PCAOB
Public Company Accounting Oversight Board

STAFF GUIDANCE

PRELIMINARY STAFF VIEWS

AN AUDIT OF INTERNAL CONTROL THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS: GUIDANCE FOR AUDITORS OF SMALLER PUBLIC COMPANIES

COMMENT #	COMMENTER	DATE RECEIVED
1	CNB Corporation, James C. Conboy, Jr., President & CEO	October 29, 2007
2	Jim Roberts	October 29, 2007
3	North Carolina State Board of Certified Public Accountant Examiners, Arthur M. Winstead, Jr., President	November 20, 2007
4	Alamo Group, Dennis M. Stevens, Director, Internal Audit	December 14, 2007
5	Financial Executives International, Karen Rasmussen, Chair, Small and Mid-Size Public Company Committee	December 14, 2007
6	Deloitte and Touche LLP	December 14, 2007
7	KPMG LLP	December 17, 2007
8	Frank Gorrell	December 17, 2007
9	ISACA and IT Governance Institute, Everett C. Johnson, Chair, Professional Issues Working Group	December 17, 2007

As of December 18, 2007

10	COSO, Larry E. Rittenberg, Chair	December 17, 2007
11	Texas Society of CPAs, Sandra K. Johnigan, Chair, Professional Standards Committee	December 17, 2007
12	PricewaterhouseCoopers LLP	December 17, 2007
13	New York State Society of CPAs, David A. Lifson, President	December 17, 2007
14	BDO Seidman, LLP	December 17, 2007
15	Center for Audit Quality, Cynthia M. Fornelli, Executive Director	December 17, 2007
16	The Institute of Internal Auditors, David A. Richards, President	December 17, 2007
17	Auditing Standards Committee, American Accounting Association	December 17, 2007
18	Tracy D. Good	December 17, 2007
19	GoldCal LLC, Danny M. Goldberg, President	December 17, 2007
20	CalPERS, Russell Read, Chief Investment Officer	December 17, 2007
21	Tatum LLC, Kathy Schrock, Partner	December 17, 2007
22	Ernst & Young LLP	December 17, 2007
23	Grant Thornton LLP	December 17, 2007

CNB CORPORATION

October 29, 2007

Office of the Secretary
PCAOB
1666 K. Street, N.W.
Washington, DC 20006-2803

Dear Sir or Madam

Re: "Preliminary Staff Views-October 17, 2007"

The purpose of this letter is to submit comment on the above which was published on October 17, 2007 by the Public Company Accounting Oversight Board. I am the CEO of Citizens National Bank of Cheboygan and CNB Corporation, both of Cheboygan, Michigan. The bank is the sole subsidiary of CNB Corporation, a one-bank holding company. CNB Corporation is an SEC registered company with just over 1,000 shareholders, $260,000,000 in assets and 80 employees with six locations in northern Lower Michigan.

While I appreciate the PCAOB's publication of the Guidance it would be very helpful if the PCAOB would recognize and comment upon the fact that the bank subsidiaries of small bank holding companies such as ours are routinely examined by federal regulators and in the case of those holding companies with state bank subsidiaries by federal and state bank regulators. These examinations which typically occur every 12 or 18 months are very through and cover many areas including internal controls and IT as well as management, compliance, capital, asset quality, earnings, liquidity, sensitivity to market risk, and the community reinvestment act.

With regards to questions 1 and 2 posed in the October 17 release I believe to the extent that regulatory exams impact internal control and financial statements of smaller public companies the companies' auditors should be able to place great reliance on them as a third party source. The exams conducted by the state and federal bank regulators are independent, in depth, and carry enforcement powers like no other third party review I am aware of. I believe the PCAOB ought to enter into dialogue with the Office of the Comptroller of the Currency, Federal Reserve, FDIC, and Conference of State Bank Supervisors independently or through the Federal Financial Institutions Examination Council to determine how examinations may be relied upon for purposes of Audit Standard 5.

Frankly in all the discussions and literature regarding section 404 I have heard or read I have not seen or heard mention of reliance on regulatory exams which are unique to depository financial institutions.

Thank you for considering my comments.

Sincerely,

James C. Conboy, Jr.
President & CEO

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From: Jim Roberts [mailto:jimr@twcareers.com]
Sent: Monday, October 29, 2007 9:35 AM
To: Comments
Subject: "Preliminary Staff Views - October 17, 2007"

I intend on having full comments soon, but I would like to point out quickly, that your title is extremely misleading and could lead auditors to wrong conclusion about what they are charged with under AS#5.

AS #5 ***An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*** directs the auditor in methodology of evaluating ICFR.

Your Staff Guidance is titled, ***AN AUDIT OF INTERNAL CONTROL THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS: GUIDANCE FOR AUDITORS OF SMALLER PUBLIC COMPANIES*** You left out "Over financial Reporting". The audit firms I deal with are having enough trouble distinguishing between "internal controls" and ICFR, without being confused by an official pronouncement that is misleading. I implore you to clarify exactly what type internal controls you are addressing.

Jim Roberts
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November 19, 2007

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: Preliminary Staff Views – October 17, 2007

To Whom It May Concern:

The North Carolina State Board of CPA Examiners (the Board) has reviewed the proposed publication, *Preliminary Staff Views – An Audit of Internal Control That Is Integrated With an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies.* The Board believes that the proposed publication will help auditors design and execute audit strategies to be utilized during audits of smaller less complex companies that will achieve the objectives of Auditing Standards No. 5.

The Board offers the following comments:

- Chapter 3, Page 18 (first paragraph under **Assessing the Risk of Management Override and Evaluating Mitigating Actions)**

  The Board recommends adding a sentence to the text that reads as follows:

  "Because of the characteristics of fraud, the auditor's exercise of professional skepticism is of upmost importance when considering the risk of management override in connection with assessing the risk of material misstatement due to fraud."

- Chapter 3 Page 19 (second bullet under **Evaluating Mitigating Controls)**

  The Board recommends that the second bullet read as follows:

  "Active audit oversight by an independent audit committee or board of directors"

- Chapter 5 Page 26 (*Characteristics of Less Complex IT Enviro*nments)

  The Board recommends adding a first bullet that reads as follows:

  "Security and Access. Security administration tends to be centralized and policies and procedures tend to be documented informally."

The Board commends the PCAOB for its work to make audits of public companies more efficient, effective and useful.

Sincerely,

Arthur M. Winstead, Jr., CPA
President

Alamo Group
Always On The Cutting Edge℠

Dennis M. Stevens
Director, Internal Audit
Alamo Group
1627 E. Walnut
Seguin, TX 78155
December 14, 2007

Office of the Secretary
PCAOB
1666 K Street, N.W.,
Washington, DC 20006-2803

Re: Preliminary Staff Views – October 17, 2007

Gentlemen:

The staff views concerning "An Audit Of Internal Control That Is Integrated With An Audit Of Financial Statements" as further defined in AS 5 serve to further clarify the level of assurance investors receive through the audit of internal control. On page 10 of that 52 page document, we note the following observations concerning differences between an audit of internal control and the more familiar audit of financial statements:

> To express an opinion on internal control . . . , the auditor must obtain evidence . . . that internal control has operated effectively for a sufficient period, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. . . . In an audit of financial statements, the auditing standards require the auditor to obtain evidence that the relevant controls operated effectively during the entire period for which the auditor plans to place reliance.

This means if an auditor performs an external 'audit of internal control' and fully satisfies the requirements of AS 5; the auditor does ***not*** have a sufficient basis for relying on the company's controls when validating its financial statements. Without doing control testing that covers the full fiscal year the auditor of financial statements ***cannot*** rely on the more limited testing that may be performed in conjunction with the audit of internal control.

While this clarification is helpful, **we believe it inappropriate for the PCAOB to require external auditors to offer investors a level of assurance that external auditors themselves cannot rely upon, particularly when that level of assurance is obtained at an extraordinarily high cost to all registrants.**

We strongly urge the PCAOB and SEC to work with Congress to pursue ways of more reasonably defining requirements presently imposed on public accounting firms while reinforcing the notion that maintaining, assessing and reporting on internal controls is primarily a *management* responsibility that *management* must satisfy as *management* considers necessary and appropriate to protect and enhance shareholder value.

Respectfully submitted,

Dennis M. Stevens
Director, Internal Audit
Alamo Group
dstevens@alamo-group.com

Small and Mid-size Public Companies Committee

December 14, 2007

J. Gordon Seymour
Office of the Secretary,
Public Company Accounting Oversight Board
1666 K Street, N.W.,
Washington, DC 20006-2803

Submitted via email to: comments@pcaobus.org

RE: Preliminary Staff Views – October 17, 2007"

Dear Mr. Seymour,

Financial Executives International's ("FEI's") Small and Mid-size Public Companies Committee ("FEI SMPCC") appreciates the opportunity to provide its views on the Public Company Accounting Oversight Board's ("PCAOB's") "Preliminary Staff Views - An Audit of Internal control That is Integrated With An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies," (the "Preliminary Staff Views" or "PSV").

FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. FEI SMPCC is a committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations, from the perspective of small public companies. This document represents the views of FEI SMPCC, and not necessarily those of FEI or its members individually

General support for emphasis on how controls at small companies can differ, and examples
In general, we strongly support the PSV's emphasis of five major areas where smaller, less complex companies may achieve the objectives of internal control differently from large, complex companies. These are: use of entity-level controls, risk of management override, implementation of segregation of duties and alternative controls, use of information technology, maintenance of financial reporting competencies (which the PSV helpfully notes may include consideration of third party assistance), and nature and extent of documentation.

These factors properly recognize the importance of 'tone at the top'. We also believe the approach taken in the PSV to provide examples of application of the guidance is helpful.

Concern about overly prescriptive approach to 'precision'
However, we are concerned about the PSV's highly prescriptive approach to defining the term 'precision.' The term 'precision' was first used in AS5 (in the discussion of entity-level controls) and was used once in the SEC's companion interpretive guidance for management (also in a section referencing entity-level controls) but was not used previously in AS2.

Although it is arguable whether the term 'precision' was overly prescriptive in and of itself, and whether it potentially furthers an expectation gap of precision vs. reasonable assurance, the fact that it resides in AS5 and the SEC guidance does not mean the PSV should define the term in a highly granular way that can limit the use of professional judgment. The 'factors' of precision listed on pages 14-15 in Chapter 2 of the PSV run the risk of driving a check-the-box approach.

The fact that the PSV says the list of factors "might" be considered by auditors is not a strong confidence builder that auditors will not revert to adopting the checklist of factors as a de facto requirement.

Additionally, we believe some of the factors, specifically, ‘level of aggregation’ and ‘consistency of performance,’ by trying to translate a qualitative characteristic into a quantitative one, can sometimes provide ‘false negatives’ or reject the validity of certain entity-level controls that are very effective. Indeed, we are concerned the highly prescriptive approach in the PSV of defining factors of precision may lead some auditors to try to quantify the level of precision for various controls by assigning numerical values to them. The effort put into such a bright line approach, we believe, will not be efficient nor effective; it runs the risk of being overly granular in its approach.

For example, the PSV’s discussion of ‘consistency of performance,’ by stating ‘routinely’ performed controls are generally more precise than ‘sporadically’ performed controls, implies ongoing controls or testing are generally more precise than separate controls or testing, and that may not be the case. For smaller companies in particular, the frequency at which a control operates will not necessarily be indicative of its preciseness.

Further, we believe the emphasis on ‘preciseness’ may divert attention away from the need to focus on a top-down, risk based approach.

To address the concern described above, we recommend the PSV delete the discussion of “Assessing the Precision of Entity-Level Controls,” and look for a more top-down, risk-based approach to testing entity level controls.

We have three additional observations with respect to the PSV:

Monitoring
The PCAOB can consider noting that COSO is currently working on a project to develop guidance for management on use of the monitoring component of internal control, and auditors may wish to reference that guidance to help integrate the audit of internal control and make it as efficient and effective as possible.

Information technology
In some situations, less sophisticated systems may not have internal controls built into the software. In those situations, alternative controls may be applied, or there may be implications on the balancing of substantive testing vs. reliance on internal control. Additionally, the discussion assumes companies are relying on certain controls, when they are not.

We agree with chapter 5 of the PSV in its characterization of less complex IT environments in smaller companies, as well as its identification of the IT-related risks affecting financial reporting. We believe, however, that the PSV does not go far enough in encouraging auditors to apply the broader principles outlined in the other chapters in their audit of IT general controls, IT-dependent controls, and automated controls.

Chapter 5 of the PSV should take the opportunity to extend the discussion of entity-level controls to entity-level *IT* controls. Entity-level IT controls, such as IT steering committees, change control boards, and monitoring, may reduce the need for testing of IT general controls. Similarly, in planning its audit of IT controls, auditors should consider the likelihood that controls will be ineffective, the availability of documentation and evidence to ascertain operating effectiveness, and IT competencies within the organization. Auditors should also be encouraged to identify segregation of duties issues in IT early on in the audit process.

Furthermore, it is our concern that the PSV does not sufficiently emphasize the importance of evaluating IT-related risks in the broader context of a smaller company’s overall control objectives. The extent to which a company relies on IT general controls may be reduced by the existence of alternative controls. Transactional processes may be handled by IT systems, but by virtue of the fact that inputs and outputs may be more easily reconciled in less complex environments a company may rely more heavily on financial reconciliations rather than IT general controls in attaining its control objectives.

On a more specific note, the PSV does not sufficiently discourage check-box audits of IT controls. For example, many smaller companies may lack formalized change management programs for applying patches to common off the shelf software. By itself, this might appear to be a deficiency in IT controls, however, the existence of a robust incident response program (to include feedback from application users) and robust back-up procedures may sufficiently mitigate the risks inherent in less formal change management procedures.

Reliance on substantive audit vs. controls

Page 9 of the PSV notes that, "Historically, the approach for financial statement audits of smaller less complex companies has been to focus primarily on testing accounts and disclosures, with little or no testing of controls." The PSV then states "The internal control reporting requirements under Sections 103 and 404 of the Sarbanes-Oxley Act give auditors the opportunity to re-consider their traditional approach to the financial statement audit portion of the integrated audit."

We believe it is important to point out that this "opportunity" may not be cost effective. There are often disproportional costs for small, less complex companies associated with establishing internal control systems that mirror those of larger companies. Therefore we believe the historic approach of relying significantly on substantive audit testing vs. controls will still be a major factor for small companies, and the key will be in properly balancing and integrating the work done to achieve an integrated audit of the financial statements and internal control.

This point can be clarified in the PSV. We recommend bringing forward into the last paragraph of the Scaling section of Chapter 1 the scope limitation discussion of Chapter 8, "Even if the auditor lacks sufficient evidence to express an opinion on internal control, the auditor might still be able to obtain sufficient [substantive] evidence to perform an audit of the financials"

FEI's SMPCC greatly appreciates the PCAOB's efforts to make reporting under Sarbanes-Oxley Section 404 more efficient and cost-effective, and we thank you for considering our views. We would be happy to discuss our comments and recommendations at your convenience. If you have any questions, please feel free to contact me at Karen@rasgroup.net or Serena Dávila, sdavila@financialexecutives.org , Director, Technical Activities, in FEI's Washington DC office, if you have any questions or wish to discuss.

Sincerely,

Karen Rasmussen
Chair, Small and Mid-Size Public Company Committee
Financial Executives International

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December 14, 2007

Public Company Accounting Oversight Board
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Re: **Preliminary Staff Views**
An Audit of Internal Control That Is Integrated With An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies

Dear Sir or Madam:

Deloitte & Touche LLP is pleased to respond to the request for comments from the PCAOB with respect to its Preliminary Staff Views – *An Audit of Internal Control That Is Integrated With An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies* (the "proposed staff guidance" or the "document"). We support all efforts to continuously improve the effectiveness and efficiency of the Section 404 assessment process (including both management's assessment and the integrated audit), and we commend the PCAOB in its efforts to develop the proposed staff guidance. We believe that the combined efforts by the Securities and Exchange Commission (SEC), the PCAOB, as well as other efforts underway by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) will support additional improvements and refinements in the Section 404 process.

Overall, we agree with the concepts discussed in the PCAOB proposed staff guidance, and we support its issuance. We believe auditors, particularly those who have not performed an internal control audit integrated with the financial statement audit, will benefit from this guidance and that this guidance will facilitate the implementation of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements* (AS 5) for non-accelerated filers.

Based on our analysis of the document, we have some general observations and detailed recommendations that we believe would clarify some of the points made in the document. We believe these recommendations will help avoid implementation issues and questions that may arise when applying the concepts explained in the document. Our general comments along with our responses to the questions posed in the release are below, and our detailed recommendations are in the attached Appendix.

General Comments

Under the Board's Rule 3101 *Certain Terms Used in Auditing and Related Professional Practice Standards*, the auditor is required to fulfill specific responsibilities within an audit standard based on use of the word "must" or "should" (i.e., an "unconditional" or a "presumptively mandatory" responsibility, respectively). In order for the auditor to demonstrate that he or she has fulfilled these responsibilities, and to comply with Auditing Standard No. 3, *Audit Documentation* (AS 3), he or she must have appropriate documentation within the working papers demonstrating what procedures were performed relative to each instance of a "must" or "should."

We note that the proposed staff guidance uses terms such as "must, should, might, and may" throughout the document. We understand based on discussions with PCAOB staff that the use of these words represents instances where the guidance is directly repeating guidance from AS 5. We recommend that the Introduction include a notice informing readers of this link to AS 5. We note that footnotes with references are included in some instances, but not all. We also suggest that the PCAOB include footnotes that reference the use of each these words, in all instances, to their source in AS 5. Doing so will avoid any confusion that the document is creating new requirements by the use of these certain terms.

<u>Staff Questions in the Release</u>

Does the guidance in this publication, including the examples, appropriately consider the environment of the smaller, less complex company? If not, what changes are needed?

Yes. We believe the guidance does address the main challenges that will be encountered while performing an integrated audit in a smaller, less complex company.

We also believe that the guidance in the document focuses more on the complexity of the company rather than its size, and that the concepts discussed in the proposed staff guidance may be applicable in other situations, such as in a larger but less complex company. As such, we recommend that the PCAOB add a sentence in the Introduction to inform auditors that the issues addressed in the document could be encountered at companies of all sizes. If such language is not added, auditors may believe that the guidance can not be applied outside of the smaller company environment. We do not think this is the intent of the document.

Are there additional audit strategies or examples that the staff should consider including in this publication? If so, please provide details.

We believe the examples provided are very helpful, and we are supportive of the broad topics they cover. Because these examples will receive a great deal of attention and because auditors will directly apply them in practice, we believe these examples should be as clear as possible. As such, in reading some of the examples we found that certain clarifications and modifications should be made in order to avoid confusion and potentially inappropriate application. Please refer to our detailed comments in the Appendix regarding examples 2-1, 2-2, 3-1, 4-1, 5-1, 6-1, 7-2, 8-1, and the example on page 10. We believe these recommended changes will result in examples which are more useful in practice and more easily applied.

With respect to additional audit strategies the staff may consider, we believe after the initial after some additional experience is gained in applying AS5 in a smaller company environment, it would be useful for the staff to revisit these topics with audit practitioners. The objective of revisiting the document with audit practitioners would be to determine whether additional best practices have developed, particularly in the areas related to information technology, evaluating competencies, and evaluating the risk of management override which are some of the more challenging audit issues in the smaller company environment.

* * * * * *

We would welcome the opportunity to further discuss these issues with the Board and the staff. If you have any questions or would like to discuss these issues, please contact John Fogarty at (203) 761-3227.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: Mark W. Olson, Chairman
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Bill Gradison, Member
Charles D. Niemeier, Member
Tom Ray, Chief Auditor and Director of Professional Standards

Chairman Christopher Cox, Securities and Exchange Commission
Commissioner Paul Atkins
Commissioner Annette Nazareth
Commissioner Kathleen Casey
Conrad Hewitt, Chief Accountant
John White, Director, Division of Corporation Finance
Zoe-Vonna Palmrose, Deputy Chief Accountant for Professional Practice

APPENDIX

Reference	Recommendation
Overall	We noted that in some places the document includes repetitive statements. In order to shorten the document, we believe these statements could be deleted without sacrificing the intended point in the guidance. For example on Page 43, the first sentence in the "Pervasive Deficiencies that Result in Material Weaknesses" section states "The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting." Also, the second bullet on page 44, the two sentences that follow the subtitle seem to be saying the same thing. We recommend that sentences such as these be deleted as they needlessly add to the volume of the guidance.
Chapter 1	**Scaling the Audit for Smaller, Less Complex Companies**
Page 7, Scaling the Audit	We recommend that this section include a discussion about the importance of focusing on certain issues first, such as the implications of pervasive control deficiencies, general computer controls, segregation of duties, and entity-level controls, as the evaluation of these areas may significantly affect the nature, extent and timing of audit procedures. Alternatively, this comment could be included in the Appendix to the document.
Page 10, 3rd paragraph (the sentence that begins "For example …")	We recommend revising this example. First, it seems to be suggesting that the auditor not take a control reliance strategy over a high risk area. We recommend that this paragraph be more neutral in terms of taking a control reliance strategy and mirror the guidance in AS5. In general, we do not believe the document should indicate that auditors should not be following a control reliance strategy in high risk areas. Rather, we believe the contrary, that in high risk areas, it is more important to test internal controls. Further, we think it would be difficult to distinguish controls over billing and collections from controls over revenue. In addition, this example might be misunderstood to imply that in testing revenue the best approach might be to not test controls surrounding revenue recognition. However, we believe auditors should be encouraged to test controls surrounding revenue recognition, as this area is one of the more likely causes of restatements[1] and a frequent source of fraudulent financial reporting.[2]
Page 11	The text in the first paragraph on page 11 is different from that in paragraph B9 of AS 5. The first paragraph on Page 11 states the following: "The results of substantive tests of accounts and disclosures do not provide sufficient evidence for the auditor to conclude on the operating effectiveness of controls. However, the results of substantive tests could affect the auditor's risk assessments associated with the internal controls. Risk assessments, in turn, affect the nature, timing, and extent of procedures performed in evaluating the effectiveness of internal control." Whereas paragraph B9 of AS5 states the following: "To obtain evidence about whether a selected control is effective, the control must be tested directly; the

[1] *The Errors of Their Ways*, Glass Lewis & Co, February 27, 2007.
[2] *Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002*, The Securities and Exchange Commission, January 27, 2003.

	effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control." To avoid confusion, the paragraph on page 11 should be changed to mirror the language in AS5 paragraph B9.
Chapter 2	**Evaluating Entity-Level Controls**
Page 14 1st paragraph (Factors that auditors …)	As drafted, the factors listed on page 14 are to be used in evaluating precision. However, we believe these factors relate more to the broader design of the control, of which precision is just one factor. Accordingly, we recommend that the lead in sentence to the list of bullets be modified to state that "when evaluating an entity-level control, the following factors are considered." And, we also recommend that the bullet regarding the criteria for investigation include a discussion about precision. Additionally, we believe two other factors should be considered in evaluating an entity-level control as follows: 1) who performs the activity and their competence and objectivity and 2) the procedures for investigating and obtaining adequate competent evidence to conclude about the effectiveness of the control. We recommend these be added to the list.
Page 16 Example 2-1	Some aspects of the audit approach in this example should be clarified. For example, the thought process that the CFO's review is a check, not reperformance may not be well understood. We recommend revising the first sentence to state that the CFO's review is not sufficient to be the control that addresses the relevant assertions but it may have some value in terms of reducing the extent of evidence that the auditor (and management) needs to obtain. In other words, the CFO's review is a monitoring activity, but not a control activity in its own right, and thus it would not be sufficient by itself to achieve an assertion.
Page 16 Example 2-2	We recommend revising this example. With respect to the scenario, we recommend more specific information be provided regarding the activities of the CFO (i.e., describe the types of analytical reviews the CFO performed to identify signs of improprieties). For example, when the CFO reviews the weekly payroll summary reports, the scenario could explain that the CFO would be able to detect a material misstatement on the basis of his/her expectation of what payroll expense should be based on their personal knowledge of the number of employees and average salary. With respect to the audit approach, we recommend that more explanation be provided with respect to the type of "other evidence" that the auditor obtains. The idea of obtaining other evidence implies the CFO keeps documentary evidence of his review, which might not be the case. If so, what sorts of other evidence would be sufficient? Also, is this example saying that there needs to be some "other evidence"? Also, with respect to the audit approach, as drafted, it indicates that the CFO's review is an effective control. However, it then goes on to say that the CFO is relying on certain reports and that his review can only be effective if the reports that the CFO is relying on are complete and accurate. As such, the auditor (and management) needs to

	consider the integrity of the reports and the completeness and accuracy of the underlying data; however, doing so will likely scope back in most of the payroll cycle process controls. A better example would be that the CFO is ***not*** relying on the reports, to avoid driving the audit work back in to the detailed process level. Or, alternatively (again to avoid driving the audit work back into the detailed process level) revise the example such that the CFO is only relying on a headcount report and limit the consideration of data integrity to the controls related to the completeness and accuracy of that report. We also note that in the second paragraph under the audit approach (where it states that "the CFO approaches his review with the intention…") implies that the auditor can audit the "intent" of management. We suggest this be modified to indicate that based on the thresholds used in his review that material misstatements would be detected.
Chapter 3	**Assessing the Risk of Management Override and Evaluating Mitigating Actions**
Page 19, Evaluating Mitigating Controls	We recommend revising the words "might implement" prior to the listing of the bullet points as some of the bullets should be present in all cases, while others may be used depending on the circumstances. For instance, integrity and ethical values would be expected and having a whistleblower program in place is required, as indicated in footnote 4 of the document by certain exchange listing standards; whereas increased oversight by the audit committee and monitoring controls over certain journal entries might be in place depending on the facts and circumstances. Additionally, in order to more closely align with the COSO document, we recommend that the 4th bullet "Monitoring of controls over certain journal entries" be removed.
Page 22 Example 3-1	We recommend this example be modified. It would be helpful if this example was tailored to the small company environment; as drafted it seems generic to any size company. For instance, if senior management performs significant control activities themselves (estimates, review of journal entries, etc.) as is common in a smaller company environment, this example could explain how the audit committee monitors those controls. It would also be helpful if this example more clearly explained the auditor's objective. This example seems to suggest the auditor's objective is to evaluate the audit committee's assessment of the risk of management override. We recommend that this language be revised such that the objective of the auditor is to evaluate the mitigating controls which exist to address the risk of management override.
Chapter 4	**Evaluating Segregation of Duties and Alternative Controls**
Page 25, Example 4-1	The scenario seems to contradict itself. At first it says that the person responsible for the components has access to the accounting records, but later it explains that IT access controls prevent that person from entering transactions or modifying account balances. Is this example saying that initially the person had access, and then in response to the risk, IT access controls were implemented to address the access issue? If so, then this example, as currently presented, does not indicate a segregation of duties issue. We recommend the example be revised to describe an apparent segregation of duties issue at the process-level which is then mitigated by a higher-level control.

Chapter 5	**Auditing IT Controls in a Less Complex IT Environment**
Page 29, Example 5-1	We recommend revising this example. We recommend that because the example is focused on "IT-Dependent Controls," the discussion of segregation of duties be removed from the example, as it clouds the main point. We believe the only relevant information in the first paragraph is that senior management performs a number of reviews as detective controls over transaction processing. If that information is maintained, we also recommend that the process around a business process review be better explained including how it is a mitigating control for a lack of adequate segregation of duties at the process level. It would also be helpful, in the first bullet, to describe more definitively the activity of "review procedures" in terms of the entity-level controls chapter; e.g. the purpose and relevance to detecting an error related to one or more assertions. As written, it may leave the impression that this is all the auditor needs to think about and document. Also, in the first sub bullet under the second main bullet, it says tests of controls should include "the data inputs into the report are accurate and complete and that this is accomplished through testing the initiation, processing, and recording of the respective transactions that feed into the report." There should be some emphasis here that the completeness and accuracy of data inputs can be addressed through "high level controls" that are sufficiently precise to achieve multiple control objectives related to the data inputs of the report. Otherwise, the user might interpret the example as reason to continue testing lower level process controls, and thus forgoing many of the efficiency opportunities afforded with AS 5. In addition, we believe the second sub bullet is confusing. We recommend that it be reworded to focus consideration of "whether the report logic and parameters" are designed and executed as intended to pull the desired ranges of input data. Also, the second sub bullet should suggest that the auditor could use a benchmarking strategy if settings have not changed.
Page 30	Within the Security and Access section, the operating system layer has been omitted from the discussion on access restrictions. This should be added and considered in this discussion topic along with applications, databases and networks.
Page 31, 1st paragraph (Tests of controls …)	This paragraph states the following: "Test of controls could include evaluating the general system security settings and password parameters; evaluating the process for adding, deleting, and changing security access; and evaluating the access capabilities of various types of users." It is unclear why one would test all of these areas if there is a lack of segregation of duties in the IT function (per prior setup in the prior paragraph). We recommend clarifying this paragraph.
Chapter 6	**Considering Financial Reporting Competencies and Their Effects on Internal Control**
Page 36	We recommend that the document provide expanded guidance regarding the types of controls that would be expected over the exchange of information and testing of the work performed by the outside accounting professional. In other words, what types of

	controls would be expected over the work of the outside accounting professional *beyond* those expected over the completeness and accuracy of the information provided?
Page 37, Example 6-1	The scenario presents a very clean-cut example in which management has basic knowledge and takes the initial step in preparing the tax provision. We recommend either revising this example or providing an additional example where the facts and circumstances present the more typical scenario in which the preparation of the tax provision is done by the third party. This additional example could demonstrate what management does to take responsibility when they involve a third party expert who is preparing the provision (i.e., discuss, understand, review the work, etc.) and what procedures the auditor may consider in such a situation.
Chapter 7	**Obtaining Sufficient Competent Evidence When the Company has Less Formal Documentation**
Various	We recommend that this chapter include a discussion clarifying the difference between the concepts of "formal" versus "less formal" documentation. For example, is the difference in the form of the documentation (e-mails and memoranda versus manuals)?
Page 40, Other Considerations	We recommend that this section, in order to educate auditors, include a reference to the SEC's rules and interpretive guidance regarding the requirement that entities have documentation that provides reasonable support for management's 404 assessment. For instance, part 3, section "d" of the SEC's Final Rule, *Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports* states the following: "An assessment of the effectiveness of internal control over financial reporting must be supported by evidential matter, including documentation, regarding both the design of internal controls and the testing processes. This evidential matter should provide reasonable support: for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; for the conclusion that the tests were appropriately planned and performed; and that the results of the tests were appropriately considered." Additionally parts A.1.e. and A.2.c. in the Commission's *Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* provides additional guidance regarding management's documentation.
Page 39, last paragraph (Obtaining sufficient evidence …)	It would be helpful if this guidance explained what the auditor is to do if there is no documentary evidence. For instance, in those situations it may be appropriate for the auditor to then seek to corroborate with observation and reperformance alone.
Page 42, Example 7-2	It would be helpful if the set-up of this example clarified that this is not intended to be a direct entity-level control precise enough to achieve an assertion, rather it is an indirect pervasive activity related to preparing the financial statements. If this is not clarified, some may interpret this to mean that the control described is the only control needed. With respect to the approach, as this is an indirect entity- level control, inquiry, observation, and reviewing corroborative information seem appropriate. However, it

<table>
<tr><td></td><td>would be helpful to explain that if this related to a direct entity-level control that achieves an assertion, then the auditor would also likely need to perform additional procedures to test the operating effectiveness through reperformance.</td></tr>
<tr><td>Chapter 8</td><td>Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies</td></tr>
<tr><td>Page 43, last sentence in 2nd paragraph</td><td>We recommend the guidance be clearer in stating that the auditor “would likely not be able to” express an opinion in some of these situations.</td></tr>
<tr><td>Page 44, 4th bullet</td><td>In the context of “the following might impair the effectiveness of other controls over relevant assertions” the following is listed:

“Frequent management override of controls. A control that is frequently overridden is less likely to operate effectively.”

This bullet does not differentiate between appropriate and inappropriate management override. In this context, we believe the potential for inappropriate override is more relevant, rather than frequency.

We suggest that this bullet be changed to read as follows:
“Inappropriate management override of controls. A control that has been inappropriately overridden is not likely to operate effectively.”</td></tr>
<tr><td>Page 44, last paragraph</td><td>Two sentences in the example are inconsistent. These sentences read as follows:

“For example, if a control is likely to be impaired because of another control deficiency, the inquiries and observations during walkthroughs might provide enough evidence to conclude that the design of a control is deficient, and thus could not prevent or detect misstatements. In some cases, limited testing of a control might be necessary to conclude that a control is not operating effectively.”

If the auditor can conclude that the design of a control is deficient during the walkthrough, why would limited testing of a control be necessary?

We recommend that these sentences be replaced with the following clear statements:
o If a control is ineffectively designed, the auditor does not have to test for operating effectiveness.

o If a control is designed properly but the auditor believes it is not operating effectively – less evidence is needed to support a conclusion that a control is not operating effectively.</td></tr>
<tr><td>Page 46</td><td>The lead in for example 8-2 should be moved to be directly above that example and there should be a similar lead in for example 8-1.</td></tr>
<tr><td>Page 46</td><td>Example 8-1 should include a conclusion about the auditor’s report (similar to example 8-2)</td></tr>
<tr><td>Appendix</td><td>The Integrated Audit Process</td></tr>
<tr><td>Page 48; 2nd paragraph</td><td>We recommend that this wording be moved up to be a bold-face introductory paragraph to the entire Appendix. The PCAOB may wish to include additional wording to make it clear that the Appendix is not meant to replace AS 5.</td></tr>
</table>

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December 17, 2007

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

Preliminary Staff Views – October 17, 2007
An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies

Dear Mr. Secretary:

KPMG appreciates this opportunity to comment on the publication, "Preliminary Staff Views - An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies" (the Guidance). We applaud the Board and Staff for the significant effort expended in developing the Guidance.

In order for smaller, less complex companies and their stakeholders to realize benefits associated with public reporting on internal control by management and auditors, it is critical that auditors consider the challenges of a smaller, less complex company environment when planning and performing effective and efficient audits of these entities. We believe that the Guidance will assist auditors of smaller, less complex companies to more effectively and efficiently apply the provisions of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Overall, we believe that the Guidance appropriately addresses the financial reporting challenges of smaller, less complex companies. This letter provides our general comments and observations regarding potential changes to improve the clarity and effectiveness of the Guidance. Other, less significant comments for your consideration are included in the Appendix to this letter.

Use of Certain Defined Terms

The Guidance explains that it was developed to help auditors effectively and efficiently apply the provisions of Auditing Standard No. 5 to audits of smaller, less complex companies. The Guidance also indicates that the discussion of certain types of controls and the examples are intended to provide a context for discussion of audit strategies associated with evaluating the effectiveness of the controls. In accomplishing these objectives, we observe that the Guidance often includes footnote references to paragraphs of Auditing Standard No. 5, and to other standards of the Board, when certain terms defined in the Board's professional standards, such as 'should', are used to describe auditor actions in auditing smaller, less complex companies. We believe that such references add significantly to the usefulness and clarity of the Guidance. These references enable users to better understand which responsibilities, as set forth in the Board's professional standards, are being explained. However, we observe that a number of instances exist where defined terms are used in the Guidance without reference to the relevant standards. We recommend that the Guidance be revised to include references to the Board's professional standards in all instances where use of the defined terms in the Guidance is referencing specific responsibilities established in those standards. Further, we recommend that the Guidance clarify the auditor's responsibility when those defined terms are used without such references.

Evidence from Substantive Audit Procedures

Auditors design control testing strategies in an integrated audit with the objective of obtaining sufficient appropriate evidence to confirm the control risk assessments made for the purpose of the financial statement audit, and to support an opinion on internal control over financial reporting. In comparison to audits for larger, more complex companies, control testing strategies for smaller, less complex companies may contemplate limited or no reliance on internal control for purposes of the financial statement audit. Accordingly, we support the inclusion of discussion and examples in the Guidance that illustrate and explain how, in these situations, auditors may design an effective and efficient integrated audit control testing strategy. However, we believe that the discussion of these situations in the Guidance may lead to confusion and misunderstanding about the evidence necessary to support an opinion on internal control.

For example, Chapter 1 discusses that auditors may choose to not rely on controls to reduce substantive procedures performed in the financial statement audit, and illustrates this concept with an example of how auditors might approach the testing of billing and revenue recognition controls differently. We observe, however, that the third and fourth paragraphs on page 10 appear to address only the auditor's judgments about how to most effectively and efficiently obtain audit evidence regarding a financial statement assertion.

We believe that an example illustrating an auditor's judgments made to design a testing strategy in an *integrated* audit would be more useful; explaining not only the financial statement audit control testing decisions, but also how those decisions may impact the auditor's decisions about the evidence necessary in an audit of internal control. An integrated audit example could more clearly illustrate that, in situations where the auditor decides to not test the operating effectiveness of controls in the financial statement audit (i.e., substantive procedures only), the results of the financial statement audit procedures represent one factor that the auditor considers in determining the evidence necessary for the audit of internal control. Moreover, such an example could demonstrate that the evidence necessary to persuade the auditor that a given control is operating effectively is determined based on the auditor's assessment of the risk associated with the control (i.e., paragraphs 46 - 49 of Auditing Standard No. 5), which includes factors such as the effectiveness of management's monitoring activities, the nature and materiality of errors the controls are designed to prevent or detect, and the inherent risk of the underlying account or disclosure.

We recommend that the Guidance be revised to clarify that, although an account balance can be efficiently and effectively audited through the application of substantive procedures only, the results of which may not identify misstatements, the auditor may necessarily determine that the risk associated with one or more of the controls necessary to address the risk of misstatement for the account is high. In such situations, the auditor would need to plan and perform appropriately responsive tests of operating effectiveness for purposes of the audit of internal control. As presented, we believe that the Guidance may be misunderstood to suggest that the absence of an error detected by performing substantive audit procedures is a predominant factor in determining the amount of evidence necessary for the audit of internal control, or otherwise de-emphasize the importance of the other risk factors relevant in an audit of internal control.

We also believe that the last paragraph of page 51 may be similarly misunderstood. The last sentence of that paragraph states that, "When no misstatements are detected from substantive procedures for an assertion, the auditor should take that into account, along with the factors discussed in paragraphs 46-49 of Auditing Standard No. 5, in considering the risk associated with the controls…" We note that "whether the account has a history of errors" is a factor included in paragraph 47. Accordingly, we do not believe that it is necessary to emphasize the occurrence of misstatements separate from the factors discussed in paragraphs 46-49. Moreover, because the nature, timing and extent of substantive procedures are planned, in part, based on assessments of control risk, emphasizing the results of such procedures in determining the evidence that is necessary about the operating effectiveness of internal control may result in inappropriate auditor judgments arising from circular reasoning.

Further, we observe that Chapter 2 directs the auditor to "take into consideration *contradictory audit evidence* [emphasis added], such as misstatements in the relevant assertion that are identified by the auditor" when assessing the precision of such controls. Management's assertions regarding the precision of an entity-level control should be supported by management with appropriate evidence. While we agree that auditors should consider contradictory audit evidence in evaluating the effectiveness of internal control, its absence does not represent persuasive evidence in support of the precision of an entity-level control. Moreover, because judgments about the precision of entity-level controls often are integral to management's assessment of the effectiveness of its internal control over financial reporting and to the efficiency of an auditor's integrated audit, we recommend that the Guidance be revised to clarify and remind auditors that, in the absence of contradictory audit evidence (e.g., misstatements identified by the auditor), sufficient appropriate other audit evidence is necessary to support management's assertion relative to the precision at which an entity-level control operates.

The Evaluation of Entity-Level Controls

Evidence from Entity-Level Controls

The first section of Chapter 2, *Evaluating Entity-Level Controls*, explains that, through the evaluation of entity-level controls, "the auditor *can* [emphasis added] obtain a substantial amount of evidence about the effectiveness of internal control", as a consequence of senior management in smaller, less complex companies being involved in many day-to-day business activities and performing many important control activities. The discussion appearing in the next section of Chapter 2 states that, "while evaluating entity-level controls, auditors *might* [emphasis added] identify controls that are capable of preventing or detecting misstatements in the financial statements." The use of "can" and "might" in these sentences appears contradictory, and may lead to confusion as to the intended meaning of the first statement. We believe that this discussion would be more useful if the basis for the statements in the first section of Chapter 2 (i.e., the phrase "can obtain") was explained further and more directly linked to the remaining sections in Chapter 2 or other chapters. Such revisions would ensure that the Staff's intent is clearly understood by users of the Guidance.

Precision of Entity-Level Controls

We believe that the discussion of factors the auditor might consider in assessing the precision of entity-level controls appears appropriate for all audits of internal control, and not only those of smaller, less complex companies. Accordingly, we recommend that the Staff consider issuing this portion of the Guidance separately as a Staff Question and Answer, or otherwise clarify in the Guidance that the factors are relevant for all integrated audits. In addition, we have the following general observations regarding the factors the auditor might consider when assessing the precision at which an entity-level control is intended to operate:

- Several of the factors and related discussion in the Guidance appear similar to concepts and guidance in AU sec. 329, *Analytical Procedures*. We believe that additional guidance contained within AU sec. 329 could be integrated into the Guidance to improve the clarity and usefulness of the Guidance. For example:

    - *Level of Aggregation* – We recommend that the following text, derived from paragraph 19 of AU sec. 329, be included as the second sentence for this factor, "Generally, as the risk increases that errors or misstatements could be obscured by offsetting factors, the precision of the entity-level control decreases."

    - *Predictability of Expectations* – We recommend that the discussion regarding predictability of expectations be expanded to include the concepts contained within paragraphs 15 and 16 of AU sec. 329 that relate to the "availability and reliability of data" upon which expectations are developed, including consideration of whether management takes steps to ensure the data was developed from a reliable system with adequate controls, and that, when applicable, the data comes from objective sources.

- We recommend that the discussion of the factor, *Correlation to relevant assertion,* be revised to clarify the relevance of "directly related" versus "indirectly related" when determining the precision at which an entity-level control is designed to operate. Directly related controls (defined in footnote 33 of the SEC's Interpretive Guidance as those designed to have a specific effect on a financial reporting element) may not be designed at a level of precision sufficient to identify material misstatements. Similarly, indirect controls may not be designed at a level of precision sufficient to identify material misstatements. As such, we believe that the Guidance is unclear as to how the distinction between "directly related" and "indirectly related" is useful for purposes of assessing the precision of an entity-level control.

- We recommend that discussion of the factor, *Consistency of Performance*, be expanded to clarify that the frequency with which the entity-level control is designed to operate should be consistent with its objective of either *a)* preventing or detecting on a timely basis misstatements that could be material to either interim or annual financial reporting, or *b)* detecting on a timely basis possible break-downs in lower level controls that could, individually or in combination with other controls, give rise to a material weakness in internal control over financial reporting. Entity-level controls that do not meet these design conditions would not, by definition, be sufficient to reduce or eliminate the need to evaluate lower level controls.

Identifying Entity-Level Controls
We observe that the discussion in the *Identifying Entity-Level Controls* section of Chapter 2 states that, "the process of identifying relevant entity-level controls *could begin with discussions* [emphasis added] between the auditor and appropriate management personnel for the purpose of obtaining a preliminary understanding of each component of internal control over financial reporting." We recommend that this section of the Guidance be revised to reiterate the statements found on page 8, which explains that a practical starting point for identifying controls is to consider the controls management relies on to achieve its financial reporting objectives. Moreover, we recommend that this discussion reference Section II A.1.e of the SEC's Interpretive Guidance, which states that "documentation of the design of controls management has placed in operation to adequately address the financial reporting risks, including the *entity-level and pervasive elements necessary for effective internal control over financial reporting* [emphasis added], is an integral part of the reasonable support management is required to maintain for its assessment." We believe that auditors will find such documentation a useful starting point in planning and performing an integrated audit, including the discussions with management about each component of internal control over financial reporting, and those controls management relies on to achieve its financial reporting objectives.

Guidance for Evaluating Other Entity-Level Controls
We also note that the discussion of factors that the auditor might consider in judging the precision of entity-level controls represents substantially all the guidance (excluding examples) within Chapter 2 that is not drawn directly from Auditing Standard No. 5. We recommend that the Staff consider expanding the guidance in Chapter 2 to discuss auditing considerations related to evaluating the design and operation of other entity-level controls, such as a company's entity-level risk assessment process and monitoring function.

Assessing the Risk of Management Override and Evaluating Mitigating Actions

The second paragraph of Chapter 3, *Assessing the Risk of Management Override and Evaluating Mitigating Actions,* explains that the auditor should consider the risk of management override in connection with assessing the risk of material misstatement due to fraud. The sixth paragraph of Chapter 3 explains that the auditor should evaluate whether management has appropriately addressed the risk of management override. The last paragraph of Chapter 3 explains that, if the auditor identifies indications of management override of controls, then such indications should be taken into account when evaluating the risk of management override and the effectiveness of any mitigating actions. As noted in our first general comment, revising the Guidance to include references to the Board's professional standards from which these statements are drawn would improve overall clarity by providing readers more context as to the source of the requirement (i.e., Auditing Standard No. 5 or AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*). Further, we believe that these statements should clarify that the auditor's assessment of the risk of management override and the adequacy or effectiveness of mitigating actions (i.e., controls) are made within the context of the risk of material misstatement to the financial statements.

We also observe that the *Evaluating Mitigating Controls* section of Chapter 3 provides four examples described as "controls" that a smaller, less complex company "might" implement to address the risk of management override. We recommend that the examples be more closely aligned with the COSO guidance found on pages 5 and 6 of the July 2006 Guidance for Smaller Public Companies which describes "important steps" in an effective system of internal control over financial reporting to mitigate risks of management override. We also recommend that the bullet item related to "monitoring of controls over certain journal entries" be eliminated and the related discussion be presented within the section on evaluating the effectiveness of audit committee oversight.

Lastly, we recommend that the discussion on the evaluation of the effectiveness of audit committee oversight be revised to specifically address the expectation of greater audit committee involvement as a mitigating action to address risk of override arising from senior management's involvement in day-to-day business activities and performance of many important controls in smaller, less complex companies, and the auditor's evaluation thereof. As presented, the discussion is of a general nature that conceivably applies to any audit committee, and does not necessarily address considerations specific to smaller, less complex companies.

* * * * * * *

We share the Board's goal of providing auditor guidance to assist in effectively scaling an audit of internal control, and fully support the Board and the Staff's efforts to help auditors apply the provisions of the Auditing Standard No. 5 to audits of smaller, less complex companies in a more effective and efficient manner. If you have any questions about our comments or other information included in this letter, please do not hesitate to contact Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

cc: PCAOB Board Members

Mr. Mark W. Olson, Chairman
Ms. Kayla L. Gillan
Mr. Daniel L. Goelzer
Mr. Willis D. Gradison
Mr. Charles D. Niemeier

SEC Commissioners

Mr. Christopher Cox, Chairman
Mr. Paul S. Atkins
Ms. Annette L. Nazareth
Ms. Kathleen L. Casey

Mr. Thomas Ray, Chief Auditor and Director of Professional Standards – PCAOB
Mr. Conrad Hewitt, Chief Accountant – SEC
Dr. Zoe-Vonna Palmrose, Deputy Chief Accountant for Professional Practice - SEC

Appendix

Preliminary Staff Views – October 17, 2007 *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies*

The following specific comments are presented for consideration:

1 We recommend that the following statement on page 14 be revised as follows:

- As noted previously, the key consideration in assessing the level of precision is whether the control is designed ~~and operating effectively enough~~ in a manner that would ~~to~~ prevent or detect on a timely basis, misstatements in one or more assertions that could cause the financial statements to be materially misstated and whether such control is operating effectively.

2 We recommend that the following statement on page 15 be revised as follows:

- The degree to which the auditor might be able to reduce testing of controls over relevant assertions in such cases depends on the precision of the entity-level controls and the operating effectiveness of such controls.

3 We recommend that Example 2-2 on page 16 be revised to clarify the actions that the CFO undertakes to "quickly [identify] any sign of improprieties with payroll and their underlying cause." As drafted, the example does not illustrate the nature of the activities comprising the control, or how the auditor considers those activities when evaluating the precision of the entity-level control.

4 We recommend the following statements on page 20 be revised as follows:

- A whistleblower program provides an outlet for employees or others to report behaviors that might have violated company policies and procedures, including management override of controls.
- The audit committee ~~may~~ reviews reports of significant matters and considers the need for corrective action.

5 We recommend that the following statements on page 23 be revised as follows:

- ~~Despite personnel limitations, s~~ Some smaller, less complex companies might ~~still~~ divide incompatible functions by ~~using~~ engaging the services of external parties,~~.~~ while ~~O~~ others ~~smaller, less complex companies~~ might implement ~~alternative~~ compensating controls ~~intended~~ to achieve the ~~same~~ objectives of ~~as~~ segregation of duties ~~for certain processes~~.
- ~~Where walkthroughs are~~ The procedures performed to achieve the objectives of a walkthrough~~, those procedures~~ can help identify matters related to segregation of duties.

6 We recommend that the following statement on page 25 be revised as follows:

- When ~~If~~ the auditor applies a top-down approach, starting at the financial statement level and evaluating entity-level controls, the auditor might identify entity-level controls that address the risk of misstatement for one or more relevant assertions.

7 We recommend that the characteristics of less complex IT environments appearing on page 26 be revised to include fewer IT personnel, less ability to segregate duties, and less job processing.

8 We recommend that the following statement on page 28 be revised as follows:

- The IT-related risks that are reasonably possible to result in material misstatement of the financial statements depend on the nature of the IT environment ~~and other facts and circumstances~~.

Alternatively, we recommend that the Staff either expand the discussion to address the other relevant facts and circumstances or provide an appropriate reference to relevant paragraphs of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.

9 We recommend that the second paragraph on page 29 include a statement reminding auditors that IT general control deficiencies should be evaluated for severity, including consideration of the "prudent-official test," to determine whether they represent a significant deficiency or material weakness in internal control over financial reporting.

10 We recommend that the following statement appearing in the Scenario of Example 5-1 on page 29 be revised as follows:

- Since the company uses packaged software, and there have been changes to the system or processes in the past year, the ~~relevant~~ IT general controls relevant to the audit of the effectiveness of internal control over financial reporting are limited to certain access controls and certain computer operation controls related to identification and correction of processing errors.

11 We recommend that the last sentence beginning on page 30, which states that "controls for mitigating the risk caused by a lack of segregation of duties over operating systems, data and applications tend to be detective controls rather than preventive" be supplemented to provide examples of detective controls that companies might implement to mitigate segregation of duties risks in IT.

12 We recommend that the following statement on page 34 be revised as follows:

- For recurring clients, the auditor's experience in prior audit engagements ~~can be~~ ordinarily is a source of information regarding management's financial reporting competencies.

13 We recommend that the following sentence in footnote 2 on page 35 be revised as follows:

- It also does not apply to management's use of specialists in subject matters ~~outside of~~ that indirectly affect accounting and financial reporting, such as actuaries, engineers, environmental consultants, and geologists.

14 We recommend that the following statement on page 39 be revised as follows:

- ~~Where walkthroughs are performed, auditors could use those~~ In performing procedures to meet the objectives of a walkthrough, auditors may use the information about processes and controls found in other documentation to assist in obtaining an understanding of the flow of transactions affecting relevant assertions and to assessing the design effectiveness of certain controls.

15 The discussion on page 39 of documentation of the operating effectiveness of controls states that "evidence of a control's operation might exist only for a limited period." We believe that this discussion should be revised to clarify that management must maintain evidence that provides reasonable support for its assessment of the effectiveness of internal control over financial reporting. In this regard, we also suggest that the following statement on page 39 be revised as follows:

- Also, documentation created by the operation ~~evidence~~ of a controls~~' operation~~ might exist only for a limited period of time.

16 We believe that Example 7-2 on page 42 may help auditors understand how to evaluate the operating effectiveness of a control (e.g. a direct entity-level control) when its operation does not create a traditional 'audit trail.' However, in practice, even in the case of smaller, less complex companies, the precision of a CFO review of the financial statements is often not designed to operate at a level that is adequate to prevent or detect misstatements. As such, we recommend revising the example to explicitly state that the auditor is undertaking the tests of operating effectiveness after concluding that sufficient appropriate evidence exists to support management's assertion that the design of the CFO review control is such that it would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions, or otherwise clarify the reason why the auditor is testing the operating effectiveness of the CFO review control. These revisions would serve to avoid misunderstanding and improve the usefulness of the example.

17 We recommend that the following statement on page 43 be revised as follows:

- Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain ~~competent~~ sufficient appropriate audit evidence ~~that is sufficient to obtain~~ that provides reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment.

18 We recommend that the following statement in footnote 1 on page 43 be revised as follows:

- To enable the auditor to express an unqualified opinion on internal control, the company would need to remediate all of its material weaknesses early enough before year end to enable the auditor to obtain sufficient appropriate audit evidence about the remediated controls to support an unqualified opinion on internal control over financial reporting.

19 We recommend that the following statements on page 45 be revised as follows:

- The auditor ~~may~~ should take into account the effect of the pervasive control deficiencies on the selected controls in assessing risk associated with the controls and determining the amount of evidence of their operating effectiveness that is necessary to persuade the auditor. ~~needed~~.

- Pervasive deficiencies in a company's internal control do not necessarily prevent an auditor from obtaining sufficient appropriate audit evidence to express an opinion on internal control. The auditor's evaluation of the impact of these deficiencies requires consideration of the nature of the deficiencies and their implications on the audit evidence that could be obtained. If the auditor concludes that sufficient appropriate audit evidence is available to express an opinion, the auditor should perform tests of controls and other required audit procedures ~~evaluate~~ after considering the effect of the identified control deficiencies.
- The auditor should, however, take into account the control deficiencies and issues encountered in the audit of internal control in assessing risk and in determining the nature, timing, and extent of tests of accounts and disclosures in the audit of the financial statements.

20 We recommend that the following sentence included in Example 8-2 on page 47 be revised as follows:

- The auditor's report on internal control contains a disclaimer of opinion and disclosure of the substantive reasons for the disclaimer and the material weaknesses of which she is aware ~~that she~~ ~~identified~~.

December 17, 2007

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

Re: PCAOB Preliminary Staff Views
An Audit of Internal Control That Is Integrated With an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies
October 17, 2007

Dear Board Staff Members,

I am submitting my comments to you regarding the above referenced Preliminary Staff View. These are my personal comments and do not necessarily reflect those of my employer. You specifically asked respondents to answer two questions and provide any general comments.

1. **Does the guidance in this publication, including the examples, appropriately consider the environment of the smaller, less complex company? If not, what changes are needed?** And,

2. **Are there additional audit strategies or examples that the staff should consider including in this publication? If so, please provide details.**

Here is my response to your requests.

The Staff lists internal control-related matters starting on page seven that may affect an integrated audit of financial statements and internal controls over financial reporting (ICFR) for smaller, less complex companies. The sixth bullet point states–

> *Nature and extent of documentation.* A smaller, less complex company typically needs less formal documentation to run the business, including maintaining effective internal control. The auditor may take that into account when selecting controls to test and planning tests of controls. ...

Every company has a right to pursue issuance of equity shares and/or debt instruments to the public. However, with issuance comes a higher level of financial reporting responsibility. Would a prudent investor buy shares or bonds from a company that cannot document that management override is not prevalent? Would this prudent investor merely accept that this company, which has grown to the point of an initial public offering, cannot add sufficient staff to ensure some level of segregation of duties (SOD)? When I worked for an insurance company, we were faced with an SOD problem. There were only five in the accounting department. Our solution was to have one person handle all cash receipts and one person all cash disbursements. I was in a position to review, along with two other senior people.

These smaller companies do need to develop a plan for growth, and the auditor ought to be aware of how the issuer will address growth. In fact, I draw the Staff's attention to the fifth bullet of the above referenced list. It is written that these smaller companies are challenged to maintain financial reporting competency. Smaller companies can hire qualified personnel–including certified public accountants (CPA), who must continue their education if they desire to keep their license. (I do know that there are some instances where a CPA need not reach a certain level of continuing professional education where the CPA is *not* practicing in the public domain. For example, see New York State's Article 149 § 7409 at http://www.op.nysed.gov/article149.htm.) Might one say that management needs sufficient competence either to assess the design and effectiveness of their company's ICFR or the work of specialists? Ultimately, each issuing company must have sufficient controls over their financial statement assertions regardless of size.

The Staff may want to advise smaller companies and their auditors that some level of documentation must exist. Process narratives or flow charts may be the only formal procedure documentation. Controls that are not documented do not exist. Example 2-1 seems almost contradictory. The chief financial officer (CFO) "periodically reviews the bank reconciliations," and it is suggested that this is *not* a reperformance. Then we read that the auditor may deem the review effective enough to reduce direct testing. Perhaps each of the reconciliations ought to be reviewed—and some re-performed—every month. This also begs the question of how the CFO documents this review. Without any evidence of reperformance, this cursory review may be pointless. The Staff may wish to revisit Example 2-1.

Example 2-2 raises the risk of key personnel being lost for any reason. The CFO seems to have a great deal of information that is not written down. This could be crucial for a small company. The risks include the CFO becomes disabled, dies, or leaves the company for another. In fact, it is also possible that if the CFO leaves for a new company, the CFO may take others from the original company. The Staff may want to advise auditors to consider this entity-level control, that is the CFO's knowledge, but to consider how the loss of this control affects the small company.

Chapter 3 seems quite thorough. I suggest adding some discussion, even an example scenario, where management desires to be present with all auditor conversations with employees. This may indicate that there are instances of override—or worse—that senior management wants to conceal. Management's insistence on attending these meetings may signal employees to be less forthright.

Segregation of duties is discussed in Chapter 4. I can certainly understand a small, private company having a single bookkeeper and a supervisor to handle all accounting. It is hard to imagine that a company capable of going public cannot hire two or more people for an accounting department. As I wrote above, offering debt or equity to the public comes with minimum responsibilities. The auditor ought to look for how the smaller company meets these responsibilities.

I will reiterate this same "responsibilities" argument in relation to Chapter 6. A company that is issuing on a United States' exchange must have competent persons in key roles. This includes a licensed CPA as chief financial officer, and I suggest having CPAs in other financial reporting roles. I would say that having a CPA who maintains his or her license is critical. This demonstrates a desire to stay current with generally accepted accounting principles (GAAP) and a commitment to professionalism. Having a license on the line may prevent bad decisions. The Staff may be familiar with the advice, "How would this look on the front page of *The Washington Post*?" This concerns the level of ethics in the organization.

In addition to GAAP, there is a movement towards International Financial Reporting Standards. Therefore, competent individuals are needed at all companies who are registered on US exchanges. This may be an area, along with some internal audit functions, may be a place for outside help, as the Staff suggests.

Example 7-2 discusses a CFO's review of financial statements prepared by a controller. For a small, less complex company, having these roles filled by separate persons is fantastic. I would not want to be the auditor tasked with getting a retrieved version of the e-mail, and the auditor may suggest that true copies be kept. Beyond this, however, the Staff may wish to add another example. Consider the auditing difficulty where the CFO and controller is one and the same person. This scenario would create less than optimal documentation.

I believe that Chapter 8 leads to more questions than answers. The Staff writes of what an auditor faces when the client has pervasive deficiencies in ICFR. If the presumption is that the auditor discovers controls are ineffective, is the Staff leading auditors to seek controls to test that appear to work well? On the top of page 45—

> Some companies might have pervasive control deficiencies and still have effective controls over some relevant assertions. For the selected controls that are likely to be effective, the auditor should test those controls to obtain the evidence necessary to support a conclusion about their operating effectiveness. The auditor may take into account the effect of the pervasive control deficiencies on the selected controls in assessing risk and determining the amount of evidence needed. [Reference deleted.]

I wholeheartedly believe that auditors must approach smaller companies differently from larger companies. I also believe that the prudent investor wants comparability. If a large, accelerated filer has "pervasive deficiencies" one expects an adverse opinion. Would the auditor start looking for controls that work well? The report on ICFR is not expected to read, "...overall ICFR is not effective, but there are a few controls covering some financial statement assertions that are effective."

Fortunately, I do believe that there is hope for the small company that needs to tighten its ICFR. While an adverse opinion is in order for ICFR, the auditor may find that there are no material misstatements in the financial statements. The auditor may be guided by the Staff to turn her or his attention to the financial statements and more detailed testing. In this case, the smoke is not being caused by a fire, but merely an ICFR blowback. (This is borrowed from a frequent occurrence when heating units are not cleaned each year, causing dust and debris to burn in the heating unit and force smoke into the room. Proper maintenance, *a lá* ICFR, prevents this.) If an auditor finds that the financial statements are fairly presented, the small company may gain a reprieve in the market.

It is important that we have guidance for auditors for large and small companies. Investors ought to know that smaller issuers will not be held to a lesser standard than their larger counterparts. Internal controls over financial reporting ought to be effective in design and operation. There are many routes to this destination. However, short-cuts ought to be avoided.

Thank you for your efforts and attention to this matter.

Respectfully submitted,
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17 December 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Via e-mail to comments@pcaobus.org

RE: Preliminary Staff Views—An Audit of Internal Control That Is Integrated With An Audit of Financial Statements—Guidance for Auditors of Smaller Public Companies—October 17, 2007

Dear PCAOB Board Members:

We very much appreciate the opportunity to provide comments and recommendations to the Public Company Accounting Oversight Board (PCAOB) for the proposed Guidance for Auditors of Smaller Public Companies.

These comments and recommendations are offered on behalf of both ISACA and the IT Governance Institute (ITGI), international, independent thought leaders on IT governance, control, security and assurance. A brief description of the organizations is provided at the end of this letter.

General Comments

ISACA is responding to the PCAOB questions principally from an information technology (IT) perspective.

We believe the proposed guidance will be useful to auditors of smaller public companies and congratulate the PCAOB on its accomplishments. In addition, portions of this proposed guidance may be applicable to audits of larger public companies that are not particularly complex.

Responses to PCAOB Questions

Based on our review of the proposed PCAOB guidance, our responses to questions 1 and 2 are as follows:

1. *Does the guidance in this publication, including the examples, appropriately consider the environment of the smaller, less complex company? If not, what changes are needed?*

Our response includes several suggestions that would add clarity to the document's objectives. (*Italicized words indicate modifications.)*

A. The section "Scaling the Audit of Internal Control," starting on page 6, should include an additional attribute along the lines of "relatively simple organizational structure with operations in only one country." Smaller companies may have operations in several countries, often with a corporate structure in each country in which they operate. This structure could introduce additional complexities due to adhering to different laws and regulations, managing within varying cultural aspects, operating with multiple IT systems including more extensive network configurations, etc. We suggest that companies having this additional attribute be excluded from consideration in this document.

B. This comment is directed to chapter 5, "Auditing Information Technology Controls in a Less Complex IT Environment," specifically to page 26, second bullet point "Software." Suggesting a company that uses off-the-shelf software "without modification" is a characteristic of a smaller, less complex company over-simplifies the issue. The wording may suggest an unintentional over-reliance on the implementation of off-the-shelf software as a basis for supporting the auditor's conclusion to reduce risk assessment conclusions and thus reduce review effort in this area.

   A proposed enhancement to this section is: Software: The company typically uses off-the-shelf packaged software without *programming and data flow modifications. While this reduces the risks associated with program development and changes, the auditor should recognize that system, table, processing, and control configuration settings need to be determined upon implementation and are subject to the risks and categories of IT controls discussed within this section.*

C. The section "End User Computing Controls" in chapter 5, page 32, should be modified to strengthen the impact these types of applications have in the smaller, less complex company.

   Currently the text (first paragraph of the section) reads: "End-user computing refers to a variety of user-based computer applications, including spreadsheets, databases, ad-hoc queries, stand-alone desktop applications and other user-based applications. These applications might be used as the basis for making journal entries or preparing other financial statement information. End-user computing is especially prevalent in smaller, less complex companies."

   A proposed enhancement is: End-user computing refers to a variety of user-based computer applications, including spreadsheets, databases, ad-hoc queries, stand-alone desktop applications and other user-based applications. *End-user computing is especially prevalent in smaller, less complex companies. The risk associated within this area is that these applications may be used as the basis for making manual journal entries or preparing other financial statement information. In smaller companies, data for such applications is frequently downloaded from other applications or manually entered or re-entered and these applications may be subject to informal or no controls. The auditor should clearly identify all end-user applications and categorize the applications by* *dollar-level effect/impact, owner, process input/source requirements (for control totals) and document significant logic criteria as to the creation and manipulation of data to obtain a result.*

2. *Are there additional audit strategies or examples that the staff should consider including in this publication? If so, please provide details.*

   A. We suggest adding an example about prepackaged software to dispel the common misperception of the software package mitigating any other risks than application development risk or expanding the example in 5.1 to include this. This example might cover a software package that handles billing and accounts receivable, accounts payable and disbursements, general ledger, fixed assets, etc., with risk and control considerations for the auditor to consider. These considerations might include the set-up of the chart of accounts, input editing parameters, pricing tables, customer terms, approval levels, and criteria for exception reports, access control profiles (which govern who can do what).

   B. We also suggest adding on page 33 an example illustrating adequate controls over a spreadsheet that directly affects entries to the general ledger, such as an analysis warranty claims.

   C. ISACA would be pleased to assist the PCAOB in developing these examples.

Other Comments

We have included additional, more detailed, comments and suggestions in the attachment, which we believe will help clarify the guidance.

* * * * *

With more than 65,000 members in more than 140 countries, ISACA (*www.isaca.org)* is a recognized worldwide leader in IT governance, control, security and assurance. Founded in 1969, ISACA sponsors international conferences, publishes the *Information Systems Control Journal*, and develops international information systems auditing and control standards. It also administers the globally respected Certified Information Systems Auditor (CISA) designation, earned by more than 50,000 professionals since inception; the Certified Information Security Manager (CISM) designation, earned by 7,000 professionals since it was established in 2002; and the new Certified in the Governance of Enterprise IT (CGEIT) designation.

The IT Governance Institute (ITGI) was established by ISACA in 1998 to advance international thinking and standards in directing and controlling an enterprise's information technology. ITGI developed *Control Objectives for Information and related Technology* (COBIT®), now in its fourth edition, and offers original research and case studies to assist enterprise leaders and boards of directors in their IT governance responsibilities.

Thank you for this opportunity to relay our comments regarding the PCAOB Guidance**.** Because ISACA and ITGI represent many of the individuals engaged in Sarbanes-Oxley compliance efforts and much of the guidance informing those efforts, we believe we are uniquely positioned to bring value to any future projects to address our recommendations. Please feel free to call on us if we can be of assistance to the PCAOB in any way including task forces, committees, work groups or just for reference purposes.

Respectfully submitted,

Everett C. Johnson, CPA
Chair, Professional Issues Working Group
Past International President, 2005-2007
ISACA (*www.isaca.org*)
IT Governance Institute (*www.itgi.org*)

Attachment–Additional Comments and Suggestions

Page 9: Clarify the statement, "If none of the controls that are designed ..., the auditor can take that into account in determining the test of that control." As written, it seems to imply that none of the controls designed to address a risk are effective, but they still need to be tested.

Page 11: Implies that the auditor is performing substantive tests before performing the risk assessment and determining the nature, timing and extent of evaluating controls. We suggest clarifying.

Page 13: In the paragraph immediately after "Evaluation of Entity-Level Controls and Testing of Other Controls," the last line discusses evaluating the company's control environment and period-end financial reporting process. We believe this is a good spot to note "including IT."

Page 16: At the end of example 2.1, this statement is made: "she could reduce the direct testing of the reconciliation controls, absent other indications of risk." It would be helpful if a bit more specificity could be added around "reduce." In other words, the text would benefit from further clarification, maybe with an example, how direct testing might be reduced.

Page 25: In the "End-user computing" bullet, the definition says "which are used to process, accumulate, summarize, and report the results of business operations..." We suggest, from a consistency perspective, using "initiate, authorize, record, process and report."

Page 28: Two paragraphs above "IT-Dependent Controls," the last line says "controls over backups of data necessary for financial statement preparation." It is difficult to support a statement that if you do not have backups, you would not have the data necessary for preparing financial statements. We appreciate that backups are critical in the event that a data file is corrupted or destroyed, but absent that happening, the lack of controls over backup of data would not appear to result in a situation where financial statements could not be prepared or their reliability would be affected.

Pages 28 and 32: The PCAOB defines IT-Dependent Controls and Other Automated Controls on page 28 and then defines Application Controls on page 32 as "automated or IT-dependent controls." The discussion on these two pages is very similar and could be consolidated.

Page 29: In example 5-1 in the paragraph above Audit Approach, the term "correction of processing errors" is used. That could be interpreted as processing errors from a financial calculation perspective. Is it to reference errors from jobs being processed in the wrong sequence (based upon lack of controls over operations), or is it intended to identify application processing errors? We suggest this be clarified.

Page 30: Inside the box, and in the first bullet under the main bullet, the sentence reads "the data inputs into the report are accurate and complete." We suggest it be changed to read "the data included on the report is accurate and complete." Normally one would not think of inputting data into a report. If it is changed as we suggest, there may need to be a test over the application that generates the report in addition to considering the transaction inputs.

Page 30: The second bullet point says “This might be accomplished through testing controls over the initiation, processing and recording...” We suggest adding “authorization” to the list.

Page 31: Under “Computer Operations,” the last two lines of the first paragraph read “continuity of financial reporting data is maintained through effective data backup and recovery procedures.” We believe this overemphasizes the contribution (if any) of such procedures to reliable financial reporting. As we noted previously, such procedures generally are relevant only if there has been an incident requiring the recovery of data from backup files.

In the next paragraph, the last line reads “backup procedures tend to be manual.” We suggest this be clarified to indicate that backup procedures/programs are initiated manually vs. automatically.

Page 32: In the first line, we suggest rewording “process for testing new applications and updates” to “process for user testing of new applications and updates.” In the first paragraph under Application Controls, we suggest adding “manual” at the end of the first paragraph, i.e., “example of an IT-dependent manual control.”

In the first paragraph in the “Application Controls” section, the automated control description is built out and then there is one sentence for the IT-dependent manual control example. We believe IT-dependent controls warrant more verbiage. At the very least we suggest the sentence that currently reads “Management’s review and reconciliation of the exception report” be changed to “Management’s review and reconciliation of an exception report” as there is nothing to which “the” references back.

Page 49: The top of the page does not appear to read well. We suggest revising the second line “material misstatement **of** the financial statements” to “material misstatement in the financial statements.” We also suggest clarifying the meaning of the end of that sentence: “thus could inform the auditor’s risk assessments during the audit.” Specifically what is meant by the use of the word “inform”?

COSO

The Committee of Sponsoring Organizations of the Treadway Commission

COSO Chairman

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December 15, 2007

Public Company Auditing Oversight Board
166 K Street, NW
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Re: Preliminary Staff Views – October 17, 2007

We applaud the PCAOB in bring forth the guidance to assist auditors in audits of smaller public companies. We appreciate the references to the COSO guidance developed in 2006 which is a principles-based approach to implementing internal control over financial reporting in smaller public companies.

The preliminary views, as they relate to internal control over financial reporting are consistent with the COSO recommendations for good internal control. However, we noted one area that we would like to bring to your attention. That area deals with audit committees and boards of directors. During the development of the COSO *Internal Control over Financial Reporting – Guidance for Smaller Public Companies* (referred to hereinafter as COSO 2006 Guidance), we had extensive discussion of the nature of boards in smaller public companies and the occasional difficulty some companies might have in developing fully functional audit committees (because of size, expertise, resources, and so forth). Thus, we recognized, as your guidance does, that there may be occasions that the full board will fulfill the role that is traditionally performed by an audit committee. You recognize this on p. 12 of the preliminary views where footnote 2 states that "If no audit committee exists, all references to the audit committee in this publication apply to the entire Board of Directors of the company." We are concerned that some people may misinterpret this footnote to assume that any board can fulfill such activities – even if that board is composed entirely of internal management.

Principle 2 of the COSO 2006 Guidance deals with the oversight responsibilities of the board. The guidance further states:

> "Corporate governance has evolved such that audit committees perform most of the activities noted below. Increasingly, boards of smaller companies have audit committees of independent directors. When a board chooses not to have an audit committee, the full

board performing the activities described should have a sufficient number of independent members." (p.23)

The COSO 2006 Guidance also identifies a primary attribute as:

> *"Operates Independently* – The board has a critical mass of members who are independent directors." (p. 23)

As with the other parts of the document, we view the intent of footnote 2 in your "Preliminary Views" was to be consistent with the COSO 2006 guidance. Therefore we would suggest a minor modification to your footnote that would incorporate the concept of a critical mass of independent directors. One suggestion is that the footnote be amended to refer to the COSO guidance and read as follows:

> "If no audit committee exists, all references to the audit committee in this publication apply to the entire Board of Directors of the company. See also COSO's 2006 *Guidance for Smaller Public Companies*, Principle 2, which states: "Corporate governance has evolved such that audit committees perform most of the activities noted below. Increasingly, boards of smaller companies have audit committees of independent directors. When a board chooses not to have an audit committee, the full board performing the activities described should have a sufficient number of independent members."

We appreciate your efforts in developing this guidance. Please let us know if you have any questions.

On Behalf of COSO Board

Larry E
Rittenberg

Digitally signed by Larry E Rittenberg
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Larry E. Rittenberg, PhD, CPA, CIA

Texas Society of
Certified Public Accountants

December 17, 2007

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

RE: "Preliminary Staff Views – October 17, 2007" *An Audit of Internal Control that is Integrated with an Audit of Financial Statements: Guidance for Auditors of Smaller Companies*

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas, as well as the public interest. The views expressed herein are written on behalf of the Professional Standards Committee (PSC) of the TSCPA. The committee has been authorized by the TSCPA Board of Directors to submit comments on matters of interest to the committee membership. The views expressed in this letter have not been approved by the TSCPA Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policy of the TSCPA.

We are delighted to have the opportunity to provide the input of the PSC into your deliberations regarding the proposed guidance for auditors of smaller companies when performing an audit of internal control that is integrated with an audit of the financial statements. Our committee is generally in agreement with the guidance presented in this document. We do have some comments regarding certain issues found in Chapters 1, 4, 6, and 7. Those comments are noted in the paragraphs below.

The second paragraph on page 10, in Chapter 1, includes a brief discussion of assessing control risk. This paragraph ends with a quote from Auditing Standard No. 5, paragraph B4, which indicates that the auditor is not required to assess control risk at less than the maximum for all relevant assertions, and, for a variety of reasons, the auditor may choose not to do so. We realize that this guidance is appropriate for a financial statement audit. However, we believe such guidance would not allow an auditor to be able to issue an unqualified opinion on internal control. If we are correct in our belief, shouldn't the proposed guidance make mention of this fact?

In Chapter 4 on page 23, a discussion of Segregation of Duties and Alternative Controls is provided. In this document, the components of segregation of duties include: authorizing transactions; recording transactions; reconciling information; and maintaining custody of assets. In other related literature (COSO Integrated Framework and AICPA Audit and Accounting Guide: Internal Control) the components of segregation of duties include authorizing transactions, recording transactions, and maintaining custody. These other documents do not include reconciling information as a component of the definition of segregation of duties. We wonder why the reconciling component is only added to the definition of segregation of duties in reference to small entities. Is there some special significance of "reconciling" as it relates to small entities of which we are unaware? If there is some significance to this issue, we believe it should be explained in the document.

We have some concern with the discussion of testing entity-level controls in the Management Oversight and Review section of Chapter 4. We feel that it is unlikely that the level of precision needed to adequately reduce the risk of material misstatement for a specific assertion can be attained from entity-level controls. Thus, we believe this section should include some comments that caution practitioners in this regard. We recognize that this concern is addressed in Example 2-1 on page 15 of the document. However, we feel a clear warning in the body of this chapter is warranted.

One additional issue in Chapter 4 concerns a mention of insurance/bonding in mitigating the risks from inadequate segregation of duties. The concept of insurance/bonding has long been a recommended control in mitigating losses that might result from inappropriate employee behavior caused by a lack of segregation of duties.

In Chapter 6, we believe the section entitled Supplementing Competencies with Assistance from Outside Professionals should include a cautionary statement about creating a control deficiency by over-reliance or improper-reliance on outside professionals. We recommend more cautionary language and a discussion of possible control deficiencies that could occur as a result of the degree and manner of reliance on outside professionals as a substitute for controls within the company.

The introductory paragraph in Chapter 7 seems to assume that "smaller, less complex" implies "simplicity." We believe smaller companies do have complex control issues, just smaller in scope than larger businesses. We would suggest including a statement to this effect in this discussion. Our committee also believes that the document would be enhanced by the inclusion of some practical steps to consider as "Audit Strategy Considerations." Some examples might include the following:

1. Use an internal control questionnaire as a focal point, and adapt it as necessary to make it more applicable.

2. Senior decision-makers are generally more involved in control areas and, as such, should be interviewed by the auditor to enhance the auditor's understanding of the control areas and help management better understand the effectiveness of such controls in mitigating relevant risks.

3. Emphasize the "walk through" approach to understanding a business process and the effectiveness of the controls put in place to mitigate the risks related to that process.

We have some concern about example 7-2 in Chapter 7. There is no discussion in this example of the cost considerations of poorly documented controls. Other parts of the document address costs by emphasizing the use of others' work to reduce the auditor's testing. The use of simple substantive procedures appears to be more efficient than testing controls around an assertion. Also, we believe that testing controls is a waste of time when there are scope limitations at the outset. We feel it would be worthwhile to mention in Chapter 7 that there is a cost trade-off to poorly documented controls, e.g., higher audit fees that result from chasing down evidence of controls in operations plus the risk that sufficient evidence may not be found.

We appreciate the opportunity to provide our input to the standard setting process.

Sincerely,

Sandra K. Johnigan

Sandra K. Johnigan, CPA, CFE
Chair, Professional Standards Committee
Texas Society of Certified Public Accountants

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December 17, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

RE: Preliminary Staff Views – October 17, 2007

Dear Sir:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB") Preliminary Staff Views – *An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies* (the "Guidance"). We support the PCAOB staff's efforts to develop guidance for audits of internal control of smaller public companies.

While we believe that Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("AS 5"), is scalable to companies of varying size and complexity, we believe that many will find the Guidance to be helpful.

In our view, the Guidance is consistent with the principles and concepts in AS 5, and we believe it is important for the PCAOB staff to ensure that the final Guidance, when issued, preserves this consistency.

We believe it is appropriate that the Guidance focuses on the complexity of a company, which is generally more relevant to the auditor than size. Accordingly, we believe that the Guidance, including the concepts and examples discussed therein, has broader applicability than just to audits of smaller public companies. In order to encourage broader consideration of the Guidance, we suggest that the title be amended to "*Guidance for Auditors of Less Complex and Smaller Public Companies*", which we believe better describes the scalability of AS 5. We also recommend that the PCAOB staff amend the introduction to more fully discuss the broader applicability of the Guidance.

In addition to the above, the Appendix to this letter provides broad commentary and suggestions with regard to each chapter of the Guidance.

* * * * *

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions. Please contact Jorge Milo (973-236-4300) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

APPENDIX

Preliminary Staff Views – An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies

Chapter 1 - Scaling the Audit for Smaller, Less Complex Companies

In the discussion on the bottom of page 8, "Selection of Controls to Test", we suggest that the PCAOB include language that reiterates that the selection of controls for testing should follow a top-down approach. We also believe that additional language should be included on page 10 in the section that discusses how the auditor may perform primarily substantive tests of the assertion without relying on controls. The language should clarify that when conducting an integrated audit, and when controls have been effective for a sufficient period of time, substantive testing without control reliance for purposes of the financial statement audit may be inefficient, because evidence of the operating effectiveness of the control would continue to be necessary for the internal control audit.

In addition, on the bottom of page 10, when discussing how the auditor may decide to perform substantive tests of the assertions without relying on controls, we believe that the PCAOB staff should highlight the auditor's ability to vary his or her testing based upon the risk associated with the individual control. We suggest including the language from, or a reference to, the Note in paragraph 49 of AS 5 to emphasize that a walkthrough alone may, in some circumstances, provide sufficient evidence of operating effectiveness.

Lastly, page 6 of the Guidance discusses the attributes typically shared by smaller, less complex companies. We believe it would be more appropriate to state that these companies typically share "one or more", as opposed to "many" of the attributes listed.

Chapter 3 - Assessing the Risk of Management Override and Evaluating Mitigating Actions

Page 19 of the Guidance discusses the auditor's evaluation of mitigating controls over the risk of management override. The second paragraph of this section identifies controls that a less complex company "might implement to address the risk of management override". We suggest the Guidance not use the word "implement", which implies that these controls should be implemented by issuers as a result of the Guidance. These controls should already be in place based on other authoritative literature. We recommend that the lead-in to the bullet points read instead as follows: "The following are examples of controls that might address the risk of management override".

Chapter 4 - Evaluating Segregation of Duties and Alternative Controls

Example 4-1, footnote 5, cites the "COSO Small Companies Guidance, Volume II: Guidance, page 26". We believe that when defined on page 5 and again on page 16 that the COSO Guidance should be referred to as "COSO Smaller Company Guidance".

While adapted from the COSO Guidance, the scenario appears to be clearer in its original version. As adapted, Example 4-1 appears to contain a contradiction. Specifically, the second sentence states, "…person responsible for the components has access both to the storeroom and the related accounting records", while the last sentence states, "IT access controls are implemented to prevent the person responsible for the components from entering transactions…" While we understand that the latter is intended to address the issue in the former sentence, we believe that as written, this fact pattern could be confusing to users. We suggest that the PCAOB staff clarify the language, or use the language exactly as written in the COSO guidance. In addition, the page reference from which Example 4-1 was adapted should be page 60.

While we believe the chapter effectively establishes the issue of segregation of duties at smaller, less complex companies, it would benefit from additional guidance on how to address this common problem. Additionally, the Guidance should include a discussion of how the limited resources of smaller, less complex companies, that often results in a lack of segregation, may also lead to a lack of objective personnel available to evaluate the effectiveness of internal control over financial reporting. As a result, the auditor may have a limited ability to use the work of others in the audit of internal control. It would be helpful if the Guidance highlighted that the auditor should consider this potential limited ability to use the work of others in the planning stages of the integrated audit.

Chapter 5 - Auditing Information Technology Controls in a Less Complex IT Environment

Page 26 of the Guidance discusses the Characteristics of Less Complex IT environments. While we agree with the characteristics identified, we believe that it would be more appropriate to state that smaller, less complex IT environments tend to have "one or more" of the characteristics cited.

In addition, while we find Example 5-1 to be helpful, we believe that the Guidance should note that the auditor should verify that the code in the packaged software cannot be altered by the users. A similar reference should be included in the related discussion in the last full paragraph on page 31.

Other Observations

We do not believe that the Appendix adds sufficient value as an example of a process when weighed with the risk that it could be misinterpreted as a best practice or limit creation of alternative, though effective, processes. We recommend that the PCAOB staff consider the relative merit of retaining the Appendix.

If the Appendix is retained, we believe that the PCAOB should include "Communication" as one of the major components of an integrated audit approach as listed on page 48. There should also be additional cautionary language in the introduction of the Appendix to make clear that it is not intended to amend or contradict AS 5.

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December 17, 2007

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

By e-mail: comments@pcaobus.org

Re: Preliminary Staff Views – An Audit of Internal Control that is Integrated with an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies (October 17, 2007)

Ladies and Gentlemen:

The New York State Society of Certified Public Accountants, representing 30,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the Preliminary Staff Views referenced above.

The NYSSCPA's SEC Practice Committee deliberated the Preliminary Staff Views and drafted the attached comments. If you would like additional discussion with us, please contact Rita M. Piazza, Chair of the SEC Practice Committee, at (914) 684-2700, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

David A. Lifson
President

Attachment

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COMMENTS ON PCAOB'S PRELIMINARY STAFF VIEWS (OCTOBER 2007) – AN AUDIT OF INTERNAL CONTROL THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS: GUIDANCE FOR AUDITORS OF SMALLER PUBLIC COMPANIES

December 17, 2007

Principal Drafter

Anthony S. Chan

NYSSCPA 2007 - 2008 Accounting & Auditing Oversight Committee

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New York State Society of Certified Public Accountants

Comments on PCAOB's Preliminary Staff Views – An Audit of Internal Control that is Integrated with an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies

We welcome the opportunity to comment on the Preliminary Staff Views and applaud the Staff's efforts in assembling the guidance. This principles-based guidance is properly aligned with the risk-based, top-down approach promulgated by Auditing Standard No. 5 and covers a broad range of topics that are essential to the planning of an effective and efficient integrated audit for smaller public companies. By supplementing its discussion with illustrative examples, the Staff has created an easy-to-use reference guide that promotes a more practical approach in the design of a scalable, efficient audit.

For this guidance to be more effective and practical, we suggest that the Staff consider expanding the scope of its discussion of the challenges that may arise in the audits of smaller public companies and provide more illustrative examples. Specifically, the guidance should:

1. Compare and contrast the different strategies that may be considered in scaling the audit for a "start-up, development-stage company" and "a mature business that is deemed small because of the size of its public float." Such comparison should be supplemented by a discussion on "how to weigh" the control risks and attributes associated with these two different types of companies.
2. Discuss the alternative approaches that may be considered in designing the audit for companies with an ineffective control environment and limited management review and oversight, and how such approaches may impact the related testing strategies.
3. Discuss the alternative approaches that may be considered in designing the audit for companies that do not have sufficient mitigating controls to address the risk of management override, and how such approaches may impact the related testing strategies.
4. Discuss the alternative approaches that may be considered in designing the audit for companies with poor segregation of duties and limited compensating controls to address the relevant fraud and financial reporting risks, and how such approaches may impact the related testing strategies.
5. Discuss the alternative approaches that may be considered in designing the audit for companies that do not have effective general IT computer controls over information security and change in control management, and how such approaches may impact the related testing strategies.

6. Discuss the alternative approaches that may be considered in designing the audit for companies that are heavily dependent on spreadsheets but do not have appropriate end-user computing controls, and how such approaches may impact the related testing strategies.
7. Contain a specific discussion on how to determine the correct test sample size without compromising the effectiveness of the audit.
8. Contain a specific discussion on how to aggregate, quantify and classify control deficiencies efficiently without compromising the effectiveness of the audit.
9. Describe the essential steps auditors must take to support their conclusion on control effectiveness.

In conclusion, we believe that the addition of more examples, as suggested above, would better illustrate the many complex situations that practitioners face and greatly improve reporting.

BDO Seidman, LLP
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December 17, 2007

Via E-mail: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Release: Preliminary Staff Views - An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies

Dear Members and Staff of the Public Company Accounting Oversight Board:

BDO Seidman, LLP is pleased to respond to the Public Company Accounting Oversight Board's ("PCAOB") invitation to comment on the above-referenced publication, *Preliminary Staff Views – An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies.* Our comments reflect our unique perspective and insight, derived from our extensive experience in providing audit services to this group of issuers.

We fully support the PCAOB's commitment to providing guidance on scaling the audit of internal control for these issuers through publications such as this and through other venues, including the forums on auditing in the small business environment.

Our letter is organized such that we have first responded to your specific request for comments on the two questions posed in the invitation to comment, followed by additional commentary on other related matters. Within each response below, we have categorized, where appropriate, our comments into broad topics for ease of review.

1. **Does the guidance in this publication, including the examples, appropriately consider the environment of the smaller, less complex company? If not, what changes are needed?**

Overall we believe that the guidance, including the examples presented throughout the document, appropriately considers the environment and provides practical approaches to complying with Auditing Standard No. 5, for the smaller, less complex company. The guidance appropriately builds upon the principles first laid out in the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") publication, *Internal Control over Financial Reporting – Guidance for Smaller Public Companies*, and our comments below are intended to indicate where we believe the guidance could further enhance the implementation of these principles.

Monitoring Controls

We believe that in the smaller, less complex company environment, monitoring controls are an important aspect of internal control over financial reporting. Monitoring activities may be routinely performed by managers in all size companies, both in running a business and also in providing feedback on the functioning of other components of internal control. However, in the smaller, less complex company environment, these monitoring activities can be particularly important to achieving an efficient and effective management assessment.

This draft guidance, Chapter 2 (page 13), describes one type of monitoring controls: namely, those controls that monitor the effectiveness of other controls. We also believe that monitoring the results of operations or account balances may, in certain circumstances, also be an effective entity level monitoring control. This second type of monitoring activity can directly act as a control and may, if properly implemented, also help mitigate an increased risk of management override that may exist at smaller companies. Because we believe this type of monitoring control is frequently used by many companies, including smaller companies, we recommend enhancing the guidance and providing an example demonstrating how such a control activity, operating at a sufficient level of precision to prevent or detect a material misstatement, would be sufficient to address or reduce the assessed risk of misstatement.

The Information Technology (IT) Environment

Chapter 5, *Auditing Information Technology Controls in a Less Complex IT Environment*, (page 26) describes the characteristics of less complex IT environments, such as those that are more likely to be found at smaller, less complex companies. We suggest adding additional discussion about how manual controls, as opposed to IT controls, are sometimes relied on more extensively in this environment and may serve to mitigate weaknesses in the IT environment.

Further, guidance about how Entity Level Controls can be used in a smaller company environment to monitor information produced by the IT systems and help reduce the risk of an IT control failure could also be presented.

This chapter also presents the IT-related risks affecting the reliability of financial reporting and lists the seven specific risks presented in AU sec. 319.19. As the importance of these risks may be assessed differently depending on the nature and characteristics of an entity's information system, we suggest adding such a discussion to the guidance to clarify that the nature and extent of these risks to internal control vary based on the unique characteristics of an entity, such that certain of these risks may not be applicable to the environment at smaller, less complex entities.

2. Are there <u>additional audit strategies or examples</u> that the staff should consider including in this publication? If so, please provide details.

We have provided the following comments regarding additional examples that we believe will enhance the effectiveness of this publication related to testing the operating effectiveness of controls for less than the entire period and assessing end-user computing and spreadsheet controls.

<u>Testing Operating Effectiveness for Less than the Entire Period</u>

Chapter 1, *Scaling the Audit for Smaller, Less Complex Companies,* provides guidance about how to test operating effectiveness of controls in a smaller, less complex environment. For purposes of supporting the opinion on internal control, the first full paragraph on page 10 provides that evidence obtained may be for less than the entire period. For purposes of assessing control risk at less than maximum for the financial statement audit, the second paragraph indicates the period of testing of controls is the entire period for which the auditor intends to place reliance (which is not necessarily the entire year). Later in this section, an example is provided regarding controls over billing and collection and revenue recognition. We believe that it would be helpful if this example was enhanced to illustrate how the auditor might test controls for a period less than the entire year, perhaps only the last several months of the year, particularly when the period for which the controls are being relied on for the financial statements is less than the entire year, and/or the impact of the conclusions from tests of internal controls on the extent of substantive testing performed is unlikely to be significant. For example, the auditor might be able to conclude that controls over billings and collections are effective based on testing of those controls closer to year end. The auditor might also be able to reduce the number of confirmations of accounts receivable based on testing of those controls during this shorter period if the underlying receivables outstanding at year end primarily originated during the period of testing, which might only be two or three months.

Further, this chapter describes how the results of substantive tests can inform the auditor's risk assessment but how such tests alone do not provide sufficient evidence for the auditor to conclude on the operating effectiveness of controls. To clarify this concept and demonstrate the impact that substantive tests may have on the extent of tests of controls, we suggest providing an example.

<u>End-User Computing Controls</u>

End-user computing and spreadsheet controls are used heavily at smaller, less complex companies; this topic is presented in Chapter 5, starting on page 32. We recommend expanding this discussion to better describe the risks and the related auditing procedures, including the role that substantive testing can play when assessing risk with respect to these controls.

Additionally, the guidance (page 33) offers examples of tests of controls over end-user computing that include reviewing the procedures for backing up the applications and data. We believe that these types of procedures would not always be considered important to internal control over financial reporting (ICFR) at smaller companies. We suggest that this section be amended or that additional discussion about the relevance of these procedures to ICFR at smaller companies be provided to clarify the concept.

Additional Commentary

Selection of Controls to Test

The guidance in Chapter 1 lists two factors to consider in selecting controls to test, besides the overriding consideration of whether a control addresses the risk of misstatement. They are (1) whether the control is likely to be effective and (2) what evidence exists regarding the operation of the control. We believe it is clear that a control that provides an audit trail is preferable to select for testing over one that does not; however, it is unclear what factors should be considered when evaluating whether the control is likely to be effective. As such, we suggest elaborating how to assess this factor and additionally how this may be similar to, or differ from, assessing the design of a control.

Overall Response to Risk

Footnote 4 on page 50 explains that for accounts, disclosures and assertions not considered to be significant, where the auditor's assessment of the risk that undetected misstatements would cause the financial statements to be materially misstated is unacceptably high, the auditor may perform substantive procedures. This footnote should describe the circumstances where an account could be considered "not significant" while at the same time the risk of material misstatement in the account is unacceptably high. We suggest providing additional clarification on this point. Additionally, consider whether the inverse is true, that the auditor may perform control testing procedures related to accounts, disclosures and assertions that are not determined to be significant for the same reasons cited in the footnote.

Evaluating Mitigating Controls

Consider rephrasing the bullets in the third paragraph on page 19, as follows:

- Maintaining integrity and ethical values
- Audit committee oversight

- Whistleblower programs
- Controls over certain journal entries

* * * * *

We would be pleased to answer any questions you may have about our comments. Please contact Wayne Kolins, National Director of Assurance, at (212) 885-8595 or via electronic mail at wkolins@bdo.com with any questions.

Very truly yours,

/s/ BDO Seidman, LLP

BDO Seidman, LLP

CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets

December 17, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

RE: Preliminary Staff Views – An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies

Dear Office of the Secretary:

The Center for Audit Quality (CAQ or the Center) is an autonomous public policy organization serving investors, public company auditors and the capital markets and is affiliated with the American Institute of Certified Public Accountants. The CAQ's mission is to foster confidence in the audit process and aid investors and the markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. Based in Washington, D.C., the CAQ consists of approximately 800 member firms that audit or are interested in auditing public companies. We welcome the opportunity to share our views on the Public Company Accounting Oversight Board's (PCAOB or the Board) Preliminary Staff Views – An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies (Preliminary Staff Views or Document).

The CAQ applauds the PCAOB's efforts to develop guidance for auditors of smaller, less complex public companies. These efforts demonstrate the PCAOB's commitment to facilitating the scalability of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

In the Document, the PCAOB staff asked commenters to focus on the following two questions:

1. Does the guidance in this publication, including the examples, appropriately consider the environment of the smaller, less complex company? If not what changes are needed?

We believe the guidance in the Preliminary Staff Views appropriately considers the environment of smaller, less complex companies and that the topics covered address many of the specific challenges that auditors of smaller, less complex companies are encountering in practice. While we support the guidance overall, we are particularly supportive of the discussion and guidance in the following sections of each chapter which may be of significant benefit to auditors of smaller, less complex companies:

- The auditor's possible decision, for purposes of the financial statement audit, that a relevant assertion can sometimes be tested more effectively and efficiently by performing substantive procedures rather than relying on controls (discussed in Chapter 1);
- The factors that auditors might consider when judging the level of precision of an entity-level control (discussed in Chapter 2);
- The discussion of the auditor's consideration of some controls that a smaller, less complex company might implement to address the risk of management override (discussed in Chapter 3);
- The audit strategy considerations related to evaluating segregation of duties and obtaining sufficient competent evidence when the company's documentation lacks formality (discussed in Chapters 4 and 7);
- The discussion of the auditor's consideration of IT-related risks affecting financial reporting in a smaller, less complex company (discussed in Chapter 5);
- The factors that auditors might consider when determining whether a smaller, less complex company is adequately identifying and responding to risks when an outside professional is enlisted to assist in financial reporting matters (discussed in Chapter 6); and
- The discussion of how the auditor's strategy for testing controls, in certain situations, may depend on the effect of pervasive deficiencies on other controls (discussed in Chapter 8).

2. Are there additional audit strategies or examples that the staff should consider including in this publication? If so, please provide details.

We also generally believe the illustrative examples provided throughout the Preliminary Staff Views will be useful for auditors of smaller, less complex companies in better understanding the principles of Auditing Standard No. 5 and how they are scalable to the smaller, less complex company environment.

While we support the guidance in the Preliminary Staff Views, we also have some recommendations that we believe would improve the clarity of certain aspects of the Document, including the examples. Our general comments are included below and our more detailed recommendations are included in the attached Appendix.

General Comments

Although the guidance is appropriately focused on matters that might be encountered in performing audits for smaller less complex companies, we believe that some of the concepts are also applicable for audits of many larger, less complex companies. Accordingly, we recommend that the PCAOB amend the Introduction to emphasize that the guidance could apply to audits of companies of all sizes so that auditors are encouraged to apply the concepts in the guidance to audits of larger organizations. Perhaps the PCAOB could consider language similar to that found in the Committee of Sponsoring Organizations of the Treadway Commission (COSO) *Internal Control over Financial Reporting – Guidance for Smaller Public Companies* Executive Summary which states:

> "Although there is a tendency to want a "bright line" to define businesses as small, medium-size or large, this guidance does not provide such definitions. It uses the term "smaller" rather than "small" business suggesting there is a wide range of companies to which the guidance is directed."

We understand that the uses of the terms "should and must" throughout the Preliminary Staff Views represent direct excerpts from existing PCAOB auditing standards. We recommend that the Document's Introduction include a notice informing readers of this link to Auditing Standard No. 5. We also suggest that the PCAOB consider including footnotes referencing these terms to their source in Auditing Standard No. 5. This additional information might reduce the risk of certain thoughts/positions being taken out of context.

We also recommend that the Document clarify the discussion regarding the objectives of the auditor's testing of controls in an audit of the financial statements and in an audit of internal control over financial reporting. The guidance in the third paragraph of page 10, particularly the references to "relying on controls" and the example provided, is confusing. For example, the language suggesting that "the auditor might perform primarily substantive tests of the assertions without relying on controls" does not clarify that, in an integrated audit, the auditor is required to obtain sufficient evidence to support the auditor's opinion on internal control as of year-end. Further, we believe the example provided related to controls over revenue recognition and billings and collections may further confuse readers in that (a) it is unlikely that controls over billings and collections and revenue recognition are substantially different, (b) the performance of primarily substantive tests in a routine process such as revenue recognition may not be a more effective and efficient strategy, and (c) it suggests that auditors would be more likely to apply this strategy for higher risk account assertions affected by routine processes.

Specific Comments

As stated above, we also have identified a number of additional comments relating to specific aspects of the Preliminary Staff Views. Please see the Appendix for these detailed recommendations.

* * * * *

We appreciate the opportunity to comment on the Preliminary Staff Views and would welcome the opportunity to meet with you to discuss any of our comments.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

Cc: PCAOB
Mark W. Olson, Chairman
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Willis D. Gradison, Member
Charles D. Niemeier, Member
Thomas Ray, Chief Auditor and Director of Professional Standards

SEC
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Commissioner Annette L. Nazareth
Commissioner Kathleen L. Casey
Conrad Hewitt, Chief Accountant
Dr. Zoe-Vonna Palmrose, Deputy Chief Accountant for Professional Practice
John W. White, Director of Division of Corporation Finance

APPENDIX

This Appendix provides detailed comments regarding specific aspects of the Preliminary Staff Views.

Reference in Preliminary Staff Views	**Current Wording**	**Our Comment**
Overall	Various	We noted some repetitive statements that could be deleted without sacrificing the intended point in the guidance. (For example on Page 43, the first sentence in the "Pervasive Deficiencies that Result in Material Weaknesses" section states, *The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting.)* We recommend that sentences such as these be deleted as they needlessly add to the volume of the guidance.
Chapter 2		
Page 14, fourth bullet	*Correlation to relevant assertions.* A control that is directly related to an assertion normally is more likely to prevent or detect misstatements than a control that is only indirectly related to an assertion.	We recommend that further clarification be made regarding the difference between "directly related" versus "indirectly related", including the intent of this bullet in summarizing factors that should be considered by an auditor in auditing management's assertion about the precision of its controls. Directly related controls (i.e., defined in footnote 33 of the SEC's interpretive guidance as those designed to have a specific effect on a financial reporting element) may not be designed at a level of precision sufficient to identify material misstatements. Similarly, indirect controls may or may not be designed at a level of precision sufficient to identify material misstatements. As a result, it appears that this bullet is not introducing a concept that is helpful in making judgments about the precision of a particular control.

Page 16; Example 2.1	Audit Approach: The CFO's review is a check of the staff accountant's work rather than a reperformance of the reconciliation, so the review is not sufficiently precise to detect misstatements. However, the CFO's review could influence the auditor's assessment of risk. The auditor obtains evidence about the CFO's review through inquiry and document inspection, evaluates the review's effectiveness, and determines the amount of direct testing of the reconciliation controls that is needed based on the assessed level of risk. If the auditor concludes that the CFO's review is effective, she could reduce the direct testing of the reconciliation controls, absent other indications of risk.	It is not clear what is meant by "If the auditor concludes that the CFO's review is effective she could reduce the direct testing of the reconciliation controls, absent other indications of risk." Given the premise of the first sentence (that reperformance is not performed), it is unclear how this "monitoring control" could be effective if the CFO never looks closely enough to see whether the reconciliation is performed appropriately by the staff accountant.
Chapter 3		
Page 19; second paragraph under "Evaluating Mitigating Controls"	The following are examples of some of the controls that a smaller, less complex company might implement to address the risk of management override – • Maintaining integrity and ethical values • Increased oversight by the audit committee • Whistleblower program • Monitoring of controls over certain journal entries	We recommend that these bullets be more closely aligned with the COSO guidance found on pages 5 and 6 of the July 2006 Guidance for Smaller Public Companies which describes 'important' steps in an effective system of internal control over financial reporting to mitigate risks of management override. We also recommend that the 4th bullet "Monitoring of controls over certain journal entries" also be included on page 20 of "Evaluating Audit Committee Oversight,**"** especially as it relates to journal entries prepared by senior management.
Chapter 4		
Page 25; Example 4-1	The person responsible for the components has access both to the storeroom and the related accounting records. IT access controls are implemented to prevent the person responsible for the components from entering transactions	We recommend that the example be revised because the scenario seems to contradict itself. We do not understand how the person responsible for the components can have access to the accounting records if IT access controls prevent that person from entering transactions or modifying account balances. As this example is currently presented, a

	or modifying related account balances	segregation of duties issue does not exist. The example should be modified to explain what the auditor can do when a segregation of duties issue does exist.
Chapter 5		
Page 29, Example 5-1	First paragraph.	Since the example is focused on "IT-Dependent Controls", discussion of segregation of duties should be removed from the example, as it obscures the main point. The only relevant information in the first paragraph is that senior management performs a number of reviews as detective controls over transaction processing.
Page 29, Example 5-1	In the first sub bullet under the 2nd main bullet, it says tests of controls should include "the data inputs into the report are accurate and complete and that this is accomplished through testing the initiation, processing, and recording of the respective transactions that feed into the report."	The Document should emphasize that the completeness and accuracy of data inputs can be addressed through "high level controls" that are sufficiently precise to achieve multiple control objectives related to the data inputs of the report. Otherwise, the user might interpret the example as reason to continue testing lower level process controls, and thus forgoing many of the efficiency opportunities afforded with Auditing Standard No. 5. In addition, the 2nd sub bullet is confusing. It should be reworded to focus consideration of "whether the report logic and parameters" are designed and executed as intended to pull the desired ranges of input data.
Chapter 6		
Page 36; 4th bullet	Whether management has established controls over the work of the outside accounting professional (e.g., controls over the exchange of information and controls to test their work) and over the completeness and accuracy of the information provided to the outside professional.	We recommend that the Document provide expanded guidance regarding the the types of controls that would be expected over the exchange of information and testing of the work performed by the outside accounting professional. In other words, what types of controls would be expected over the work of the outside accounting professional *beyond* those expected over the completeness and accuracy of the information provided?

Chapter 7		
Various	General references to “formal” versus “less formal” documentation.	We recommend that this chapter include a discussion clarifying the difference between the concepts of “formal” versus “less formal” documentation and the impact of the distinction on the audit. For example is the difference in the form of the documentation (e.g., e-mails and memoranda versus manuals)?
Page 40; First sentence in 3rd paragraph under “Other Considerations”	If the company does not have formal documentation of its processes and controls, the auditor may consider whether other documentation is available before drafting formal descriptions of processes and controls for the audit documentation.	We observe that this paragraph does not include a reference to the requirement in the SEC’s interpretive guidance, Sections II A.1.e, which states that documentation of the design of controls management has placed in operation to adequately address the financial reporting risks, including the entity-level and pervasive elements necessary for effective internal control over financial reporting, is an integral part of the reasonable support management is required to maintain for its assessment. We also observe that the guidance does not contain a reference to Section II A.2.c, which states that management’s documentation in support of its assessment may include its evaluation approach, the evaluation procedures, and the basis for its conclusions about the effectiveness of controls related to individual financial reporting elements and the entity-level and other pervasive elements that are important to management’s assessment. References to these sections might provide a more complete picture of appropriate documentation considerations.
Chapter 8		
Page 44, fourth bullet	Frequent management override of controls. A control that is frequently overridden is less likely to operate effectively.	We recommend that the Document clarify how frequent management overrides of controls might impair the effectiveness of other controls by rendering their design ineffective or by keeping them from operating effectively. We believe frequent override of controls should be considered when the auditor is assessing the control environment. To that end, we recommend that this bullet be deleted and frequent management override of

		controls be addressed in the first bullet "Ineffective control environment."
Page 44, last paragraph; 3rd and 4th sentence	For example, if a control is likely to be impaired because of another control deficiency, the inquiries and observations during walkthroughs might provide enough evidence to conclude that the design of a control is deficient and thus could not prevent or detect misstatements. In some cases, limited testing of a control might be necessary to conclude that a control is not operating effectively.	It is unclear whether the second sentence relates to the example of an impaired control caused by another control deficiency or a situation where the design of the control is deemed ineffective. If the latter is the case, we recommend that additional guidance be provided regarding the determination of the audit strategy for controls whose design is deemed ineffective (i.e., what would be expected of the auditor in terms of testing operating effectiveness).
Appendix		
Page 48; 2nd paragraph	This appendix illustrates one approach for integrating the audit of internal control with the audit of the financial statements and is not intended to present all of the procedures that are required for a particular audit. Auditors should plan and perform their integrated audits to achieve the objectives of the audits and to comply with standards of the PCAOB.	We recommend that this wording be relocated as a bold-face introductory paragraph to the entire Appendix. The PCAOB may wish to include additional wording to make it clear that the Appendix is not meant to replace or modify Auditing Standard No. 5.

The Institute of Internal Auditors

David A. Richards, CIA
IIA President

December 17, 2007

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803 USA

Response e-mailed to Comments@pcaobus.org

RE: Preliminary Staff Views – October 17, 2007

Dear Sir/Madam:

The Institute of Internal Auditors (IIA) welcomes the opportunity to respond to the PCAOB's Guidance for Auditors of Smaller Public Companies.

We commend the PCAOB for developing guidance for audits of internal control for smaller public companies. The guidance is valuable and provides useful examples for performing audits of internal control in smaller, less complex companies.

We would appreciate consideration by the Staff of the following comments:

The section *Categories of IT Controls* is not consistent with the guidance in Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements. Auditing Standard No. 5 states that the scope of work should be focused on the risk of material misstatement of the financials, which is determined using a top-down and risk-based process. The *Categories of IT Controls* section within the proposed guidance adopts a more general approach of assessing IT controls (especially IT general controls) before reliance on IT controls has been established. IT general controls need only be assessed if there are automated application controls (including IT-dependent controls) that are relied upon to prevent or detect material misstatement.

The IIA believes that in a small company or IT department, there is always the need to perform a review based on risks. We believe this should be more specifically stated in the document as well as the need to consider informal procedures and standards and the experience of the IT staff when assessing risks.

Finally, we recommend the chief audit executive (CAE) is specifically mentioned as one of the appropriate management personnel consulted for the purpose of obtaining an understanding of the control environment and the risk of fraud. In addition, it is appropriate and important that the CAE is consulted as part of the audit planning process.

The IIA welcomes the opportunity to discuss these recommendations with you. If we can be of further assistance, please contact me.

Best Regards,

David A Richards

David A. Richards, CIA

About The Institute of Internal Auditors
The IIA is the global voice, acknowledged leader, principal educator, and recognized authority of the internal audit profession and maintains the *International Standards for the Professional Practice of Internal Auditing (Standards)*. These principles-based standards are recognized globally and are available in 29 languages. The IIA represents more than 150,000 members across the globe, and has 99 affiliates in 165 countries that serve members at the local level.

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December 17, 2007

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

Via email to comments@pcaobus.org

RE: Preliminary Staff Views – October 17, 2007. *An Audit of Internal Control That is Integrated With An Audit of Financial Statements: Guidance for Auditors of Smaller Companies.*

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association welcomes the opportunity to comment on the Preliminary Staff Views – October 17, 2007 – *An Audit of Internal Control That is Integrated With An Audit of Financial Statements: Guidance for Auditors of Smaller Companies*. We very much appreciate the opportunity to provide input.

The views expressed in this letter and attachments are those of the Auditing Standards Committee members and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist in finalizing the proposed guidance. If the Board has any questions about our input, please feel free to contact our committee chair for additional follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section - American Accounting Association

Committee Members:
Chair – Thomas M. Kozloski, Wilfrid Laurier University, tel: 519-884-0710 ext. 2679, int: tkozloski@wlu.ca
Past Chair - Robert D. Allen, University of Utah
Vice Chair – Randal J. Elder, Syracuse University
Ed O'Donnell, University of Kansas
Robert J. Ramsay, University of Kentucky
Sandra Shelton, DePaul University
Jay Thibodeau, Bentley College

General Comments

The Committee commends the PCAOB ("the Board") staff for providing preliminary staff views regarding audits of internal control (integrated with audits of financial statements) for auditors who audit smaller public companies. We believe this guidance, in conjunction with other recently published guidance from the Committee of Sponsoring Organizations ("COSO") regarding internal control in smaller companies, addresses very important issues and concerns facing practitioners in public accounting who serve smaller clients. Among many other desirable qualities, the guidance seems to seek to enhance efficiency in audits of internal control over financial reporting at smaller companies without comprising effectiveness.

The Board staff views presented in this document ("the publication") are very well presented, and are consistent with and well-anchored to previous standards and guidance provided by both the Board and COSO. As such, this should facilitate the wide acceptance of this guidance as an important part of the overall body of standards and guidance in the area of internal control and audits of internal control at smaller companies.

The following section presents a number of specific comments or suggestions relating to the publication.

Specific Comments

Clarification of important terms

We suggest a very minor clarification/elaboration to be placed somewhere in the front of the document: namely that all references to the audit of internal control in the publication refer to the audit of internal control over financial reporting ("ICFR").

In addition, the term "precision" is used frequently in Chapter 2 and other places in the publication (and in AS 5). Although the meaning of the term might be inferred from context and the examples provided, specifically defining the term would strengthen the publication.

Effects of results of substantive tests on testing ICFR

On page 11 of the publication the staff indicates that, "The results of substantive tests of accounts and disclosures do not provide sufficient evidence for the auditor to conclude on the operating effectiveness of controls. However, the results of substantive tests could affect the auditor's risk assessments associated with the internal controls. Risk assessments, in turn, affect the nature, timing, and extent of procedures performed in evaluating the effectiveness of internal control."

The Committee understands this statement to mean that the successful results of substantive tests do not allow the auditor to conclude that controls are <u>effective</u>, although unsuccessful results could be used as evidence that controls are <u>not effective</u>, necessitating a revision in the risk assessment, testing judgments, or conclusion regarding deficiency relating to the relevant control. We believe the quoted section of the publication could be more clearly stated, and more readily understood, by including language in the body of the document that is similar to the language used to explain this concept in the appendix (see page 51).

<u>Use of prior audit experience at client as source of information and/or evidence</u>

As discussed in the document, the auditor will use knowledge gained in prior audit engagements with the client as a source of information about the client. This information will impact risk assessments and decisions about the nature, timing, and extent of audit testing. References to the use of this previously acquired knowledge seem to be presented primarily in a negative frame – i.e., if the auditor's previously acquired knowledge indicates <u>problems</u> in a certain area, then she can modify her planning appropriately. (See bottom of page 34 for an example in the area of competency.)

However, the auditor's previous knowledge may alternatively indicate that certain areas of financial reporting have been well-controlled in the past. The Committee believes that the publication might benefit from some clarification regarding the use of such "positive" knowledge gained in prior audits, and the extent to which this knowledge can constitute competent evidence for the audit of internal control.

<u>Competence and objectivity of others whose work is used by the auditor</u>

Chapter 6 of the publication alludes to the assessment of the competence of outside professionals by the auditor, but does not mention an assessment of objectivity. (See bottom of page 35/top of page 36.) Chapter 7 (footnote 6) mentions the need to assess the competence and objectivity when using the work of others although in a different context from the mention in Chapter 6. Even though, as footnote 6 in Chapter 7 indicates, AS 5 comments on the need to assess both competence and objectivity, the current publication might be enhanced by an explicit mention of the need to assess both characteristics regarding outsiders whose work is used by the auditor, and to make this mention in the body of the publication.

<u>Audit committees in smaller companies</u>

On page 12, footnote 2 of the publication states: "If no audit committee exists, all references to the audit committee in this publication apply to the entire Board of Directors of the company." We contend that this statement conveys a message about internal control and governance at smaller companies that may not be in the best interest of ICFR. An audit committee in a smaller public company serves as an important component of the control environment and can play a key oversight role. This oversight role is especially relevant to mitigating the risk of management override and serving as a mechanism to achieve the goals of segregation of duties.

We encourage smaller public companies (and indeed all companies) to ensure the existence of a properly staffed and functioning audit committee.

Effects of deficiencies in general controls on automated (application) controls

On page 29 of the publication, the staff offers an example of a situation where an automated control may be tested and considered effective even in the presence of a deficient general (program change) control. It would seem that this particular situation could manifest itself only if the testing of the automated control was performed at the absolute end of the period (i.e., the last day of the fiscal year) – otherwise the automated control might have been changed.

We believe the auditor should be cautioned about the interpretation of the results of testing of automated controls in the presence of deficient general controls. In addition, perhaps the example provided in the publication and noted above could be changed or removed.

Office of the Secretary,
PCAOB,
1666 K Street,
N.W., Washington, D.C. 20006-2803

RE: Preliminary Staff Views – October 17, 2007 on
AN AUDIT OF INTERNAL CONTROL THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS: GUIDANCE FOR AUDITORS OF SMALLER PUBLIC COMPANIES

In review of the PCAOB's latest guidance, I have the following comments related to Entity Level Controls (ELCs):

The PCAOB defines ELC's as "controls that have a pervasive effect on a company's internal control. These controls include:

- Controls related to the control environment;
- Controls over management override;
- The company's risk assessment process;
- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the audit committee and self-assessment programs;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management"

Since these controls are considered "pervasive', it would seem that they affect the entity as a whole, and not just one or two critical processes within an entity. One can conclude that these controls are tone setting, meaning controls related to the integrity and ethical aspects prompted by management in a "top-down" approach through out the business organization.

The guidance further suggests that

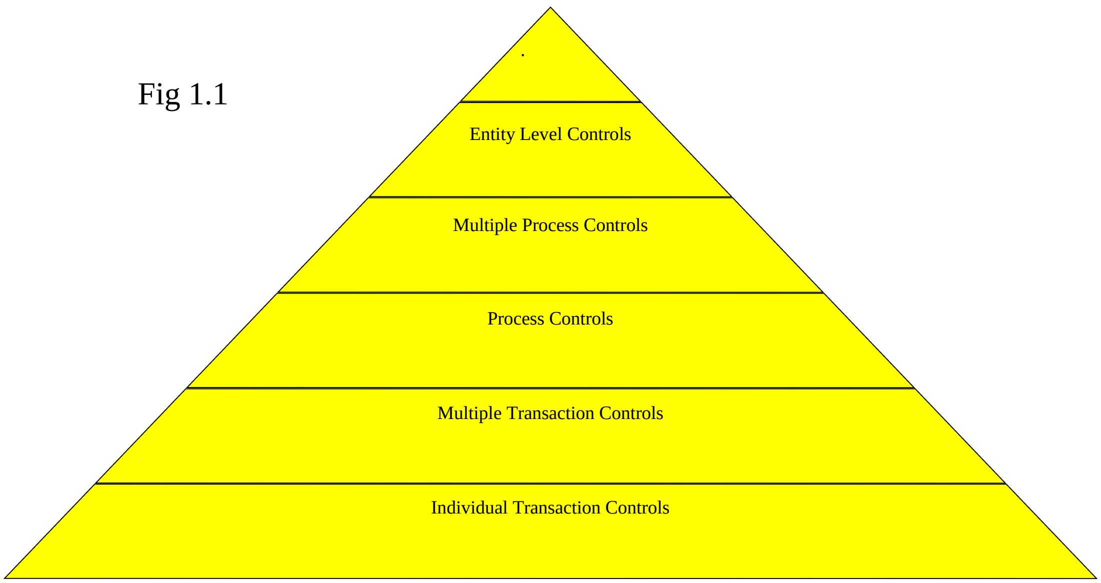
> "Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk."

To support this statement, the guidance refers to example 2.2, which illustrates a Chief Financial Officer's review as a control over payroll processing. This example, however, seems in conflict with the PCAOB's definition and purpose of an ELC, because the control mentioned in the example seems more attuned to a “process control” within the payroll process versus a control that is pervasive in nature.

Hence, I believe that the PCAOB should expand its discussions on the definitions, classifications, utilization, and limitations of ELCs and other types of controls within an organization. I believe that the PCAOB, in its attempt to identify and segregate the nature of ELC, should, especially for small companies, expound upon the nature and scope of all organizational controls. In furtherance of this goal, the PCAOB should identify and provide support for the various strata of organizational controls that address various organizational risks and support relevant financial assertions.

For example, I have identified the following organizational control structure. This organizational control structure is composed of five control strata.

Fig 1.1



These strata are defined as:

- **Entity Level Controls** are those controls that have a pervasive effect on a company's internal controls covering the entire organization to support an assertion related to financial reporting.
- **Multiple Process Controls** are those controls that are pervasive on a company’s internal controls covering more than one uniquely identifiable process within the organization to support an assertion related to financial reporting.
- **Process Controls** are those controls that are pervasive on a company’s internal controls covering one uniquely identifiable process within the organization to support an assertion related to financial reporting.

- **Multiple Transaction Controls** are those controls that are specific to multiple transaction types within a uniquely identifiable process to support an assertion related to financial reporting.
- **Individual Transaction Controls** are those controls that are specific to a single transaction within a uniquely identifiable process to support an assertion related to financial reporting.

I believe this new structure will allow for a better clarification of controls, control objectives, and relevant assertions affecting, in particular, the needs of smaller companies. Further, this structure will help facilitate the auditors' ability to assess the effectiveness of a smaller company's internal control environment over financial reporting, because this structure allows for a better mechanism for determining the nature and extent of the pervasiveness of ELC's, as it allows one to measure the reach to which the effects of the an ELC is felt throughout the organization.

From this structure, it becomes apparent that the PCAOB's Example 2.2 in its guidance, is better categorized as a "process" control, as this control is confined in only one process, and, thus, it is not an ELC.

In addition, this structure facilitates assessing whether or not a particular financial statement assertion is achieved by analyzing the design and effectiveness of the control within a given strata, as shown in examples 1.1.through 1.5.

Example 1.1
Monitoring Controls as an Entity Level Control/Assertion Reporting and Disclosure.
A small oil and gas company holds detailed weekly financial and operational meetings, analyzing each element of the financial statements. These meetings last no fewer than two hours, and each department has obligations to explain any variance greater than 2% from budget. The CFO is the manager of the meeting. These meetings support management's oversight and control over the assertion of presentation and disclosures

Hence, these meetings are examples of ELCs, as these controls support the control objectives of the entire entity and it supports the relevant financial assertion of reporting and disclosure.

Example 1.2
Application Controls as a Multiple Process Control/ Assertion - Completeness
A small manufacturing company utilizes an ERP system to link its accounts payable, accounts receivable, and financial reporting modules. The company has application controls which ensures that these data are entered once and that

these data flow seamlessly from one module to the other modules, ensuring that the assertion of completeness is supported.

Hence, the application controls have achieved the control objective of completeness, covering multiple processes.

Example 1.3

Process Control/ Assertion – Rights/Obligations

An oil and gas company participates in hedging its future oil production. The company has a derivatives department, which is composed of front, middle, and back office phases to ensure that contractual provisions are within company guidelines and that settlement procedures are separate from contract creation. The company uses a recording device to record all telephone calls with third parties within each phase of the contract. The telephone recordings are used to ensure that verbal confirmation exists in the event of a contract dispute.

Example 1.4

Application Controls as a Multiple Transaction Control/ Assertion - Valuations

A wholesale company maintains a four person account receivables department, which is composed of one supervisor and three staff accountants. One staff accountant is responsible for recording all "on account" transactions. One staff accountant is responsible for accessing whether a customer is delinquent in paying the amounts owed to the company and issuing dunn letters. Another accountant is responsible for initiating write-off of account receivables deemed uncollectible. Each staff accountant must submit, on a monthly basis, progress reports of his activities. The supervisor of the department reviews and signs-off on each progress report to ensure that appropriate evaluation of the account receivable account.

Example 1.5

Application Controls as an individual transaction control/Assertion – Safeguarding of Assets

A manufacturing company maintains its manual check stock in a locked safe to ensure only authorized access.

Hence, the scope of the control objective and the control will determine whether a control is an ELC or a control affecting a different organizational stratum. The success of each control stratum will depend on its design and effectiveness in supporting relevant financial statement assertions; namely,

- *Existence* – Assets, liabilities, and ownership interests exist at a specific date, and recorded transactions represent events that actually occurred during a certain period.

- *Completeness* – All transactions and other events and circumstances that occurred during a specific period, and should have been recognized in that period, have been recorded.
- *Rights and Obligations* – Assets are the rights, and liabilities are the obligations, of the entity at a given date.
- *Valuation or Allocation* – Asset, liability, revenue, and expense components are recorded at appropriate amounts in conformity with relevant and appropriate accounting principles. Transactions are mathematically correct, appropriately summarized, and recorded in the entity's books and records.
- *Presentation and Disclosure* – Items in the financial statements are properly described, sorted, and classified.

Therefore, I believe that the PCAOB should expand, define, and clarify the different strata of controls within a business organization. Further, I believe that such a clarification would allow auditors to better assess the nature, timing and extent of auditing smaller companies.

Tracy D. Good, CPA, CIA

The information contained herein is the work of Tracy D. Good, CPA, CIA, as an individual, and does not in any way reflect the opinions of my employer, AXIA Resources, or the management of AXIA Resources.

www.thesoftaudit.com

December 17, 2007

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

RE: Preliminary Staff Views – October 17, 2007

Dear Sir/Madam:

This letter is in response to the above-captioned release and the opportunity to submit comments on the PCAOB's Preliminary Staff Views on An Audit of Internal Control that is Integrated with an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies, dated October 17, 2007.

Initially, these title of the preliminary staff views should be adjusted to add "over Financial Reporting" to the title to read: "Preliminary Staff Views on An Audit of Internal Control over **Financial Reporting** that is Integrated with an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies, dated October 17, 2007. This will make the title consistent with AS 5 and alleviate any misgivings in regards to the contents.

On Page 19, there is a discussion of Evaluating Integrity and Ethical Values, which is integral to any audit. These are very difficult to quantify and this evaluation is subjective in nature. My question is should there be a requirement, especially in the audits of smaller public companies that management can exert significant influence over a company, to perform a certain level of substantive testing in regards to fraud? I realize the difficulty in specifying testing in this regard, due to the inherent nature of quantifying the control environment, but I believe additional detail in regards to level and types of fraud testing could be of great benefit to auditors.

On Page 20, in the fourth sentence on the discussion of Evaluating Whistleblower programs, the Staff discusses the intention of audit procedures are to assess whether the programs are "appropriately implemented, monitored and maintained". Throughout this discussion, there is no mention of a review of the sufficiency of the Whistleblower program. Many companies are meeting the minimum standard in regards to compliance with Whistleblower programs but are they sufficient and effective in operation? I believe this is a question the PCAOB should begin to ask.

On page 26, Chapter 5, the Staff discusses auditing information technology controls in a less complex IT environment. In the final paragraph of the chapter on page 33, the Staff discusses controls over spreadsheets on a very minimal part. I believe the PCAOB should be much more specific as to the testing that should be completed in regards to key spreadsheets. I am well versed Price Waterhouse Cooper's whitepaper on the subject as well as IT Control Objectives for Sarbanes-Oxley, 2nd Edition however I believe the PCAOB should compile and standardize this data for all auditors to maintain consistency during the audit process.

Finally, I do not believe the Staff addressed the issue of reliance on the work of others in a small public company. Does the size of the company affect the reliance aspect and overall risk assessment other than the key points outlined in the document? Should there be lesser reliance on the work of others if it is a small company? I believe this should be addressed specifically by the PCAOB.

Thank you for the opportunity to comment and I hope these comments are useful.

These comments are made on my personal behalf and reflect my personal views and opinions and not of my employer.

Sincerely,

Danny M. Goldberg
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December 17, 2007

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

RE: **Preliminary Staff Views – October 17, 2007** "*An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies*"

Dear Mr. Seymour:

I am writing to you on behalf of the California Public Employees' Retirement System (CalPERS). CalPERS is the largest public pension system in the U.S., managing approximately $250 billion in assets. We manage retirement benefits and health insurance on behalf of nearly 1.5 million members.

As a long-term shareowner, CalPERS has a vested interest in maintaining the integrity and efficiency of the capital markets. CalPERS is a strong supporter of the Sarbanes-Oxley Act of 2002 to ensure the integrity of financial reporting. The application of Section 404 of Sarbanes-Oxley moves all public companies in the direction of implementing and maintaining internal controls that work effectively. Maintaining these internal controls provides greater integrity to the financial reports of companies that trade in the U.S. public markets. The accuracy of financial reports enables investors to have the opportunity to better assess the risks and rewards for their investments.

Through this letter, CalPERS strongly recommends that the Commission and PCAOB not weaken investor protections which are designed to strengthen the integrity of financial reporting and provided for in the Sarbanes-Oxley Act. The Sarbanes-Oxley Act does not make any distinction based on a publicly traded company's size or complexity. CalPERS believes it would be inappropriate to provide any company, including micro and small capitalization companies, relief from complying with Section 404 of Sarbanes-Oxley. We specifically do not see the need to emphasize the scaling or tailoring of evaluation methods, extension periods, and procedures based solely on company size limits.

Providing relief or exemptions from compliance with Section 404 of Sarbanes-Oxley would undermine the integrity of financial statements on which investors rely. Therefore, we believe one standard is needed for all publicly traded companies in order to maintain investor confidence in the financial reporting framework of the capital markets.

CalPERS is prepared to provide assistance to the SEC at its request. Please contact Christianna Wood, Senior Investment Officer – CalPERS Global Equity, at (916) 795-0209 if there are any questions or if we can be of further assistance.

Sincerely,

cc: Fred Buenrostro, Chief Executive Officer, CalPERS
Anne Stausboll, Chief Operating Investment Officer, CalPERS
Christianna Wood, Senior Investment Officer, CalPERS
Peter Mixon, General Counsel, CalPERS
Dennis Johnson, Senor Portfolio Manager, CalPERS

Tatum™
Create more value.

December 17, 2007

Via email to:

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

RE: Preliminary Staff Views – October 17, 2007

Dear Office of the Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) Preliminary Staff Views – An Audit of Internal Control that Is Integrated with an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies.

Tatum LLC is the largest and fastest-growing executive services firm in the Unites States providing clients with, among other professional services, Sarbanes-Oxley compliance and consulting services. Tatum, like many other professional services firms, has been on the frontline with the Sarbanes-Oxley Act since it was passed in 2002. This experience has enabled us to see full well the challenges that companies have faced and are currently experiencing with initial compliance as well as on-going monitoring.

Overall, we believe that the adoption of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting that Is Integrated with an Audit of Financial Statements* (AS 5) will have a significant impact on the way in which auditors perform their audits of the financial statements and internal control over financial reporting (ICFR). In our letter dated February 26, 2007 in connection with the proposed AS 5 (PCAOB Rulemaking Docket Matter No. 021), a number of our comments related to providing more specific and practical guidance and examples, particularly in the area of integrating the audits and scaling for smaller companies. We applaud the PCAOB's effort to provide practical guidance for implementing AS 5 to audits of smaller, less complex organizations.

Following are our observations and suggestions for your consideration. We have organized them into the two specific questions posed in the invitation to comment.

Responses related to Question 1 – Does the guidance in this publication, including the examples, appropriately consider the environment of the smaller, less complex company? If not, what changes are needed?

For the most part, the guidance and examples in the publication appear to adequately consider the control environment of smaller, less complex companies. While page five of the document clearly states that it is "not intended as guidance to management regarding establishing or evaluating internal controls over financial reporting," it is important to note that, in practice, auditors will refer to the examples in attempting to identify controls and in making control recommendations to management. In addition, while there are specific and appropriate references to, and adaptations of, the COSO Guidance for Small Businesses, companies that wish to increase or maximize auditor reliance on the work performed by management or others on behalf of management will also refer to this guidance to facilitate those discussions. We have provided suggestions below related to certain examples contained in the Staff Views that may present practical challenges or that we believe warrant additional clarification.

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Example 2-2
The entity-level control in this scenario could operate at a slightly lower level in a more complex company while arguably having the same impact on the testing of other controls. To illustrate, the CFO who has a thorough understanding of the business processes, including payroll, performs a review of the weekly payroll summary reports prepared by the centralized accounting function, identifies improprieties and investigates whether misstatements have occurred. At a larger more complex company, the same review may be performed by a divisional controller who has a comparable level of knowledge of the divisional business processes, including hiring and terminations of the division. All facts being identical, it would seem that the auditor could conclude that the review by the divisional controller could detect misstatements related to payroll processing of the division.

Example 3-1
With respect to some of the controls noted in Example 3-1, we have found in practice that many companies, under the guidance of general counsel, have implemented strong risk management and documentation policies that limit retention and detailed documentation of certain information that may include detailed minutes of executive session. We recommend acknowledgement of this and/or modification of the example to include more reliance on inquiry and observation (as appropriate) in these situations and reference to the use of agendas versus minutes (if no minutes are kept for these particular meetings or not kept in sufficient detail).

Example 5-1
The current wording in the Audit Approach section may create confusion, particularly in the second main bullet. We believe this example needs to clarify that the controls being tested (to establish reliability of reports) relate to those reports used in the "alternative control" (senior management's reviews and analysis), not the controls over transaction processing (thus reports generated) that were deemed ineffective due to incompatible duties (e.g., lack of SOD). In addition, we suggest that the example be expanded to include examples of those reports and/or controls including analytics (KPIs or other) that are of a sufficient precision and reliability.

On page 36, the first full paragraph and bullets relate to use of outside professionals, and the third bullet specifically states that "Management is not required to possess the expertise to perform or re-perform the services." We have observed significant challenges in this area in practice and believe that more detailed practical examples (in addition to example 6-1) are warranted. Some specific examples that may be helpful are situations where the company uses an outside party for assistance in accounting for stock compensation in accordance with FAS 123R, financial instruments such as derivatives or hedging (not as a service organization), FIN 46 analysis, and/or for financial statement preparation. Example 6-1 refers to a situation where the company prepares a preliminary provision, we suggest an example in which the company doesn't prepare it, but rather, the outside firm/party prepares the provisions and related deferred asset/liability information and the company reviews it as this is what we typically see most often in practice with smaller companies. Please see additional comments below related to Example 6-1.

Example 6-1
The Audit Approach section refers to confirmation that the data used by the third-party is complete and accurate; however, we suggest that the "scenario" section should also contain reference to this as the facts must exist in the scenario in order to be considered in the Audit Approach. In addition, we have often seen a lack of controls in this area (confirming that final financial information was used) particularly in companies that are very spreadsheet and/or top-side adjustment driven because version control issues may lead to inaccurate or preliminary data being used in the calculation. This is typical in smaller, less sophisticated organizations.

Example 7-1
We recommend expanding the example to encourage consideration of any existing documentation, including desk reference or notes used by the person who performs the control and/or any documentation created in support of management's assessment of ICFR. Similar comments are made throughout this letter with respect to encouraging auditors to consider the availability and **substance** of existing documentation rather than the **form** to improve efficiency and limit inefficient or unnecessary procedures on their part that simply serve to create additional/duplicative documentation in a different form.

Example 7-2
Understandably, many auditors have historically been reluctant to place reliance on controls in which there is little or no documented evidence of occurrence, especially for high risk pervasive controls. Example 7-2 provides an audit strategy related to how an auditor may obtain evidence for the period-end financial reporting process through inquiry with the CFO, review of comments sent to the controller and observing the CFO's review with the audit committee. Given that the audit evidence will be comprised primarily of inquiry and observation, many auditors may feel that the evidence is not sufficient given the significance of the CFO's review and the risk associated with the period-end financial reporting process, as well as current audit requirements in connection with evaluating the financial statement close process.

As previously noted, (1) these examples will be referred to by auditors in making recommendations to management, and (2) we have observed in practice that many companies have implemented strong policies related to retention/destruction of prior versions of financial statements and related notes. Therefore, the description of the control in which the CFO retains copies of prior versions of the financial statements with her notes may not be practical or appropriate as the evidence may only exist at a certain point in time. We recommend modification of the example to acknowledge this and/or to provide additional guidance that refers to the many meetings or conversations, and related changes or journal entries that occur throughout the review process. Thus demonstrating that much of the evidence may be provided through inquiry and observation including the auditor involvement in the process of reviewing the black-line versions of the financial statements and related filings at the time they are generated. In addition, the example could refer to guidance provided elsewhere in the Staff Views regarding evidence that only exists at a certain point in time.

We recommend additional examples or guidance related to certain matters within the responses related to question 2 below.

Responses related to Question 2 – Are there additional audit strategies or examples that the staff should consider including in this publication? If so, please provide details.

We recommend stronger guidance and more frequent reference related to consideration of documentation and evidence of control design that exists within the company – particularly documentation that may have been developed in connection with and in support of management's assessment report. This guidance should include practical examples and strong language related to considering the content and substance of the documentation over the form. As briefly noted in comments related to Example 7-1 above, we have experienced situations in which auditors have refused or have been reluctant to "accept" documentation prepared by the company if it is not in the form contemplated by their historical approach or their audit methodology. For example, for a relatively non-complex, lower risk process, management may have developed a risk and control matrix that identified the individual risks and controls over financial reporting associated with the specific relevant assertions; however, the auditors insisted that a detailed narrative (and in some cases a flow diagram) was also necessary in order for them to use or rely on the work performed by the company. In certain cases, auditors attempted to "prescribe" the format the company should use to document controls and/or in the absence of compliance with their request, they may perform additional work to develop this documentation resulting in a largely duplicative and inefficient effort. In addition, certain auditors provided comments to companies requesting grammatical or editorial changes to the company's documentation. This information may be particularly relevant within the Audit Strategy Considerations section (see additional comments related to that section further below)

We also recommend that additional examples and guidance be provided with respect to tailoring the audit approach related to the audit of ICFR versus the audit of the financial statements when controls change during the year. We believe this is an area where greater efficiency and effectiveness could be gained with proper examples. We have observed situations where auditors applied the same control testing criteria (e.g., sample sizes, nature, timing and extent) to both the controls in place earlier in the year and those in place at the end of the year. It has not always been apparent and they have not always been able to articulate that there was a corresponding reduction in substantive procedures either under the previous or the latest control structure; therefore, the effort appeared largely duplicative. While this certainly applies to larger organizations (especially those involved in M&A activity), it is particularly important in smaller organizations that are experiencing rapid growth because their control environments are often dynamic with frequent changes in personnel, operations, business processes, and IT systems. Paragraph 3 on page 10, as currently worded, may create additional confusion regarding this matter. We recommend additional language and examples related to effective and efficient audit strategies in these situations.

On page 10, the last two paragraphs may create confusion when compared and contrasted because the last paragraph implies that if the auditor determines substantive procedures are more effective and efficient than relying on controls, they may test fewer controls in support of the ICFR opinion; however, it is not clear whether that means a fewer number of individual key controls overall will be tested or that sample sizes may be reduced. This comment also applies to the last paragraph on page 40 that refers to choosing to test one of two controls, that being the one for which evidence can be obtained more readily. In practice, we have observed that audit firms generally tend to test **all** key controls for purposes of the ICFR opinion and that they have fairly standard sample sizes and metrics related to testing those controls for the purposes of an opinion on ICFR, thus this very individualized approach seems very challenging to implement and to evaluate from an effectiveness and efficiency standpoint. This may improve as AS 5 implementation progresses, but specific and practical guidance would serve to further this effort.

There are a number of paragraphs within the guidance that refer to whether controls are designed or operating effectively to "prevent or detect on a timely basis misstatements in one or more assertions that could cause the financial statements to be materially misstated." We believe that more of these paragraphs should also include reference to the timely correction of errors that are detected. In practice we have observed controls that appear to be adequately designed and operating, but upon further investigation, the identified errors were not resolved in a timely manner. For example reconciling items may have been identified on a timely basis, but they continued to be carried forward on reconciliations in multiple periods. This comment is particularly relevant to page 14 within the full paragraph as well as the bullet related to purpose of the control.

On Page 32, the second paragraph under Application Controls could be clarified to indicate whether the "test fewer items" reference refers to testing fewer controls overall or to reducing sample size.

We recommend that the Audit Strategy Considerations section and related examples on pages 38 – 42 be expanded to address reliance strategies in sufficient detail, both as it relates to documentation of the design of controls as well as testing/evaluation documentation. With respect to our previous comments regarding substance versus form of control design documentation, we specifically suggest expanded discussion and examples related to how the auditor may use the documentation of controls design created by management in connection with their evaluation for purposes of management's assessment. We also suggest additional guidance regarding strategies for using the work of others within smaller organizations, particularly as it relates to walkthroughs and testing. While we have generally seen significant improvements in both of

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these areas over the years, this guidance applies to all audits of ICFR, regardless of size and complexity. However, there are additional effectiveness and efficiency considerations as it relates to smaller organizations because some may benefit greatly from increased reliance, while others may not. Some of this is certainly addressed in the guidance on using the work of others; however, given the limited resources of smaller organizations, they often face unique challenges in obtaining the level of "competent, objective and independent" testing evidence at a sufficient level to maximize auditor reliance. In addition, we recommend expanding the paragraph at the top of page 40 to include some additional practical scenarios and examples.

In connection with the first comment in this section (responses to question 2), with respect to the Appendix, we suggest that significant discussion be added related to using evidence available in connection with management's assessment. For example, the planning and risk assessment sections contain no reference to review, coordination or discussion of management's materiality, risk assessment and scoping activities as a basis or validation of the auditors activities. The approach as currently documented implies that the auditor's activities should occur independently and without any consideration of management's work or the work performed on behalf of management. This comment is applicable to the entire appendix because except for one minor comment in the first paragraph on page 51, references to using the work of others or information available from management's assessment is absent. In order to fully reconfirm the guidance in AS 5, we encourage adding these points of consideration and communication to the entire discussion throughout the Appendix as we have observed in practice that open communication between management and the auditors early and often, and proper planning to reduce duplicative and inefficiencies enhances the effectiveness and efficiency of the compliance and audit effort.

Overall, the guidance provides audit strategies that are tailored to the smaller company environment. However, we believe that the challenge will be in the implementation of the guidance as most public accounting firms have a fairly standardized audit methodology that is used for all audits of internal control regardless of size or complexity as it generally promotes quality and consistency. In developing their audit strategies, most auditors will feel compelled to ensure that their audit is in compliance with their firm's methodology and will generally only consider alternative procedures when their methodology allows such judgment to occur and provides sufficient guidance. Unless audit firms are able to update their audit methodology in a timely manner and provide for the consideration of the audit strategies proposed in the guidance for smaller, less complex companies, many auditors may not fully implement the recommendations.

We believe that some of the provisions of the Staff Views publication, especially those regarding the use of entity-level controls to achieve control objectives, are applicable to all audits regardless of size and complexity, and encourage the PCAOB to consider providing additional practical guidance that can be used for all audits.

We appreciate the efforts being made by the PCAOB to ensure audit quality and efficiency. Again, we appreciate the opportunity to comment on the preliminary staff views and are available to talk or meet with you to clarify any of our comments.

Sincerely,

Kathy Schrock

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December 17, 2007

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

Preliminary Staff Views – October 17, 2007

Dear Office of the Secretary:

Ernst & Young LLP is pleased to comment on the “Preliminary Staff Views – An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies” (Staff Views) publication developed by the staff of the Board’s Office of the Chief Auditor.

We strongly support the Board’s efforts to develop guidance for auditors of smaller public companies and believe the Staff Views will help increase the effectiveness and efficiency of integrated audits of smaller public companies, particularly non-accelerated filers implementing Section 404 for the first time. We believe the Staff Views appropriately considers the environment of smaller, less complex companies and that each topical chapter provides useful guidance, including examples, of how certain principles in PCAOB Auditing Standard No. 5 (AS5) are scalable based upon a company’s size and complexity. Furthermore, we believe the guidance and examples included in the Staff Views also will aid the effectiveness and efficiency of integrated audits of some larger, less complex companies, particularly those with locations or business units that have characteristics of smaller businesses.

The guidance included in the Staff Views was developed with the assistance of a working group of experienced auditors and other parties who helped to both identify issues posing particular challenges in audits of smaller, less complex public companies and provide insights and examples relevant to addressing such issues. We commend the Office of the Chief Auditor’s efforts to organize such a working group, which we believe enhanced the quality of the Staff Views publication. We strongly support such a process to help the PCAOB staff in developing guidance for auditors and urge the Board to identify appropriate opportunities for similar working groups in the future.

We provide below our general and detailed comments to address the questions included in the Invitation to Comment.

General Comments

We note the guidance provided to auditors in the Staff Views uses certain statements such as "should" and "must." We believe the Staff Views should clarify whether these unconditional and presumptively mandatory performance requirements draw from or repeat the requirements of existing PCAOB auditing standards. To the extent that such statements simply repeat language in existing standards, we believe the Staff Views should include appropriate citations.

We believe the illustrative examples included in the Staff Views are relevant and will generally be helpful to auditors of smaller, less complex public companies. However, we believe the Staff Views could benefit from additional illustrative examples, and encourage the Board to continue to explore ways to gather practical examples from both issuers and auditors.

The Appendix to the Staff Views illustrates one approach for integrating the audit of internal control with the audit of the financial statements. We are unclear as to the intended use of the Appendix by auditors of smaller public companies and therefore question its usefulness. If the intent of the Appendix is simply to illustrate the aspects of the integrated audit where decisions affecting the audit of the financial statements also affect the audit of internal control, and vice versa, we believe auditors would benefit by having that point explicitly stated in the Appendix. Without that frame of reference, auditors might be confused as to how the approach described in the Staff Views aligns with the overall requirements of an integrated audit in AS5. Moreover, auditors with less experience in performing integrated audits might wonder what other approaches are appropriate besides the "one approach" described in the Appendix. Accordingly, we recommend that the staff either provide additional clarity on the intended use of the Appendix or consider removing it altogether.

Detailed Comments

<u>Tests of Controls in an Integrated Audit</u> (Chapter 1, Page 10 of 52)

We agree that, in an integrated audit, the auditor could decide to test controls of certain relevant assertions only as necessary to support his or her opinion on the company's internal control over financial reporting at year end (i.e., obtain evidence that internal control has operated effectively for a sufficient period, which may be less than the entire period covered by the financial statements) and assess control risk at the maximum for purposes of the financial statement audit. However, we believe the following aspects of the guidance to auditors in the third paragraph on page 10 are not sufficiently clear as to the auditor's decisions regarding tests of controls:

- The paragraph refers several times to the auditor's decision about "relying on controls" without making it clear that this decision is solely for purposes of the financial statement audit. For example, the paragraph states the auditor "might perform primarily substantive tests of the assertions without relying on controls" which, absent clarification, could be misinterpreted by some auditors as suggesting that no control testing in an integrated audit might be an acceptable strategy.

- The paragraph suggests that the auditor might perform primarily substantive tests of the assertions without relying on controls because of the nature of the risks of misstatement. However, neither the Staff Views nor AS5 describe how the nature of the risks of misstatement might influence the auditor's decision in this regard. We believe the auditor's decision with respect to testing controls for purposes of the financial statement audit should be primarily guided by whether controls are expected to have operated effectively throughout the period of reliance, and the auditor's judgment as to the effectiveness and efficiency of the approach.

- The example provided in the third paragraph also is potentially confusing by discussing different testing strategies for controls over the billings of a company and controls over revenue recognition. In our experience, especially for smaller or less complex companies, controls within these processes are much more likely to be common. Further, if the Staff Views is meant to convey that an auditor might take different approaches to control testing and reliance on controls for different relevant assertions, we believe this particular example makes the illustration of this concept difficult to understand.

<u>Considering the Effect of Pervasive Control Deficiencies</u> (Chapter 8, Page 44 of 52)

We agree with the Staff Views that some pervasive control deficiencies could be so severe that they render the design of other controls ineffective or prevent other controls from operating effectively. Additionally, we agree that when such pervasive control deficiencies are present, the auditor can take such deficiencies into account when planning the audit. However, absent further discussion, clarification, and illustration, we believe there is a risk that auditors might conclude too quickly that certain entity-level control deficiencies are pervasive, and therefore conclude that no further testing of other controls is needed or appropriate, without fully considering how other controls are affected.

Specifically, we believe the following aspects of the guidance are not sufficiently clear regarding the auditor's decisions with regard to pervasive control deficiencies:

- The four bullet points on page 44 provide examples of certain deficient entity-level controls that, because of their pervasiveness, might impair the effectiveness of other controls over relevant assertions. However, other than in the first bullet point, there is no indication of whether the deficient entity-level controls would render the design of other controls ineffective and/or prevent them from operating effectively, nor are any examples provided to illustrate this linkage. We recommend the discussion of each bullet point on page 44 be enhanced to clearly describe and illustrate how that entity-level control deficiency could impair the effectiveness of other controls (i.e., by rendering their design ineffective, or preventing them from operating effectively).

- The last paragraph of page 44 includes a discussion of how the auditor might modify his or her strategy when pervasive control deficiencies are believed to impair the effectiveness of other controls. However, the discussion of the principles the auditor would apply when modifying his or her strategy is unclear. The last paragraph suggests that the inquiries and observations during walkthroughs might provide enough evidence to conclude design ineffectiveness but then states "In some cases, limited testing of a control might be necessary to conclude that a control is not operating effectively." We believe it is unclear from this statement what the nature or extent of the auditor's control testing might be in these circumstances.

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

Ernst + Young LLP

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December 17, 2007

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

Via e-mail: comments@pcaobus.org

Re: Preliminary Staff Views – October 17, 2007, *An Audit of Internal Control That is Integrated with an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies*

Dear Board Members and Staff,

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") Preliminary Staff Views, *An Audit of Internal Control That is Integrated with an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies* ("Preliminary Staff Views").

We support the issuance of the Preliminary Staff Views and believe, except as otherwise expressed herein, it appropriately summarizes the unique circumstances in which smaller, less complex companies and their auditors find themselves. Because the document formalizes how auditors can address these circumstances based on previous experience, discussions amongst other firms and smaller, less complex companies, and the PCAOB staff, we believe it will promote consistency in the performance of integrated audits. We also believe it will assist companies in further understanding the affect these circumstances have on the integrated audit.

We respectfully submit our responses to your specific questions below. Additional comments, concerns, and recommendations are presented in Appendix B.

1. Does the guidance in this publication, including the examples, appropriately consider the environment of the smaller, less complex company? If not, what changes are needed?

   Except as otherwise expressed herein, the Preliminary Staff Views appropriately considers the environment of smaller, less complex companies. However, we suggest the staff reconsider the tone of the document by further clarifying that audits of smaller, less complex companies may require a greater work effort due to the unique circumstances that present themselves in such audits and that auditors are required to comply with professional standards, regardless of the company's size or complexity.

In addition, to further enhance and clarify the document, we believe the staff should:

- Clarify that the guidance can be applied to all companies, regardless of size or complexity, if the situation or circumstance exists.
- Provide a better link and discussion of the *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934,* particularly as it relates to Chapter 7.

Our specific comments on these matters are discussed further in Appendix A of this letter.

2. Are there additional audit strategies or examples that the staff should consider including in this publication? If so, please provide details.

   We do not have specific recommendations for additional audit strategies or examples. However, we believe the examples used, throughout the publication, need additional clarification. Primarily, the examples should indicate the risk being addressed and the controls related to the relevant assertion being tested. Without such details, we fear that some auditors may incorrectly assume that other testing to determine operating effectiveness is not necessary or required.

We would be pleased to discuss our comments with you. If you have any questions, please contact Mr. John L. Archambault, Managing Partner of Professional Standards, at (312) 602-8701, or Mr. Keith O. Newton, National Partner in Charge - Audit Methodology at (312) 602-9001.

Very truly yours,

Grant Thornton LLP

Grant Thornton LLP

Appendix A – Other Recommendations

Introduction

We believe the staff should further clarify that the Preliminary Staff Views is written on the premise that it applies to smaller, less complex companies. However, many of the concepts and much of the guidance therein can be equally applied to audits of other companies, regardless of size or complexity. We believe this to be true because even a large, complex company may have simple operations in certain areas. Accordingly, the guidance can be applied if the situation or circumstance exists.

Chapter 2

Page	Proposed Text	Recommendation
12	In smaller, less complex companies, senior management often is involved in many day-to-day business activities and performs many important controls. Consequently, through the evaluation of entity-level controls, the auditor can obtain a substantial amount of evidence about the effectiveness of internal control.	As indicated in our comments on paragraph 24 of Chapter 4, we do not believe a control activity performed by senior management makes it an entity-level control. The control still operates at the activity level. We believe it would be helpful to provide additional guidance in this area (see our comments below), as these statements combined, particularly the phrase “a substantial amount of evidence,” may be misinterpreted to permit the auditor to simply test “entity-level” controls performed by senior management.
15	*Criteria for investigation.* For detective controls, the threshold for investigating deviations or differences from expectations relative to materiality is an indication of a control’s precision. For example, a control that investigates items that are near the threshold for financial statement materiality has less precision and a greater risk of failing to prevent or detect misstatements that could be material than a control with a lower threshold for investigation.	It may be helpful to clarify the reference to materiality. For instance, the auditor considers the threshold used by the entity in investigating deviations or differences. This threshold is then compared to the auditor’s evaluation of materiality in order to evaluate the level of precision from the auditor’s perspective.
15	Example 2-1 – Monitoring the Effectiveness of Other Controls	To clarify this example, we believe the staff should expand on the phrase “periodically reviews” and on how such reviews influence the auditor’s risk assessment. Further, it would be helpful to explain how the auditor could reduce his or her direct testing and why this approach would be more effective than testing the reconciliation controls themselves.

16	Example 2-2 – Entity-Level Controls Related to Payroll Processing	The example should more clearly show the nature of a precise review that might influence the auditor's scope. Without a more detailed example of precision, some may be left with the impression that a high level quarterly budget-to-actual comparison might be enough to significantly influence the audit scope.

Chapter 3

Page	Proposed Text	Recommendation
19	Smaller, less complex companies can take a number of actions to address the risk of management override. The following are examples of some of the controls that a smaller, less complex company might implement to address the risk of management override – • Maintaining integrity and ethical values • Increased oversight by the audit committee • Whistleblower program • Monitoring of controls over certain journal entries	We believe the list of items indicated in this statement applies to all companies, regardless of size and complexity. In addition, we believe the list can be expanded to include monitoring controls performed directly by senior management, not just monitoring controls over certain journal entries.
20	An active and independent audit committee (or board of directors, if the company has no audit committee) evaluates the risk of management override, including identifying areas in which management override of internal control could occur, and assesses whether those risks are appropriately addressed within the company. As part of their oversight duties, the audit committee might perform duties such as meeting with management to discuss significant accounting estimates and reviewing the reasonableness of significant assumptions and judgments.	We believe that smaller, less complex companies may face certain challenges in attracting the appropriate individuals with the necessary skills to properly oversee the financial reporting process, including management. Accordingly, the staff should include additional guidance in evaluating the board of directors, if the company has no audit committee. This is essential guidance that needs to be incorporated in order for the auditor to properly respond to the risk of management override.
21	Section entitled "Considering the Effects of Other Evidence"	We believe this section, with slight modification, may be better positioned at the beginning of the Chapter.
20	Section entitled "Evaluating Audit Committee Oversight"	To further enhance the discussion on evaluating audit committee oversight, we believe the guidance should refer back to the list of examples a company ordinarily implements to address the risk of

		management override (page 19). In that regard, the auditor may perform further inquiries to determine the extent to which, for example, the audit committee monitors controls over journal entries.
22	Example 3-1 – Audit Committee Assessment of Risk of Override	Because we believe that effective audit committee oversight is essential to mitigate the risk of management override, this example should be more robust. We do not believe it adequately captures the work effort needed by the audit committee to achieve effective oversight.

Chapter 4

Page	Proposed Text	Recommendation
23	Other small, less complex companies might implement alternative controls intended to achieve the same objectives as segregation of duties for certain processes.	In this statement, and throughout this Chapter, we note the use of the term "alternative controls" in lieu of the term "compensating controls," which is used in the Committee of Sponsoring Organization's *Internal Control – Integrated Framework: Guidance for Smaller Public Companies Reporting on Internal Control Over Financial Reporting* (COSO Small Companies Guidance). We understand that both "alternative controls" and "compensating controls" are used in AS 5. However, we believe additional guidance may be needed to clarify any perceived difference in these two terms.
24	Section entitled "Use of External Resources"	We believe additional clarification is needed with regard to the use of external resources, particularly the difference between the use of service organizations, outside professionals (as discussed in Chapter 6), and other external sources. In this regard, we believe the guidance should be focused on the use of these "other external sources," as there is a difference between a temporary employee, an outsourced internal audit function, and other functions that are performed "externally" by an outsourced service provider.
24	Section entitled "Management Oversight and Review"	We believe this section appropriately highlights the compensating controls performed by management, as outlined in the COSO Small Companies Guidance. However, to further clarify the point that

		these "management activities could be entity-level controls," we suggest the document further discuss these matters as monitoring activities or control activities. A control activity performed by management is not necessarily an entity-level control. Many of the examples provided herein can be either monitoring activities (an entity-level control) or control activities, depending on the purpose of the activity. Although it is not necessary to "classify" the control, we believe it is important for the auditor to understand the different types of controls, and the purpose with which they are being performed, in order to select the appropriate controls to test and to evaluate the severity of the identified deficiencies.
25	If the auditor applies a top-down approach, starting at the financial statement level and evaluating entity-level controls, the auditor might identify controls that address the risk of misstatement for one or more relevant assertions. In those cases, the auditor could select and test those entity-level controls rather than test the process controls that could be affected by inadequate segregation of duties.	Although we agree that it may be possible that an entity has an entity-level control that could be tested in such a manner, we suggest the staff clearly state that such an entity-level control would need to operate at a level of precision to detect or prevent a material misstatement, as described in Chapter 2 (page 14). We believe that if this is not clarified, auditors may inappropriately test "entity-level" controls that do not operate at a sufficient level of precision to justify the exclusion of any controls at the activity level.
25	Example 4-1 – Alternative Controls over Inventory	We suggest the staff reconsider the example. We do not fully understand the segregation of duties deficiency, especially with regard to how the individual responsible for the components has access to the related accounting records when appropriate information technology access controls have been implemented.

Chapter 5

We believe this Chapter inappropriately equates "smaller" with "less complex." Information technology (IT) is not size dependent and auditors should evaluate the complexity of IT systems, regardless of company size. The comments below further illustrate our concerns on this matter.

Page	Proposed Text	Recommendation
26	Software. The company typically uses off-the-shelf packaged software without modification. The packaged software	We believe this gives a false impression that off-the-shelf packaged software has, by default, functional integrity and that

	requires relatively little user configuration to implement.	automated controls and control reporting are sufficient. We believe the risks associated with each application should be evaluated based on the circumstances. In addition, even with off-the-shelf packaged software, the entity must configure security access, among others. This creates risks that the auditor should evaluate.
26	Systems configurations. Computer systems tend to be centralized in a single location, and there are a limited number of interfaces into the system.	We suggest replacing the phrases “tend to be” and “are” with the phrase “may be.” It also may be helpful to reconsider the language in this Chapter to remove other blanket generalizations about IT systems at smaller, less complex companies.
26	End-user computing. The company is relatively more dependent on spreadsheets and other user-developed applications, which are used to process, accumulate, summarize, and report the results of business operations, and perform straightforward calculations using relatively simple formulas.	We believe this suggests that spreadsheets tend to be simple and have lower risk. However, spreadsheets may create complexity and can be a source of increased financial reporting risk.
28	For example, even the simplest IT environments generally rely on access controls to prevent unauthorized changes to data, controls to make sure that necessary software updates are appropriately installed, and controls over backups of data necessary for financial statement preparation.	We believe backup and recovery controls are more granular versions of disaster and business recovery, rather than security and change controls. Accordingly, we believe the staff should consider substituting “controls over backups and data necessary for financial statement preparation” with “controls over the execution of programs.”
28	Many controls that smaller, less complex companies rely on are manual controls. Some of those controls are designed to use information in reports generated by IT systems, and the effectiveness of those controls depend on the accuracy and completeness of the information in the reports.	Many smaller companies place excessive reliance on manual controls that do not have the capacity to detect IT application processing errors. This is a risk that companies, as well as their auditors, face (i.e., placing undue reliance on user controls). This matter should be clarified and discussed further.
29	In some situations, an automated or IT-dependent control might be effective even if deficiencies exist in IT general controls. For example, despite the presence of deficient program change controls, the auditor might directly test the related automated control, giving consideration to the risk associated with the deficient change controls in his or her risk assessment and audit strategy. If the testing results were satisfactory, the auditor could	We would like the staff to consider another scenario that illustrates that while IT general controls are operating effectively during the period, no untested assumptions can be made regarding the functional integrity of applications, controls and data. For example, a legacy system may not process transactions in accordance with management’s expectations, and controls may be insufficient to prevent or detect processing errors. Strong IT general controls in the

	conclude that the automated controls operated effectively at that point in time. On the other hand, deficient program change controls might result in unauthorized changes to application controls, in which case the auditor could conclude that the application controls are ineffective.	current audit period can provide assurance that the application functions consistently during the period, but not necessarily correctly.
30	Section entitled "Categories of IT Controls"	This section may be better suited as an appendix or at the beginning of the Chapter. Alternatively, a reference to this section at the beginning of the Chapter may suffice.
31	A smaller, less complex IT environment typically includes a single or small number of off-the-shelf packaged applications that do not allow for modification of source code.	This describes IT applications used by smaller, less complex companies in a way that suggests they are inherently simple and represent low-risk. While some companies do not own the source code for IT applications, they frequently have the ability to configure system functions and reports. In addition, many companies employ report-writers that can emulate application-generated reports without the functional integrity and controls of the underlying IT application.

Chapter 6

We note this Chapter uses various terms to describe how the company supplements in-house competencies, such as through the use of service providers, outside professionals, and outside accounting professionals. We suggest the staff reconsider the consistent use of terms.

Page	Proposed Text	Recommendation
36	Whether management has established controls over the work of the outside accounting professional (e.g., controls over the exchange of information and controls to test their work) and over the completeness and accuracy of the information provided to the outside professional.	It would be helpful to provide additional guidance on the controls the company would implement to test the work performed by the outside professional. We believe these procedures may include inquiries of the professional with regard to their skills and competencies and their monitoring and review procedures, and inquiries specific to their work. Such procedures may also include a review of the work performed by the professional, including recalculations, as deemed necessary or appropriate.

37	Example 6-1 – Audit Approach: The auditor observes that management identifies risks to financial reporting related to accounting for income taxes and engages a qualified professional to provide technical assistance. Further, the auditor inspects the engagement letter, other correspondence between the company and the third-party firm, and the tax schedules and other information produced by the third-party firm. The auditor also evaluates the controls over the completeness and accuracy of the information furnished by the company to the third-party firm. The auditor also assesses whether the third-party accounting firm has the proper skills and staff assigned to do this work.	In this example, it is not clear what the auditor is testing and for what purpose. Particularly, the example only captures some of the matters identified on page 36 that may be considered in determining the company's controls over how events and transactions are properly accounted for and whether the financial statements are free of material misstatement when the company uses an outside professional. We believe these matters might be contemplated within the auditor's inspection of the engagement letter, other correspondence or information, and the tax schedules; however, the purpose of such inspection is not delineated.

Chapter 7

As a general comment, it may be helpful to provide guidance with regard to what constitutes formal versus less formal documentation. In addition, the section entitled "Other Considerations" could be positioned at the beginning of the Chapter.

Page	Proposed Text	Recommendation
40	If the Company does not have formal documentation of its processes and controls, the auditor may consider whether other documentation is available before drafting formal descriptions of processes and controls for the audit documentation.	With regard to this statement, it should be noted that the *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* clarifies management's responsibility for maintaining documentation in support of its assessment. We believe it is imperative to reference and consider this guidance and to caution auditors about preparing "formal" documentation for audit purposes so as to not perform a management function.

Chapter 8

Page	Proposed Text	Recommendation
43	Ordinarily, the auditor's strategy should include tests of controls necessary to support a conclusion that internal control over financial reporting is effective.	We believe this sentence may be taken out of context. Accordingly, we suggest replacing the sentence with the following: In an audit of internal control, the auditor obtains evidence about the effectiveness of controls by performing tests of selected controls over relevant assertions.
44	A control that is frequently overridden is	We believe when a control is inappropriately

	less likely to operate effectively.	overridden and not caught within a reasonable period of time, the control is ineffective – not "less likely to operate effectively."