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Via Email

February 26, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-24-06

Dear Ms. Morris:

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 Securities and Exchange Commission's (SEC) proposed interpretive guidance, *Management's Report on Internal Control Over Financial Reporting* (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.

I applaud the SEC 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 SEC has crafted a reasonable standard for providing guidance to management in reporting on internal control. Nonetheless, I have some significant concerns with the SEC's ED, particularly when coupled with the PCAOB's proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals*. The proposals are less detailed, some would say more principles-based, than was the guidance in 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 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 the proposals 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.

Need to Consider Incentives Faced by Top Management

The SEC ED seems to suggest that reliance on on-going monitoring procedures might be sufficient for low risk accounts (see p. 37 of the ED). Fixed assets at WorldCom would probably have been considered a low risk account, but given the strong financial incentives faced by Mr. Ebbers and Mr. Sullivan to hit earnings targets a seemingly low risk account can be used to perpetrate a financial reporting fraud. The SEC ED would be improved if the incentives faced by top management to misstate the financial statements, especially via fraudulent reporting, were explicitly recognized.

Assessing Effectiveness of Audit Committee Oversight

The SEC ED states that a strong indicator of a material weakness is an ineffective control environment, and an example of an ineffective control environment is ineffective oversight of financial reporting and internal control by the audit committee (see p. 45). No guidance is offered in the SEC ED as to the characteristics of effective (or ineffective) audit committee oversight. This is unfortunate because 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 the SEC ED as guidance that can be used by management in assessing audit committee oversight of financial reporting, at least as it relates to the risk of fraudulent financial reporting.

Consequences of Increased Reliance on Management Judgment

The SEC ED permits management great flexibility in defining the scope and nature of its testing of internal control. Increased reliance on management judgment may work well where management is competent and *honest*. However, in situations where management lacks integrity (i.e., fraud situations), increased reliance on management judgment is likely to result in management's opinion being totally worthless.

The SEC ED will almost certainly result in management doing less testing than was previously the case. This reduction in management testing will reduce the assurance provided by management's certification, seemingly calling for greater assurance from the auditor. But the PCAOB's proposed replacement of AS #2 will almost assuredly result in less audit work and probably less audit assurance. This combination, although likely lowering the costs of internal control reporting, is also likely to result in a lowering of the assurance of internal control effectiveness received by investors.

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

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