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Office of the Secretary
Public Company Accounting Oversight Board
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Preliminary Staff Views – October 17, 2007

An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies

Dear Mr. Secretary:

KPMG appreciates this opportunity to comment on the publication, “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 Guidance). We applaud the Board and Staff for the significant effort expended in developing the Guidance.

In order for smaller, less complex companies and their stakeholders to realize benefits associated with public reporting on internal control by management and auditors, it is critical that auditors consider the challenges of a smaller, less complex company environment when planning and performing effective and efficient audits of these entities. We believe that the Guidance will assist auditors of smaller, less complex companies to more effectively and efficiently apply the provisions of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Overall, we believe that the Guidance appropriately addresses the financial reporting challenges of smaller, less complex companies. This letter provides our general comments and observations regarding potential changes to improve the clarity and effectiveness of the Guidance. Other, less significant comments for your consideration are included in the Appendix to this letter.

Use of Certain Defined Terms

The Guidance explains that it was developed to help auditors effectively and efficiently apply the provisions of Auditing Standard No. 5 to audits of smaller, less complex companies. The Guidance also indicates that the discussion of certain types of controls and the examples are intended to provide a context for discussion of audit strategies associated with evaluating the effectiveness of the controls. In accomplishing these objectives, we observe that the Guidance often includes footnote references to paragraphs of Auditing Standard No. 5, and to other standards of the Board, when certain terms defined in the Board’s professional standards, such as



'should', are used to describe auditor actions in auditing smaller, less complex companies. We believe that such references add significantly to the usefulness and clarity of the Guidance. These references enable users to better understand which responsibilities, as set forth in the Board's professional standards, are being explained. However, we observe that a number of instances exist where defined terms are used in the Guidance without reference to the relevant standards. We recommend that the Guidance be revised to include references to the Board's professional standards in all instances where use of the defined terms in the Guidance is referencing specific responsibilities established in those standards. Further, we recommend that the Guidance clarify the auditor's responsibility when those defined terms are used without such references.

Evidence from Substantive Audit Procedures

Auditors design control testing strategies in an integrated audit with the objective of obtaining sufficient appropriate evidence to confirm the control risk assessments made for the purpose of the financial statement audit, and to support an opinion on internal control over financial reporting. In comparison to audits for larger, more complex companies, control testing strategies for smaller, less complex companies may contemplate limited or no reliance on internal control for purposes of the financial statement audit. Accordingly, we support the inclusion of discussion and examples in the Guidance that illustrate and explain how, in these situations, auditors may design an effective and efficient integrated audit control testing strategy. However, we believe that the discussion of these situations in the Guidance may lead to confusion and misunderstanding about the evidence necessary to support an opinion on internal control.

For example, Chapter 1 discusses that auditors may choose to not rely on controls to reduce substantive procedures performed in the financial statement audit, and illustrates this concept with an example of how auditors might approach the testing of billing and revenue recognition controls differently. We observe, however, that the third and fourth paragraphs on page 10 appear to address only the auditor's judgments about how to most effectively and efficiently obtain audit evidence regarding a financial statement assertion.

We believe that an example illustrating an auditor's judgments made to design a testing strategy in an *integrated* audit would be more useful; explaining not only the financial statement audit control testing decisions, but also how those decisions may impact the auditor's decisions about the evidence necessary in an audit of internal control. An integrated audit example could more clearly illustrate that, in situations where the auditor decides to not test the operating effectiveness of controls in the financial statement audit (i.e., substantive procedures only), the results of the financial statement audit procedures represent one factor that the auditor considers in determining the evidence necessary for the audit of internal control. Moreover, such an example could demonstrate that the evidence necessary to persuade the auditor that a given control is operating effectively is determined based on the auditor's assessment of the risk associated with the control (i.e., paragraphs 46 - 49 of Auditing Standard No. 5), which includes factors such as the effectiveness of management's monitoring activities, the nature and materiality of errors the controls are designed to prevent or detect, and the inherent risk of the underlying account or disclosure.



We recommend that the Guidance be revised to clarify that, although an account balance can be efficiently and effectively audited through the application of substantive procedures only, the results of which may not identify misstatements, the auditor may necessarily determine that the risk associated with one or more of the controls necessary to address the risk of misstatement for the account is high. In such situations, the auditor would need to plan and perform appropriately responsive tests of operating effectiveness for purposes of the audit of internal control. As presented, we believe that the Guidance may be misunderstood to suggest that the absence of an error detected by performing substantive audit procedures is a predominant factor in determining the amount of evidence necessary for the audit of internal control, or otherwise de-emphasize the importance of the other risk factors relevant in an audit of internal control.

We also believe that the last paragraph of page 51 may be similarly misunderstood. The last sentence of that paragraph states that, “When no misstatements are detected from substantive procedures for an assertion, the auditor should take that into account, along with the factors discussed in paragraphs 46-49 of Auditing Standard No. 5, in considering the risk associated with the controls...” We note that “whether the account has a history of errors” is a factor included in paragraph 47. Accordingly, we do not believe that it is necessary to emphasize the occurrence of misstatements separate from the factors discussed in paragraphs 46-49. Moreover, because the nature, timing and extent of substantive procedures are planned, in part, based on assessments of control risk, emphasizing the results of such procedures in determining the evidence that is necessary about the operating effectiveness of internal control may result in inappropriate auditor judgments arising from circular reasoning.

Further, we observe that Chapter 2 directs the auditor to “take into consideration *contradictory audit evidence* [emphasis added], such as misstatements in the relevant assertion that are identified by the auditor” when assessing the precision of such controls. Management’s assertions regarding the precision of an entity-level control should be supported by management with appropriate evidence. While we agree that auditors should consider contradictory audit evidence in evaluating the effectiveness of internal control, its absence does not represent persuasive evidence in support of the precision of an entity-level control. Moreover, because judgments about the precision of entity-level controls often are integral to management’s assessment of the effectiveness of its internal control over financial reporting and to the efficiency of an auditor’s integrated audit, we recommend that the Guidance be revised to clarify and remind auditors that, in the absence of contradictory audit evidence (e.g., misstatements identified by the auditor), sufficient appropriate other audit evidence is necessary to support management’s assertion relative to the precision at which an entity-level control operates.

The Evaluation of Entity-Level Controls

Evidence from Entity-Level Controls

The first section of Chapter 2, *Evaluating Entity-Level Controls*, explains that, through the evaluation of entity-level controls, “the auditor *can* [emphasis added] obtain a substantial amount of evidence about the effectiveness of internal control”, as a consequence of senior management in smaller, less complex companies being involved in many day-to-day business activities and performing many important control activities. The discussion appearing in the next section of Chapter 2 states that, “while evaluating entity-level controls, auditors *might* [emphasis added]



identify controls that are capable of preventing or detecting misstatements in the financial statements.” The use of “can” and “might” in these sentences appears contradictory, and may lead to confusion as to the intended meaning of the first statement. We believe that this discussion would be more useful if the basis for the statements in the first section of Chapter 2 (i.e., the phrase “can obtain”) was explained further and more directly linked to the remaining sections in Chapter 2 or other chapters. Such revisions would ensure that the Staff’s intent is clearly understood by users of the Guidance.

Precision of Entity-Level Controls

We believe that the discussion of factors the auditor might consider in assessing the precision of entity-level controls appears appropriate for all audits of internal control, and not only those of smaller, less complex companies. Accordingly, we recommend that the Staff consider issuing this portion of the Guidance separately as a Staff Question and Answer, or otherwise clarify in the Guidance that the factors are relevant for all integrated audits. In addition, we have the following general observations regarding the factors the auditor might consider when assessing the precision at which an entity-level control is intended to operate:

- Several of the factors and related discussion in the Guidance appear similar to concepts and guidance in AU sec. 329, *Analytical Procedures*. We believe that additional guidance contained within AU sec. 329 could be integrated into the Guidance to improve the clarity and usefulness of the Guidance. For example:
 - *Level of Aggregation* – We recommend that the following text, derived from paragraph 19 of AU sec. 329, be included as the second sentence for this factor, “Generally, as the risk increases that errors or misstatements could be obscured by offsetting factors, the precision of the entity-level control decreases.”
 - *Predictability of Expectations* – We recommend that the discussion regarding predictability of expectations be expanded to include the concepts contained within paragraphs 15 and 16 of AU sec. 329 that relate to the “availability and reliability of data” upon which expectations are developed, including consideration of whether management takes steps to ensure the data was developed from a reliable system with adequate controls, and that, when applicable, the data comes from objective sources.
- We recommend that the discussion of the factor, *Correlation to relevant assertion*, be revised to clarify the relevance of “directly related” versus “indirectly related” when determining the precision at which an entity-level control is designed to operate. Directly related controls (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 not be designed at a level of precision sufficient to identify material misstatements. As such, we believe that the Guidance is unclear as to how the distinction between “directly related” and “indirectly related” is useful for purposes of assessing the precision of an entity-level control.



- We recommend that discussion of the factor, *Consistency of Performance*, be expanded to clarify that the frequency with which the entity-level control is designed to operate should be consistent with its objective of either *a) preventing or detecting on a timely basis misstatements that could be material to either interim or annual financial reporting, or b) detecting on a timely basis possible break-downs in lower level controls that could, individually or in combination with other controls, give rise to a material weakness in internal control over financial reporting.* Entity-level controls that do not meet these design conditions would not, by definition, be sufficient to reduce or eliminate the need to evaluate lower level controls.

Identifying Entity-Level Controls

We observe that the discussion in the *Identifying Entity-Level Controls* section of Chapter 2 states that, “the process of identifying relevant entity-level controls *could begin with discussions* [emphasis added] between the auditor and appropriate management personnel for the purpose of obtaining a preliminary understanding of each component of internal control over financial reporting.” We recommend that this section of the Guidance be revised to reiterate the statements found on page 8, which explains that a practical starting point for identifying controls is to consider the controls management relies on to achieve its financial reporting objectives. Moreover, we recommend that this discussion reference Section II A.1.e of the SEC’s Interpretive Guidance, 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* [emphasis added], is an integral part of the reasonable support management is required to maintain for its assessment.” We believe that auditors will find such documentation a useful starting point in planning and performing an integrated audit, including the discussions with management about each component of internal control over financial reporting, and those controls management relies on to achieve its financial reporting objectives.

Guidance for Evaluating Other Entity-Level Controls

We also note that the discussion of factors that the auditor might consider in judging the precision of entity-level controls represents substantially all the guidance (excluding examples) within Chapter 2 that is not drawn directly from Auditing Standard No. 5. We recommend that the Staff consider expanding the guidance in Chapter 2 to discuss auditing considerations related to evaluating the design and operation of other entity-level controls, such as a company’s entity-level risk assessment process and monitoring function.

Assessing the Risk of Management Override and Evaluating Mitigating Actions

The second paragraph of Chapter 3, *Assessing the Risk of Management Override and Evaluating Mitigating Actions*, explains that the auditor should consider the risk of management override in connection with assessing the risk of material misstatement due to fraud. The sixth paragraph of Chapter 3 explains that the auditor should evaluate whether management has appropriately addressed the risk of management override. The last paragraph of Chapter 3 explains that, if the auditor identifies indications of management override of controls, then such indications should be taken into account when evaluating the risk of management override and the effectiveness of any mitigating actions. As noted in our first general comment, revising the Guidance to include



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references to the Board’s professional standards from which these statements are drawn would improve overall clarity by providing readers more context as to the source of the requirement (i.e., Auditing Standard No. 5 or AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*). Further, we believe that these statements should clarify that the auditor’s assessment of the risk of management override and the adequacy or effectiveness of mitigating actions (i.e., controls) are made within the context of the risk of material misstatement to the financial statements.

We also observe that the *Evaluating Mitigating Controls* section of Chapter 3 provides four examples described as “controls” that a smaller, less complex company “might” implement to address the risk of management override. We recommend that the examples 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 bullet item related to “monitoring of controls over certain journal entries” be eliminated and the related discussion be presented within the section on evaluating the effectiveness of audit committee oversight.

Lastly, we recommend that the discussion on the evaluation of the effectiveness of audit committee oversight be revised to specifically address the expectation of greater audit committee involvement as a mitigating action to address risk of override arising from senior management’s involvement in day-to-day business activities and performance of many important controls in smaller, less complex companies, and the auditor’s evaluation thereof. As presented, the discussion is of a general nature that conceivably applies to any audit committee, and does not necessarily address considerations specific to smaller, less complex companies.

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We share the Board's goal of providing auditor guidance to assist in effectively scaling an audit of internal control, and fully support the Board and the Staff's efforts to help auditors apply the provisions of the Auditing Standard No. 5 to audits of smaller, less complex companies in a more effective and efficient manner. If you have any questions about our comments or other information included in this letter, please do not hesitate to contact Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

cc: PCAOB Board Members

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Appendix

Preliminary Staff Views – October 17, 2007 An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies

The following specific comments are presented for consideration:

- 1 We recommend that the following statement on page 14 be revised as follows:
 - As noted previously, the key consideration in assessing the level of precision is whether the control is designed ~~and operating effectively enough~~ in a manner that would prevent or detect on a timely basis, misstatements in one or more assertions that could cause the financial statements to be materially misstated and whether such control is operating effectively.
- 2 We recommend that the following statement on page 15 be revised as follows:
 - The degree to which the auditor might be able to reduce testing of controls over relevant assertions in such cases depends on the precision of the entity-level controls and the operating effectiveness of such controls.
- 3 We recommend that Example 2-2 on page 16 be revised to clarify the actions that the CFO undertakes to “quickly [identify] any sign of improprieties with payroll and their underlying cause.” As drafted, the example does not illustrate the nature of the activities comprising the control, or how the auditor considers those activities when evaluating the precision of the entity-level control.
- 4 We recommend the following statements on page 20 be revised as follows:
 - A whistleblower program provides an outlet for employees or others to report behaviors that might have violated company policies and procedures, including management override of controls.
 - The audit committee ~~may~~ reviews reports of significant matters and considers the need for corrective action.
- 5 We recommend that the following statements on page 23 be revised as follows:
 - ~~Despite personnel limitations, s~~ Some smaller, less complex companies might still divide incompatible functions by using engaging the services of external parties,- while ~~o~~ others smaller, less complex companies might implement alternative compensating controls intended to achieve the same objectives of as-segregation of duties for certain processes.
 - ~~Where walkthroughs are~~ The procedures performed to achieve the objectives of a walkthrough, those procedures can help identify matters related to segregation of duties.
- 6 We recommend that the following statement on page 25 be revised as follows:



- ~~When~~ If the auditor applies a top-down approach, starting at the financial statement level and evaluating entity-level controls, the auditor might identify entity-level controls that address the risk of misstatement for one or more relevant assertions.
- 7 We recommend that the characteristics of less complex IT environments appearing on page 26 be revised to include fewer IT personnel, less ability to segregate duties, and less job processing.
- 8 We recommend that the following statement on page 28 be revised as follows:
- The IT-related risks that are reasonably possible to result in material misstatement of the financial statements depend on the nature of the IT environment ~~and other facts and circumstances~~.
- Alternatively, we recommend that the Staff either expand the discussion to address the other relevant facts and circumstances or provide an appropriate reference to relevant paragraphs of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.
- 9 We recommend that the second paragraph on page 29 include a statement reminding auditors that IT general control deficiencies should be evaluated for severity, including consideration of the “prudent-official test,” to determine whether they represent a significant deficiency or material weakness in internal control over financial reporting.
- 10 We recommend that the following statement appearing in the Scenario of Example 5-1 on page 29 be revised as follows:
- Since the company uses packaged software, and there have been changes to the system or processes in the past year, the ~~relevant~~ IT general controls relevant to the audit of the effectiveness of internal control over financial reporting are limited to certain access controls and certain computer operation controls related to identification and correction of processing errors.
- 11 We recommend that the last sentence beginning on page 30, which states that “controls for mitigating the risk caused by a lack of segregation of duties over operating systems, data and applications tend to be detective controls rather than preventive” be supplemented to provide examples of detective controls that companies might implement to mitigate segregation of duties risks in IT.
- 12 We recommend that the following statement on page 34 be revised as follows:
- For recurring clients, the auditor’s experience in prior audit engagements ~~can be~~ ordinarily is a source of information regarding management’s financial reporting competencies.
- 13 We recommend that the following sentence in footnote 2 on page 35 be revised as follows:
- It also does not apply to management's use of specialists in subject matters ~~outside of that indirectly affect~~ accounting and financial reporting, such as actuaries, engineers, environmental consultants, and geologists.
- 14 We recommend that the following statement on page 39 be revised as follows:



- ~~Where walkthroughs are performed, auditors could use those~~ In performing procedures to meet the objectives of a walkthrough, auditors may use the information about processes and controls found in other documentation to assist in obtaining an understanding of the flow of transactions affecting relevant assertions and to assessing the design effectiveness of certain controls.
- 15 The discussion on page 39 of documentation of the operating effectiveness of controls states that “evidence of a control’s operation might exist only for a limited period.” We believe that this discussion should be revised to clarify that management must maintain evidence that provides reasonable support for its assessment of the effectiveness of internal control over financial reporting. In this regard, we also suggest that the following statement on page 39 be revised as follows:
- Also, documentation created by the operation ~~evidence~~ of a controls’ ~~operation~~ might exist only for a limited period of time.
- 16 We believe that Example 7-2 on page 42 may help auditors understand how to evaluate the operating effectiveness of a control (e.g. a direct entity-level control) when its operation does not create a traditional ‘audit trail.’ However, in practice, even in the case of smaller, less complex companies, the precision of a CFO review of the financial statements is often not designed to operate at a level that is adequate to prevent or detect misstatements. As such, we recommend revising the example to explicitly state that the auditor is undertaking the tests of operating effectiveness after concluding that sufficient appropriate evidence exists to support management’s assertion that the design of the CFO review control is such that it would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions, or otherwise clarify the reason why the auditor is testing the operating effectiveness of the CFO review control. These revisions would serve to avoid misunderstanding and improve the usefulness of the example.
- 17 We recommend that the following statement on page 43 be revised as follows:
- Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain ~~competent~~ sufficient appropriate audit evidence ~~that is sufficient to obtain that provides~~ reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment.
- 18 We recommend that the following statement in footnote 1 on page 43 be revised as follows:
- To enable the auditor to express an unqualified opinion on internal control, the company would need to remediate all of its material weaknesses early enough before year end to enable the auditor to obtain sufficient appropriate audit evidence about the remediated controls to support an unqualified opinion on internal control over financial reporting.
- 19 We recommend that the following statements on page 45 be revised as follows:
- The auditor ~~may~~ should take into account the effect of the pervasive control deficiencies on the selected controls in assessing risk associated with the controls and determining the amount of evidence of their operating effectiveness that is necessary to persuade the auditor. needed.



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- Pervasive deficiencies in a company's internal control do not necessarily prevent an auditor from obtaining sufficient appropriate audit evidence to express an opinion on internal control. The auditor's evaluation of the impact of these deficiencies requires consideration of the nature of the deficiencies and their implications on the audit evidence that could be obtained. If the auditor concludes that sufficient appropriate audit evidence is available to express an opinion, the auditor should perform tests of controls and other required audit procedures ~~evaluate~~ after considering the effect of the identified control deficiencies.
- The auditor should, however, take into account the control deficiencies and issues encountered in the audit of internal control in assessing risk and in determining the nature, timing, and extent of tests of accounts and disclosures in the audit of the financial statements.

20 We recommend that the following sentence included in Example 8-2 on page 47 be revised as follows:

- The auditor's report on internal control contains a disclaimer of opinion and disclosure of the substantive reasons for the disclaimer and the material weaknesses of which she is aware ~~that she identified~~.