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August 31, 2006

Chairman Cox, Securities and Exchange Commission
Cc: Public Company Accounting Oversight Board
Charles A. Bowsher

Re: SEC File No. S7-11-06

I am an independent financial management consultant and a member of the Standing Advisory Group of the PCAOB. I have been involved with internal control and related enforcement issues through most of my professional life. [1]

This letter focuses on major issues affecting the success of 404 that you should consider, namely:

- The COSO Guidance for Smaller Public Companies issued in June, and
- The problems of management led fraud for all companies, especially smaller companies; and the identification of material weaknesses.

Internal Control over Financial Reporting – Guidance for Smaller Public Companies

This excellent Guidance fills many of the gaps mentioned in the SEC Concept Release.

The SEC should accept it as an integral part of the COSO Framework, and designate it as a suitable reference point for 404 reporting by company managements. It may obviate the need for some of the anticipated SEC rule making, and it provides a structure for SEC application guidance and for on-going cost reducing measures being developed by the private sector.

Any faults in the Guidance discovered over time can be corrected by SEC rule making.

[1] As Director of Auditing for Arthur Young &company and client handling partner I dealt with control and related management fraud problems and with FCPA implementation issues. In the late 80's and most of the 90's, as Assistant Comptroller General and Chief Accountant, I was a chief critic of the lack of enforcement for COSO's internal control proposal and assisted the Comptroller General in helping to frame the provisions of FDICA following the S&L crisis. As an independent consultant I evaluated the quality and degree of coordination on internal and external audits, advised banking and government critics on professional standard issues at Enron and Tyco, and served as an advisor on NASDAQ's listing standards following the passage of SOX. I participated in early thinking that led to the provisions of AS#2.

Though inspired by the needs of smaller companies for help in designing, implementing and evaluating cost effective systems of internal control, it will also help some larger companies to improve their control effectiveness and efficiency.

Importantly, the Guidance provides the basis for bringing non-accelerated filers into compliance with 404 at an early date.

The Guidance has these important features:

- It retains much of the essential flexibility of the existing COSO Framework while providing a needed Structure for its application. Its Principles inform users what Framework Concepts mean. Its Attributes provide characteristics of the Principles and evaluation criteria, which in turn provide legitimizing bridges to approaches to designing controls that will satisfy the Attributes and Principles. Its Attributes are key both to making the Structure work and to the processes of the evaluation and documentation

- It provides a top down, risk based approach that starts with a company's financial reporting objectives and related risks to their achievement.

- Its suggested Tools for the evaluation of internal control demonstrate that:
    - It is scalable in the sense that control evaluation starts with a company's own business model, and thereby accommodates smaller companies and changing business environments.
    - It is efficient because the Tools are integrated with the Structure and use a series of matrix type risk oriented forms that enable the evaluator to move systematically from the business model and significant accounts and assertions to a summary of both the design and operating effectiveness of entity-wide and process level controls, and to findings of potential control weaknesses.
    - Needed documentation or links to documentation can be easily associated with the evaluation.

- It tries to deal with, but does not impose impractical solutions for the inherent control problems of smaller companies, e.g. greater potential for management fraud and bias, high fixed costs of audit committees and internal audit, lack of ideal segregation of duties, etc. Auditing procedures will need to be responsive to these kinds of inherent risks.

- It emphasizes that controls interact to satisfy Attributes, Principles and Concepts, and it encourages the use of good judgment deciding whether or not a company's controls are adequate.

- It includes important cost saving and efficiency guidance, as well as "right sizing" guidance for documentation.

- It should reduce the negative effects of AS #2 by providing a basis for integration of essential auditing procedures with the company's control evaluation, joint auditor – company discussion of judgmental issues, and reduction of audit costs.

Management Led Fraud and Material Weaknesses

I have included these matters in this letter because the Concept Release raises the question of what companies can do about management override of controls and fraud risk.

As noted above, I think the COSO Guidance goes as far as is practicable. But, the remaining risk of override and fraud is still substantially higher than it is that for large companies, and that risk is not tolerable for either.

In my judgment the level of integrity and ethical values remains no better than it was at time that SOX was enacted. This has been confirmed by Moody's May 2006 report [2], and most recently by the widespread option scandal.

I believe that today's risk of override and major fraud is mostly an auditing issue that should be addressed by PCAOB in its planned revision of AS #2.

These are the auditing problems that should be addressed:

- Management fraud risk is not being identified and properly evaluated in the audit of internal controls.

- Control concerns that are identified and evaluated by auditors are not being reported as material until material financial reporting errors are found.

Requiring the improvements in auditing processes described in the accompanying memorandum (titled "Serious Process Problems Require Amendments to AS # 2") will go a long way toward eliminating these problems. They are prerequisites to changes in AS#2 that would reduce testing in reliance on company controls, allow more judgment in determining whether a material deficiency exists, and reduce auditor involvement in management's control evaluation.

That memorandum (sent to the PCAOB on June 23rd) and this one, were reviewed by Charles A. Bowsher, who contributed valuable advice.

Don Chapin

[2] Report titled "The Second Year of Section 404 Reporting on Internal Control"

SERIOUS PROCESS PROBLEMS REQUIRE AMENDMENTS TO AS #2

The Problems in Brief:

1. **Management fraud risk is not being identified and properly evaluated in the auditor's review of the control environment and other company level controls.** Management inspired major fraud was the reason for SOX and the PCAOB. This continuing, insufficiently addressed, risk should not be tolerated.

2. **Control concerns that are identified and evaluated by the auditor are often first reported by the auditor as significant, and are identified as material only when material financial reporting errors are found at some later time.** Early identification of material control weaknesses will provide timely information to investors and will reduce the number of restatements

Evidence:

Moody's May 2006 report, current data showing that publicly reported material weaknesses lag restatements; the recent history of major frauds; now obvious faults in AS #2, and my personal experience with management led frauds and materiality questions.

Some Causes of the Problems:

Judgments about the severity of control weaknesses and their causes are difficult to make. Concerns about the control environment, and to some extent other company level controls, are difficult to link to particular auditing procedures. Auditors are reluctant to raise concerns about management behavior to management and the audit committee without substantial evidence. Newly hired and insufficiently experienced auditors may be making important judgments.

Sufficient and clear cut process guidance in AS #2 will go a long way toward dealing with the above mentioned causes and will reduce the incidence of the problems.

Suggestions to deal with Problem #1:

Management fraud risk is not being identified and properly evaluated in the auditor's review of the control environment and other company level controls.

These process improvements include some that are new and some that are refinements or amplifications of present standards. If accepted as useful they must be in the standards so that the right people will undertake them; and managements and audit committees will not resist them on the basis that they are optional or penalize the lead auditor or his or her firm for insisting on them.

- **Take a top-down look.** Auditors should seek to identify any misstatement concerns before starting the control work through analysis of the client's most recent public reports by auditors trained in analysis of such reports, through inquiry of other analysts covering the client's securities and through careful evaluation of public information about the client's top management people.

- **Compare top management members with the characteristics of fraudsters.** Include a composite personal profile of recent top management fraudsters in the standard, and require an informed evaluation by the audit team of the top management group against that profile. One or more of the large accounting firms may already have such a profile.

- **Examine transactions involving senior management.** Management's extraordinary ability to conceal fraud and illegal acts requires careful analysis by competent business minded audit personnel of all transactions in which senior management may personably benefit. Management self interest and greed are often associated with financial statement fraud.

- **Add other diagnostic requirements.** These could be drawn from earlier deliberations of the Board, and it's SAG, on revisions to the fraud and risk assessment standards, auditing firm criteria for client acceptance and rejection, GAO experience and other respected sources. The risk factors included in the present fraud standards are not focused on senior management fraud and those that might be associated with senior management should be updated by pursuing these references.

- **Involve audit partners.** Require more involvement of audit partners in the evaluation of the control environment; in the process of fraud risk identification, assessment and follow-up required by SAS 99, and in the evaluation of controls specifically intended to address the risks of fraud as required by Paragraph #24 of AS #2. The American Accounting Association Report dated 2/7/06 suggests that fraud risk assessments are "not well calibrated to the presence of risk factors" and that "individual risk factors are difficult to interpret measure and weigh"; and, further, that "proper weighting of global risk factors is challenging in the fraud context".

- **Make the lead audit partner responsible for the key decisions.** Require that the lead audit partner conclude whether or not there is a reasonable possibility of management fraud and, if there is that possibility, designate any further necessary procedures beyond those mentioned below. Individuals may rationalize and not face critical decisions on a timely basis unless strongly encouraged to do so.

- **Require certain limited procedures if fraud is considered reasonably possible.** As a minimum, employees who might be knowledgeable should be asked directly or indirectly whether or not they are concerned about management behavior. Almost always, some employees either know about or suspect management fraud if it exists, or can cite instances of questionable management behavior that should be pursued with other employees. Employees who are not involved in fraud don't want to lie to an auditor and are forbidden to do so by SOX.

- **Ways to make effective employee inquiries should be described** These should include fraud focused questioning during extended walkthroughs of transactions and accounting processes and/or confidential questionnaires about the tone at the top and fraud risk. Either approach should also explore any specific concerns, if it was more than intuition, that caused the lead partner to conclude that fraud was reasonably possible. Guidance should be sufficient to help the responsible auditor craft specific questions that are likely to be effective.

- **Audit Committee involvement.** As with any other critical part of an audit the Committee should be informed of the lead partner's conclusion before the above described procedures are begun. Audit Committee members may have concerns triggered by the auditor's conclusion that fraud is reasonably possible, and these should also be explored in the employee inquiries. The results of the limited procedures should be reported to the audit committee, and the decision to proceed further, or not, considered jointly. If so, the forensic approach should also be jointly considered. The auditor must be satisfied with the decision, the adequacy of the forensic procedures and the appropriateness of the conclusion.

- **Audit Committee issues**
    - Ordinarily, the auditor should resign from the engagement only if the above-mentioned conditions are not met. The existing standard relating to auditor resignation should be modified to encourage the auditor to continue work after concluding that fraud is reasonably possible so that any fraud will be exposed and dealt with expeditiously.
    - Auditors should always inform the Audit Committee if the company is on the audit firm's "high risk" list. This should result in dialog that may help the auditor identify specific risks of management fraud and the related control issues.
    - The lack of an independent Audit Committee or a conclusion by the auditor that the Audit Committee is ineffective raises audit risk and requires both discussion with the full Board and more intensive audit procedures than would otherwise be required especially with respect to the control environment and the monitoring process.

Suggestions to deal with Problem #2:

Control concerns that are identified and evaluated by the auditor are often first reported by the auditor as significant and are identified as material only when material financial reporting errors are found at some later time.

These suggestions, in addition to providing more timely public information and reducing the number of restatements, may sometimes help to identify management fraud.

- **Failure to correct significant weaknesses should not be tolerated.** Any significant weaknesses that are not remedied before the conclusion of the following audit should be publicly reported and the failure to correct them reported as a material weakness in the control environment. This should help, early on, to sharpen the description of the weaknesses and engage the client in developing appropriate solutions.

- **Clarify the existing definition of material weaknesses.** Identified risks of material misstatement that are more than remote and have continuing control implications (whether or not transactions or adjustments have been identified that could be the result of the risk) should always be reported as material weaknesses in internal control.

- **Require audit partner involvement in determining materiality**. In particular, partners should make the final judgments about the materiality of any of the "deficiencies" and "indications" found in the audit that are cited in Paragraphs 139 and 140 of AS #2. This will inject better judgment into these critical parts of AS #2.

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Don Chapin
June 23, 2006