am sympathetic to this point of view and agree that the reporting of more material weaknesses—if that is indeed what happens—will be confusing and disruptive in the short term. However, I believe that this confusion can be overcome with communication and education, and in the long run, we all are better served by a definition of material weakness that is capable of relatively consistent interpretation.

Regarding question 20, I disagree with the proposal to require the communication in writing of all internal control deficiencies (not just material weaknesses and significant deficiencies). The costs of complying with this standard are significant enough. I am not convinced that the benefits of including control deficiencies that are not considered significant in a written correspondence outweigh the costs.

In a related matter, I would like to comment on paragraph 126, specifically the guidance provided in the 4<sup>th</sup> and 5<sup>th</sup> bullets. I can understand the Board's rationale for including these matters in the guidance in this paragraph. However, I find the practical implementation of this guidance to be problematic. If the matters indicated in paragraph 126 are to be considered strong indicators of a material weakness, then it seems to me that both the auditor's and management's process for evaluating the effectiveness of internal control should address them. From a practical standpoint, what procedures should the auditor perform to assess the effectiveness of the company's internal audit function? If you require management's and the auditor's process to consider the effectiveness of the company's regulatory compliance function, aren't you, in effect, expanding the evaluation of internal control to include, not just financial reporting, but compliance with laws and regulations? At a minimum, I believe that additional guidance is needed to help auditors and management understand what is required to comply with these two requirements of paragraph 126.

*Auditor Independence (Questions 28 – 29)*

Initially, I was disappointed in the relative paucity of guidance provided on this matter. This subject has been the subject of much discussion and heated debate, and I was hoping that the Board would provide definitive guidance on this topic. I have since reconsidered my opinion and have come to respect the wisdom of your approach. By putting the onus on the audit committee to decide the matter, you in effect, are letting “the marketplace” decide the degree to which the external auditors will become involved in non-audit services relating to internal control. This seems appropriate to me, especially in light of your comments that you may reconsider the matter at a later point in time. The only suggestion I would make is the addition of “documentation” to the second sentence of paragraph 32. I believe that this addition would be consistent with the emphasis that the rest of the proposed standard places on the documentation of a company’s internal control policies and procedures.

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Thank you for the opportunity to participate in this process.

/s/ Michael Ramos, CPA