PCAOB
Public Company Accounting Oversight Board

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STANDING ADVISORY GROUP MEETING

SUBSEQUENT EVENTS

JULY 15, 2010

Introduction

The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is evaluating whether to amend or replace AU sec. 560, *Subsequent Events* ("AU sec. 560"), including requirements relating to the auditor's responsibility for identifying subsequent events only through the auditor's report date.[1/] A potential project on AU sec. 560 was added to the staff's standards-setting agenda as a result of the Financial Accounting Standards Board's ("FASB") project on subsequent events. In May 2009, FASB issued Statement on Financial Accounting Standard No. 165, *Subsequent Events* ("FAS 165"),[2/] which requires public companies to evaluate, as of each reporting period, events or transactions that occurred after the balance sheet date through the date that the financial statements were issued. While the requirements in FAS 165 did not result in requiring amendment of AU sec. 560, the staff has identified several areas in which, existing requirements could be improved that the Board could consider in a standards-setting project.

This briefing paper provides background information on the provisions of AU sec. 560 (which is included as an appendix). This paper includes the following two

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1/ References to AU sections ("AU sec.") throughout this paper are to the PCAOB's interim auditing standards, which consist of generally accepted auditing standards, as described in the American Institute of Certified Public Accountants ("AICPA") Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. These standards are available on the PCAOB's web site at: http://pcaobus.org/Standards/Auditing/Pages/default.aspx.

2/ See FASB Codification Topic No. 855.

discussion topics and related discussion questions: (1) audit procedures for identifying subsequent events and (2) the auditor's responsibility for identifying subsequent events after the auditor's report date. The staff is seeking the SAG's feedback in determining whether to revise AU sec. 560 to supplement or amend certain requirements in the standard and related requirements in other standards.

Background

AU sec. 560 was issued in November 1972 and was adopted by the PCAOB as one of its interim standards in April 2003. AU sec. 560 defines subsequent events as events or transactions that occur "subsequent to the balance-sheet date, but prior to the issuance of the financial statements, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements."[3/] The standard describes the types of subsequent events that require adjustment to the financial statements and the types of subsequent events that require disclosure. Subsequent events that require adjustment "provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements."[4/] For example, "the settlement of litigation for an amount different from the liability recorded in the accounts would require adjustment of the financial statements if the events, such as personal injury or patent infringement, that gave rise to the litigation had taken place prior to the balance-sheet date."[5/] Subsequent events that may require disclosure "provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date."[6/] Examples of subsequent events that would require disclosure would be the sale of a bond or capital stock issue or the purchase of a business subsequent to the balance sheet date.[7/]

AU sec. 560 further provides that the time period in which the auditor considers subsequent events is known as the "subsequent period" and is considered to extend

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3/ AU sec. 560.01.

4/ AU sec. 560.03.

5/ AU sec. 560.04.

6/ AU sec. 560.05.

7/ AU sec. 560.06.

from the balance sheet date to the date of the auditor's report.[8/] Additionally, AU sec. 560 describes auditing procedures the auditor is required to perform during the subsequent period for the purpose of ascertaining if subsequent events have occurred.[9/]

Discussion Topics

Audit Procedures for Identifying Subsequent Events

AU sec. 560 requires that certain audit procedures be performed after the balance sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure in the financial statements.[10/] These procedures include reading available information including interim financial statements and minutes of meetings, and making inquiries and obtaining written representations of officers, executives, and the client's legal counsel.

Given the potential importance of subsequent events to the financial statements, the staff is considering whether the existing procedures should be supplemented with additional requirements or revisions. For example, the standard requires the auditor to inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to whether any unusual adjustments were made during the period from the balance-sheet date to the date of inquiry.[11/] The standard could be modified to explicitly require the auditor to perform tests on nonstandard journal entries in the subsequent period to identify subsequent events, to perform analytical procedures relating to the latest available interim financial statements, or to perform substantive procedures relating to contingent liabilities or commitments that existed at the date of the balance sheet.

Discussion Question –

1. Should any of the existing audit procedures for identifying subsequent events be strengthened? Should the standard require any additional audit procedures?

8/ AU sec. 560.10.

9/ AU sec. 560.12.

10/ AU sec. 560.12.

11/ Ibid.

Auditor's Responsibility for Identifying Subsequent Events after the Report Date Through Issuance of the Financial Statements

AU sec. 560.10 defines the period during which the auditor considers subsequent events to extend from the balance sheet date to the date of the auditor's report. The requirement for dating the audit report in AU sec. 530, *Dating of the Independent Auditor's Report* ("AU sec. 530"), specifies that "[t]he auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion."[12/] In an integrated audit, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same dates.[13/]

AU sec. 530 states that the auditor has no responsibility to make any inquiry or carry out any auditing procedures for the period after the date of his report.[14/] Paragraph .03 of AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report,* includes similar language by stating that "the auditor has no obligation to make any further or continuing inquiry or perform any other auditing procedures with respect to the audited financial statements covered by that report, unless new information which may affect the report comes to his or her attention."[15/]

The staff recognizes that audit reports for U.S. public companies are, in practice, often dated close to the date the financial statements are issued. However, International Financial Reporting Standards require management to consider subsequent events through the date the financial statements were authorized to be issued,[16/] which, may be more than a few days prior to issuance. Similarly, the audit reports of these financial statements might also be dated more than a few days prior to issuance which could result in a longer period not being covered by subsequent event procedures under AU sec. 560.

[12/] AU sec. 530.01.

[13/] Ibid.

[14/] AU sec 530.02.

[15/] AU sec. 530.03.

[16/] International Accounting Standard No. 10, *Events after the Reporting Period*, describes the accounting for subsequent events.

The U.S. Securities and Exchange Commission ("SEC" or "Commission") has rules that specify that financial statements must not be misleading as of the date they are filed with the Commission.[17/] When financial statements are filed with the SEC there also are additional requirements regarding subsequent events. AU sec. 711, *Filings Under Federal Securities Statutes* ("AU sec. 711"), requires the auditor to perform subsequent event procedures after the date of the auditor's report. That standard sets out subsequent events procedures applicable in situations in which an auditor's report is included in a registration statement filed under the Securities Act of 1933, e.g., when annual financial statements are included or incorporated by reference in a registration statement. AU sec. 711 requires the auditor to consider subsequent events up to the effective date of the filing "or as close thereto as is reasonable and practicable in the circumstances."[18/]

Discussion Questions –

2. Should the auditor be required to perform additional procedures similar to those in AU sec. 560 to identify and evaluate subsequent events to cover the period from report date through issuance, or should any additional procedures during this period be limited to inquiries regarding material adverse effects?

3. What effect would adding requirements during this period have on when auditors would date their report or on the offering process?

* * *

The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

[17/] Rules 10b-5 and 12b-20 under the SEC's Securities Exchange Act of 1934.

[18/] AU sec. 711.10.

Appendix

AU Section 560

Subsequent Events

Source: SAS No. 1, section 560; SAS No. 12; SAS No. 98.

Issue date, unless otherwise indicated: November, 1972.

.01

An independent auditor's report ordinarily is issued in connection with historical financial statements that purport to present financial position at a stated date and results of operations and cash flows for a period ended on that date. However, events or transactions sometimes occur subsequent to the balance-sheet date, but prior to the issuance of the financial statements, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements. These occurrences hereinafter are referred to as "subsequent events." [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 93-97 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which provide direction with respect to subsequent events in an audit of internal control over financial reporting.

.02

Two types of subsequent events require consideration by management and evaluation by the independent auditor.

.03

The first type consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.

.04

Identifying events that require adjustment of the financial statements under the criteria stated above calls for the exercise of judgment and knowledge of the facts and circumstances. For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy subsequent to the balance-sheet date would be indicative of conditions existing at the balance-sheet date, thereby calling for adjustment of the financial statements before their issuance. On the other hand, a similar loss resulting from a customer's major casualty such as a fire or flood subsequent to the balance-sheet date would not be indicative of conditions existing at the balance-sheet date and adjustment of the financial statements would not be appropriate. The settlement of litigation for an amount different from the liability recorded in the accounts would require adjustment of the financial statements if the events, such as personal injury or patent infringement, that gave rise to the litigation had taken place prior to the balance-sheet date.

.05

The second type consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements.[fn1] Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading. Occasionally such an event may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements.

.06

Examples of events of the second type that require disclosure to the financial statements (but should not result in adjustment) are:

a. Sale of a bond or capital stock issue.

b. Purchase of a business.

c. Settlement of litigation when the event giving rise to the claim took place subsequent to the balance-sheet date.

d. Loss of plant or inventories as a result of fire or flood.

e. Losses on receivables resulting from conditions (such as a customer's major casualty) arising subsequent to the balance-sheet date.

.07

Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities ordinarily will require adjustment of the financial statements (see paragraph .03) because such events typically represent the culmination of conditions that existed over a relatively long period of time. Subsequent events such as changes in the quoted market prices of securities ordinarily should not result in adjustment of the financial statements (see paragraph .05) because such changes typically reflect a concurrent evaluation of new conditions.

.08

When financial statements are reissued, for example, in reports filed with the Securities and Exchange Commission or other regulatory agencies, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. Events occurring between the time of original issuance and reissuance of financial statements should not result in adjustment of the financial statements [fn2] unless the adjustment meets the criteria for the correction of an error or the criteria for prior period adjustments set forth in Opinions of the Accounting Principles Board. [fn*] Similarly, financial statements reissued in comparative form with financial statements of subsequent periods should not be adjusted for events occurring subsequent to the original issuance unless the adjustment meets the criteria stated above.

.09

Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his report an explanatory paragraph directing the reader's attention to the event and its effects. (See section 508.19.)

AUDITING PROCEDURES IN THE SUBSEQUENT PERIOD

.10

There is a period after the balance-sheet date with which the auditor must be concerned in completing various phases of his audit. This period is known as the "subsequent period" and is considered to extend to the date of the auditor's report. Its duration will depend upon the practical requirements of each audit and may vary from a relatively short period to one of several months. Also, all auditing procedures are not carried out at the same time and some phases of an audit will be performed during the subsequent period, whereas other phases will be substantially completed on or before the balance-sheet date. As an audit approaches completion, the auditor will be concentrating on the unresolved auditing and reporting matters and he is not expected to be conducting a continuing review of those matters to which he has previously applied auditing procedures and reached satisfaction.

.11

Certain specific procedures are applied to transactions occurring after the balance-sheet date such as (a) the examination of data to assure that proper cutoffs have been made and (b) the examination of data which provide information to aid the auditor in his evaluation of the assets and liabilities as of the balance-sheet date.

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[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005A. For audits of fiscal years ending before November 15, 2007, click here.]

In addition, the independent auditor should perform other auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles. These procedures should be performed at or near the date of the auditor's report. The auditor generally should:

a. Read the latest available interim financial statements; compare them with the financial statements being reported upon; and make any other comparisons considered appropriate in the circumstances. In order to make these procedures as meaningful as possible for the purpose expressed above, the auditor should inquire of officers and other executives having responsibility for financial and accounting matters as to whether the interim statements have been prepared on the same basis as that used for the statements under audit.

b. Inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:

(i) Whether any substantial contingent liabilities or commitments existed at the date of the balance sheet being reported on or at the date of inquiry.

(ii) Whether there was any significant change in the capital stock, long-term debt, or working capital to the date of inquiry.

(iii) The current status of items, in the financial statements being reported on, that were accounted for on the basis of tentative, preliminary, or inconclusive data.

(vi) Whether any unusual adjustments had been made during the period from the balance-sheet date to the date of inquiry.

c. Read the available minutes of meetings of stockholders, directors, and appropriate committees; as to meetings for which minutes are not available, inquire about matters dealt with at such meetings.

d. Inquire of client's legal counsel concerning litigation, claims, and assessments. [As amended, January 1976, by Statement on Auditing Standards No. 12.] (See section 337.)

e. Obtain a letter of representations, dated as of the date of the auditor's report, from appropriate officials, generally the chief executive officer, chief financial officer, or others with equivalent positions in the entity, as to whether any events occurred subsequent to the date of the financial statements being reported on by the independent auditor that in the officer's opinion would require adjustment or disclosure in these statements. The auditor may elect to have the client include representations as to significant matters disclosed to the auditor in his performance of the procedures in subparagraphs (*a*) to (*d*) above and (*f*) below. (See section 333, *Management Representations*.)

f. Make such additional inquiries or perform such procedures as he considers necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures, inquiries, and discussions.

Footnotes (AU Section 560 – Subsequent Events):

[fn1] This paragraph is not intended to preclude giving effect in the balance sheet, with appropriate disclosure, to stock dividends or stock splits or reverse splits consummated after the balance-sheet date but before issuance of the financial statements.

[fn2] However, see paragraph .05 as to the desirability of presenting pro forma financial statements to supplement the historical financial statements in certain circumstances.

[fn*] See also Statement of Financial Accounting Standards No. 16, Prior Period Adjustments (AC section A35).