

Corporate Governance Center

THE UNIVERSITY OF TENNESSEE

College of Business Administration
511 Stokely Management Center
Knoxville, Tennessee 37996-0550
(865) 974-8455



C. Warren Neel
Executive Director

Joseph V. Carcello
Director of Research

Michael C. Ehrhardt
Research Fellow

Scott M. Gilpatric
Research Fellow

Joan M. Heminway
Research Fellow

Dana R. Hermanson
Research Fellow

George W. Kuney
Research Fellow

Paul D. Lapidés
Research Fellow

Michael J. McKee
Research Fellow

Terry L. Neal
Research Fellow

Rudy Santore
Research Fellow

Glen E. Shuler
Research Fellow

Ronald E. Shrieves
Research Fellow

James W. Wansley
Research Fellow

Tracie Woidtke
Research Fellow

Via Email

February 26, 2007

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Board Members and Staff of the Chief Auditor:

I am writing in my capacity as an accounting professor at the University of Tennessee (UT), where I serve as Director of Research for UT's Corporate Governance Center. I appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (hereafter AS #5 – ED) and *Related Other Proposals* (hereafter AS #6 – ED).

I have spent much of my career studying fraudulent financial reporting and audit committee activities and performance. I write from the perspective of one who believes that Section 404 of the Sarbanes-Oxley Act (SOX) and Auditing Standard No. 2 are essential in improving the quality of financial reporting, including reducing the incidence and severity of fraud – in my view, the fundamental motivation behind the passage of SOX. Therefore, although efforts to reduce unnecessary procedures, and hence cost, are laudable and appropriate goals, the ultimate litmus test is that any successor standard must not be any less effective in having the capacity to improve the quality of financial reporting.

I applaud the PCAOB for its work in an environment characterized by intense lobbying by well-funded and well-organized groups that often were more concerned with their narrow self-interest than with the public good. Given this political cauldron, I think the PCAOB has crafted a remarkably well-balanced standard – one that should reduce costs without sacrificing quality for most registrants. Nonetheless, I have some significant concerns with AS #5 – ED. AS #5 – ED is less detailed, some would say more principles-based, than was AS #2. But critically, for a principles-based regime to work well, there must be vigilant

and effective enforcement. Is this the case? The PCAOB has largely adopted an inspection model, not an enforcement model. This puts the onus on the Securities and Exchange Commission (SEC), but the SEC's budget has been squeezed in recent years. The backstop to insufficient or ineffective enforcement by the SEC is private securities litigation, but accounting firms are seeking liability relief and even the SEC has recently filed a friend-of-the-court brief with the U.S. Supreme Court that would make it harder for investor lawsuits to succeed. Therefore, in the presence of less vigilant enforcement, I believe that AS #5 – ED (coupled with the SEC's ED on management's report on internal control) will likely reduce costs without hurting effectiveness for "good actors," but at the cost of reducing effectiveness for "bad actors." Is this result socially optimal? Is this result in the best interest of investors? These are the questions that should be asked.

Overemphasis on Efficiency

The PCAOB's public statements surrounding the issuance of AS #5 – ED, as well as statements regarding the recent focus of its inspection program, seem to suggest a focus by the Board on efficiency. Although efficiency means accomplishing objectives with the minimum effort and cost needed (certainly an appropriate goal), a focus on efficiency is sometimes interpreted, especially by accounting firms or registrants whose only focus is cost, as an excuse to do less work. The role of a regulator is to prescribe a certain level of performance (i.e., effectiveness) that must be met by the regulated entity. Concerns with efficiency are best met via a market test. If an accounting firm spends too much time performing an audit of internal control over financial reporting the audit committee should fire that firm and hire another firm. A focus on efficiency, especially by a regulator, can easily lead to insufficient audit work and a decline in audit quality.

Assessing Effectiveness of Audit Committee Oversight

AS #5 – ED indicates that an ineffective control environment is a strong indicator of a material weakness, and an example of an ineffective control environment is ineffective oversight of financial reporting and internal control by the audit committee (see p. A1-30). No guidance is offered in AS #5 – ED (or in the SEC's ED on management's report on internal control) as to the characteristics of effective (or ineffective) audit committee oversight. This lack of guidance is particularly problematic because: (1) there is no evidence in the literature that suggests that auditors are proficient in evaluating audit committee oversight of financial reporting, and (2) there is a natural conflict in making such an assessment given that the audit committee now has the authority to hire, fire, and compensate the external auditor. In addition, there is excellent guidance available for audit committees to use in evaluating the financial reporting process, particularly the area of that process most in need of audit committee oversight – the ever present risk of management override of internal control.

That guidance – *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention* – should be included in AS #5 – ED as guidance that can be used by auditors in assessing audit committee oversight of financial reporting, at least as it relates to the risk of fraudulent financial reporting.

Scaling the Audit for Smaller Public Companies

A primary motive for issuing AS #5 – ED is to provide a more “scalable” audit approach, an approach designed to lower costs for smaller public companies without sacrificing effectiveness. AS #5 – ED suggests that, for smaller entities, control objectives can be met through daily interaction of top management (see p. A1-8). What if senior management is corrupt? For example, fraud is more prevalent when the founder is still involved with top management, and smaller entities are more likely to have continuing founder involvement.

AS #5 – ED suggests, for smaller entities, that inquiry and observation of a control may provide sufficient evidence of whether a control is effective (even if the control being relied upon is not documented) (see p. A1-8). If fraud is going on top management is not going to tell you that via inquiry, and the very act of observing behavior changes that behavior.

AS #5 – ED seems to suggest that smaller entities can get by with relatively unsophisticated financial reporting staffs (see p. A1-9). Even if a business enters into simple transactions (no derivatives, no leases, no defined benefit pension/postretirement benefit plans), they still will have deferred taxes and still will have to prepare a statement of cash flows. FAS-109, FIN-48, and FAS-95 (not to mention any applicable EITFs and FSPs) are complex standards requiring high-level skills.

Elimination of the Principle Evidence Provision

AS #5 – ED eliminates the AS #2 requirement that the auditor gather the “principle evidence” to support his or her opinion. It appears that if management personnel (not just internal auditors) appear objective and competent that they could gather the principal evidence, and not just for the audit of internal control over financial reporting but also for the financial statement audit. If so, what do we need auditors for? And, roll back the clock to the late 1990s, I think most everyone would have described Mr. Fastow and Mr. Sullivan as honest and competent (both men were recognized for their excellence by *CFO Magazine*). The risk of incorrectly assessing managerial objectivity and competence, and then relying on their work – particularly for the financial statement audit, seems to appreciably increase of the risk of material financial statement misstatements not being detected on a timely basis.

This AS #5 – ED provision is particularly problematic given certain recommendations contained in the Panel on Audit Effectiveness’ Report (2000).¹ The Panel on Audit Effectiveness recommended that, “The external auditor should *not use* (my emphasis) the work of internal auditors in carrying out tests directed at the possibility of fraud” (p. 91). Two to three years before the Enron and WorldCom frauds (which cost investors billions of dollars), this blue-ribbon group recommended that auditors should not rely on internal auditors for performing certain substantive tests. Internal auditors are almost universally regarded as a more appropriate source for auditor reliance than management. But AS #5 – ED would seem to permit the auditor to rely on management, with no obvious restrictions as to amount and audit area. I ask the Board – does AS #5 – ED or the recommendation of the Panel on Audit Effectiveness Report provide greater protection to the investing public?

Replacement of the Term “More than Remote” with “Reasonable Possibility”

AS #5 – ED replaces the term “more than remote” with “reasonable possibility” in evaluating the likelihood of a financial statement misstatement as a result of an internal control deficiency. Amer, Hackenbrack, and Nelson (1994) report that audit managers assign a mean (median) probability threshold of 12.33% (10%) to the term remote and 58.57% (60%) to the term reasonably possible. If these probability assessments are still valid today, I believe that it is problematic to only consider the effect of an internal control weakness if there is a 60% or greater chance that the weakness would result in a financial statement misstatement.

Importance of Audit Committee Independence, Regardless of Exchange-Listing Standards

AS #5 – ED indicates that a lack of audit committee independence may indicate ineffective oversight of financial reporting, but only if the entity trades on a stock exchange requiring an independent audit committee. The language in AS #5 – ED seems to suggest that it is acceptable to not have an independent audit committee unless the entity is required to have such by stock exchange listing rules. The COSO framework’s discussion of the control environment emphasizes the importance of audit committee independence. Moreover, there is

¹ The Panel on Audit Effectiveness was created under the auspices of the Public Oversight Board, at the encouragement of the SEC. This group was chaired by the former chairman of Price Waterhouse, and had among its members two former SEC commissioners and an academic who currently is a senior staff member at the SEC. The recommendations of this group were made two years before revelations of the fraud at Enron and three years before revelation of the fraud at WorldCom.

an extensive body of research literature that documents the salutary benefits of audit committee independence. For example:

- Audit committee and/or board independence is associated with a lower incidence of fraudulent financial reporting (see Dechow, Sloan, and Sweeney, 1994; Beasley, 1996; Farber, 2005)
- Audit committee independence is associated with a lower incidence of restatements (see Abbott, Parker, and Peters, 2004; Carcello, Neal, Palmrose, and Scholz, 2006)
- Audit committee independence is associated with less earnings management (Klein, 2002; Bédard, Chtourou, and Courteau, 2004)
- Audit committee independence is associated with a higher incidence of going concern reports for financially distressed companies (Carcello and Neal 2000)
- Audit committee independence is associated with a lower incidence of auditor dismissals following the issuance of a going concern report (Carcello and Neal 2003)

Moreover, recent research (Bronson, Carcello, Hollingsworth, and Neal, 2007) finds that even *one* non-independent audit committee member reduces the effectiveness of the committee. Therefore, it seems that AS #5 – ED should emphasize the importance of audit committee independence regardless of whether independence is required by any applicable stock exchange rule.

Inclusion of Size Thresholds

AS #5 – ED indicates that the auditor should consider the company’s size and complexity when planning and performing the audit of internal control (see p. A1-7). This is appropriate guidance. But then AS #5 – ED defines size using cutoffs from the report of the SEC Advisory Committee on Smaller Public Companies. The risk in including these size cutoffs is that certain registrants will seek a “less rigorous” audit based solely on these size thresholds and some accounting firms may comply with this request. I suggest the elimination of the Note to paragraph 9 and the elimination of footnote 6. Neither are necessary to support the concept embodied in paragraph 9.

Reliance on the Work of Others

As discussed previously, I think it is a mistake to allow the auditor to rely on the work of management, especially in auditing the financial statements and in auditing certain areas of internal control (e.g., the control environment). If the Board decides to allow the auditor to rely on the work of management, I think the Board should limit such reliance and proscribe reliance in certain audit areas.

AS #6 – ED indicates that the auditor cannot rely on the work of others unless these individuals are objective and competent, and factors for making these

judgments are included in the ED. However, AS #6 – ED does not differentiate between the work performed by management and the work performed by internal audit. I believe there is an important difference between these two groups. Although I agree that objectivity and competence are paramount, job titles do matter. Job titles often create a mindset, and they may involve compliance with a set of professional standards and a code of ethics (e.g., many internal auditors follow the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*).

My comments are meant to help the Board in improving AS #5 – ED and AS #6 – ED. Although these comments are constructively critical, they should in no way be interpreted as an overall criticism of what I view as a superb job by the Board and its staff in developing a standard that will reduce the cost burden on companies without generally reducing the effectiveness of internal control reporting.

Thank you for the opportunity to comment. I am happy to respond to any questions or to provide any further information.

Sincerely,



Joseph V. Carcello
Ernst & Young Professor
Director of Research – Corporate Governance Center