



1666 K Street, N.W.  
Washington, DC 20006  
Telephone: (202) 207-9100  
Facsimile: (202) 862-8430  
www.pcaobus.org

---

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

)  
)  
)  
) PCAOB Release No. 2004-007  
) June 9, 2004  
)  
) PCAOB Rulemaking  
) Docket Matter No. 009  
)  
)  
)  
)  
)  
)  
)

Summary: After public comment, the Public Company Accounting Oversight Board (the "PCAOB" or "Board") has adopted Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*. The Board will submit this rule to the Securities and Exchange Commission ("SEC" or "Commission") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This rule will not take effect unless approved by the Commission.

Board  
Contacts: Greg Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org), and Bella Rivshin, Assistant Chief Auditor (202/207-9180; rivshinb@pcaobus.org).

\* \* \*

Section 103 of the Act directs the Board to establish auditing and related professional practice standards, including auditing, attestation, quality control, ethics, and independence standards, applicable to registered public accounting firms in the preparation and issuance of audit and other reports for public companies. To date, the Board has adopted rules that require registered public accounting firms and their associated persons to "comply with all applicable auditing and related professional practice standards," (Rule 3100) and designate as interim standards of the Board certain standards that existed as of April 16, 2003 (Rules 3200T – 3600T).

## RELEASE

On October 7, 2003, the Board proposed Rule 3101 to set forth the terminology the Board will use to describe the degree of responsibility that the auditing and related professional practice standards impose on registered auditors. As proposed, this terminology also would apply to the Board's interim standards. The Board believes that the use of clear, concise, consistent, and definitive imperatives will improve audit quality.

The Board received 12 comment letters from a variety of interested parties, including auditors, professional associations, and government agencies. In response to the comments received, several changes were made to the requirements of the rule, which are described in detail in Appendix 2.

Appendices 1 and 2 to this release contain, respectively, the text of Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, and the Section-by-Section Analysis.

### A. Introduction

Until now, the accounting profession has not expressly defined imperatives used to describe different degrees of the auditor's responsibility when conducting engagements in accordance with professional standards. Because of its concerns regarding the clarity in and consistency of existing standards, the Public Oversight Board's Panel on Audit Effectiveness recommended that the various levels of imperatives in auditing standards be clarified.<sup>1/</sup> The Board agrees that defining these levels of imperatives will assist auditors with their work and further enhance the quality of audits.

Rule 3101 defines terminology the Board will use to describe the degrees of responsibility that the standards impose on the auditors as follows –

1. Unconditional Responsibility. The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies.

---

<sup>1/</sup> Panel on Audit Effectiveness, *Report and Recommendations* §2.228 (August 31, 2000).

## RELEASE

2. Presumptively Mandatory Responsibility. The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard.

3. Responsibility To Consider. The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility 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 consistent with the objectives of the standard.

### B. Applicability to Interim Standards

Although the auditing and related professional practice standards did not previously expressly define the degree of responsibility attached to these terms, the Board determined that the terminology defined in Rule 3101 is consistent with the existing interpretation of the interim standards. The Board believes that applying Rule 3101 to all auditing and related professional practice standards, including the interim standards, will create a common understanding among auditors of performance expectations when conducting engagements in accordance with the PCAOB standards. Therefore, the Board concluded that it is appropriate to apply the definitions of these particular terms to the interim standards.

### C. Documentation Requirement for Presumptively Mandatory Responsibility

The integrity of the audit depends, in large part, on the existence of a complete and understandable record of the work performed, the conclusions reached, and the evidence obtained to support those conclusions. Clear, complete, and comprehensive audit documentation enhances the quality of the audit. Audit documentation should demonstrate compliance with professional standards and provide an explanation to justify the reasons for any variations in procedures performed.

The PCAOB standards require that the auditor document the procedures performed, evidence obtained, and conclusions reached during an engagement. To further enhance the quality of the audit, Rule 3101(a)(2) adds a specific documentation

## RELEASE

requirement to achieve complete and comprehensive audit documentation for situations in which the auditor does not perform a presumptively mandatory activity. In those instances, auditors must document the reasons they chose not to perform the presumptively mandatory activity and how the alternative procedure performed sufficiently achieved the objectives of the specific standard.

During an internal or external review of the engagement, other evidence, including oral explanation, may help substantiate the procedures performed by the auditor during the audit. However, because the auditor is required to document his or her work during the audit, oral explanation should be used only to clarify the documented work performed. Furthermore, the reviewer should give appropriate consideration to the credibility of the individual(s) providing the oral explanation, and the oral explanation should be consistent with the documented evidence.

### D. Effective Date

Because of the specific documentation requirement in paragraph (a)(2) of this rule, the Board has determined that the implementation date for the documentation requirement contained in Rule 3101 should coincide with that of PCAOB Auditing Standard No. 3, *Audit Documentation*. Therefore, the documentation requirement for Rule 3101(a)(2) will be effective for audits of financial statements with respect to fiscal years ending on or after the later of November 15, 2004, or 30 days after the date of approval of this rule by the SEC. The remaining Rule 3101 provisions become effective immediately following approval by the SEC.

**RELEASE**

\* \* \*

On the 9th day of June, in the year 2004, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour  
Acting Secretary

June 9, 2004

APPENDICES –

1. Rule 3101 – Certain Terms Used in Auditing and Related Professional Practice Standards
2. Section-by-Section Analysis of Rule 3101

**[Intentionally Left Blank]**

**RELEASE**

**Appendix 1 – Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards**

**RULES OF THE BOARD**

**SECTION 1. GENERAL PROVISIONS**

**Rule 1001. Definitions of Terms Employed in Rules**

**(a)(xi) Auditor**

The term "auditor" means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof.

**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 of responsibility that the standards impose on auditors.

(1) **Unconditional Responsibility:** The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. Failure to discharge an unconditional responsibility is a violation of the relevant standard and Rule 3100.

(2) **Presumptively Mandatory Responsibility:** The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. Failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule

## RELEASE

3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.

Note: In the rare circumstances in which the auditor believes the objectives of the standard can be met by alternative means, the auditor, as part of documenting the planning and performance of the work, must document the information that demonstrates that the objectives were achieved.

(3) **Responsibility To Consider:** The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility 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 consistent with the objectives of the standard.

Note: If a Board standard provides that the auditor "should consider" an action or procedure, consideration of the action or procedure is presumptively mandatory, while the action or procedure is not.

(b) The terminology in paragraph (a) of this rule applies to the responsibilities imposed by the auditing and related professional practice standards, including the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T.

(c) The documentation requirement in paragraph (a)(2) is effective for audits of financial statements or other engagements with respect to fiscal years ending on or after [insert date the later of November 15, 2004, or 30 days after approval of this rule by the Securities and Exchange Commission].

## RELEASE

### Appendix 2 – Section-by-Section Analysis of Rule 3101

#### Rule 3101(a)

In drafting its standards, the Board intends to distinguish among three levels of auditor responsibility. Rule 3101(a) explains the terminology regarding imperatives used in the standards the Board establishes.

Rule 3101(a)(1) provides that the words "must," "shall," and "is required" in standards indicate unconditional responsibilities. The auditor must accomplish responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. A failure to discharge an unconditional responsibility imposed under the Board's standards is a violation of the relevant standard and Rule 3100.

Rule 3101(a)(2) provides that the word "should" in standards indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. In the rare circumstances in which the auditor believes the objectives of the standard can be met by alternative means, the auditor, as part of documenting the planning and performance of the work, must document the information that demonstrates that the objectives were achieved. The Board has determined that a failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.

Rule 3101(a)(3) provides that the words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility 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.

The Board added the following captions to Rule 3101(a): 3101(a)(1) Unconditional Responsibility, 3101(a)(2) Presumptively Mandatory Responsibility, and 3101(a)(3) Responsibility To Consider. Proposed Rule 3101(a) did not have a caption or designation for each category of terms. Rather, the proposed rule simply referenced the category of certain terms by using the standard format in PCAOB rulemaking. The

## **RELEASE**

Board added the captions in response to a commenter's recommendation that a caption be added to each category of certain terms for ease of reference and clarity.

One commenter recommended replacing the term "obligation" in Rule 3101 with a comparable term because the commenter believed that the term "obligation" in legal and governmental environments has a connotation that is inconsistent with the intent of Rule 3101 and may be misinterpreted by legal or governmental officials. After considering this comment, the Board replaced the term "obligation" with the synonym "responsibility" in Rule 3101.

Rule 3101(a)(2) defines a presumptively mandatory responsibility as a requirement that the auditor must comply with "unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard." Furthermore, Rule 3101(a)(2) states that "failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard."

The Board also added a note to Rule 3101(a)(2) to require auditors to document compliance with presumptively mandatory responsibilities by alternative means. The Board originally proposed that the auditor be required to "demonstrate by verifiable, objective, and documented evidence" that the alternative procedures he or she followed were sufficient in the specific circumstances. Commenters stated that they believed that the documentation requirement was important, both to promote discipline of thought and to provide a uniform basis for evaluating compliance with the standards. Several of these commenters went even further to recommend that the Board strengthen the documentation requirement by adding language such as "contemporaneous" and "memorialized at the time of the audit" to the rule.

Conversely, other commenters suggested that the documentation requirement was unduly onerous and placed too great a documentation burden on the auditors. The commenters argued that the documentation would be too voluminous and would add very little value to the audit. Some of these commenters further recommended that, in lieu of the proposed documentation requirement, the rule require that the auditor consider the significance of the particular audit area and document only the significant issues or findings. A commenter also recommended that other evidence, such as oral

## **RELEASE**

explanation, should be allowed as support for the reasons why the auditor chose not to perform a presumptively mandatory responsibility. Additionally, some commenters recommended that the documentation requirement should be addressed in the standard on audit documentation.

The integrity of the audit depends, in large part, on the existence of a complete and understandable record of the work performed, the conclusions reached, and the evidence obtained to support those conclusions. Clear, complete, and comprehensive audit documentation enhances the quality of the audit. Audit documentation should demonstrate compliance with professional standards and justify the reasons for any variations in procedures performed.

The PCAOB standards require the auditor to document the procedures performed, evidence obtained, and conclusions reached during an engagement. To further enhance the quality of the audit, Rule 3101(a)(2) adds a specific documentation requirement to achieve complete and comprehensive audit documentation in engagement working papers for situations in which the auditor does not perform a presumptively mandatory responsibility. In those instances, it is essential that auditors document the reasons they chose not to perform the presumptively mandatory responsibility and how the alternative procedure they performed sufficiently achieved the objectives of the specific standard.

Because circumstances will be rare in which the auditor will perform an alternative procedure, the Board anticipates that the documentation requirement in the rule ought not to result in unduly onerous consequences or too voluminous documentation. Furthermore, since the auditor must already document the work performed as part of the audit, adding a concise explanation as to why the auditor chose to perform the alternative procedure should not increase the volume of documentation to an unreasonable level.

During an internal or external review of the engagement, other evidence, including oral explanation, may help substantiate the procedures performed by the auditor during the audit. However, because the auditor is required to document his or her work in the engagement working papers during the audit, oral explanation should be used only to clarify the documented work performed. The justification as to why the alternative procedure was performed rather than the presumptively mandatory responsibility must be documented in the working papers. Furthermore, the reviewer

## RELEASE

should give appropriate consideration to the credibility of the individual(s) providing the oral explanation, and the oral explanation should be consistent with the documented evidence in the engagement working papers.

Moreover, the Board concluded that applying the documentation requirement only to significant issues, findings, or procedures is impractical because it will not be efficient or effective to determine, each time, whether the level of significance of an audit area warranted the auditor to document the reasons for choosing to perform an alternative procedure instead of the presumptively mandatory procedure. The purpose of Rule 3101 is to bring uniformity to definitions and requirements that auditors have to follow. In addition, the Board determined that moving Rule 3101(a)(2)'s documentation requirement to the audit documentation standard would not be appropriate because of its specific subject matter.

Additionally, the Board has added a note, originally a footnote in the Board's proposing release accompanying its proposed rule, describing an auditor's responsibility in a "should consider" scenario to the text of Rule 3101(a)(3), Responsibility to Consider. Some commenters recommended that this footnote be added directly to the text of the rule because they saw it as an important clarification that was not included in the original proposed rule. A commenter further urged the Board to elaborate on its applicability and the documentation requirements for a "should consider" action.

Another commenter suggested that the "should consider" footnote be excluded from the rule because it implies that the action would require the auditor to document every instance of compliance with a "should consider" action. The commenter, instead, recommended that Rule 3101(a)(3) be revised to apply to all considerations regardless of how the obligation is expressed (for example, whether it is preceded by a "should," "may," "could," or "might").

Because the "should consider" terminology is widely used in the interim standards, the Board determined that it is important to state the Board's expectation for compliance and, therefore, agreed with commenters who recommended adding the "should consider" footnote to the text of Rule 3101(a)(3). Furthermore, the Board concluded that there is an important difference between a "should consider" and a "may consider" action or procedure. The difference is a direct correlation to the definitions of "should" and "may." The auditor has a greater responsibility in a "should consider" action because the auditor has a presumptively mandatory responsibility to consider the

## **RELEASE**

action or procedure versus just having a responsibility to consider the action. Therefore, Rule 3101(a)(3) was not revised to apply to all considerations regardless of how the obligation is expressed.

Additionally, the Board determined that the documentation requirement relating to a procedure that an auditor "should consider" is not the same as the documentation requirement for a presumptively mandatory responsibility because in a "should consider" situation, only the consideration of the action is presumptively mandatory, while the action or procedure itself is not. In these situations, the auditor should use his or her professional judgment in determining how to document his or her consideration of the specific action or procedure.

### **Rule 3101(b)**

Rule 3101(b) provides that the terminology in paragraph (a) of this rule applies to all the auditing and related professional practice standards, including the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T. Rule 3101(b) applies to conduct occurring after the effective date of the rule.

Therefore, Rule 3101(b) provides that the terminology in Rule 3101(a) is applicable to all existing auditing and related professional practice standards with which auditors must comply. The Board determined that a failure to comply with a presumptively mandatory responsibility in an interim standard will be treated as a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the specific circumstances, compliance was not necessary to achieve the objectives of the standard.

Some commenters on the proposed rule stated that the imperatives the Board identified are consistent with the way auditors currently interpret existing auditing and related professional practice standards, while other commenters recommended that Rule 3101(a) not apply to the interim standards on the grounds that the new definitions could create confusion or have unintended consequences. Because the accounting profession previously had not expressly defined these terms, commenters further recommended that the Board perform a comprehensive analysis of how and in what context the interim standards use the defined terms to determine whether current practice is consistent with the Rule 3101(a) definitions.

## **RELEASE**

The Board concluded that the terminology defined in Rule 3101 is consistent with the existing interpretation regarding the application of the terminology in the interim standards. Rule 3101 creates a common understanding among the auditors as to what is expected of them when performing engagements in accordance with the PCAOB standards and, therefore, Rule 3101 will apply to the interim standards.

Furthermore, a commenter recommended that the Board clarify the level of authority the appendices carry when accompanying the Board's standards. Because the Board adopts the appendices to its permanent standards as rules, the appendices to the Board's permanent standards carry the same level of authority as the standards themselves. In addition, the appendices to the interim standards, which in certain circumstances carry a different level of authority, retain their original level of authority as adopted on April 16, 2003.

### **Rule 3101(c)**

Rule 3101(c) establishes an effective date for the documentation requirement in paragraph (a)(2). The Board agreed with commenters who recommended establishing an effective date to provide a reasonable amount of time for auditors to implement procedures to properly comply with the new documentation requirement.

Rule 3101 does not apply retroactively. Therefore, conduct occurring before the rule is effective will be evaluated in light of the standards as they existed at the time of the conduct. As noted above, however, the Board believes that, except for the documentation requirement in Rule 3101(a)(2), the definitions in Rule 3101 are consistent with the existing interpretation of these terms in the existing, interim standards. Therefore, as an interpretive matter, the Board expects that it will interpret these terms in the existing, interim standards in a manner consistent with their definitions in Rule 3101, in light of the facts and circumstances of each particular situation.