

File No. PCAOB-2004-06  
Consists of 88 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

---

Form 19b-4

Proposed Rule

By

Public Company Accounting Oversight Board

In accordance with Rule 19b-4 under the  
Securities Exchange Act of 1934

1. Text of the Proposed Rule

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule, "Certain Terms Used in Auditing and Related Professional Practice Standards." The proposed rule sets forth terminology the Board will use to describe the degree of responsibility that the auditing and related professional practice standards impose on auditors. The proposed rule is attached as Exhibit A to this rule filing.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Board

(a) The Board approved the proposed rule, and authorized it for filing with the SEC, at its Open Meeting on June 9, 2004. No other action by the Board is necessary for the filing of this proposed rule.

(b) Questions regarding this rule filing may be directed to Gordon Seymour, Deputy General Counsel (202-207-9034; seymourg@pcaobus.org), Kathleen Peters, Assistant General Counsel (202/207-9190; petersk@pcaobus.org), or Bella Rivshin, Assistant Chief Auditor (202-207-9180; rivshinb@pcaobus.org).

3. Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules

(a) Purpose

Section 103(a)(1) of the Act authorizes the PCAOB to establish, by rule, auditing standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by the Act. PCAOB Rule 3100, "Compliance with Auditing and Related Professional Practice Standards," requires auditors to comply with all applicable auditing and related professional practice standards established by the PCAOB. The Board has adopted as interim standards, on an initial, transitional basis, the generally accepted auditing standards described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003 (the "interim standards").

The proposed rule sets forth terminology the Board will use in auditing and related professional practice standards established or adopted by the Board.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

4. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. Pursuant to the Act and PCAOB Rule 3100, auditing and related professional practice standards established by the PCAOB must be complied with by all registered public accounting firms.

5. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

The Board released the proposed rule for public comment on October 7, 2003. See Exhibit 2(a)(A). The Board received 12 written comment letters relating to its proposal. See Exhibits 2(a)(B) and 2(a)(C).

The Board has carefully considered all comments it has received. In response to the written comments received, the Board has clarified and modified certain aspects of the proposed rules. The Board's response to the comments it received and the changes made to the rules in response to these comments are summarized in Exhibit 3 to this filing.

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

The proposed rules are not based on the rules of another board or of the Commission.

9. Exhibits

Exhibit A – Text of the Proposed Rule

Exhibit 1 – Form of Notice of Proposed Rule for Publication in the Federal Register

Exhibit 2(a)(A) – PCAOB Release No. 2003-018 (October 7, 2003)

Exhibit 2(a)(B) – Alphabetical List of Comments

Exhibit 2(a)(C) – Written comments on the rule proposed in PCAOB Release No. 2003-018

Exhibit 3 – PCAOB Release No. 2004-007 (June 9, 2004)

10. Signatures

Pursuant to the requirements of the Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

BY: \_\_\_\_\_  
William J. McDonough, Chairman

Date: June 18, 2004

Exhibit A – Text of the Proposed Rule

SECTION 1. GENERAL PROVISIONS

Rule 1001. Definitions of Terms Employed in Rules

\* \* \*

(a)(xii) Auditor

The term "auditor" means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof.

\* \* \*

SECTION 3. PROFESSIONAL STANDARDS

\* \* \*

Part 1 – General Requirements

Rule 3101. Certain Terms Used in Auditing and Related Professional Practice Standards

(a) The Board's auditing and related professional practice standards use certain terms set forth in this rule to describe the degree of responsibility that the standards impose on auditors.

(1) Unconditional Responsibility: The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. Failure to discharge an unconditional responsibility is a violation of the relevant standard and Rule 3100.

(2) Presumptively Mandatory Responsibility: The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. Failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the

circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.

Note: In the rare circumstances in which the auditor believes the objectives of the standard can be met by alternative means, the auditor, as part of documenting the planning and performance of the work, must document the information that demonstrates that the objectives were achieved.

(3) Responsibility To Consider: The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances consistent with the objectives of the standard.

Note: If a Board standard provides that the auditor "should consider" an action or procedure, consideration of the action or procedure is presumptively mandatory, while the action or procedure is not.

(b) The terminology in paragraph (a) of this rule applies to the responsibilities imposed by the auditing and related professional practice standards, including the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T.

(c) The documentation requirement in paragraph (a)(2) is effective for audits of financial statements or other engagements with respect to fiscal years ending on or after [insert date the later of November 15, 2004, or 30 days after approval of this rule by the Securities and Exchange Commission].

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34- ; File No. PCAOB-2004-06)

[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rule  
on Technical Amendments to Interim Standards Rules

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on June 18, 2004, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") the proposed rule described in Items I, II, and III below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rule from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rule

On June 9, 2004, the Board adopted Rule 3101, *Certain Terms used in Auditing and Related Professional Practice Standards* ("the proposed rule"). The proposed rule text is set out as follows:

RULES OF THE BOARD

SECTION 1. GENERAL PROVISIONS

Rule 1001. Definitions of Terms Employed in Rules

(a)(xii) Auditor

The term "auditor" means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof.

## SECTION 3. PROFESSIONAL STANDARDS

### Part 1 – General Requirements

#### Rule 3101. Certain Terms Used in Auditing and Related Professional Practice Standards

(a) The Board's auditing and related professional practice standards use certain terms set forth in this rule to describe the degree of responsibility that the standards impose on auditors.

(1) **Unconditional Responsibility:** The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. Failure to discharge an unconditional responsibility is a violation of the relevant standard and Rule 3100.

(2) **Presumptively Mandatory Responsibility:** The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. Failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.

Note: In the rare circumstances in which the auditor believes the objectives of the standard can be met by alternative means, the auditor, as part of documenting the planning and performance of the work, must document the information that demonstrates that the objectives were achieved.

(3) **Responsibility To Consider:** The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances consistent with the objectives of the standard.

Note: If a Board standard provides that the auditor "should consider" an action or procedure, consideration of the action or procedure is presumptively mandatory, while the action or procedure is not.

(b) The terminology in paragraph (a) of this rule applies to the responsibilities imposed by the auditing and related professional practice standards, including the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T.

(c) The documentation requirement in paragraph (a)(2) is effective for audits of financial statements or other engagements with respect to fiscal years ending on or after [insert date the later of November 15, 2004, or 30 days after approval of this rule by the Securities and Exchange Commission].

## II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rule and discussed any comments it received on the proposed rule. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

### A. Board's Statement of the Purpose Of, and Statutory Basis for, the Proposed Rule

#### (a) Purpose

Section 103(a)(1) of the Act authorizes the PCAOB to establish, by rule, auditing standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by the Act. PCAOB Rule 3100, "Compliance with Auditing and Related Professional Practice Standards," requires auditors to comply with all applicable auditing and related professional practice standards established by the PCAOB. The Board has adopted as interim standards, on an initial, transitional basis, the generally accepted auditing standards described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003 (the "interim standards").

The proposed rule sets forth terminology the Board will use in auditing and related professional practice standards established or adopted by the Board.

(b) Statutory Basis

The statutory basis for the proposed rule is Title I of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. Pursuant to the Act and PCAOB Rule 3100, auditing and related professional practice standards established by the PCAOB must be complied with by all registered public accounting firms.

C. Board's Statement on Comments on the Proposed Rule Received from Members, Participants or Others

The Board released the proposed rule for public comment in PCAOB Release No. 2003-018 (October 7, 2003). A copy of PCAOB Release No. 2003-018 and the comment letters received in response to the PCAOB's request for comment are available on the PCAOB's Web site at [www.pcaobus.org](http://www.pcaobus.org). The Board received 12 written comments. The Board has modified certain aspects of the proposed rule in response to comments it received, as discussed below:

Rule 3101(a)

The Board added the following captions to Rule 3101(a): 3101(a)(1) Unconditional Responsibility, 3101(a)(2) Presumptively Mandatory Responsibility, and 3101(a)(3) Responsibility To Consider. Proposed Rule 3101(a) did not have a caption or designation for each category of terms. Rather, the proposed rule simply referenced the category of certain terms by

using the standard format in PCAOB rulemaking. The Board added the captions in response to a commenter's recommendation that a caption be added to each category of certain terms for ease of reference and clarity.

One commenter recommended replacing the term "obligation" in Rule 3101 with a comparable term because the commenter believed that the term "obligation" in legal and governmental environments has a connotation that is inconsistent with the intent of Rule 3101 and may be misinterpreted by legal or governmental officials. After considering this comment, the Board replaced the term "obligation" with the synonym "responsibility" in Rule 3101.

Rule 3101(a)(2) defines a presumptively mandatory responsibility as a requirement that the auditor must comply with "unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard." Furthermore, Rule 3101(a)(2) states that "failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard."

The Board also added a note to Rule 3101(a)(2) to require auditors to document compliance with presumptively mandatory responsibilities by alternative means. The Board originally proposed that the auditor be required to "demonstrate by verifiable, objective, and documented evidence" that the alternative procedures he or she followed were sufficient in the specific circumstances. Commenters stated that they believed that the documentation

requirement was important, both to promote discipline of thought and to provide a uniform basis for evaluating compliance with the standards. Several of these commenters went even further to recommend that the Board strengthen the documentation requirement by adding language such as "contemporaneous" and "memorialized at the time of the audit" to the rule.

Conversely, other commenters suggested that the documentation requirement was unduly onerous and placed too great a documentation burden on the auditors. The commenters argued that the documentation would be too voluminous and would add very little value to the audit. Some of these commenters further recommended that, in lieu of the proposed documentation requirement, the rule require that the auditor consider the significance of the particular audit area and document only the significant issues or findings. A commenter also recommended that other evidence, such as oral explanation, should be allowed as support for the reasons why the auditor chose not to perform a presumptively mandatory responsibility. Additionally, some commenters recommended that the documentation requirement should be addressed in the standard on audit documentation.

The integrity of the audit depends, in large part, on the existence of a complete and understandable record of the work performed, the conclusions reached, and the evidence obtained to support those conclusions. Clear, complete, and comprehensive audit documentation enhances the quality of the audit. Audit documentation should demonstrate compliance with professional standards and justify the reasons for any variations in procedures performed.

The PCAOB standards require the auditor to document the procedures performed, evidence obtained, and conclusions reached during an engagement. To further enhance the quality of the audit, Rule 3101(a)(2) adds a specific documentation requirement to achieve complete and comprehensive audit documentation in engagement working papers for situations in which the auditor does not perform a presumptively mandatory responsibility. In those instances, it is essential that auditors document the reasons they chose not to perform the presumptively mandatory responsibility and how the alternative procedure they performed sufficiently achieved the objectives of the specific standard.

Because circumstances will be rare in which the auditor will perform an alternative procedure, the Board anticipates that the documentation requirement in the rule ought not to result in unduly onerous consequences or too voluminous documentation. Furthermore, since the auditor must already document the work performed as part of the audit, adding a concise explanation as to why the auditor chose to perform the alternative procedure should not increase the volume of documentation to an unreasonable level.

During an internal or external review of the engagement, other evidence, including oral explanation, may help substantiate the procedures performed by the auditor during the audit. However, because the auditor is required to document his or her work in the engagement working papers during the audit, oral explanation should be used only to clarify the documented work performed. The justification as to why the alternative procedure was performed rather than the presumptively mandatory responsibility must be documented in the working

papers. Furthermore, the reviewer should give appropriate consideration to the credibility of the individual(s) providing the oral explanation, and the oral explanation should be consistent with the documented evidence in the engagement working papers.

Moreover, the Board concluded that applying the documentation requirement only to significant issues, findings, or procedures is impractical because it will not be efficient or effective to determine, each time, whether the level of significance of an audit area warranted the auditor to document the reasons for choosing to perform an alternative procedure instead of the presumptively mandatory procedure. The purpose of Rule 3101 is to bring uniformity to definitions and requirements that auditors have to follow. In addition, the Board determined that moving Rule 3101(a)(2)'s documentation requirement to the audit documentation standard would not be appropriate because of its specific subject matter.

Additionally, the Board has added a note, originally a footnote in the Board's proposing release accompanying its proposed rule, describing an auditor's responsibility in a "should consider" scenario to the text of Rule 3101(a)(3), Responsibility to Consider. Some commenters recommended that this footnote be added directly to the text of the rule because they saw it as an important clarification that was not included in the original proposed rule. A commenter further urged the Board to elaborate on its applicability and the documentation requirements for a "should consider" action.

Another commenter suggested that the "should consider" footnote be excluded from the rule because it implies that the action would require the auditor to document every instance of compliance with a "should consider" action. The commenter, instead, recommended that Rule 3101(a)(3) be revised to apply to all considerations regardless of how the obligation is expressed (for example, whether it is preceded by a "should," "may," "could," or "might").

Because the "should consider" terminology is widely used in the interim standards, the Board determined that it is important to state the Board's expectation for compliance and, therefore, agreed with commenters who recommended adding the "should consider" footnote to the text of Rule 3101(a)(3). Furthermore, the Board concluded that there is an important difference between a "should consider" and a "may consider" action or procedure. The difference is a direct correlation to the definitions of "should" and "may." The auditor has a greater responsibility in a "should consider" action because the auditor has a presumptively mandatory responsibility to consider the action or procedure versus just having a responsibility to consider the action. Therefore, Rule 3101(a)(3) was not revised to apply to all considerations regardless of how the obligation is expressed.

Additionally, the Board determined that the documentation requirement relating to a procedure that an auditor "should consider" is not the same as the documentation requirement for a presumptively mandatory responsibility because in a "should consider" situation, only the consideration of the action is presumptively mandatory, while the action or procedure itself is not. In these

situations, the auditor should use his or her professional judgment in determining how to document his or her consideration of the specific action or procedure.

#### Rule 3101(b)

Some commenters on the proposed rule stated that the imperatives the Board identified are consistent with the way auditors currently interpret existing auditing and related professional practice standards, while other commenters recommended that Rule 3101(a) not apply to the interim standards on the grounds that the new definitions could create confusion or have unintended consequences. Because the accounting profession previously had not expressly defined these terms, commenters further recommended that the Board perform a comprehensive analysis of how and in what context the interim standards use the defined terms to determine whether current practice is consistent with the Rule 3101(a) definitions.

The Board concluded that the terminology defined in Rule 3101 is consistent with the existing interpretation regarding the application of the terminology in the interim standards. Rule 3101 creates a common understanding among the auditors as to what is expected of them when performing engagements in accordance with the PCAOB standards and, therefore, Rule 3101 will apply to the interim standards.

Furthermore, a commenter recommended that the Board clarify the level of authority the appendices carry when accompanying the Board's standards. Because the Board adopts the appendices to its permanent standards as rules, the appendices to the Board's permanent standards carry the same level of

authority as the standards themselves. In addition, the appendices to the interim standards, which in certain circumstances carry a different level of authority, retain their original level of authority as adopted on April 16, 2003.

#### Rule 3101(c)

Rule 3101(c) establishes an effective date for the documentation requirement in paragraph (a)(2). The Board agreed with commenters who recommended establishing an effective date to provide a reasonable amount of time for auditors to implement procedures to properly comply with the new documentation requirement.

#### III. Date of Effectiveness of the Proposed Rule and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents the Commission will:

(a) by order approve such proposed rule; or

(b) institute proceedings to determine whether the proposed rule should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule is consistent with the requirements of Title I of the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange

Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All submissions should refer to File No. PCAOB-2004-06 and should be submitted within [ ] days.

By the Commission.

Secretary





PCAOB Release No. 2003-018  
 October 7, 2003  
 Page 2

should be received by the Board no later than 5:00 PM (EST) on November 6, 2003.

Board

Contact: Douglas Carmichael, Chief Auditor (202/207-9058; [carmichaeld@pcaobus.org](mailto:carmichaeld@pcaobus.org)); Thomas Ray, Deputy Chief Auditor (202/207-9112; [rayt@pcaobus.org](mailto:rayt@pcaobus.org)).

\* \* \*

On April 18, 2003, the Board issued *Statement Regarding the Establishment of Auditing and Other Professional Standards*, PCAOB Release No. 2003-005 regarding the process by which it intends to establish Auditing and Related Professional Practice Standards, including auditing, attestation, quality control, ethical, and independence standards, applicable to registered public accounting firms in the preparation and issuance of audit and other reports for public companies. The Board subsequently adopted Rule 3100, which, if approved by the Securities and Exchange Commission ("Commission"), will require registered public accounting firms and their associated persons to "comply with all applicable auditing and related professional practice standards."<sup>1/</sup> This release proposes an additional rule, proposed Rule 3101, which would afford further guidance concerning Board standard setting.

---

<sup>1/</sup> On June 30, 2003, the Board adopted Rule 3100 and the related definition in Rule 1001(a)(viii) of the term "auditing and related professional practice standards." The term "auditing and related professional practice standards" means the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act. See *Compliance With Auditing and Related Professional Practice Standards*, PCAOB Release No. 2003-009 (June 30, 2003). These rules, and certain other rules relating to the standard-setting process, were filed with the Commission on July 11, 2003. Rule 3100 will not take effect unless approved by the Commission pursuant to Section 107 of the Act.



PCAOB Release No. 2003-018  
October 7, 2003  
Page 3

A. Use of Terminology in Future Board Standards

Proposed Rule 3101(a) defines certain terms that the Board will employ to describe the professional obligations of registered firms and associated persons under its standards. The proposed rule describes three categories of professional obligations—

1. Obligations that are unconditional. The words "must," "shall," and "is required" indicate unconditional obligations. The auditor must accomplish obligations of this type in all cases in which the circumstances exist to which the obligation applies. The Board understands that "must" appears infrequently in the interim standards, and the Board expects that such an unconditional obligation will be used sparingly in the Board's future standards. However, the Board believes that certain obligations of the auditor are truly unconditional and should be clearly articulated as such.
2. Obligations that are presumptively mandatory. The word "should" indicates obligations that are presumptively mandatory. The auditor must comply with the requirements of this nature specified in the Board's standards unless the auditor can demonstrate, by verifiable, objective, and documented evidence, that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard and serve adequately to protect the interests of investors and further the preparation of informative, fair, and independent audit reports.
3. Obligations that are subsidiary to the unconditional or presumptively mandatory obligations. The words "may," "might," "could," or other terms and phrases describe actions and procedures that auditors have a professional obligation to consider.<sup>2/</sup> Matters described in this fashion require the auditor's attention and understanding. Whether (and, if so, how) the auditor takes the action or implements the procedure in question will depend on an exercise of professional judgment in the circumstances.

---

<sup>2/</sup> Therefore, if a Board standard provides that an action or procedure is one that the auditor "should consider," consideration of the action or procedure is presumptively mandatory, while the action or procedure is not.



PCAOB Release No. 2003-018

October 7, 2003

Page 4

The Board believes that use of the terminology in these three categories will provide clear, concise, and definitive imperatives, thereby improving audit quality. Further, the Board believes that, to bring all auditors to a uniform level of diligence regarding the interpretation of "should," deviations from a presumptively mandatory obligation must be supported by "verifiable, objective and documented evidence." This requirement, which is set forth in proposed Rule 3101(a)(2), would go beyond existing standards or interpretations. Under existing standards, the auditor may justify the failure to perform a "should" directive by presenting persuasive evidence, but this evidence could be formulated after the completion of the audit and could even be oral.

B. Use of Terminology in Interim Board Standards

Proposed Rule 3101(b) would apply the terminology described in proposed Rule 3101(a) to the Board's interim standards. Rules 3200T, 3300T, 3400T, 3500T, and 3600T require registered public accounting firms and their associated persons to comply with certain standards in existence on April 16, 2003. These standards frequently employ the word "should" or other terms discussed in Rule 3101(a).

The Board believes that it is appropriate to extend proposed Rule 3101(a) to the interim standards because the terminology described in Rule 3101(a) is generally consistent with the manner in which the profession currently interprets existing auditing literature. Diligent auditors have historically understood "should" to represent a high threshold of obligation, consistent with the description in proposed Rule 3101(a)(2). The American Bar Association's *Auditor's Letter Handbook*, originally published in 1976, states the following regarding "should" as an imperative –

In accounting literature, the customary phraseology is "should disclose." On the basis of discussions with those knowledgeable on the subject in the course of the preparation of the ABA and AICPA Statements, the Committee understands that, in context, this phrasing means, and is intended to mean, "must disclose" and may properly be read so. In this connection, the Committee has been advised that a prescription in accounting literature that something "should" be done is an admonition that it *must* be done unless the accountant is prepared to accept the



PCAOB Release No. 2003-018  
 October 7, 2003  
 Page 5

considerable burden of justifying the departure from (generally accepted) standards.<sup>3/</sup>

More recently, the Public Oversight Board's Panel on Audit Effectiveness observed –

\* \* \* [M]any SASs lack imperatives that compel auditors to take definitive steps in specified circumstances. For example, in some cases an SAS may impose an imperative on an auditor by indicating what an auditor definitely "should" do, while in other cases an SAS might only indicate what an auditor "should consider," allowing significant latitude for the exercise of judgment based on the circumstances of the engagement and on the auditor's assessment of risk and materiality.<sup>4/</sup>

Because of its concerns regarding the clarity and consistency in existing standards, the Panel on Audit Effectiveness recommended that the various levels of imperatives in auditing standards be clarified.<sup>5/</sup> The Board believes that Rule 3101(b),

---

<sup>3/</sup> American Bar Association, *Auditor's Letter Handbook*, at page 34 (December 1976 – reprinted February 1990). The *Handbook* was prepared under the direction of The Committee on Audit Inquiry Responses Section of Business Law.

<sup>4/</sup> Panel on Audit Effectiveness, *Report and Recommendations* § 2.221 (August 31, 2000).

<sup>5/</sup> Id. at § 2.228. In Section 2.228, the Panel on Audit Effectiveness also observed –

The Panel believes that auditing standards must serve to provide both reasonable and measurable benchmarks for performance by auditors. Standards need to be reasonable in that they should not force auditors to adhere to rules that do not take into account the myriad of circumstances that may exist on audits.

The Board agrees with this statement, and intends therefore to use the term "must" sparingly, as do the interim standards.



PCAOB Release No. 2003-018  
 October 7, 2003  
 Page 6

which would prospectively apply the terminology in Rule 3101(a) to the standards in existence on April 16, 2003 would accomplish that objective.<sup>6/</sup>

C. Scope of Proposed Rule 3101

While proposed Rule 3101, if adopted, would apply to both the Board's permanent standards and to the Board's interim standards, it would not be applicable to interpretations of the Board's other rules. The proposed rule would also not govern the Board's interpretation of any other requirements to which registered public accounting firms and their associated persons are subject, including the Commission rules.

\* \* \*

On the 7th day of October, in the year 2003, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ISSUED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour  
 Acting Secretary

October 7, 2003

---

<sup>6/</sup> For the reasons discussed above, the Board believes that, except for the documentation requirement in Rule 3101(a)(2), the principles in Rule 3101(a) will usually also apply to the interpretation of the interim standards with respect to conduct occurring prior to the effective date of Rule 3101(b). However, in the case of conduct prior to the effective date of the rule, the Board will consider, on a case-by-case basis, in light of all the circumstances, the proper interpretation of imperatives in the existing standards.



PCAOB Release No. 2003-018  
October 7, 2003  
Page 7

APPENDICES –

1. Proposed Rule 3101 – Certain Terms Used in Auditing and Related Professional Practice Standards
2. Section-by-Section Analysis of Proposed Rule 3101



## **Appendix 1 – Proposed Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards**

### **RULES OF THE BOARD**

#### **SECTION 3. PROFESSIONAL STANDARDS**

##### **Part 1 – General Requirements**

#### **Rule 3101. Certain Terms Used in Auditing and Related Professional Practice Standards**

**(a)** The Board's auditing and related professional practice standards use certain terms set forth in this rule to describe the degree to which the Board expects registered public accounting firms and their associated persons to comply with the professional obligations included in those standards.

- (1) The words "must," "shall," and "is required" indicate unconditional obligations. The auditor must accomplish obligations of this type in all cases in which the circumstances exist to which the obligation applies. Failure to discharge an unconditional obligation is a violation of Rule 3100.
- (2) The word "should" indicates obligations that are presumptively mandatory. The auditor must comply with requirements of this nature specified in the Board's standards unless the auditor can demonstrate, by verifiable, objective, and documented evidence, that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard and serve adequately to protect the interests of investors and further the preparation of informative, fair, and independent audit reports. Failure to discharge a presumptively mandatory obligation is a violation of Rule 3100 unless the firm or associated person carries the burden of establishing that, in the circumstances, compliance was not necessary to achieve the objectives of the standard.
- (3) The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a professional obligation to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the



PCAOB Release No. 2003-018  
October 7, 2003  
Appendix 1 – Rule  
Page A1-2

auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances.

**(b)** The Board will use the terminology in paragraph (a) of this rule in interpreting the obligations imposed by, and evaluating compliance with, the Auditing and Related Professional Practice Standards, including the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T .



## **Appendix 2 – Section-by-Section Analysis of Proposed Rule 3101**

### **Proposed Rule 3101(a)**

In drafting its standards, the Board intends to distinguish as clearly as possible between three levels of auditor responsibility. Proposed Rule 3101(a) explains the terminology regarding imperatives that the Board proposes to use in the standards it issues.

Rule 3101(a)(1) provides that the Board will use the words "must," "shall," and "is required" in standards it issues to indicate unconditional obligations. The auditor must accomplish obligations of this type in all cases in which the circumstances exist to which the obligation applies. The Board will treat a failure to discharge an unconditional obligation imposed under its standards as a violation of Rule 3100.

Rule 3101(a)(2) provides that the Board will use the word "should" in standards it issues to indicate obligations that are presumptively mandatory. The auditor must comply with requirements of this nature unless the auditor can demonstrate that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard and serve adequately to protect the interests of investors and further the preparation of informative, fair, and independent audit reports. Deviations must be justified by verifiable, objective, and documented evidence. Such evidence must be memorialized at the time of the audit, not after-the-fact, and must be made a part of the audit workpapers. The Board will treat a failure to discharge a presumptively mandatory obligation as a violation of Rule 3100 unless the firm or associated person carries the burden of establishing that, in the circumstances, compliance was not necessary to achieve the objectives of the standard. As noted, this burden must be carried by documentary evidence, contemporaneous with the audit.

Rule 3101(a)(3) provides that the Board will use the words "may," "might," "could," and other terms and phrases to describe actions and procedures that auditors have a professional obligation to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances.

### **Proposed Rule 3101(b)**

Proposed Rule 3101(b) provides that the Board will use the terminology in paragraph (a) of this rule in interpreting the obligations imposed by, and evaluating compliance with, the Auditing and Related Professional Practice Standards, including



PCAOB Release No. 2003-018  
October 7, 2003  
Appendix 2 – Section-by-Section Analysis  
Page A2-2

the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T. Rule 3101(b) will apply to conduct occurring after the effective date of the rule.

In effect, the adoption of proposed Rule 3101(b) would make the terminology in Rule 3101(a) applicable to all existing standards with which registered public accounting firms and their associated persons must comply. The Board will treat a failure to comply with a presumptively mandatory requirement in an interim standard as a violation of Rule 3100 unless the firm or associated person carries the burden of establishing, by documented, contemporaneous evidence, that, in the circumstances, compliance was not necessary to achieve the objectives of the standard. Carrying that burden would, in turn, require showing that alternative actions served adequately to protect the interests of investors and to further the preparation of informative, fair, and independent audit reports.



PCAOB 2004-06  
Exhibit 2(a)(B)  
Page 1

**19b-4**

## Exhibit 2(a)(B)

Tab Number	Comment Source
1	American Institute of Certified Public Accountants, Authors: S. Scott Voynich, CPA, Chairman of the Board, and Barry C. Melancon, CPA, President and CEO, November 6, 2003
2	Deloitte & Touche LLP, November 5, 2003
3	Ernst & Young LLP, November 6, 2003
4	Grant Thornton LLP, Author: John L. Archambault, Managing Partner of Professional Standards, November 5, 2003
5	Institut der Wirtschaftsprüfer, Authors: Dr. Gross, Executive Director, and Wolfgang P. Böhm, Referatsleiter, November 6, 2003
6	International Federation of Accountants, Author: James M. Sylph, Technical Director IAASB, October 24, 2003
7	KPMG LLP, November 6, 2003
8	National Association of State Boards of Accountancy; Authors: David A. Vaudt, CPA, Chair, and David A. Costello, CPA, President & CEO November 5, 2003
9	National State Auditors Association, Authors: Bill Holland, Auditor General (IL) and President of the National State Auditors Association (NSAA), and Walter Kucharski, Auditor of Public Accounts (VA) and Chair of the NSAA Audit Standards and Reporting Committee, November 6, 2003
10	PricewaterhouseCoopers LLP, November 6, 2003
11	United States General Accounting Office, Author: David M. Walker, Comptroller General of the United States, November 6, 2003
12	William L. Livingston, PE, November 5, 2003



November 6, 2003

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. 009 Proposed Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards**

Dear Mr. Secretary:

The American Institute of Certified Public Accountants ("AICPA") appreciates the opportunity to submit written comments on the Public Company Accounting Oversight Board's ("PCAOB") proposed rule regarding certain terminology used in auditing and related professional practice standards. The AICPA is the largest professional association of Certified Public Accountants in the United States, with more than 340,000 members in public practice, business, industry, government, and education.

The AICPA commends the PCAOB for developing guidelines on the use of certain terms in auditing and related professional practice standards. We are, however, concerned with the implication for practitioners of some of the guidelines in the proposed rule. We acknowledge the very technical nature of the proposed rule and our comments. As a result, we stand ready to meet with the PCAOB and its staff to further clarify any of our recommendations. Our concerns are as follows:

**AICPA Comments on Rule 3101(a)(1)**

The proposed rule states:

The words "must," "shall," and "is required" indicate unconditional obligations. The auditor must accomplish obligations of this type in all cases in which the circumstances exist to which the obligation applies. Failure to discharge an unconditional obligation is a violation of Rule 3100.

We fully support use of the terms in connection with principles (for example, the auditor must exercise due professional care). We are, however, concerned that the rule may limit an auditor's ability to apply professional judgment in carrying out his or her obligations when it involves actions or procedures. Therefore, as the PCAOB promulgates future standards, we encourage it to use "must" when discussing principles and "shoulds" in connection with detailed procedures. We believe that using the term "must" in

Office of the Secretary  
October 2, 2003  
Page 2

connection with detailed procedures will reduce the effectiveness of auditing procedures because it will not allow the auditor to tailor those to the applicable industry and circumstances.

### **AICPA Comments on Rule 3101(a)(2)**

The proposed rule states:

The word "should" indicates obligations that are presumptively mandatory. The auditor must comply with requirements of this nature specified in the Board's standards unless the auditor can demonstrate, by verifiable, objective, and documented evidence, that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard and serve adequately to protect the interests of investors and further the preparation of informative, fair, and independent audit reports. *Failure to discharge a presumptively mandatory obligation is a violation of Rule 3100 unless the firm or associated person carries the burden of establishing that, in the circumstances, compliance was not necessary to achieve the objectives of the standard [emphasis added].*

We have two concerns with this rule. First, the italicized text above seems inconsistent with the second sentence. Second, with respect to the required documentary evidence, Appendix 2, *Section-by-Section Analysis of Proposed Rule 3101*, indicates that the "evidence must be memorialized at the time of the audit, not after-the-fact, and must be made a part of the audit workpapers." This is not clearly stated in the rule. If the PCAOB's intent is to require the auditor to document the evidence during the audit and include it with the audit documentation, the AICPA recommends specifically stating that requirement in the rule.

To address our two concerns, we recommend to the PCAOB that it consider replacing the last sentence of Rule 3101(a)(2) (see italicized text above), with the following:

Failure to discharge a presumptively mandatory obligation is a violation of Rule 3100 unless the firm or associated person demonstrates that, in the circumstances, compliance with the specified obligation was not necessary to achieve the objectives of the standard. In that situation, the auditor must include in the audit documentation an explanation of how the alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard and serve adequately to protect the interests of investors and further the preparation of informative, fair, and independent audit reports. That explanation must be supported in the audit documentation by objective and verifiable evidence.

Office of the Secretary  
October 2, 2003  
Page 3

Additionally, the interim standards contain a number of requirements to consider ("should consider") certain actions or procedures. Because of the documentation requirement in Rule 3101(a)(2) and the fact that a "consideration" doesn't generally result in documentary evidence, Rule 3101(a)(2) in effect is requiring the auditor to document every instance of *compliance* with a "should consider" obligation. We therefore recommend that PCAOB specifically exclude from the scope of Rule 3101(a)(2) the "should consider" professional obligation. The professional obligation to "consider" matters, which is addressed in Rule 3101(a)(3) should be revised to apply to *all* considerations regardless of how that obligation is expressed (that is, whether it's preceded by a "should," "may," "might," or "could").

\*\*\*\*\*

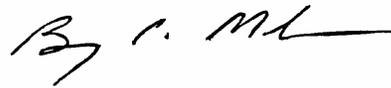
The AICPA recognizes the enormous effort put forth by the PCAOB members and staff to implement the provisions of the Sarbanes Oxley Act. Initially, a significant responsibility of PCAOB will be to help restore public confidence in audited financial statements of public companies and establishment and maintenance of high quality auditing and other professional standards is critical to that goal. The AICPA is committed to working with the PCAOB to continue developing high quality standards for audits of issuers.

We would be pleased to meet with PCAOB members and staff to discuss our comments.

Sincerely,



S. Scott Voynich, CPA  
Chairman of the Board



Barry C. Melancon, CPA  
President and CEO

Deloitte & Touche LLP  
10 Westport Road  
PO Box 820  
Wilton, CT 06897-0820

Tel: 203-761-3000  
Fax: 203-834-2200



November 5, 2003

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. 009**  
**Proposed Rule Regarding Certain Terms Used in Auditing and**  
**Related Professional Practice Standards**

Deloitte & Touche LLP is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its *Proposed Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards*, PCAOB Rulemaking Docket Matter No. 009 (October 7, 2003). This proposed standard creates three categories of professional obligations in effort to provide definitive imperatives for procedures performed by auditors. The three categories of imperatives as defined in the proposed standard are as follows: 1) must, shall, and is required; 2) should; and 3) may, might, could. We support the concept of providing clear standards and guidance to auditors. However, we have certain concerns regarding the proposed standard which are described below.

The first category of "must, shall, and is required" describes obligations that the auditor must accomplish. We believe the words "must, shall, and is required" should be used judiciously in setting standards, especially in conjunction with the word "all." It is not possible to anticipate all potential fact patterns in which the auditor may not be able to perform certain procedures.<sup>1</sup> Accordingly, we support the Board's intent to use "must, shall, and is required" sparingly as stated in the release discussion of the proposed rule.<sup>2</sup>

Additionally, the proposed standard indicates that the three categories will be applied to the interim standards adopted by the Board. The Board acknowledges in the release discussion that "must" appears infrequently in the interim standards. But to be clear, we urge the Board to be explicit in the final rule or accompanying release that any elevation of procedures contained in the

---

<sup>1</sup> As noted by the Board, the Panel on Audit Effectiveness observed that "standards need to be reasonable in that they should not force auditors to adhere to rules that do not take into account the myriad of circumstances that may exist on audits." *Report and Recommendations of the Panel on Audit Effectiveness*, Section 2.228.

<sup>2</sup> PCAOB Release No. 2003-018, page 3.

interim standards to the level of “must, shall, and is required” will be subject to the standard-setting process.

Finally, although not specifically part of this rule as proposed, we believe the Board should use this opportunity to clarify the authority level of appendices to audit standards. The Board has stated in its *Proposed Auditing Standard An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, PCAOB Release No. 2003-17, that appendices to the Board’s standards are an integral part of the auditing standards and carry the same authoritative weight as the body of the standard.<sup>3</sup> However, the status of appendices in AICPA Professional Standards, which are now the Board’s interim standards, is different. AICPA Statement on Auditing Standards (SAS 95), *Generally Accepted Auditing Standards* (AU 150), which is incorporated into the Board’s interim standards, includes appendices as interpretive publications that the auditor should be aware of and consider but they are not required to apply; if the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such guidance.<sup>4</sup> As such, while the auditor is responsible for following the interim standards themselves, the auditor has a lower level of responsibility for following the guidance in the appendices. We believe the Board should clarify that the appendices as they exist in the interim standards have not been elevated to the same authoritative level as the related interim auditing standards themselves.

Further, we are concerned that if the authority of appendices in the Board’s standards is different than the authority of appendices in the Board’s interim standards and this difference is perpetuated, confusion about the application of appendices will result. We would suggest setting a consistent level of authority for all appendices. However, if the Board decides to accomplish this by either modifying the appendices in the interim standards or elevating them to a different authority level, we would urge the Board to subject such changes to the rulemaking process on a standard by standard basis.

We appreciate the opportunity to comment, and would be pleased to discuss these issues with you further. If you have any questions or would like to discuss these issues further, please contact Robert J. Kueppers at (203) 761-3579.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: William J. McDonough, Chairman of the PCAOB  
 Kayla J. Gillan, Member  
 Daniel L. Goelzer, Member  
 Willis D. Gradison, Jr., Member  
 Charles D. Niemeier, Member

---

<sup>3</sup> PCAOB Release No. 2003-17, *Statement of Authority*, Page A-2.

<sup>4</sup> AICPA Statement on Auditing Standards (SAS) 95, *Generally Accepted Auditing Standards*, AU 150.06.



Ernst & Young LLP  
Suite 1300  
925 Euclid Avenue  
Cleveland, Ohio 44115

Phone: (216) 861-5000  
www.ey.com

November 6, 2003

Mr. J. Gordon Seymour  
Acting Secretary  
Public Company Accounting Oversight Board  
1666 K Street NW  
Washington, D.C. 20006-2803

**PCAOB Rulemaking Docket Matter No. 009,  
Proposed Rule Regarding Certain Terms Used In Auditing And Related Professional  
Practice Standards**

Dear Mr. Seymour:

We are pleased to submit this comment letter to the Public Company Accounting Oversight Board (“PCAOB” or the “Board”) regarding the above-referenced PCAOB Rulemaking Docket Matter.

We support the Board’s efforts to clarify and define the professional obligations of Registered Public Accounting Firms (“auditors”) in connection with services provided in accordance with the Board’s Auditing and Related Professional Practice Standards (“standards”). We share your view that it is desirable for the Board’s standards to provide clear, concise, and definitive imperatives that contribute to quality.

We also agree that significant actions and procedures associated with the terminology in proposed Rule 3101(a) and Rule 3101(b) generally are consistent with the manner in which independent auditors currently interpret existing auditing literature. However, as discussed further below, we believe that the documentation requirements in the proposed Rule, particularly the documentation requirements for a presumptively mandatory obligation, would be quite different than the requirements under current auditing standards.

Our specific views and significant comments on the proposed Rule are set out in this letter.

**Documentation Requirements**

The proposed Rule does not provide guidance on how the auditor demonstrates compliance with obligations that are unconditional or presumptively mandatory. The Section-by-Section Analysis of Proposed Rule 3101(a)(2) regarding deviations from obligations that are presumptively mandatory states:

Deviations must be justified by verifiable, objective, and documented evidence. Such evidence must be memorialized at the time of the audit, not after-the-fact, and must be made part of the audit workpapers.

November 6, 2003

Mr. J. Gordon Seymour

The proposed Rule provides that failure to discharge an unconditional obligation or a presumptively mandatory obligation is a violation of Rule 3100, which requires auditors to comply with the Board's standards. As a result, one might infer that the proposed Rule requires auditors to prepare documented evidence of performance of each unconditional or presumptively mandatory obligation as well as any deviations from such obligations. If that is the Board's intent, we believe that the resulting required documentation would significantly exceed the current level of documentation.

The terms included in the proposed definitions appear frequently in paragraphs throughout the Board's Interim standards. For example, the following table illustrates the results of our electronic search of the occurrence of each of the defined terms within Rule 3200T, *Interim Auditing Standards*, and Rule 3300T, *Interim Attestation Standards*.

	Rule 3200T - Interim Auditing Standards	Rule 3300T - Interim Attestation Standards
<i>Obligations that are unconditional:</i>		
Must	73	7
Shall	29	28
Is required	<u>46</u>	<u>9</u>
	148	44
<i>Obligations that are presumptively mandatory</i>		
Should	1,300	486
<i>Other terms and phrases to consider:</i>		
May	1,310	328
Might	188	60
Could	<u>144</u>	<u>30</u>
	1,642	418

There are many instances in the Board's Interim standards where the term "should" is used in the context of the auditor applying judgment. Also, there are many instances where the proposed terms are not in the context of the auditor performing procedures.

We are concerned that if the proposed Rule or the manner in which it is implemented effectively requires documentation of all obligations that are unconditional and those that are presumptively mandatory, as well as all deviations from obligations that are presumptively mandatory, such documentation will be voluminous and in many situations will be of little value.

Accordingly, we recommend that the final Rule address only the proposed definitions of terms that the Board will use on a prospective basis, and that the related documentation requirements be addressed in the Board's documentation project or in the Board's review of each of the Interim standards. As each Interim standard is reviewed, the Board can consider whether to maintain or modify each instance of the terms indicated in the proposed Rule and also consider

November 6, 2003

Mr. J. Gordon Seymour

additional procedures applicable to that standard that should be unconditional, presumptively mandatory, or that need to be otherwise considered.

**Effective Date**

The text of the proposed Rule 3101(b) does not indicate an effective date for the application of the terms in the proposed Rule, but footnote 6 to item B of the Release (which is not included in the proposed Rule) states the Board believes the principles apply “with respect to conduct occurring prior to the effective date” of the proposed Rule. The Section-by-Section Analysis of Proposed Rule 3101(b) (which also is not included in the proposed Rule) states that Rule 3101(b) will apply to conduct occurring after the effective date of the Rule. However, most of the services provided by auditors in accordance with the Board’s standards cover a period of time.

We believe that the final Rule should not be applied before the effective date, nor should it extend to services that are in process as of the effective date. Furthermore, because the proposed terms are included in the Board’s Interim standards numerous times, auditors will need reasonable time to modify service methodologies to meet requirements of the proposed Rule. Accordingly, we believe that a specific effective date should be included in a final Rule (e.g., effective for audits of periods beginning on or after December 15, 2003) to facilitate a reasonable implementation process.

\*\*\*\*\*

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

Very truly yours,

/s/ Ernst & Young LLP

Grant Thornton LLP  
The US Member Firm of  
Grant Thornton International

175 West Jackson  
Chicago, IL 60604  
312 602-8000

Grant Thornton 

November 5, 2003

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

Re: PCAOB Rulemaking Docket Matter No. 009, *Proposed Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards*

Dear Board Members and Staff,

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("Board" or "PCAOB") proposed Rule 3101 regarding certain terms to be used in the Auditing and Related Professional Practice Standards to describe the differing levels of professional obligations to be imposed on registered public accounting firms and their associated persons ("auditors").

We support the Board's intentions and actions to improve audit quality and believe that the imperatives identified by the Board are primarily consistent with the way auditors currently interpret and apply generally accepted auditing standards (GAAS) adopted by the Auditing Standards Board of the American Institute of Certified Public Accountants. We do, however, have concerns with respect to the proposal and certain other related matters, as follows.

### Contemporaneous Documentary Evidence

The Board has proposed to use the term "should" to indicate obligations that are presumptively mandatory and ordinarily must be performed by the auditor. Alternative actions with respect to such obligations must be justified by verifiable, objective and documented evidence, contemporaneous with the audit. We agree with the use of the term "should" to indicate a high threshold of obligation consistent with the current interpretation of existing standards. However, we believe that the contemporaneous documentation requirement (in effect documenting what was not done) will not increase the quality of audits but rather add tremendous cost to an audit.

The nature, timing and extent of audit procedures and the quantity, type and content of audit documentation are matters involving the professional judgment of the auditor. Many factors are considered in determining the nature, timing and extent of audit procedures and the quantity, type and content of the documentation for a particular audit area, such as the risk of material

misstatement, significance of the account or class of transactions, relevance of the assertions, extent of judgment involved in performing the work and evaluating the results, nature of the procedure, nature and extent of exceptions identified, and the significance of evidence obtained. Certain conclusions are readily determinable from the work performed or are evident from a review of the financial statements (e.g., immaterial account balance). The auditor, therefore, considers the need to document a conclusion or the basis for a conclusion that is not otherwise readily determinable.

In lieu of the proposed requirement, we recommend that the rule require the auditor to consider the significance of the particular audit area to which the “should” directive relates. For audit findings or issues that are significant, the auditor should document the actions taken, any additional evidence obtained, and the basis for the final conclusions reached. This requirement is consistent with existing standards and allows auditor judgment in determining the nature and extent of audit documentation. Such requirement also reduces the time and effort required to document procedures relating to insignificant matters or matters that are readily determinable from the existing documentation.

### Use of Terminology in Interim Board Standards

The Board’s Interim Professional Auditing Standards were adopted on an initial, transitional basis until the Board could determine whether such standards were appropriate to adopt permanently. The Board stated that it would establish a schedule and procedures to review such pre-existing standards, on a standard-by-standard basis, to determine whether they should be permanent, repealed, or modified.

The Board has now proposed to extend the differing levels of professional obligations as described in the proposed rule to the interim standards. Such pre-existing standards were drafted under a separate framework that required a high threshold of obligation by using the words “is required” and “should,” but allowed the auditor to justify a departure using persuasive and/or documented evidence. Accordingly, we believe that the term “should” in the interim standards implies an obligation that is presumptively mandatory, and in certain circumstances, an obligation that is unconditional. We do not believe that the lack of performance of a “should” directive, however, constitutes a “failure” under existing standards, as indicated by the Board.

Notwithstanding our concerns expressed above, we oppose the application of the contemporaneous documentation requirement to the interim standards, without actually performing a standard-by-standard review to determine the impact of such a request. Although we support the Board’s intentions, we believe this obligation may lead to an unintended result, simply due to the framework used to draft the interim standards.

For example, footnote two states “Therefore, if a Board standard provides that an action or procedure is one that the auditor “should consider,” consideration of the action or procedure is presumptively mandatory, while the action or procedure is not.” We believe that in certain circumstances, under the interim standards, the action or procedure itself is presumptively mandatory. For instance, paragraph 34 of SAS No. 99 (AU Section 316), *Consideration of Fraud in a Financial Statement Audit*, states the following:

“The auditor should consider other information that may be helpful in identifying risks of material misstatement due to fraud. Specifically, the discussion among the engagement team members (see paragraphs 14 through 18) may provide information helpful in identifying such risks. In addition, the auditor should consider whether information from the results of (a) procedures relating to the acceptance and continuance of clients and engagements<sup>14</sup> and (b) reviews of interim financial

statements may be relevant in the identification of such risks. Finally, as part of the consideration of audit risk at the individual account balance or class of transaction level (see SAS No. 47, AU sec. 312.24 through 312.33), the auditor should consider whether identified inherent risks would provide useful information in identifying the risks of material misstatement due to fraud (see paragraph 39).”

In this circumstance, the word “consider” is used to define something the auditor is required to think about when identifying risks of material misstatement due to fraud. This paragraph does not infer that the auditor has the option of not performing such procedures, after they have considered them. Accordingly, the action or procedure itself is presumptively mandatory.

### Scope of Proposed Rule 3101

The Board’s adoption of interim standards incorporated the content of the existing body of literature, including auditing standards, interpretive publications, and other auditing publications. An auditor is required to comply with the auditing standards. An auditor should also be aware of and consider interpretive publications applicable to the audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the auditing standards addressed by such guidance. When using other auditing publications, the auditor should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate.

We are aware of several instances where the interpretive publications (“level 2” GAAS) and other auditing publications (“level 3” GAAS) utilize the terms proposed by the Board to describe professional obligations. Proposed Rule 3101 does not directly address the application of the differing levels of obligations to the interpretive and other auditing publications. Accordingly, we recommend that the Board clarify how the differing levels of professional obligations relate to level 2 and level 3 GAAS.

### Other Descriptive Material

The proposal contains descriptive material, such as background information and reasons and conclusions reached. It also includes an analysis by section in Appendix 2. Such material is not included in the proposed rule, but appears to be included to assist registered public accounting firms and their associated persons in understanding and implementing the rule. We recommend that the PCAOB clarify the authoritative status of such information and describe how it will be maintained for reference purposes.

### Exposure Period

We acknowledge and support the PCAOB’s authority to establish and adopt auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports for issuers. However, we also promote the development of global generally accepted standards, which we believe will lay the foundation for consistent, timely, reliable and transparent information in global financial markets. The Public Oversight Board’s Panel on Audit Effectiveness also noted the development of a uniform global set of standards as part of its findings.

Hence, we believe it is essential and in the public interest for the rulemaking process to allow sufficient time for interested parties around the globe to submit comments. We recommend that the Board recognize and consider any comments received from international organizations subsequent to the date the comment period for this docket matter ends. Such interested parties may not have been provided with adequate time to submit written comments, as many countries

November 5, 2003

would need to first translate the document. We urge the Board to consider such matters for future proposals.

\*\*\*\*\*

We would be pleased to discuss any of our comments with you. If you have any questions, please contact Mr. John L. Archambault, Managing Partner of Professional Standards, at (312) 602-8701.

Very truly yours,

A handwritten signature in black ink, reading "John L. Archambault". The signature is written in a cursive style with a large, looping initial "J".

Grant Thornton LLP

INSTITUT  
DER  
WIRTSCHAFTSPRÜFER

**IDW**

Düsseldorf, November 6, 2003

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

By E-Mail: [comments@pcaobus.org](mailto:comments@pcaobus.org)

Dear Sir(s):

**Re: PCAOB Rulemaking Docket Matter No. 009  
IDW Comments on the PCAOB Proposed Rule Regarding Certain Terms  
Used in Auditing and Related Professional Practice Standards**

We would like to thank you for the opportunity to comment on the PCAOB Proposed Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards. The Institut der Wirtschaftsprüfer represents approximately 85 % of the German Wirtschaftsprüfer (German Public Auditor) profession. The German profession seeks to comment on the proposals by the PCAOB noted above because we believe that this Proposed Rule will affect not only the development of auditing standards in the United States, but also influence auditing standards on a worldwide basis. Furthermore, a significant number of German Wirtschaftsprüfer are or will be subject to the requirements of the Sarbanes-Oxley Act.

**General comments**

We were disappointed to see the very short exposure period in which comments can be provided to the PCAOB. Comment periods of 30 days are too short in an international environment, since many organizations would like to have the opportunity to consult with their stakeholders. We would suggest that 60 days might be more appropriate for short proposals such as this one; 90 days may be adequate for longer proposals.

Institut der Wirtschaftsprüfer  
in Deutschland e.V.  
Tersteegenstr. 14  
40474 Düsseldorf  
Postfach 320580  
40420 Düsseldorf

Telefonzentrale 0211/4561-0  
Fax Geschäftsleitung 0211/4541097  
Fax Fachabteilung 0211/4561233  
Fax Bibliothek 0211/4561204  
Internet <http://www.idw.de>  
E-Mail [info@idw.de](mailto:info@idw.de)

Geschäftsführender Vorstand:  
Prof. Dr. Klaus-Peter Naumann,  
WP StB, Sprecher des Vorstands  
Dr. Gerhard Gross  
Dipl.-Kfm. Peter Marks, WP StB

Bankverbindung:  
Deutsche Bank AG  
Düsseldorf  
BLZ 300 700 10  
Kto. Nr. 7 480 213

We support the establishment of a sound basis for setting and interpreting auditing and related professional practice standards (hereinafter, we will refer only to auditing standards, but mean both auditing and related professional practice standards). In our view, the establishment of such a sound basis is predicated upon the development and application of rigorous definitions of terms used in auditing standards. Consequently, we support the efforts of the PCAOB to bring clarity into its auditing standard setting processes and the interpretation of these standards.

However, we suspect that terms in relation to the degree to which the PCAOB expects registered public accounting firms and their associated persons to comply with the professional obligations included in those standards do not constitute the only terms that may require definition. We therefore believe that the PCAOB rules constituting auditing standards ought to include a section on definitions, much like the Glossary of the International Standards on Auditing, that covers the key terms used in the standards. In addition, it may be helpful to readers seeking to interpret the standards if the rules also included a section that covered the major drafting conventions covering the use of language (and the reasons for using a particular convention) in setting the standards.

## **Comments on Rule 3101 by Paragraph**

### *Unconditional Obligations*

Rule 3101 (a) (1) proposes that the words “must”, “shall”, and “is required” indicate unconditional obligations that the auditor must accomplish in all cases in which the circumstances exist to which the obligation applies. We would like to point out that the phrase “in all cases in which the circumstances exist to which the obligation applies” makes the obligation conditional upon the existence of certain circumstances. In our view, this implies that words or phrases indicating unconditional obligations should only be used in conjunction with **circumstances explicitly specified** in the standard that lead to the application of the obligation, because the lack of such specificity of circumstances may lead to the scope of application of the obligation being unclear. This is a good example of a drafting convention that may need to be established in connection with the use of words and phrases that create obligations.

Furthermore, we believe that it is incumbent upon the PCAOB to ensure that unconditional obligations that apply in circumstances explicitly specified in the standard *always* apply – that is, the existence of a single counterexample should be sufficient to prevent the use of wording that indicates an unconditional obligation. Of course, the explicitly specified circumstances could be adjusted to ensure that one or a few coun-

counterexamples are taken into account to allow the application of wording leading to an unconditional obligation, but this implies that no additional counterexamples may exist. On this basis, we surmise that the use of wording leading to unconditional obligations for explicitly specified circumstances will be relatively rare, which is in consonance with the PCAOB's view as expressed in Part A of the Release that such unconditional obligations will be used sparingly.

We would agree that a *clear* failure to discharge an unconditional obligation ought to be a violation of Rule 3100. However, there may be some question as to whether or not the explicitly specified circumstances exist to which the obligation applies, and hence, it may be unclear as to whether failure to discharge has occurred. The questions that arise in this respect is whether the auditor or the PCAOB bears the burden of production that these explicitly specified circumstances did not exist at the time of the audit, and that therefore a violation has occurred, and what burden of persuasion applies. This question ties into our comments on presumptively mandatory obligations (see below).

With respect to the burden of production, we note that under Rule 5204 (a) the interested division of the PCAOB bears the burden of proving that a violation has occurred. Hence, an auditor's failure to prove that no violation has occurred does not in itself entitle the PCAOB to conclude that a violation has occurred. Consequently, if an auditor does not perform an unconditional obligation on the grounds that the explicitly specified circumstances creating the unconditional obligation do not exist in a particular case, the auditor is not required to prove to the PCAOB that these circumstances did not exist: rather, the PCAOB must prove that a violation has occurred because the explicitly specified circumstances did exist. Therefore, it would not be appropriate to place the onus on the auditor to prove that, at the time of the audit, the explicitly specified circumstances did not exist because this would not be consistent with the burden of production stipulated in Rule 5204 (a). Nevertheless, this does not relieve the auditor from the obligation to gather and evaluate evidence concerning the existence of the explicitly specified circumstances and to document the evidence gathered, evaluation performed and conclusions drawn.

A violation of evidence gathering and documentation requirements by the auditor in this respect does not imply that the explicitly specified circumstances did not exist. We recognize, however, that the violation of evidence gathering and documentation requirements by the auditor where the consequent lack of evidence precludes the PCAOB from making a judgment as to whether the explicitly specified circumstances existed then ought to result in disciplinary action commensurate to the violation of an unconditional obligation. This discussion about evidence begs the question as to what evidence and documentation requirements ought to be established for the audi-

tor for those situations in which the auditor decides that the explicitly specified circumstances did not exist. However, it appears that this question can only be answered in relation to the burden of persuasion that the PCAOB must meet to prove that the explicitly specified circumstances existed at the time of the audit.

Rule 5204 (a) states that the interested division of the PCAOB must prove that a violation has occurred by a preponderance of the evidence. In our view, if the Rules require the PCAOB to meet a low burden of persuasion (preponderance of the evidence) to support the existence of explicitly specified circumstances leading to the applicability of an unconditional obligation and a finding of a violation, but require the auditor to meet a higher burden of persuasion (i.e., either clear and convincing evidence or beyond any reasonable doubt) to justify that explicitly specified circumstances do not exist, then this will lead to situations in which the auditor performs procedures because he or she cannot meet the burden of persuasion required, even though the PCAOB would have concluded under a lower burden of persuasion that the auditor need not have performed those procedures. In other words, the auditor would be performing procedures that the PCAOB would have otherwise concluded as not having been necessary. Consequently, we believe that an auditor need only satisfy himself or herself by the preponderance of the evidence that the explicitly specified circumstances do not exist.

The application of a lower burden of persuasion is, of course, particularly relevant in situations where verifiable, objective evidence may be difficult to obtain. In conclusion, we believe that failure to discharge an unconditional obligation would arise only if the PCAOB proved by a preponderance of the evidence that those explicitly specified circumstances exist to which the obligation applies. Hence, auditors should obtain and document enough evidence to satisfy themselves by a preponderance of that evidence that such circumstances do not exist when they decide that an unconditional obligation is not applicable. An important point in this respect addressed in the proposed rule 3101 (a) (3) but not in (1) is that the decision as to whether a preponderance of the evidence that explicitly specified circumstances leading to an unconditional obligation exist or do not exist has been obtained and properly documented may involve the exercise of considerable professional judgment on the part of the auditor.

As a practical matter, we believe some additional flexibility of wording should be allowed for indicating unconditional obligations so that the language of the standards does not become awkward. Other possible phrases that come to mind include “have to”, “need to”, “requires”, or “entails”. Furthermore, sometimes such obligations can be expressed by the use of adjectives (e.g., “required”, “compulsory”, etc.). In any case, the PCAOB should develop a policy for using the different kinds of wording for unconditional obligations in a consistent manner.

### *Presumptively Mandatory Obligations*

We agree that some obligations should be presumptively mandatory, and that the word “should” can be used to describe these kinds of obligations. However, given our discussion of the burden of production and persuasion that ought to be borne by the auditor in deciding not to apply unconditional obligations, we do not agree with the standard of evidence required of the auditor to overcome the presumption.

We consider the proposed requirement (in which violation of Rule 3100 would occur when an auditor fails to demonstrate, by verifiable, objective, and documented evidence, that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard and serve adequately to protect the interest of investors and further the preparation of informative, fair and independent audit reports) to place the burden of production upon the auditor, which is not consistent with Rule 5204 (a), and to require the auditor to do so with a burden of persuasion that exceeds that required of the PCAOB (preponderance of the evidence) in that Rule. Furthermore, we do not believe that the auditor should carry the burden of establishing that, in the circumstances, compliance was not necessary to achieve the objectives of the standard.

Like unconditional obligations, presumptively mandatory obligations would need to be defined in conjunction with explicitly specified circumstances (as we defined in our discussion on unconditional obligations) that lead to the presumption. Of course, this means that auditors need to obtain and document enough evidence to satisfy themselves by a preponderance of the evidence that such circumstances do not exist when they decide that a presumptively mandatory obligation is not applicable. As mentioned previously, this may require the auditor to exercise considerable professional judgment.

In a similar manner, if an auditor comes to the conclusion that a presumptively mandatory obligation is applicable based upon the circumstances, we believe that the auditor need only overcome, by obtaining and documenting preponderance of the evidence, the presumption that only the fulfillment of this obligation (as opposed to

some other means) will fulfill the objectives of the engagement (which, presumably involves the protection of the interests of investors *through* the preparation of informative, fair and *objective* audit reports). In this case, the auditor must obtain and document the preponderance of the evidence to satisfy himself or herself that the presumption has been overcome by means other than the presumptively mandatory obligation. This decision and the adequacy of its documentation may also require the exercise of considerable professional judgment by the auditor. A violation of Rule 3100 would, in our view, only occur if the auditor did not fulfill the presumptively mandatory obligation and the PCAOB proved by a preponderance of the evidence that: 1. the explicitly specified circumstances exist to which the presumptively mandatory obligation applies and 2. the objectives of the engagement (as we defined above) had not been fulfilled by other means, or 3. the auditor has not obtained or properly documented adequate evidence to satisfy himself or herself that either the explicitly specified circumstances do not exist or the objectives of the engagement have been fulfilled by other means.

#### *Professional Obligations to Consider*

We also agree that terms such as “may”, “might”, “could” and other terms and phrases be used to describe actions and procedures that auditors have a professional obligation to consider.

#### *Application of the New Terminology to the Interim Standards*

We are concerned that the impact of the new terminology on the interim standards may not have been sufficiently analyzed in detail – sentence by sentence in each paragraph. We believe that giving new meaning to old words in existing standards is a process likely to lead to confusion in the application of standards. We would prefer the PCAOB to apply the new terminology consistently only in any new standards issued by the PCAOB, because this would give those affected by the new standards the opportunity to comment on the impact of those words on their obligations. In essence, applying new meanings to the old standards does not allow those affected to properly assess that impact in the exposure period given, nor to then provide the PCAOB with their comments on those impacts.

We hope you find our comments helpful and would be pleased to be of assistance to you if you have any questions about these comments.

Yours very truly,



Dr. Gross  
Executive Director



Wolfgang P. Böhm  
Referatsleiter

494/500

**International Federation of Accountants**

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

24 October 2003

Office of the Secretary, Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, DC  
2006-2803

Via Email

**Re: PCAOB Rulemaking Docket Matter No. 009**

Staff of the IFAC's International Auditing and Assurance Standards Board (IAASB) appreciates this opportunity to comment on the PCAOB's Proposed Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*. We applaud the efforts of the PCAOB to clarify the use of certain terms that communicate the level of obligation imposed on the auditor in complying with the PCAOB's standards.

As you likely are aware, the IAASB is also exploring ways to improve the clarity of its standards so that the responsibilities of the auditor are stated in a clear, concise and definitive manner, thereby improving audit quality and consistency. The IAASB's initiative encompasses a review of the drafting convention it uses and, similar to the PCAOB's Proposed Rule, the consideration of how to articulate differing levels of professional obligations in the standards it issues. At its October 2003 meeting, the IAASB discussed developments in its project to improve the clarity of IAASB Standards and, within that context, discussed the PCAOB's Proposed Rule.

Noting its strong desire for national and international standards to be aligned as closely as possible, the IAASB expressed disappointment with respect to the short 30-day response period for comments on the Proposed Rule – a Rule which has significant implications for both practitioners and for standard setters at the national and international levels. The IAASB believes the issues surrounding the Proposed Rule require adequate time (such as the 90-day comment period ordinarily provided by the IAASB) for the development of a formal and measured response. Unfortunately, the comment period provided makes such an exercise unrealistic and unworkable.

Accordingly, the following represent Staff's reaction to the PCAOB's proposals. The comments contained herein do not necessarily represent the views of the IAASB.

## **General Comments**

In principle, we support the PCAOB's proposed approach which sets forth professional obligations in three different categories: unconditional obligations, presumptively mandatory obligations and condition obligations. We also commend the PCOAB in recognizing that the auditor must apply expertise and exercise judgment in the planning and conduct of an audit. We concur that it would not be possible, nor desirable, to attempt to supplant the auditor's judgment by prescribing, in inflexible detail, how the auditor should discharge his or her responsibilities.

We also believe that the proposed terminology used to describe the degree to which auditors are expected to comply with the professional obligations is clear, concise and suitably definitive. In particular, we support the PCAOB's use of a selection of words when identifying unconditional obligations in order to allow standards to express the intent of the drafters in the best manner appropriate in the circumstances. As a result, we will suggest to the IAASB that it consider adopting some of these concepts into its own project on improving the clarity of IAASB Standards.

We note that current US auditing literature uses the adverbs "ordinarily" and "normally" when describing certain actions or procedures by the auditor. Arguably, the use of such words could imply another level of obligation distinct from those identified in the Proposed Rule. We presume any revision to existing US standards, and as adopted by the PCOAB, would consider the elimination of such words in order to avoid potential confusion.

## **Specific Concerns**

### **DOCUMENTATION REQUIREMENTS**

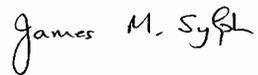
We do have significant concern with Proposed Rule 3101(a)(2). We view the requirement for the auditor to comply with presumptively mandatory obligations "unless the auditor can demonstrate, by verifiable, objective, and [contemporaneously] documented evidence, that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard ..." as unduly onerous and as placing an enormous documentation burden on auditors.

The practical implication of this requirement is of particular concern in light of the very extensive occurrence in current US auditing literature of the word "should", which we assume will be retained in new or revised PCAOB standards. The resulting obligation may have the unintended consequence of diverting the auditor's focus from thoughtful assessment of the particular circumstances of each engagement, to strict adherence to documentation rules that may detract from the auditor's role of exercising professional judgment on a timely basis to obtain sufficient competent evidential matter to support the audit opinion.

CONSULTATION

An alignment of the hierarchy of professional obligations (and the language used to differentiate them) between the PCAOB and the IAASB would be very beneficial from a global convergence perspective. I am sure the IAASB would be pleased to have the opportunity to discuss this matter with PCAOB staff before the respective rules are finalized. I would be happy to facilitate such a discussion.

Yours sincerely,

A handwritten signature in black ink that reads "James M. Sylph". The signature is written in a cursive style with a large initial 'J' and a stylized 'S'.

James M. Sylph  
Technical Director, IAASB



280 Park Avenue  
New York, N.Y. 10017  
8<sup>th</sup> Floor

Telephone 212-909-5600  
Fax 212-909-5699

November 6, 2003

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, DC 20006-2803

**PCAOB Rulemaking Docket Matter No. 009**  
**Proposed Rule Regarding Certain Terms Used in**  
**Auditing and Related Professional Practice Standards**

Dear Mr. Secretary:

KPMG appreciates this opportunity to comment on the Public Company Accounting Oversight Board's (Board) Proposed Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards* (Proposed Rule). KPMG fully supports the Board's efforts to improve financial reporting, corporate governance and audit quality in the interest of furthering the public interest and restoring confidence in our capital markets system.

In general, we agree with the definitions in the Proposed Rule for terms representing unconditional obligations, obligations that are presumptively mandatory and subsidiary obligations. In addition, we agree with the Board that the Interim Standards adopted by the Board in April 2003 contain few unconditional imperatives and support the Board's expressed intention to use sparingly those terms that represent unconditional obligations on the part of the registered public accounting firms and associated personnel. Our comments outlined below represent matters for consideration by the Board as it deliberates a final rule on this subject.

**Impact on Interim Standards**

As indicated in the Proposed Rule, the Board would use the proposed definitions when interpreting obligations of registered public accounting firms and associated personnel pursuant to the provisions of Interim Standards. The Proposed Rule points out (i) the terminology is "generally consistent with the manner in which the profession currently interprets existing auditing literature" and (ii) the Public Oversight Board's Panel on Audit Effectiveness raised concerns about the clarity and consistency in existing standards of the various levels of imperatives. However, we believe a comprehensive analysis of how and in what context the defined terms are used in the Interim Standards is necessary in order to determine whether current practice is consistent with the proposed



definitions. We encourage the Board to undertake such an analysis and carefully evaluate whether, and to what extent, use of the defined terms in the Interim Standards is consistent with the Board's expectations relative to professional obligations of registered public accounting firms and their associated personnel.

As an example, consider paragraph 80 of AU Section 319, *Consideration of Internal Control in a Financial Statement Audit*. This paragraph includes the terms, 'should consider,' 'generally' and 'must provide' (see below).

**.80** The conclusion reached as a result of assessing control risk is referred to as the assessed level of control risk. In determining the evidential matter necessary to support an assessed level of control risk below the maximum level, the auditor should consider the characteristics of evidential matter about control risk discussed in paragraphs 90 through 104. Generally, however, the lower the assessed level of control risk, the greater the assurance the evidential matter must provide that the controls relevant to an assertion are designed and operating effectively.

Applying the proposed definitions, we interpret the last sentence of paragraph 80 of AU Section 319 to reflect an obligation that is presumptively mandatory (generally), not an obligation that is unconditional (must). This is but one instance where terms defined in the Proposed Rule and appearing in the Interim Standards may require further consideration to ensure consistent interpretation by all interested parties.

The Board indicated in Release 2003-006, *Establishment of Interim Professional Auditing Standards*, that the Interim Standards will be reviewed on a standard-by-standard basis to determine if they should be modified, repealed, replaced or adopted permanently. As the review of each interim standard is completed, appropriate actions will be taken before a standard becomes a permanent standard. As an alternative to the comprehensive analysis noted above, the Board may consider use of the defined terms as each Interim Standard is reviewed and propose changes as deemed appropriate to reflect the intended professional obligation.

### **Conduct Prior to the Effective Date of a Final Rule**

Footnote 6 of the release indicates, "...the principles in Rule 3101(a) will usually also apply to the interpretation of the interim standards with respect to conduct occurring prior to the effective date of Rule 3101(b). However, in the case of conduct prior to the effective date of the rule, the Board will consider, on a case-by-case basis, in light of all of the circumstances, the proper interpretation of imperatives in the existing standards." Footnote 6 applies to a sentence in the release that refers to prospective application of the defined terms in Rule 3101(a) to the Interim Standards. Further, in Appendix 2 to the release, the Board notes that "[r]ule 3101(b) will apply to conduct occurring after the effective date of the rule." It is unclear to us how footnote 6 to the release affects the prospective application of Rule 3101.





Because of the potential inconsistencies in the interpretation of defined terms used in the Interim Standards, one example of which we note above, and consistent with the language included in Appendix 2 to the release, we do not believe it is appropriate for the Board to retroactively impose provisions of the Proposed Rule to work performed prior to the effective date of Rule 3101. In addition, we believe it would be premature for the provisions of Rule 3101 to become effective relative to the Interim Standards until such time as the Board has completed one of the analyses of the Interim Standards suggested in the immediately preceding section of our letter.

### **Application of “Should Consider”**

Footnote 2 to the release clarifies that for an action or procedure the auditor “should consider,” only consideration of the action or procedure is presumptively mandatory, not the action or procedure itself. We recommend that this clarification also be included in the text of Rule 3101(a)(2).

\* \* \* \* \*

If you have questions regarding the information included in this letter, please contact Sam Ranzilla, (212) 909-5837, [sranzilla@kpmg.com](mailto:sranzilla@kpmg.com) or Craig W. Crawford, (212) 909-5536, [ccrawford@kpmg.com](mailto:ccrawford@kpmg.com).

Yours sincerely,

**KPMG LLP**





National Association of State Boards of Accountancy

150 Fourth Avenue North ♦ Suite 700 ♦ Nashville, TN 37219-2417 ♦ Tel 615/880-4200 ♦ Fax 615/880/4290 ♦ Web [www.nasba.org](http://www.nasba.org)

David A. Costello, CPA  
President & CEO

**November 5, 2003**

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

Via E-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org)

**Re: PCAOB Rulemaking Docket Matter No. 009**  
PCAOB Release No. 2003-018, October 7, 2003  
(Proposed Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards)

Dear Board Members:

We appreciate the opportunity to offer comment to the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") on its proposed rule regarding certain terms used in auditing and related professional practice standards. The Board is considering the proposed rule for adoption and submission to the Securities and Exchange Commission (the "Commission" or the "SEC") pursuant to the Sarbanes-Oxley Act of 2002 (the "Act").

The National Association of State Boards of Accountancy (NASBA) is the national organization of the accountancy regulators of all states and other U.S. jurisdictions (collectively, the "states"). NASBA's member boards (the "State Boards") are government agencies composed of both licensees and non-licensee public members. As the only authorities empowered to grant or revoke licenses of certified public accountants (CPAs), the State Boards understand the delicate balance between the need for swift discipline and the necessity of procedural fairness.

NASBA's ongoing primary focus is upon rules and policies relating to enforcement (including the collection of information that will facilitate enforcement in appropriate cases), with special attention to fostering federal/state cooperation. We believe that close cooperation and a working partnership of the PCAOB and the SEC with NASBA and the State Boards will result in more effective regulatory efforts than otherwise would be achieved. We are pleased that the Commission Orders approving PCAOB rules for a registration system and PCAOB rules relating to compliance with auditing and related professional practice standards and advisory groups encouraged "continued close cooperation" between the PCAOB and state regulatory bodies.

**I. General Comments Regarding Proposed Rule.**

We applaud the decision to propose descriptions of the meanings of certain terms, and thus of the differing levels of professional obligations, used in Auditing and Related Professional Practice Standards. We urge adoption of the rule. The rule will result in greater clarity and uniformity of application of the various

Auditing and Related Professional Practice Standards. This should promote compliance with the standards. It also will provide greater uniformity (and thus fairness) in evaluating compliance with the standards – and thus in the basis of disciplinary action when appropriate (whether by the PCAOB or State Boards or both).

Accordingly, this proposed rule advances NASBA's previously expressed view that new regulations should promote vertical clarity so that State Boards can easily translate PCAOB and SEC case results into swift, equitable and defensible disciplinary actions against licensed audit firms and individual licensees (or unlicensed firms or accountants for whom a license is required) implicated in violations. In so doing, the PCAOB and the SEC will be able to place greater practical reliance upon an effectively administered State Board licensing and discipline function that puts offending licensees at risk of losing not just their SEC clients but their certificates and their livelihoods as CPAs.

## **II. Comments on Selected Provision of the Proposed Rule.**

### **Proposed Rule 3101. Certain Terms Used in Auditing and Related Professional Practice Standards – Section 3101(a)(2).**

We agree generally with the proposed provision that deviations from a presumptively mandatory obligation be supported by “verifiable, objective, and documented evidence”. The documentation standard is important both to promote a proper discipline of thought and to provide a uniform basis for evaluating compliance with the standard.

### **Conclusion.**

NASBA appreciates the opportunity to provide these comments. Should you have questions about our thoughts on the proposed rule or other matters, please contact us. We look forward to ongoing communication and cooperation with the PCAOB and the SEC.

Sincerely,



David A. Vaudt, CPA  
Chair



David A. Costello, CPA  
President & CEO



# National State Auditors Association

November 6, 2003

## OFFICERS AND EXECUTIVE COMMITTEE

### OFFICERS

#### President

WILLIAM G. HOLLAND  
Auditor General  
Iles Park Plaza  
740 E. Ash Street  
Springfield, IL 62703  
(217) 782-3536

#### President-Elect

RALPH CAMPBELL, JR.  
State Auditor  
North Carolina

#### Secretary/Treasurer

AUSTON JOHNSON  
State Auditor  
Utah

### OTHER MEMBERS

#### Immediate Past President

RICHARD L. FAIR  
State Auditor  
New Jersey

#### ERNEST A. ALMONTE

Auditor General  
Rhode Island

#### BRUCE MYERS

Legislative Auditor  
Maryland

#### RUSSELL HINTON

State Auditor  
Georgia

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. 009

Dear Board Members:

On behalf of the National State Auditors Association, we appreciate the opportunity to respond to the PCAOB's proposed rule regarding certain terms used in auditing and related professional practice standards.

We support the proposed rule defining certain terms that the Board will employ to describe the professional obligations of registered firms and associated persons under its standards. The three categories of professional obligations seem reasonable and will provide clear, concise, and definitive imperatives, thereby improving audit quality.

However, we have a few suggestions that we believe the Board should consider as it finalizes the rule. First, regarding the burden placed on an auditor when not complying with a "should" obligation, Appendix 1 (text of the proposed rule) requires the auditor to demonstrate, by verifiable, objective, and documented evidence, that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. Appendix 2 (analysis of the proposed rule) provides slightly more detailed instructions in that the documented evidence must be "memorialized" at the time of the audit, not after-the-fact, and must be made part of the audit workpapers. To strengthen the rule, we believe the Board should add the sentence, "Such evidence must be memorialized at the time of the audit, not after-the-fact, and must be made a part of the audit workpapers," after the second sentence of the proposed Rule 3101 (a)(2).

Second, we suggest the Board label the three categories of professional obligations listed as (a) (1), (2), and (3) as *Unconditional Obligations*, *Mandatory Obligations* and *Subsidiary Obligations* for ease of reference and clarity.

In addition to the suggestions above, we believe the PCAOB should establish an effective date for this proposed rule. Although we believe the intent is for this rule to be effective upon issuance, establishing an effective date in the rule would provide clearer guidance.

We appreciate the efforts of the Board and the opportunity to provide our comments. Should you have any questions or need additional information regarding our response, please contact Sherri Rowland of NSAA at (859) 276-1147 or me at (217) 782-3536.

Sincerely,

William G. Holland  
President, NSAA

## NASACT EXECUTIVE DIRECTOR

R. KINNEY POYNTER  
Lexington, Kentucky



**PricewaterhouseCoopers LLP**  
400 Campus Dr.  
Florham Park NJ 07932  
Telephone (973) 236 4000  
Facsimile (973) 236 5000  
Direct phone (973) 236 4478

November 6, 2003

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

**Subject: PCAOB Rulemaking Docket Matter No. 009, Comment Letter from PricewaterhouseCoopers LLP on Proposed Rule Regarding Certain Terms Used in Auditing and Professional Practice Standards**

Dear Mr. Secretary:

We appreciate this opportunity to provide our views on the PCAOB's (the "Board's") proposed rule regarding certain terms to be used in auditing and professional practice standards.

**Use of Terminology in Future Board Standards**

We support the Board's goal of clarifying language used to describe the professional obligations of registered firms and associated persons under the Board's standards.

We concur with the Board's intent to significantly limit the use of unconditional obligations (those using the words "must," "shall," and "is required") in the Board's future standards. We believe this appropriately recognizes the paramount importance of the auditor's professional judgment, applied to the particular facts and circumstances of the particular audit, in determining and obtaining the necessary audit evidence to support his or her opinion.

We have strong concerns with respect to Proposed Rule 3101(a)(2). This Rule requires the auditor to comply with obligations that are presumptively mandatory (those using the word "should") in the Board's auditing and related professional practice standards "unless the auditor can demonstrate, by verifiable, objective, and documented evidence, that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard and serve adequately to protect the interests of investors and further the preparation of informative, fair, and independent audit reports. Failure to discharge a presumptively mandatory obligation is a violation of Rule 3100 unless the firm or associated person carries the burden of establishing that, in the circumstances, compliance was not necessary to achieve the objectives of the standard."

Considering the extensive use of the word "should" throughout the Board's interim standards as well its likely use in future standards (e.g., the PCAOB's proposed standard, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements), the proposed rule would drive the auditor towards a highly prescriptive, "checklist" audit approach that might detract from the auditor's ability to appropriately apply professional judgment to the unique facts



and circumstances of each audit engagement. This requirement would be extremely onerous and result in a large effort to document matters that have no overall relevance to the auditor's conclusions. We believe the requirement that the auditor appropriately document the decision not to apply a specific procedure should be limited to matters that are significant on an overall basis to the auditor's performance of a GAAS audit. In our view, the quality of the audit should be evaluated on an overall basis as opposed to on whether every deviation, however insignificant, from a presumptively mandatory obligation is formally documented on a contemporaneous basis. While we agree that contemporaneous documentation of significant matters is preferable and facilitates review, we believe that the auditor should be allowed to present other evidence, including oral evidence, in support of why a presumptively mandatory obligation was not performed.

We believe the approach taken by the Board with regard to documentation in its draft standard on an audit of internal control over financial reporting is the appropriate one. While the word "should" is used many times in the text with regard to the auditor's considerations and performance, specific documentation requirements are set forth in one section, which acknowledging the overall documentation requirements set forth in AU 339. To require documentation of each instance where the auditor did not perform a "should" procedure -- when specific documentation of the procedure's performance may not itself be required -- would be inconsistent.

At a minimum, we believe any consideration of broad, far-reaching requirements for additional audit documentation such as this should be considered as part of the Board's current project on audit documentation. This rule should be confined to clarifying the auditor's performance obligations rather than prematurely mandating new documentation requirements.

We believe the Board should consider a fourth category where use of the present indicative form would be an appropriate alternative. For example, phrases such as "the auditor considers" and "the auditor plans" might better describe those cases where the auditor goes through a thought process, using professional judgment, as opposed to performing a specific auditing procedure, (e.g., "should examine", "should confirm", "should inspect") or developing necessary documentation, (e.g. "should document"). We believe the proposal's discussion of "consider" in A.3 on page 3 of the release and the related footnote is limited to instances where the auditor "considers" whether or not to perform a specific auditing procedure. "Should consider" is also used many times in the interim standards in a different context for items the auditor must/should think about rather than make a yes/no decision on. To avoid confusion, we believe the proposed standard should address this distinction.

### **Use of Terminology in Interim Board Standards**

We recommend that the Board apply this guidance, in whatever its final form, only to new standards adopted by the Board and not extend it at this time to the interim standards. Rather, the application of any guidance to interim standards should come after the Board has reconsidered the broad topic of audit documentation and as part of its review of each particular interim standard. Use of the word "should" in the Board's interim standards evolved over a long period of time and encompassed both imperatives the auditor must meet to perform an audit as well as other items the auditor may legitimately decide are not required, using professional judgment and based on the facts and circumstances of the particular audit.

In many cases, the interim standards use "should" where the related obligations may be unconditional, so that regarding them as presumptively mandatory because they use the word "should" would be inappropriate. For example, AU 312.13 states: "The auditor should plan the audit so that audit risk will



be limited to a low level that is, in his or her professional judgment, appropriate for expressing an opinion on the financial statements.” In addition, AU 319.02 states: “In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation.”

As a result, we believe application of the Board’s proposed use of “should” as meaning “presumptively mandatory” to the numerous instances of its use in the interim standards is not appropriate and will create significant confusion among auditors.

\* \* \* \* \*

In conclusion, we support the Board’s goal of clarifying language used to describe the professional obligations of registered firms and associated persons under the Board’s standards. However, we believe the approach adopted by the Board should allow the auditor to exercise the necessary professional judgment in carrying out his or her responsibilities.

Thank you for this opportunity to provide our views. Should you have any questions about anything in this letter, please call Jim Lee at 973-236-4478.

Very truly yours,

PricewaterhouseCoopers LLP

Comptroller General  
of the United StatesUnited States General Accounting Office  
Washington, DC 20548

November 6, 2003

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, DC 20006

Subject: *PCAOB Rulemaking Docket Matter No. 009—Proposed Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards*

This letter provides the U.S. General Accounting Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) October 7, 2003, proposed rule explaining the terminology it will use in auditing and related professional practice standards to describe the requirements of those standards for registered public accounting firms.

GAO supports improved transparency and increased accountability in the accounting and auditing professions, and we support the PCAOB's efforts in this endeavor. We commend the PCAOB for promoting clear, concise, and definitive language to distinguish the differing levels of professional requirements in its auditing standards.

Following are our comments on this PCAOB proposed rule.

### **Clarify and Expand Documentation Requirement**

GAO especially supports the requirement in proposed Rule 3101(a)(2) that documented evidence be prepared during the audit to justify deviations from presumptively mandatory requirements. Audit documentation should demonstrate compliance with professional standards and justify reasons for any deviation from the standards. This requirement also is consistent with the concepts discussed at the September 29, 2003, PCAOB Roundtable on Audit Documentation and with the requirements of *Government Auditing Standards*.<sup>1</sup>

The section-by-section analysis of proposed Rule 3101(a)(2) in Appendix 2 clearly spells out, "Such evidence must be memorialized at the time of the audit, not after-the-fact, and must be made a part of the audit workpapers." We support this concept. The proposed rule itself is not as explicit on this matter. Therefore, we suggest

---

<sup>1</sup>U.S. General Accounting Office, *Government Auditing Standards*, GAO-03-673G (Washington, D.C.: June 2003).

clarifying proposed Rule 3101(a)(2) by adding the words shown in bold to the proposed rule, as follows:

“The word ‘should’ indicates obligations that are presumptively mandatory. The auditor must comply with requirements of this nature specified in the Board’s standards unless the auditor can demonstrate, by verifiable, objective, and documented evidence, **gathered before the report is issued**, that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard . . .”

*Government Auditing Standards* also requires that audit documentation should contain “the known effect that not following the applicable standard had, or could have had, on the audit.”<sup>2</sup> The Board may also want to expand the documentation requirement to encompass this wording.

### **Clarify Documentation Requirements for Proposed Rule 3101(a)(3)**

Proposed rule 3101(a)(3) defines “may,” “might,” and “could” as actions that auditors have a professional obligation to consider. The Board cover letter has a footnote stating that for Board standards the term “should consider” means that the consideration of the action will be presumptively mandatory. The proposed rule itself does not contain this point of clarification, nor does the proposed rule specify whether the documentation required for “should consider” is equivalent to those presumptively mandatory requirements indicated by the word “should” as specified for proposed Rule 3101(a)(2). We recommend that the Board clarify these matters in its final rule. However, we are not advocating that “should consider” actions have the same level of documentation as “should” requirements.

### **Replace the Term “Professional Obligation” with “Professional Requirement”**

To further clarify the proposed rule, we believe that the term “professional obligation” should be replaced by “professional requirement” throughout the proposed rule and related documents. In legal and governmental environments, “obligation” has specific meanings and/or connotations that are inconsistent with the intent of this proposed rule. The overarching concept of the terminology in this proposed rule could ultimately affect other auditing standards or be misinterpreted by legal or government officials. Therefore, we suggest that the Board adopt a term, such as “professional requirement,” that will be usable and clear for all types of audits.

---

<sup>2</sup>U.S. General Accounting Office, *Government Auditing Standards*, GAO-03-673G (Washington, D.C.: June 2003), 4.24 b.

### Redefine the Terms “May,” “Might,” and “Could”

Proposed Rule 3101(a)(3) describes the words “may,” “might,” and “could” as “actions and procedures that auditors **have a professional obligation to consider** [bold added for emphasis].” Standard usage of these terms, however, would generally imply that compliance is optional, and practitioners would likely interpret them this way, when, in fact, the Board has defined these terms to mean that an auditor should consider the action and make a professional judgment about whether to take the action in question. AICPA standards do not define the level of auditor responsibility implied by these terms.

In addition, the last paragraph of Appendix 2 states that “the adoption of proposed Rule 3101(b) would make the terminology in Rule 3101(a) applicable to all existing standards with which registered public accounting firms and their associated persons must comply.” This would include the interim auditing standards adopted by the Board on April 18, 2003, including “GAAS proposed and promulgated by the AICPA and the ASB, as they existed on April 16, 2003.” The PCAOB’s proposed rule, when applied in such a broad manner to the interim standards, could create confusion and uncertainty or have unintended effects. In the enclosure, we have provided excerpts of AICPA standards in which the PCAOB’s definition of “may,” “might,” and “could,” if applied to the AICPA standards, would likely cause confusion and uncertainty.

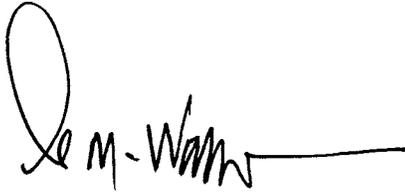
Therefore, we suggest that the Board apply proposed Rule 3101(a)(3) only to those standards issued by the PCAOB subsequent to April 18, 2003, and use the terms “may,” “might,” and “could” only when the procedures are optional. The term “should consider” could in the Board’s standards then be used in those cases in which it is a professional requirement for the auditor to consider a procedure. This use of terminology would simplify the Board’s standards and clarify the professional requirements of the auditor. We recommend that the Board reword this proposed rule as follows:

“The words ‘may,’ ‘might,’ and ‘could’ indicate optional actions. How and whether the auditor takes these actions will depend on the auditor’s exercise of professional judgment under the circumstances of the audit.”

We also, however, recognize the need for clarifying and strengthening the auditor’s responsibilities set forth in the interim standards. Therefore, we recommend that the Board review in more detail the AICPA and ASB standards, as they existed on April 16, 2003, and determine the appropriate level of auditor responsibility for actions in the standards on a case-by-case basis.

We thank you for considering our comments on this very important issue.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D. M. Walker", followed by a horizontal line extending to the right.

David M. Walker  
Comptroller General  
of the United States

cc: The Honorable William H. Donaldson, Chairman  
Securities and Exchange Commission

The Honorable William J. McDonough, Chairman  
Public Company Accounting Oversight Board

### **Excerpts of Standards in Which Proposed Definitions May Cause Confusion**

Proposed Rule 3101(a)(3) states: “The words ‘may,’ ‘might,’ and ‘could,’ . . . describe actions and procedures that auditors have a professional obligation to consider. . . . How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances.”

In the interim standards adopted by the PCAOB, “may” is frequently used in situations that do not involve auditor responsibility. In some cases, it may be unclear whether the word “may” appropriately translates into auditor responsibility to consider taking an action as currently specified in proposed Rule 3101(a)(3). Where PCAOB’s blanket application of changes in terminology and auditor responsibility could be interpreted as changing the original intent of the AICPA standards, it may be difficult to uphold PCAOB’s intended standard.

The examples below, which are excerpted from AICPA auditing standards, highlight the use of “may” and “might” where application of proposed Rule 3101(a)(3) could lead to confusion or unintended consequences.

### **Examples of Potential Uncertainty When Applying Proposed Rule 3101(a)(3)**

#### **AU Section 312—Audit Risk and Materiality in Conducting an Audit**

Source: SAS No. 47; SAS No. 82; SAS No. 96; SAS No. 98.

.14 Section 311, Planning and Supervision, requires the auditor, in planning the audit, to take into consideration, among other matters, his or her preliminary judgment about materiality levels for audit purposes. That judgment **may or may** not be quantified.

.16 An assessment of the risk of material misstatement (whether caused by error or fraud) should be made during planning. The auditor's understanding of internal control **may** heighten or mitigate the auditor's concern about the risk of material misstatement.

.31 The auditor **might** make separate or combined assessments of inherent risk and control risk.

#### **AU Section 316—Consideration of Fraud in a Financial Statement Audit**

Source: SAS No. 99.

.09 An audit conducted in accordance with GAAS rarely involves the authentication of such documentation, nor are auditors trained as or expected to be experts in such authentication. In addition, an auditor **may** not discover the existence of a modification of documentation through a side agreement that management or a third party has not disclosed.

**Examples of Potential Unintended Effects When Applying Proposed Rule 3101(a)(3)**

**AU Section 312—Audit Risk and Materiality in Conducting an Audit**

Source: SAS No. 47; SAS No. 82; SAS No. 96; SAS No. 98.

.17 Higher risk **may** cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence.

.21 In some situations, the auditor considers materiality for planning purposes before the financial statements to be audited are prepared. In other situations, planning takes place after the financial statements under audit have been prepared, but the auditor may be aware that they require significant modification. In both types of situations, the auditor's preliminary judgment about materiality **might be** based on the entity's annualized interim financial statements or financial statements of one or more prior annual periods, as long as recognition is given to the effects of major changes in the entity's circumstances (for example, a significant merger) and relevant changes in the economy as a whole or the industry in which the entity operates.

.27c Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or a class of transactions and partly because of other uncertainties that exist even if he or she were to examine 100 percent of the balance or class. Such other uncertainties arise because an auditor **might** select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results.

**AU Section 350—Audit Sampling**

Source: SAS No. 39; SAS No. 43; SAS No. 45.

.11 Nonsampling risk includes all the aspects of audit risk that are not due to sampling. An auditor **may** apply a procedure to all transactions or balances and still fail to detect a material misstatement.

.22 The auditor **may** be able to reduce the required sample size by separating items subject to sampling into relatively homogeneous groups on the basis of some characteristic related to the specific audit objective.

---

**From:** William Livingston [vitalith@earthlink.net]  
**Sent:** Wednesday, November 05, 2003 5:36 PM  
**To:** Comments  
**Subject:** PCAOB rulemaking docket matter No. 009

Office of the Secretary:

On October 7, 2003, you voted to seek comment on Rule 3101, describing the use of certain key terms used to impose obligations on the internal control (for financial reporting) practitioner. I am a registered professional engineer (PE), associated with various SarBox response initiatives, burdened by an unconditional obligation to warn preemptively when an engagement project is certain to fail. The conditions of license, through our code of ethics, hold public safety, health and welfare paramount.

As our society ascends in complexity, lifted by a surge of engineered artifacts, it becomes increasingly difficult to design a set of permanent rules that avoids significant unintended consequences to stakeholders. The following commentary originates from the perspective of the rapidly advancing process of engineering and addresses the three categories of "rules" described in your Rule 3101 briefing paper.

The working-level structure of a "rule"

To engineering process, a rule is a task action imperative in the form of an "if, then" statement. Rules impose a direct obligation to perform a specified activity in specified circumstances under specified conditions. A rule forcibly removes the intellectual duty from the practitioner at the work face to be acquainted with mission objectives, stakeholders, or the variety of task action alternatives. Higher authority has ordained the appropriate goal-seeking action.

Like the coach that sends in plays to the huddle, whatever consequences (ends) develop from strict obedience to the rule are the sole responsibility of the rule maker (means). Wherever rules command means, both goals and consequences automatically become immaterial to the executors. Governance by rules, appropriately applied, is the most productive organizational arrangement for repetitive, routine labor, exhibiting a significant property described mathematically in control theory as super stability.

"shall"

Your conventional definition of unconditional obligation imposes a direct duty to perform a specified activity under (presumably) defined circumstances and conditions. The present definition is dangerously incomplete. It should be clearly stated that, with faithful rule execution, the PCAOB takes full legal responsibility for all consequences. You cannot include objectives for the "shall" category. Since professional judgment (intelligence) has been administratively subsumed, only the rule maker can logically be responsible for outcomes. "Shall" is the practitioner latch-in switch to robotic obedience mode. There is an apt saying in the engineering profession exactly equivalent to this rule category - "Whoever picks the parts owns the behavior."

Severe consequences attend any attempt to associate the practitioner with either goals or consequences - for the unconditional obligation category. If the practitioner is held responsible for any role other than blind obedience to execute the task, you will encourage the very consequences you seek to avoid. When you instruct the practitioner to obey a command without employing intelligence (appropriate selection) - and then attach responsibility for any damage that should result, all advantage to this category is immediately destroyed. The practitioner, trapped in cognitive dissonance by the dichotomy, becomes your adversary instead of your ally.

"should"

Your definition of presumptively mandatory is logically consistent. You provide the objectives of the rule in full coherent, structured detail (from prime to generalized to functional to tangible) because the uniquely possible circumstances are too variable, numerous and complex to describe. It is then reasonable to require the professional to provide a scrutably connected rationale for his goal-seeking action choice. Since the professional is accountable for appropriate selection, and vested with commensurate authority to pursue necessary and sufficient competent evidential matter, he is fully and independently responsible for outcomes.

While you correctly require the effort to provide scrutable connectivity for rule deviations, you must also require the same rationally linked audit trail for rule adherence. The chances that the stated "should" rule is an appropriate selection for a particular assignment are no better than the alternatives. When the practitioner is required to objectively justify the stated rule, the chances that a superior alternative will be found for the client approach certainty. When the burden of proof is placed asymmetrically on the alternative, the selection criteria at the work face become skewed to obedience and professionalism, along with the client, suffers another blow.

The logical curse of "rule" is that when you specify both goals and means, you have irrationally locked two vastly separate and dissimilar domains together that can never comprise an appropriate selection in the operational reality. Locking means to ends (perform "this" activity but attain "that" goal) is forbidden by the second law of thermodynamics to be appropriate selection. At the same time the practitioner shows his selected strategy of action to be appropriate, he is obliged to show contemporaneously that your rule choice is less appropriate. This is not an added burden because the procedure is, exactly, how the practitioner selects the alternative in the first place. Meanwhile, of course, the second law is incessantly increasing the entropy of the "shall" category until, sooner or later, it too must collapse.

Further, rules from the institutionalized regulatory process are the product of a protracted damage response record. The science and technology of damage avoidance for an uncertain future, which is another way of saying engineering design process, makes an intellectual demand three orders of magnitude above that required for damage response. Forming rules from damage sustained is a "rule" itself, unrelated to the method technology of prevention. In the last five years, thanks to new levels of computer power, the capability of the process of engineering to avoid damage has rendered the conventional standards process obsolete. When damage avoidance is practical, regulation by damage response makes little sense.

"may"

The definition of subsidiary obligation is logically consistent. Any practitioner will welcome all the applicable checklists he can find. Investigating a variety of considerations is, basically, what practitioners mostly do. You have a duty here limited to describing the originating circumstances of the "may" issues, actions and procedures in abundant detail. The context for intelligent choice (appropriate selection) is more critical to success than the task action menu. While you have no duty to goals or consequences, if you intend for the practitioner to make appropriate choices, your descriptions of relevant circumstances must be lavish. The mere fact this category is deemed essential at all is the historical record of unexpected wrecks and calamities. These hard-won scenarios of lessons-learned should be brightly illuminated.

Overriding constraint

The PCAOB assignment to spawn rules that will remedy the class of Enron cataclysm is much more than challenging. Your mission is impossible. The assumption that internal control over financial reporting can be treated in isolation, to some systemic benefit, has been proven fallacious by the Institute of Internal Auditors (IIA) for over fifty years. Internal control over financial reporting is so densely coupled to company operations and civil law, experience has shown, that regulatory trifurcation will greatly increase, not decrease, the window of opportunity for undetected mischief. The attempt to design a set of rules confined to one third of an integrated system that will "somehow" regulate the system as a whole, is just another uninteresting failure of man to defy universal law. Nobody defies control theory.

The opportunity to provide commentary to the PCAOB in this convenient format is greatly appreciated.

William L. Livingston, PE





PCAOB Release 2004-007  
June 9, 2004  
Page 2

## RELEASE

On October 7, 2003, the Board proposed Rule 3101 to set forth the terminology the Board will use to describe the degree of responsibility that the auditing and related professional practice standards impose on registered auditors. As proposed, this terminology also would apply to the Board's interim standards. The Board believes that the use of clear, concise, consistent, and definitive imperatives will improve audit quality.

The Board received 12 comment letters from a variety of interested parties, including auditors, professional associations, and government agencies. In response to the comments received, several changes were made to the requirements of the rule, which are described in detail in Appendix 2.

Appendices 1 and 2 to this release contain, respectively, the text of Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, and the Section-by-Section Analysis.

### A. Introduction

Until now, the accounting profession has not expressly defined imperatives used to describe different degrees of the auditor's responsibility when conducting engagements in accordance with professional standards. Because of its concerns regarding the clarity in and consistency of existing standards, the Public Oversight Board's Panel on Audit Effectiveness recommended that the various levels of imperatives in auditing standards be clarified.<sup>1/</sup> The Board agrees that defining these levels of imperatives will assist auditors with their work and further enhance the quality of audits.

Rule 3101 defines terminology the Board will use to describe the degrees of responsibility that the standards impose on the auditors as follows –

1. Unconditional Responsibility. The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies.

---

<sup>1/</sup> Panel on Audit Effectiveness, *Report and Recommendations* §2.228 (August 31, 2000).



PCAOB Release 2004-007  
June 9, 2004  
Page 3

## RELEASE

2. Presumptively Mandatory Responsibility. The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard.

3. Responsibility To Consider. The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances consistent with the objectives of the standard.

### B. Applicability to Interim Standards

Although the auditing and related professional practice standards did not previously expressly define the degree of responsibility attached to these terms, the Board determined that the terminology defined in Rule 3101 is consistent with the existing interpretation of the interim standards. The Board believes that applying Rule 3101 to all auditing and related professional practice standards, including the interim standards, will create a common understanding among auditors of performance expectations when conducting engagements in accordance with the PCAOB standards. Therefore, the Board concluded that it is appropriate to apply the definitions of these particular terms to the interim standards.

### C. Documentation Requirement for Presumptively Mandatory Responsibility

The integrity of the audit depends, in large part, on the existence of a complete and understandable record of the work performed, the conclusions reached, and the evidence obtained to support those conclusions. Clear, complete, and comprehensive audit documentation enhances the quality of the audit. Audit documentation should demonstrate compliance with professional standards and provide an explanation to justify the reasons for any variations in procedures performed.

The PCAOB standards require that the auditor document the procedures performed, evidence obtained, and conclusions reached during an engagement. To further enhance the quality of the audit, Rule 3101(a)(2) adds a specific documentation



PCAOB Release 2004-007  
June 9, 2004  
Page 4

## RELEASE

requirement to achieve complete and comprehensive audit documentation for situations in which the auditor does not perform a presumptively mandatory activity. In those instances, auditors must document the reasons they chose not to perform the presumptively mandatory activity and how the alternative procedure performed sufficiently achieved the objectives of the specific standard.

During an internal or external review of the engagement, other evidence, including oral explanation, may help substantiate the procedures performed by the auditor during the audit. However, because the auditor is required to document his or her work during the audit, oral explanation should be used only to clarify the documented work performed. Furthermore, the reviewer should give appropriate consideration to the credibility of the individual(s) providing the oral explanation, and the oral explanation should be consistent with the documented evidence.

### D. Public Comment Process and Board Responses

The Board released its proposed rule on certain terms on October 7, 2003. The Board received 12 written comment letters.<sup>2/</sup> In response to these comments, the Board's rule both clarifies and modifies certain aspects of the proposal. Most significantly, the changes include –

- Replacing the word "obligation" with the synonym "responsibility" when describing the different degrees of imperatives.
- Amending the presumptively mandatory responsibility definition to state that the auditor "must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative procedures he or she followed in the circumstances were sufficient to achieve the objectives of the standard."

---

<sup>2/</sup> The Board's responses to the comments are discussed in more detail in the section-by-section analysis in Appendix 2. The comment letters are available on the Board's Web site – [www.pcaobus.org](http://www.pcaobus.org) – and will be attached to the Form 19b-4 that the Board will file with the Commission.



PCAOB Release 2004-007  
June 9, 2004  
Page 5

## RELEASE

- Adding a note to Rule 3101(a)(2) to require auditors to document compliance with presumptively mandatory responsibilities by alternative means.
- Adding a note to 3101(a)(3) to describe the auditor's responsibility in a "should consider" scenario.

### E. Effective Date

Because of the specific documentation requirement in paragraph (a)(2) of this rule, the Board has determined that the implementation date for the documentation requirement contained in Rule 3101 should coincide with that of PCAOB Auditing Standard No. 3, *Audit Documentation*. Therefore, the documentation requirement for Rule 3101(a)(2) will be effective for audits of financial statements with respect to fiscal years ending on or after the later of November 15, 2004, or 30 days after the date of approval of this rule by the SEC. The remaining Rule 3101 provisions become effective immediately following approval by the SEC.

\* \* \*

On the 9th day of June, in the year 2004, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour  
Acting Secretary

June 9, 2004



PCAOB Release 2004-007  
June 9, 2004  
Page 6

## **RELEASE**

### APPENDICES –

1. Rule 3101 – Certain Terms Used in Auditing and Related Professional Practice Standards
2. Section-by-Section Analysis of Rule 3101



PCAOB Release 2004-007  
June 9, 2004  
Page A1-1 – Rule

## RELEASE

### Appendix 1 – Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards

#### RULES OF THE BOARD

#### SECTION 1. GENERAL PROVISIONS

##### Rule 1001. Definitions of Terms Employed in Rules

###### (a)(xi) Auditor

The term "auditor" means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof.

#### SECTION 3. PROFESSIONAL STANDARDS

##### Part 1 – General Requirements

##### Rule 3101. Certain Terms Used in Auditing and Related Professional Practice Standards

(a) The Board's auditing and related professional practice standards use certain terms set forth in this rule to describe the degree of responsibility that the standards impose on auditors.

(1) **Unconditional Responsibility:** The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. Failure to discharge an unconditional responsibility is a violation of the relevant standard and Rule 3100.

(2) **Presumptively Mandatory Responsibility:** The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. Failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule



PCAOB Release 2004-007  
June 9, 2004  
Page A1-2 – Rule

## RELEASE

3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.

Note: In the rare circumstances in which the auditor believes the objectives of the standard can be met by alternative means, the auditor, as part of documenting the planning and performance of the work, must document the information that demonstrates that the objectives were achieved.

(3) **Responsibility To Consider:** The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances consistent with the objectives of the standard.

Note: If a Board standard provides that the auditor "should consider" an action or procedure, consideration of the action or procedure is presumptively mandatory, while the action or procedure is not.

(b) The terminology in paragraph (a) of this rule applies to the responsibilities imposed by the auditing and related professional practice standards, including the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T.

(c) The documentation requirement in paragraph (a)(2) is effective for audits of financial statements or other engagements with respect to fiscal years ending on or after [insert date the later of November 15, 2004, or 30 days after approval of this rule by the Securities and Exchange Commission].



PCAOB Release 2004-007  
June 9, 2004  
Page A2-1 – Section-by-Section Analysis

## RELEASE

### Appendix 2 – Section-by-Section Analysis of Rule 3101

#### Rule 3101(a)

In drafting its standards, the Board intends to distinguish among three levels of auditor responsibility. Rule 3101(a) explains the terminology regarding imperatives used in the standards the Board establishes.

Rule 3101(a)(1) provides that the words "must," "shall," and "is required" in standards indicate unconditional responsibilities. The auditor must accomplish responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. A failure to discharge an unconditional responsibility imposed under the Board's standards is a violation of the relevant standard and Rule 3100.

Rule 3101(a)(2) provides that the word "should" in standards indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. In the rare circumstances in which the auditor believes the objectives of the standard can be met by alternative means, the auditor, as part of documenting the planning and performance of the work, must document the information that demonstrates that the objectives were achieved. The Board has determined that a failure to discharge a presumptively mandatory responsibility is a violation of the



PCAOB Release 2004-007  
June 9, 2004  
Page A2-2 – Section-by-Section Analysis

## RELEASE

relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.

Rule 3101(a)(3) provides that the words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances.

The Board added the following captions to Rule 3101(a): 3101(a)(1) Unconditional Responsibility, 3101(a)(2) Presumptively Mandatory Responsibility, and 3101(a)(3) Responsibility To Consider. Proposed Rule 3101(a) did not have a caption or designation for each category of terms. Rather, the proposed rule simply referenced the category of certain terms by using the standard format in PCAOB rulemaking. The Board added the captions in response to a commenter's recommendation that a caption be added to each category of certain terms for ease of reference and clarity.

One commenter recommended replacing the term "obligation" in Rule 3101 with a comparable term because the commenter believed that the term "obligation" in legal and governmental environments has a connotation that is inconsistent with the intent of Rule 3101 and may be misinterpreted by legal or governmental officials. After



PCAOB Release 2004-007  
June 9, 2004  
Page A2-3 – Section-by-Section Analysis

## RELEASE

considering this comment, the Board replaced the term "obligation" with the synonym "responsibility" in Rule 3101.

Rule 3101(a)(2) defines a presumptively mandatory responsibility as a requirement that the auditor must comply with "unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard." Furthermore, Rule 3101(a)(2) states that "failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard."

The Board also added a note to Rule 3101(a)(2) to require auditors to document compliance with presumptively mandatory responsibilities by alternative means. The Board originally proposed that the auditor be required to "demonstrate by verifiable, objective, and documented evidence" that the alternative procedures he or she followed were sufficient in the specific circumstances. Commenters stated that they believed that the documentation requirement was important, both to promote discipline of thought and to provide a uniform basis for evaluating compliance with the standards. Several of these commenters went even further to recommend that the Board strengthen the



PCAOB Release 2004-007  
June 9, 2004  
Page A2-4 – Section-by-Section Analysis

## **RELEASE**

documentation requirement by adding language such as "contemporaneous" and "memorialized at the time of the audit" to the rule.

Conversely, other commenters suggested that the documentation requirement was unduly onerous and placed too great a documentation burden on the auditors. The commenters argued that the documentation would be too voluminous and would add very little value to the audit. Some of these commenters further recommended that, in lieu of the proposed documentation requirement, the rule require that the auditor consider the significance of the particular audit area and document only the significant issues or findings. A commenter also recommended that other evidence, such as oral explanation, should be allowed as support for the reasons why the auditor chose not to perform a presumptively mandatory responsibility. Additionally, some commenters recommended that the documentation requirement should be addressed in the standard on audit documentation.

The integrity of the audit depends, in large part, on the existence of a complete and understandable record of the work performed, the conclusions reached, and the evidence obtained to support those conclusions. Clear, complete, and comprehensive audit documentation enhances the quality of the audit. Audit documentation should demonstrate compliance with professional standards and justify the reasons for any variations in procedures performed.



PCAOB Release 2004-007  
June 9, 2004  
Page A2-5 – Section-by-Section Analysis

## **RELEASE**

The PCAOB standards require the auditor to document the procedures performed, evidence obtained, and conclusions reached during an engagement. To further enhance the quality of the audit, Rule 3101(a)(2) adds a specific documentation requirement to achieve complete and comprehensive audit documentation in engagement working papers for situations in which the auditor does not perform a presumptively mandatory responsibility. In those instances, it is essential that auditors document the reasons they chose not to perform the presumptively mandatory responsibility and how the alternative procedure they performed sufficiently achieved the objectives of the specific standard.

Because circumstances will be rare in which the auditor will perform an alternative procedure, the Board anticipates that the documentation requirement in the rule ought not to result in unduly onerous consequences or too voluminous documentation. Furthermore, since the auditor must already document the work performed as part of the audit, adding a concise explanation as to why the auditor chose to perform the alternative procedure should not increase the volume of documentation to an unreasonable level.

During an internal or external review of the engagement, other evidence, including oral explanation, may help substantiate the procedures performed by the auditor during the audit. However, because the auditor is required to document his or



PCAOB Release 2004-007  
June 9, 2004  
Page A2-6 – Section-by-Section Analysis

## **RELEASE**

her work in the engagement working papers during the audit, oral explanation should be used only to clarify the documented work performed. The justification as to why the alternative procedure was performed rather than the presumptively mandatory responsibility must be documented in the working papers. Furthermore, the reviewer should give appropriate consideration to the credibility of the individual(s) providing the oral explanation, and the oral explanation should be consistent with the documented evidence in the engagement working papers.

Moreover, the Board concluded that applying the documentation requirement only to significant issues, findings, or procedures is impractical because it will not be efficient or effective to determine, each time, whether the level of significance of an audit area warranted the auditor to document the reasons for choosing to perform an alternative procedure instead of the presumptively mandatory procedure. The purpose of Rule 3101 is to bring uniformity to definitions and requirements that auditors have to follow. In addition, the Board determined that moving Rule 3101(a)(2)'s documentation requirement to the audit documentation standard would not be appropriate because of its specific subject matter.

Additionally, the Board has added a note, originally a footnote in the Board's proposing release accompanying its proposed rule, describing an auditor's responsibility in a "should consider" scenario to the text of Rule 3101(a)(3), Responsibility to



PCAOB Release 2004-007  
June 9, 2004  
Page A2-7 – Section-by-Section Analysis

## RELEASE

Consider. Some commenters recommended that this footnote be added directly to the text of the rule because they saw it as an important clarification that was not included in the original proposed rule. A commenter further urged the Board to elaborate on its applicability and the documentation requirements for a "should consider" action.

Another commenter suggested that the "should consider" footnote be excluded from the rule because it implies that the action would require the auditor to document every instance of compliance with a "should consider" action. The commenter, instead, recommended that Rule 3101(a)(3) be revised to apply to all considerations regardless of how the obligation is expressed (for example, whether it is preceded by a "should," "may," "could," or "might").

Because the "should consider" terminology is widely used in the interim standards, the Board determined that it is important to state the Board's expectation for compliance and, therefore, agreed with commenters who recommended adding the "should consider" footnote to the text of Rule 3101(a)(3). Furthermore, the Board concluded that there is an important difference between a "should consider" and a "may consider" action or procedure. The difference is a direct correlation to the definitions of "should" and "may." The auditor has a greater responsibility in a "should consider" action because the auditor has a presumptively mandatory responsibility to consider the action or procedure versus just having a responsibility to consider the action.



PCAOB Release 2004-007  
June 9, 2004  
Page A2-8 – Section-by-Section Analysis

## **RELEASE**

Therefore, Rule 3101(a)(3) was not revised to apply to all considerations regardless of how the obligation is expressed.

Additionally, the Board determined that the documentation requirement relating to a procedure that an auditor "should consider" is not the same as the documentation requirement for a presumptively mandatory responsibility because in a "should consider" situation, only the consideration of the action is presumptively mandatory, while the action or procedure itself is not. In these situations, the auditor should use his or her professional judgment in determining how to document his or her consideration of the specific action or procedure.

### **Rule 3101(b)**

Rule 3101(b) provides that the terminology in paragraph (a) of this rule applies to all the auditing and related professional practice standards, including the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T. Rule 3101(b) applies to conduct occurring after the effective date of the rule.

Therefore, Rule 3101(b) provides that the terminology in Rule 3101(a) is applicable to all existing auditing and related professional practice standards with which auditors must comply. The Board determined that a failure to comply with a presumptively mandatory responsibility in an interim standard will be treated as a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that,



PCAOB Release 2004-007  
June 9, 2004  
Page A2-9 – Section-by-Section Analysis

## **RELEASE**

in the specific circumstances, compliance was not necessary to achieve the objectives of the standard.

Some commenters on the proposed rule stated that the imperatives the Board identified are consistent with the way auditors currently interpret existing auditing and related professional practice standards, while other commenters recommended that Rule 3101(a) not apply to the interim standards on the grounds that the new definitions could create confusion or have unintended consequences. Because the accounting profession previously had not expressly defined these terms, commenters further recommended that the Board perform a comprehensive analysis of how and in what context the interim standards use the defined terms to determine whether current practice is consistent with the Rule 3101(a) definitions.

The Board concluded that the terminology defined in Rule 3101 is consistent with the existing interpretation regarding the application of the terminology in the interim standards. Rule 3101 creates a common understanding among the auditors as to what is expected of them when performing engagements in accordance with the PCAOB standards and, therefore, Rule 3101 will apply to the interim standards.

Furthermore, a commenter recommended that the Board clarify the level of authority the appendices carry when accompanying the Board's standards. Because the Board adopts the appendices to its permanent standards as rules, the appendices



PCAOB Release 2004-007  
June 9, 2004  
Page A2-10 – Section-by-Section Analysis

## **RELEASE**

to the Board's permanent standards carry the same level of authority as the standards themselves. In addition, the appendices to the interim standards, which in certain circumstances carry a different level of authority, retain their original level of authority as adopted on April 16, 2003.

### **Rule 3101(c)**

Rule 3101(c) establishes an effective date for the documentation requirement in paragraph (a)(2). The Board agreed with commenters who recommended establishing an effective date to provide a reasonable amount of time for auditors to implement procedures to properly comply with the new documentation requirement.

Rule 3101 does not apply retroactively. Therefore, conduct occurring before the rule is effective will be evaluated in light of the standards as they existed at the time of the conduct. As noted above, however, the Board believes that, except for the documentation requirement in Rule 3101(a)(2), the definitions in Rule 3101 are consistent with the existing interpretation of these terms in the existing, interim standards. Therefore, as an interpretive matter, the Board expects that it will interpret these terms in the existing, interim standards in a manner consistent with their definitions in Rule 3101, in light of the facts and circumstances of each particular situation.