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Office of the Secretary, PCAOB
1666 K Street, NW
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The internal control standard, AS No. 2, was the Board's first substantive standard. The Board recognized that internal control was an essential underpinning for the effectiveness of all other standards, and that AS No. 2 should address control deficiencies that allowed major frauds.

I am disappointed that the proposals both weaken the effectiveness of AS No. 2 and fail to remedy a major shortcoming in how it addressed those control deficiencies.

This is what I believe happened:

> Company executives and investment bankers brought intense political pressure on the SEC to reduce regulation and its attendant costs. The SEC unduly influenced the deliberations of an independent Board. And, the Board listened to the expressed concerns of companies without hearing much from investor groups and defenders of the public interest. There was a rush to do something. The accounting firms, who have a strong influence on the Board, appear to have been satisfied by the liability limiting reduction of specific requirements, more reliance on judgment, and no expansion of their duty to detect fraud.

While a number of cost reductions are appropriate, the Board appears to have overdone it, and has not done it in ways that would protect investors from major frauds.

Each of the following <u>underlined</u> deficiencies in the Board's proposals is accompanied by commentary in *italics.*

1. <u>The chance of success of the Board's many good cost saving proposals depends, in part, on improving the "old" general standards of auditing.</u>

> In one form or another, the first two improvements suggested below have long been advocated by those concerned with the public interest. Some aspects of the third have been considered by the SAG:

(a) Auditors should be made professionally responsible to investors, stockholders and creditors, and some additional specific rules to further reduce pro-management bias should be adopted.

(b) Auditors' responsibility for the detection of fraud should be strengthened, with sufficient guidance to accomplish this obligation.

(c) Auditors' technical training and proficiency requirements should meet today's demands, with guidance on how to develop and manage the required skills.

The good judgments required by the Board's proposals, and acquiring all the necessary facts to support them, make the above mentioned improvements in the general standards even more necessary than they were for SAS No. 2.

2. <u>In making risk assessments more emphasis should be placed on identifying weaknesses in the control environment.</u>

This is essential for the success of the "top-down, risk based" approach. The proposed required assessments should be expanded to include all the principles of the control environment addressed in a recent COSO report. The proposed assessment process is founded on observable signs and does not, as it should, require follow-up inquires and additional observations or tests of the implementation of any of those control principles that have the potential to contribute to a material weakness in internal control. At this very top level of internal control, auditors should be encouraged to look for significant weaknesses

Weaknesses in the control environment have pervasive effects on all other risk assessments. They have a direct effect on the strength of other company level controls, and increase audit risk at all lower levels of control. Contrary to some views, I believe that limited effectiveness of individual control principles that have a reasonable possibility of contributing to a material weakness, if identified, can help focus the audit on particular areas of control weakness. Sometimes, they can help in identifying specific problematic accounts and disclosures.

3. <u>The proposed standards fail to emphasize that fraud, especially management led fraud, is a far greater control risk than pure error.</u>

Failure to adopt a fraud risk priority is hard to justify in view of the fact that fraud was the major reason for the passage of Sarbanes Oxley and the creation of PCAOB.

Errors in the choice and application of accounting standards do result in material misstatements, but reduction of that risk is helped considerably by the audits of *financial statements. A very good proposal with specific requirements that should help to reduce fraud and also help identify misapplication of accounting standards is the proposal for walkthrough of the period-end financial reporting process.*

But, strangely and discussed later, another proposal reduces the effectiveness of walkthroughs of operations that have the dual purpose of identifying systematic causes of error as well as fraud. The Board's proposal also fails to identify the inherent weaknesses in IT systems that can be used by management to override controls, and IT systems are an integral part of the period-end financial reporting process.

Other types of error ordinarily deserve relatively low priority in both audits because it is probable that they cannot be of such size as to constitute a material error. The major exception to this generalization occurs when company level controls are weak, thus opening the possibility of a great number of small errors.

I think the benefit of close coordination of both audits should be emphasized more than it has, and guidance that would assist that coordination should be issued

The Board should use this opportunity to set more definitive priorities in ways that will both help to make justifiable reductions in audit costs and provide better protection to investors and stockholders from the disastrous losses of major financial statement fraud.

4. The "top-down, risk based" model is deficient in its failure to correct the major shortcoming of AS No. 2, namely its failure to require an effective evaluation of the ethics and integrity of senior management.

There is convincing evidence that senior management commits a very high percentage of the frauds that damage investors and stockholders, and that auditors, in large measure, are failing to detect those frauds.

Investors and stockholders need auditors to apply an anti- fraud standard that will deter management led frauds as well as detect them, including the new types of fraud that are not now addressed and may not be addressed by PCAOB until long after the damage has been done.

To accomplish that, auditors should be required to look for fraud by applying a chain of required processes that start with procedures to appraise senior management's ethics and integrity.

I have made a comprehensive remedial suggestion to the Board. It requires that the partner primarily responsible for the audit make a truly informed decision, based on a careful evaluation of the ethics and integrity of senior management, as *to whether or not management fraud is reasonably possible. Then, working closely with audit committee and with its agreement and help, it requires inquires whose results would indicate whether of not to conduct more extensive forensic auditing procedures.*

The details of this suggestion were previously sent to the SEC as well as the PCAOB.

Individual audit partners will certainly have liability if they fail to apply the designated processes and fraud is not detected as a result. As I understand it, under the way existing law is being interpreted, auditing firms will probably be exposed to additional liability. But, there is good argument that the firms should not have such liability if they were not complicit in the failure of the responsible individual partners to apply the required processes.

Costs of execution of the required anti-fraud processes can be justified by the very substantial reduction of overall audit risk that will permit substantial reductions in other auditing procedures. The benefits of the required processes to investors and the markets are immeasurably great.

The procedures of AU 316 (Consideration of Fraud in a Financial Statement Audit) cannot stop management led fraud. AU 316 requires "discussion among engagement personnel regarding the risk of material misstatement due to fraud", but it does not focus on senior management ethics and integrity. It does not have requirements, as my suggestion has, for specific evaluation processes, decision making, investigative processes and, when indicated, forensic procedures. The need for requirements when it comes to fraud is indicated by recent PCAOB inspections. They found that auditors are not always implementing fraud standards when they should, especially the procedures described in AU 316.

5. <u>The proposals do not include needed improvements in the audit risk standard (AU 312)</u>

The AICPA has already adopted changes in this and in a number of other risk related standards in response to recommendations by the former Public Oversight Board's Panel on Audit Effectiveness. Its new standards mention the need for processes to evaluate risk. I have not had a chance to study their more recently issued implementation guidance, so that I do not know how they suggest applying this requirement.

Taken as a whole the Board's proposals seem to reduce required processes, rather than increase their use to help guide auditor risk assessments. The AICPA guidance should be considered by The Board.

Some time ago, that the Board's staff discussed the audit risk standard (AU 312) with the SAG, but no changes have been proposed. And, there is not much in the existing standard about how to make control risk assessments. I can think of questions that might deserve some coverage, e.g. how higher level control evaluations affect lower ones as the auditor works from top to bottom; and whether, or to what extent, attention should be paid to low risk assessments at the bottom in the face of high risk at the top.

Risk assessment itself is a risky process, especially when there is limited guidance on how to make these judgments.

6. <u>Decreased emphasis on the nature and extent of AS No. 2 walkthroughs increases the likelihood of undetected material weaknesses and successful management fraud.</u>

   The impact of the proposed changes goes far beyond what might be thought from just reading the release that accompanies the new proposed standard. They will change what might be considered an audit of transaction flows into a limited review. They will put the auditor more out of touch with what is actually going on, and do not put sufficient emphasis on situations that might accommodate fraud, including controls override.

   This is one of the most worthwhile parts of AS No. 2, and was written that way because auditors were not finding major fraud and were not looking for it. Managements will object to attempts to go beyond the confines of what is written in this proposal. This is a good example of proposed changes where reliance on auditor judgment to do the right things is unjustifiably risky.

7. <u>Increased reliance on auditor judgment in lieu of specific requirements in the standards should be coupled with additional evidential requirements and partner level involvement in important judgments</u>

   I do not fully understand what the proposal says about evidence and the use of judgment.

   It seems to me that evidential requirements for judgments should be similar to those for the audit of financial statements, such as: (a) Auditors should consider all relevant evidential matter, and their judgments should be based on evidence that appears to contradict the company's control evaluation as well as that which supports it, and (b) The evidence for whatever judgment is made should be at least persuasive.

   Partners should determine what judgments are important, be aware of the evidence for them, and make them. Critical judgments should require concurrence by the partner responsible for the audit and the "concurring partner".

But, even if additional evidential requirements coupled with participation by responsible partners were imposed, if auditors act as they have in the past when AICPA standards were in effect, the " principles based" approach applied to this inherently more subjective audit of internal control could contribute to audit failure. The general standards, the audit risk standard and the other standards mentioned in this critique need to be strengthened. Back then, important financial statement audit problems were not always identified by the auditors; and, if they were identified, auditor discussions with management frequently led to waiving "borderline" adjustments and disclosures.

8. Defining materiality for internal control as the same as materiality for financial statements may serve to continue auditor failures to identify material weaknesses before misstatements occur.

   Materiality for internals control should be determined based in part on what the effects of weaknesses on future financial statements may be, and should always give consideration to weaknesses in company level controls that do not yet relate directly to any particular accounts or disclosures.

   It should be stated explicitly that identified significant risks of material misstatement that have continuing control implications should always be reported as material weaknesses in internal control, whether or not transactions or adjustments have been identified that could be the result of those risks.

9. Proposed changes relating to significant weaknesses appear to be problematic; and taken together, they may unnecessarily increase the number of restatements

   (a) A proposed change to stop auditors from searching for significant weaknesses may cause auditors to seek to identify only such control deficiencies that in themselves rise to the level of a material weakness, rather than significant deficiencies that taken together might constitute a material weakness.

   (b) Defining "significant" as less than material, yet important enough to merit attention by those responsible for oversight of the company's financial reporting, may limit the deficiencies that are reported in writing to the audit committee, and a result in failure to remedy them on a timely basis

   (c) Failure to designate a "strong indicator" of a material weakness as at least a significant deficiency should require the auditor to carry the burden of proof that it is not a significant weakness, e.g. have convincing, rather than persuasive, evidence that it is not.

(d) The proposal that reported significant weaknesses, uncorrected over a reasonable period of time, may indicate a material deficiency in the control environment is a good concept. But determining whether or not they should be considered as components of a material weakness at later date is overly dependent on good judgment at a time of stress when the basis for the initial reasoning and evidence for it may not be clearly remembered. As written, the proposal will not force the discussion with management and the audit committee as to whether the weaknesses are truly significant back to the time when they were first identified. This, and the consequent possible delay in remediation, tends to allow some truly significant weaknesses to continue longer than necessary, and thus unnecessarily contribute to restatements.

10. <u>The proposals' advice for "scaling" the audit of smaller companies turns the inherent control risks of smaller companies into a control benefit, by stressing the benefits, more than the risks of greater management involvement in the control environment, the monitoring function, etc</u>.

There is persuasive evidence that smaller companies are more likely to be subject to fraud.

Management must have a high level of ethics and integrity to play a positive role in turning the inherent risks of a smaller company into a controls benefit.

11. <u>The proposal that the auditor needs only to understand management's control evaluation process, rather than evaluate that process, will increase audit risk unless the company's evaluation is a systematic, adequately tested and well documented evaluation.</u>

If the SEC requires that companies use COSO's Guidance for Smaller Public Companies, as amended to include the anticipated improvement in its monitoring component, the suggested approach could work. But, if the basic COSO framework or some other requirement that is also less susceptible to auditor understanding is prescribed by the SEC, then the proposal will increase the difficulties auditors face in determining weaknesses in controls' design and effectiveness.

12. <u>Major problems in applying the proposed standards should be expected.</u>

The "top-down, risk based" audit and its application in a "principles" based standard will be difficult to implement. Similar approaches in the past were unsuccessful. Even if strengthened as I have suggested, it will need interpretive guidance and more competent audit teams.

Large auditing firms using the knowledge and experience of their top professional people may be able develop appropriate interpretive guidance before a new standard becomes effective. The guidance will probably reinstate some of the specifics that the proposals seek to reduce.

It will take longer to build audit teams with the necessary higher skill levels and mature judgment to apply the standard successfully. Better training, development of existing staff, bringing in people with experience and putting more partners on the job will all be necessary.

The problems of smaller firms will be greater, and those will be accentuated by the demand for "scaling".

Audit failures will be high in what is likely to be a long shakedown period.

Conclusions:

The Board has used a flawed "top-down, risk based" approach and encouraged the use of audit judgment in a "principles based" proposal in ways that will substantially increase the risk of audit failure.

The proposal does not cure an important existing shortcoming in AS #2, and fails to make changes in other existing standards that are important adjuncts to an effective internal control standard.

All the effects of the proposal are difficult to comprehend.

I think the comment period should be extended to allow time for investors and their representatives to understand it and express their concerns, so that all the necessary amendments can be considered, and hopefully made.

Sincerely yours,

Donald H. Chapin

End Note:

I am submitting a copy of this critique to the cognizant Congressional Committees as a supplement to my report dated January 3rd titled "Fraud Related Auditing Standards are Inadequate".

Investors and their representatives can obtain an E-mail copy of the January 3rd report, by sending a request to DonChapin@gmail.com.