

December 14, 2007

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

Staff Questions in the Release

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.

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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, 3 rd paragraph (the sentence that begins “For example ...”)	<p>We recommend revising this example.</p> <p>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.</p> <p>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 restatements¹ and a frequent source of fraudulent financial reporting.²</p>
Page 11	<p>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.”</p> <p>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</p>

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.

	<p>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.</p>
Chapter 2	Evaluating Entity-Level Controls
Page 14 1 st paragraph (Factors that auditors ...)	<p>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.</p> <p>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.</p> <p>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.</p>
Page 16 Example 2-1	<p>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.</p>
Page 16 Example 2-2	<p>We recommend revising this example.</p> <p>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.</p> <p>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”?</p> <p>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</p>

	<p>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.</p> <p>A better example would be that the CFO is <i>not</i> 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.</p> <p>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.</p>
<p>Chapter 3</p>	<p>Assessing the Risk of Management Override and Evaluating Mitigating Actions</p>
<p>Page 19, Evaluating Mitigating Controls</p>	<p>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.</p>
<p>Page 22 Example 3-1</p>	<p>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.</p> <p>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.</p>
<p>Chapter 4</p>	<p>Evaluating Segregation of Duties and Alternative Controls</p>
<p>Page 25, Example 4-1</p>	<p>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?</p> <p>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.</p>

Chapter 5	Auditing IT Controls in a Less Complex IT Environment
Page 29, Example 5-1	<p>We recommend revising this example.</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p>
Page 30	<p>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.</p>
Page 31, 1 st paragraph (Tests of controls ...)	<p>This paragraph states the following:</p> <p>“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.”</p> <p>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.</p>
Chapter 6	Considering Financial Reporting Competencies and Their Effects on Internal Control
Page 36	<p>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</p>

	controls would be expected over the work of the outside accounting professional <i>beyond</i> 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	<p>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.</p> <p>For instance, part 3, section “d” of the SEC’s Final Rule, <i>Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports</i> states the following:</p> <p>“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.”</p> <p>Additionally parts A.1.e. and A.2.c. in the Commission’s <i>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</i> provides additional guidance regarding management’s documentation.</p>
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	<p>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.</p> <p>With respect to the approach, as this is an indirect entity- level control, inquiry, observation, and reviewing corroborative information seem appropriate. However, it</p>

	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.
Chapter 8	Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies
Page 43, last sentence in 2 nd paragraph	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.
Page 44, 4 th bullet	<p>In the context of “the following might impair the effectiveness of other controls over relevant assertions” the following is listed:</p> <p>“Frequent management override of controls. A control that is frequently overridden is less likely to operate effectively.”</p> <p>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.</p> <p>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.”</p>
Page 44, last paragraph	<p>Two sentences in the example are inconsistent. These sentences read as follows:</p> <p>“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.”</p> <p>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?</p> <p>We recommend that these sentences be replaced with the following clear statements:</p> <ul style="list-style-type: none"> ○ If a control is ineffectively designed, the auditor does not have to test for operating effectiveness. ○ 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.
Page 46	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.
Page 46	Example 8-1 should include a conclusion about the auditor’s report (similar to example 8-2)
Appendix	The Integrated Audit Process
Page 48; 2 nd paragraph	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.