
STANDING ADVISORY GROUP MEETING

PROPOSAL TO RECONSIDER THE HIERARCHY OF AUDITING STANDARDS AND GUIDANCE

NOVEMBER 17-18, 2004

Introduction

At its meeting in June 2004, the Standing Advisory Group ("SAG") considered and provided advice on two questions related to the nature and breadth of auditing guidance available to auditors of issuers:

1. What kind of guidance should be available to help auditors and others interpret PCAOB standards?
2. How should we manage the fact that there is existing guidance on interim standards that has some authority today but may become superseded or outdated over time?

Since that time, the staff has considered the advice of the SAG and continued development of a proposal to clarify the authority of the Board's interim auditing standards. The staff is seeking additional advice from the SAG on several issues central to the development of such proposal.

The Need to Revise the Hierarchy

The existing "hierarchy" of auditing literature is described in Statement on Auditing Standards (SAS) No. 95, "Generally Accepted Auditing Standards." A copy of SAS 95, which is codified as AU section 150 in the American Institute of Certified Public Accountants ("AICPA") Professional Standards, is presented as Appendix A.

<p>This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the SAG. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or PCAOB staff.</p>

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SAS No. 95 established two authoritative categories of auditing literature (auditing standards and interpretive publications) and one non-authoritative category (other auditing publications). The two authoritative categories contain different expectations about the auditor's compliance therewith, and interpretive publications are subordinate to auditing standards in this regard. The auditor "should be prepared to justify departures" from the SASs but needs only to "be prepared to explain how he or she complied with the SAS provisions" addressed by an interpretive publication if the auditor does not apply the interpretive publication.

The staff believes that this hierarchy of auditing literature should be reconsidered at this time. There are at least two reasons for this. First, the Board's Rule 3100, "Compliance with Auditing and Related Professional Practice Standards," and Rule 3101, "Certain Terms Used in Auditing and Related Professional Practice Standards," serve the objectives of a hierarchy by describing the authority of the Board's standards and the degree of responsibility the standards impose on auditors. Rule 3101 applies to the application of the Board's interim standards; however, the categories of authoritative auditing literature described in SAS 95 are not necessarily consistent with this rule.

Second, one form of interpretive publication, auditing guidance included in AICPA Guides, is subject to continuing development and updating. Only the editions of those guides in existence on April 16, 2003, (the date on which the Board adopted SAS 95 as an interim auditing standard) are a part of the Board's interim auditing standards. Those editions are aging, will quite possibly become outdated based on developments in industry and auditing practice, and might not be compatible with auditing standards issued by the Board.

There are a number of issues that must be resolved in addressing this subject, the most significant of which are summarized below.

1. Is there a need for more than one category of authoritative auditing guidance? Or is the distinction between authoritative and non-authoritative sufficient?

The staff's preliminary view is that the distinction between authoritative and non-authoritative auditing publications is sufficient.

As indicated above, more than one category of authoritative auditing literature might be confusing to auditors and others, particularly as it relates to the application of

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the terms defined in Rule 3101 to the different categories. For example, the distinction between a presumptively mandatory obligation (the auditor "should" do something) in an auditing standard and one in an interpretive publication may not be clear. Additionally, because Rule 3101 describes the degree of responsibility the standards impose on auditors through the use of certain terminology, there is a reduced need for more than one category of authoritative auditing literature.

A subsidiary issue is whether there is a need to describe the authority of the auditing literature within the auditing standards themselves. Such a description probably would not be necessary, provided that the Board's rules are sufficiently descriptive. As discussed above, the Board's rules describe the authority of the Board's standards and the degree of responsibility the standards impose on auditors through the use of certain terminology. Eliminating the hierarchy in SAS No. 95 would require the Board to amend Rule 3200T to clarify that auditors must comply with Statements on Auditing Standards in effect on April 16, 2003, to the extent not superseded or amended by the Board, rather than generally accepted auditing standards as described in SAS 95.

Revising the Classifications Within the Hierarchy

If the Board revises the hierarchy, the Board must consider how to address the status of the auditing publications included in the second category of authoritative auditing literature, interpretive publications. Interpretive publications include appendices to the SASs, auditing interpretations of the SASs, auditing statements of position, and auditing guidance included in AICPA Audit and Accounting Guides. This matter is addressed in questions 2 and 3, below.

2. Should the Board recognize the auditing interpretations of the SASs and the appendices to the SASs in the same manner as it recognizes the SASs?

The staff's preliminary view is that the auditing interpretations of the SASs and the appendices to the SASs should be recognized in the same manner as the SASs.

The auditing interpretations of the SASs represent recommendations on the application of the SASs in specific circumstances, and are well-known by auditors because of the fact that they are published with the interim auditing standards in the AICPA Codification of Auditing Standards and the AICPA Professional Standards. The auditing interpretations were developed in accordance with an established process, and

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are generally regarded as being of a quality consistent with that of the SASs and as representing appropriate applications of the auditing standards in the circumstances described. The appendices to the SASs that are codified with the SASs in the AICPA Codification of Statements on Auditing Standards are similarly regarded.

On the other hand, the auditing interpretations of the SASs were not subject to public exposure and comment, and the appendices to the SASs generally consist of examples rather than definitive guidance.

3. What role should the auditing Statements of Position (SOPs) and the auditing guidance included in the AICPA Guides play in public company auditing?

As discussed above, auditing guidance included in AICPA Guides is subject to continuing development and updating. Only the editions of those guides in existence on April 16, 2003, (the date on which the Board adopted SAS 95 as an interim auditing standard) are a part of the Board's interim auditing standards. Those editions are aging, will quite possibly become outdated based on developments in industry and auditing practice, and might not be compatible with auditing standards issued by the Board. It's the staff's view that it is inappropriate to hold auditors accountable to guidance in outdated materials; accordingly, the staff's preliminary view is that the 2003 editions of the AICPA Guides should be classified as non-authoritative.

Experienced auditing practitioners and other specialists are involved in the development and maintenance of the AICPA Guides and those publications are a resource to auditors. Indeed, the Board's interim auditing standards require auditors to be knowledgeable about the nature of the audit client's business and industry and to be continually aware of developments taking place in business and in the auditing profession, and the AICPA Guides provide auditors with relevant information in this regard. Those publications also provide auditors with numerous examples of procedures that can be applied in specific circumstances, some of which are unique to particular industries.

The staff does not believe it is a viable option to designate current editions of AICPA Guides as authoritative as the AICPA Guides are developed and controlled by the AICPA and not the PCAOB. Any changes to the Guides must go through the Board's rulemaking process—including SEC approval—for them to be authoritative.

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A listing of existing AICPA Guides is presented as Appendix B.

Auditing SOPs were issued from time to time by the Auditing Standards Board ("ASB") to address the application of the auditing standards in specific situations, principally in specialized industries. They are similar to AICPA Guides, in that they provide recommendations on detailed auditing procedures. Like the AICPA Guides, auditing SOPs are neither codified with the SASs nor published in the AICPA Professional Standards. Additionally, auditing SOPs ordinarily are not subject to regular updating. The staff's preliminary view is that auditing SOPs should be classified as non-authoritative. A listing of auditing SOPs is presented as Appendix C.

Continuing Relevance of the 10 Standards

In addition to describing the categories of auditing literature, as discussed above, SAS No. 95 describes the difference between auditing standards and auditing procedures, and summarizes the 10 generally accepted auditing standards (the 10 standards), which were originally adopted by the membership of the AICPA.

4. *Should the Board eliminate the special distinction that is attached to the 10 standards?*

The codification of the interim auditing standards is organized around a framework of 10 general, field work, and reporting standards (the ten standards). These ten standards originally were adopted by the membership of the AICPA and, prior to the adoption of SAS No. 95, were referred to as the generally accepted auditing standards. Even after SAS No. 95 was adopted, the 10 standards continued to hold a special distinction, appearing to be separate and superior to the SASs. Part of this is attributable to the way in which they are worded, by the fact that paragraph 4 of SAS No. 95 requires that auditors "be prepared to justify departures from the SASs" without mentioning the 10 standards, and by the fact that the 10 standards continue to serve as the organizing framework of the codified SASs.

The staff's preliminary view is that this special distinction that is attached to the 10 standards be eliminated, but that the requirements of the 10 standards be retained in the interim standards. The 10 standards, as currently presented in the Board's interim auditing standards, are as follows:

General Standards

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1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in performance of the audit and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should

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contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

The 10 standards were established in 1947 and 1948 and, although they remain largely unchanged, they remain relevant and essential auditing requirements. There have been many substantial changes to the auditing standards since 1948, however, that are not explicitly included within the 10 standards. For example, although four of the standards address auditor reporting, none address the auditor's obligation to communicate with the audit committee. Additionally, there is no recognition in the 10 standards of the auditor's responsibility for the detection of financial statement misstatements caused by fraud. Accordingly, the 10 standards might not be sufficiently complete to have the special distinction they currently are conferred in the interim auditing standards. Nevertheless, because they represent relevant and essential auditing requirements, it seems appropriate to retain them as requirements, even without the special distinction.

Even if the Board decides to eliminate the special distinction, the Board could retain the 10 standards as a framework of fundamental auditing requirements around which the auditing standards could be organized. The interim standards are organized around the notions of general, field work and reporting standards, and auditors are familiar with this organizing structure. There are other ways to logically organize the standards, however, and it might be beneficial to allow the Board and its staff the flexibility to determine the most appropriate organizing principle.

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APPENDIX A

AU Section 150

Generally Accepted Auditing Standards

.01 An independent auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. Auditing procedures differ from auditing standards. Auditing procedures are acts that the auditor performs during the course of an audit to comply with auditing standards.

Auditing Standards

.02 The general, field work, and reporting standards (the 10 standards) approved and adopted by the membership of the AICPA, as amended by the AICPA Auditing Standards Board (ASB), are as follows:

General Standards

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

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3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons, therefore, should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

.03 Rule 202, *Compliance With Standards*, of the AICPA Code of Professional Conduct [ET section 202.01], requires an AICPA member who performs an audit (the auditor) to comply with standards promulgated by the ASB.^{1/} The ASB develops and issues standards in the form of Statements on Auditing Standards (SASs) through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs are codified within the framework of the 10 standards.

^{1/} In certain engagements, the auditor also may be subject to other auditing requirements, such as Government Auditing Standards issued by the comptroller general of the United States, or rules and regulations promulgated by the U.S. Securities and Exchange Commission.

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.04 The auditor should have sufficient knowledge of the SASs to identify those that are applicable to his or her audit. The nature of the 10 standards and the SASs requires the auditor to exercise professional judgment in applying them. Materiality and audit risk also underlie the application of the 10 standards and the SASs, particularly those related to field work and reporting.^{2/} The auditor should be prepared to justify departures from the SASs.

Interpretive Publications

.05 *Interpretive publications* consist of auditing Interpretations of the SASs, appendixes to the SASs,^{3/} auditing guidance included in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position.^{4/} Interpretive publications are not auditing standards. Interpretive publications are recommendations on the application of the SASs in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the ASB after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs. [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.06 The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

^{2/} See section 312, *Audit Risk and Materiality in Conducting an Audit*.

^{3/} Appendixes to SASs referred to in paragraph .05 of this section do not include previously issued appendixes to original pronouncements that when adopted modified other SASs. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

^{4/} Auditing Interpretations of the SASs are included in the codified version of the SASs and are cross-referenced from the related AU sections in Appendix C. AICPA Audit and Accounting Guides and auditing Statements of Position are listed in Appendix D. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

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Other Auditing Publications

.07 *Other auditing publications* include AICPA auditing publications not referred to above; auditing articles in the *Journal of Accountancy* and other professional journals; auditing articles in the *AICPA CPA Letter*; continuing professional education programs and other instruction materials, textbooks, guide books, audit programs, and checklists; and other auditing publications from state CPA societies, other organizations, and individuals.^{5/} Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the SASs.

.08 If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit, and appropriate. In determining whether another auditing publication is appropriate, the auditor may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying the SASs and the degree to which the issuer or author is recognized as an authority in auditing matters. Other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate.^{6/}

Effective Date

.09 This section is effective for audits of financial statements for periods beginning on or after December 15, 2001.

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^{5/} The auditor is not expected to be aware of the full body of other auditing publications. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

^{6/} Other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are listed in Appendix F. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

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APPENDIX B

AICPA Audit and Accounting Guides

Agricultural Producers and Agricultural Cooperatives

Airlines

Analytical Procedures

Audit Sampling

Auditing Derivative Instruments, Hedging Activities, and Investments in Securities

Auditing Revenue in Certain Industries

Brokers and Dealers in Securities

Casinos

Common Interest Realty Associations

Consideration of Internal Control in a Financial Statement Audit

Construction Contractors

Depository and Lending Institutions

Employee Benefit Plans

Entities With Oil and Gas Producing Activities

Federal Government Contractors

Government Auditing Standards and Circular A-133 Audits

Guide for Prospective Financial Information

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Guide for the Use of Real Estate Appraisal Information

Health Care Organizations

Investment Companies

Life and Health Insurance Entities

Non-for-Profit Organizations

Personal Financial Statements

Property and Liability Insurance Companies

Service Organizations: Applying SAS No. 70

State and Local Governmental Units (Non GASB 34 Edition)

State and Local Governments (GASB 34 Edition)

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APPENDIX C

AICPA Auditing Statements of Position

<u>Title</u>	<u>Year Issued</u>
Confirmation of Insurance Policies in Force	1978
Auditing Property and Liability Reinsurance	1982
Auditing Life Reinsurance	1984
Reports on Audited Financial Statements of Investment Companies	1989
Report on the Internal Control Structure in Audits of Investment Companies	1989
Questions Concerning Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations	1990
Report on the Internal Control Structure in Audits of Futures Commission Merchants	1990
Questions and Answers on the Term Reasonably Objective Basis and Other Issues Affecting Prospective Financial Statements	1992
Auditing Insurance Entities' Loss Reserves	1992
Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions	1992

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<u>Title</u>	<u>Year Issued</u>
Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations	1993
The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises	1993
Inquiries of State Insurance Regulators	1994
Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule	1995
Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises	1995
Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association	1998
Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program	1999
Auditing Health Care Third-Party Revenues and Related Receivables	2000
Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law	2001
Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards	2001

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<u>Title</u>	<u>Year Issued</u>
Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code	2002

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