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,
Frank Gorrell, MSA, CPA

Frank Gorrell, MSA, CPA