
PROPOSED RULE REGARDING CERTAIN
TERMS USED IN AUDITING AND RELATED
PROFESSIONAL PRACTICE STANDARDS

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) PCAOB Release No. 2003-018
) October 7, 2003
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) PCAOB Rulemaking
) Docket Matter No. 009
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Summary: The Public Company Accounting Oversight Board ("the Board" or "PCAOB") has proposed a rule regarding the terminology it will use in its Auditing and Related Professional Practice Standards to describe the obligations those standards impose on registered public accounting firms and their associated persons. PCAOB Rule 3100 requires all such firms and persons to comply with the Board's Auditing and Related Professional Practice Standards in connection with the preparation or issuance of any audit report for an issuer, as defined in the Sarbanes-Oxley Act of 2002 (the "Act").

Proposed Rule 3101 explains how the Board will articulate differing levels of professional obligations in the standards it issues. The terminology set forth in proposed Rule 3101 will also apply to the Board's interpretation of the interim standards with which Rules 3200T, 3300T, 3400T, 3500T, and 3600T require compliance.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 009 in the subject or reference line and

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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); Thomas Ray, Deputy Chief Auditor (202/207-9112; rayt@pcaobus.org).

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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."^{1/} This release proposes an additional rule, proposed Rule 3101, which would afford further guidance concerning Board standard setting.

^{1/} 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.

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.^{2/} 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.

^{2/} 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.

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

considerable burden of justifying the departure from (generally accepted) standards.^{3/}

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.^{4/}

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.^{5/} The Board believes that Rule 3101(b),

^{3/} 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.

^{4/} Panel on Audit Effectiveness, *Report and Recommendations* § 2.221 (August 31, 2000).

^{5/} 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.

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

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.

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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

^{6/} 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.

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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

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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

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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.