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November 19, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: <u>PCAOB Rulemaking Docket Matter No. 008</u>

I am pleased to have this opportunity to comment on the PCAOB's Proposed Auditing Standard, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements." This proposed standard is exceptionally well written and comprehensive, and, in my opinion, will significantly enhance investor protection by improving the credibility and reliability of financial reporting by public companies. I, therefore, wholeheartedly endorse this much needed and well balanced standard and recommend its early adoption by the PCAOB. I also wish to commend the authors of the proposed standard for their significant efforts in producing such an excellent document.

The remainder of this letter constitutes my detailed comments and suggestions relative to certain provisions of the proposed standard, and I respectfully request that the PCAOB consider them in finalizing the standard. Such comments and suggestions refer to the specific paragraph numbers in the text of the proposed standard.

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1. **Paragraphs 32-35 Independence**

Paragraph 32 states that: "The applicable basic principles of independence are that, to remain independent, the auditor must not function in the role of management and must not audit his or her own work." I recommend that the proposed standard also include a statement that the auditor must not act as an advocate of the client and not enter into improper relationships with the client that would result in a conflict of interests. This could result, for example, in a situation where the auditor designs and implements systems and controls that have a significant impact on the audit client's internal controls and financial reporting.

I am concerned about an auditor providing "internal control services" (paragraph 33) to his or her audit client when the auditor must also render an opinion regarding the client's internal control. Unless the internal control services are insignificant, it is difficult to imagine that the auditor is not compromising the appearance of his or her independence and that the auditor is not running the risk of auditing his or her own work. Moreover, having the audit committee pre-approve the internal control-related services does not mitigate or cure the two problems referred to above. Unless the internal control services performed by the auditor are insignificant, it would be better to prohibit such internal control services in order to avoid problems and abuses regarding this potential conflict.

2. **Paragraphs 79-83 Performing Walkthroughs**

I agree that walkthroughs should be a required procedure and that they should be performed directly by the auditor. However, in practice, I have seen repeated failures regarding two aspects of walkthroughs. The first is that the scope of the walkthroughs is often woefully inadequate. I have seen auditors trace only one transaction through systems for key accounting cycles. This is especially risky where there may be different types of transactions in a particular accounting cycle. The second aspect is that inexperienced, new staff personnel typically perform walkthroughs despite that they may not have the audit experience and training to even understand all of the processes involved in a complex accounting cycle. Accordingly, I recommend that the PCAOB consider these two issues and incorporate language in the proposed standard that requires walkthroughs to be performed by appropriately experienced staff and clarify that the scope be sufficient to provide assurance that the auditor has covered all types of transactions in a particular accounting cycle. I further recommend that language be incorporated that specifically requires the tracing of more than one transaction through a particular accounting cycle system.

3. Paragraphs 103-110 Use of the Work of Management and Others

In paragraph 109, the proposed standard states that the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. I recommend that an additional statement be made following such sentence emphasizing that the higher the risk of misstatement relative to a particular account or system, the greater the requirement for the auditor to perform the testing himself or herself.

In paragraph 103, consideration should be given to adding an additional factor in deciding whether to use the work of management and others, as follows: "The potential for management override of particular controls and the overall system of internal control." Consideration should also be given to adding this same point in paragraph 104.

4. **Paragraphs 116-127 Evaluating Deficiencies in Internal Control Over Financial Reporting**

Paragraph 126 states that one of the strong indicators that a material weakness in internal control over financial reporting exists involves significant deficiencies that have been communicated to management and the audit committee which remain uncorrected "after some reasonable period of time." I suggest that consideration be given to providing a guideline or a definition as to the meaning of "some reasonable period of time" in order to avoid confusion and inconsistency in the application of this provision of the proposed standard.

5. **Paragraphs 128-130 Requirement for Written Representations**

Paragraph 128 states that in an audit of internal control over financial reporting, the auditor should obtain written representations from management. I recommend that an additional sentence be added which states that, while such representations constitute part of the evidence the auditor obtains, client representations alone are insufficient evidence upon which to base the auditor's opinion and are not a substitute for obtaining other sufficient competent audit evidence.

6. **Appendix E Special Internal Control Over Financial Reporting Considerations for Small and Medium-Sized Companies**

Paragraph E3 states that the integrity of senior management often plays a critical role in establishing a strong control environment in a small company. Moreover, throughout Appendix E, statements are made to the effect that the interaction of senior management in small companies can provide an effective control environment and, thus, play an important role in maintaining effective internal controls in such companies. While such statements are certainly true, there can also be an additional risk factor in small companies caused by the dominance of one or a few senior management individuals which, in turn, can cause a significantly increased risk of management override and circumvention of controls and systems. In practice, I have seen as many problems with senior management override of controls and systems as I have seen enhanced internal control by senior management. Accordingly, I recommend that a description be included in Appendix E which explains that dominance by senior management can often cause greater potential override of internal control systems in small companies.

Thank you for this opportunity to express my views and offer recommendations relative to the proposed standard on internal control. Should you have any questions or need additional information, please do not hesitate to contact me.

Yours very truly,

Charles R. Drott