

December 17, 2007

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, D.C. 20006-2803

### **Preliminary Staff Views – October 17, 2007**

Dear Office of the Secretary:

Ernst & Young LLP is pleased to comment on the “Preliminary Staff Views – An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies” (Staff Views) publication developed by the staff of the Board’s Office of the Chief Auditor.

We strongly support the Board’s efforts to develop guidance for auditors of smaller public companies and believe the Staff Views will help increase the effectiveness and efficiency of integrated audits of smaller public companies, particularly non-accelerated filers implementing Section 404 for the first time. We believe the Staff Views appropriately considers the environment of smaller, less complex companies and that each topical chapter provides useful guidance, including examples, of how certain principles in PCAOB Auditing Standard No. 5 (AS5) are scalable based upon a company’s size and complexity. Furthermore, we believe the guidance and examples included in the Staff Views also will aid the effectiveness and efficiency of integrated audits of some larger, less complex companies, particularly those with locations or business units that have characteristics of smaller businesses.

The guidance included in the Staff Views was developed with the assistance of a working group of experienced auditors and other parties who helped to both identify issues posing particular challenges in audits of smaller, less complex public companies and provide insights and examples relevant to addressing such issues. We commend the Office of the Chief Auditor’s efforts to organize such a working group, which we believe enhanced the quality of the Staff Views publication. We strongly support such a process to help the PCAOB staff in developing guidance for auditors and urge the Board to identify appropriate opportunities for similar working groups in the future.

We provide below our general and detailed comments to address the questions included in the Invitation to Comment.

## **General Comments**

We note the guidance provided to auditors in the Staff Views uses certain statements such as “should” and “must.” We believe the Staff Views should clarify whether these unconditional and presumptively mandatory performance requirements draw from or repeat the requirements of existing PCAOB auditing standards. To the extent that such statements simply repeat language in existing standards, we believe the Staff Views should include appropriate citations.

We believe the illustrative examples included in the Staff Views are relevant and will generally be helpful to auditors of smaller, less complex public companies. However, we believe the Staff Views could benefit from additional illustrative examples, and encourage the Board to continue to explore ways to gather practical examples from both issuers and auditors.

The Appendix to the Staff Views illustrates one approach for integrating the audit of internal control with the audit of the financial statements. We are unclear as to the intended use of the Appendix by auditors of smaller public companies and therefore question its usefulness. If the intent of the Appendix is simply to illustrate the aspects of the integrated audit where decisions affecting the audit of the financial statements also affect the audit of internal control, and vice versa, we believe auditors would benefit by having that point explicitly stated in the Appendix. Without that frame of reference, auditors might be confused as to how the approach described in the Staff Views aligns with the overall requirements of an integrated audit in AS5. Moreover, auditors with less experience in performing integrated audits might wonder what other approaches are appropriate besides the “one approach” described in the Appendix. Accordingly, we recommend that the staff either provide additional clarity on the intended use of the Appendix or consider removing it altogether.

## **Detailed Comments**

### Tests of Controls in an Integrated Audit (Chapter 1, Page 10 of 52)

We agree that, in an integrated audit, the auditor could decide to test controls of certain relevant assertions only as necessary to support his or her opinion on the company’s internal control over financial reporting at year end (i.e., obtain evidence that internal control has operated effectively for a sufficient period, which may be less than the entire period covered by the financial statements) and assess control risk at the maximum for purposes of the financial statement audit. However, we believe the following aspects of the guidance to auditors in the third paragraph on page 10 are not sufficiently clear as to the auditor’s decisions regarding tests of controls:

- The paragraph refers several times to the auditor's decision about "relying on controls" without making it clear that this decision is solely for purposes of the financial statement audit. For example, the paragraph states the auditor "might perform primarily substantive tests of the assertions without relying on controls" which, absent clarification, could be misinterpreted by some auditors as suggesting that no control testing in an integrated audit might be an acceptable strategy.
- The paragraph suggests that the auditor might perform primarily substantive tests of the assertions without relying on controls because of the nature of the risks of misstatement. However, neither the Staff Views nor AS5 describe how the nature of the risks of misstatement might influence the auditor's decision in this regard. We believe the auditor's decision with respect to testing controls for purposes of the financial statement audit should be primarily guided by whether controls are expected to have operated effectively throughout the period of reliance, and the auditor's judgment as to the effectiveness and efficiency of the approach.
- The example provided in the third paragraph also is potentially confusing by discussing different testing strategies for controls over the billings of a company and controls over revenue recognition. In our experience, especially for smaller or less complex companies, controls within these processes are much more likely to be common. Further, if the Staff Views is meant to convey that an auditor might take different approaches to control testing and reliance on controls for different relevant assertions, we believe this particular example makes the illustration of this concept difficult to understand.

#### Considering the Effect of Pervasive Control Deficiencies (Chapter 8, Page 44 of 52)

We agree with the Staff Views that some pervasive control deficiencies could be so severe that they render the design of other controls ineffective or prevent other controls from operating effectively. Additionally, we agree that when such pervasive control deficiencies are present, the auditor can take such deficiencies into account when planning the audit. However, absent further discussion, clarification, and illustration, we believe there is a risk that auditors might conclude too quickly that certain entity-level control deficiencies are pervasive, and therefore conclude that no further testing of other controls is needed or appropriate, without fully considering how other controls are affected.

Specifically, we believe the following aspects of the guidance are not sufficiently clear regarding the auditor's decisions with regard to pervasive control deficiencies:

- The four bullet points on page 44 provide examples of certain deficient entity-level controls that, because of their pervasiveness, might impair the effectiveness of other controls over relevant assertions. However, other than in the first bullet point, there is no indication of whether the deficient entity-level controls would render the design of other controls ineffective and/or prevent them from operating effectively, nor are any examples provided to illustrate this linkage. We recommend the discussion of each bullet point on page 44 be enhanced to clearly describe and illustrate how that entity-level control deficiency could impair the effectiveness of other controls (i.e., by rendering their design ineffective, or preventing them from operating effectively).
- The last paragraph of page 44 includes a discussion of how the auditor might modify his or her strategy when pervasive control deficiencies are believed to impair the effectiveness of other controls. However, the discussion of the principles the auditor would apply when modifying his or her strategy is unclear. The last paragraph suggests that the inquiries and observations during walkthroughs might provide enough evidence to conclude design ineffectiveness but then states “In some cases, limited testing of a control might be necessary to conclude that a control is not operating effectively.” We believe it is unclear from this statement what the nature or extent of the auditor’s control testing might be in these circumstances.

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

*Ernst & Young LLP*