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Office of the Secretary
PCAOB
1666K Street NW
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Re: Proposed Auditing Standard on ENGAGEMENT QUALITY REVIEW

Overview:

My perspectives are from the view of an academic who has spent my entire career with a career-long interest in auditing. I currently sit on two public company boards, one in China and one in the U.S. I understand the need for the PCAOB to issue guidance to ensure that there is consistent execution of the audit programs by partners and staff. A robust internal review of engagements for the quality of the audit performed should be helpful in meeting this overall objective. Thus, I am supportive of the PCAOB's efforts to improve audit quality.

At the most recent audit committee meeting of a U.S. Company on which I serve, the partner (from a Big 4 firm) presented a brief review of proposed PCAOB standards and how they might affect the audit. I was surprised to hear that they estimated that the engagement quality review standard would result in an increase of between 75 – 100 hours of partner time and additional costs of review (for \$1 billion revenue company).

The Audit Committee Chair questioned why the additional 75 – 100 hours was necessary when the firm had demonstrated to us that they had adequate processes to protect both the public and the audit committee, and that was a factor we considered when we changed auditors this year. My sense was that the standard was aimed at codifying best practices and I wondered if the firm was overreacting. The idea of ensuring that high quality audits are performed seems unassailable.

My understanding is that the PCAOB believes that many (but probably not all) firms need to improve their engagement review processes because the PCAOB inspection process uncovers too many audit deficiencies. The overall goal is to ensure high quality audits without adding disproportionately to the cost of audits.

Upon a second and third reading the proposed standard, I have developed some reservations about the current wording in the proposed standard. I have become concerned that the standard may have *some unintended consequences* of adding costs without adding (or contributing) to an increase in the quality of the audit. My sense, partially based on my reading of PCAOB inspection reports, is that there is a real need for consistent guidance for engagement reviews, but in particular for some of the smaller firms that audit public companies. I concur with the concern that many smaller public accounting firms have not demonstrated the expertise to fully implement concurring partner reviews, and some of the larger firms may not be sufficiently challenging the engagement partner. In my view, the addition of guidance for all firms is a good thing, and the firms must demonstrate that they are performing meaningful engagement quality reviews. Alternatively, if the firms cannot demonstrate meaningful engagement quality reviews, they should not be in the business of performing public company audits. Thus, there is a need for guidance. However, there is always a potential trade-off in becoming too prescriptive in a standard that may raise costs beyond that required to perform high quality engagement reviews.

I will first describe some overall concerns with the proposed standard and then will talk about specific paragraphs within the standard that may cause some problems. I will also address some of the specific questions you raise in your introduction to the standard.

Objective of the Guidance

I am concerned about the lack of a clear objective for the performance of the Engagement Quality Review. Let's assume that a public accounting firm has processes that are designed to ensure that all issues are properly documented and addressed in the audit engagement (a requirement under current standards). Then, I need to ask: What is the major purpose of the Engagement Quality Review? Is it:

1. To ensure that all of the required procedures have been performed, including documentation and resolution of high risk, or other significant areas, in the audit engagement, or
2. To require an independent, competent audit and accounting skeptic to evaluate the major decisions made by the engagement team, i.e. to exercise independent judgment as to whether the engagement team reached the correct solutions, as well as gathered appropriate evidence. In essence, this would be a 'super engagement partner' (at least one more independent level above the engagement partner).

I view these two objectives as being distinctly different. For example, paragraph 7 states that the review 'should include an evaluation of the significant judgments made by the engagement team and the conclusions reached ...". This statement would imply that the objective of the standard is the second one listed above, i.e. a second evaluation of significant judgments. On the other hand, paragraph 10 covers the review of documents, and indicates that the review of documentation should address whether the documentation "indicates that the engagement team responded appropriately to matters that present a significant risk." Thus, paragraph 10 implies an Objective 1 noted above. Perhaps the standard intends to imply both, but if it does, you might want to consider timing issues. Further, we need to ask if this objective is necessary given that (a) it is the engagement partner's responsibility to see that documentation is adequate, and (b) a firm should have a formal internal review process to see that its auditors are adhering to professional (and firm) standards requiring adequate documentation.

I believe that the standard should be very clear that the objective is to ensure that there is an independent review by a knowledgeable person (or group) within the firm to ensure that a sufficient audit has taken place and that the financial statements reflect appropriate treatment of all material items in the financial statement. The ISA statement (footnote 8) implies objective no. 2 above. Does the PCAOB want both, or is objective 1 part of a normal quality review process that every firm should have, but is not required before the completion of the audit? That is a decision you will have to make based on more detailed information that you have from your inspection reports. Then, within the guidelines you present, I would leave it up to the firms to determine the most appropriate way to accomplish that objective.

One additional comment, if the objective is no. 1 above, we need to make sure that in this era of 'accelerated filings' and the pressure by the SEC to move the time deadline for audited filings to a quicker date after year-end, whether such a review can be completed before the deadlines to file such reports. Perhaps it can be addressed, as the standard describes, by more interim reviews of documentation by the engagement quality review team. My preference might be to leave objective no. 1 as part of the firm's internal review procedures to ensure quality audits.

Performance of the Engagement Quality Review

There is an implicit assumption that all of the review work is performed by **one person**, and that person must be an audit partner with a level of knowledge about a client that is equal to that of the engagement partner. However, I may be reading too much into the overall standard because a note to paragraph 5 does state that the reviewer “may seek assistance from others.” But, it does not specify the level (partner, manager, senior, etc.) from which that assistance may be procured. As I review the nature of the engagement quality review guidance proposed in the standard, it is my opinion that there is some work that could be reliably performed by someone other than a partner.

I will use an old example here. Back when I worked for Ernst & Ernst, they had a technical review committee in Detroit for the Detroit region. It was composed of partners, senior managers, and heavy seniors. They were experienced in auditing and accounting and very knowledgeable. Most of their reviews were of a technical nature, focusing on the 10K, but they also looked at the documented rationale of significant judgments made on an audit (for example, valuation of inventory or receivables). I found their reviews to be incredibly well done. The department was independent of the engagement partner, and they had the final word on whether the audit report could be issued. More importantly, the work could be reviewed at different levels, e.g. senior managers reviewing documentation, planning, and support for conclusions. Partners reviewed risk and major accounting or audit issues. A heavy senior might review aspects of documentation. It seems that such a model might work if the standard addresses both of the objectives noted above. However, the proposed standard does not seem to contemplate such a structure. I would allow the flexibility for a firm to determine the best way to accomplish the objective, rather than focusing on a ‘review partner’ approach. The engagement partner ultimately has a responsibility to determine that the audit was completed in accordance with PCAOB standards and the financial results are appropriate according to GAAP. The reviewing team should determine that there is sufficient support for that conclusion.

The introductory material in the proposed standard cites research by Epps and Messier. While I agree with the nature of their research, I am concerned that the standard may be implying that a “checklist or practice aid” may be required for all engagement reviews. While I do believe that many firms would benefit from such a practice aid, I also worry that we may contribute further to the checklist approach to auditing. Each firm should design their own procedures that best meet the objectives of quality review. A checklist may be useful, but so would other approaches that rely on more significant inquiry by the engagement team.

Other Comments

1. I am not sure why the standard is required for *reviews of interim financial information*. These engagements provide a different level of assurance than do the audit engagements. In my view, firms should develop their own internal quality processes that may, or may not, include an engagement quality reviewer for interim financial information.
2. There are a couple of issues in *paragraph 8* that might be improved:
 - a. I believe that in part b, the engagement quality reviewer should also obtain information about the quality of internal control, *as it had existed at the date of last report*, as important information to determine if the audit had been properly planned. Part 8(g) only seems to imply that the auditor look at the current report on internal control.
 - b. Part (f) implies that consultations take place on an engagement, but no criteria are given as to what is required for consultation. If it is judgmental, then the standard should so state. I am worried about this requirement because all of the firms will face continuing pressure to make more ‘principles-based’ decisions in the near future, and thus there will be a need to push more of the accounting analysis down to the engagement team. The key is to have processes in place, that could include consultation, that the engagement team gathers the correct information to make an informed and supportable accounting choice regarding the economic substance of transactions, or current states of value, and the client records them according to the appropriate GAAP.
3. Consistent with my comment earlier about the review process, I believe that *paragraph 10* could be spelled out a bit differently. The engagement audit partner and manager should determine that appropriate documentation is developed. There should be a process within a firm’s audit methodology to demonstrate that such documentation has been developed. Thus, in my mind, the engagement reviewer (or team) should:
 - a. Determine that such a process to ensure that proper documentation exists, and there is evidence of that process in the working papers.
 - b. Then, assuming such a process exists, the engagement quality reviewer should sample existing documentation to determine that it meets the requirement. The sampling could be risk based, or on some other base that the PCAOB may think appropriate.

Further, the lead-in focuses on “engagement documentation of the matters that were subject to engagement quality review procedures”. It is not clear what is meant by that phrase. Is it limited to the areas described in paragraph 8, or are there other criteria that may be applicable? Is it contemplated that there should be some random, or risk-based approach to examine audit evidence?

4. *Qualifications of the Engagement Quality Reviewer.* Para 4 on Competence may be difficult to clearly implement. For example, if an engagement partner is going to perform the engagement quality review of a company in a highly specialized industry, must that engagement reviewing partner have the same level of industry expertise as the engagement partner? This could cause some difficulty in areas such as oil and gas. The real issue, in my view, is whether the PCAOB expects to have the engagement review team utilize a review process to see that the audit is properly performed, or does it expect the engagement reviewing partner (or team) to have the level of expertise to fully understand all the risks applicable to that engagement, and to understand those risks at the same level as the engagement partner and engagement team, and thus be in a position to second guess the audit. The proposed wording, in my mind, assumes the latter. I think there should be consideration as to whether the former would be sufficient (my preference). I personally believe that a good reviewer, with knowledge of an industry, could do a sufficient engagement review, but not have all the same expertise as the engagement partner.
5. *Paragraph 12.* Let us assume that the purpose of the standard is to provide enough guidance such that the standard is adhered to by all firms that are registered to practice with the PCAOB. If that is the case, I don't believe we need the partial sentence that states: "or should know based upon the requirements of this standard. . .". That phrase introduces legal jargon into the auditing literature that could be dysfunctional. I believe such jargon is unnecessary because the presumption should always be that auditors will follow the standards.

Suggested Improvements

The following suggestions are intended to be constructive and address many of the issues raised in the introduction to the standard.

1. I would prefer a more *objectives-based* approach to the standard. If the objectives are more clearly laid out, the firms should be provided with flexibility to demonstrate that they are accomplishing the objectives (most likely within guidelines you further develop).
2. I prefer a change in *terms*. Rather than using the term "engagement quality reviewer", I suggest using a term that might recognize that an engagement quality review can be an individual partner, or could be a team that is led by an individual partner and might include other members. Such a term could be "engagement quality review team."

3. Given the objective of the engagement review process, it might be possible that the engagement quality review team might have more general expertise, such as expertise in reviewing the quality of audit engagements. This is in contrast to the detailed knowledge of the company being audited and the industry risks. That is not to say that I don't believe industry knowledge is necessary, but that knowledge may be pulled in by the engagement team and the engagement review process should determine that there is evidence that such knowledge was utilized in the audit.
4. The requirement for an engagement quality review should be eliminated for review reports on interim information. Since these reviews are not audits, and rely heavily on the quality of the company's internal control processes, I do not see the need for mandated engagement quality reviews.
5. An integrated audit requires an audit opinion on both the financial statements and the effectiveness of the company's internal control over financial reporting. I did not get the impression that these two issues are treated on an equal footing in the proposed standard (admittedly, I am probably biased here). I would suggest that issues related to internal control evaluations be elevated to the same level as the financial reports.
6. As noted earlier, the guidance on consultations could be improved. It is not clear when consultations are needed. It is usually a call by the engagement partner, or sometimes by the audit client, or there may be explicit guidance by each firm. It should be recognized that judgment is used in determining whether consultations are required and those judgments should be documented. Thus, the proposed guidance on consultations with the engagement review team could be placed in that context.

Responses to Specific Questions

1. *Overall objective.* Yes, I believe the standard definitely needs a more explicit objective statement.
2. *Requirement.* I believe it should be required only for audit engagements, and not for reviews of interim financial information. The level of assurance added by auditors in providing interim reviews is very different than that provided in connection with an audit.)
3. *Qualifications of Reviewer.* No, I do not believe the qualifications of the engagement quality reviewer are properly described. There are alternative ways to accomplish the objectives of an engagement quality review. Refer to comments above.

4. *Engagement team consultation with the engagement reviewer.* Each firm should have processes in place that determine when, and if, consultations with someone else in the firm should be performed. As stated in the views expressed above, I believe the purpose of this standard should be on the audit process that a firm has employed to conduct a high quality audit in accordance with the PCAOB standards. Thus it should not be necessary to consult with the engagement reviewer. However, I would stop short of prohibiting such a consultation. My major concern is that each firm should develop a process, and the engagement review team should focus on the audit process and the existence of support for conclusions reached by the engagement team, including an analysis of both accounting and internal control issues to support the audit opinions.
5. *Scope and Extent of the Engagement.* I do not believe they are appropriately described. Nor, do I believe they can be appropriately described until such time as the objective becomes clearer.
6. *Risk-based approach.* I believe the guidance is fine on this dimension. However, it is difficult to fully assess this question without better understanding the overall objectives of the proposed standard.
7. *Review of documentation.* The lead-in material that is described just before you ask question 7 seems clearer to me than the actual standard.
8. *Timing.* This seems fine.
9. *Standard for concurring approval.* I think this area can, and should be, improved. See my comments above.
10. *Documentation requirements for a review.* These seem appropriate.
11. *There was no question 11.*
12. *Relationship to AS3.* Yes, I believe the reference is appropriate.

Summary

Reading the proposed standard once again reminds me of how difficult the job of standard-setting is. Based on my reading of selected PCAOB inspection reports, there is a need for the proposed guidance. The guidance as to areas that should be reviewed, particularly in paragraph 8, is good. I do believe that there should be more emphasis in

specifying the objective of the standard, i.e. is it a review of the audit, or a second “guessing” of the audit by an experienced partner. I see these two as different.

While I am less concerned about the cost of the review process than some of my colleagues, I do believe that the cost considerations should be considered. If the same objective could be accomplished with different approaches, we should encourage firms to concentrate on the approaches that they can demonstrate (a) accomplishes the objectives of the standard, and (b) are most cost effective for them.

I would be happy to discuss any of the above observations at your convenience. I do applaud the PCAOB for moving forward in this important area.

Sincerely,

**Larry E
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