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November 24, 2009

Securities and Exchange Commission
100 F St., N.E.
Washington, D.C. 20549-1090
Attn: Elizabeth M. Murphy, Secretary

Re: File Number PCAOB-2009-02: Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Auditing Standard No. 7, Engagement Quality Review, and Conforming Amendment

Deloitte & Touche LLP ("D&T") appreciates the opportunity to provide comments on the engagement quality review ("EQR") standard and accompanying release issued by the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") and filed with the Securities and Exchange Commission ("SEC").[1] The opportunity for public comment as the SEC reviews the EQR standard is of particular value here given the importance of the standard.

As explained in our comments to the PCAOB's earlier proposals, D&T strongly supports the function of EQR and is committed to an effective EQR process that promotes audit quality.[2] We appreciate the consideration that was given by the PCAOB to the comments we previously submitted, as several of the changes that were adopted provide additional clarity and will help facilitate implementation of the EQR standard when finalized by the SEC.

As explained below, we have two primary concerns with the EQR standard and related adopting release that the SEC should address to facilitate an effective and appropriate implementation of the EQR standard. We first provide comments regarding language in the PCAOB's release accompanying the standard that relates to the requirement that the review specified under the EQR standard be performed with "due professional care." We are concerned that the description of the due professional care requirement could be construed in a manner that

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1 *See* Public Company Accounting Oversight Board, Notice of Filing of Proposed Rules on Auditing Standard No. 7, Engagement Quality Review, and Conforming Amendment, 74 Fed. Reg. 57,357 (Nov. 5, 2009) ("EQR standard").

2 D&T's previous comment letters are available at: http://www.pcaobus.org/Rules/Docket_025/Comments/All.pdf and http://www.pcaobus.org/Rules/Docket_025/Comments/All_Reproposal.pdf.

is inconsistent with the current understanding and application of due professional care and could prove unworkable in its approach. We also provide comments on the PCAOB's description of the documentation requirements under the EQR standard, which could in effect be overly burdensome.

1. The PCAOB's Treatment Of A Due Professional Care Requirement Is Problematic

Paragraph 12 of the EQR standard (Paragraph 17 in relation to interim reviews) specifies that the review required by the standard be performed with "due professional care," as defined in AU section 230, Due Professional Care in the Performance of Work. We are fully supportive of this definition of due professional care which is consistent with our comments on the most recent proposal. However, we are concerned that the PCAOB's further descriptive statement on the due professional care requirement, as set forth in the Release accompanying the Board's adopted standard (the "Release"), *see* 74 Fed. Reg. at 57,365, is problematic for two reasons: It could be argued to suggest an unrealistic standard for concurring approval of issuance and it also improperly equates due professional care with negligence.[3]

a. The Release Could Be Argued To Impose An Unrealistic Standard For Concurring Approval.

In the Release accompanying the EQR standard, the Board states: "A qualified reviewer who has done [a review with due professional care] will, *necessarily*, have discovered any significant engagement deficiencies that could reasonably have been discovered under the circumstances." *See* 74 Fed. Reg. at 57,365 (emphasis added). This language could be read to suggest that a "flawless" standard applies to EQR, which not only conflicts with prevailing case law and other audit standards, but also would be inconsistent with the accepted understanding of EQR as a "second look." Although the subject sentence provides that the presumption applies to deficiencies that could "reasonably have been discovered under the circumstances," the notion of reasonableness is inherent in interpreting standards. This approach is thus problematic, if for no other reason, because the "will *necessarily*, have discovered" formulation, at a minimum, creates uncertainty as to how the standard for providing concurring approval will be applied.

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[3] In addition to the two items addressed in this section, also of concern is whether *any* standard of care should be explicitly stated in the EQR standard. As noted by the PCAOB in the Release, *see* 74 Fed. Reg. at 57,365, AU sec. 230 imposes a general duty upon auditors to perform audit work with "due professional care." Thus, auditors are already subject to a due professional care requirement, and explicit inclusion of this standard in the final EQR standard is unnecessary. The PCAOB seemingly acknowledges this point but asserts that there remains "some confusion about the applicable standard of care in an EQR." 74 Fed. Reg. at 57,365. Any such uncertainty would better be addressed by a note to the EQR standard or by clarifying language in the Release – that the general due professional care requirement under AU sec. 230 applies to EQR as well. Indeed, other audit standards do not contain an explicit requirement of "due professional care." Auditing Standard No. 5 does reference the standard of due professional care, but does so only by referring to the underlying requirement imposed by AU sec. 230. It would be problematic to single out the EQR process, generally, and the issuance of a concurring approval, specifically, as being subject to a specified standard of care – perhaps suggesting that the EQR standard is somehow different in this regard from other audit standards; or that the absence of an explicit invocation of due professional care in other standards must be given meaning.

It is well established that "even an audit conducted in strict accordance with professional standards countenances some degree of calibration for tolerable error which, on occasion, may result in a failure to detect a material omission or misstatement." *In re Ikon Office Solutions, Inc.*, 277 F.3d 658, 673 (3d Cir. 2002) (explaining that an "audit requires only due professional care"). There, the court noted that under applicable standards, "the auditor certifies only that it exercised appropriate, not flawless, levels of professional care and judgment." *Id*. The description of due professional care in the Release, which presumes significant engagement deficiencies will "necessarily" be discovered, cannot be reconciled with this framework.

The description in the Release of due professional care also seems at odds with the level of care that the PCAOB has elsewhere recognized that an auditor is expected to exercise under auditing standards, such as when performing an audit of internal control over financial reporting. *See* PCAOB Auditing Standard No. 5 (noting that the auditor must "perform the audit to obtain competent evidence that is sufficient to obtain *reasonable assurance* about whether material weaknesses exist as of the date specified in management's assessment") (emphasis added)). Similarly, a conforming amendment by the PCAOB to AU sec. 230.10 made when AS No. 5 was adopted provides the following with regard to due professional care: "The exercise of due professional care allows the auditor to obtain *reasonable assurance* . . . . Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. . . . Therefore, an audit conducted in accordance with the standards of the [PCAOB] *may not detect* a material weakness in internal control over financial reporting or a material misstatement to the financial statements." *See* PCAOB Rulemaking Docket Matter No. 021, app. 3 at 2 (June 12, 2007) (emphasis added).

The PCAOB itself thus recognizes that a review performed with due professional care will not "necessarily" identify every significant engagement deficiency; "reasonable assurance" is not absolute assurance. This same concept of reasonable assurance finds acceptance when courts have reviewed the performance of an audit. *See Mishkin v. Peat, Marwick, Mitchell & Co.*, 744 F. Supp. 531, 538 (S.D.N.Y. 1990) ("[The auditor] is not responsible for mere error of judgment. Reasonable adherence to the standards is a matter calling for application of experience, skill and the exercise of independent judgment.").[4]

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[4] The Release also suggests that if a review is not performed with due professional care, the reviewer may not discover significant deficiencies that "the reviewer reasonably *should know* about." (Emphasis added.) *See* 74 Fed. Reg. at 57,365. We are concerned that this language suggests the PCAOB may still be seeking to impose a "should know" standard on the EQR reviewer. The PCAOB's initial proposal included a "knows or should know" requirement within the language of the standard itself, and the PCAOB's release accompanying its revised proposed standard on EQR – in which the "knows or should know" requirement within the standard itself was replaced by the "due professional care" requirement – expressly equated due professional care with the "knows or should know" formulation in discussing the standard for issuing concurring approval. *See Proposed Auditing Standard – Engagement Quality Review and Conforming Amendments to the Board's Interim Quality Control Standards*, PCAOB Rulemaking Docket Matter No. 025 (Feb. 26, 2008); *Proposed Auditing Standard on Engagement Quality Review*, PCAOB Rulemaking Docket Matter No. 025 at 24 (Mar. 4, 2009). As we noted in our comment letters on both of these proposals, the "should know" formulation is illogical – and thus unworkable – especially in the EQR context. A reviewer cannot be expected to provide a concurring approval based on what he or she "should know," as opposed to what the reviewer actually knows.

[Footnote continued on next page]

b. The Release Incorrectly Equates Due Professional Care With A Negligence Standard.

The Release also incorrectly equates the standard of due professional care with the legal concept of negligence – e.g., the Release cites AU sec. 230 to support "[t]he application of a negligence standard to the concurring approval of issuance provision." *See* 74 Fed. Reg. at 57,365.[5] However, a finding as to negligence requires the application of the elements of a negligence cause of action to the facts and circumstances of the conduct involved in a particular matter. This determination cannot be made by way of a fiat that a departure from due professional care constitutes negligence. At a minimum, the final standard that is adopted by the SEC should clarify that conduct that may constitute a departure from due professional care will not necessarily constitute negligent conduct for regulatory or litigation purposes.

The link between due professional care and negligence referenced in the Release is unfounded. A review of the case law reveals that purported violations of "due professional care," as well as of Generally Accepted Auditing Standards ("GAAS"), generally do not *ipso facto* constitute negligent conduct. Instead, courts have applied an analysis that requires an individualized determination as to negligence rather than such a formulaic approach. Under the more nuanced approach that courts have taken, a departure from standards may, but does not necessarily, or even presumptively, give rise to a legal finding of negligence. As noted by the court in *Mishkin*, 744 F. Supp. 531 at 538:

> An auditor who undertakes to examine the books and audit the accounts of a client does not guarantee the correctness of the accounts. He does undertake to use skill and *due professional care* and to exercise good faith and to observe generally accepted auditing standards and professional guidelines, with the appropriate reasonable, honest judgment that a reasonably skillful and prudent auditor would use under the same or similar circumstances. . . . The standards concern themselves not only with the auditor's professional qualities but also provide that judgment may be exercised by him in the performance of his

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The language noted above that remains in the Release thus raises concerns that someone might try to argue that a concurring approval requires a "should know" level of knowledge and familiarity with all aspects of the audit, going far beyond the procedures that should be performed under the standard in order to conduct a second-look review.

[5] AU sec. 230, in describing due professional care, relies upon an excerpt from an edition of the treatise *Cooley on Torts* published in 1932. Not only is the reference outdated – the book was published 77 years ago – but AU sec. 230 itself is in the process of being superseded by a proposed Statement on Auditing Standards ("SAS"), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, promulgated by the American Institute of Certified Public Accountants ("AICPA"). This proposed SAS – which was discussed at an April 27-30, 2009 meeting of the AICPA's Audit Standards Board – does not address any purported linkage between due professional care and ordinary negligence, nor does it cite to *Cooley on Torts*.

examination and in his report. *Deviation from standards does not perforce thereof spell negligence in an audit, nor are innocent blunders culpable fault.*

(Emphasis added.) Accordingly, deviations from prevailing audit standards, including due professional care, do not automatically equate to negligence. Other courts have similarly held that issues regarding the exercise of due professional care and adherence to GAAS may relate to, but are not determinative of, negligent conduct.[6]

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For these reasons, we are concerned about the uncertainty and potential consequences that could arise from the discussion on due professional care in the Release. It could result in the performance of additional, unnecessary and costly procedures by EQR reviewers. It also could affect liability exposure in civil and regulatory proceedings where a party argues the Release expands the meaning of due professional care and could be relied on as an interpretative authority. The SEC should, at a minimum, instruct the PCAOB to modify the Release to avoid an overly broad interpretation of "due professional care," both as to the implication that any significant engagement deficiency will *necessarily* be discovered through EQR and that due professional care itself is equivalent to legal negligence.[7]

2. Unduly Extensive EQR Documentation Could Be Implied By The Requirement

Paragraph 19 of the EQR standard specifies that documentation of an EQR should be included in the engagement documentation and "should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of this standard, including information that identifies: a) the engagement quality reviewer, and others who assisted the reviewer, b) the documents reviewed by the engagement quality reviewer, and others who assisted the reviewer, and c) the date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval." We are completely supportive of the need to provide appropriate documentation of the review as outlined in paragraph 19. We are concerned, however, that the statements in the Release could

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[6] *See Grant Thornton, LLP, v. FDIC*, 535 F. Supp. 2d 676, 709 (S.D. W. Va. 2007) (recognizing that "a violation of GAAP or GAAS is not negligence per se") (reversed in part on other grounds). S*ee also Checkosky v. SEC*, 139 F.3d 221, 225 n.5 (D.C. Cir. 1998) (internal citation omitted) (in addressing the requirement of due professional care under GAAS, noting that the proposition "that all deviations from GAAS are per se negligent . . . might not be true, nor is it self-evidently true with respect to GAAP"); *Thayer v. Hicks*, 793 P.2d 784 (Mont. 1990) (holding that the trial court erred by instructing the jury that an accountant's "failure to comply with [GAAS] . . . constitutes negligence as a matter of law").

[7] To the extent that that the PCAOB in applying the final EQR standard purports to equate a deviation from due professional care to negligence, the Board should clarify that in the context of enforcement proceedings, this does not obviate the need for an independent determination that the individual elements of negligence are present.

have the effect of requiring documentation of *all* of the interactions between the EQR reviewer and the engagement team. We do not believe this is what was intended by the standard, as it would clearly be impracticable, and we believe it would be useful to confirm that the standard as written does not create such a documentation obligation.

EQR involves extensive dialogue and consultation between the EQR reviewer and the engagement team as issues arise during the course of the audit. For example, the EQR reviewer may inform the engagement team of questions or potential concerns as the reviewer discovers them, and vice versa. The engagement team may, in turn, provide additional information to the reviewer or otherwise supplement its audit work to address any such issues. This interactive review benefits audit quality and helps identify potentially significant issues at an early stage.

We believe that Paragraph 19 should not be interpreted as requiring by default documentation related to any and all issues that are resolved during this collaborative process. The Release suggests that even when the engagement team – in accordance with PCAOB Auditing Standard No. 3 ("AS No. 3") – documents its response to a "significant engagement deficiency" identified by the EQR reviewer, the EQR reviewer still would have to document "how the reviewer communicated the deficiency to the engagement team, why such matter was important, and how the reviewer evaluated the engagement team's response." *See* 74 Fed. Reg. at 57,366. This seems to go well beyond the requirements enumerated in paragraph 19. Furthermore, whether an issue is a significant engagement deficiency may not be known until the final stages of the audit and/or at least after back-and-forth consultations between the EQR reviewer and engagement team relating to the matter have already occurred, and it may then be difficult for the EQR reviewer to prepare documentation for the communications and other analysis that preceded the significant engagement deficiency determination. Consequently, the EQR reviewer may feel compelled to document *all* such issues requiring further inquiry as they first arise – even those issues that are readily resolved and that do not constitute a significant engagement deficiency. We do not see how such a documentation requirement would either improve the effectiveness of the review or improve the overall quality of the audit.

Accordingly, we believe it would be valuable to confirm that the documentation requirements regarding interactions between the EQR reviewer and the engagement team apply only after an affirmative significant engagement deficiency determination has been made.

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We recognize that the issues presented herein may require further discussion to understand fully the implications of particular comments made by us and by other commenters. We believe that such an open dialogue will facilitate a more complete understanding of the proposed standard and will ultimately improve the final standard and the auditor's ability to implement it effectively and efficiently. We would welcome the opportunity to participate in any such process and to further discuss these matters with the SEC and its staff.

If you have any questions or would like to discuss these issues further, please contact Robert Kueppers at 212-492-4241 or James Schnurr at 203-761-3539.

Very truly yours,

/s/ Deloitte & Touche LLP

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