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

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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Statement of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections*,^{1/} which superseded Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes*.^{2/} The FASB has also issued an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 SFAS No. 154 also superseded SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*.

RELEASE

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.

RELEASE

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.

RELEASE

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.

RELEASE

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

RELEASE

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

RELEASE

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.

RELEASE

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.

RELEASE

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

RELEASE

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."

RELEASE

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.

RELEASE

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.

RELEASE

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*.

RELEASE

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.

RELEASE

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

RELEASE

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.

RELEASE

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

RELEASE

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.

RELEASE

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

RELEASE

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.

RELEASE

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

RELEASE

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

RELEASE

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

RELEASE

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.

RELEASE

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.

RELEASE

- 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.

RELEASE

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.

RELEASE

APPENDIX 2 – AMENDMENTS TO INTERIM AUDITING STANDARDS

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

AMENDMENTS TO INTERIM AUDITING STANDARDS

RELEASE

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

RELEASE

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*.

RELEASE

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

RELEASE

- 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.

RELEASE

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.

RELEASE

.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

RELEASE

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)

RELEASE

- 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.