PROPOSED AUDITING STANDARD—

EVALUATING CONSISTENCY OF FINANCIAL
STATEMENTS

AND PROPOSED AMENDMENTS TO INTERIM
AUDITING STANDARDS

PCAOB Release No. 2007-003
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.
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FASB issued Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections,\(^1\) which superseded Accounting Principles Board Opinion No. 20, Accounting Changes.\(^2\) The FASB has also issued an exposure draft of a proposed Statement of Financial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.

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\(^2\) Accounting Principles Board Opinion No. 20, Accounting Changes (1971) ("APB Opinion 20").


\(^4\) See FASB Statement 154, paragraph 2.
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. 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.

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 by distinguishing between these events. The proposals

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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.
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

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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.
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.  

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

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9/ See FASB Statement 154, paragraph 2.
company justifies that the alternative accounting principle is preferable, as required by FASB Statement 154. These are substantially the same requirements as those currently set forth in the interim standards. 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

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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.
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.\footnote{See AU sec. 508.16.}

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."\footnote{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.}

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."\footnote{See paragraphs .12 and .16 of AU sec. 420, Consistency of Application of Generally Accepted Accounting Principles.} 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
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.
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?
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.
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
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.

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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

April 3, 2007
APPENDICES –


2. *Proposed Amendments to Interim Auditing Standards*
APPENDIX 1 – PROPOSED AUDITING STANDARD – EVALUATING CONSISTENCY OF FINANCIAL STATEMENTS

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

*Proposed Auditing Standard—*

**EVALUATING CONSISTENCY OF FINANCIAL STATEMENTS**
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,


\(^2\) See FASB Statement 154, paragraph 2c.
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c. the disclosures related to the accounting change are adequate, and

d. the company has justified that the alternative accounting principle is preferable.

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.

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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.
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.
APPENDIX 2 – PROPOSED AMENDMENTS TO INTERIM AUDITING STANDARDS
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"


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"

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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
principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{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].

\textsuperscript{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].
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.

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**

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. 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.

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.

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
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:
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:
RELEASE

- 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."