

May 12, 2003

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

PCAOB Rulemaking Docket Matter No. 004, *Statement Regarding the Establishment of Auditing and Other Professional Standards*

Dear Board Members and Staff:

Grant Thornton LLP appreciates the opportunity to comment on the proposals of the Public Company Accounting Oversight Board (the Board). We are pleased to submit our general and specific comments on PCAOB Docket Matter No. 004, *Statement Regarding the Establishment of Auditing and Other Professional Standards*.

General Comments

We support the intention of the Board to enhance and preserve the critical aspects of the current standard-setting process including its commitment to:

- Promoting the transparency of the auditing standard-setting process to increase the public's awareness and understanding of the purpose, nature and scope of audits of public companies.
- Soliciting input from a variety of constituencies including the appointment of investors and other financial statement users to the advisory group.
- Maintaining vigilance to (1) assure existing standards are updated regularly to reflect changes in business and the business environment, and (2) identify deficiencies in the current process and propose new criteria, standards, interpretations or other guidance to enhance the standard-setting process.

We also support the three primary objectives of the Board's initial agenda related to the review of the designated interim standards, assessment of standards specifically required by the Act, and a review of the standard(s) for an auditor's attestation relating to internal control pursuant to Section 404(b) of the Act. We have specific comments below related to those objectives.

We do, however, have concerns about the Board becoming a standard setting body, when as we understand it, the primary Board role is to provide a strong, independent body to oversee auditors of public companies. This results in the Board performing a critical activity itself rather than providing oversight. We suggest the Board reconsider whether this approach is in the public interest.

In addition, we have concerns with respect to the formation of the Advisory Group and related Task Forces (as outlined in subheading C.), particularly with respect to (i) the ability of the group to operate in an effective and efficient manner; (ii) the ability of the Board to staff the Advisory Group with qualified persons (that are knowledgeable in the objectives of auditing standards and understand the practical application of the specific auditing procedures) from each of the identified constituencies; and (iii) the lack of specificity related to the operations of the Advisory Group and Task Forces. Additional details about our concerns and specific recommendations are included below.

Specific Comments

Notwithstanding the concerns expressed above, our comments are summarized under the sub-headings included in the Board's Release. Our comments are intended to highlight areas of particular concern to us that we believe should be prioritized in the adoption of this process and also to identify areas of omission that we believe the proposed rule should address.

A. Adoption of New or Amended Professional Auditing Standards

The Board's adoption of interim standards effectively incorporated the content of the existing body of literature including standards, interpretations and other guidance (e.g., the AICPA's Accounting and Audit Guides). While the proposed process for developing new or amended standards clearly outlines the Board's authority and required approvals for any changes, it does not directly address the implications to those materials that are not considered "Level 1" auditing standards. Specifically, the release does not address important guidance that resides in the guides and related guidance that has historically been released through journals, SECPS releases, etc. Accordingly, we recommend that the Board consider the nature and future purpose of such guidance, not only in its deliberations in reviewing the existing body of literature, but also the appropriate process for creating, reviewing, and issuing such guidance in the future.

The proposed rulemaking states: "Any registrant that fails to adhere to the Board's Professional Auditing Standards will be subject to Board disciplinary proceedings in accordance with Section 105 of the Act." We believe that the literal interpretation of this rule is extremely proscriptive and does not allow the auditor to exercise necessary judgment with respect to audit risk and materiality. This interpretation might result in potential disciplinary proceedings in cases where a procedure(s) may have been purposefully eliminated as when, in the auditor's judgment, the sum of other procedures effectively mitigated the risk of material financial statement misstatement or when a certain audit procedure was deemed not significant. The ultimate result would likely be the auditors performing procedures unnecessarily with additional cost to issuer and ultimately the investing public. We believe the Board should adopt in its final rule the language included in SAS 95 (AU 150) that requires the auditor to (i) be familiar with all of the standards; (ii) consider audit risk and materiality in determining the appropriate application of the standards in performing specific audit procedures, and (iii) be prepared to justify departures from the standards.

We also note that auditing standards, as currently written, impact or rely on other professions such as actuaries, external legal counsel, and valuation specialists, among others. New or amended standards that might impact the auditor's ability to obtain sufficient appropriate audit evidence from other professionals should be carefully evaluated prior to proposing changes or amendments to the existing literature. As such, we recommend that the Board create standing task forces that liaise with other professions that are key to the preparation of financial statements and the performance of audits, such as the American Bar Association, the American Academy of Actuaries, and others as the Board determines appropriate.

Finally, we believe that there is a potential for confusion and inconsistency in the application of the Board's interim standards, particularly related to standard language in audit and attestation reports. For example, while we believe the Board intended for the report phrase "auditing standards generally accepted in the United States of America" to refer to the Board's Interim Professional Auditing Standards for audits of registrants, there is language in certain review and attestation reports that make reference to the AICPA standards. We recommend that the Board clarify its position on the application of those interim standards and related expectations for report language.

B. Procedure for the Adoption of New or Amended Professional Auditing Standards

We recommend that the Board consider the following comments with respect to clarifying the proposed process and facilitating implementation of new standards:

- Consider whether to maintain interpretive and other guidance using the dual exposure process proposed by the rule (i.e., initial exposure by the Board followed by an exposure period by the Securities and Exchange Commission prior to issuance). We believe this process may delay issuance of guidance or interpretations without significant value-added comments arising from the process. We suggest that for proposed interpretive or other guidance issued outside of the core standards, the Board adopt a process similar to that recently adopted for FASB Staff Positions (FSP) documents (the FSP process is described at www.fasb.org).
- Consider the proposed effective dates for new or amended standards. As the Board is aware, many public accounting firms have an extensive body of developed auditing guidance and other literature, staff training programs, and electronic tools. Changes that are limited to once or twice a year would assist in developing an approach that ensures a consistent application of the required standards over the period under audit, particularly with respect to planning and performing effective reviews of interim information and performing tests of controls throughout the period. Provisions for dealing with emergencies, as described in the proposed rule, would be retained to address critical issues that might arise. This approach will also benefit financial statement preparers as it will limit late requests and other changes in audit approach.

C. Advisory Groups and Task Forces

As noted in our General Comments, our concerns related to the formation and operation of the Advisory Group focus on (i) the ability of the group to operate in an effective and efficient manner; (ii) the ability of the Board to staff the Advisory Group with qualified persons from each of the identified constituencies (that are knowledgeable in the objectives of auditing standards and understand the practical application of the specific auditing procedures); and (iii) the lack of specificity related to the operations of the Advisory Group and Task Forces.

With respect to the selection of group members, we believe that the number of Advisory Group members should be limited to no more than 15 to 18 persons. The potential of up to 30 members, although providing a wide variety of views and opportunities for input, will be unwieldy in practice and not facilitate meaningful discussion and debate in the standard-setting process.

With respect to the composition of the members, we agree with the notion that input from other constituencies is a step forward in expanding both the breadth of input on proposed standards, but also

will, it is hoped, result in more exposure of the audit and attest standards to the public. However, we are concerned that simply appointing key members of other constituencies, although they would be knowledgeable in the financial reporting process, may not immediately result in an upgrade in the standard-setting process. We recommend that nominated members, similar to the requirements set forth for audit committee members in recently issued stock exchange and SEC requirements, be educated in the objectives, key standards, critical auditor judgments and related audit processes. This education may be provided by the Board staff or other means, and will be especially important for those members that do not have experience performing audits.

With respect to the operations of the Board, we recommend that the release be expanded, or alternatively, a separate release be issued to describe and solicit comments on the primary operating principles of the Advisory Group and Related Task Forces. Specifically, we recommend the Board specify (i) who will set and how will a timetable be set for accomplishing the first three agenda items; (ii) how often the Advisory Group will meet, (iii) whether the Advisory Group will appoint a Chairperson, and (iv) whether the Board staff will provide all resources for drafting, editing, monitoring comments, and publishing new and amended standards.

The rule proposal is silent as to the role of topic and industry-specific guidance and the development or updating of those standards and/or other interpretive auditing standards that are specific to an industry. Examples include guidance on auditing derivatives and investments, performing procedures under SAS 70, *Service Organizations*, and issuing reports that may be relied upon in public company audits, and investments company audits to name a few. We recommend that the Board expand this release to address its intentions with respect to the development of such guidance. Alternatively, the Board could issue a separate release that describes the guidance in further detail so as to clarify the process for addressing industry-specific matters.

D. Board Professional Auditing Standards Agenda

We agree with the three proposed projects that the Board expects to address as part of its initial agenda. With respect to review of the Interim Professional Standards, please see our specific comments below in the response to the specific Board requests for comment.

With respect to the assessment of the need to issue specific standards related to the review of internal controls and Section 404 Attestation Standard, we note the urgency of the need to issue final rules on this matter due to the potential September 30, 2003 management and auditor's reporting requirement as set forth in the SEC's proposed rule. We also note the intentions of the Board to issue a separate release to convene a roundtable on this matter in the near future to determine whether a new standard is needed. We assume the unstated alternative choices are that the Board would adopt either the existing standards for reporting on internal control as set forth in the Attestation Standards, or adopt the exposure draft issued by the ASB as part of its body of Professional Auditing Standards. We look forward to the opportunity to participate in such discussions.

Responses to the Board's Questions

The Board solicited comments on the following specific matters:

The Board seeks comment on Proposed Rule 3100 and the related definition. In particular, the Board seeks views on whether there are other standards, in addition to the Board's Professional Auditing Standards, with which the Board should require registered firms to comply.

We believe the standards as described in the definition of Proposed Auditing Standards as set forth by the Board in Rule 1001 and Rule 3100 are sufficient and complete with respect to the body of literature covered by those standards. We note that the existence and requirements of other standards that impact or require the auditors' assessments of company compliance with laws and regulations such as those in the banking, broker/dealer and insurance industry, for example, should remain in a separate body of literature from the proposed Professional Auditing Standards.

Also with respect to this proposed rule, we note that the summary description included the phrase "...in connection with the preparation or issuance of any audit report for an issuer (as defined in the Act)." A literal reading of the proposed rule might lead to the conclusion that the application of Professional Auditing Standards would be required for performance of any and all audits performed by registered accounting firms and not limited to those engagements for public companies. We also note that for certain situations where the financial statements are not used in SEC filings, "issuers" should be able to engage independent accountants to perform audit and other attest procedures using professional standards other than those of the Board (e.g., an audit and report under International Standards on Auditing for use outside the United States; an agreed upon procedures engagement for private use; or an attest examination report on internet privacy to be published on a web site).

Related to the schedule and procedure for review of the interim standards, the Board requested the following:

The Board invites public comment and suggestions concerning the appropriate priorities for the review of the Interim Professional Auditing Standards and concerning any changes to them that the Board should consider.

The review of the entire body of the adopted Interim Professional Standards is an obviously daunting task. We appreciate the Board's request for feedback with respect to prioritizing such a review. We recommend that the Board consider the blueprint offered by the report issued by the Public Oversight Board's Panel on Audit effectiveness. As the Board is aware, many of the Panel's recommendations were recently incorporated into standards issued (e.g., SAS 99), or are in process or under consideration by the Auditing Standards Board. Specifically, we recommend the Board consider the following in developing its agenda:

- Convergence with International Standards on Auditing—most recently, the efforts to develop a global set of auditing standards resulted in the joint release of several proposed amendments and a continued effort to achieve convergence of U.S. and International auditing standards. The Panel noted this objective as part of its findings. We recommend the Board continue those efforts in developing its agenda, particularly with respect to the recently issued exposure drafts related to materiality and the audit risk model.

Also in this regard, the Board should consider whether it would improve transparency and access to U.S. capital markets if it were to adopt the international auditing standards as its base and focus efforts on any incremental performance and reporting requirements considered to be needed for companies

in the U.S. securities markets. In addition to promoting convergence, this would reinforce the Board as primarily an oversight body, improve the effectiveness of the use of Board resources and reduce the cost of the standards-setting component of the Board's activities.

- Assessing of recently issued accounting standards and current accounting projects. The Panel on Audit Effectiveness cited a need to assess the “auditability” of proposed new accounting standards. We strongly agree with the recommendation and exhort the Board to include in its agenda discussions with accounting standard-setters to discuss mutual cooperation in those assessments.
- Focusing on key problem areas. There have been several articles and studies issued lately with respect to likely areas of fraudulent financial reporting and other financial statement issues that have resulted in restatements. The Panel on Audit Effectiveness focused on many of these areas as well and their findings are well documented. We recommend the Board (i) consider the findings of the Panel and the status of implementation of those related recommendations, and (ii) in their upcoming reviews, focus on the auditors' performance in those areas to assess the auditor's risk assessments and related testing with a view towards identifying possible deficiencies in existing standards. Based on this analysis, the Board can assess whether the standards or the audit execution may be resulting in alleged audit failures. We believe that the Board is in a unique and advantageous position to make this evaluation as a result of its statutory authority. Without such a detailed review and assessment, changes in existing standards would potentially be based on supposition and not facts.
- Promoting applied audit research and incorporate the results in new standards and changes to standards. The findings of applied audit research, including research into auditor behavioral matters, should be incorporated into and underlie the adoption of new standards and changes to standards. We believe the profession needs to grow beyond the era of anecdotal standards setting to a position of standards being established based on empirical evidence. We are not suggesting that auditor judgment is any less essential, but that it should be guided by knowledge of what does and doesn't work well to address an audit risk. We believe the Board's support of applied audit research could result in significant improvements in audit effectiveness.

Concluding Remarks

Overall, we ask the Board to proceed cautiously in amending and adopting new standards. We believe the Board's current and future Professional Auditing Standards will set a standard not just for U.S. Public Company audits, but will also influence performance for U.S. non-public company audits and audits performed under international standards. Finally, as part of the Board's agenda prioritization and ongoing standard-setting process, we urge the Board to work with the accounting educators and accounting firms to assess the potential impact of new standards and the required skillsets to effectively execute proposed new standards and amendments to existing standards.

We would be pleased to discuss any of our comments with the Board or its staff. Please direct any inquiries to Karin French, National Partner in Charge of SEC Regulations, at (703) 847-7533.

Very truly yours,

Grant Thornton LLP