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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,

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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."