

**The New Audit Documentation Standard:
Implications for Internal Auditors**

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Introduction

In its continuing quest to operationalize the mandates of the Sarbanes-Oxley Act of 2002, the PCAOB released Auditing Standard (AS) 3, "Audit Documentation." With the SEC's approval, the latest Standard became effective for audits of financial statements covering fiscal years ending on or after November 15, 2004. External auditors are required to adhere to the mandates of AS 3 as they prepare their written record of the engagement.

The new Standard notes the objectives of the documentation of the external audit work and provides guidance as to the general content of such documentation. Also, specific matters that must be included in the documentation and a requirement that an engagement completion document be developed for each audit are set forth. Finally, requirements relating to the retention of audit documentation are specified and procedures to follow if a need arises which necessitates the alteration of the audit documentation are provided.

AS 3 has significant implications to internal auditors as they prepare their own audit documentation (working papers). Also, because they consult and interact with others in the organization who might be preparing documentation to be used by the external auditors, internal auditors should have a thorough understanding of the requirements in the Standard. They can then advise and aid these various parties regarding its provisions. Management, systems personnel, and others who are

responsible for preparing documentation that may be utilized by the external auditors will all benefit.

There is no doubt that the time necessary for external auditors to prepare audit documentation will increase as a result of AS 3. Because the cost of the increased time will be passed on to the entity, it is essential that internal auditors and others in the organization prepare their documentation keeping in mind the mandates of AS 3. Developing documentation in accordance with the Standard will facilitate sharing of working papers between the internal auditors, others in the entity, and the external auditors. The external auditors will then be able to perform their work more efficiently and the overall cost to the entity of the audit can be controlled.

Objectives of Audit Documentation

AS 3 notes that documenting the work of the external audit engagement addresses several objectives. First, the documentation provides a written record of the work performed. It also serves as the basis for the conclusions reached by the external audit team. Further, the planning, performance, and supervision of the engagement are all aided by audit documentation. Finally, review of the engagement by various parties is based on the documentation of the work.

Several categories of documentation should be included in the record of each engagement. Both the planning and the performance of the work must be documented. Also, the procedures performed and the evidence obtained are included. Further, the conclusions reached on the engagement are noted.

In preparing audit documentation, external audit team members should keep in mind the various parties that might be utilizing the work papers. These include the team

members themselves and their supervisors. Also, independent partners, in performing reviews of the work prior to the release of the audit opinion, access the audit documentation. Further, quality reviews performed in-house, peer reviews completed for firm licensure, and PCAOB inspections are all based on the documentation of the engagement. Other parties, such as audit committee consultants or personnel involved in an acquisition of the firm, may ask to access the work papers.

Besides those examining the current period's documentation, work papers from prior years might be perused by team personnel new to the audit. Also, as they plan an engagement, external auditors will refer to prior-year documentation. Finally, successor auditors may request information maintained in the audit documentation.

General Audit Documentation Requirements

The general documentation requirements of AS 3 note that the external auditor must provide a certain level of detail in the work papers. That detail should allow an experienced auditor, familiar with the industry, to understand the work performed. Also, the person who performed the work and when, and the person who reviewed the work and the date, should be clear.

AS 3 states that audit documentation should be prepared which includes the purpose of the documentation. Also, the source of the documentation should be readily determinable. Finally, the conclusions reached must be incorporated into the work papers and the audit documentation should be organized.

Any number of formats and forms may be used to prepare audit documentation. Audit programs, memos, confirmations, schedules, correspondence, and letters of

representation all might be included. Electronic or paper documentation is acceptable, as is evidence prepared in other media forms.

Regardless of the form and format of audit documentation, as a whole, it must demonstrate that the engagement complied with PCAOB standards. Also, the conclusions reached on the engagement should be supported by the documentation. Finally, agreement between, or reconciliation of, the accounting records and the financial statements must be demonstrated.

Audit documentation must clearly show that the work was actually performed. While this seems obvious, AS 3 explains that the requirement applies not only to the work of audit team members, but also to that of specialists who may be assigned to the engagement. Thus, the specialists' conclusions alone are not sufficient; the work supporting those conclusions must be included in the external audit work papers.

In pondering the appropriate nature and extent of audit documentation, the external auditor should consider the procedures performed and the risk of material misstatement for the assertions. Also, the degree of judgment involved in the work and conclusions reached should be contemplated. For example, work related to accounting estimates involves a high degree of auditor judgment and thus, more detailed documentation is appropriate. Further, the significance of the evidence to the assertion and the auditor's duty to document a conclusion which does not naturally follow from the evidence acquired should be considered.

During the course of the engagement, members of the audit team may obtain information that is not consistent with, or even contradicts, other evidence. The audit documentation must include records of both. Procedures performed as a result of

scrutiny of the inconsistent information should be recorded, as should consultations made regarding the issue. Also, if the engagement team members did not agree on the appropriate treatment of the matter, their differences in professional judgment and the resolution of the issue should be documented.

After the audit documentation has been finalized, the external auditor may become aware that the working papers lack certain information. Perhaps the audit documentation fails to indicate that certain procedures were performed, that needed evidence was obtained, or that appropriate conclusions were reached. In such a situation, documentation of other persuasive evidence may need to be added to the work papers. Persuasive other evidence may take any numbers of forms, including oral evidence. While oral testimony may be utilized, it does not constitute sufficient persuasive other evidence to support audit conclusions; further evidence beyond the oral data must be obtained.

Specific Matters to Document

Besides setting forth general requirements for audit documentation, AS 3 also mandates several specific matters which must be incorporated into the work papers.

Some company contracts or agreements will likely have a significant impact on the audit work; abstracts or copies of these must be maintained in the audit documentation. Also, individual items that are tested by the external auditor should be identified in the audit documentation. For tests involving inspection of documents, such as confirmations, tests of details, test of operating effectiveness, and walkthroughs, the individual records selected should be noted. This may be accomplished by recording the identifying numbers of the documents scrutinized. Alternatively, the source from which

the items were chosen, and the selection criteria (for example: all checks over \$10,000 or for a systematic sample, the starting point and the sampling interval) may be included in the working papers.

Some matters required to be documented may be maintained in a location other than with the audit documentation for the specific engagement. For example, documentation of client acceptance or retention, independence matters, and audit staff training and proficiency may be stored in a central location. Although not required to be kept with the documentation for the engagement, such matters must be referenced, with the location noted where such documentation is filed, in the working papers for the engagement.

For each engagement, the external auditor must document significant issues which arise as well findings which are deemed significant. Also, the procedures employed to address the issues, and also the basis for the conclusions, must be included in the audit documentation.

Significant issues and findings may relate to any area of the audit and financial statements. However, matters which typically are deemed significant include those related to the selection, application, and consistency of use of accounting principles. Also, the existence of material misstatements, significant internal control deficiencies, or material weaknesses in internal control are significant. Further, the need to amend planned audit procedures is considered significant.

Other issues and findings which are significant are audit adjustments and disagreements among members of the engagement team or parties which were consulted about the engagement. Also, considerable difficulty in applying audit procedures, large

changes in audit risk and the external auditor's resulting response, and any matters which could give rise to a modification of the auditor's unqualified opinion are all judged to be significant.

The Exhibit notes audit issues and findings deemed to be significant. As mentioned, these should be included in the audit documentation.

[Exhibit about here]

Besides noting several specific matters, including significant issues and findings, which must be incorporated into the audit documentation, AS 3 specifies that an "engagement completion document" be developed for each audit. This working paper serves to identify all significant issues addressed during the engagement. Further, the engagement completion document includes all findings related to the engagement that are judged to be significant. Rather than note every significant issue and finding, the engagement completion document might provide cross-references to other audit documentation that address such matters.

Regardless of whether the engagement completion document specifies significant issues and findings or provides cross-references to other audit documentation, the work paper must achieve a certain level of specificity. That is, the engagement completion document must provide information that is sufficient and competent enough to allow a reviewer to comprehend the significant issues and findings encountered. Also, if the engagement completion document is being prepared as part of the work on the annual audit, it must incorporate not only significant findings and issues addressed during the yearly work, but also those from interim reviews.

Retention of Audit Documentation

In setting forth mandates related to the retention of audit documentation, the PCAOB introduces two key terms. The first is “report release date.” This is the date at which the external auditor grants permission to the client to utilize the audit report in connection with the issuance of the financial statements.

The second new term used by the PCAOB is “documentation completion date.” By this date, which is not more than 45 days after the report release date, the external auditors must have assembled and finalized the complete set of audit documentation.

The PCAOB requires that audit documentation be retained for a period of at least seven years from the report release date. A longer length of time may be specified by laws or regulations of other agencies and professional groups.

For some engagements, the external auditor may never have issued a report. In these cases, the retention period is for seven years from the date that fieldwork was substantially completed. There may also be instances in which not only was a report never issued, but also, the engagement was never completed. For these situations, the audit documentation should be retained for a period of seven years from the point at which the engagement ceased.

Changes to Audit Documentation

Occasionally, the external auditor may find it necessary to add to the audit documentation after the report release date. All audit procedures necessary to support the opinion on the financial statements should have been completed prior to the date the report is released. However, for companies issuing stock on the exchanges, the auditor is required to perform certain procedures through the effective date of the registration

statement. Thus, additional procedures, which must be documented, will necessarily be performed after the report release date. Another reason that the auditor may have to add to the work papers after the report release date is the discovery that certain audit procedures, previously thought to have been performed, to have been omitted. As a result, it may become essential to perform additional procedures.

Regardless of the issue which gives rise to the necessity of further work after the report release date, the external auditor must document those additional procedures that are performed. The nature of the augmentation to the audit documentation and the reasons for it should be noted. Also, the date of the addition and the name of the person who prepared the new work papers must be noted. If any documentation relating to the issue had previously been included in the work papers, it may not be discarded.

Recommendations for Internal Auditors

In every aspect of their work, internal auditors should be bearing in mind the mandates of AS 3. They can then prepare their own work papers in such a way as to both fulfill the documentation needs for their own work and to aid in the external audit. Also, the internal audit group can serve the entity well by coaching managers as in they develop their documentation in such a way that it is useful to the external auditors.

General Documentations Requirements

To fulfill the goals of audit documentation, internal auditors and others in the organization should include in their working papers a record of the planning process undertaken for the work. Also, the procedures performed and the evidence gathered must be documented.

As the entity records the work completed in-house in preparation for the external audit, those at all levels of the organization should keep in mind that numerous parties may review the documentation. Not only will the external audit staff members peruse the materials, but their supervisors will also. Further, second, or independent, partners, internal quality reviewers, peer reviewers, and PCAOB inspectors may access the internal documentation if it was considered during the external engagement. Other parties, such as external audit team members assigned to future engagements, a successor auditor, audit committee consultants, or parties involved in an acquisition of the firm might also study documentation prepared by internal audit or management and included in the external audit workpapers.

The audit documentation developed by the internal auditors and management might take any number of acceptable forms. The internal auditors might want to query the external group as to its preference regarding work paper format, if any. While the external auditor may favor audit documentation in a specific form, as long as the work papers fulfill the objectives of audit documentation, they are in compliance with the mandates of AS 3.

In preparing audit documentation, the internal audit function and management should include a certain level of detail. As mentioned, an experienced external auditor, familiar with the industry, should be able to understand the work performed. Also, more detail is appropriate in areas which are significant to the external audit. Therefore, when planning their work and documentation, the internal auditors might consult with the external audit team regarding areas it deems to be significant. Further, as the level of professional judgment required when examining an account increases, more detail is

called for. Again, the internal and external audit groups might confer regarding which accounts require more judgment; the internal team can then adjust its documentation accordingly. Finally, if some information appears inconsistent with other evidence, the details of both should be incorporated into the audit documentation.

Specific Documentation

Besides considering general issues related to audit work papers, internal auditors should also bear in mind the specific matters which should be included in their documentation for it to be useful to the external group. For example, the particular items chosen for testing by the internal auditors should be noted. Also, significant issues unearthed by the internal auditors and significant findings reached must be included. Further, matters related to the selection, application, and consistent use of accounting procedures should be documented.

As the internal auditors perform their work, they may locate material misstatements in the financial statements. Based on internal audit's suggestion, management may elect to book adjusting journal entries to correct these misstatements prior to the external auditors commencing their work. Similarly, the internal audit group may discover deficiencies or material weaknesses in internal control as they perform their procedures. Again, management may choose to make changes to the system before the external auditors commence their work. Further, the internal auditors may encounter difficulties in applying procedures or may find that the risk associated with an account is greater than originally assessed. In response to any of these situations, the internal auditors may decide to amend their originally planned audit coverage and procedures.

Correcting financial misstatements and instituting improvements in internal control prior to the external audit is certainly beneficial. Also, difficulties in performing the internal audit and changes in risk levels are not entirely unexpected. Still, the organization, and in particular, the internal audit group, should bear in mind that the external auditors require a clear audit trail. Thus, both internal audit and management should be especially careful in documenting misstatements and internal control deficiencies and material weaknesses found and corrected. Also, the internal audit group should be sure to note any amendments to assessed risks and to its original audit plan. The reasons for such changes should be documented and clearly explained.

Retention of Documentation

When developing their own documentation retention policies, the internal auditors and management should bear in mind PCAOB requirements applicable to the external auditors. Although the mandates do not directly pertain to documentation developed internally by the entity, the work the internal auditors and management perform impact that of the external team. Thus, documentation developed internally should be maintained for a period consistent with that applicable to the external audit work papers.

Because the independent audit firm is mandated to retain its audit documentation for seven years from the date of the release of the report, the organization should adopt procedures to maintain its internally-prepared working papers for a somewhat longer period. The internal auditor and members of management normally commence their work well in advance of the external audit. Therefore, the internal documentation should be maintained for a period of, say, seven and a half or even eight years from the date at which it was developed.

Changes to Documentation

While not common, the entity or the external auditor may discover, after the report release date, that further procedures are necessary. Because of this new work and the need to document it, additions to the internal or external working papers are also required.

When performing procedures and preparing work papers after the external auditors have released their opinion, the internal auditors should bear in mind that such additional documentation will be scrutinized especially closely. The external audit team as well as regulators and others will study the work papers carefully. They will be attempting to understand not only the work and the findings, but perhaps more importantly, the reasons behind the need for the additional procedures. Therefore, any amendments to the original audit documentation should be prepared quite carefully.

Conclusion

The internal audit activity is an active participant in the entity's quest to comply with the Sarbanes-Oxley Act. Also, the unit can be a leader as the organization strives to adhere to the Act in a cost-efficient manner. Thus, it is essential that internal auditors have a thorough grasp of the mandates facing their external colleagues. Armed with such a comprehension, the internal auditors can plan their own work accordingly and also, coach others in the organization.

The PCAOB's audit documentation standard is rich with implications for both the internal audit activity and management. If both groups abide by the requirements of AS 3, the internal documentation will dovetail with that of the external team and the efficiency and effectiveness of the overall audit effort will be enhanced.

Exhibit
Significant Audit Issues and Findings
to be Documented

- Selection, application, and consistency of accounting principles and disclosure, especially for complex or unusual transactions, accounting estimates, and uncertainties
- Audit procedures that indicate a need to significantly modify planned audit work
- Material misstatements or omissions in the financial statements
- Significant internal control deficiencies or material weaknesses
- Audit adjustments, whether or not recorded by management
- Disagreements among members of the audit team or others consulted regarding the engagement
- Difficulties in applying auditing procedures
- Significant changes in the level of audit risk and the external auditor's resulting response
- Matters which could give rise to a modification of the auditor's unqualified opinion
- Engagement completion document

References/End Notes

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