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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

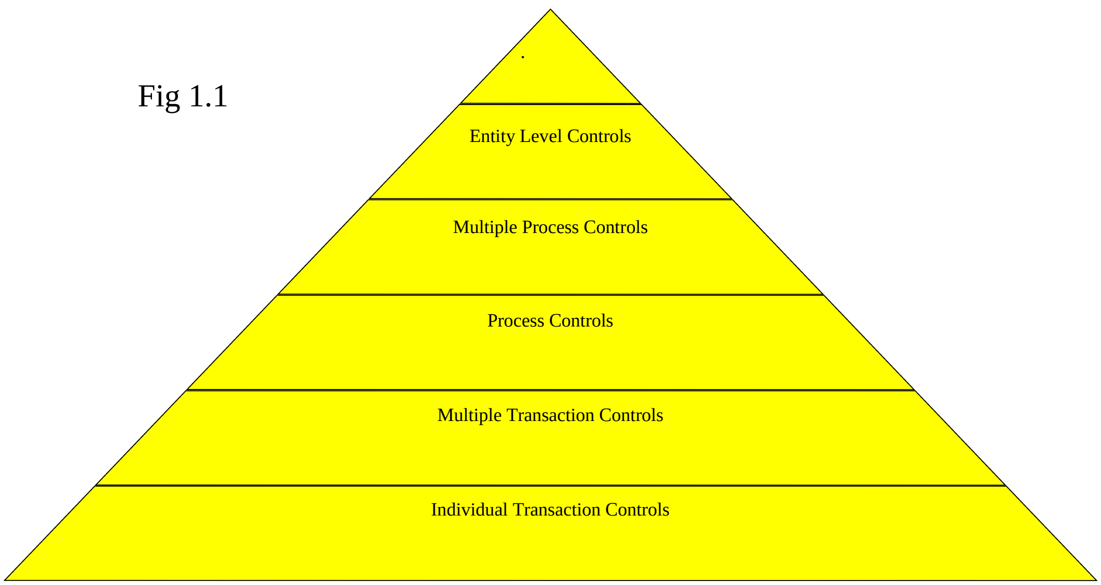
> "Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test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

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
<u>*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*</u>

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.

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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.