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Public Company Accounting Oversight Board

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BRIEFING PAPER

PROPOSED RULE 3101 – CERTAIN TERMS USED IN AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

OCTOBER 7, 2003 PUBLIC MEETING OF THE BOARD

At its public meeting on October 7, 2003, the Public Company Accounting Oversight Board voted unanimously to propose, and seek comment on, Rule 3101. Rule 3101 describes the use of certain terms in the auditing and related professional practice standards to communicate the level of obligation imposed on registered public accounting firms and their associated persons in complying with the standards.

PCAOB Rule 3100 requires all registered public accounting firms and their associated 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. Proposed Rule 3101 explains how the Board will refer to, and distinguish among, differing levels of professional obligations in the future standards it issues and in the Board's interim standards (in Rules 3200T, 3300T, 3400T, 3500T, and 3600T).

Background of Proposed Rule 3101

The Board recognizes that the work of the auditor involves exercising professional judgment. The nature, size, and complexity of public companies and of their systems of internal control over financial reporting vary widely. To obtain the requisite level of support for the auditor's opinions on the issuer's financial statements and on management's assessment of internal control, the auditor must apply expertise and exercise judgment in planning and conducting the audit. It is not possible, nor would it be desirable, for the Board to attempt to supplant the auditor's judgment by prescribing, in inflexible detail, how the auditor should discharge his or her professional responsibilities.

However, certain core objectives and responsibilities must be accomplished in every audit. For example, a bedrock principle of auditing is that the auditor must obtain sufficient competent evidential matter to afford a reasonable basis for the auditor's opinion regarding the financial statements.[1/] That requirement, in turn, compels the auditor to perform particular procedures to obtain and evaluate evidential matter concerning the assertions in the financial statements. The specific procedures employed depend on the nature of the issuer's business, the assertions in its financial statements, the auditor's determination regarding reliance on internal controls, and a variety of other factors.

Conceptually, the Board believes that the existing standards set forth professional obligations that fall into three categories –

- **Obligations that are unconditional**. The auditor must accomplish obligations of this type in all cases in which the circumstances exist to which the obligation applies. For example, the auditor must make certain communications to the audit committee for all SEC engagements.[2/] As another example, the auditor must perform audit procedures with respect to the period after the balance-sheet date to ascertain whether subsequent events have occurred that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles.[3/]

- **Obligations that are presumptively mandatory.** The auditor must accomplish obligations of this type except in unusual circumstances in which he or she can demonstrate that performing the obligation in question is unnecessary because the objective of the obligation will be accomplished in some other manner. For example, confirmation of accounts receivable is a generally accepted auditing procedure; therefore, there is a presumption that the auditor will request confirmation of accounts receivable during an audit. However, confirmation of accounts

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[1/] This basic requirement is known as the "third standard of field work." See Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards* (AU sec. 150.02) and Statement on Auditing Standards No. 31, *Evidential Matter* (AU sec. 326).

[2/] AU sec. 380, *Communication with Audit Committees*.

[3/] AU sec. 560.12, *Subsequent Events*.

receivable would be unnecessary if (1) accounts receivable is immaterial to the financial statements; (2) the use of confirmations would be ineffective, in which case, the auditor would be expected to apply suitably effective alternative procedures; or (3) the auditor determines that the assessed level of inherent and control risk is low and, in conjunction with the evidence provided by analytical procedures or other substantive tests of details, audit risk can be reduced to a sufficiently low level without confirming accounts receivable. In many situations, both confirmation of accounts receivable and other substantive tests of details are necessary to reduce audit risk to an acceptably low level for the applicable financial statement assertions. Additionally, if the auditor does not request confirmation of accounts receivable, the auditor should document how he or she overcame this presumption.[4/]

- **Obligations that are subsidiary to the unconditional or presumptively mandatory obligations.** In many cases, existing standards contain extensive discussion that is descriptive rather than imperative. That is, the standards explain why auditors should consider and employ particular procedures, depending on circumstances. While auditors must consider subsidiary guidance, that guidance is not intended to impose a direct obligation for the auditor to perform a specific action or procedure. Rather, subsidiary guidance provides information for the auditor to consider in exercising his or her professional judgment with respect to planning and performing the audit. For example, the auditor may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities.[5/] As another example, in addition to the specific inquiries a successor auditor should make of the predecessor auditor when accepting a new engagement, the auditor may wish to make other reasonable inquiries.[6/]

4/ AU sec. 330.34 and .35, *The Confirmation Process*.

5/ AU sec. 332.05, *Auditing Derivative Instruments*.

6/ AU sec. 315.09, *Communications Between Predecessor and Successor Audit*ors.

Overview of Proposed Rule

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

- 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 accomplish obligations of this type 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.

  The auditor must justify deviations from presumptively mandatory obligations by verifiable, objective, and documented evidence that must be obtained at the time of the audit, not after-the-fact, and must be made a part of the audit documentation. 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) provides that the Board will use the terminology in paragraph (a) of this rule in interpreting the obligations imposed by, and evaluating compliance with, its Auditing and Related Professional Practice Standards, including the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T. In effect, adoption of proposed Rule 3101(b) would make the terminology in Rule 3101(a) applicable to interim standards with which registered public accounting firms and their associated persons must comply.

Public Comment

Interested parties are encouraged to submit their views to the Board. Written comments should be sent to 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 should be received by the Board no later than 5:00 PM (EST) on November 6, 2003.

The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to adopt a final rule, with or without amendments. Any final rule adopted will be submitted to the Securities and Exchange Commission for approval. Pursuant to Section 107 of the Act, Board rules do not take effect until approved by the Commission.

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.