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CERTIFIED PUBLIC ACCOUNTANT • CERTIFIED FRAUD EXAMINER

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

**Re: PCAOB Rulemaking Docket Matter No. 012**

I am pleased to have this opportunity to comment on the PCAOB's Proposed Auditing Standard, "Audit Documentation," and Proposed Amendment to Interim Auditing Standards, "Part of Audit Performed By Other Independent Auditors." Comprehensible and thorough audit documentation is essential in order to achieve audit integrity and quality. It provides greater discipline to the audit process which, in turn, should result in enhanced investor protection.

This proposed standard is a significant improvement over the existing standard on audit documentation because it incorporates many new provisions which are necessary to (1) enhance the quality of audits; (2) enable the PCAOB to fulfill its oversight and inspection mandates; and (3) improve investor protection by reducing the incidence of audit failures. I, therefore, enthusiastically endorse this greatly improved audit documentation standard and recommend its early adoption by the PCAOB. I also wish to highly commend the authors of the proposed standard for their significant efforts in producing such greatly improved guidance to the nation's auditors.

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

### OBJECTIVES OF AUDIT DOCUMENTATION

#### Paragraph 3

Paragraph 3.c. of the proposed standard states that: "Engagement partners and engagement quality control reviewers review documentation to understand how the engagement team reached significant conclusions and whether there is adequate evidential support for those conclusions." I recommend that an additional reason be given for such reviews which states that reviewers review documentation to ensure that an appropriate opinion is issued relative to the audit engagement based on the evidence obtained. Such a comment should be added because it describes the primary objective of any review by an engagement partner or engagement quality control reviewer.

### CONTENT OF AUDIT DOCUMENTATION

#### Paragraph 5

Paragraph 5 of the proposed standard states the following:

Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement:

- a. To understand the nature, timing, extent and results of the procedures performed, evidence obtained, and conclusions reached, and
- b. To determine who performed the work and the date such work was completed, as well as the person who reviewed the work and the date of such review.

I support the above described language for inclusion in this proposed standard, which is similar to the G.A.O.'s standard on audit documentation, because it clearly represents a significant improvement over the current existing standard. However, I

recommend other additional items for inclusion in this paragraph. First, the term "experienced auditor" needs to be defined, or at least explained, because, without such definition or explanation, it is vague and open to widely varying interpretation. Such definition or explanation should, at a minimum, refer to an appropriate level of experience relative to the risks and complexities of the engagement and the industry in which the client company operates.

I further suggest that paragraph 5.a. be expanded to include "an understanding of the logic and reasoning supporting important audit judgments." If such logic and reasoning are not appropriately documented, there is no effective manner for an "experienced auditor" or reviewer to evaluate the soundness of significant audit judgments made and their compliance with professional standards. In essence, without such documentation, overall audit quality is difficult to evaluate, which has been a significant continuing problem for firms and peer reviewers as well as regulators and others who review audit documentation.

Paragraph 5.b. states that audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement to determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review. I fully support this requirement, which is very similar to a provision of a newly enacted California regulation. It is critical for firms and outside reviewers to know the identities of the professionals responsible for the work and the timing thereof in order to evaluate the exercise of due professional care in the engagement and compliance with other professional practice standards (independence, training, adequate professional skepticism, etc.).

The new California regulation referred to above, however, also includes certain other provisions that this proposed standard does not currently incorporate. Such California regulation requires that audit documentation also include both the audit report (opinion) date and the date such audit report was issued because such vital information is often not included in audit documentation. Further, there is another California requirement that audit documentation include an index or guide which identifies the components of the audit documentation. I respectfully request, therefore, that the PCAOB give

consideration to including these additional requirements in its final standard in order to further enhance the usefulness of audit documentation to the PCAOB's inspection staff and others who review audit documentation.

#### **Paragraph 6**

Paragraph 6 of the proposed standard incorporates the rebuttable presumption provision which I wholeheartedly endorse. Such provision, which has been enacted into law in California, states that failure by an auditor to document audit procedures performed, evidence obtained, and conclusions reached will create a presumption that the procedures were not applied, the evidence was not obtained, and the conclusions reached were not suitably supported. Such presumption, however, can be rebutted by persuasive other evidence that the procedures were applied and the evidence was obtained to provide sufficient support for the conclusions reached.

The California Board of Accountancy ("California Board") has continually encountered instances in enforcement proceedings where auditors claimed that audit work was performed but not documented. This has made the California Board's investigations and related enforcement proceedings very difficult because the burden of proof at the time rested with such Board. In order to better protect consumers and investors by enhancing the ability of its enforcement staff to engage in meaningful investigations of alleged audit failures, the California Board and lawmakers adopted a rebuttable presumption provision which shifted the burden of proof to the auditor that performed the audit. The California Board and lawmakers determined that it was not only logical but also more fair to consumers and investors for the burden of proof to be shifted from the California Board to the auditor that performed the work because the auditor is the most knowledgeable about the actual work that was performed.

I noted that the PCAOB's November 12, 2003 Briefing Paper contained an important statement that is not included in paragraph 6 of the proposed standard. Such statement is as follows:

Oral explanation alone does not constitute persuasive other evidence (to rebut the presumption that the

audit procedures were not performed, the evidence was not obtained, and the conclusions reached were not suitably supported).

In response to the PCAOB's invitation to comment on the addition of such a requirement to the proposed standard, I strongly believe that while auditors should be allowed to offer oral explanations regarding the performance of audit procedures and evidence obtained, such oral explanations alone should not constitute persuasive other evidence. Accordingly, I urge the PCAOB to incorporate into its final standard the critical statement described above that was included in its Briefing Paper in order to discourage auditors from claiming that audit work was performed but not documented. By taking this position, the PCAOB will greatly enhance investor protection.

#### **Paragraph 9**

Paragraph 9 of the proposed standard describes several examples of "significant findings or issues" that must be reflected in audit documentation. As one such example, paragraph 9.d. refers to disagreements among members of the engagement team or with others consulted on the engagement about conclusions reached in significant accounting or auditing matters. I suggest that this example be expanded to also include disagreements with client management or other representatives of the client regarding significant accounting or auditing matters. Further, I would also include another example, as follows: "Evidence of and conclusions regarding fraudulent financial reporting or misappropriation of assets." This is a particularly important example to include in the standard because of the significant number of incidences of fraudulent financial reporting involving public companies in recent years.

Although paragraph 9 gives several good examples, as referred to above, there is no clear definition or explanation of "significant findings or issues." I suggest that the proposed standard include a definition or an explanation as well as examples of "significant findings and issues" in order to provide as much guidance as possible to auditors, and, thus, minimize confusion in the application of the standard.

**Paragraph 10**

Paragraph 10 of the proposed standard requires that the auditor identify all significant findings or issues in an engagement completion memorandum and that such memorandum be as specific as necessary in the circumstances and include cross-references to other supporting audit documentation. As the use of an engagement completion memorandum currently varies in practice, I fully support the provision to require its use in all audits of public companies. Such a memorandum that reflects all significant findings or issues is a valuable and efficient tool to assist the audit engagement partner and others that review audit documentation in identifying and evaluating important matters in an audit engagement. Its value is especially evident in large engagements involving audit work performed and documentation generated in multiple locations.

I further recommend that paragraph 10 be expanded to require that the engagement completion memorandum include a discussion of any audit evidence that does not support or that contradicts the auditor's final conclusions (see paragraph 12 of the proposed standard) or where there has been a difference of opinion among the audit staff or between client management and the auditors regarding any significant auditing or accounting issue. Further, I also recommend the inclusion in paragraph 10 of a provision that requires the audit engagement partner to state his or her conclusions regarding the appropriateness of the audit opinion issued and whether the audit work has complied with all relevant auditing and other professional practice standards.

**RETENTION OF AND SUBSEQUENT CHANGES TO AUDIT DOCUMENTATION**

**Paragraph 13**

Paragraph 13 of the proposed standard requires that audit documentation be retained for seven years from the date of completion of the engagement, as indicated by the date of the auditor's report, unless a longer period of time is required by law. I recommend that an additional provision be included in the proposed standard which provides that all audit documentation required to be maintained shall be maintained in

accessible form. Further, the proposed standard should also include a statement that if audit documentation is required to be kept for longer than seven years because of a pending PCAOB or other regulatory investigation or disciplinary action, audit documentation shall not be destroyed until the audit firm or auditor has been notified in writing by the PCAOB or other regulatory agency of the closure of the investigation or disciplinary proceeding.

I also strongly recommend that a further provision be added to paragraph 13 which requires audit firms to maintain and document compliance with a written audit documentation retention and destruction policy. Such policy should provide for the preservation of audit documentation for the full seven year period or longer period of time required by law, as described above. The policy and documentation of compliance therewith must be made available to the PCAOB or other regulatory agencies upon request. The policy should include procedures for maintaining audit documentation, approving changes to audit documentation, approving the destruction of audit documentation, and authorized custody of audit documentation.

#### **Paragraphs 14 and 15**

Paragraph 14 of the proposed standard requires that the auditor complete all necessary auditing procedures and obtain sufficient evidence to support the representations in the auditor's report prior to granting permission to use the auditor's report in connection with the issuance of the client's financial statements. Such proposed standard further states that a complete and final set of audit documentation must be assembled for retention within a reasonable period of time following the first time the auditor grants permission to use the auditor's report in connection with the issuance of the client's financial statements, and that "such reasonable period of time ordinarily should not be more than 45 days." (Emphasis added).

While this is an excellent provision, I am concerned that use of the phrase "ordinarily should not be more than 45 days" is vague, confusing, and may open the door for circumvention of an otherwise good provision. I, therefore, strongly recommend elimination of the word "ordinarily" from the above phrase which clarifies that there is a 45 day maximum time period to

assemble a complete and final set of audit documentation for retention.

As stated above, paragraph 14 of the proposed standard requires that the auditor complete all necessary auditing procedures and obtain sufficient evidence to support the representations in the auditor's report prior to granting permission to use the auditor's report in connection with the issuance of the client's financial statements. However, paragraph 15 then states that circumstances may require subsequent additions to the audit documentation. Moreover, paragraph 15 also refers to obtaining evidence after completion of the engagement as well as "post-issuance procedures." I am concerned that auditors may view paragraph 15 as somewhat contradictory to paragraph 14 and, as a result, there could be confusion as to what is allowed regarding work performed or evidence obtained subsequent to issuance of the audit report.

In order to provide clarity, I recommend that paragraph 15 be expanded to include an explanation and/or examples of the "circumstances" that may require subsequent additions to audit documentation and an explanation of the circumstances under which evidence may be obtained after completion of the engagement. Moreover, I further suggest that an explanation and/or examples be given in paragraph 15 of the reasons for performing and the nature of any "post-issuance procedures." I am concerned that without such explanations and/or examples, auditors may erroneously conclude that there may be circumstances where they can actually perform audit procedures and obtain evidence subsequent to the issuance of an audit report which would violate the requirements of paragraph 14, as discussed above.

In order to avoid such a problem, the California Board of Accountancy adopted regulations which stated the following:

During a 60 day period after the date of issuance of the audit report, documents may be added to the file for the assemblage and documentation of work previously performed. Nothing in this subsection authorizes the deferral of audit procedures required to be performed prior to the date of issuance of the [audit] report. (Emphasis added).

Paragraph 15 also contains a requirement that any additions or changes to audit documentation subsequent to issuance of the audit report must reflect the date the information was added or changed, by whom it was added or changed, the reason for the addition or change, and, in the case of a change in documentation, the nature of the change. I very much support these new requirements and recommend a further requirement in paragraph 15 (similar to the new requirement enacted in California), as follows:

The documentation which is added or changed must contain sufficient detail to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, reasons for, and extent of the addition or change.

#### **Paragraph 16**

Paragraph 16 of the proposed standard requires that audit documentation sufficient to meet the requirements of paragraphs 4-12 of such standard must be retained by the office issuing the auditor's report. As paragraph 16 notes, this requirement encompasses documentation of work performed by others, such as affiliated firms (including foreign affiliates) of the auditor issuing the audit report. I fully support and have advocated this new requirement because of significant problems encountered in the past in not being able to obtain audit documentation from foreign affiliates of audit firms whose work was being investigated because of foreign legal jurisdictional issues and lack of cooperation from foreign affiliates.

It is critically important that the PCAOB and other regulatory agencies have access to all audit documentation for an audit engagement, including documentation from foreign affiliate firms, for inspection at the office that issued the audit report. It is only logical and reasonable to have all the audit documentation at the office that issued the audit report, especially since the engagement partner at such office has the ultimate responsibility to review the documentation and sign such audit report. The only possible hardship on the audit firm would be transportation and/or copying costs which pale compared

to the inability of the PCAOB and other regulatory agencies to inspect audit documentation of foreign affiliates. Further, in instances where the audit work performed by foreign affiliates constitute significant support for the audit report, the problem is exacerbated.

I, therefore, applaud the PCAOB for including this important provision in its proposed standard in order to assure that all audit documentation is available for inspection by the PCAOB and other regulatory agencies. In my opinion, if this new language does not remain intact in the proposed standard because of opposition to its inclusion, it will open the door for further abuse by audit firms that either do not want to go to the trouble of making such documentation available to all authorized agencies, or that have performed substandard audit work at foreign locations and wish to conceal the evidence of such work from the PCAOB and other regulatory agencies.

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

Yours very truly,

Charles R. Drott