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Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

VIA ELECTRONIC MAIL

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir/Madam:

I appreciate this opportunity to comment on the proposed PCAOB Auditing Standard No. 5 (AS 5), which would supersede AS 2. I am responding to Question 9 in PCAOB Release 2006-007 (Release). Specifically, my comments pertain to the use of the term "reasonable possibility" in the proposed redefinitions of "significant deficiency" and "material weakness."

Recommended Revisions to Proposed AS 5

1. Revise Paragraph A8 to delete the term "reasonable possibility" in the definition of "material weakness" and insert the appropriate number, as follows:

   A **material weakness** is a control deficiency, or combination of control deficiencies, such that there is at least a *[insert number between 0.0 and 1.0 here]* probability that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.

2. Delete the note to Paragraph A8.

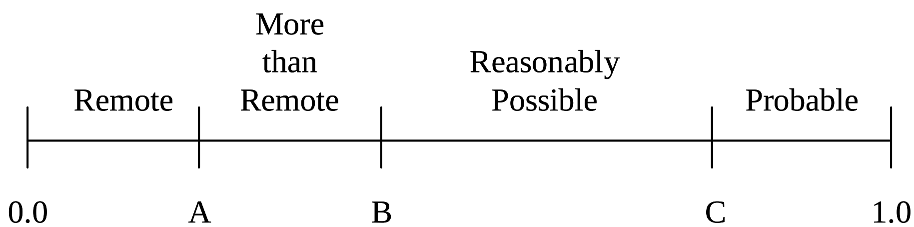
3. Revise Paragraph A12 to delete the term "reasonable possibility" in the definition of "significant deficiency" and insert the appropriate number, as follows:

   A **significant deficiency** is a control deficiency, or combination of control deficiencies, such that there is at least a *[insert number between 0.0 and 1.0 here]* probability that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected.

4. Delete the note to Paragraph 73 of proposed AS 5.

Analysis

In the Release, the PCAOB has stated that it is adopting terminology from Statement of Financial Accounting Standards No. 5 (SFAS 5), which employs the qualitative terms "more than remote", "reasonably likely [or possible]" and "probable." The points A, B and C in the diagram below denote unspecified probabilities that must, of necessity, demarcate the ranges of uncertainty used to apply SFAS 5:



Before proceeding further, it is important to note that Points A, B and C do not change. In other words, the points are unaffected by the facts and circumstances of a particular transaction; similarly, no publication of the PCAOB that I am aware of provides any indication that the PCAOB believes that the points should vary across audit engagements for the purpose of determining whether a significant deficiency or material weakness exists.

Regardless of the FASB's motives for promulgating SFAS 5 as it did, it is neither in the public interest, nor is it consistent with the PCAOB's mission, to continue to follow the unnecessarily vague approach to dealing with uncertainty set forth in SFAS 5. The FASB did not disclose any information concerning the process by which "probable" and other qualitative terms for describing uncertainty were selected in the Basis for Conclusions section of SFAS 5; or whether quantitative probabilities were even considered. Arguably, many of the well-known problems in application of SFAS 5 have resulted from the absence of explicit points of demarcation—particularly Point C in the above diagram. The ambiguity and inevitable disagreement between auditors, preparers and users as to the appropriate demarcation Points B and C has had two effects: (1) substantial lack of comparability of financial statements, and (2) windfalls to auditors and preparers by allowing them to avoid being held to account for misleading financial statements.

With regard to auditing standards, investor protection is less than adequate by ambiguous specification of the point between "more than remote" and "reasonably possible" in AS 5 (i.e, Point B in the above diagram). Blurring the demarcation point with vague terminology adds judgment and cost to financial reporting while providing no discernible purpose that is consistent with the mission of the PCAOB. While I am sympathetic to a desire to avoid bright-line rules in principles-based standards, it is not always appropriate to do so. In respect to thresholds in the form of probabilities, the normative economic principles that address the use of judgment in decision making require that subjective probabilities be quantified. These principles have been widely applied for generations, taught in all accredited schools of business and accounting, and incorporated into more recent accounting standards. [1]

As applied to auditing, risk assessment is inherently quantitative and structured, even though an assessment of materiality may be more judgmental and dependent on facts and circumstances. Along these lines, the Board's contention that "evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made *without* [emphasis supplied] quantifying the probability of occurrence as a specific percentage or range"[2] runs counter to norms of rational decision making. For example:

> *Assume that Point B in the earlier diagram represents the probability 0.4. In the terms of proposed AS 5, this is the lower bound of "reasonably possible." Further assume that the auditor determines the materiality threshold for a misstatement of revenues to be $1,000,000. Therefore, $400,000 (0.4 x $1,000,000) represents the <u>maximum allowable expected misstatement</u> (given that a misstatement is at least reasonably possible) such that an ICFR weakness would not be disclosed as material.*

I am not sure how the Board can expect an auditor to obtain reasonable assurance for its opinion within the framework of AS 5 without undertaking a process substantially similar to the one described by the above example. Stated another way, as AS 2 was written, and as proposed AS 5 is currently written, it should be unacceptable for auditors to adopt different threshold probabilities for different clients, or even for different financial statement amounts[3] (although materiality or significance thresholds may reflect these factors). The unavoidable conclusion from the PCAOB's language in these auditing standards is that it should not be necessary, or required, for each auditor and client to come to separate conclusions on each engagement, and negotiate the threshold probability for "reasonably possible." Yet, the vague specification of Point B is an invitation for such negotiations to occur.

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[1] SFAS 144 on impairment of long-lived assets recognizes that probability-weighted cash flows may be used to test the recoverability of long-lived assets (¶17). SFAS 109 on income taxes specifies a probability threshold of 0.5 when measuring the deferred tax asset valuation allowance (¶17). Perhaps most germane is the auditing literature, wherein it is stated in AU Section 350 on sampling, "…the auditor should determine an acceptable audit risk and subjectively ***quantify*** [emphasis supplied] his or her judgment of the risk of material misstatement." (¶20).

[2] Note to ¶73 of proposed AS 5

[3] To illustrate a problem of static thresholds, consider the following extension of my numerical example: if a particular control over revenues had a probability of misstatement of 0.39, the control would never be reportable as a material weakness even if the resulting misstatement would be significantly greater than $1,000,000. Thus, thresholds *per se* in proposed AS 5 lack a foundation in principle.

In summary, the probability threshold in the definitions of “significant deficiency” and “material weakness” can be, and therefore should be, explicitly quantified. A change from qualitative terminology (i.e., “more than remote” in AS 2, or “reasonably possible” in proposed AS 5) would simplify auditing standards, increase reliability of ICFR audits, and reduce audit and compliance costs. Such a change would better protect the interests of investors and further the public interest through greater clarity and transparency of auditing and financial reporting. Especially since the PCAOB’s position is that probability thresholds should not change with facts and circumstances, I know of no reason for intentionally blurring the lines with ambiguous language when precise thresholds are feasible.

About the Commentator

I am an emeritus professor of accounting of the Thunderbird School of Global Management and a former academic accounting fellow at the SEC, Office of the Chief Accountant. At present, I provide professional education, consulting and litigation support services. I also serve on the advisory board of the Association of Audit Committees, Inc.

If the PCAOB staff has any questions concerning this submission, please feel free to contact me at 602.228.4871, or via e-mail at tom.selling@grovesite.com.

Very truly yours,

Thomas I. Selling PhD, CPA