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.

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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

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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.