

Mr. J. Gordon Seymour
Secretary
Public Company Accounting Oversight Board
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12 May 2008

Proposed Auditing Standard–Engagement Quality Review and Conforming Amendment to the Board’s Interim Quality Control Standards; PCAOB Rulemaking Docket Matter No. 025

Dear Mr. Seymour:

We are pleased to comment on the Public Company Accounting Oversight Board’s (“PCAOB” or the “Board”) Proposed Auditing Standard–Engagement Quality Review (“the Proposed Standard”) and Conforming Amendment to the Board’s Interim Quality Control Standards (“the Proposed Amendment”), collectively referred to as “the Proposal.”

As a preliminary matter, we support the Board’s efforts to adopt a comprehensive standard consistent with Section 103 (a) (2) (A) (ii) of the Sarbanes-Oxley Act, which requires that the Board adopt a standard that registered public accounting firms “provide a concurring or second partner review and approval of [each] audit report (and other related information), and concurring approval in its issuance, by a qualified person (as prescribed by the Board) associated with the public accounting firm, other than the person in charge of the audit, or by an independent reviewer (as prescribed by the Board).” We also are of the view that engagement quality reviews are but one element of an overall system of quality control. Therefore, proposed changes to the Board’s interim standards should be considered in the context of a firm’s system of quality control taken as a whole.

An engagement quality review that focuses on significant judgments made and conclusions reached by the engagement team is effective in promoting audit quality. Because of the importance of this role, we also believe an engagement quality review should be required for every audit conducted pursuant to the standards of the PCAOB. We also believe ongoing consultations between the engagement team and the engagement quality reviewer are critical to the audit process. Therefore, we also agree that the engagement team should be permitted to consult with the engagement quality reviewer during the engagement, providing the engagement team and the reviewer do so in a manner that does not impair the reviewer’s objectivity.

We believe the final standard should state the purposes and objectives of the engagement quality review. It is critically important that regulators, investors, audit committees, and company management have a consistent understanding of the intent of the engagement quality review. Further, a clear articulation of the overall purpose and objective of the review will help auditors in applying professional judgment in determining the nature and extent of the review procedures to be

applied. A clearly stated objective also will aid in differentiating the role and function of the engagement quality reviewer from that of the engagement partner and other members of the engagement team.

We agree with the Board's view that "well-performed engagement quality reviews are an important element in establishing a basis for investor reliance on audits." However, despite our support for a comprehensive standard, we are concerned with the following aspects of the Proposed Standard that we believe will significantly change the nature and scope of the engagement quality review and will result in additional costs associated with such reviews without a corresponding benefit to audit quality.

Summary Views on the Proposed Standard

The Proposed Standard would significantly change the nature and scope of the engagement quality review. Since its inception as a membership requirement of the SEC Practice Section of the AICPA Division for CPA Firms, the engagement quality review has been a "fatal flaw" review with the stated objective of identifying potential matters that, if not addressed prior to issuance of the audit report, potentially would require recalling and reissuing the audit report when subsequently discovered. Under current PCAOB interim standards, the engagement quality reviewer can provide concurring approval so long as "no matters had come to his or her attention that would cause the [reviewer] to believe" that the financial statements did not conform to generally accepted accounting principles in all material respects or that the audit was not performed in accordance with generally accepted auditing standards. We believe that PCAOB inspection reports of both larger and smaller audit firms, for the most part, corroborate that engagement quality reviews performed under existing standards have accomplished this objective.

Furthermore and as more fully described in later sections of this comment letter, the Proposed Standard differs substantially from the requirements of international auditing standards promulgated by the International Auditing and Assurance Standards Board. We believe the final standard should more closely align with international standards, which would result in a more appropriate focus for the engagement quality review. Moreover, doing so would be consistent with the growing demand for convergence of world wide accounting and auditing standards and the broad-based recognition of the benefits of developing a single set of standards for worldwide use. We believe that further consideration should be given to the benefits of convergence and to avoiding the creation of unnecessary substantive differences in standards.

The Proposed Standard, when considered in its entirety, would require the engagement quality reviewer to determine that he or she has sufficient grounds to positively concur with the issuance of the audit report. In our view, this requirement would significantly expand the scope, effort, and related cost involved with performing the engagement quality review as it would require the reviewer to duplicate many aspects of the role and function of the engagement partner and other members of the engagement team and likely duplicate other firm-wide monitoring procedures. Under the Proposed Standard, the engagement quality reviewer would be compelled to develop separate determinations and judgments on significant matters rather than evaluate the significant judgments made and conclusions reached by the engagement team in the audit. This, in turn, would require that the reviewer acquire his or her own base of knowledge to make such determinations and judgments. Further, this requirement would shift the focus of the engagement quality review away from

identifying potential material misstatement(s) of the financial statements and determining whether the engagement team reached reasonable conclusions about significant matters and instead focus on the adequacy of the review itself and the basis for the reviewer's separate determinations. We do not believe this shift in focus would serve to enhance audit quality.

We also believe the Proposed Standard sets expectations, obligations, and performance standards for an engagement quality reviewer that practically would be very difficult to satisfy with a reasonable amount of effort. Because the engagement quality reviewer must maintain independence and objectivity and not assume responsibilities for the audit or supervise the engagement team, there is a difference in the nature of the information available to the engagement partner and the engagement quality reviewer. The engagement quality reviewer's conclusion will necessarily be based on a more limited amount of first hand knowledge. In our view, an engagement quality reviewer could interpret the Proposed Standard in such a way that results in the performance of significant additional work for the purpose of obtaining such first hand knowledge in order to establish grounds to positively concur with the issuance of the audit report. We believe the natural consequences of such interpretation would be the creation of an engagement quality review that, in many respects, duplicates the review procedures required of the engagement partner and results in measurable increases in costs associated with the independent review without corresponding enhancements to audit quality.

Views Relating to Paragraphs 9 and 10 of the Proposed Standard

Paragraphs 9 and 10 of the Proposed Standard require the engagement quality reviewer to (1) assess whether there are areas within the engagement that pose a higher risk that the engagement team has failed to obtain sufficient competent evidence or reached an inappropriate conclusion and (2) to evaluate, for those areas reviewed, the engagement team's documentation. These requirements would appear to conflict with paragraph 6, which prohibits the engagement quality reviewer from assuming responsibilities of the engagement team or supervising the engagement team. We believe the assessment of audit risk and preparation and review of audit documentation are core responsibilities of the engagement team under existing auditing standards.

Paragraph 3.c of PCAOB Auditing Standard No. 3, *Audit Documentation (AS3)*, states that an engagement quality reviewer reviews documentation to "understand how the engagement team reached significant conclusions." In our view, this reference in the PCAOB's existing guidance describes the engagement quality reviewer's appropriate role as an objective reviewer who does not assume responsibilities of the engagement team.

We note that the reference to "higher risk" in paragraph 9 is not directed to the potential for material misstatements or any other objective standard. Instead, the Proposed Standard instructs the engagement quality reviewer to "assess whether there are areas within the engagement that pose a higher risk that *the engagement team* has failed to obtain sufficient competent evidence or reached an inappropriate conclusion." We believe this incorrectly implies that the engagement quality reviewer should assess the ability of the engagement team to address the risks posed by the engagement rather than, or in addition to, reviewing the engagement team's assessment of the risks posed by the engagement. We believe this paragraph should be revised to focus the reviewer on determining whether certain "significant" matters, such as significant risks of material misstatement of the financial statements, might not have been previously identified by the engagement team.

We believe that preparation and review of audit documentation are core responsibilities of the engagement team under existing auditing standards. Paragraph 13 of AS3 requires that the engagement team “identify all significant findings or issues in an engagement completion document.” Paragraph 13 further states that “this document, along with any documents cross-referenced, should collectively be as specific as necessary in the circumstances for a reviewer to gain a thorough understanding of the significant findings or issues.” If the engagement team is required to prepare an engagement completion document and the primary purpose of that document is to facilitate an engagement quality review, then it would seem duplicative for the engagement quality reviewer, as proposed, to be required to evaluate the engagement team’s underlying documentation for matters that were subject to the engagement quality review procedures. In our view, a qualified engagement quality reviewer should be able to achieve the objectives for the engagement quality review by performing the procedures outlined in paragraphs 7 and 8 of the Proposed Standard, which reflect existing requirements and also would include reading the engagement completion document.

We also believe paragraph 10 of the Proposed Standard is impractical, particularly for multi-location engagements where engagement documentation is prepared by multiple global teams, many times in a variety of languages. Paragraph 19 of AS3 requires the office issuing the report to obtain, review and retain only certain items of the documentation related to the work performed by other auditors, including other offices of the firm or affiliated firms. Accordingly, it would not be possible for the engagement quality reviewer to evaluate whether documentation of the matters at all locations that were subject to the engagement quality review procedures is appropriate as indicated in paragraph 10. The engagement quality reviewer’s evaluation of engagement documentation would necessarily be limited to only those items of documentation forwarded to the office issuing the report.

In attempting to position the engagement quality review as the linchpin for a quality audit through the requirements of paragraphs 9 and 10, the Board has unnecessarily complicated the engagement quality review. In our view, these additional requirements would add time, effort and cost to the engagement quality review without a corresponding benefit in audit quality. In comparison to current practice, we do not believe that the requirements in paragraphs 9 and 10 of the Proposed Standard often would enhance the identification of significant matters previously unidentified by the engagement team, but rather might result in the identification of relatively insignificant or minor issues that do not justify attention beyond that given by the engagement team. We recommend that the Board modify the proposed requirements in paragraphs 9 and 10 to instead refocus on significant risks of material misstatement to the financial statements and significant difficult, judgmental, or contentious matters that either were identified and considered, or should have been identified and considered, by the engagement team. If such matters are found to exist that were not previously identified and considered by the engagement team, the engagement quality reviewer should be required to communicate these matters to the engagement team and assess whether the engagement team responds appropriately.

Views Relating to Paragraph 12 of the Proposed Standard

We are concerned that the “knows or should know based upon the requirements of this standard” language in paragraph 12 of the Proposed Standard will expose engagement quality reviewers to substantial risk of sanctions, either by the SEC or the PCAOB, in nearly every occasion where an audit is later found to be deficient. As discussed above, the engagement quality review process set forth in

paragraphs 7 through 11 of the Proposed Standard would impose significant new obligations on the reviewer, and given these obligations a reviewer may find it difficult to show that he could not have known about an audit deficiency. Thus, persons performing engagement quality reviews will interpret paragraph 12 to mean that they must be as informed, if not more informed, as the engagement partner before providing concurring approval of issuance. This acquisition of first hand knowledge would therefore entail significant additional involvement and effort by the engagement quality reviewer. He or she presumably would have to review the audit work and documentation for each high risk area in order to form his or her own conclusions on significant matters rather than rely on inquiries of engagement team members or review of summary documentation (e.g., the engagement completion document) prepared by the engagement team. When read in connection with paragraph 10, paragraph 12 could effectively require the engagement quality reviewer to review in considerable detail all key audit documentation for the areas selected for review as it would be presumed that the engagement quality reviewer “should know” whether there was a deficiency with the work that was performed, the documentation, or the conclusions.¹

This “should know” standard would doubtlessly result in increased time, effort, and cost for performing an engagement quality review. In this regard, the Release accompanying the Proposed Standard states that the Board has attempted to draft a standard that will avoid the imposition of “unnecessary costs,” but we do not believe that the obligation set on the engagement quality reviewer set forth in this paragraph of the Proposed Standard meets that objective.

Views Relating to Paragraph 4 of the Proposed Standard

We are concerned that the level of competence established in the Proposed Standard for the engagement quality reviewer is too precise and will unnecessarily limit the pool of individuals who could perform an engagement quality review. Paragraph 4 of the Proposed Standard states “the engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial or other reporting required to serve as the person who has overall responsibility for the same type of engagement (emphasis added).” In its Release accompanying the Proposed Standard at II.B.1. on page 9, the Board provides, as an example of the appropriate knowledge and competence of an engagement quality reviewer, a statement that a person assigned to perform the engagement quality review for an audit of a company involved in “oil and gas exploration” should have experience sufficient to serve as the engagement partner in this specialized industry. We are concerned that the requirements in the Proposed Standard and the example in the accompanying Release place too much focus on a specific type of engagement or specialized industry expertise. We recommend removing this example from the Release, and including a statement in paragraph 4 of the Proposed Standard that “considerations in evaluating competence include, but are not limited to, technical expertise, experience, knowledge of SEC rules and regulations pertinent to the engagement, and industry knowledge.”

¹ In this regard, the rulemaking record of Rule 3502, “Responsibility Not to Cause Violations,” is relevant. The Board originally proposed a rule that would have allowed the Board to impose discipline on a person associated with a registered accounting firm when that person “knew or should have known” that his or her actions would contribute to a violation by the registered firm. After reviewing comments on this proposal the Board determined to instead adopt a standard of “knowing, or recklessly not knowing” of the violation. We believe that here, with respect to engagement quality reviewers, the “should know” standard is similarly too low a threshold.

Also in the Release accompanying the Proposed Standard at II.B.1 on page 9, the Board indicates that “the proposed standard seeks to establish more clearly the level of expertise and experience that is necessary to perform an objective engagement quality review.” However, the Release does not provide the Board’s rationale for doing so, or indicate whether, in the Board’s view, the clearer delineation of the level of expertise and experience is intended to change current practice. We believe a clearer understanding of the degree to which the Board intends for the Proposed Standard to change current practice in the selection and assignment of engagement quality reviewers and the procedures to be performed when conducting an engagement quality review will aid auditors in developing or refining their policies and procedures.

Views Relating to Paragraph 14 of the Proposed Standard

We believe documentation of the engagement quality review should not be more extensive than documentation of other required reviews in the conduct of an audit. Engagement partners ordinarily sign and date those workpapers (e.g., analyses, memoranda, contracts and agreements, correspondence, audit programs) that were reviewed and additionally sign and date other checklists and practice aids to document other matters that were considered and other procedures that were performed. These sign-offs ordinarily provide relevant information about the matters listed in items a through f of paragraph 14 of the Proposed Standard. We further believe checklists and other standard practice aids are effective and efficient methods of determining that all required procedures have been performed and further believe such tools result in unequivocal approval (or non-approval) of issuance of the audit opinion.

Views Relating to Paragraph 8 of the Proposed Standard

Item i of paragraph 8 requires the engagement quality reviewer to “determine if appropriate matters have been communicated, or identified for communication to the audit committee, management, and other parties, such as regulatory bodies.” We believe the phrase “determine if appropriate matters have been communicated” could be interpreted by an engagement quality reviewer to mean he or she needs to be present when the communications are made. In our view, this expectation also conflicts with the prohibition in paragraph 6. We recommend that the final standard indicate that the reviewer should consider whether appropriate matters of which the engagement quality reviewer is aware have been communicated, or identified for communication to the audit committee, management, or other parties, such as regulatory bodies.

Views Relating to Applicability of the Proposed Standard

As currently drafted, the Proposed Standard would require an engagement quality review and concurring partner approval of issuance for each engagement performed and completed in accordance with the standards of the PCAOB. While we agree that it is appropriate for an engagement quality review standard to apply to all engagements performed in accordance with the auditing standards of the PCAOB, the requirements in the Proposed Standard are so specifically tailored to audits of financial statements or integrated audits of financial statements and internal control over financial reporting, that it would be difficult to apply the Proposed Standard to other types of engagements with any consistency. For example, the Proposed Standard does not specifically state what the responsibilities of the engagement quality reviewer would be in an interim review or how the

review procedures would differ. It might be appropriate to presume that certain requirements do not apply (for example, reading management's report on internal control would not apply in a review of interim financial information). However, in other situations, the Board's intent is less clear.

We recommend that the final standard address the Board's intent regarding the application of this standard to engagements other than financial statement audits and integrated audits. We believe the final standard initially should only apply to financial statement audits, to integrated audits, and—providing the final standard clarifies how the standard should be implemented—to reviews of interim financial information.

Part II.A. of the Release accompanying the Proposed Standard discusses the engagements for which an engagement quality review is required. The Release states that, in addition to audit engagements performed in accordance with the standards of the PCAOB, the Proposed Standard also would apply to "other audit and attestation engagements" performed in accordance with the Board's standards. Paragraph 1 of the Proposed Standard states that the engagement quality review would be required for "each engagement" performed and completed in accordance with PCAOB standards. In our view, it is unclear whether the Board intends the review to apply to all attestation engagements performed for issuers (e.g., agreed-upon procedures reports) or only those for which a report would be filed with the SEC, such as reports required under Regulation AB. We believe that further clarification about the applicability of the proposed engagement quality review requirement would be helpful.

In any event, we believe that a requirement to apply an auditing standard on engagement quality review to an engagement otherwise performed in accordance with attestation, not auditing, standards would result in confusion and inconsistent practice. Accordingly, we believe any engagement quality review requirement for attestation engagements should be provided for separately in the attestation standards rather than the auditing standards.

Views Relating to the Proposed Effective Date

We are concerned that the proposed effective date for reports issued on or after December 15, 2008 will not permit sufficient lead time for audit firms to re-evaluate the engagement quality reviewer assignments under the Proposed Standard. Engagement quality reviewer assignments typically are made at the beginning of the annual audit cycle so the assigned reviewer can participate in audit planning activities and timely reviews of interim financial information. Assignment of a different engagement quality reviewer later in the 2008 audit cycle could cause inefficiencies and might detract from the effectiveness of the reviews. We recommend that the effective date of the final standard be for audits and interim reviews of periods beginning on or after December 15, 2008.

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We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

Ernst & Young LLP