



G A O

Accountability * Integrity * Reliability

Comptroller General
of the United States

United 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*.¹

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

¹U.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.”² 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.

²U.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.

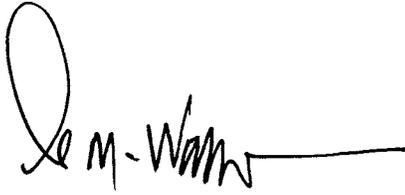
Therefore, we suggest that the Board apply proposed Rule 3101(a)(3) only to those standards issued by the PCAOB subsequent to April 18, 2003, and use the terms “may,” “might,” and “could” only when the procedures are optional. The term “should consider” could in the Board’s standards then be used in 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", with a long 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.