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SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 19b-4

Proposed Rule

By

Public Company Accounting Oversight Board

**SEC Mail
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**Washington, DC
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In accordance with Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of the Proposed Rule

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") proposed rules. The proposed rules consist of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, and conforming amendments to the Board's interim auditing standards. The proposed rules update the requirements for evaluating consistency of the financial statements in light of changes in the accounting standards and remove the hierarchy of generally accepted accounting principles from the Board's auditing standards, and make related amendments to the Board's interim auditing standards. The proposed rules are attached as Exhibit A to this rule filing.

(b) As described more fully in Exhibit 3, the proposed rules would supersede AU secs. 420 and 9420 and amend AU sec. 411 of the Board's interim auditing standards, and make related amendments to the Board's interim auditing standards.

(c) Not applicable.

2. Procedures of the Board

(a) The Board approved the proposed rules, and authorized them for filing with the SEC, at its Open Meeting on January 29, 2008. No other action by the Board is necessary for the filing of the proposed rules.

(b) Questions regarding this rule filing may be directed to Jacob Lesser, Associate General Counsel (202-207-9284; lesserj@pcaobus.org) or Gregory Fletcher, Associate Chief Auditor (202-207-9203; fletcher@pcaobus.org).

3. Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules

(a) Purpose

Section 103(a) of the Act directs the Board, by rule, to establish, among other things, "auditing and related attestation standards . . . to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by th[e] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." As discussed more fully in Exhibit 3, The Board proposed certain changes to its auditing standards in response to two actions of the Financial Accounting Standards Board ("FASB").

First, in May 2005, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections*,^{1/} which superseded Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes*.^{2/} SFAS No. 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle

^{1/} Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections* (2005) ("SFAS No. 154").

^{2/} Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes* (1971). SFAS No. 154 also superseded SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*.

in the absence of explicit transition requirements specific to a newly adopted accounting principle. SFAS No. 154 also redefines the term "restatement" to refer only to "the process of revising previously issued financial statements to reflect the correction of an error in those financial statements."^{3/} Under SFAS No. 154, therefore, the term "restatement" does not refer to changes made to previously issued financial statements to reflect a change in accounting principle.

AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, the Board's interim standard on the auditor's responsibilities for evaluating the consistency of the application of generally accepted accounting principles ("GAAP"), generally reflected the provisions of APB Opinion No. 20, which was superseded by SFAS No. 154. To better align the Board's standards with the new accounting standard, the Board adopted a new auditing standard on evaluating consistency, which will supersede AU sec. 420, and conforming amendments to AU sec. 508, *Reports on Audited Financial Statements*, of its interim auditing standards.

Second, the FASB has also issued an exposure draft of a proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*.^{4/} The FASB's proposed standard would incorporate the hierarchy found in the auditing standards into the accounting standards. Historically, a description of the GAAP hierarchy has resided only in

^{3/} See SFAS No. 154, paragraph 2j.

^{4/} FASB, Proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*, Exposure Draft (April 2005).

the auditing standards. Because the GAAP hierarchy identifies the sources of accounting principles and the framework for selecting principles to be used in preparing financial statements, the Board believed that these requirements are more appropriately located in the accounting standards. Accordingly, the Board adopted amendments to its auditing standards to remove the GAAP hierarchy.^{5/}

The proposed standard and amendments to the Board's interim standards are intended to update and clarify the auditing standards in light of SFAS No. 154 and the FASB's proposal on the GAAP hierarchy. In particular, these updates and clarifications should enhance the clarity of auditor reporting on accounting changes and corrections of misstatements by distinguishing between these events.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

4. Board's Statement on Burden on Competition

The Board does not believe that the proposed rules will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rules would apply equally to all registered public accounting firms and their associated persons.

^{5/} If the amendments are approved by the SEC, the effective date for the removal of the GAAP hierarchy from the auditing standards will be 60 days after the standard and amendments are approved by the SEC. The Board has coordinated with the FASB and understands that the FASB intends to coincide the effective date of its standard on the GAAP hierarchy with that of the PCAOB.

5. Board's Statement on Comments on the Proposed Rule Received from Members, Participants or Others

The Board released the rules for public comment on April 3, 2007. See Exhibit 2(a)(A). The Board received 11 written comment letters relating to its proposal. See Exhibits 2(a)(B) and 2(a)(C).

The Board has carefully considered all comments it has received. In response to the written comments received, the Board has clarified and modified certain aspects of the proposed rules. The Board's response to the comments it received and the changes made to the rules in response to these comments are summarized in Exhibit 3 to this filing.

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

Not applicable.

9. Exhibits

Exhibit A – Text of the Proposed Rules

Exhibit 1 – Form of Notice of Proposed Rule for Publication in the Federal Register.

Exhibit 2(a)(A) – PCAOB Release No. 2007-003 (April 3, 2007)

Exhibit 2(a)(B) – Alphabetical List of Comments

Exhibit 2(a)(C) – Written comments on the rules proposed in PCAOB
Release No. 2007-003

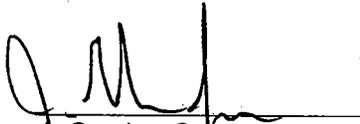
Exhibit 3 – PCAOB Release No. 2008-001 (January 29, 2008)

10. Signatures

Pursuant to the requirements of the Act and the Securities Exchange Act
of 1934, as amended, the Board has duly caused this filing to be signed on its
behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

By:



J. Gordon Seymour
General Counsel
and Secretary

Exhibit A – Text of the Proposed Rules**Auditing Standard No. 6**
Supersedes AU secs. 420 and 9420**Evaluating Consistency of Financial Statements****Consistency and the Auditor's Report on Financial Statements**

1. This standard establishes requirements and provides direction for the auditor's evaluation of the consistency of the financial statements, including changes to previously issued financial statements, and the effect of that evaluation on the auditor's report on the financial statements.
2. To identify consistency matters that might affect the report, the auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles or by material adjustments to previously issued financial statements for the relevant periods.
3. The periods covered in the auditor's evaluation of consistency depend on the periods covered by the auditor's report on the financial statements. When the auditor reports only on the current period, he or she should evaluate whether the current-period financial statements are consistent with those of the preceding period. When the auditor reports on two or more periods, he or she should evaluate consistency between such periods and the consistency of such periods with the period prior thereto if such prior period is presented with the financial statements being reported upon.^{1/} The auditor also should evaluate whether the financial statements for periods described in this paragraph are consistent with previously issued financial statements for the respective periods.^{2/}

^{1/} For example, assume that a company presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor auditor reports, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented.

^{2/} When a company uses retrospective application, as defined in Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("SFAS No. 154"), to account for a change in accounting principle, the financial statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and,

Note: The term "current period" means the most recent year, or period of less than one year, upon which the auditor is reporting.

4. The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:

- a. A change in accounting principle
- b. An adjustment to correct a misstatement in previously issued financial statements.^{3/}

Change in Accounting Principle

5. A change in accounting principle is a change from one generally accepted accounting principle to another generally accepted accounting principle when (1) there are two or more generally accepted accounting principles that apply, or when (2) the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.^{4/}

Note: A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of a misstatement.

6. The auditor should evaluate and report on a change in accounting estimate effected by a change in accounting principle like other changes in accounting principle.^{5/} In addition, the auditor should recognize a change in the

therefore, will appear different from those previous years' financial statements on which the auditor previously reported. This standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

^{3/} The term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards.

^{4/} See SFAS No. 154, paragraph 2c.

^{5/} SFAS No. 154, paragraph 2e, defines a "change in accounting estimate effected by a change in accounting principle" as "a change in accounting estimate that is inseparable from the effect of a related change in accounting principle."

reporting entity^{6/} by including an explanatory paragraph in the auditor's report, unless the change in reporting entity results from a transaction or event. A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit does not require recognition in the auditor's report.

7. The auditor should evaluate a change in accounting principle to determine whether –

- a. The newly adopted accounting principle is a generally accepted accounting principle,
- b. The method of accounting for the effect of the change is in conformity with generally accepted accounting principles,
- c. The disclosures related to the accounting change are adequate,^{7/} and
- d. The company has justified that the alternative accounting principle is preferable.^{8/}

8. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph 7 have been met, the auditor should add an explanatory paragraph to the auditor's report, as described in AU sec. 508, *Reports on Audited Financial Statements*. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and address the matter as described in AU sec. 508.

^{6/} "Change in reporting entity" is a change that results in financial statements that, in effect, are those of a different reporting entity. See SFAS No. 154, paragraph 2f.

^{7/} Newly issued accounting pronouncements usually set forth the method of accounting for the effects of a change in accounting principle and the related disclosures. SFAS No. 154 sets forth the method of accounting for the change and the related disclosures when there are no specific requirements in the new accounting pronouncement.

^{8/} The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See SFAS No. 154, paragraph 14.

Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph (following the opinion paragraph) to the auditor's report, as described in AU sec. 508.

Correction of a Material Misstatement in Previously Issued Financial Statements

9. The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as described in AU sec. 508.

10. The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in AU sec. 431, *Adequacy of Disclosure in Financial Statements*, and AU sec. 508.

Change in Classification

11. Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs 7 and 8 and AU sec. 508. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs 9 and 10 and AU sec. 508.

Amendments to PCAOB Auditing Standards

Auditing Standards

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

Statement on Auditing Standards ("SAS") No. 101, "Auditing Fair Value Measurements and Disclosures," (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows:

- a. The text of footnote 4 to paragraph .19 is replaced with the following:

Statement of Financial Accounting Standard No. 157, *Fair Value Measurements*, states that a change in valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances.

AU sec. 410, "Adherence to Generally Accepted Accounting Principles"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 410 (AU sec. 410, "Adherence to Generally Accepted Accounting Principles"), as amended, is amended as follows:

- a. Paragraph .02 is replaced with following paragraph, and the reference to footnote 1 is moved to the end of the new paragraph .02.

The fourth standard of reporting is:

The report shall either contain 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 therefor 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.

AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"

SAS No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles" (AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"), as amended, is amended as follows:

- a. The third sentence of paragraph .01 is replaced with the following:

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

- b. Paragraphs .02, .05, .07, and .09-.18 are deleted.

AU sec. 9411, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*, Auditing Interpretations of Section 411"

Auditing Interpretation No. 3, "The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events" of the auditing interpretations of AU sec. 411 (AU sec. 9411.11-.15) is deleted.

AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles," and AU sec. 9420, "Consistency of Application of Generally Accepted Accounting Principles, Auditing Interpretations of Section 420"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 420 (AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles"), as amended, and the related auditing interpretations (AU sec. 9420) are superseded by PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*.

AU sec. 431, "Adequacy of Disclosure in Financial Statements"

SAS No. 32, "Adequacy of Disclosure in Financial Statements" (AU sec. 431, "Adequacy of Disclosure in Financial Statements") is amended as follows:

- a. Footnote 1 is deleted.
- b. Paragraph .04 is deleted.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows:

- a. In Paragraph .03, footnote 2 is deleted.

- b. In Paragraph .11, item .11b is deleted; item .11c is reordered as .11b; .11d is reordered as .11c; the paragraph references in .11c (formerly .11d) to paragraphs .16 through .18 are replaced with paragraph references .17A through .17E; and a new item .11d is added as follows:

"A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C)."

- c. Paragraphs .14-.15 are deleted, along with the preceding heading "Departure From a Promulgated Accounting Principle," and the note following the paragraph.

- d. The text of paragraph .16 is replaced with the following:

The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:

- a. A change in accounting principle
- b. An adjustment to correct a misstatement in previously issued financial statements
- e. Paragraphs .17-.18 and related footnotes 12 and 13 are replaced with the following:

Change in Accounting Principle

.17A As discussed in PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.^{12/} A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.

^{12/} The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a

preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See FASB Statement 154, paragraph 14.

.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

As discussed in Note X to the financial statements, the company has changed its method of accounting for [describe accounting method change] in [year(s) of financial statements that reflect the accounting method change] due to the adoption of [name of accounting pronouncement].

.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement.

As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [describe accounting method change] in [year(s) of financial statements that reflect the accounting method change].

.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

.17E If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.

Correction of a Material Misstatement in Previously Issued Financial Statements

.18A Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.^{13/} The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate

explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.

As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

^{13/} The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

.18B This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

.18C The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41 and in AU sec. 431.

f. Paragraph .50 is deleted.

g. The text of paragraph .51 is replaced with the following:

Departures from generally accepted accounting principles related to changes in accounting principle. Paragraph .17A states the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

h. In paragraph .52:

- The first three sentences of the paragraph are replaced with the following:

The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is

an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

- In the second sentence of the first paragraph of the example report, the phrase "for making this change" is replaced with the phrase "that this accounting principle is preferable."

In the text of footnote 17, the first two sentences are deleted; the word, "However" is deleted at the beginning of the third sentence; the word "because" at the beginning of the third sentence is capitalized; the phrase "the middle paragraph" is replaced with "this paragraph;" and the references to paragraphs ".16 through .18" are replaced with references to paragraphs "17A through 17E."

- i. The text of paragraph .57 is replaced with the following:

If the auditor issues a qualified or adverse opinion because the company has not justified that an allowable accounting principle adopted in an accounting change is preferable, as described in paragraph .52, the auditor should continue to express that opinion on the financial statements for the year of change as long as those financial statements are presented and reported on. However, the auditor's qualified or adverse opinion relates only to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing a qualified or adverse opinion for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express a qualified or adverse opinion on the use of the newly adopted principle in subsequent periods.

- j. In the text of footnote 19 to paragraph .59, "(b)" is added to the beginning of the list of subsections.

- k. The first sentence of footnote 20 to paragraph .62 is deleted.

- l. In the second sentence of footnote 25 to paragraph .67, replace the phrase "section 420, *Consistency of Application of Generally Accepted Accounting Principles*," with the phrase "PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*"

- m. In the second sentence of paragraph .69:

- Item (c) is inserted as follows:

(c) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period,

- Item (c) is changed to (d)
- Item (e) is inserted as follows:

(e) if applicable, a reference to the company's disclosure of the correction of the misstatement,

- Item (d) is changed to (f) and the words "the fact" are inserted at the beginning of the item

n. In the third sentence of paragraph .73, the word "restated" is replaced with the word "adjusted."

o. In paragraph .74:

- In the first sentence of the third text paragraph, the word "restated" is replaced with the word "adjusted," and the word "restatement" is replaced with the words "the adjustments."
- In the second sentence of the third text paragraph, the word "restatement" is deleted, and the word "his" is replaced with the words "the auditor's."

AU sec. 561, Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

SAS No. 1, "Codification of Auditing Standards and Procedures," section 561, "Subsequent Discovery of Facts Existing at the Date of Report," as amended, is amended as follows:

a. The text of footnote 3 to paragraph .06 is replaced with the following:

See paragraphs 26 and 27 of Accounting Principles Board Opinion No. 9 and paragraphs 25 and 26 of FASB Statement No. 154, regarding disclosure of adjustments applicable to prior periods.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. PCAOB-2008-01)

[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rule on Auditing Standard No. 6, Evaluating Consistency of Financial Statements and Conforming Amendments.

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on February 1, 2008, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") the proposed rule described in Items I, II, and III below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rule from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rule

On January 29, 2008, the Board adopted Auditing Standard No. 6 and amendments to the Board's interim auditing standards ("the proposed rules"). The proposed rules text is set out below.

Auditing Standard No. 6
Supersedes AU secs. 420 and 9420

Evaluating Consistency of Financial Statements

Consistency and the Auditor's Report on Financial Statements

1. This standard establishes requirements and provides direction for the auditor's evaluation of the consistency of the financial statements, including

changes to previously issued financial statements, and the effect of that evaluation on the auditor's report on the financial statements.

2. To identify consistency matters that might affect the report, the auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles or by material adjustments to previously issued financial statements for the relevant periods.
3. The periods covered in the auditor's evaluation of consistency depend on the periods covered by the auditor's report on the financial statements. When the auditor reports only on the current period, he or she should evaluate whether the current-period financial statements are consistent with those of the preceding period. When the auditor reports on two or more periods, he or she should evaluate consistency between such periods and the consistency of such periods with the period prior thereto if such prior period is presented with the financial statements being reported upon.^{1/} The auditor also should evaluate whether the financial statements for periods described in this paragraph are consistent with previously issued financial statements for the respective periods.^{2/}

^{1/} For example, assume that a company presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor auditor reports, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented.

^{2/} When a company uses retrospective application, as defined in Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("SFAS No. 154"), to account for a change in accounting

Note: The term "current period" means the most recent year, or period of less than one year, upon which the auditor is reporting.

4. The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:
 - a. A change in accounting principle
 - b. An adjustment to correct a misstatement in previously issued financial statements.^{3/}

Change in Accounting Principle

5. A change in accounting principle is a change from one generally accepted accounting principle to another generally accepted accounting principle when (1) there are two or more generally accepted accounting principles that apply, or when (2) the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.^{4/}

principle, the financial statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous years' financial statements on which the auditor previously reported. This standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

^{3/} The term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards.

^{4/} See SFAS No. 154, paragraph 2c.

Note: A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of a misstatement.

6. The auditor should evaluate and report on a change in accounting estimate effected by a change in accounting principle like other changes in accounting principle.^{5/} In addition, the auditor should recognize a change in the reporting entity^{6/} by including an explanatory paragraph in the auditor's report, unless the change in reporting entity results from a transaction or event. A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit does not require recognition in the auditor's report.
7. The auditor should evaluate a change in accounting principle to determine whether –
 - a. The newly adopted accounting principle is a generally accepted accounting principle,
 - b. The method of accounting for the effect of the change is in conformity with generally accepted accounting principles,

^{5/} SFAS No. 154, paragraph 2e, defines a "change in accounting estimate effected by a change in accounting principle" as "a change in accounting estimate that is inseparable from the effect of a related change in accounting principle."

^{6/} "Change in reporting entity" is a change that results in financial statements that, in effect, are those of a different reporting entity. See SFAS No. 154, paragraph 2f.

- c. The disclosures related to the accounting change are adequate,^{7/}
and
 - d. The company has justified that the alternative accounting principle
is preferable.^{8/}
8. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph 7 have been met, the auditor should add an explanatory paragraph to the auditor's report, as described in AU sec. 508, *Reports on Audited Financial Statements*. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and address the matter as described in AU sec. 508.

Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting

^{7/} Newly issued accounting pronouncements usually set forth the method of accounting for the effects of a change in accounting principle and the related disclosures. SFAS No. 154 sets forth the method of accounting for the change and the related disclosures when there are no specific requirements in the new accounting pronouncement.

^{8/} The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See SFAS No. 154, paragraph 14.

principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph (following the opinion paragraph) to the auditor's report, as described in AU sec. 508.

Correction of a Material Misstatement in Previously Issued Financial Statements

9. The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as described in AU sec. 508.

10. The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in AU sec. 431, *Adequacy of Disclosure in Financial Statements*, and AU sec. 508.

Change in Classification

11. Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications

of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs 7 and 8 and AU sec. 508. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs 9 and 10 and AU sec. 508.

Amendments to PCAOB Auditing Standards

Auditing Standards

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

Statement on Auditing Standards ("SAS") No. 101, "Auditing Fair Value Measurements and Disclosures," (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows:

- a. The text of footnote 4 to paragraph .19 is replaced with the following:

Statement of Financial Accounting Standard No. 157, *Fair Value Measurements*, states that a change in valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances.

AU sec. 410, "Adherence to Generally Accepted Accounting Principles"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 410 (AU sec. 410, "Adherence to Generally Accepted Accounting Principles"), as amended, is amended as follows:

- a. Paragraph .02 is replaced with following paragraph, and the reference to footnote 1 is moved to the end of the new paragraph .02.

The fourth standard of reporting is:

The report shall either contain 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 therefor 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.

AU sec. 411, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*"

SAS No. 69, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*" (AU sec. 411, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*"), as amended, is amended as follows:

- a. The third sentence of paragraph .01 is replaced with the following:

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

- b. Paragraphs .02, .05, .07, and .09-.18 are deleted.

AU sec. 9411, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*, Auditing Interpretations of Section 411"

Auditing Interpretation No. 3, "The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events" of the auditing interpretations of AU sec. 411 (AU sec. 9411.11-.15) is deleted.

AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles," and AU sec. 9420, "Consistency of Application of Generally Accepted Accounting Principles, Auditing Interpretations of Section 420"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 420 (AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles"), as amended, and the related auditing interpretations (AU sec. 9420) are superseded by PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*.

AU sec. 431, "Adequacy of Disclosure in Financial Statements"

SAS No. 32, "Adequacy of Disclosure in Financial Statements" (AU sec. 431, "Adequacy of Disclosure in Financial Statements") is amended as follows:

- a. Footnote 1 is deleted.
- b. Paragraph .04 is deleted.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows:

- a. In Paragraph .03, footnote 2 is deleted.
- b. In Paragraph .11, item .11b is deleted; item .11c is reordered as .11b; .11d is reordered as .11c; the paragraph references in .11c (formerly .11d) to paragraphs .16 through .18 are replaced with paragraph references .17A through .17E; and a new item .11d is added as follows:

"A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C)."

- c. Paragraphs .14-.15 are deleted, along with the preceding heading "Departure From a Promulgated Accounting Principle," and the note following the paragraph.
- d. The text of paragraph .16 is replaced with the following:

The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:

 - a. A change in accounting principle
 - b. An adjustment to correct a misstatement in previously issued financial statements

- e. Paragraphs .17-.18 and related footnotes 12 and 13 are replaced with the following:

Change in Accounting Principle

.17A As discussed in PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.^{12/} A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.

^{12/} The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of

generally accepted accounting principles. See FASB Statement 154, paragraph 14.

.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].

.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement.

As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].

.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

.17E If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.

Correction of a Material Misstatement in Previously Issued Financial Statements

.18A Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.^{13/} The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.

As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

^{13/} The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

.18B This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

.18C The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41 and in AU sec. 431.

- f. Paragraph .50 is deleted.
- g. The text of paragraph .51 is replaced with the following:
Departures from generally accepted accounting principles related to changes in accounting principle. Paragraph .17A states the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.
- h. In paragraph .52:
 - The first three sentences of the paragraph are replaced with the following:

The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the

effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

- In the second sentence of the first paragraph of the example report, the phrase "for making this change" is replaced with the phrase "that this accounting principle is preferable." In the text of footnote 17, the first two sentences are deleted; the word, "However" is deleted at the beginning of the third sentence; the word "because" at the beginning of the third sentence is capitalized; the phrase "the middle paragraph" is replaced with "this paragraph;" and the references to paragraphs ".16 through .18" are replaced with references to paragraphs "17A through 17E."
- i. The text of paragraph .57 is replaced with the following:

If the auditor issues a qualified or adverse opinion because the company has not justified that an allowable accounting principle adopted in an accounting change is preferable, as described in paragraph .52, the auditor should continue to express that opinion on the financial statements for the year of change as long as those financial statements are presented and reported on. However, the auditor's qualified or adverse opinion relates only to the accounting

change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing a qualified or adverse opinion for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express a qualified or adverse opinion on the use of the newly adopted principle in subsequent periods.

- j. In the text of footnote 19 to paragraph .59, "(b)" is added to the beginning of the list of subsections.
- k. The first sentence of footnote 20 to paragraph .62 is deleted.
- l. In the second sentence of footnote 25 to paragraph .67, replace the phrase "section 420, *Consistency of Application of Generally Accepted Accounting Principles*," with the phrase "PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*"
- m. In the second sentence of paragraph .69:
 - Item (c) is inserted as follows:

(c) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period,
 - Item (c) is changed to (d)
 - Item (e) is inserted as follows:

(e) if applicable, a reference to the company's disclosure of the correction of the misstatement,
 - Item (d) is changed to (f) and the words "the fact" are inserted at the beginning of the item

- n. In the third sentence of paragraph .73, the word "restated" is replaced with the word "adjusted."
- o. In paragraph .74:
- In the first sentence of the third text paragraph, the word "restated" is replaced with the word "adjusted," and the word "restatement" is replaced with the words "the adjustments."
 - In the second sentence of the third text paragraph, the word "restatement" is deleted, and the word "his" is replaced with the words "the auditor's."

AU sec. 561, Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

SAS No. 1, "Codification of Auditing Standards and Procedures," section 561, "Subsequent Discovery of Facts Existing at the Date of Report," as amended, is amended as follows:

- a. The text of footnote 3 to paragraph .06 is replaced with the following:
- See paragraphs 26 and 27 of Accounting Principles Board Opinion No. 9 and paragraphs 25 and 26 of FASB Statement No. 154, regarding disclosure of adjustments applicable to prior periods.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rule and discussed any comments it received on the proposed rule. The text of these statements may be

examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

Section 103(a) of the Act directs the Board, by rule, to establish, among other things, "auditing and related attestation standards . . . to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by th[e] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." The Board proposed certain changes to its auditing standards in response to two actions of the Financial Accounting Standards Board ("FASB").

First, in May 2005, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections*,^{9/} which superseded Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes*.^{10/} SFAS No. 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted

^{9/} Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections* (2005) ("SFAS No. 154").

^{10/} Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes* (1971). SFAS No. 154 also superseded SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*.

accounting principle. SFAS No. 154 also redefines the term "restatement" to refer only to "the process of revising previously issued financial statements to reflect the correction of an error in those financial statements."^{11/} Under SFAS No. 154, therefore, the term "restatement" does not refer to changes made to previously issued financial statements to reflect a change in accounting principle.

AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, the Board's interim standard on the auditor's responsibilities for evaluating the consistency of the application of generally accepted accounting principles ("GAAP"), generally reflected the provisions of APB Opinion No. 20, which was superseded by SFAS No. 154. To better align the Board's standards with the new accounting standard, the Board adopted a new auditing standard on evaluating consistency, which will supersede AU sec. 420, and conforming amendments to AU sec. 508, *Reports on Audited Financial Statements*, of its interim auditing standards.

Second, the FASB has also issued an exposure draft of a proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*.^{12/} The FASB's proposed standard would incorporate the hierarchy found in the auditing standards into the accounting standards. Historically, a description of the GAAP hierarchy has resided only in the auditing standards. Because the GAAP hierarchy identifies the sources of

^{11/} See SFAS No. 154, paragraph 2j.

^{12/} FASB, Proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*, Exposure Draft (April 2005).

accounting principles and the framework for selecting principles to be used in preparing financial statements, the Board believed that these requirements are more appropriately located in the accounting standards. Accordingly, the Board adopted amendments to its auditing standards to remove the GAAP hierarchy.^{13/}

The proposed standard and amendments to the Board's interim standards are intended to update and clarify the auditing standards in light of SFAS No. 154 and the FASB's proposal on the GAAP hierarchy. In particular, these updates and clarifications should enhance the clarity of auditor reporting on accounting changes and corrections of misstatements by distinguishing between these events.

(b) Statutory Basis

The statutory basis for the proposed rule is Title I of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rules will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rules would apply equally to all registered public accounting firms and their associated persons.

^{13/} If the amendments are approved by the SEC, the effective date for the removal of the GAAP hierarchy from the auditing standards will be 60 days after the standard and amendments are approved by the SEC. The Board has coordinated with the FASB and understands that the FASB intends to coincide the effective date of its standard on the GAAP hierarchy with that of the PCAOB.

C. Board's Statement on Comments on the Proposed Rule Received from Members, Participants or Others

The Board released the proposed rules for public comment in PCAOB Release No. 2007-003 (April 3, 2007). A copy of PCAOB Release No. 2007-003 and the comment letters received in response to the PCAOB's request for comment are available on the PCAOB's web site at www.pcaobus.org. The Board received 11 written comments. The Board has carefully considered all comments it has received. In response to the written comments received, the Board has clarified and modified certain aspects of the proposed rules, as discussed below.

Evaluating Consistency

Under Auditing Standard No. 6, auditors are required to evaluate the consistency of a company's financial statements and report on inconsistencies. The new standard updates these requirements and aligns them more closely with SFAS No. 154^{14/} by requiring the auditor's report to recognize a company's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. Based on a discussion at an October 2005 meeting of the Board's Standing Advisory Group, the Board understands that this requirement is consistent with current practice. The new standard focuses on the auditor's responsibilities regarding events that warrant recognition in the auditor's report on the financial statements—changes in accounting

^{14/} Because SFAS No. 154 provides comprehensive, authoritative accounting guidance on changes in accounting principle and corrections of errors, Auditing Standard No. 6 omits the accounting guidance that was included in AU sec. 420.

principles and corrections of misstatements in previously issued financial statements.^{15/} The standard also clarifies that the auditor's report should indicate whether an adjustment to prior-period financial statements results from a change in accounting principle or the correction of a misstatement.

Materiality

There were several comments on materiality. Some commenters suggested that the standard should specifically state that the auditor need not recognize the correction of a misstatement that is immaterial to the previously issued financial statements. Another suggested that the standard should remind the auditor that professional judgment is required to evaluate consistency. Another commenter said that additional guidance on materiality as applied to individual matters in the financial statements would be helpful in applying the standard. Others suggested that clarity would be improved by inserting the word "material" in several places.

In general, the Board's view is that the purpose of the standard is to provide direction on evaluating consistency; for example, the accounting periods the auditor should evaluate, the recognition in the auditor's report of consistency matters prescribed by the accounting standards, and the related audit reporting requirements. Because an audit is predicated on the use of reasoned judgment and the consideration of materiality in planning, performing, and reporting on the

^{15/} AU sec. 420 also required recognition of those events. However, it only required recognition in the auditor's report of the correction of a misstatement involving an accounting principle. In addition, unlike AU sec. 420, the new standard does not describe the accounting changes that do not require recognition in the auditor's report.

audit, the Board does not believe it is necessary for this standard to specifically direct the auditor to exercise judgment and apply materiality. Further, materiality is a concept that is defined under the federal securities laws, and it is not the objective of this standard to alter or interpret that concept.

The Board did agree that clarity could be improved in some areas by inserting the word "material" to modify the word "misstatement." The Board added "material" to AU secs. 508.18A and B to be consistent with paragraph 4 of Auditing Standard No. 6. However, AU sec. 508.18C does not include "material" because that sentence summarizes the SFAS No. 154 requirement for correcting a misstatement, which does not directly mention materiality.

Periods Covered by the Evaluation of Consistency

The new standard describes the scope of the required evaluation of consistency in terms that are similar to the description in AU sec. 420. Under the new standard, when the auditor reports only on the current period, the auditor should evaluate whether the financial statements of the current period are consistent with those of the preceding period. When the auditor reports on two or more years, the auditor should evaluate whether the financial statements reported on are consistent with each other and with the prior year's financial statements, if presented. For example, assume that a company presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor

auditor reports, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented. In response to comments, the Board added this example to the final standard.

When a company uses retrospective application, as defined in SFAS No. 154, to account for a change in accounting principle, the financial statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous years' financial statements on which the auditor previously reported. For example, consider a company that adopts a new accounting standard in 2007 that requires retrospective application to 2006 and 2005. The financial statements for 2006 and 2005 will be consistent, as presented with 2007. However, the financial statements for the years 2006 and 2005 that were issued a year earlier will not reflect the retrospective application and hence will not be consistent with 2007 and will be different from the 2006 and 2005 financial statements that are presented with 2007. The new standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

Paragraph 3 of the proposed standard described the financial statement periods covered by the evaluation of consistency. The third sentence of that paragraph was intended to be a clarification of the requirement in AU sec. 420.22 regarding the evaluation of two or more years. However, some commenters

found the third sentence of paragraph 3 to be confusing and recommended retaining the language in AU sec. 420.22, unless the Board had intended to change the auditor's responsibilities for evaluating the consistency of GAAP. Because the Board wanted to be clear that the auditor's responsibilities had not changed, the Board decided to retain the original sentence from AU sec. 420.22, with some changes, instead of the proposed third sentence of paragraph 3. The inserted sentence, adapted from AU sec. 420.22, reads as follows (additions underlined and deletions struck through):

When the ~~independent~~ auditor reports on two or more periods ~~years~~, he or ~~she~~ should evaluate ~~address the consistency of the application of~~ ~~accounting principles~~ between such periods ~~years~~ and the consistency of such periods ~~years~~ with the period ~~year~~ prior thereto if such prior period ~~year~~ is presented with the financial statements being reported upon.

The Board did not include the reference to "the application of accounting principles" because paragraph 3 also relates to the auditor's evaluation of a company's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. The Board also used the word "evaluate" because it describes the auditor's responsibilities consistently with the rest of the paragraph.

Two commenters suggested that the last sentence of proposed paragraph 3, which described the auditor's responsibility to evaluate whether the financial statements are consistent with previously issued financial statements for the same period, was confusing and unnecessary. These commenters suggested

deleting the last sentence of paragraph 3. In addition, one commenter suggested that paragraph 3 of the proposed standard could be clarified by including the explanatory language from the proposing release regarding retrospective application under SFAS No. 154. As discussed above, the new standard is intended to clarify that the auditor's evaluation of consistency should include an evaluation of previously issued financial statements for the relevant periods. Accordingly, the Board believed that the final sentence of paragraph 3 is necessary. However, the Board agreed that including the suggested explanatory language from the proposing release regarding retrospective application would clarify the paragraph and has added that language as a footnote to paragraph 3.

Reference to Application of Accounting Principles

Consistent with the discussion above related to paragraph 3 of the proposed standard, the Board also removed the reference to "application of accounting principles" from the first paragraph of Auditing Standard No. 6. Because the auditor's evaluation of consistency under this standard includes errors not involving an accounting principle, the consistency evaluation is broader than that described under the second standard of reporting. Accordingly, the Board also removed the reference to the second standard of reporting from paragraph 2 of Auditing Standard No. 6.

Change in Accounting Principle

The new standard requires the auditor to evaluate a change in accounting principle^{16/} that has a material effect on the financial statements to determine whether: (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with GAAP, (3) the disclosures related to the accounting change are adequate, and (4) the company justifies that the alternative accounting principle is preferable,^{17/} as required by SFAS No. 154.^{18/} Under the amendments to AU sec. 508, if the four criteria are met,^{19/} the auditor would recognize the change in accounting principle in the auditor's report through the addition of an explanatory paragraph consisting of an identification of the nature of the change and a reference to the issuer's note disclosure describing the

^{16/} The proposed and final standards use the definition of a change in accounting principle found in SFAS No. 154, paragraph 2c.

^{17/} In certain circumstances, Securities and Exchange Commission ("SEC") rules require issuers to file a letter from the auditor indicating whether or not a change is to an alternative accounting principle that is preferable. See Rule 10-01(b)(6) of Regulation S-X, 17 C.F.R. § 210.10-01(b)(6).

^{18/} Under SFAS No. 154, the issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle as long as the change in accounting principle is made in accordance with the GAAP hierarchy. See SFAS No. 154, paragraph 14.

^{19/} The auditor has substantially the same responsibility for evaluating a change in accounting principle as under AU sec. 431, *Adequacy of Disclosure in Financial Statements*, and paragraph .50 of AU sec. 508, *Reports on Audited Financial Statements*. The language in Auditing Standard No. 6 has, however, been updated to be consistent with SFAS No. 154.

change. If those criteria are not met, the auditor would issue a qualified or adverse opinion.^{20/}

Some commenters recommended that the Board reconsider whether it was necessary for the auditor to recognize in the audit report changes that result when a company is required to adopt a newly issued accounting standard. They indicated that the significance of a company's discretionary change in accounting principle may be diluted if the auditor recognizes both discretionary changes and those changes in accounting principles required by a newly-issued standard in the report. Another commenter suggested that the auditor should not be required to include an explanatory paragraph in the audit report when changes in accounting principle have been applied retrospectively because, in such cases, the financial statements included in the filing will appear consistent. As noted above, the Board believes that it is important for investors to be informed when the prior year financial statements presented with the current year are different from previously issued financial statements. In addition, the Board believes that the different language in the auditor's report for discretionary changes and those required by a newly-issued standard provides sufficient notification to investors of the general nature of the change. Therefore, the Board adopted the requirement as proposed.^{21/}

^{20/} This responsibility is substantially unchanged from AU sec. 508.51.

^{21/} In addition, one commenter suggested that the standard include an example of a change in the method of applying an accounting principle. The final standard, like the proposed standard, notes that under SFAS No. 154 a change in the method of applying an accounting principle is also a change in accounting principle. While the Board believes that it is helpful for the standard to reference

One commenter suggested that the proposed standard deleted useful information about a change in accounting principle that also involves a change in an estimate. The proposed standard did not carry forward the requirement of AU sec. 420.13 that the auditor should recognize in his or her report a change in accounting principle that is inseparable from a change in estimate. After considering this comment, the Board concluded that the requirement in AU sec. 420.13 does result in useful information being included in the auditor's report. Accordingly, the Board updated the language in AU sec. 420 to reflect the term used in SFAS 154, and included the requirement in Auditing Standard No. 6.^{22/}

Some commenters asked the Board to clarify the reporting requirement related to a change in reporting entity. According to AU sec. 420.08, a change in reporting entity resulting from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit, does not require that the auditor include an explanatory paragraph in the auditor's report. Under the proposed standard, the auditor may have been required to report on, for example, the disposition of a subsidiary or business unit because SFAS No. 154 (and its predecessor, APB Opinion No. 20) did not specifically exempt such a transaction from the definition of a change in reporting entity. Generally, dispositions or spin-offs have specific disclosure requirements

the accounting requirement, it also believes that it is not appropriate for the auditing standard to provide accounting guidance.

^{22/} The new standard uses the term "change in accounting estimate effected by a change in accounting principle," which is defined in SFAS No. 154 as "a change in accounting estimate that is inseparable from the effect of a related change in accounting principle."

in the accounting standards and the Board did not intend to change practice and require the auditor to report on these events through an explanatory paragraph. Accordingly, the Board carried forward the requirement from AU sec. 420.08 regarding a transaction or event. In addition, the Board also added a reference to paragraph 2f in SFAS No. 154, which describes a change in reporting entity, as suggested by some commenters.

In response to comments, the Board also modified paragraph 8 of the proposed standard, which provided direction for reporting a change in accounting principle. Some commenters noted that the proposed conforming amendments to AU sec. 508.17 had a more clearly stated version of the number of years that the auditor is required to include an explanatory paragraph related to a change in principle than did footnote 5 to paragraph 8. After considering the commenters' recommendation that the language in the footnote be changed, the Board decided that the footnote was not necessary because paragraph 8 referred the auditor directly to the reporting requirements in AU sec. 508. The Board therefore removed footnote 5 from the final standard.

Correction of a Material Misstatement in Previously Issued Financial Statements

Under Auditing Standard No. 6, the correction of a material misstatement in previously issued financial statements (i.e., a "restatement") is recognized in the auditor's report through the addition of an explanatory paragraph. Under the conforming amendments to AU sec. 508, the explanatory paragraph in the auditor's report regarding a restatement should include (1) a statement that the previously issued financial statements have been restated for the correction of a

misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. The first statement in the explanatory paragraph distinguishes restatements from adjustments to prior-period financial statements resulting from changes in accounting principle. Previously, the auditor's responsibilities for reporting on most restatements were the same as for reporting on changes in accounting principle.

One commenter suggested that the proposed standard did not clearly explain whether corrections of an error not involving a principle would require recognition in the auditor's report. Unlike the previous requirement, the proposed standard did not distinguish between the "correction of an error in principle" and an "error correction not involving a principle."^{23/} Rather, the proposed standard required recognition in the auditor's report of any correction of a material misstatement, whether or not the error involved a principle. The Board reconsidered the language and concluded that the requirement as proposed was sufficiently clear. The new standard aligns the auditor's reporting responsibilities with the accounting standards, which require disclosure of all restatements, by requiring an explanatory paragraph when the company has restated the financial statements.

Some commenters suggested that it would not improve clarity to have the auditor's report include a statement that the financial statements were restated "to correct a material misstatement." They noted that SFAS No. 154 already

^{23/} This distinction previously was in paragraphs .12 and .16 of AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*.

defines a restatement as the revision of previously issued financial statements to reflect the correction of an error. The Board decided to retain the reporting requirement as proposed because it clearly distinguishes corrections of misstatements from changes in accounting principle. Also, the required reporting language regarding restatements is more informative because it does not rely entirely on the user's knowledge of the definition of "restatement" in the accounting standard.^{24/}

One commenter also recommended that the auditor's explanatory paragraph about the correction of a misstatement should contain additional information. The commenter recommended that the explanatory paragraph include a statement that (1) the previously issued auditor's report should not be relied on because the previously issued financial statements were materially misstated, and (2) the previously issued report is replaced by the auditor's report on the restated financial statements.

The Board believes that the recommended additional language is not necessary because existing PCAOB standards and rules of the Securities and Exchange Commission ("SEC") are sufficient to inform users about misstatements in previously issued financial statements. Specifically, AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, requires the auditor to take specific action when he or she concludes that

^{24/} Two commenters suggested that the standard include the explanation from the release that the term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards. The Board agreed and has included that explanation in the final standard.

information discovered after the financial statements have been issued would have affected his or her report if the company had not reflected the information in the financial statements and people are currently relying or are likely to rely on the financial statements and auditor's report. According to AU sec. 561.06, the auditor should advise the company to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report.^{25/}

A U.S. public company that is not a foreign private issuer under SEC rules also is required to file a Form 8-K current report, if it concludes that any previously issued financial statements should no longer be relied upon because of an error in such financial statements.^{26/} If the auditor has notified the issuer that action should be taken to prevent future reliance on a previously issued audit report, the company also must disclose that information in the Form 8-K.

^{25/} AU sec. 561.06 also requires that if the effect on the financial statements or auditor's report can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. If issuance of the financial statements with an auditor's report for a later period is imminent, a company is permitted to disclose the revision to the financial statements instead of reissuing earlier statements. When the effect on the financial statements cannot be determined without a prolonged investigation, appropriate disclosure would consist of notification that the financial statements and auditor's report should not be relied on and that revised financial statements and auditor's report will be issued upon completion of an investigation.

^{26/} See Securities Exchange Act Rule 13a-11, 17 C.F.R. § 240.13a-11.

Changes in Classification

Auditing Standard No. 6 does not require the auditor's report to recognize a change in classification^{27/} in previously issued financial statements, except for a reclassification that is also a change in accounting principle or correction of a material misstatement.^{28/} Accordingly, the new standard clarifies that the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change is also a change in accounting principle or a correction of a material misstatement. For example, in some circumstances, a change in financial statement classification also may be the correction of a misstatement. A restatement to correct the misclassification of an account as short- or long-term or misclassification of cash flows would be both a restatement and reclassification. Therefore, the auditor should evaluate these matters as part of the evaluation of corrections of misstatements. Under Auditing Standard No. 6, a classification change that is also a change in accounting principle should be reported on as a change in accounting principle, and a classification change that is also a correction of a material misstatement should be reported on by the auditor as a restatement.

^{27/} AU sec. 420.17 also did not require recognition of a change in financial statement classification in the auditor's report.

^{28/} SFAS No. 154 uses the term "presentation" in its definition of an error in previously issued financial statements. The directions in paragraph 11 of the new standard address the auditor's responsibilities for changes in classification, which is an element of the presentation and disclosure financial statement assertion under the auditing standards. See, e.g., paragraph .08 of AU sec. 326, *Evidential Matter*.

Some commenters recommended slight revisions to the first sentence of paragraph 11 to clarify the auditor's responsibilities. The first sentence stated that changes in classification in previously issued financial statements do not require recognition in the auditor's report. This seemed to conflict with the second sentence which required the auditor to review a material change in classification and related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. The Board agreed with the comments and modified the first sentence to state that a change in classification does not require audit report recognition unless the change represents the correction of a material misstatement or a change in accounting principle. Additionally, in the proposed standard, the Board used the word "review" to describe the auditor's responsibility when there has been a material change in financial statement classification. The Board concluded that the word "evaluate" better describes the auditor's responsibilities in this area and is more consistent with the other requirements in Auditing Standard No. 6. Accordingly, the Board replaced "review" with "evaluate."

Description of GAAP and Removal of the GAAP Hierarchy from the Auditing Standards

As discussed previously, the FASB has proposed to incorporate the GAAP hierarchy into its own standards. The Board believes that it is appropriate to locate the GAAP hierarchy in the accounting standards rather than in the auditing standards. Thus, the Board amended its interim standards to remove the GAAP hierarchy from the auditing standards. These amendments do not change the

principles in AU sec. 411 for evaluating fair presentation of the financial statements in conformity with GAAP.

Commenters strongly supported removing the GAAP hierarchy from the auditing standards and stated that it was appropriate for the GAAP hierarchy to be contained in the accounting standards. However, one commenter observed that the proposed amendments contain significant differences from the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") proposed amendment to AU sec. 411 of the ASB's standards.^{29/}

The Board believes that the amendments to AU sec. 411 are consistent with the Board's objective of removing the GAAP hierarchy from the auditing standards, and retaining, or providing, direction necessary for audits of public companies. The significant differences between the ASB's amendments to its AU sec. 411 and the Board's amendments primarily are related to sources of GAAP for governmental entities and direction on the application of accounting principles, which the Board did not believe was appropriate for inclusion in the proposed amendments. In addition, the Board deleted references to Rule 203 of the AICPA's *Code of Professional Conduct*. Rule 203 prohibits auditors from expressing an opinion on financial statements that do not conform to GAAP unless the auditor can demonstrate that due to unusual circumstances the

^{29/} In addition, this commenter suggested that U.S. auditing standard-setters should work together to achieve consistency on core auditing standards that are used by almost all auditors of U.S. entities. This commenter also suggested that if the Board continues issuing its own standards for audits of public companies, it should adopt alternative numbering/referencing schemes in order to reduce confusion between its interim standards and the AICPA standards. The Board is considering these comments as it seeks to make continuous improvements to its standard-setting and other programs.

financial statements would have been misleading without departing from GAAP. In 2003, when the Board adopted certain AICPA rules and ASB standards as interim Board standards, the Board did not adopt Rule 203. Consistent with that action, the proposed amendments did not include a reference to Rule 203.

Section-by-Section Description of Amendments to the Interim Auditing Standards

In addition to proposing an auditing standard on evaluating consistency of financial statements, the Board also proposed amendments to other interim auditing standards and related interpretations. The following sections describe key aspects and elements of the amendments to the standards and interpretations, comments received, and changes incorporated in the final amendments.

AU sec. 410, Adherence to Generally Accepted Accounting Principles

The Board proposed to delete AU sec. 410.02 which discussed the meaning of "generally accepted accounting principles" and included other matters that are addressed elsewhere in the standards. However, some commenters suggested that, to improve clarity, AU sec. 410 should retain the sentence in existing AU sec. 410.02 which states that the "first standard is construed not to require a statement of fact by the auditor but an opinion."

The Board agreed that, when viewed alone, the first standard of reporting, contained in AU sec. 410.01, does not provide a complete description of the auditor's responsibilities related to fair presentation in conformity with GAAP. However, the first standard of reporting combined with the fourth standard clearly indicates that the auditor is providing a statement of an opinion and not a

statement of fact. The fourth standard of reporting provides that the auditor's 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. To emphasize that the first and fourth reporting standards must be read together, the Board is including the fourth standard of reporting in the final amendment to AU sec. 410. However, as proposed, the prior statement on the meaning of "generally accepted accounting principles" has been deleted from AU sec. 410.02.

AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles

The Board proposed to delete AU sec. 411.02, which was a detailed description of GAAP, and AU secs. 411.05, .07 and .09-.15, which described the application of the GAAP hierarchy. The Board proposed to replace the description of GAAP in AU 411.02, with a statement that GAAP refers "to the accounting principles recognized in the standards of the Financial Accounting Standards Board or in the standards of any other standard-setting body recognized by the U.S. Securities and Exchange Commission."

However, commenters had concerns about the proposal. One commenter noted that the SEC might allow companies to file financial statement prepared in conformity with international financial reporting standards ("IFRS") but not recognize the International Accounting Standards Board, which issues IFRS, as a standard-setting body. Another commenter suggested that to avoid potential confusion by users, the Board should acknowledge that there are other sources of GAAP for entities other than public companies.

In response to these comments, the Board decided to modify its proposed amendment of AU 411. It deleted AU sec. 411.02, which described GAAP, and revised AU sec. 411.01 to indicate that the auditor should look to the requirements of the SEC for the company under audit to identify the accounting principles that are applicable to that company. This change should also clarify that the standard is focused only on the accounting principles that may be used for purposes of the federal securities laws. Other accounting principles may apply to financial statements prepared for other purposes or by entities that are not issuers. The Board also modified AU 411.01 to better emphasize that standard's focus on the meaning of the phrase "present fairly."

Finally, as proposed, the Board eliminated AU secs. 411.16 and .17 which set an effective date and transition requirements that are no longer applicable.

AU sec. 420, Consistency of Application of Generally Accepted Accounting Principles

AU sec. 420 has been superseded by Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*. However, some commenters suggested that parts of AU sec. 420 should have been incorporated into Auditing Standard No. 6. Commenters suggested that guidance on the objective of the consistency standard and the relationship of consistency and comparability, matters that may not affect consistency, and changes expected to have a material future effect provided useful direction.

The Board believes that it is unnecessary to include the preceding direction. The proposed standard clarified that the auditor's report should recognize only those matters that require recognition under the existing auditing

standards—i.e., a change in accounting principle or the correction of a material misstatement. The Board does not believe it is necessary to list in a standard those matters that do not require recognition in the auditor's report. Also, the Board believes that paragraph 1 clearly describes the objective of the standard. Paragraph 2 makes it clear that the standard considers comparability to be between periods for the company under audit.

AU sec. 431, Adequacy of Disclosure in Financial Statements

AU sec. 431 describes the auditor's responsibilities for evaluating the adequacy of disclosures in the financial statements. The amendments address two technical matters relating to that section.

Footnote 1 to AU sec. 431.03 is not consistent with the SEC's independence rules regarding non-audit services and therefore has been eliminated.

AU sec. 431.04 is an application of the AICPA's *Code of Professional Conduct* regarding the disclosure of confidential client information. In 2003, when the Board adopted certain AICPA rules and ASB standards as interim Board standards, the Board did not adopt Rule 301. Consistent with that action, the proposed amendments would eliminate AU sec. 431.04.

Some commenters expressed concerns that the proposed elimination of AU sec. 431.04 would change the auditor's obligations, or reflected Board policy, regarding the use of confidential client information in connection with evaluating the adequacy of financial statement disclosures. Those commenters generally recognized the limited nature of AU sec. 431.04 and acknowledged that, since in

2003 the Board did not adopt Rule 301, removing a portion of the interim standards based on that rule was a conforming amendment. However, they were concerned that the Board's action might be construed as minimizing the auditor's responsibilities for maintaining the confidentiality of client information.

The Board is aware that many auditors have legal or professional obligations to maintain the confidentiality of client information. These requirements arise from the rules of state licensing authorities,^{30/} the rules of professional organizations such as the AICPA and the International Federation of Accountants, and the laws of some foreign jurisdictions. The Board's decision to omit Rule 301 from its interim standards was based on a determination that incorporation of that rule was not necessary to fulfill the Board's mandate under Section 103(a)(1) and (3) of the Sarbanes-Oxley Act. It did not reflect a decision that auditor confidentiality requirements imposed by other authorities were inappropriate. Similarly, in amending AU sec. 431, the Board seeks neither to modify nor to detract from existing confidentiality requirements.

^{30/} For example, confidentiality requirements are included in the provisions of the Uniform Accountancy Act, which has been enacted in some form by many states.

Interpretations of the Auditing Standards in AU 400 Sections

The auditing interpretation in AU sec. 9420.52-.54 has been incorporated into Auditing Standard No. 6 and therefore has been eliminated, as proposed.

The auditing interpretations in AU sec. 9411 and the remaining auditing interpretations in AU sec. 9420 are addressed by the accounting standards and therefore also have been eliminated as proposed.^{31/}

AU sec. 508, Reports on Audited Financial Statements

In general, the Board has adopted the amendments as proposed. The amendments have conformed this interim auditing standard to Auditing Standard No. 6 on evaluating consistency and the amendments to AU secs. 410 and 411, described above. For example, AU sec. 508.16 now specifically identifies the matters related to consistency of the company's financial statements that should be recognized in the auditor's report. Similarly, AU sec. 508.17A provides the requirements for evaluating consistency, that also is in paragraph 7 of Auditing Standard No. 6. AU secs. 508.17B and C, and AU sec. 508.18A provide separate requirements for reporting on changes in accounting principles and restatements, as discussed previously.

^{31/} One commenter suggested that some of the auditing interpretations should be retained because the guidance is still relevant. The Board considered the view of this commenter but decided to eliminate the interpretations because other auditing standards provided the necessary direction regarding the matter addressed in the interpretation, the interpretation dealt with items not requiring recognition in the auditor's report, or the interpretation was related to an accounting consideration of the company.

In addition, the amendments eliminate AU sec. 508.14-.15. Those paragraphs were an application of AICPA Ethics Rule 203, which, as previously noted, was not adopted as an interim standard by the Board.^{32/}

Finally, in light of the definitions in SFAS No. 154, the amendments change references to "restatements" to the more general term "adjustments" to refer broadly to changes to previously issued financial statements that may result from either a correction of a misstatement or a change in accounting principle.^{33/}

References to APB Opinion No. 20

In addition, the Board has adopted other amendments to update references to APB Opinion No. 20, which was superseded by SFAS No. 154.

^{32/} One commenter expressed concern about deleting these paragraphs and suggested that, if the Board's intent was to delete all reference to the AICPA Code of Professional Conduct from the Board's interim standards, the Board should indicate the professional ethics that auditors should follow when conducting audits according to PCAOB standards. The Board's Rules 3500T and 3600T describe the Board's interim ethics and independence standards, respectively. These standards include certain provisions from the AICPA's Code of Professional Conduct. In addition, the Board has adopted ethics and independence rules concerning independence, tax services, and contingent fees. See PCAOB Release No. 2005-014 (July 26, 2005). State law and membership organizations may impose additional requirements.

^{33/} Some commenters suggested that certain other changes were needed to AU sec. 508 or that certain amendments were not necessary. For example, some commenters suggested eliminating AU sec. 508.57 and retaining the original terminology in AU secs. 508.73 - .74. The Board decided that some of the suggested changes would change existing practice, such as the elimination of AU sec. 508.57, and were outside the scope of this project. For the others, the Board concluded that the amendments were consistent with the direction in Auditing Standard No. 6. In addition, one commenter believed that there were inconsistencies between the proposed amendments to AU sec. 508 and Staff Questions and Answers, *Adjustments to Prior-Period Financial Statements Audited By a Predecessor Auditor*. However, the Board reviewed the Staff Questions and Answers and did not agree that there were inconsistencies with the proposed amendments to AU sec. 508.

Accordingly the Board amended AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, footnote 3 to paragraph .06, to reference paragraphs 25 and 26 of SFAS No. 154. For AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, footnote 4 to paragraph .19, the Board referenced paragraph 20 of SFAS No. 157, *Fair Value Measurements*, which states that a change in valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. This replaces a reference to the preferability requirement in SFAS No. 157 because that requirement does not apply to a change in a company's method for determining fair value. Paragraph 20 is the accounting guidance applicable to a company's change in method for determining fair value.

Effective Date

The standard and amendments will be effective 60 days after approval by the SEC.

III. Date of Effectiveness of the Proposed Rule and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents, the Commission will:

- (a) by order approve such proposed rule; or

(b) institute proceedings to determine whether the proposed rule should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule is consistent with the requirements of Title I of the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All submissions should refer to File No. PCAOB-2008-01 and should be submitted within [] days.

By the Commission.

Secretary



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PROPOSED AUDITING STANDARD—)	
EVALUATING CONSISTENCY OF FINANCIAL STATEMENTS)	PCAOB Release No. 2007-003
AND PROPOSED AMENDMENTS TO INTERIM AUDITING STANDARDS)	April 3, 2007
)	PCAOB Rulemaking
)	Docket Matter No. 023
)	
)	
)	
)	

Summary: The Public Company Accounting Oversight Board (the "Board" or "PCAOB") is proposing changes to its auditing standards in light of the Financial Accounting Standards Board's issuance of Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, and Proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*. The Board's proposals would, if adopted and approved by the Securities and Exchange Commission, supersede AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, with a new auditing standard, *Evaluating Consistency of Financial Statements*; remove the hierarchy of generally accepted accounting principles ("GAAP hierarchy") from the interim auditing standards; and make conforming amendments to the interim auditing standards. Appendices 1 and 2 contain the text of the proposed auditing standard and proposed amendments to the interim auditing standards, respectively.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may 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. 023 in the subject or reference line and should be received by the Board no later than 5:00 p.m. EDT on May 18, 2007.



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Board

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A. Introduction

Two actions of the Financial Accounting Standards Board ("FASB") have prompted the Board to propose certain changes to its auditing standards. In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*,^{1/} which superseded Accounting Principles Board Opinion No. 20, *Accounting Changes*.^{2/} The FASB has also issued an exposure draft of a proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*.^{3/}

FASB Statement 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle. FASB Statement 154 also redefines the term "restatement" to refer only to "the process of revising previously issued financial statements to reflect the correction of an error in those financial statements."^{4/} Under FASB Statement 154, therefore, the term "restatement" does not refer to changes made to previously issued financial statements to reflect a change in accounting principle.

^{1/} Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* (2005) ("FASB Statement 154").

^{2/} Accounting Principles Board Opinion No. 20, *Accounting Changes* (1971) ("APB Opinion 20").

^{3/} FASB, Proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*, Exposure Draft (April 2005).

^{4/} See FASB Statement 154, paragraph 2.



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AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, the Board's interim standard on the auditor's responsibilities for evaluating the consistency of the application of generally accepted accounting principles ("GAAP"), generally reflects the provisions of APB Opinion 20, which was superseded by FASB Statement 154. To better align the Board's standards with the new accounting standard, the Board is proposing a new auditing standard on evaluating consistency, which would supersede AU sec. 420, and conforming amendments to AU sec. 508, *Reports on Audited Financial Statements*, of its interim auditing standards.

The FASB's proposed Statement of Financial Accounting Standards on the GAAP hierarchy would incorporate that hierarchy into the accounting standards. Currently, a description of the GAAP hierarchy resides only in the auditing standards.^{5/} Because the GAAP hierarchy identifies the sources of accounting principles and the framework for selecting principles to be used in preparing financial statements, the Board agrees that these requirements are more appropriately located in the accounting standards. Accordingly, the Board is proposing to remove the GAAP hierarchy from the auditing standards.^{6/}

The proposed new auditing standard and amendments are intended to update and clarify the auditing standards in light of FASB Statement 154 and the FASB's proposal on the GAAP hierarchy. As described below, these updates and clarifications should also enhance the clarity of auditor reporting on accounting changes and corrections of misstatements^{7/} by distinguishing between these events. The proposals

^{5/} See AU sec. 411, *The Meaning of "Present Fairly in Conformity with GAAP."*

^{6/} If the proposal is adopted by the Board and approved by the SEC, the Board will coordinate the effective date for the removal of the GAAP hierarchy from the auditing standards with the effective date of FASB's inclusion of the hierarchy in the accounting standards.

^{7/} FASB Statement 154 uses the term "error" instead of "misstatement." This release, including the proposed standard and amendments, uses "misstatement," the prevailing term used in PCAOB auditing standards. The term "error," as used in FASB Statement 154, is equivalent to "misstatement," as used in the auditing standards.



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are not, however, intended to fundamentally change the auditor's existing responsibilities.

The Board requests comment on all aspects of these proposals.

B. Evaluating Consistency

The proposed new standard on evaluating consistency would retain the basic principles of AU sec. 420 of the interim standards. Under the proposed standard, auditors would still be required to evaluate the consistency of the issuer's application of GAAP and report on inconsistencies. The proposed standard would update these requirements and align them more closely with FASB Statement 154 by omitting accounting guidance that is currently included in AU sec. 420; requiring the auditor's report to recognize the issuer's correction of a material misstatement, regardless of whether it involves the application of an accounting principle; and clarifying that the auditor's report should indicate whether an adjustment to prior-period financial statements results from a change in accounting principle or the correction of a misstatement.

FASB Statement 154 provides comprehensive, authoritative accounting guidance on changes in accounting principle. Therefore, the Board's proposed standard omits unnecessary accounting guidance and, instead, focuses on the auditor's responsibilities regarding those events that warrant recognition in the auditor's report on the financial statements. Under the proposed standard and the interim auditing standards, those events are changes in accounting principles and corrections of misstatements in previously issued financial statements.^{8/} Unlike AU sec. 420, the proposed standard does not describe the accounting changes that do not require recognition in the auditor's report (e.g., changes in accounting estimates).

The proposed standard describes the scope of the required evaluation of consistency in terms that are similar to the description in AU sec. 420. Under the proposed standard, when the auditor reports only on the current period, the auditor

^{8/} As discussed in Section B.2., however, under the interim standards, only the correction of a misstatement involving an accounting principle requires recognition in the auditor's report.



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would evaluate whether the financial statements of the current period are consistent with those of the preceding period. When the auditor reports on two or more years, the auditor would evaluate whether the financial statements reported on are consistent with each other and with the prior year's financial statements, if presented. For example, assume that an issuer presents comparative financial statements covering three years and has a change in auditors. In the first year following the change in auditors, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year following the change in auditors, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented.

When a company uses retrospective application, as defined in FASB Statement 154, to account for a change in accounting principle, the financial statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous years' financial statements on which the auditor previously reported. The proposed standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

1. Change in Accounting Principle

A change in accounting principle is a change from one generally accepted accounting principle to another generally accepted accounting principle when –

- a. there are two or more generally accepted accounting principles that apply, or
- b. the accounting principle formerly used is no longer generally accepted.^{9/}

The proposed standard would require the auditor to evaluate a change in accounting principle that has a material effect on the financial statements to determine whether: (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with GAAP, (3) the disclosures related to the accounting change are adequate, and (4) the

^{9/} See FASB Statement 154, paragraph 2.



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company justifies that the alternative accounting principle is preferable,^{10/} as required by FASB Statement 154.^{11/} These are substantially the same requirements as those currently set forth in the interim standards.^{12/} The language has, however, been updated to be consistent with FASB Statement 154.

The auditor's reporting requirements when there has been a change in accounting principle with a material effect on the financial statements would remain substantially unchanged under the proposed standard. Under the proposed amendments to AU sec. 508 of the interim standards, if the four criteria in the preceding paragraph are met, the auditor would continue to recognize the change in accounting principle in the auditor's report through the addition of an explanatory paragraph consisting of an identification of the nature of the change and a reference to the issuer's note disclosure describing the change. If those criteria are not met, the auditor would issue a qualified or adverse opinion.

2. Correction of a Material Misstatement in Previously Issued Financial Statements

Under the proposed auditing standard, the correction of a material misstatement in previously issued financial statements (i.e., a "restatement") would be recognized in the auditor's report through the addition of an explanatory paragraph. Currently, the

^{10/} In certain circumstances, SEC rules require issuers to file a letter from the auditor indicating whether or not a change is to an alternative accounting principle that is preferable. Rule 10-01(b)(6) of Regulation S-X, 17 C.F.R. § 210.10-01(b)(6). The auditor may be requested to provide such a letter.

^{11/} Under FASB Statement 154, the issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle as long as the change in accounting principle is made in accordance with the GAAP hierarchy. See FASB Statement 154, paragraph 14.

^{12/} See AU sec. 431, *Adequacy of Disclosure in Financial Statements*, and paragraph .50 of AU sec. 508, *Reports on Audited Financial Statements*.



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auditor's responsibilities for reporting on most restatements are the same as for reporting on changes in accounting principle. In both cases, as described above, the interim standards indicate that the auditor's report should contain an explanatory paragraph that includes identification of the nature of the change and a reference to the note in the financial statements describing the change.^{13/}

FASB Statement 154 establishes terminology and disclosure requirements that apply when an issuer corrects a material misstatement in previously issued financial statements. This further distinguishes restatements, on the one hand, from adjustments to prior-period financial statements resulting from changes in accounting principle, on the other. In light of FASB Statement 154, the Board is proposing to clarify auditor reporting by providing separate directions for reporting on restatements.

Under the proposed amendments to AU sec. 508, the explanatory paragraph in the auditor's report regarding a restatement should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. The proposed requirement to state that the previously issued financial statements have been restated for the correction of a misstatement is intended to clarify the existing requirement in AU sec. 508.16 to "identify the nature of the change."^{14/}

Unlike the existing requirements in the interim standards, the proposed auditing standard would not distinguish between the "correction of an error in principle" and an "error correction not involving a principle."^{15/} Under the interim standards, a restatement involving an accounting principle or its application should be recognized in the auditor's report. Recognition in the auditor's report is not required, however, for "mathematical mistakes, oversight, or misuse of facts" that do not involve accounting principles or their

^{13/} See AU sec. 508.16.

^{14/} The proposed standard would not change the auditor's existing responsibilities, described in AU sec. 431 and AU sec. 508, when the issuer's disclosure regarding a restatement is inadequate.

^{15/} See paragraphs .12 and .16 of AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*.



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application.^{16/} The proposed standard would align the auditor's reporting responsibilities with the disclosure requirements in the accounting standards, which require disclosure of all restatements, by requiring an explanatory paragraph regardless of whether the material misstatement corrected involved an accounting principle or its application.

3. Changes in Classification

The proposed standard would not require the auditor's report to recognize a change in classification^{17/} in previously issued financial statements, except for a reclassification that is also a change in accounting principle or correction of a material misstatement.^{18/} The proposed auditing standard clarifies that the auditor should review a material change in financial statement classification and the related disclosure to determine whether such a change is also a change in accounting principle or a correction of a material misstatement. For example, in some circumstances, a change in financial statement classification also may be the correction of a misstatement. A restatement to correct the misclassification of an account as short- or long-term or misclassification of cash flows would be both a restatement and reclassification. The auditor currently evaluates these matters as part of the evaluation of corrections of misstatements.^{19/} Under the proposed standard, a classification change that is also a change in accounting principle would be reported on as a change in accounting principle, and a classification change that is also a correction of a material misstatement would be reported on by the auditor as a restatement.

^{16/} See AU sec. 420.16.

^{17/} The interim auditing standards also do not require recognition of a change in financial statement classification in the auditor's report.

^{18/} FASB Statement 154 uses the term "presentation" in its definition of an error in previously issued financial statements. The directions in paragraph 11 of the proposed standard address the auditor's responsibilities for changes in classification, which is an element of the presentation and disclosure financial statement assertion under the auditing standards. See, e.g., paragraph .08 of AU sec. 326, *Evidential Matter*.

^{19/} See, e.g., AU sec. 420.12.



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Questions

1. Does the proposed auditing standard appropriately describe how the auditor should evaluate the consistency of the application of GAAP? Do the proposed auditing standard and amendments provide sufficient direction regarding the evaluation of changes to previously issued financial statements resulting from retrospective application of changes in accounting principle and corrections of misstatements?
2. Does the proposed auditing standard appropriately reflect the changes to the accounting requirements made by FASB Statement 154?
3. Would the proposed reporting language for auditor's reports on restated financial statements, i.e., requiring a statement that the financial statements have been restated to correct a misstatement, improve the clarity of auditor reporting?
4. Would the proposal to apply the auditor reporting requirements to all restatements, including those not involving an accounting principle, improve auditor reporting?

C. Description of GAAP and Removal of the GAAP Hierarchy from the Auditing Standards

As discussed previously, the FASB has proposed to incorporate the GAAP hierarchy, currently found in AU sec. 411, into its own standards. The Board believes that it is appropriate to locate the GAAP hierarchy in the accounting standards rather than in the auditing standards. Thus, the Board is proposing amendments to its interim standards that would remove the GAAP hierarchy from the auditing standards. These proposed amendments would not change the principles in AU sec. 411 for evaluating fair presentation of the financial statements in conformity with GAAP.

Questions

5. Is it appropriate to remove the GAAP hierarchy from the auditing standards if it is included in the accounting standards?



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6. Do the proposed amendments to AU secs. 410 and 411 appropriately reflect the proposed FASB statement on the GAAP hierarchy?

D. Section-by-Section Description of Proposed Amendments to the Interim Auditing Standards

The preceding sections of this release discuss the objectives and key elements of the proposed auditing standard and amendments to the interim standards. This section describes the nature of the proposed amendments to the interim auditing standards and related interpretations.

AU sec. 410, Adherence to Generally Accepted Accounting Principles

The proposed amendments would eliminate AU sec. 410.02, which contains a comment on the meaning of "generally accepted accounting principles" and includes other matters that are addressed elsewhere in the interim standards.

AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles

AU sec. 411.02 presents a detailed description of GAAP, and AU secs. 411.05, .07 and .09-.15 describe the application of the GAAP hierarchy. The proposed amendments would replace the definition of GAAP with a more general description that refers to the role of FASB in establishing accounting principles for public companies and eliminate the paragraphs in the standard that explain the application of the GAAP hierarchy. The proposed amendments would also eliminate AU secs. 411.16 and .17 which set an effective date and transition requirements that are no longer applicable.

AU sec. 420, Consistency of Application of Generally Accepted Accounting Principles

AU sec. 420 would be superseded by the proposed new auditing standard on evaluating consistency of financial statements.



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AU sec. 431, Adequacy of Disclosure in Financial Statements

AU sec. 431 describes the auditor's responsibilities for evaluating the adequacy of disclosures in the financial statements. The proposed amendments address two technical matters relating to that section.

Footnote 1 to AU sec. 431.03 is not consistent with the SEC's independence rules regarding non-audit services and would therefore be eliminated.

AU sec. 431.04 is an application of AICPA Ethics Rule 301 regarding the disclosure of confidential client information. In adopting certain interim standards and rules as of April 16, 2003, the Board did not adopt Rule 301 of the AICPA's *Code of Professional Conduct*. The proposed amendments would therefore eliminate AU sec. 431.04.

Interpretations of the Auditing Standards in AU 400 sections

The auditing interpretation in AU sec. 9420.52-.54 would be incorporated into the proposed auditing standard and therefore would be eliminated. The auditing interpretations in AU sec. 9411 and the remaining auditing interpretations in AU sec. 9420 are addressed by the accounting standards and would therefore be eliminated.

AU sec. 508, Reports on Audited Financial Statements

The proposed amendments would conform this interim auditing standard to the proposed new auditing standard on evaluating consistency and the amendments to AU secs. 410 and 411, described above. For example, these conforming amendments would provide separate requirements for reporting on restatements and changes in accounting principles, as discussed previously.

In addition, the proposed amendments would eliminate AU sec. 508.14-.15. Those paragraphs are an application of AICPA Ethics Rule 203, which was not adopted as an interim standard by the Board.

Finally, in light of the definitions in FASB Statement 154, the proposed amendments change references to "restatements" to the more general term "adjustments" to refer broadly to changes to previously issued financial statements that



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may result from either a correction of a misstatement or a change in accounting principle.

E. Opportunity for Public Comment

The Board will seek comment on the proposed standard and amendments for a 45-day period. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, DC 20006-2803. Comments also may 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. 023 on the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on May 18, 2007.

* * *

On the 3rd day of April, in the year 2007, 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
Secretary

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APPENDICES –

1. *Proposed Auditing Standard – Evaluating Consistency of Financial Statements*
2. *Proposed Amendments to Interim Auditing Standards*



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APPENDIX 1 – PROPOSED AUDITING STANDARD – EVALUATING CONSISTENCY OF FINANCIAL STATEMENTS

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard—

EVALUATING CONSISTENCY OF FINANCIAL STATEMENTS





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Auditing Standard No. X Supersedes AU secs. 420 and 9420

Evaluating Consistency of Financial Statements

Consistency and the Auditor's Report on Financial Statements

1. This standard establishes requirements and provides direction for the auditor's evaluation of the consistency of the application of generally accepted accounting principles in the financial statements, including changes to previously issued financial statements, and the effect of that evaluation on the auditor's report on the financial statements.

2. Paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*, states that the auditor's report on the financial statements "shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period." To identify consistency matters that might affect the report, the auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles or by material adjustments to previously issued financial statements for the relevant periods.

3. The periods covered in the auditor's evaluation of consistency depend on the periods covered by the auditor's report on the financial statements. When the auditor reports only on the current period, he or she should evaluate whether the current-period financial statements are consistent with those of the preceding period. When the auditor reports on two or more years, he or she should evaluate whether the financial statements reported on are consistent (1) with each other and (2) with the prior year's financial statements, if presented with the financial statements reported on. The auditor also should evaluate whether the financial statements for periods described in this paragraph are consistent with previously issued financial statements for the respective periods.

Note: The term "current period" means the most recent year, or period of less than one year, upon which the auditor is reporting.

4. The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:



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- a. A change in accounting principle
- b. An adjustment to correct a misstatement in previously issued financial statements.

Change in Accounting Principle

5. A change in accounting principle is a change from one generally accepted accounting principle to another generally accepted accounting principle when –
 - a. there are two or more generally accepted accounting principles that apply, or
 - b. the accounting principle formerly used is no longer generally accepted.^{1/}
6. A change in the method of applying an accounting principle is also a change in accounting principle.^{2/} In addition, the auditor should report on a change in the reporting entity as if it were a change in accounting principle.

Note: A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of a misstatement.

7. The auditor should evaluate a change in accounting principle to determine whether –
 - a. the newly adopted accounting principle is a generally accepted accounting principle,
 - b. the method of accounting for the effect of the change is in conformity with generally accepted accounting principles,

^{1/} See Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("FASB Statement 154").

^{2/} See FASB Statement 154, paragraph 2c.



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- c. the disclosures related to the accounting change are adequate,^{3/} and
- d. the company has justified that the alternative accounting principle is preferable.^{4/}

8. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph 7 have been met, the auditor should add an explanatory paragraph to the auditor's report, as described in AU sec. 508, *Reports on Audited Financial Statements*.^{5/} If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and address the matter as described in AU sec. 508.

Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph (following the opinion paragraph) to the auditor's report, as described in AU sec. 508.

^{3/} Newly issued accounting pronouncements usually set forth the method of accounting for the effects of a change in accounting principle and the related disclosures. FASB Statement 154 sets forth the method of accounting for the change and the related disclosures when there are no specific requirements in the new accounting pronouncement.

^{4/} The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See FASB Statement 154, paragraph 14.

^{5/} The explanatory paragraph should be included in the auditor's report even if the change in accounting principle is applied to the financial statements for all periods presented.



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Correction of a Material Misstatement in Previously Issued Financial Statements

9. The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as described in AU sec. 508.

10. The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in AU sec. 431, *Adequacy of Disclosure in Financial Statements*, and AU sec. 508.

Change in Classification

11. Changes in classification in previously issued financial statements do not require recognition in the auditor's report. However, the auditor should review a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs 7-8 and AU sec. 508. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraph 9 and AU sec. 508.



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APPENDIX 2 – PROPOSED AMENDMENTS TO INTERIM AUDITING STANDARDS

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

PROPOSED AMENDMENTS TO INTERIM AUDITING STANDARDS





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Proposed Amendments to PCAOB Auditing Standards

The following proposed amendments relate to the standards and auditing interpretations comprising the AU 400s sections and AU sec. 508 of the Board's interim auditing standards.

Auditing Standards

AU sec. 410, "Adherence to Generally Accepted Accounting Principles"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," AU sec. 410, "Adherence to Generally Accepted Accounting Principles," as amended by SAS No. 62, "Special Reports" (AU sec. 410, "Adherence to Generally Accepted Accounting Principles") is amended as follows:

- a. Paragraph .02 is deleted, and the reference to footnote 1 is moved to the end of paragraph .01.

AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"

Statement on Auditing Standards ("SAS") No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles," as amended by SAS No. 91, "Federal GAAP Hierarchy," and SAS No. 93, "Omnibus Statement on Auditing Standards – 2000" (AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles") is amended as follows:

- a. Paragraph .02 is replaced with the following paragraph text:

Generally accepted accounting principles refer to the accounting principles recognized in the standards of the Financial Accounting Standards Board or in the standards of any other standard-setting body recognized by the U.S. Securities and Exchange Commission.



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- b. Paragraph .05, .07, and .09-.18 are deleted.

AU sec. 9411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles, Auditing Interpretations of Section 411"

Auditing Interpretation No. 3, "The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events" of the auditing interpretations of AU sec. 411 (AU sec. 9411.11-.15) is deleted.

AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles," and AU sec. 9420, "Consistency of Application of Generally Accepted Accounting Principles, Auditing Interpretations of Section 420"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles," as amended by SAS No. 43, "Omnibus Statement on Auditing Standards," and SAS No. 88, "Service Organizations and Reporting on Consistency" (AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles") and the related auditing interpretations (AU sec. 9420) are superseded by PCAOB Proposed Auditing Standard, *Evaluating Consistency of Financial Statements*.

AU sec. 431, "Adequacy of Disclosure in Financial Statements"

Statement on Auditing Standards ("SAS") No. 32, "Adequacy of Disclosure in Financial Statements" (AU sec. 431, "Adequacy of Disclosure in Financial Statements,") is amended as follows:

- a. Footnote 1 is deleted.
- b. Paragraph .04 is deleted.

AU sec. 508, "Reports on Audited Financial Statements"

Statement on Auditing Standards ("SAS") No. 58, "Reports on Audited Financial Statements," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990," SAS No. 79, "Amendment to Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements*," SAS No. 85, "Management Representations," SAS No. 93, "Omnibus Statement on Auditing



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Standards – 2000," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 508, "Reports on Audited Financial Statements,") is amended as follows:

- a. In Paragraph .03, footnote 2 is deleted.
- b. In Paragraph .11, item 11b is deleted; item .11c is reordered as .11b; .11d is reordered as .11c; the paragraph references in .11c (formerly .11d) to paragraphs .16 through .18 are replaced with paragraph references .17A through .17E; and a new item 11d is added as follows:

"A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C)."

- c. Paragraphs .14-.15 are deleted, along with the preceding heading "Departure From a Promulgated Accounting Principle," and the note following the paragraph.
- d. The text of paragraph .16 is replaced with the following:

The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:

- a. A change in accounting principle
- b. An adjustment to correct a misstatement in previously issued financial statements
- e. Paragraphs .17-.18 and related footnotes 12 and 13 are replaced with the following:

Change in Accounting Principle

.17A As discussed in PCAOB Proposed Auditing Standard, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting



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principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.^{12/} A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.

^{12/} The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See FASB Statement 154, paragraph 14.

.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the issuance of a new accounting pronouncement:

As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to issuance of [*name of accounting pronouncement*].

.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change resulting from the issuance of a new accounting pronouncement.

As discussed in Note X to the financial statements, management has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].

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.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

.17E If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.

Correction of a Material Misstatement in Previously Issued Financial Statements

.18A Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.^{13/} The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a misstatement in previously issued financial statements.

As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

^{13/} The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

.18B This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior

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misstatement. The paragraph need not be repeated in subsequent years.

.18C The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41 and in AU sec. 431.

- f. Paragraph .50 is deleted.
- g. The text of paragraph .51 is replaced with the following:

Departures from generally accepted accounting principles related to changes in accounting principle. Paragraph .17A states the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

- h. In paragraph .52:
 - The text of the paragraph preceding the report is replaced with the following:

The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

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- In the second sentence of the first paragraph of the example report, the phrase "for making this change" is replaced with the phrase "that this accounting principle is preferable."

In the text of footnote 17, the first paragraph is deleted; the word, "However" is deleted at the beginning of the second paragraph.; the word "because" at the beginning of the sentence is capitalized; the phrase "the middle paragraph" is replaced with "this paragraph;" and the references to paragraphs ".16 through .18" are replaced with references to paragraphs "17A through 17E."

- i. The text of paragraph .57 is replaced with the following:

If the auditor issues a qualified or adverse opinion because the company has not justified that an allowable accounting principle adopted in an accounting change is preferable, as described in paragraph .52, the auditor should continue to express that opinion on the financial statements for the year of change as long as those financial statements are presented and reported on. However, the auditor's qualified or adverse opinion relates only to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing a qualified or adverse opinion for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express a qualified or adverse opinion on the use of the newly adopted principle in subsequent periods.

- j. In the text of footnote 19 to paragraph .59, "(b)" is added to the beginning of the list of subsections.
- k. The first sentence of footnote 20 to paragraph .62 is deleted.
- l. In the second sentence of footnote 25 to paragraph .67, replace the phrase "section 420, *Consistency of Application of Generally Accepted Accounting Principles*," with the phrase "PCAOB Proposed Auditing Standard, *Evaluating Consistency of Financial Statements*"
- m. In the second sentence of paragraph .69:

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- Item (c) is inserted as follows:

(c) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period,
 - Item (c) is changed to (d)
 - Item (e) is inserted as follows:

(e) if applicable, a reference to the company's disclosure of the correction of the misstatement,
 - Item (d) is changed to (f) and the words "the fact" are inserted at the beginning of the item
- n. In the third sentence of paragraph .73, the word "restated" is replaced with the word "adjusted."
- o. In paragraph .74:
- In the first sentence of the third text paragraph, the word "restated" is replaced with the word "adjusted," and the word "restatement" is replaced with the words "the adjustments."
 - In the second sentence of the third text paragraph, the word "restatement" is deleted, and the word "his" is replaced with the words "the auditor's."

**Exhibit 2(a)(B)****Alphabetical List of Comments**

BDO Seidman, LLP

CalPERS, Russell Read, Chief Investment Officer

Center for Audit Quality, Cynthia M. Forneli, Executive Director

Crowe Chizek and Company LLC

Deloitte & Touche LLP

Ernst & Young LLP

Grant Thornton LLP

KPMG LLP

New York State Society of CPAs, Thomas E. Riley, President

PricewaterhouseCoopers LLP

U.S. Government Accountability Office, David M. Walker, Comptroller General of the United States



May 18, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 023, Proposed Auditing Standard -
*Evaluating Consistency of Financial Statements and Proposed Amendments to
Interim Auditing Standards***

Dear Members and Staff of the Public Company Accounting Oversight Board:

BDO Seidman, LLP appreciates this opportunity to comment on the Public Company Accounting Oversight Board's proposed standard on *Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards*. We recognize the importance of aligning the Board's auditing standards with the pronouncements of other standard setters, specifically the Financial Accounting Standards Board's ("FASB") issuance of Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("FASB Statement 154") and issuance of an exposure draft of a proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*. As such, we have included responses to the specific questions posed in the PCAOB Release No. 2007-003 dated April 3, 2007 and have also included additional commentary on other related matters, at the end of this letter, for your consideration.

1. Does the proposed auditing standard appropriately describe how the auditor should evaluate the consistency of the application of GAAP?

Generally, we believe that the proposed auditing standard appropriately describes how the auditor should evaluate the consistency of the application of GAAP. However, we have provided comments for your consideration related to the periods covered by the auditor's evaluation.

The periods covered by the auditor's evaluation of consistency are appropriately described as dependent on the periods covered by the auditor's report on the financial statements and are similar to the current descriptions in AU sec. 420, and as such we believe that with respect to the periods to which the consistency standard relates, the proposed standard has appropriately described the auditor's evaluation. However, we believe that additional guidance, such as that provided in the PCAOB Release, would be beneficial regarding the auditor's responsibility to evaluate whether the financial statements for periods covered in the auditor's report are consistent with previously issued financial statements, as described in the last sentence of paragraph 3 of the proposed auditing standard. Accordingly we suggest the following description, from



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the PCAOB Release, be added to the proposed standard to clarify the auditor's responsibility in this regard:

When a company uses retrospective application, as defined in FASB Statement 154, to account for a change in accounting principle, the financial statements presented will generally be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous year's financial statements on which the auditor previously reported. The auditor's evaluation of consistency should encompass these previously issued financial statements for the relevant periods.

Further, paragraph 3 of the proposed auditing standard requires the auditor to evaluate whether the financial statements reported on are consistent (1) with each other and (2) with the prior year's financial statements if presented with the financial statements reported on, when the auditor is reporting on two or more years. The distinction being made between item (1) and (2) is unclear, as it would seem that item (1) encompasses financial statements for all years presented. However, if the example described in the PCAOB Release, that assumes an issuer has a change in auditors when the issuer presents comparative financial statements covering three years, is the circumstance in which this proposed guidance would apply, then we suggest that this example be included in the proposed auditing standard.

Do the proposed auditing standard and amendments provide sufficient direction regarding the evaluation of changes to previously issued financial statements resulting from retrospective application of changes in accounting principle and corrections of misstatements?

We believe that the proposed auditing standard and amendments provide sufficient direction regarding the evaluation of changes to previously issued financial statements resulting from retrospective application of changes in accounting principle and corrections of misstatements, however we do have one suggestion regarding the use of consistent terminology which we have explained in our response to question 2 below.

2. Does the proposed auditing standard appropriately reflect the changes to the accounting requirements made by FASB Statement 154?

Generally we agree that the proposed auditing standard appropriately reflects the changes to the accounting requirement made by FASB Statement 154. We do have two comments however; the first on the use of consistent terms and the second on changes



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affecting consistency. While FASB Statement 154 uses the term *retrospective application* to mean the application of different accounting principles to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in reporting entity, this term, *retrospective application*, is not used in the proposed auditing standard. To clarify and reconcile the two related standards, we suggest that the proposed auditing standard use the same terminology where appropriate. For instance see footnote 5 where the concept of retrospective application is described but not specifically referenced.

Further, the proposed auditing standard characterizes a change in the *method* of applying a principle to be a change in accounting principle, consistent with the guidance in AU sec. 420. However, the example presented in AU sec. 420 of a change in the method of applying a principle is no longer appropriate, and in fact FASB Statement 154 considers the example presented in AU sec. 420 to be a change in accounting estimate effected by a change in accounting principle.¹ Given this change, we believe that it would be appropriate to provide an example of a change in the method of applying an accounting principle under the proposed auditing standard to clarify and illustrate this point.

3. Would the proposed reporting language for auditor's reports on restated financial statements, i.e., requiring a statement that the financial statements have been restated to correct a misstatement, improve the clarity of auditor reporting?

We believe that the important part of the auditor's report in this circumstance is the reference to the issuer's disclosure in the footnotes to the financial statements that describes the underlying reason for such misstatement. So while the explanatory paragraph will include the above statement to identify the nature of the change, the real clarity for investors will come from the disclosure in the financial statements.

4. Would the proposal to apply the auditor reporting requirements to all restatements, including those not involving an accounting principle, improve auditor reporting?

We believe that the proposal to apply the auditor reporting requirements to all restatements, including those not involving an accounting principle; such as mathematical errors, oversight, or misuse of facts, will improve auditor reporting by

¹ AU sec. 420.06 provides an example of a change in the method of applying an accounting principle to be a change from the straight-line method to the declining balance method of depreciation for all assets in a class or for all newly acquired assets in a class.



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aligning the auditor's reporting responsibilities with the disclosure requirements of the accounting standards by requiring an explanatory paragraph.

Description of GAAP and Removal of the GAAP Hierarchy from the Auditing Standards

5. Is it appropriate to remove the GAAP hierarchy from the auditing standards if it is included in the accounting standards?

We believe that it is appropriate for the GAAP hierarchy to reside in the accounting standards and that therefore it should be removed from the auditing standards for public entities, just as it was previously removed from the auditing standards for private entities by the Auditing Standards Board.

6. Do the proposed amendments to AU Secs. 410 and 411 appropriately reflect the proposed FASB statement on the GAAP hierarchy?

We agree with the proposed amendments to AU sections 410 and 411.

Additional Commentary

We have provided additional commentary on the following two paragraphs of the proposed auditing standard, *Evaluating Consistency of Financial Statements*, for your consideration. We believe these revisions will help clarify the proposed auditing standard.

Rephrasing of paragraph 4 to reflect auditor's judgment

We suggest the following change, reflected in bold text, to paragraph 4:

*The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report, **when in the auditor's judgment** those matters have a material effect on the financial statements.*

Rephrasing of paragraph 6 to reflect the two distinct matters that are also considered to be a change in accounting principle



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We suggest the following change, reflected in bold text, to paragraph 6:

Other matters that are also considered to be a change in accounting principle include a change in the method of applying an accounting principle and a change in the reporting entity.

We appreciate your consideration of our comments and suggestions and we would be pleased to discuss these with you at your convenience. Please direct any questions to Wayne Kolins, National Director of Assurance at (212) 885-8595 (wkolins@bdo.com)

Very truly yours,

BDO Seidman, LLP

/s/ BDO Seidman, LLP



Russell Read

Chief Investment Officer

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May 18, 2007

J. Gordon Seymour

Office of the Secretary

Public Company Accounting Oversight Board

1666 K Street N.W.

Washington, D.C. 20006-2803

RE: Rulemaking Docket Matter No. 023 – Proposed Auditing Standard – Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards (PCAOB Release No. 2007-03)

Dear Mr. Seymour:

I am writing you on behalf of the California Public Employees' Retirement System (CalPERS). CalPERS is the largest US Public Pension Fund with total assets of \$245.7 billion and more than 1.5 million members. CalPERS is pleased to provide the Public Company Accounting Oversight Board (Board) with comment regarding the proposed changes to its auditing standards in light of Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections, and Proposed Statement of Financial Accounting Standards, The Hierarchy of Generally Accepted Accounting Principles. This proposed new auditing standard on evaluating consistency would supersede AU sect 420 and conforming amendments to AU sec. 508 Reports on Audited Financial Statements of its interim auditing standards.

CalPERS supports the proposed auditing standard which provides the auditor guidance on evaluating whether the financial statements are consistent with prior years' financial statements retrospectively when financial statements reflect a change in accounting principle and therefore, will appear different from those previous years' financial statements on which the auditor previously reported. We support the Board's efforts to revise its auditing standards in recognition of the Financial Accounting Standards Board's (FASB) revised accounting and disclosure requirements.

CalPERS, as a significant institutional investor supports the efforts of the Board to ensure strong market regulation and enforcement designed to protect investors, ensure integrity in the capital markets and provide adequate disclosure to protect the integrity of a company's financial reporting.

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CalPERS believe the proposed auditing standard provides assurance that auditors are provided adequate direction and reflect the changes to the accounting requirements made by FASB statement 154. As an investor and to provide better transparency, CalPERS supports the changes that require auditors to expand their report/opinion to address why there have been restatements and the reason for the misstatement. We also support the proposal that the auditor reporting requirements should apply to all restatements. This additional requirement is in line with the spirit of Sarbanes-Oxley Act of 2002, Section 404 and would provide additional clarity on potential internal control weaknesses and/or issues.

Additionally, we support the Board's decision to delete the Generally Accepted Accounting Principles (GAAP) hierarchy from the auditing standards if it is included in the accounting standards.

CalPERS is prepared to provide assistance to the PCAOB at its request. Please contact Dennis Johnson, Senior Portfolio Manager – Corporate Governance at (916) 795-2731 if there are questions or if we can be of further assistance.

Sincerely,



Russell Read
Chief Investment Officer

Cc: Fred Buenrostro, Chief Executive Officer, CalPERS
Anne Stausboll, Chief Operating Investment Officer, CalPERS
Christy Wood, Senior Investment Officer, CalPERS
Peter Mixon, General Counsel, CalPERS
Dennis Johnson, Senior Portfolio Manager, CalPERS



May 18, 2007

Cynthia M. Fornelli, Executive Director

GOVERNING BOARD

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Pricewaterhouse Coopers LLP

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 023- Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards, PCAOB Release No. 2007-003

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is a group created by the public company auditing profession and the American Institute of Certified Public Accountants (AICPA) to help foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. The CAQ consists of approximately 800 member firms that audit or are interested in auditing public companies. We welcome the opportunity to share our views on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2007-003, *Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards* (April 3, 2007) (the Release).

The CAQ supports the PCAOB's proposed auditing standard on evaluating consistency of the application of generally accepted accounting principles (GAAP) in financial statements; the proposed amendments to remove the hierarchy of GAAP from the interim auditing standards; and the other conforming amendments to the interim standards. Our comments have been drafted primarily in response to the questions posed by the PCAOB within the Release. In addition to responding to the specific questions, we have also included further comments and suggestions throughout our letter.



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Proposed Auditing Standard on Evaluating Consistency of Financial Statements

- 1. Does the proposed auditing standard appropriately describe how the auditor should evaluate the consistency of the application of GAAP? Do the proposed auditing standard and amendments provide sufficient direction regarding the evaluation of changes to previously issued financial statements resulting from retrospective application of changes in accounting principle and corrections of misstatements?***

Generally, we believe that the proposed auditing standard appropriately describes how the auditor should evaluate the consistency of the application of GAAP and provides sufficient direction regarding the evaluation of changes to previously issued financial statements. The interim auditing standard which this proposal would supersede, AU Section 420, *Consistency of Application of Generally Accepted Accounting Principles* (AU 420), contained specific information in paragraphs 15 through 21 related to changes that do not affect consistency. As stated in the Release, the proposal does not describe the accounting changes that do not require recognition in the auditor's report, as the previous interim auditing standard did. We suggest that the Board consider adding similar language to the proposed auditing standard so as to provide the auditor with clear guidance as to changes that do *not* affect consistency of the application of GAAP.

- 2. Does the proposed auditing standard appropriately reflect the changes to the accounting requirements made by FASB Statement 154?***

We believe that the proposed auditing standard appropriately addresses and reflects the changes made within Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* (FAS 154); however, we do note that the Board uses the term "misstatement" as opposed to "error," which is used in FAS 154. While we understand the Board's rationale for the use of the word "misstatement," as described in footnote 7 of the Release, we suggest that the explanation for this terminology be included in the standard itself to avoid possible confusion.

- 3. Would the proposed reporting language for auditor's reports on restated financial statements, i.e., requiring a statement that the financial statements have been restated to correct a misstatement, improve the clarity of auditor reporting?***

We believe that the proposed reporting language for the auditor's reports on restated financial statements would improve the clarity of auditor reporting.



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4. *Would the proposal to apply the auditor reporting requirements to all restatements, including those not involving an accounting principle, improve auditor reporting?*

We believe that the application of auditor reporting requirements to all restatements improves overall auditor reporting. In fact, we believe that many audit firms, as a matter of practice, have referenced restatements not involving an accounting principle in the auditors' report.

Proposed Amendments to Interim Auditing Standards for the Removal of the GAAP Hierarchy from Auditing Standards

5. *Is it appropriate to remove the GAAP hierarchy from the auditing standards if it is included in the accounting standards?*

We agree with the removal of the GAAP hierarchy from the auditing standards as we believe it is more appropriate to have it located in the accounting standards.

6. *Do the proposed amendments to AU secs. 410 and 411 appropriately reflect the proposed FASB statement on the GAAP hierarchy?*

We agree with the removal of the GAAP hierarchy from auditing standards, which is accomplished with the proposed amendments to AU Section 410, *Adherence to Generally Accepted Accounting Principles* (AU 410) and AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

Proposed Conforming Amendments to Interim Auditing Standards

Below are our comments relative to the proposed conforming amendments to the interim auditing standards:

AU sec. 431, Adequacy of Disclosure in Financial Statements

We understand that the proposed amendments to this interim auditing standard would eliminate AU sec 431.04 which is an application of AICPA *Code of Professional Conduct*, Rule 301 regarding the disclosure of confidential client information and specifically states-

“In considering the adequacy of disclosure, and in other aspects of his audit, the auditor uses information received in confidence from the



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client. Without such confidence, the auditor would find it difficult to obtain information necessary for him to form an opinion on financial statements. Thus, the auditor should not ordinarily make available, without the client's consent, information that is not required to be disclosed in financial statements to comply with generally accepted accounting principles (see AICPA *Code of Professional Conduct*, Rule 301 [ET section 301.01]).”

Since, in adopting certain interim standards and rules as of April 16, 2003, the Board did not adopt Rule 301 of the AICPA's *Code of Professional Conduct*, the Board is proposing to eliminate this section. Rather than eliminating this section, we encourage you to consider adopting Rule 301 or a comparable requirement within the PCAOB's professional standards to further address the auditor's performance of their professional responsibilities. Specifically, we believe it is imperative that communications between the client and auditor be candid and forthcoming. Without the protection afforded by Rule 301, such communications may be stifled. In addition, AICPA Rule 301 provides an exception for purposes of complying with applicable laws and government regulations and we interpret this to cover a firm's requirement to cooperate and comply with requests for information as part of the PCAOB inspection and investigation processes.

General Comment on Proposed Amendments to Interim Standards to Facilitate Effective and Efficient Implementation

In the future, we believe it would be helpful for the Board to provide a marked version indicating how proposed conforming amendments would affect the current interim auditing standards, rather than explaining them through written text. This would provide for a more effective and efficient review of the Board's proposed amendments, which would facilitate the public comment process. It would also help auditors implement final standards in a more effective and efficient manner.

Additionally, providing an explanatory section in the release that highlights expected changes in practice would be extremely helpful in making implementation efforts more effective and efficient.



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Public Company Accounting Oversight Board
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Sincerely,

A handwritten signature in black ink that reads "Cynthia M. Fornelli". The signature is written in a cursive style with a prominent initial "C".

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc: Mark W. Olson, Chairman
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Willis D. Gradison, Member
Charles D. Niemeier, Member
Thomas Ray, Chief Auditor and Director of Professional Standards



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May 18, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 023, Proposed Auditing Standard - *Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards*, PCAOB Release No. 2007-03

Dear Office of the Secretary:

Crowe Chizek and Company LLC appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standard and amendments, *Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards* (the "Proposed Standard"). The Proposed Standard clearly separates the hierarchy of generally accepted accounting principles ("GAAP") from the interim auditing standards and clarifies the auditor's responsibility to report on the consistency of application of GAAP.

We support the Proposed Standard and Amendments. We believe the separation of the GAAP hierarchy from the auditing literature is a natural and appropriate change. This change emphasizes that the overall selection of accounting policies and the application of accounting rules is a function of the company's management, whereas the auditing of the application of GAAP is the function of the auditor. In addition, the auditor presently has a responsibility to report on the consistency of the application of GAAP and the changes being proposed by PCAOB provide clarification in determining consistency and appropriate reporting for situations that are not now consistent. This change will help users of the financial statements understand consistency changes between reporting periods.

The following provides responses to the six specific questions for which the Board requested public comment. Following that, we have provided other observations and comments to help the Board better achieve its goals for this Proposed Standard and Amendments.

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1. *Does the proposed auditing standard appropriately describe how the auditor should evaluate the consistency of the application of GAAP? Do the proposed auditing standard and amendments provide sufficient direction regarding the evaluation of changes to previously issued financial statements resulting from retrospective application of changes in accounting principle and corrections of misstatements?*

The Proposed Standard appropriately describes how the auditor should evaluate the consistency of the application of GAAP from period to period based on the number of years being presented, as described in paragraph three. In addition, a change in accounting principle is appropriately defined as well as correction of a material misstatement in previously issued financial statements. The indication that both a change in accounting principle or a correction of a material misstatement requires an explanatory paragraph in the auditor's report, eliminates the judgment used in the past of determining if an item represented a change in principle or a correction of an error.

While the Proposed Standard should provide additional uniformity in auditor reporting of restatements, it provides no guidance as to materiality considerations, including individual financial statements and line items therein. We believe that additional guidance on materiality as applied to individual matters within financial statements would be helpful in applying the Proposed Standard. Such guidance should increase uniformity in reporting.

There is an alternative view that no auditor reporting is needed for changes in accounting principles that are retrospectively applied such that the financial statements presented are consistent with each other, and the change is properly measured, reported, and disclosed in the financial statements. Generally accepted accounting principles establish the accounting for and disclosure of accounting changes in financial statements. Consequently when such principles have been followed, there would be no need to also report such matters in the auditor's report.

2. *Does the proposed auditing standard appropriately reflect the changes to the accounting requirements made by FASB Statement No. 154?*

Yes, the Proposed Standard appropriately reflects the changes in the accounting requirements made by FASB Statement No. 154. However, terminology differences between the Proposed Standard and FASB Statement No. 154 should be explained, such as use of "misstatement" vs. "error", or conformed to FASB Statement No. 154.

3. *Would the proposed reporting language for auditor's reports on restated financial statements, i.e., requiring a statement that the financial statements have been restated to correct a misstatement, improve the clarity of auditor reporting?*

We believe the proposed reporting language for auditor's reports on restated financial statements requiring a statement that the financial statements have been restated to

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correct a material misstatement improves the auditor's report. The Proposed Standard should be clarified to state that an immaterial restatement does not require mention in the auditor's report. In addition, the auditor's report will serve as another communication of the restatement for the user of the financial statements. However, management must take primary responsibility for communication to financial statement users, and the auditor's report should not be viewed as supplementing adequate issuer disclosure.

4. *Would the proposal to apply the auditor reporting requirements to all restatements, including those not involving an accounting principle, improve auditor reporting?*

We believe a requirement to have the auditor report all material restatements, including those not involving an accounting principle, will improve overall auditor reporting and consistency, especially where there was concern over the classification of a correction as being a correction caused by the adoption of a new accounting principle versus a correction of a misstatement.

5. *Is it appropriate to remove the GAAP hierarchy from the auditing standards if it is included in the accounting standards?*

Yes.

6. *Do the proposed amendments to AU secs. 410 and 411 appropriately reflect the proposed FASB statement on the GAAP hierarchy?*

Yes.

Other Comments

Appendix 2, deletion of paragraph AU 431.04

The text of paragraph AU 431.04 speaks to the obligation of the auditor to maintain the confidentiality of information received from the client during the audit. We understand that this ethical obligation would be better positioned outside of the auditing standards. However, the Board elected to not adopt such a provision when adopting its interim standards, so this paragraph should not be deleted until such time that the Board otherwise adopts a comparable provision.

Appendix 2, AU sec. 508 e. paragraphs .17B and .17C

In the example report paragraphs provided, in paragraph 17B, the "company" has changed its method of accounting, which seems appropriate. However, in paragraph 17C, the sample report states that "management has elected to change its method of accounting", instead of the company. Although management is responsible for the financial statements, the financial

Office of the Secretary
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statements are those of the company, and, we recommend that the example in paragraph 17C be modified to indicate that it is the “company” making the election.

* * * * *

We hope that our comments and observations will assist the Board in finalizing the Proposed Standard. Crowe Chizek and Company LLC fully supports the Board’s efforts to improve auditing standards with the objective of furthering the public interest.

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff. If you have any questions or would like to discuss these issues, please contact Wes Williams or Michael Yates at (574) 232-3992.

Cordially,



Crowe Chizek and Company LLC



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May 18, 2007

Office of the Secretary
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Re: **PCAOB Release No. 2007-03, PCAOB Rulemaking Docket Matter No. 23**
Proposed Auditing Standard – Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards

Dear Members and Staff of the Public Company Accounting Oversight Board:

Deloitte & Touche LLP is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (“PCAOB” or the “Board”) with respect to its Proposed Auditing Standard – *Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards* [PCAOB Release No. 2007-003; PCAOB Rulemaking Docket Matter No. 23]. We hope this submission will be useful to the Board as it considers the proposed standard and proposed amendments.

Overall, we are supportive of the proposed standard and the proposed amendments. We do have several recommendations for improving the understandability of the proposed auditing standard and changes to the interim auditing standards. These recommendations include 1) providing a summary of the expected changes in practice as a result of the new standard and 2) providing a mark-up of the interim standards to clearly show changes adopted in the final standard.¹ Providing both of these will enhance the auditor’s understanding of adopted changes, and facilitate the auditor’s implementation of expected changes in practice. More importantly, providing such information will make the implementation process more effective and efficient. In the format the exposure draft has been issued, it is difficult to comprehend the proposal and determine the impacts. As such, when adopting the final standard, we believe it is critical for the Board to provide a summary of the changes it expects in practice and to provide marked versions of the interim standards demonstrating the changes. These comments, as well as, others are discussed below and are organized based on the questions posed in the Release.

¹ We also recommend that, going forward, this information be provided at the time the Board issues an exposure draft.

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Proposed Auditing Standard on Evaluating Consistency of Financial Statements

1. Does the proposed auditing standard appropriately describe how the auditor should evaluate the consistency of the application of GAAP? Do the proposed auditing standard and amendments provide sufficient direction regarding the evaluation of changes to previously issued financial statements resulting from retrospective application of changes in accounting principle and corrections of misstatements?

Generally, we believe the proposed auditing standard appropriately describes how the auditor should evaluate the consistency of the application of GAAP. However, we believe enhancements could be made to the proposed standard and its related Release to provide clear direction to the auditor as follows:

Articulate in the standard changes that do not impact consistency.

The interim auditing standard that the proposed standard will supersede, AU Section 420, *Consistency of Application of Generally Accepted Auditing Standards*, contains specific guidance in paragraphs 15-21 related to changes that do not impact consistency. It is clear that certain matters contained in paragraphs 15-21 are addressed separately in the proposed standard (i.e. changes in estimates); however, the disposition of other matters is unclear. Specifically, we note the following:

- AU Section 420.16 of the interim auditing standards, which addresses errors not involving principles, seems to now be addressed through paragraph 4 of the proposal. However, it is not clear whether this change is intentional, nor is the Board's intent clear with respect to changes not involving principles. It seems the intent may be for the auditor to evaluate whether such errors are material, and if so they would be considered "an adjustment to correct a misstatement in previously issued financial statements." We recommend that the final standard provide clearer guidance regarding errors not involving principles.
- AU Section 420.20 of the interim auditing standards states: "for changes expected to have a material future effect, the auditor need not recognize such change in his report." This circumstance does not appear to be addressed in the proposal. We believe the current guidance on this matter is appropriate and should be retained.

In addition to the above, we recommend that the PCAOB reconsider including some guidance in the standard regarding those matters that may not impact consistency. We also recommend that, in the Release, the reason for the removal of guidance previously included in the interim auditing standards be explained (see further discussion of this recommendation below).

Provide a section in the release that specifically discusses expected changes in practice.

It is currently difficult to understand how the proposed auditing standard will impact current practice. We encourage the Board to clearly articulate in the Release the expected changes in practice (on a go-forward basis we recommend that such articulation be included in both proposed standards and in final standards). This could be done, similar to the method the Financial Accounting Standards Board ("FASB") has used, by including a section titled "Differences between this Statement and Current Practice." Additionally, if previous

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guidance that was included in the interim auditing standards is no longer within a proposed (and later final) standard, the Release should explain why such guidance is no longer relevant. Further, if new requirements are contained within the proposed (and final) standard, these should be clearly described. Providing this information will help auditors 1) obtain a better understanding of the impacts of the proposed standard and 2) more efficiently and effectively implement the new standard once it is adopted.

Include guidance related to predecessor/successor reporting issues.

The proposed standard does not include guidance related to predecessor/successor reporting issues. However, matters related to predecessor/successor reporting issues are directly related to matters involving the consistency of the financial statements. Additionally, currently there are several inconsistencies between the PCAOB interim standards and the Staff Questions and Answers, *Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor* (“Staff Questions and Answers”).

For instance, the Staff Questions and Answers provide guidance that an “auditor may re-issue his or her report on prior-period financial statements when a successor auditor has been engaged to audit and report on adjustments made to those prior financial statements, provided that the predecessor auditor has determined that the report on those financial statements is still appropriate, other than with respect to the error correction.” Under such circumstances, the Staff Questions and Answers permit the predecessor auditor to issue a report and specify that the audit of the financial statements was conducted “before the effects of the adjustments for the correction of an error.” However, if the predecessor auditor has not audited the adjustments related to the correction of an error, the predecessor auditor is not in a position to report the effects of the errors as would be required under AU Section 508.37-.38. Nor can the auditor follow the guidance in AU Section 508.72 which states that the auditor should decide on the basis of evidential matter obtained, whether to revise the report.

The Staff Questions and Answers also do not address predecessor/successor issues with respect to the reports on internal control over financial reporting (“ICFR”).

As such, we recommend predecessor/successor reporting issues be addressed in conjunction with this proposed auditing standard (to resolve inconsistencies and provide guidance with respect to auditor reports on ICFR). We believe it is important that such issues be resolved through the standard setting process subject to public comment.

The need for guidance with respect to predecessor/successor reporting issues most often arises because of independence issues related to the predecessor auditor. Therefore, one solution would be to have different independence standards for predecessor auditors, which generally have a more limited role with respect to the audited financial statements on a go-forward basis.

Reconsider whether changes in the reporting entity impact consistency.

Paragraph 6 of the proposed standards states the following: “the auditor should report on a change in the reporting entity as if it were a change in accounting principle.” As a result,

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under the proposed standard a change in the reporting entity would require an explanatory paragraph in the auditor's report related to consistency of the financial statements. This is a change from the PCAOB interim auditing standards (AU Section 420.08), which provides that a change in a reporting entity resulting from a transaction or event does not require an explanatory paragraph about consistency to be included in the auditor's report.

We believe the approach in the current interim standards is appropriate because the consistency analysis relates to evaluating the application of generally accepted accounting principles in the financial statements. We do not believe changes in the reporting entity (i.e., changes in the company itself) result in financial statements not being consistent. Instead, following a change in reporting entity, the financial statements relate to a new entity that is reporting for the first time. Moreover, current standards do not preclude the auditor from including an explanatory paragraph, if the auditor believed that the circumstances warranted emphasis in his or her report; however, an explanatory paragraph is not required when there is a change in reporting entity. As such, we recommend that the proposed standard be modified such that an explanatory paragraph is not required when there is a change in the reporting entity.

If the Board decides to move forward to require an explanatory paragraph when there are changes in the reporting entity, we encourage the Board to highlight this new requirement in a separate section of the proposed standard. As currently proposed, this new requirement is not clear, and we recommend that if it remains it should be more prominent in the standard.

Clarify guidance in the standard regarding periods covered.

The language in the proposed paragraph 3 is unclear. Specifically, what is meant by evaluating whether the financial statements are consistent with each other and how does that differ from an evaluation of whether they are consistent with the prior year financial statements presented? Assuming the intention is for the auditor to evaluate the current year financial statements with the prior year financial statements presented and the prior year financial statements presented with the immediately preceding year not presented, it is unclear how items (1) and (2) in paragraph 3 are meant to differ. Unless the PCAOB is intending to change current practice, we recommend that the language in paragraph 3 of the proposed standard be replaced with the language currently contained in the interim standards at AU Section 420.22. If the PCAOB is intending to change current practice, this should be clearly articulated in paragraph 3 and should be discussed in a section that explains expected changes in practice (see comment above).

Clarify guidance in the standard regarding reclassifications.

The first sentence of paragraph 11, which states: "Changes in classification in previously issued financial statements do not require recognition in the auditor's report," is inconsistent with the remainder of the paragraph. We recommend clarifying this sentence by adding the following to the end of it: "unless the change results from a change in accounting principle or a correction of a misstatement." As a result, paragraph 11 would start with the following: "Changes in classification in previously issued financial statements do not require recognition

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in the auditor's report unless the change results from a change in accounting principle or a correction of a misstatement."

Retain guidance about the relationship of consistency and comparability.

The proposed standard does not include the guidance currently in AU Section 420.03 regarding consistency and comparability. It is not clear why this guidance has been removed. We believe this guidance is helpful and should be retained in the PCAOB auditing standards.

Retain certain guidance currently in AU Section 9420.

Currently AU Section 9420.11-20 discusses *The Effect of APB Opinion 28 on Consistency* and the *Impact on the Auditor's Report of FIFO to LIFO Change in Comparative Financial Statements*. We believe this guidance is still relevant and useful, and we believe it should be retained in the PCAOB auditing standards.

Additionally, currently AU Section 9420.64-65 addresses the question as to whether a change in the format of presentation of accumulated benefit information or a change in the date as of which such information is presented requires the auditor to add an explanatory paragraph to the audit report. The proposed standard does not currently address this topic. We believe the guidance contained in AU Section 9420.64-65 is helpful and should be retained in the PCAOB auditing standards.

Footnote 5 of the Proposed Standard should be consistent with changes to AU 508.

Footnote 5 of the proposed standard currently states "the explanatory paragraph should be included in the auditor's report even if the change in accounting principle is applied to the financial statements for all periods presented." However, the new proposed paragraph 17D to AU Section 508 states the following: "The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change." We recommend, to provide clear and consistent guidance, footnote 5 should be consistent with the language in the proposed 17D.

2. Does the proposed auditing standard appropriately reflect the changes to the accounting requirements made by FASB Statement 154?

Generally, we believe the proposed auditing standard appropriately reflects the changes to the accounting requirements made by FASB Statement 154. However, the proposed standard uses the phrase "correct a misstatement" rather than the phrase used in FASB Statement 154 "correct an error." We recognize this difference is explained in footnote 7 of the Release. We recommend the explanation in footnote 7 be included within the proposed standard, as information in the Release does not appear in the codification of the PCAOB auditing standards.

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We also note that the example reports in the Staff Questions and Answers, *Adjustments to Prior-period Financial Statements Audited by a Predecessor Auditor*, use the phrase “correction of an error.” As discussed previously, we recommend the Staff Questions and Answers be reconsidered and addressed in conjunction with this proposed auditing standard (to resolve inconsistencies and provide guidance with respect to auditor reports on ICFR).

3. *Would the proposed reporting language for auditor's reports on restated financial statements, i.e., requiring a statement that the financial statements have been restated to correct a misstatement, improve the clarity of auditor reporting?*

Current PCAOB auditing standards do not require specific language for auditor’s reports on restated financial statements. We do not believe including the statement that “the financial statements have been restated to correct a misstatement” is very descriptive, so we do not believe it improves the clarity of the auditor’s report. To allow flexibility for further description, we recommend that the standard provide the elements required to be included in the explanatory paragraph and then allow the auditor, using his or her judgment, to decide the actual language to be used in the report based on the specific fact pattern. In this case, we would recommend the elements for the explanatory paragraph include 1) a statement that the financial statements have been restated and 2) a reference to the disclosure describing the restatement.

4. *Would the proposal to apply the auditor reporting requirements to all restatements, including those not involving an accounting principle, improve auditor reporting?*

The proposal applies to all restatements and, by definition under the proposed standard, the purpose of a restatement is to correct a “material misstatement.” Paragraph 9 of the proposed standard makes this clear, and we believe that this application is appropriate. However, paragraph 10 should be clarified by adding the word “material” to the first sentence so that it reads as follows:

10. The accounting pronouncements generally require certain disclosures relating to restatements to correct **material** misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in AU sec. 431, *Adequacy of Disclosure in Financial Statements*, and AU sec. 508.

We believe the issuance of Securities and Exchange Commission (“SEC”) Staff Accounting Bulletin 108 will likely increase the frequency of situations in which errors immaterial to prior periods are corrected by adjusting previously issued financial statements because if corrected in the current period such errors would be material to that period. Accordingly, it would also be helpful if the standard provided guidance with respect to auditor’s reports for situations in which adjustments to previously issued financial statements may occur that do not result in a material restatement as defined in FASB Statement 154. The standard could provide this guidance by stating that the correction of immaterial (both qualitatively and quantitatively) misstatements need not be referred to in the auditor’s report.

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Guidance on other types of immaterial corrections could be provided through the use of examples. For instance, examples could include a typographical error, an omission of a word or phrase, an immaterial mathematical error, and a transposition error (the result of which may be the balance sheet does not balance), among others. In these situations, a company may want to correct the record with appropriate disclosure; however, this does not seem to warrant a reference to the correction in the auditor's report.

Proposed Amendments to Interim Auditing Standards for the Removal of the GAAP Hierarchy from Auditing Standards

5. Is it appropriate to remove the GAAP hierarchy from the auditing standards if it is included in the accounting standards?

Yes, we believe it is appropriate to remove the GAAP hierarchy from the auditing standards if it is included in the accounting standards. However, we do recommend that the PCAOB consider whether any audits of state, local, or federal governmental entities have audits performed in accordance with PCAOB standards and, if so, whether the GAAP hierarchy summary currently in AU Section 411 is necessary guidance for those audits.

6. Do the proposed amendments to AU Sections 410 and 411 appropriately reflect the proposed FASB statement on the GAAP hierarchy?

We believe several enhancements and modifications should be considered with respect to the proposed amendments to AU Sections 410 and 411 as follows:

Provide marked changes to the interim standards as a result of proposed and new standards.

To enhance the reader's understanding of the proposed and final changes to the interim standards, we strongly encourage the Board to provide mark-ups of the interim standards (showing both deleted text and inserted text) at the time of the exposure draft, at the time the standard is approved by the Board, and at the time the standard is approved by the SEC (if further changes are made). Providing such mark-ups enhances the auditors understanding of the proposed and final changes being made and the related impacts. Such information also facilitates efficient and effective implementation of a new standard because the auditor, by reading a mark-up, can more easily decipher the changes being made to current standards and practice. Additionally, providing such information at the time a standard is proposed will facilitate a more effective comment process as potential practice issues might be more readily identified and, therefore, raised through the comment process. As such, the Board and its staff would have an opportunity to address such issues at the front-end of the standard setting process rather than on the back-end by issuing staff questions and answers to resolve implementation issues.

Retain the second sentence of AU Section 410.02 and related footnote.

The second sentence of AU Section 410.02 currently states the following: "The first reporting standard is construed not to require a statement of fact by the auditor but an opinion as to

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whether the financial statements are presented in conformity with such principles.” This sentence provides important clarity regarding the auditor’s responsibility with respect the application of generally accepted accounting principles and issuing an audit opinion. As such, we believe this sentence should be retained in the PCAOB auditing standards.

Retain AU Section 9411 paragraphs 11 and 12.

These paragraphs provide important audit guidance with respect to evaluating the application of accounting principles when there are no established sources of accounting principles. Because these paragraphs provide guidance on the audit procedures to perform (and not accounting guidance), we believe they should be retained in the PCAOB auditing standards. We recognize that some modifications to paragraph 12 may be appropriate; however, the guidance to the auditor on the procedures to perform should be retained.

Other Comments on Proposed Changes to Interim Standards

Retain paragraph 4 in AU Section 431 and adopt rule 301, Confidential Client Information.

Paragraph 4 of AU Section 431 discusses the auditor’s responsibility with respect to maintaining the confidentiality of client information. Since the Board did not adopt Rule 301 of the AICPA’s Code of Professional Conduct, the Board is proposing to eliminate this paragraph and the reference to Rule 301. Rather than removing this paragraph and the reference to Rule 301, we believe this paragraph should be retained and the PCAOB should adopt a rule that addresses the auditor’s responsibility with respect to maintaining the confidentiality of client information. Obtaining or having access to client information is vital to performing a quality audit in an efficient manner. Further, candid and forthcoming communications between the client and the auditor is an imperative for audit quality. Without the acknowledgement in the PCAOB standards with respect to the auditor’s professional responsibility regarding the confidentiality of client information, such communications may be stifled.

Reconsider proposed changes to AU Section 508.69.

The proposal currently adds situations involving corrections of a misstatement to AU Section 508.69, which provides guidance for when an opinion on prior-period financial statements is different from the opinion previously expressed. However, in a correction of a misstatement situation, the prior report expressed an unqualified opinion on the misstated financial statements and the report on the restated financial statements expresses an unqualified opinion. Accordingly, there is no difference in the opinion; only an explanatory paragraph is added to the report. Thus, we do not believe it is appropriate to add the proposed guidance to AU Section 508.69.

Retain current language in AU Section 508.73-.74.

The proposed modifications to paragraphs 73 and 74 of AU 508 would remove the word “restated” and replace it with the word “adjusted.” It appears, however, that using the word “adjusted” would incorporate all reclassifications, which under paragraph 11 of the proposed standard may not, in all cases, be considered restatements. Therefore, we recommend that the word “restated” be retained in both paragraphs 73 and 74.

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* * * * *

We would welcome the opportunity to further discuss these matters with the Board and the staff. If you have any questions or would like to discuss these matters, please contact James Schnurr at (203) 761-3539, Guy Moore at (203) 761-3226, or John Fogarty at (203) 761-3227.

Sincerely,

/s/ Deloitte & Touche LLP

cc: Mark W. Olson, Chairman
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Bill Gradison, Member
Charles D. Niemeier, Member
Tom Ray, Chief Auditor and Director of Professional Standards

Chairman Christopher Cox, Securities and Exchange Commission
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May 16, 2007

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Rulemaking Docket Matter No. 023
Proposed Auditing Standard—Evaluating Consistency of Financial Statements and
Proposed Amendments to Interim Auditing Standards

Ladies and Gentlemen:

Ernst & Young LLP is pleased to comment on the PCAOB's proposed auditing standard, "Evaluating Consistency of Financial Statements" (the Proposed Standard), and related proposed amendments to interim auditing standards.

Proposed Auditing Standard on Evaluating Consistency and Related Conforming Amendments

In our view, the Proposed Standard reflects the changes to the accounting requirements as a result of the issuance of FASB Statement 154, "Accounting Changes and Error Corrections" (Statement 154), and provides appropriate direction to auditors regarding the circumstances in which auditors would be required to evaluate the consistency of the application of generally accepted accounting principles (GAAP) in financial statements.

We support the requirement that the auditor's report contain an explanatory paragraph drawing attention to a restatement of prior year financial statements for the correction of a material misstatement. In our view, the purpose of the explanatory paragraph in the auditor's report is to call the reader's attention to the fact that the financial statements have been restated, and to refer the reader to a more detailed disclosure by management about the restatement in the footnotes to the financial statements. Auditors commonly include such an explanatory paragraph currently. Accordingly, we do not believe that the specific inclusion of "restated to correct a misstatement" in the proposed reporting language would have a significant effect on the clarity of auditor reporting.

Public Company Accounting Oversight Board

We recommend that the Board include in the final standard the comparison of the term “error” as used in Statement 154 with the term “misstatement” used in the Proposed Standard that was provided in footnote 7 of the Board’s Release. We believe it is helpful to auditors to understand that the terms have equivalent meaning and believe this discussion should be preserved in the final standard.

We recommend the Board revise slightly the first sentence of paragraph 11 of the Proposed Standard. As written, the sentence is a declarative statement that changes in classification do not require recognition in the auditor’s report, when in fact some changes in classification may result in a modification to the auditor’s report as discussed in the remainder of the paragraph. The first sentence could be revised to indicate that changes in classification in previously issued financial statements “generally do not require recognition” or “may not always require recognition” in the auditor’s report. This would make the first sentence consistent with the remainder of the paragraph.

Proposed Amendments to Interim Standards Relating to the GAAP Hierarchy

We support moving the responsibility for GAAP for nongovernmental entities from the Board’s interim auditing standards to the accounting literature and, therefore, agree with deleting the GAAP hierarchy. We believe the proposed amendments to AU sec. 410, “Adherence to Generally Accepted Accounting Principles”, and 411, “The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles” adequately clarify that GAAP refers to the accounting principles recognized in the standards of the Financial Accounting Standards Board or in the standards of any other standard-setting body recognized by the U.S. Securities and Exchange Commission.

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

Ernst & Young LLP

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The US Member Firm of
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Grant Thornton 

May 18, 2007

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Via e-mail: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 023, *Proposed Auditing Standard – Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards*

Dear Board Members and Staff,

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("Board" or "PCAOB") proposed new auditing standard and proposed amendments, *Proposed Auditing Standard – Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards*. We respectfully submit our comments and responses to your questions in the accompanying appendix.

We would be pleased to discuss our comments with you. If you have any questions, please contact Mr. John L. Archambault, Managing Partner of Professional Standards, at (312) 602-8701.

Very truly yours,



Grant Thornton LLP

May 18, 2007

Appendix – Responses to Questions

1. Does the proposed auditing standard appropriately describe how the auditor should evaluate the consistency of the application of GAAP? Do the proposed auditing standard and amendments provide sufficient direction regarding the evaluation of changes to previously issued financial statements resulting from retrospective application of changes in accounting principle and corrections of misstatements?

We support the proposal and believe it appropriately describes the auditor's responsibilities relating to the application of GAAP and the correction of misstatements. To enhance the proposal, we suggest the Board consider the following:

- Deleting the last sentence of paragraph 3, as we believe it is not necessary and may potentially be confusing with regard to the auditor's responsibilities to evaluate consistency with previously issued financial statements. We believe this sentence applies when the company uses the retrospective application to account for a change in accounting principle. In this circumstance, the auditor is aware of the inconsistency and reports accordingly. If this sentence is not deleted, we suggest providing additional clarification.
- Clarifying the requirement in the last sentence of paragraph 6 by referring to the definition of a change in reporting entity in FASB Statement 154.
- Clarifying, in footnote 5, when the auditor could discontinue the inclusion of the explanatory paragraph when a change in accounting principle is applied to all periods presented (as discussed in paragraph .17D of the amended AU sec. 508).
- Including footnote 7 (on page 3 of the Release), or a similar footnote, within the auditing standard itself.

2. Does the proposed auditing standard appropriately reflect the changes to the accounting requirements made by FASB Statement 154?

We believe the proposal appropriately reflects the changes to the accounting requirements made by FASB Statement 154. See our specific response to question numbers 3 and 4 below.

3. Would the proposed reporting language for auditor's reports on restated financial statements, i.e., requiring a statement that the financial statements have been restated to correct a misstatement, improve the clarity of auditor reporting?

The proposal to include an explanatory paragraph that (a) refers to the company's disclosure of the correction, and (b) states that the financial statements have been restated for the correction is appropriate to clearly recognize the restatement for financial statement users. It will also provide consistency in auditor reporting with regard to restatements.

4. Would the proposal to apply the auditor reporting requirements to all restatements, including those not involving an accounting principle, improve auditor reporting?

FASB Statement 154 essentially defines a restatement as the revision of previously issued financial statements to correct an error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, or an error resulting from mistakes in the application of GAAP, or oversight or misuse of facts. We believe the proposal properly aligns the auditor reporting requirements with FASB Statement 154 and therefore, in the public's best interest, requires the auditor to recognize the correction of a material misstatement in previously issued financial statements.

May 18, 2007

5. Is it appropriate to remove the GAAP hierarchy from the auditing standards if it is included in the accounting standards?

The GAAP hierarchy appropriately belongs in the accounting literature. Accordingly, we support the removal of the GAAP hierarchy from the auditing standards upon its inclusion in the accounting standards.

6. Do the proposed amendments to AU secs. 410 and 411 appropriately reflect the proposed FASB statement on the GAAP hierarchy?

We believe the proposed amendments to AU secs. 410 and 411 appropriately reflect the removal of the GAAP hierarchy from the auditing standards.

With regard to the amendment to AU sec. 411.02, we believe the Board could expand on the definition of GAAP by referring to the framework adopted by management that is used in the preparation of financial statements. In addition, the Board could further clarify the definition as it relates to the accounting principles of other standard-setting bodies recognized by the SEC. We believe the SEC may not specifically recognize all standard-setting bodies that govern the accounting principles of foreign private issuers. In this regard, for foreign private issuers, it may be more appropriate to refer to accounting principles adopted by the International Accounting Standards Board and other accounting principles generally accepted in the country of incorporation as permitted by the SEC.



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May 16, 2007

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**PCAOB Rulemaking Docket Matter No. 023 -
Proposed Auditing Standard, *Evaluating Consistency of Financial Statements*, and
Proposed Amendments to Interim Auditing Standards**

Dear Mr. Secretary:

KPMG LLP appreciates this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) Release No. 2007-003, that includes the following Appendices (collectively, the Proposals):

- Proposed Auditing Standard – *Evaluating Consistency of Financial Statements*, and
- Proposed Amendments to Interim Auditing Standards.

We would like to take this opportunity to formally recognize the efforts of the PCAOB and its staff in development of the Proposals. We support the Board's efforts to revise its auditing standards in recognition of the FASB's revised accounting and disclosure requirements for changes in accounting principles and error corrections. Further, we support the Board's proposal to remove the hierarchy of generally accepted accounting principles (GAAP) from its interim auditing standards in light of the FASB's proposal to include the GAAP hierarchy in its accounting standards.

We offer the following comments for your consideration in finalizing the provisions of the Proposals:

Voluntary and Involuntary Changes in Accounting Principles

The proliferation of new and revised accounting literature in recent years has resulted in the common recognition of consistency and comparability matters in the auditors' report for accounting changes mandated by the FASB. While we fully support auditors' report recognition for voluntary changes in accounting principles and restatements of prior year financial statements to correct material misstatements, we believe that little benefit is



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derived from auditors' report recognition of those changes in accounting that result from the issuance of new or revised standards by the accounting standard setters. Rather, the significance of voluntary changes in accounting principles disclosures may be diluted when no distinction is drawn between voluntary and involuntary changes for purposes of recognition in the auditors' report.

Accordingly, we recommend that the Board consider whether it is necessary to require recognition in the auditors' report for changes in accounting principles that result from promulgation of new or revised standards by the accounting standard setters. We believe that the usefulness of recognition in the auditors' report of changes in accounting principles would be enhanced if such recognition was required only for voluntary changes in accounting principles.

Alignment with SEC Staff Accounting Bulletin No. 108

SEC Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108), provides guidance on the correction of prior year financial statements for immaterial errors in accounting. In SAB 108, the SEC Staff differentiates between immaterial corrections and material restatements of prior year financial statements. We believe that the disclosures required by FASB Statement No. 154, *Accounting Changes and Error Corrections*, are not required for immaterial corrections of prior year financial statements. In addition, we believe that current practice is to not recognize immaterial corrections of prior year financial statements in the auditors' report. Paragraph 4 of the Proposed Auditing Standard states that, "The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:

- a. A change in accounting principle
- b. An adjustment to correct a misstatement in previously issued financial statements."

Paragraph 9 of the Proposed Auditing Standard states that, "The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as explained in AU sec. 508." We believe that the intent of paragraphs 4 and 9 of the Proposed Auditing Standard could be clarified by explicitly stating that the auditors' report need not recognize immaterial corrections of prior year financial statements. This additional clarification would more closely align the provisions of the Proposed Auditing Standard with the notion of corrections of immaterial misstatements of prior year financial statements in SAB 108.

In addition, we suggest that the word "material" be added before the word "misstatement" in the last sentence of paragraph 18A, the first sentence of paragraph 18B and the first



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sentence of paragraph 18C of amended AU sec. 508 included in the Proposed Amendments to Interim Standards. We believe that these changes would further clarify that recognition in the auditors' report is required only when the prior year financial statements have been restated to reflect the correction of a material misstatement, and thereby more closely align with the guidance in SAB 108.

Paragraph 3 of the Proposed Auditing Standard

The penultimate sentence of paragraph 3 of the Proposed Auditing Standard states that, "When the auditor reports on two or more years, he or she should evaluate whether the financial statements reported on are consistent (1) with each other and (2) with the prior year's financial statements, *if presented with the financial statements reported on*" [emphasis added]. We believe that the italicized wording of this sentence is confusing. The auditors' report makes reference only to those financial statements presented by the issuer and, accordingly, it appears that (1) and (2) noted above effectively are equivalent notions. In order to appropriately address comparability of financial statements between years, we believe that the above italicized portion of the penultimate sentence of paragraph 3 should be eliminated.

Proposed Amendment to AU sec. 508.57

AU sec. 508.57 addresses the unusual circumstance where an auditor expresses a qualified or an adverse opinion on an entity's financial statements when management has not justified as preferable a change to an allowable accounting principle. Specifically, AU sec. 508.57 indicates that the auditors' opinion on the financial statements for the period of change should be modified as long as those financial statements are presented and reported on. The auditors' opinion on financial statements for periods subsequent to the period of change need not be modified.

We recognize that the Board is not proposing substantive revisions to AU sec. 508.57. However, this guidance generally is not applicable in audits of issuer financial statements due to the SEC's preferability letter requirements. In addition, the circumstances under which such guidance would become applicable in a non-issuer audit environment are rare.

Notwithstanding the fact that the guidance in AU sec. 508.57 rarely is applicable in an audit of financial statements, we fundamentally disagree with the premise that the passage of time remedies the misstatement that originally led to modification of the auditors' opinion. We believe that a change in accounting to an "inferior" principle is akin to a departure from generally accepted accounting principles, and the auditors' opinion should be modified consistent with other departures from generally accepted accounting principles. Accordingly, we believe that the Board should consider elimination of AU sec. 508.57 in its final standard.



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May 16, 2007

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We appreciate the opportunity to comment on the Proposals. If you have questions or comments regarding information included in this letter, please contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

Cc: Mr. Mark W. Olson, Chairman
Ms. Kayla J. Gillan
Mr. Daniel L. Goelzer
Mr. Willis D. Gradison
Mr. Charles D. Niemeier

Mr. Thomas Ray
Dr. Zoe-Vonna Palmrose



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May 16, 2007

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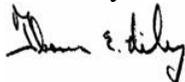
Re: Proposed Auditing Standard – Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards

PCAOB Release No. 2007-003
PCAOB Rulemaking Docket Matter No. 023

The New York State Society of Certified Public Accountants, representing 30,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the Proposed Auditing Standard and related amendments referenced above.

The NYSSCPA's Auditing Standards and Procedures Committee deliberated the proposed auditing standard and believe it should be adopted in its current form. If you would like additional discussion with us, please contact Robert W. Berliner, the Chair of the Auditing Standards and Procedures Committee, at (212) 503-8853, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,



Thomas E. Riley
President

Attachment



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COMMENTS ON PCAOB PROPOSED AUDITING STANDARD

**Evaluating Consistency of Financial Statements and Proposed Amendments to
Interim Auditing Standards**

PCAOB Release No. 2007-003

PCAOB Rulemaking Docket Matter No. 023

MAY 16, 2007

Principal Drafters

Robert W. Berliner

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NYSSCPA Comment on PCAOB Proposed Auditing Standard

**Evaluating Consistency of Financial Statements and Proposed Amendments to
Interim Auditing Standards**

PCAOB Release No. 2007-003

The NYSSCPA's Auditing Standards and Procedures Committee deliberated the proposed auditing standard and we believe it should be adopted in its current form.



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May 18, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

RE: PCAOB Rulemaking Docket No. 023, *Proposed Auditing Standard – Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards*

Dear Sir:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") proposed auditing standard, *Evaluating Consistency of Financial Statements*, and proposed amendments to the Board's interim auditing standards (collectively the "proposal").

We generally support the Board's proposal and believe that the proposed auditing standard on evaluating consistency and the conforming amendments to the interim auditing standards are responsive to and consistent with the provisions of FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154).

While we agree that the auditor should be required to evaluate and report on the consistency of the application of generally accepted accounting principles in the financial statements, we believe that the requirement to reference changes in accounting principles in the auditor's report should be limited to voluntary changes in accounting principles that materially impact the comparability of the financial statements. We believe that recognizing mandatory changes in accounting principles (i.e., those accounting changes required by the adoption of new accounting principles) in the auditor's report (1) duplicates the disclosures already required by FAS 154 and (2) detracts from the significance of other explanatory information that may be included in the auditor's report or of disclosures in the financial statements that may be of equal or greater importance to users of the financial statements. Accordingly, we propose that the Board reconsider the requirement that the auditor include a consistency reference in his or her report in this circumstance.

We have included our responses to the specific questions raised in the Board's release in the appendix to this letter. The appendix also includes certain other comments intended to further enhance and clarify the Board's proposal.



We would be pleased to discuss our comments and to answer any questions that the PCAOB staff or the Board may have. Please contact Jim Lee (973-236-4478) or Jorge Milo (973-236-4300) regarding our submission.

Sincerely,

PriceWaterhouseCoopers LLP



Proposed Auditing Standard – Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards

Evaluating Consistency

- 1. Does the proposed auditing standard appropriately describe how the auditor should evaluate the consistency of the application of GAAP? Do the proposed auditing standard and amendments provide sufficient direction regarding the evaluation of changes to previously issued financial statements resulting from retrospective application of changes in accounting principles and corrections of misstatements?**

We believe that the proposed auditing standard provides appropriate guidance for the auditor to evaluate the consistency of the application of GAAP. We believe that the proposed standard appropriately omits unnecessary accounting guidance from the existing auditing standards and instead focuses on the auditor's responsibility for events that merit recognition in the auditor's report. While generally supportive of the proposed standard, as noted in our letter, we do not believe that the auditor should be required to reference mandatory changes in accounting principle in the auditor's report.

We also believe that the proposed auditing standard and amendments provide sufficient direction regarding the evaluation of changes to previously issued financial statements resulting from retrospective application of changes in accounting principles and corrections of misstatements. While the financial statements presented will generally be consistent when a company uses retrospective application, the prior year's financial statements will appear different from the financial statements on which the auditor previously reported. We believe that the proposed standard appropriately clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

- 2. Does the proposed auditing standard appropriately reflect the changes to the accounting requirements made by FASB Statement 154?**

We believe that the Board's proposed auditing standard appropriately reflects the changes to the accounting requirements made by FAS 154. We also believe that the proposed standard will appropriately clarify the auditor's responsibility for differentiating between accounting changes and corrections of misstatements.

- 3. Would the proposed reporting language for auditor's reports on restated financial statements, i.e., requiring a statement that the financial statements have been restated to correct a misstatement, improve the clarity of auditor reporting?**

We believe that the proposed reporting language for auditor's reports on restated financial statements will improve the clarity of auditor reporting. We support transparency in financial reporting and agree that the proposed requirement will clarify



the existing requirement of PCAOB AU Section 508, *Reports on Audited Financial Statements* (AU 508) paragraph 16, to "identify the nature of the change."

We believe that the requirement to recognize the correction of a misstatement in previously issued financial statements in the auditor's report through the addition of an explanatory paragraph is consistent with current practice. Accordingly, we agree with the Board that the explanatory paragraph in the auditor's report should include (1) a statement that the previously issued financial statements have been restated and (2) a reference to the company's disclosure of the correction of the misstatement. However, because FAS 154 already defines a restatement as the process of revising previously issued financial statements to reflect the correction of an error, we believe that the suggested language in paragraph 18A of the proposed amendment to AU 508 should be amended as follows:

As discussed in Note X to the financial statements, the 20X2 financial statements have been restated ~~to correct a misstatement~~.

4. Would the proposal to apply the auditor reporting requirements to all restatements, including those not involving an accounting principle, improve auditor reporting?

The proposal to apply the auditor reporting requirements to all material restatements, including those not involving an accounting principle, will improve the consistency of auditor reporting by appropriately identifying the nature of the change as required by AU 508.16.

We agree that the proposed standard should not require the auditor's report to recognize a change in classification unless the change in classification was also a change in accounting principle or the correction of a material misstatement. We believe that it is appropriate to remind the auditor that professional judgment is required to determine (1) whether a change in classification is material and (2) whether a change in classification represents a change in accounting principle or the correction of a material misstatement.

Description of GAAP and Removal of the GAAP Hierarchy from the Auditing Standards

5. Is it appropriate to remove the GAAP hierarchy from the auditing standards if it is included in the accounting standards?

We believe that the GAAP hierarchy should be included in the accounting standards. Consequently, we support the Board's proposal to remove the GAAP hierarchy from the auditing standards, which is appropriately responsive to the FASB's proposed accounting standard, *The Hierarchy of Generally Accepted Accounting Principles*.



6. Do the proposed amendments to AU secs. 410 and 411 appropriately reflect the proposed FASB statement on the GAAP hierarchy?

We believe the Board's proposed conforming amendments to PCAOB AU Section 410, *Adherence to Generally Accepted Accounting Principles*, and PCAOB AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*, appropriately reflect the changes contemplated by the FASB's proposed statement on the GAAP hierarchy.

Other Comments

We believe that the following recommendations would further enhance and clarify the Board's proposal:

- Paragraph 6 of the proposed auditing standard addresses reporting on a change in the reporting entity. In order to improve the clarity of this guidance, we suggest amending the language as follows:

In addition, the auditor should report on a change in the reporting entity as defined by FASB Statement 154, *Accounting Changes and Error Corrections*, as if it were a change in accounting principle.

- For a change in accounting principle resulting from the adoption of a new accounting pronouncement, we believe that identifying the name of the accounting pronouncement is unnecessary since this is inherent in describing the accounting that has changed. This would also provide consistency with the language prescribed by AU 508.17. Further, it is possible that several FASB Staff Positions and/or Interpretations may have been issued related to the new accounting principle. In such a case, inclusion of the name of each applicable pronouncement would appear confusing and would provide little value to readers of the auditor's report. Accordingly, we recommend that proposed paragraph 17B of AU 508 be revised as follows:

As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting change method*] ~~due to issuance of~~ [*name of accounting pronouncement*].

- If the Board determines not to delete the phrase "due to the issuance of..." from the proposed illustrative example of an explanatory paragraph for a change in accounting principle, we believe that it is important to replace the word "issuance" with the words "the adoption" as follows:

As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting change method*] due to ~~issuance~~ the adoption of [*name of accounting pronouncement*].



- Within the proposed amendments to AU 508, the differentiation between the applicability of paragraph 17B and paragraph 17C is not substantive. We believe that the example of an explanatory paragraph included in paragraph 17B, as amended per our above recommendations, provides adequate disclosure of the change in accounting principle regardless of whether the change resulted from the required adoption of a new accounting principle or a voluntary election. Accordingly, the language in paragraph 17B could be amended to apply to both scenarios as follows:

.17B Following is an example of an explanatory paragraph for a change in accounting principle ~~resulting from the issuance of a new accounting pronouncement~~:

This edit would make paragraph 17C redundant and, as a result, it should be deleted.



G A O

Accountability * Integrity * Reliability

Comptroller General
of the United StatesUnited States Government Accountability Office
Washington, DC 20548

May 18, 2007

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Subject: PCAOB Release No. 2007-003—*Proposed Auditing Standard—Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards.*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) proposed new auditing standard and amendments to its interim auditing standards. We commend the PCAOB for its efforts to better align its auditing standards with the new accounting standards issued by the Financial Accounting Standards Board (FASB). While we agree with the board's efforts, we continue to have serious concerns about its approach to updating its interim standards.

First, we support enhancing AU sec. 420 and 508 of the PCAOB interim standards to require recognition in the auditors' report of a correction of a material misstatement in previously issued financial statements. *Government Auditing Standards*, January 2007 Revision, has similar auditor requirements, including requiring an explanatory paragraph in the auditors' report. We believe that additional auditor disclosures in this area are necessary and appropriate. The enclosure to this letter includes a discussion of these additional disclosures.

We also agree that the generally accepted accounting principles (GAAP) hierarchy should be removed from the auditing standards. We advocated this position in our June 27, 2005, letters to the FASB and the Auditing Standards Board (ASB) of the American Institute of CPAs (AICPA). In those letters, we discuss the importance of recognizing the responsibility of the reporting entity, and not the auditor, for selecting and applying accounting principles and for the adequacy of financial statement disclosure.

We continue to have concerns about the PCAOB's procedures for updating its interim standards. The PCAOB's proposed amendments to AU sec. 411 of its interim standards contain significant differences from the ASB proposed changes to AU sec. 411 of the ASB standards, which were detailed in the ASB's May 9, 2005, proposed amendment to SAS No. 69. Significant differences also exist between the PCAOB interim standards and ASB core standards such as SAS No. 107: "Audit Risk and Materiality in Conducting an Audit," SAS No. 109: "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," and SAS No. 110:

“Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.”

We strongly believe that U.S. auditing standard setters should work together to achieve agreement and consistency on core auditing standards, which are used by almost all auditors of U.S. entities. Where there is a clear and compelling reason, the standard setters should develop additional standards necessary to meet the needs of their constituencies. The nature of any differences from core auditing standards and the basis for the differences also should be communicated. GAO’s *Government Auditing Standards* uses the same core field work and reporting standards as the ASB, and supplements them with additional standards to satisfy the greater accountability needs of government entities. Inconsistencies in such core standards increase audit costs and lead to potential confusion and misapplication of the standards.

In addition to the above matters, we have identified other matters for which we are offering comments. Our comments, which are detailed in the enclosure to this letter, address the following issues:

- enhancing auditor reporting on correction of a material misstatement in previously-issued financial statements,
- acknowledging officially established accounting principles that may be applicable for entities other than listed companies,
- changes in financial statement classification that may be restatements,
- proposed deletion of guidance from PCAOB interim standards,
- clarifying requirements and guidance on auditors’ evaluation of consistency between periods, and
- references for PCAOB interim standards.

We thank you for considering our comments on these very important issues and look forward to working with you to promote high-quality auditing in the United States.

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

Enclosure

cc:

The Honorable Christopher Cox, Chairman
U.S. Securities and Exchange Commission

The Honorable Mark W. Olson, Chairman
U.S. Public Company Accounting Oversight Board

Harold Monk, Jr., Chair
Auditing Standards Board

GAO Comments on PCAOB Release 2007-003

Enhancing auditor reporting on correction of a material misstatement in previously-issued financial statements

The proposed amendment to PCAOB interim standard AU sec. 508 “Reports on Auditing Financial Statements,” paragraph 18A, “Correction of a Material Misstatement in Previously Issued Financial Statements” requires an explanatory paragraph in the auditors’ report on the correction of a material misstatement in previously-issued financial statements when there has been such a correction. We recommend enhancing the requirement by requiring that auditors include in the explanatory paragraph a statement that (1) the previously-issued auditors’ report is not to be relied on because the previously-issued financial statements were materially misstated and (2) the previously-issued auditors’ report is replaced by the auditors’ report on the restated financial statements. This disclosure is important to alert financial statement users to these matters.

Acknowledging officially established accounting principles that may be applicable for entities other than listed companies

The Board’s proposed amendment to paragraph 2 of PCAOB interim standard AU sec. 411, “The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles,” narrowly defines GAAP as those accounting principles recognized in the standards of the FASB or in the standards of any other standard-setting body recognized by the U.S. Securities and Exchange Commission (SEC). To avoid potential confusion by users, the PCAOB standards should include a reference to acknowledge that there are other sources of GAAP for entities other than issuers. Alternatively, the proposed text could be revised to clarify that the GAAP being defined in the PCAOB standard is GAAP for issuers. For example, “Generally accepted accounting principles *for issuers* refer to the accounting principles recognized in the standards of the Financial Accounting Standards Board or in the standards of any other standard-setting body recognized by the U.S. Securities and Exchange Commission.”

Changes in financial statement classification that may be restatements

Paragraph 11, “Change in Classification” on page A1-5 of the PCAOB Release includes a discussion of classification changes in previously-issued financial statements and how these changes affect the evaluation of the consistency of the application of GAAP in the audited financial statements. We support the PCAOB’s proposed changes clarifying that, in some circumstances, a change in financial statement classification also may be a correction of a material misstatement in previously-issued financial statements.

GAO Comments on PCAOB Release 2007-003Proposed deletion of guidance from PCAOB interim standards

The revisions in the PCAOB Release would delete several paragraphs from the interim standard that provide useful auditing guidance. Specifically, we are concerned about deleting the following paragraphs:

- PCAOB interim standard 420, paragraph 13, which provides valuable guidance for addressing a change in accounting principle that also involves a change in an accounting estimate.
- PCAOB interim standard 431, paragraph 4, which adds guidance for balancing required financial statement disclosures with the requirements related to confidential information.
- PCAOB interim standard 508, paragraphs 14 and 15, which include requirements and guidance regarding departures from GAAP and incorporate Rule 203 of the AICPA Code of Professional Conduct into the interim standards. If the Board's intent is to remove all reference to the AICPA Code of Professional Ethics from the PCAOB interim standards, then the Board should indicate the professional ethics that auditors should follow when conducting audits in accordance with PCAOB standards.
- PCAOB interim standard 420, paragraphs 1 through 3, which discuss the objectives of the consistency standard and incorporate the second reporting standard into the interim standards.
- PCAOB interim standard 410, paragraph 2, which explains the term "generally accepted accounting principles" and clarifies the first reporting standard.

The board did not explain the reasons for each of these proposed deletions in the introduction to the PCAOB Release, so the board's basis for removing them from the PCAOB interim standards is not clear. We are concerned that the deletion of the guidance language and resulting inconsistency with ASB standards could lead to confusion among auditors. Absent a compelling reason for the deletion, we believe that these paragraphs add value to the interim standards and should not be deleted. If there are compelling reasons, PCAOB should more clearly articulate them.

Clarify requirements and guidance on auditors' evaluation of consistency between periods

The PCAOB should clarify the wording of the third and fourth sentences of paragraph 3 of the proposed standard, "Evaluating Consistency of Financial Statements." As written, the fourth sentence adds confusion, and it is not clear which periods the PCAOB is intending to describe in this discussion.

GAO Comments on PCAOB Release 2007-003References for PCAOB interim standards

As noted in our comment letter, we strongly support development of common core auditing standards for use by auditors of U.S. entities. However, if the PCAOB decides to continue its current practice of issuing its own standards for audits of listed companies, then we suggest that the PCAOB adopt alternative numbering/referencing schemes in order to reduce confusion between its interim standards and the AICPA Codification of Statements on Auditing Standards. The PCAOB's current practice of referring to its interim standards by AU section number creates potential for such confusion. This is especially significant now that the ASB has made numerous updates to the AU sections in its codification, while at the same time the PCAOB is making changes to the AU sections that make up the interim standards adopted in April 2003.



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RELEASE

AUDITING STANDARD No. 6 —)	
EVALUATING CONSISTENCY OF FINANCIAL STATEMENTS)	PCAOB Release No. 2008-001
AND CONFORMING AMENDMENTS)	January 29, 2008
)	PCAOB Rulemaking
)	Docket Matter No. 023
)	
)	
)	
)	

Summary: After public comment, the Public Company Accounting Oversight Board is adopting Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, and amendments to the Board's interim auditing standards.

Board
 Contacts: Greg Fletcher, Associate Chief Auditor (202/207-9203, fletcherg@pcaobus.org), Keith Wilson, Associate Chief Auditor (202/207-9134; wilsonk@pcaobus.org),

A. Introduction

The Board proposed certain changes to its auditing standards in response to two actions of the Financial Accounting Standards Board ("FASB"). In May 2005, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections*,^{1/} which superseded Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes*.^{2/} The FASB has also issued an

^{1/} Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections* (2005) ("SFAS No. 154").

^{2/} Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes* (1971). SFAS No. 154 also superseded SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*.



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exposure draft of a proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*.^{3/}

SFAS No. 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle.^{4/} SFAS No. 154 also redefines the term "restatement" to refer only to "the process of revising previously issued financial statements to reflect the correction of an error in those financial statements."^{5/} Under SFAS No. 154, therefore, the term "restatement" does not refer to changes made to previously issued financial statements to reflect a change in accounting principle.

AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, the Board's interim standard on the auditor's responsibilities for evaluating the consistency of the application of generally accepted accounting principles ("GAAP"), generally reflected the provisions of APB Opinion No. 20, which was superseded by SFAS No. 154. To better align the Board's standards with the new accounting standard, on April 3, 2007, the Board proposed a new auditing standard on evaluating consistency, which would supersede AU sec. 420, and conforming amendments to AU sec. 508, *Reports on Audited Financial Statements*, of its interim auditing standards.

The FASB's proposed standard on the GAAP hierarchy would incorporate the hierarchy found in the auditing standards into the accounting standards. Historically, a description of the GAAP hierarchy has resided only in the auditing standards.^{6/}

^{3/} FASB, Proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*, Exposure Draft (April 2005).

^{4/} Among other reasons for undertaking this project, the FASB intended to eliminate differences between APB Opinion No. 20 and the International Accounting Standards Board standard, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. See introduction to SFAS No. 154.

^{5/} See SFAS No. 154, paragraph 2j.

^{6/} See AU sec. 411, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles."* Although the Board is removing the GAAP hierarchy from this standard, the standard remains in existence, as amended.



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Because the GAAP hierarchy identifies the sources of accounting principles and the framework for selecting principles to be used in preparing financial statements, the Board believed that these requirements are more appropriately located in the accounting standards. Accordingly, also on April 3, 2007, the Board proposed to remove the GAAP hierarchy from the auditing standards.^{7/}

The proposed standard provided direction for the auditor's evaluation of the consistency of financial statements. It directed the auditor to recognize a change in accounting principle or an adjustment to correct a misstatement^{8/} in previously issued financial statements in the auditor's report if it had a material effect on the financial statements. The conforming amendments to AU sec. 508, *Reports on Audited Financial Statements*, provide language for the explanatory paragraph. The proposed standard also directed the auditor to review a material change in financial statement classification and the related disclosure to determine whether the change also is a change in accounting principle or a correction of a material misstatement.

The proposed standard and amendments were intended to update and clarify the auditing standards in light of SFAS No. 154 and the FASB's proposal on the GAAP hierarchy. In particular, these updates and clarifications should enhance the clarity of auditor reporting on accounting changes and corrections of misstatements by distinguishing between these events.

The Board received 11 comment letters. In general, the commenters were supportive of the proposed standard and amendments. They generally stated that the proposed auditing standard appropriately described how the auditor should evaluate the consistency of financial statements and reflected the changes to accounting

^{7/} If the amendments are approved by the SEC, the effective date for the removal of the GAAP hierarchy from the auditing standards will be 60 days after the standard and amendments are approved by the SEC. The Board has coordinated with the FASB and understands that the FASB intends to coincide the effective date of its standard on the GAAP hierarchy with that of the PCAOB.

^{8/} SFAS No. 154 uses the term "error" instead of "misstatement." This release, including the final standard and amendments, uses "misstatement," the prevailing term used in PCAOB auditing standards. The term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards.



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requirements under SFAS No. 154. Several commenters suggested clarifications in various parts of the standard. As described in the following sections, the Board has considered the comments and made changes to the final standard and amendments.

The Board is adopting the proposed standard as Auditing Standard No. 6, as well as the amendments to the interim standards. This release describes key aspects and elements of the new standard and amendments, comments received, and changes incorporated in the final standard.

B. Evaluating Consistency

Under Auditing Standard No. 6, auditors are required to evaluate the consistency of a company's financial statements and report on inconsistencies. The new standard updates these requirements and aligns them more closely with SFAS No. 154^{9/} by requiring the auditor's report to recognize a company's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. Based on a discussion at an October 2005 meeting of the Board's Standing Advisory Group, the Board understands that this requirement is consistent with current practice. The new standard focuses on the auditor's responsibilities regarding events that warrant recognition in the auditor's report on the financial statements—changes in accounting principles and corrections of misstatements in previously issued financial statements.^{10/} This standard also clarifies that the auditor's report should indicate whether an adjustment to prior-period financial statements results from a change in accounting principle or the correction of a misstatement.

^{9/} Because SFAS No. 154 provides comprehensive, authoritative accounting guidance on changes in accounting principle and corrections of errors, Auditing Standard No. 6 omits the accounting guidance that was included in AU sec. 420.

^{10/} AU sec. 420 also required recognition of those events. However, it only required recognition in the auditor's report of the correction of a misstatement involving an accounting principle. In addition, unlike AU sec. 420, the new standard does not describe the accounting changes that do not require recognition in the auditor's report.



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1. Materiality

There were several comments on materiality. Some commenters suggested that the standard should specifically state that the auditor need not recognize the correction of a misstatement that is immaterial to the previously issued financial statements. Another suggested that the standard should remind the auditor that professional judgment is required to evaluate consistency. Another commenter said that additional guidance on materiality as applied to individual matters in the financial statements would be helpful in applying the standard. Others suggested that clarity would be improved by inserting the word "material" in several places.

In general, the Board's view is that the purpose of the standard is to provide direction on evaluating consistency; for example, the accounting periods the auditor should evaluate, the recognition in the auditor's report of consistency matters prescribed by the accounting standards, and the related audit reporting requirements. Because an audit is predicated on the use of reasoned judgment and the consideration of materiality in planning, performing, and reporting on the audit, the Board does not believe it is necessary for this standard to specifically direct the auditor to exercise judgment and apply materiality. Further, materiality is a concept that is defined under the federal securities laws, and it is not the objective of this standard to alter or interpret that concept.

The Board did agree that clarity could be improved in some areas by inserting the word "material" to modify the word "misstatement." The Board added "material" to AU secs. 508.18A and B to be consistent with paragraph 4 of Auditing Standard No. 6. However, AU sec. 508.18C does not include "material" because that sentence summarizes the SFAS No. 154 requirement for correcting a misstatement, which does not directly mention materiality.

2. Periods Covered by the Evaluation of Consistency

The new standard describes the scope of the required evaluation of consistency in terms that are similar to the description in AU sec. 420. Under the new standard, when the auditor reports only on the current period, the auditor should evaluate whether the financial statements of the current period are consistent with those of the preceding period. When the auditor reports on two or more years, the auditor should evaluate whether the financial statements reported on are consistent with each other and with the prior year's financial statements, if presented. For example, assume that a company



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presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor auditor reports, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented. In response to comments, the Board added this example to the final standard.

When a company uses retrospective application, as defined in SFAS No. 154, to account for a change in accounting principle, the financial statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous years' financial statements on which the auditor previously reported. For example, consider a company that adopts a new accounting standard in 2007 that requires retrospective application to 2006 and 2005. The financial statements for 2006 and 2005 will be consistent, as presented with 2007. However, the financial statements for the years 2006 and 2005 that were issued a year earlier will not reflect the retrospective application and hence will not be consistent with 2007 and will be different from the 2006 and 2005 financial statements that are presented with 2007. The new standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

Paragraph 3 of the proposed standard described the financial statement periods covered by the evaluation of consistency. The third sentence of that paragraph was intended to be a clarification of the requirement in AU sec. 420.22 regarding the evaluation of two or more years. However, some commenters found the third sentence of paragraph 3 to be confusing and recommended retaining the language in AU sec. 420.22, unless the Board had intended to change the auditor's responsibilities for evaluating the consistency of GAAP. Because the Board wanted to be clear that the auditor's responsibilities had not changed, the Board decided to retain the original sentence from AU sec. 420.22, with some changes, instead of the proposed third sentence of paragraph 3. The inserted sentence, adapted from AU sec. 420.22, reads as follows (additions underlined and deletions struck through):

When the ~~independent~~ auditor reports on two or more periods years, he or she should evaluate ~~address the~~ consistency of ~~the application of accounting principles~~ between such periods years and the consistency of such periods years



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with the period year prior thereto if such prior period year is presented with the financial statements being reported upon.

The Board did not include the reference to "the application of accounting principles" because paragraph 3 also relates to the auditor's evaluation of a company's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. The Board also used the word "evaluate" because it describes the auditor's responsibilities consistently with the rest of the paragraph.

Two commenters suggested that the last sentence of proposed paragraph 3, which described the auditor's responsibility to evaluate whether the financial statements are consistent with previously issued financial statements for the same period, was confusing and unnecessary. These commenters suggested deleting the last sentence of paragraph 3. In addition, one commenter suggested that paragraph 3 of the proposed standard could be clarified by including the explanatory language from the proposing release regarding retrospective application under SFAS No. 154. As discussed above, the new standard is intended to clarify that the auditor's evaluation of consistency should include an evaluation of previously issued financial statements for the relevant periods. Accordingly, the Board believed that the final sentence of paragraph 3 is necessary. However, the Board agreed that including the suggested explanatory language from the proposing release regarding retrospective application would clarify the paragraph and has added that language as a footnote to paragraph 3.

3. Reference to Application of Accounting Principles

Consistent with the discussion above related to paragraph 3 of the proposed standard, the Board also removed the reference to "application of accounting principles" from the first paragraph of Auditing Standard No. 6. Because the auditor's evaluation of consistency under this standard includes errors not involving an accounting principle, the consistency evaluation is broader than that described under the second standard of reporting. Accordingly, the Board also removed the reference to the second standard of reporting from paragraph 2 of Auditing Standard No. 6.



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4. Change in Accounting Principle

The new standard requires the auditor to evaluate a change in accounting principle^{11/} that has a material effect on the financial statements to determine whether: (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with GAAP, (3) the disclosures related to the accounting change are adequate, and (4) the company justifies that the alternative accounting principle is preferable,^{12/} as required by SFAS No. 154.^{13/} Under the amendments to AU sec. 508, if the four criteria are met,^{14/} the auditor would recognize the change in accounting principle in the auditor's report through the addition of an explanatory paragraph consisting of an identification of the nature of the change and a reference to the issuer's note disclosure describing the change. If those criteria are not met, the auditor would issue a qualified or adverse opinion.^{15/}

^{11/} The proposed and final standards use the definition of a change in accounting principle found in SFAS No. 154, paragraph 2c.

^{12/} In certain circumstances, Securities and Exchange Commission ("SEC") rules require issuers to file a letter from the auditor indicating whether or not a change is to an alternative accounting principle that is preferable. See Rule 10-01(b)(6) of Regulation S-X, 17 C.F.R. § 210.10-01(b)(6).

^{13/} Under SFAS No. 154, the issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle as long as the change in accounting principle is made in accordance with the GAAP hierarchy. See SFAS No. 154, paragraph 14.

^{14/} The auditor has substantially the same responsibility for evaluating a change in accounting principle as under AU sec. 431, *Adequacy of Disclosure in Financial Statements*, and paragraph .50 of AU sec. 508, *Reports on Audited Financial Statements*. The language in Auditing Standard No. 6 has, however, been updated to be consistent with SFAS No. 154.

^{15/} This responsibility is substantially unchanged from AU sec. 508.51.



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Some commenters recommended that the Board reconsider whether it was necessary for the auditor to recognize in the audit report changes that result when a company is required to adopt a newly issued accounting standard. They indicated that the significance of a company's discretionary change in accounting principle may be diluted if the auditor recognizes both discretionary changes and those changes in accounting principles required by a newly-issued standard in the report. Another commenter suggested that the auditor should not be required to include an explanatory paragraph in the audit report when changes in accounting principle have been applied retrospectively because, in such cases, the financial statements included in the filing will appear consistent. As noted above, the Board believes that it is important for investors to be informed when the prior year financial statements presented with the current year are different from previously issued financial statements. In addition, the Board believes that the different language in the auditor's report for discretionary changes and those required by a newly-issued standard provides sufficient notification to investors of the general nature of the change. Therefore, the Board adopted the requirement as proposed.^{16/}

One commenter suggested that the proposed standard deleted useful information about a change in accounting principle that also involves a change in an estimate. The proposed standard did not carry forward the requirement of AU sec. 420.13 that the auditor should recognize in his or her report a change in accounting principle that is inseparable from a change in estimate. After considering this comment, the Board concluded that the requirement in AU sec. 420.13 does result in useful information being included in the auditor's report. Accordingly, the Board updated the language in AU sec. 420 to reflect the term used in SFAS 154, and included the requirement in Auditing Standard No. 6.^{17/}

^{16/} In addition, one commenter suggested that the standard include an example of a change in the method of applying an accounting principle. The final standard, like the proposed standard, notes that under SFAS No. 154 a change in the method of applying an accounting principle is also a change in accounting principle. While the Board believes that it is helpful for the standard to reference the accounting requirement, it also believes that it is not appropriate for the auditing standard to provide accounting guidance.

^{17/} The new standard uses the term "change in accounting estimate effected by a change in accounting principle," which is defined in SFAS No. 154 as "a change in



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Some commenters asked the Board to clarify the reporting requirement related to a change in reporting entity. According to AU sec. 420.08, a change in reporting entity resulting from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit, does not require that the auditor include an explanatory paragraph in the auditor's report. Under the proposed standard, the auditor may have been required to report on, for example, the disposition of a subsidiary or business unit because SFAS No. 154 (and its predecessor, APB Opinion No. 20) did not specifically exempt such a transaction from the definition of a change in reporting entity. Generally, dispositions or spin-offs have specific disclosure requirements in the accounting standards and the Board did not intend to change practice and require the auditor to report on these events through an explanatory paragraph. Accordingly, the Board carried forward the requirement from AU sec. 420.08 regarding a transaction or event. In addition, the Board also added a reference to paragraph 2f in SFAS No. 154, which describes a change in reporting entity, as suggested by some commenters.

In response to comments, the Board also modified paragraph 8 of the proposed standard, which provided direction for reporting a change in accounting principle. Some commenters noted that the proposed conforming amendments to AU sec. 508.17 had a more clearly stated version of the number of years that the auditor is required to include an explanatory paragraph related to a change in principle than did footnote 5 to paragraph 8. After considering the commenters' recommendation that the language in the footnote be changed, the Board decided that the footnote was not necessary because paragraph 8 referred the auditor directly to the reporting requirements in AU sec. 508. The Board therefore removed footnote 5 from the final standard.

5. Correction of a Material Misstatement in Previously Issued Financial Statements

Under Auditing Standard No. 6, the correction of a material misstatement in previously issued financial statements (i.e., a "restatement") is recognized in the auditor's report through the addition of an explanatory paragraph. Under the conforming amendments to AU sec. 508, the explanatory paragraph in the auditor's report regarding a restatement should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective

accounting estimate that is inseparable from the effect of a related change in accounting principle."



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period and (2) a reference to the company's disclosure of the correction of the misstatement. The first statement in the explanatory paragraph distinguishes restatements from adjustments to prior-period financial statements resulting from changes in accounting principle. Previously, the auditor's responsibilities for reporting on most restatements were the same as for reporting on changes in accounting principle.

One commenter suggested that the proposed standard did not clearly explain whether corrections of an error not involving a principle would require recognition in the auditor's report. Unlike the previous requirement, the proposed standard did not distinguish between the "correction of an error in principle" and an "error correction not involving a principle."^{18/} Rather, the proposed standard required recognition in the auditor's report of any correction of a material misstatement, whether or not the error involved a principle. The Board reconsidered the language and concluded that the requirement as proposed was sufficiently clear. The new standard aligns the auditor's reporting responsibilities with the accounting standards, which require disclosure of all restatements, by requiring an explanatory paragraph when the company has restated the financial statements.

Some commenters suggested that it would not improve clarity to have the auditor's report include a statement that the financial statements were restated "to correct a material misstatement." They noted that SFAS No. 154 already defines a restatement as the revision of previously issued financial statements to reflect the correction of an error. The Board decided to retain the reporting requirement as proposed because it clearly distinguishes corrections of misstatements from changes in accounting principle. Also, the required reporting language regarding restatements is more informative because it does not rely entirely on the user's knowledge of the definition of "restatement" in the accounting standard.^{19/}

^{18/} This distinction previously was in paragraphs .12 and .16 of AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*.

^{19/} Two commenters suggested that the standard include the explanation from the release that the term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards. The Board agreed and has included that explanation in the final standard.



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One commenter also recommended that the auditor's explanatory paragraph about the correction of a misstatement should contain additional information. The commenter recommended that the explanatory paragraph include a statement that (1) the previously issued auditor's report should not be relied on because the previously issued financial statements were materially misstated, and (2) the previously issued report is replaced by the auditor's report on the restated financial statements.

The Board believes that the recommended additional language is not necessary because existing PCAOB standards and rules of the Securities and Exchange Commission ("SEC") are sufficient to inform users about misstatements in previously issued financial statements. Specifically, AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, requires the auditor to take specific action when he or she concludes that information discovered after the financial statements have been issued would have affected his or her report if the company had not reflected the information in the financial statements and people are currently relying or are likely to rely on the financial statements and auditor's report. According to AU sec. 561.06, the auditor should advise the company to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report.^{20/}

A U.S. public company that is not a foreign private issuer under SEC rules also is required to file a Form 8-K current report, if it concludes that any previously issued financial statements should no longer be relied upon because of an error in such financial statements.^{21/} If the auditor has notified the issuer that action should be taken

^{20/} AU sec. 561.06 also requires that if the effect on the financial statements or auditor's report can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. If issuance of the financial statements with an auditor's report for a later period is imminent, a company is permitted to disclose the revision to the financial statements instead of reissuing earlier statements. When the effect on the financial statements cannot be determined without a prolonged investigation, appropriate disclosure would consist of notification that the financial statements and auditor's report should not be relied on and that revised financial statements and auditor's report will be issued upon completion of an investigation.

^{21/} See Securities Exchange Act Rule 13a-11, 17 C.F.R. § 240.13a-11.



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to prevent future reliance on a previously issued audit report, the company also must disclose that information in the Form 8-K.

6. Changes in Classification

Auditing Standard No. 6 does not require the auditor's report to recognize a change in classification^{22/} in previously issued financial statements, except for a reclassification that is also a change in accounting principle or correction of a material misstatement.^{23/} Accordingly, the new standard clarifies that the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change is also a change in accounting principle or a correction of a material misstatement. For example, in some circumstances, a change in financial statement classification also may be the correction of a misstatement. A restatement to correct the misclassification of an account as short- or long-term or misclassification of cash flows would be both a restatement and reclassification. Therefore, the auditor should evaluate these matters as part of the evaluation of corrections of misstatements. Under Auditing Standard No. 6, a classification change that is also a change in accounting principle should be reported on as a change in accounting principle, and a classification change that is also a correction of a material misstatement should be reported on by the auditor as a restatement.

Some commenters recommended slight revisions to the first sentence of paragraph 11 to clarify the auditor's responsibilities. The first sentence stated that changes in classification in previously issued financial statements do not require recognition in the auditor's report. This seemed to conflict with the second sentence which required the auditor to review a material change in classification and related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. The Board agreed with the comments and modified the first sentence to state that a change in classification does not require audit

^{22/} AU sec. 420.17 also did not require recognition of a change in financial statement classification in the auditor's report.

^{23/} SFAS No. 154 uses the term "presentation" in its definition of an error in previously issued financial statements. The directions in paragraph 11 of the new standard address the auditor's responsibilities for changes in classification, which is an element of the presentation and disclosure financial statement assertion under the auditing standards. See, e.g., paragraph .08 of AU sec. 326, *Evidential Matter*.



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report recognition unless the change represents the correction of a material misstatement or a change in accounting principle. Additionally, in the proposed standard, the Board used the word "review" to describe the auditor's responsibility when there has been a material change in financial statement classification. The Board concluded that the word "evaluate" better describes the auditor's responsibilities in this area and is more consistent with the other requirements in Auditing Standard No. 6. Accordingly, the Board replaced "review" with "evaluate."

C. Description of GAAP and Removal of the GAAP Hierarchy from the Auditing Standards

As discussed previously, the FASB has proposed to incorporate the GAAP hierarchy into its own standards. The Board believes that it is appropriate to locate the GAAP hierarchy in the accounting standards rather than in the auditing standards. Thus, the Board amended its interim standards to remove the GAAP hierarchy from the auditing standards. These amendments do not change the principles in AU sec. 411 for evaluating fair presentation of the financial statements in conformity with GAAP.

Commenters strongly supported removing the GAAP hierarchy from the auditing standards and stated that it was appropriate for the GAAP hierarchy to be contained in the accounting standards. However, one commenter observed that the proposed amendments contain significant differences from the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") proposed amendment to AU sec. 411 of the ASB's standards.^{24/}

The Board believes that the amendments to AU sec. 411 are consistent with the Board's objective of removing the GAAP hierarchy from the auditing standards, and retaining, or providing, direction necessary for audits of public companies. The significant differences between the ASB's amendments to its AU sec. 411 and the

^{24/} In addition, this commenter suggested that U.S. auditing standard-setters should work together to achieve consistency on core auditing standards that are used by almost all auditors of U.S. entities. This commenter also suggested that if the Board continues issuing its own standards for audits of public companies, it should adopt alternative numbering/referencing schemes in order to reduce confusion between its interim standards and the AICPA standards. The Board is considering these comments as it seeks to make continuous improvements to its standard-setting and other programs.



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Board's amendments primarily are related to sources of GAAP for governmental entities and direction on the application of accounting principles, which the Board did not believe was appropriate for inclusion in the proposed amendments. In addition, the Board deleted references to Rule 203 of the AICPA's *Code of Professional Conduct*. Rule 203 prohibits auditors from expressing an opinion on financial statements that do not conform to GAAP unless the auditor can demonstrate that due to unusual circumstances the financial statements would have been misleading without departing from GAAP. In 2003, when the Board adopted certain AICPA rules and ASB standards as interim Board standards, the Board did not adopt Rule 203. Consistent with that action, the proposed amendments did not include a reference to Rule 203.

D. Section-by-Section Description of Amendments to the Interim Auditing Standards

In addition to proposing an auditing standard on evaluating consistency of financial statements, the Board also proposed amendments to other interim auditing standards and related interpretations. The following sections describe key aspects and elements of the amendments to the standards and interpretations, comments received, and changes incorporated in the final amendments.

AU sec. 410, Adherence to Generally Accepted Accounting Principles

The Board proposed to delete AU sec. 410.02 which discussed the meaning of "generally accepted accounting principles" and included other matters that are addressed elsewhere in the standards. However, some commenters suggested that, to improve clarity, AU sec. 410 should retain the sentence in existing AU sec. 410.02 which states that the "first standard is construed not to require a statement of fact by the auditor but an opinion."

The Board agreed that, when viewed alone, the first standard of reporting, contained in AU sec. 410.01, does not provide a complete description of the auditor's responsibilities related to fair presentation in conformity with GAAP. However, the first standard of reporting combined with the fourth standard clearly indicates that the auditor is providing a statement of an opinion and not a statement of fact. The fourth standard of reporting provides that the auditor's 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. To emphasize that the first and fourth reporting standards must be read together, the Board is including the fourth standard of



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reporting in the final amendment to AU sec. 410. However, as proposed, the prior statement on the meaning of "generally accepted accounting principles" has been deleted from AU sec. 410.02.

AU sec. 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles

The Board proposed to delete AU sec. 411.02, which was a detailed description of GAAP, and AU secs. 411.05, .07 and .09-.15, which described the application of the GAAP hierarchy. The Board proposed to replace the description of GAAP in AU 411.02, with a statement that GAAP refers "to the accounting principles recognized in the standards of the Financial Accounting Standards Board or in the standards of any other standard-setting body recognized by the U.S. Securities and Exchange Commission."

However, commenters had concerns about the proposal. One commenter noted that the SEC might allow companies to file financial statement prepared in conformity with international financial reporting standards ("IFRS") but not recognize the International Accounting Standards Board, which issues IFRS, as a standard-setting body. Another commenter suggested that to avoid potential confusion by users, the Board should acknowledge that there are other sources of GAAP for entities other than public companies.

In response to these comments, the Board decided to modify its proposed amendment of AU 411. It deleted AU sec. 411.02, which described GAAP, and revised AU sec. 411.01 to indicate that the auditor should look to the requirements of the SEC for the company under audit to identify the accounting principles that are applicable to that company. This change should also clarify that the standard is focused only on the accounting principles that may be used for purposes of the federal securities laws. Other accounting principles may apply to financial statements prepared for other purposes or by entities that are not issuers. The Board also modified AU 411.01 to better emphasize that standard's focus on the meaning of the phrase "present fairly."

Finally, as proposed, the Board eliminated AU secs. 411.16 and .17 which set an effective date and transition requirements that are no longer applicable.



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AU sec. 420, Consistency of Application of Generally Accepted Accounting Principles

AU sec. 420 has been superseded by Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*. However, some commenters suggested that parts of AU sec. 420 should have been incorporated into Auditing Standard No. 6. Commenters suggested that guidance on the objective of the consistency standard and the relationship of consistency and comparability, matters that may not affect consistency, and changes expected to have a material future effect provided useful direction.

The Board believes that it is unnecessary to include the preceding direction. The proposed standard clarified that the auditor's report should recognize only those matters that require recognition under the existing auditing standards—i.e., a change in accounting principle or the correction of a material misstatement. The Board does not believe it is necessary to list in a standard those matters that do not require recognition in the auditor's report. Also, the Board believes that paragraph 1 clearly describes the objective of the standard. Paragraph 2 makes it clear that the standard considers comparability to be between periods for the company under audit.

AU sec. 431, Adequacy of Disclosure in Financial Statements

AU sec. 431 describes the auditor's responsibilities for evaluating the adequacy of disclosures in the financial statements. The amendments address two technical matters relating to that section.

Footnote 1 to AU sec. 431.03 is not consistent with the SEC's independence rules regarding non-audit services and therefore has been eliminated.

AU sec. 431.04 is an application of the AICPA's *Code of Professional Conduct* regarding the disclosure of confidential client information. In 2003, when the Board adopted certain AICPA rules and ASB standards as interim Board standards, the Board did not adopt Rule 301. Consistent with that action, the proposed amendments would eliminate AU sec. 431.04.

Some commenters expressed concerns that the proposed elimination of AU sec. 431.04 would change the auditor's obligations, or reflected Board policy, regarding the use of confidential client information in connection with evaluating the adequacy of financial statement disclosures. Those commenters generally recognized the limited



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nature of AU sec. 431.04 and acknowledged that, since in 2003 the Board did not adopt Rule 301, removing a portion of the interim standards based on that rule was a conforming amendment. However, they were concerned that the Board's action might be construed as minimizing the auditor's responsibilities for maintaining the confidentiality of client information.

The Board is aware that many auditors have legal or professional obligations to maintain the confidentiality of client information. These requirements arise from the rules of state licensing authorities,^{25/} the rules of professional organizations such as the AICPA and the International Federation of Accountants, and the laws of some foreign jurisdictions. The Board's decision to omit Rule 301 from its interim standards was based on a determination that incorporation of that rule was not necessary to fulfill the Board's mandate under Section 103(a)(1) and (3) of the Sarbanes-Oxley Act. It did not reflect a decision that auditor confidentiality requirements imposed by other authorities were inappropriate. Similarly, in amending AU sec. 431, the Board seeks neither to modify nor to detract from existing confidentiality requirements.

Interpretations of the Auditing Standards in AU 400 Sections

The auditing interpretation in AU sec. 9420.52-.54 has been incorporated into Auditing Standard No. 6 and therefore has been eliminated, as proposed. The auditing interpretations in AU sec. 9411 and the remaining auditing interpretations in AU sec. 9420 are addressed by the accounting standards and therefore also have been eliminated as proposed.^{26/}

^{25/} For example, confidentiality requirements are included in the provisions of the Uniform Accountancy Act, which has been enacted in some form by many states.

^{26/} One commenter suggested that some of the auditing interpretations should be retained because the guidance is still relevant. The Board considered the view of this commenter but decided to eliminate the interpretations because other auditing standards provided the necessary direction regarding the matter addressed in the interpretation, the interpretation dealt with items not requiring recognition in the auditor's report, or the interpretation was related to an accounting consideration of the company.



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AU sec. 508, Reports on Audited Financial Statements

In general, the Board has adopted the amendments as proposed. The amendments have conformed this interim auditing standard to Auditing Standard No. 6 on evaluating consistency and the amendments to AU secs. 410 and 411, described above. For example, AU sec. 508.16 now specifically identifies the matters related to consistency of the company's financial statements that should be recognized in the auditor's report. Similarly, AU sec. 508.17A provides the requirements for evaluating consistency, that also is in paragraph 7 of Auditing Standard No. 6. AU secs. 508.17B and C, and AU sec. 508.18A provide separate requirements for reporting on changes in accounting principles and restatements, as discussed previously.

In addition, the amendments eliminate AU sec. 508.14-.15. Those paragraphs were an application of AICPA Ethics Rule 203, which, as previously noted, was not adopted as an interim standard by the Board.^{27/}

Finally, in light of the definitions in SFAS No. 154, the amendments change references to "restatements" to the more general term "adjustments" to refer broadly to changes to previously issued financial statements that may result from either a correction of a misstatement or a change in accounting principle.^{28/}

^{27/} One commenter expressed concern about deleting these paragraphs and suggested that, if the Board's intent was to delete all reference to the AICPA Code of Professional Conduct from the Board's interim standards, the Board should indicate the professional ethics that auditors should follow when conducting audits according to PCAOB standards. The Board's Rules 3500T and 3600T describe the Board's interim ethics and independence standards, respectively. These standards include certain provisions from the AICPA's Code of Professional Conduct. In addition, the Board has adopted ethics and independence rules concerning independence, tax services, and contingent fees. See PCAOB Release No. 2005-014 (July 26, 2005). State law and membership organizations may impose additional requirements.

^{28/} Some commenters suggested that certain other changes were needed to AU sec. 508 or that certain amendments were not necessary. For example, some commenters suggested eliminating AU sec. 508.57 and retaining the original terminology in AU secs. 508.73 - .74. The Board decided that some of the suggested changes would change existing practice, such as the elimination of AU sec. 508.57, and



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References to APB Opinion No. 20

In addition, the Board has adopted other amendments to update references to APB Opinion No. 20, which was superseded by SFAS No. 154. Accordingly the Board amended AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, footnote 3 to paragraph .06, to reference paragraphs 25 and 26 of SFAS No. 154. For AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, footnote 4 to paragraph .19, the Board referenced paragraph 20 of SFAS No. 157, *Fair Value Measurements*, which states that a change in valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. This replaces a reference to the preferability requirement in SFAS No. 157 because that requirement does not apply to a change in a company's method for determining fair value. Paragraph 20 is the accounting guidance applicable to a company's change in method for determining fair value.

were outside the scope of this project. For the others, the Board concluded that the amendments were consistent with the direction in Auditing Standard No. 6. In addition, one commenter believed that there were inconsistencies between the proposed amendments to AU sec. 508 and Staff Questions and Answers, *Adjustments to Prior-Period Financial Statements Audited By a Predecessor Auditor*. However, the Board reviewed the Staff Questions and Answers and did not agree that there were inconsistencies with the proposed amendments to AU sec. 508.



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E. Effective Date

This standard and amendments will be effective 60 days after approval by the SEC.

* * *

On the 29th day of January, in the year 2008, 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
Secretary

January 29, 2008

APPENDICES –

1. Auditing Standard No. 6 – *Evaluating Consistency of Financial Statements*
2. Amendments to Interim Auditing Standards



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APPENDIX 1 – AUDITING STANDARD NO. 6 – EVALUATING CONSISTENCY OF FINANCIAL STATEMENTS

January 29, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Auditing Standard No. 6 —

EVALUATING CONSISTENCY OF FINANCIAL STATEMENTS





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Auditing Standard No. 6 ***Supersedes AU secs. 420 and 9420***

Evaluating Consistency of Financial Statements

Consistency and the Auditor's Report on Financial Statements

1. This standard establishes requirements and provides direction for the auditor's evaluation of the consistency of the financial statements, including changes to previously issued financial statements, and the effect of that evaluation on the auditor's report on the financial statements.
2. To identify consistency matters that might affect the report, the auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles or by material adjustments to previously issued financial statements for the relevant periods.
3. The periods covered in the auditor's evaluation of consistency depend on the periods covered by the auditor's report on the financial statements. When the auditor reports only on the current period, he or she should evaluate whether the current-period financial statements are consistent with those of the preceding period. When the auditor reports on two or more periods, he or she should evaluate consistency between such periods and the consistency of such periods with the period prior thereto if such prior period is presented with the financial statements being reported upon.^{1/} The auditor also should evaluate whether the financial statements for periods described in this paragraph are consistent with previously issued financial statements for the respective periods.^{2/}

^{1/} For example, assume that a company presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor auditor reports, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented.

^{2/} When a company uses retrospective application, as defined in Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("SFAS No. 154"), to account for a change in accounting principle, the financial



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Note: The term "current period" means the most recent year, or period of less than one year, upon which the auditor is reporting.

4. The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:
 - a. A change in accounting principle
 - b. An adjustment to correct a misstatement in previously issued financial statements.^{3/}

Change in Accounting Principle

5. A change in accounting principle is a change from one generally accepted accounting principle to another generally accepted accounting principle when (1) there are two or more generally accepted accounting principles that apply, or when (2) the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.^{4/}

statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous years' financial statements on which the auditor previously reported. This standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

^{3/} The term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards.

^{4/} See SFAS No. 154, paragraph 2c.



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Note: A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of a misstatement.

6. The auditor should evaluate and report on a change in accounting estimate effected by a change in accounting principle like other changes in accounting principle.^{5/} In addition, the auditor should recognize a change in the reporting entity^{6/} by including an explanatory paragraph in the auditor's report, unless the change in reporting entity results from a transaction or event. A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit does not require recognition in the auditor's report.

7. The auditor should evaluate a change in accounting principle to determine whether –

- a. The newly adopted accounting principle is a generally accepted accounting principle,
- b. The method of accounting for the effect of the change is in conformity with generally accepted accounting principles,
- c. The disclosures related to the accounting change are adequate,^{7/} and

^{5/} SFAS No. 154, paragraph 2e, defines a "change in accounting estimate effected by a change in accounting principle" as "a change in accounting estimate that is inseparable from the effect of a related change in accounting principle."

^{6/} "Change in reporting entity" is a change that results in financial statements that, in effect, are those of a different reporting entity. See SFAS No. 154, paragraph 2f.

^{7/} Newly issued accounting pronouncements usually set forth the method of accounting for the effects of a change in accounting principle and the related disclosures. SFAS No. 154 sets forth the method of accounting for the change and the related disclosures when there are no specific requirements in the new accounting pronouncement.



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- d. The company has justified that the alternative accounting principle is preferable.^{8/}

8. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph 7 have been met, the auditor should add an explanatory paragraph to the auditor's report, as described in AU sec. 508, *Reports on Audited Financial Statements*. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and address the matter as described in AU sec. 508.

Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph (following the opinion paragraph) to the auditor's report, as described in AU sec. 508.

Correction of a Material Misstatement in Previously Issued Financial Statements

9. The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as described in AU sec. 508.

10. The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in AU sec. 431, *Adequacy of Disclosure in Financial Statements*, and AU sec. 508.

^{8/} The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See SFAS No. 154, paragraph 14.



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Change in Classification

11. Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs 7 and 8 and AU sec. 508. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs 9 and 10 and AU sec. 508.



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APPENDIX 2 – AMENDMENTS TO INTERIM AUDITING STANDARDS

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

AMENDMENTS TO INTERIM AUDITING STANDARDS





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Amendments to PCAOB Auditing Standards

The following amendments relate to the standards and auditing interpretations in AU sec. 328, the AU 400s sections, AU sec. 508, and AU sec. 561 of the Board's auditing standards.

Auditing Standards

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

Statement on Auditing Standards ("SAS") No. 101, "Auditing Fair Value Measurements and Disclosures," (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows:

- a. The text of footnote 4 to paragraph .19 is replaced with the following:

Statement of Financial Accounting Standard No. 157, *Fair Value Measurements*, states that a change in valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances.

AU sec. 410, "Adherence to Generally Accepted Accounting Principles"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 410 (AU sec. 410, "Adherence to Generally Accepted Accounting Principles"), as amended, is amended as follows:

- a. Paragraph .02 is replaced with following paragraph, and the reference to footnote 1 is moved to the end of the new paragraph .02.

The fourth standard of reporting is:

The report shall either contain 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 therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication



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of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

AU sec. 411, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*"

SAS No. 69, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*" (AU sec. 411, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*"), as amended, is amended as follows:

- a. The third sentence of paragraph .01 is replaced with the following:

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

- b. Paragraphs .02, .05, .07, and .09-.18 are deleted.

AU sec. 9411, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*, Auditing Interpretations of Section 411"

Auditing Interpretation No. 3, "The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events" of the auditing interpretations of AU sec. 411 (AU sec. 9411.11-.15) is deleted.

AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles," and AU sec. 9420, "Consistency of Application of Generally Accepted Accounting Principles, Auditing Interpretations of Section 420"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 420 (AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles"), as amended, and the related auditing interpretations (AU sec. 9420) are superseded by PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*.



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AU sec. 431, "Adequacy of Disclosure in Financial Statements"

SAS No. 32, "Adequacy of Disclosure in Financial Statements" (AU sec. 431, "Adequacy of Disclosure in Financial Statements") is amended as follows:

- a. Footnote 1 is deleted.
- b. Paragraph .04 is deleted.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows:

- a. In Paragraph .03, footnote 2 is deleted.
- b. In Paragraph .11, item .11b is deleted; item .11c is reordered as .11b; .11d is reordered as .11c; the paragraph references in .11c (formerly .11d) to paragraphs .16 through .18 are replaced with paragraph references .17A through .17E; and a new item .11d is added as follows:

"A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C)."

- c. Paragraphs .14-.15 are deleted, along with the preceding heading "Departure From a Promulgated Accounting Principle," and the note following the paragraph.
- d. The text of paragraph .16 is replaced with the following:

The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:

- a. A change in accounting principle
- b. An adjustment to correct a misstatement in previously issued financial statements



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- e. Paragraphs .17-.18 and related footnotes 12 and 13 are replaced with the following:

Change in Accounting Principle

.17A As discussed in PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.^{12/} A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.

^{12/} The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See FASB Statement 154, paragraph 14.

.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].

.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement.

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As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].

.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

.17E If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.

Correction of a Material Misstatement in Previously Issued Financial Statements

.18A Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.^{13/} The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.

As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

^{13/} The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

.18B This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

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.18C The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41 and in AU sec. 431.

- f. Paragraph .50 is deleted.
- g. The text of paragraph .51 is replaced with the following:

Departures from generally accepted accounting principles related to changes in accounting principle. Paragraph .17A states the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

- h. In paragraph .52:
 - The first three sentences of the paragraph are replaced with the following:

The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:
 - In the second sentence of the first paragraph of the example report, the phrase "for making this change" is replaced with the phrase "that this accounting principle is preferable."

In the text of footnote 17, the first two sentences are deleted; the word, "However" is deleted at the beginning of the third

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sentence; the word "because" at the beginning of the third sentence is capitalized; the phrase "the middle paragraph" is replaced with "this paragraph;" and the references to paragraphs ".16 through .18" are replaced with references to paragraphs "17A through 17E."

- i. The text of paragraph .57 is replaced with the following:

If the auditor issues a qualified or adverse opinion because the company has not justified that an allowable accounting principle adopted in an accounting change is preferable, as described in paragraph .52, the auditor should continue to express that opinion on the financial statements for the year of change as long as those financial statements are presented and reported on. However, the auditor's qualified or adverse opinion relates only to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing a qualified or adverse opinion for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express a qualified or adverse opinion on the use of the newly adopted principle in subsequent periods.

- j. In the text of footnote 19 to paragraph .59, "(b)" is added to the beginning of the list of subsections.
- k. The first sentence of footnote 20 to paragraph .62 is deleted.
- l. In the second sentence of footnote 25 to paragraph .67, replace the phrase "section 420, *Consistency of Application of Generally Accepted Accounting Principles*," with the phrase "PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*"
- m. In the second sentence of paragraph .69:
- Item (c) is inserted as follows:

(c) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period,
 - Item (c) is changed to (d)



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- Item (e) is inserted as follows:

(e) if applicable, a reference to the company's disclosure of the correction of the misstatement,
 - Item (d) is changed to (f) and the words "the fact" are inserted at the beginning of the item
- n. In the third sentence of paragraph .73, the word "restated" is replaced with the word "adjusted."
- o. In paragraph .74:
- In the first sentence of the third text paragraph, the word "restated" is replaced with the word "adjusted," and the word "restatement" is replaced with the words "the adjustments."
 - In the second sentence of the third text paragraph, the word "restatement" is deleted, and the word "his" is replaced with the words "the auditor's."

AU sec. 561, Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

SAS No. 1, "Codification of Auditing Standards and Procedures," section 561, "Subsequent Discovery of Facts Existing at the Date of Report," as amended, is amended as follows:

- a. The text of footnote 3 to paragraph .06 is replaced with the following:
- See paragraphs 26 and 27 of Accounting Principles Board Opinion No. 9 and paragraphs 25 and 26 of FASB Statement No. 154, regarding disclosure of adjustments applicable to prior periods.