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STANDING ADVISORY GROUP MEETING

Review of Existing Standards – Principles of Reporting

Evaluating and Reporting on Fair Presentation in Conformity With GAAP and Consistency of the Application of Accounting Principles

OCTOBER 5-6, 2005

A. Introduction and Overview

Recent accounting standards-setting developments prompt the discussion in this briefing paper about the need for revisions to the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") interim auditing standards.[1/] Specifically, the Financial Accounting Standards Board ("FASB") issued, in May 2005, FASB Statement No. 154 ("FASB No. 154"), *Accounting Changes and Error Corrections*, which revises the accounting for and disclosure of accounting changes in financial statements.[2/] Consequently, the PCAOB is considering what changes are needed to the

[1/] On April 16, 2003, the Public Company Accounting Oversight Board ("PCAOB" or "Board") adopted pre-existing auditing standards as interim standards to be used on an initial, transitional basis. Pursuant to Rule 3200T, interim auditing standards consist of generally accepted auditing standards, as described in the AICPA's Auditing Standards Board's Statement of Auditing Standards ("SAS") No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. See interim auditing standards of the Board at: www.pcaob.org/Standards/Interim_Standards/Auditing_Standards/index.aspx.

[2/] Financial Accounting Standards Board ("FASB") Statement No. 154 ("FASB No. 154") supersedes Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes*, and FASB No. 3, *Interim Financial Statements*.

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

corresponding auditing literature, AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, and portions of AU sec. 508, *Reports on Audited Financial Statements*, which conform to the previously existing accounting standards, to reflect the changes effected by FASB No. 154.

In addition, the FASB proposed, on April 28, 2005, to establish within its pronouncements the "hierarchy" of generally accepted accounting principles (the "GAAP hierarchy") to be used in the preparation of financial statements of nongovernmental enterprises, including U.S. public companies. The GAAP hierarchy currently exists in AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. Accordingly, if the FASB proposal is adopted, certain requirements currently included in AU sec. 411 would need to be reconsidered. Specifically, the proposed changes to the accounting literature raise a number of issues related to the first three of the four reporting standards included in the ten generally accepted auditing standards. Those three reporting standards are –

- The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (included in AU section ("AU sec.") 410, *Adherence to Generally Accepted Accounting Principles* and AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*)

- The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period (included in AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*)

- Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report (included in AU sec. 431, *Adequacy of Disclosure in Financial Statements*).

This briefing paper addresses certain aspects of these reporting standards, including the auditor's evaluation of the fair presentation of the financial statements, and the disclosures in the auditor's report for a company's accounting changes and error corrections.

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B. Evaluating and Reporting on Fair Presentation in Conformity With GAAP

As discussed in AU sec. 110, *Responsibilities and Functions of the Independent Audit*, the objective of the audit of financial statements is the expression of an opinion on the fairness with which the financial statements present financial position, results of operations, and cash flows in conformity with GAAP. Accordingly, forming an opinion on the financial statements includes evaluating whether the company has fairly presented the financial statements in accordance with specific requirements of GAAP for classes of transactions, account balances, and disclosures.

Evaluating Fair Presentation

PCAOB Auditing Standards

AU sec. 410 establishes that the auditor's report shall state whether the financial statements are presented in accordance with GAAP. This is not intended as a statement of fact by the auditor; rather, AU sec. 410 states that the auditor's statement is an opinion as to whether the financial statements are presented in conformity with GAAP. AU sec. 410 also states that GAAP is "construed to include not only accounting principles and practices, but also the methods of applying them."

AU sec. 411 builds on the meaning of the term GAAP presented in AU sec. 410 by stating, in AU sec. 411.02, that the phrase "generally accepted accounting principles" is a technical term that encompasses the "conventions, rules, and procedures necessary to define accounting practice at a particular time." This definition covers "not only broad guidelines of general application but also detailed practices and procedures." The pronouncement also establishes that conventions, rules, and procedures provide a standard by which to measure financial presentation. Therefore, GAAP is a framework of accounting principles, accounting practice, conventions, rules, methods, and broad and detailed procedures by which the auditor can evaluate a company's choices and applications of accounting principles.

AU sec. 411 also elaborates on "fairness" and states that: "the auditor's judgment of fairness of the overall presentation of financial statements should be applied within the framework of GAAP." Without the GAAP framework, there would be no "uniform standard" for judging the fairness of financial statement presentation because fairness is meaningful only within a frame of reference. The auditor, therefore, judges the overall fairness of the company's presentation based on knowledge of accounting pronouncements, accounting practice, conventions, and procedures.

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The auditor is required to evaluate more than technical compliance with accounting pronouncements in determining whether financial statements are fairly presented in conformity with GAAP.[3/] According to AU sec. 411.04, the auditor's opinion on whether the financial statements present fairly should be based on his or her judgment as to whether –

- Accounting principles selected and applied have general acceptance;
- Accounting principles are appropriate in the circumstances;
- Financial statements, including the related notes, are informative of matters that affect their use, understanding, and interpretation;
- Information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed or too condensed; and
- Financial statements reflect the underlying transactions and events in a manner that presents financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.[4/]

AU sec. 411.05 acknowledges that there is no single reference source for the body of generally accepted accounting principles and establishes what has become known as the GAAP hierarchy, with four levels of varying authoritativeness. The hierarchy places, in order of priority, all authoritative accounting literature that has been issued over time in the United States. For example, the hierarchy, in its highest priority level (category (a)), includes American Institute of Certified Public Accountants ("AICPA") Accounting Research Bulletins and Accounting Principles Board ("APB")

[3/] The auditor and others may have additional obligations under the federal securities laws. This paper only discusses the auditor's obligations under the current auditing standards. Proposed standards should not state a level of responsibility below that to which the auditor would be held under the law.

[4/] The concept of materiality is inherent in the auditor's judgments. That concept involves qualitative as well as quantitative judgments.

Opinions that are not superseded by action of the FASB; and FASB Statements of Financial Accounting Standards and Interpretations.[5/]

As previously mentioned, the FASB has proposed moving the GAAP hierarchy from the auditing literature to the accounting literature.[6/] The proposal generally keeps the hierarchy intact but revises the highest level to include some additional accounting principles that are issued after being subjected to the FASB's due process.[7/] Table A-1 in the Appendix summarizes the GAAP hierarchy levels from the FASB proposal.

The GAAP hierarchy assists the auditor in evaluating whether the accounting principles that a company selects have general acceptance and are appropriate in the circumstances. While the hierarchy deals primarily with accounting pronouncements, the auditor also is required by AU sec. 411 to recognize that GAAP is more than pronouncements and is also a framework of conventions, rules, methods, broad procedures, and detailed practices and procedures by which the auditor can evaluate a company's choices and applications of accounting principles. In addition, AU sec. 411.06 states, in part, that the auditor should consider whether the substance of transactions differs materially from their form. Recognition that the scope of GAAP is broader than the accounting pronouncements also influences the auditor's evaluation of the company's selection and application of accounting policies.

In circumstances in which there are no established accounting principles for reporting a specific transaction or event, it might be possible to report the event or transaction on the basis of its substance by selecting an accounting principle that appears appropriate when applied in a manner similar to the application of an established principle to an analogous transaction or event. The GAAP framework,

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[5/] Rules and interpretive releases of the Securities and Exchange Commission ("SEC") are sources of "category (a)" accounting principles for SEC registrants.

[6/] See FASB exposure draft, Proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles* (April 28, 2005).

[7/] FASB has proposed that FASB Staff Positions and FASB No. 133 Implementation Issues issued by the Derivatives Implementation Group also be considered sources of category (a) accounting principles.

therefore, is extended to include situations in which there are no established accounting principles for specific transactions or events.

AU sec. 431, *Adequacy of Disclosures*, emphasizes the importance of disclosures in the financial statements. AU sec. 431.02 states that the presentation of financial statements in conformity with GAAP includes adequate disclosure of material matters. These material matters are not just related to footnote disclosures but also relate to the *form*, *arrangement,* and *content* of the financial statements. The material matters include the terminology used, amount of detail given, classification of items in the statements, and the bases of amounts set forth. AU sec. 431 further requires the auditor to consider whether a particular matter should be disclosed in light of the circumstances and facts of which he or she is aware at the time.

There is evidence, however, that some participants in the U.S. financial reporting community have incorrectly viewed the term "fairly presents in conformity with GAAP" to mean nothing more than technical compliance with the authoritative accounting pronouncements. For example, some companies have used off-balance sheet arrangements and "financial engineering" to distort the true nature of transactions and events.

Recently, the Securities and Exchange Commission ("SEC") staff released a comprehensive report on its study of off-balance sheet arrangements and whether current financial statements of issuers transparently reflect the economics of off-balance sheet arrangements.[8/] The report provided a brief description of a few of Enron's transactions that illustrated lack of transparency related to special purpose entities. The SEC staff noted that it was eventually reported that aspects of Enron's business were built on non-substantive trades and related party transactions with no business purpose. "Compounding all of this, it quickly became apparent that Enron's financial reports had not revealed the company's true economic position to the market," the report said.

[8/] Staff of the Securities and Exchange Commission ("SEC"), *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (submitted to the President of the United States, the Committee on Banking, Housing, and Urban Affairs of the United States Senate and the Committee on Financial Services of the United States House of Representatives, 2005).

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The SEC staff also reported that Enron's bankruptcy examiner preliminarily concluded that "through the pervasive use of structured finance techniques involving SPEs ["special purpose entities"] and aggressive accounting practices, Enron so engineered its reported financial position and results of operations that its financial statements bore little resemblance to its actual financial condition or performance."[9/]

Financial engineering, in general, involves structuring a transaction to achieve a desired accounting outcome that is not consistent with the economics of the transaction. The SEC staff report[10/] noted that deliberate attempts to work around the intent of accounting standards have contributed to many of the largest financial reporting failures and that these attempts normally involve transactions that are structured to achieve accounting results that do not reflect the economics.

Some companies also have engaged in transactions that have no economic substance but that give the impression of operating activity. This includes, for example, buying from and selling to another company the same assets or services to increase revenues and expenses while having no effect on net income.

Discussion Question—

B1. Are the auditor's current responsibilities under AU secs. 410, 411, and 431 to opine on fair presentation of financial statements in conformity with GAAP adequate? If not, how should the current direction to the auditor be modified?

IFAC Auditing Standards

Audit reporting standards included in International Standards on Auditing ("ISAs") issued by the International Auditing and Assurance Standards Board of the International

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[9/] It is important to note that the FASB addressed special-purpose entities ("SPE"s) through issuance of *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation ARB No. 51*. That accounting standard provided additional guidance for determining whether an entity controls another entity, such as an SPE.

[10/] See footnote 8.

Federation of Accountants ("IFAC")[11/] are similar in concept to the PCAOB auditing standards and also provide more direction in some areas. ISA 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*, provides guidance for audit reporting. That standard notes that the auditor's judgment about whether the financial statements give a true and fair view, or are presented fairly, in all material respects, is made in the context of the applicable accounting requirements.[12/]

According to ISA 700, forming an opinion involves evaluating whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial framework for particular classes of transactions, account balances, and disclosures. The evaluation should include considering whether –

- Accounting policies selected and applied are consistent with the financial reporting framework and appropriate in the circumstances;
- Accounting estimates made by management are reasonable in the circumstances;
- Information presented in the financial statements, including accounting policies, is relevant, reliable, comparable, and understandable; and
- Financial statements provide sufficient disclosures to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements.

ISA 700 also explicitly requires the auditor to evaluate whether the financial statements are fairly presented in all material respects. Paragraph 14 of ISA 700 states, in part, that –

[11/] The ISAs are intended for use in all audits of financial statements—those of publicly traded companies, private business of all sizes, and government entities at all levels. The European Commission is currently considering a process and timetable for endorsement of ISAs. IFAC is a global organization for the accountancy profession.

[12/] The terms "give a true and fair view" and "are presented fairly, in all material respects" are considered by the ISAs to be equivalent.

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> Forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework also involves evaluating the fair presentation of the financial statements. The auditor considers whether the financial statements, after any adjustments made by management as a result of the audit process, are consistent with the auditor's understanding of the entity and its environment. The auditor considers the overall presentation, structure and content of the financial statements. The auditor also considers whether the financial statements, including the note disclosures, faithfully represent the underlying transactions and events in a manner that gives a true and fair view of or presents fairly, in all material respects, the information conveyed in the financial statements in the context of the financial reporting framework.

GAO Suggestions

The United States Government Accountability Office ("GAO") wrote a comment letter[13/] to the American Institute of Certified Public Accountants about the AICPA's proposed amendment to its standard on audit reporting for private nongovernmental entities.[14/] The GAO suggested that, in evaluating "fairness" of the overall financial statement presentation, auditors should consider significant qualitative factors, such as those included in the following list—based on the GAAP framework.

- Relevance, reliability, comparability, and understandability of the financial statements;
- Management's selection and application of significant accounting policies, as well as the effect of the policies on the overall presentation;

13/ Letter from David M. Walker, Comptroller General of the United States, United States Government Accountability Office, to Sherry Boothe, Audit and Attest Standards, American Institute of Certified Public Accountants (June 27, 2005).

14/ Proposed Statement on Auditing Standard—*Amendment to Statements on Auditing Standards No. 69, the Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles for Nongovernmental Entities* (May 9, 2005). This exposure draft proposes to remove the GAAP hierarchy from the AICPA's Statements on Auditing Standards No. 69.

- Impact of management judgments and estimates on the overall presentation;
- Impact of uncorrected misstatements, if any;
- Evidence of possible fraud or intentional misstatement;
- Other matters known by the auditors that could affect the recognition, measurement, and disclosure of financial statement information; and
- Any relevant subsequent events.

Discussion Questions—

B2. Should PCAOB's audit reporting standards explicitly adopt some or all of the qualitative evaluation factors in ISA 700 and in the GAO comment letter?

B3. Should there be a more explicit requirement for the auditor to stand back and evaluate whether the financial statements are misleading, even though the company appears to have technically complied with the authoritative accounting pronouncements?

Clarification of the Auditor's Responsibility in the Auditor's Report

At the June 2004 SAG meeting, the SAG touched on this concept in a related topic about what the auditor's opinion communicates about the financial statements. One SAG member mentioned that "the need to look at the auditor's report is a pressing one" and that "one interim step that seems to make sense would be to really look at whether or not we want to at least . . . break the opinion into two parts and say the financial statements are fairly presented in all material respects and in conformity with generally accepted accounting principles."

Discussion Question—

B4. Would a requirement for the auditor to express separate opinions on whether the financial statements (1) present fairly and (2) are in conformity with GAAP improve the quality of audits or audit reports? If so, how?

Informative Disclosures

The SEC staff report about arrangements with off-balance sheet implications, special purpose entities, and transparency of filings emphasized the importance of notes to the financial statements.[15/] The report stated that issuer disclosures are not as informative as they could be and, in general, that disclosures in the filings of issuers need to be better organized and integrated. The report also suggested that FASB could develop a disclosure framework that sets forth objectives to be used in disclosures and observed that disclosure guidance tends to vary from standard to standard because the FASB's conceptual framework does not contain a substantial amount of guidance related to the notes to the financial statements.[16/] The SEC staff report notes that "disclosures in the notes to the financial statements are a critically important complement to the financial statements and are necessary to achieve transparency in financial reporting." AU sec. 431 does not use terms such as transparency, understandability, or quality in framing the auditor's responsibility to evaluate the adequacy of disclosure.

Discussion Question—

B5. Given the SEC staff report about transparency in financial reporting, should the auditor's responsibility for evaluating the adequacy of disclosure be clarified? If so, how, and what criteria should the auditor use?

C. Auditing Issues Related to the Consistency of Reporting Accounting Changes and Error Corrections

This section describes changes to accounting requirements included in FASB No. 154, identifies certain aspects of existing reporting guidance in the Board's interim auditing standards related to the consistency of the application of GAAP, and provides questions for consideration and feedback regarding possible changes to current

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[15/] See footnote 8.

[16/] The FASB chairman noted, in a June 2005 press release, that the FASB has provided input to and has discussed the content of the report with SEC staff. He generally agreed with the thrust of the findings and principal recommendations, which he believed were very consistent with the FASB's current activities and plans.

auditing standards to better reflect the auditor's responsibilities related to the consistency of reporting accounting changes and error corrections.

FASB No. 154's summary indicates that certain of its requirements enhance the consistency of financial information between periods and that the improved consistency enhances the usefulness of financial information by facilitating analysis and understanding of comparative accounting data. Consistency is an important element of comparability as described in FASB Concepts Statement 2, *Qualitative Characteristics of Accounting Information*.

> Consistency in applying accounting methods over a span of time has always been regarded as an important quality that makes accounting numbers more useful.

Reporting on consistency is important from an auditing standpoint. Current reporting direction in AU sec. 508, *Reports on Audited Financial Statements*, requires reporting by exception regarding the consistency of the application of GAAP. Auditors, therefore, are not required to refer to the consistent application of GAAP unless the changes in accounting principle between periods have materially affected the comparability of a company's financial statements. Current audit report requirements are discussed later in the "Auditing Considerations" section of this paper.

Previous auditor reporting requirements (SAS No. 1, *Codification of Auditing Standards and Procedures* (Part 546, "Reporting on Inconsistency") indicated that "if there had been a change in accounting principle . . ., the appropriate reference to consistency is that the statements are consistent after giving effect to the change." FASB No. 154 prompts addressing the issue of the consistency of auditor reporting under GAAP again.

Table 1 identifies the nature of accounting changes[17/] and the types of error corrections included in FASB No. 154. In addition, the table provides auditing requirements included in AU sec. 420, *Consistency of Application of GAAP*, for recognition of changes and error corrections in the auditor's report.

[17/] According to APB Opinion No. 20, accounting changes were identified as a change in (1) an accounting principle, (2) an accounting estimate, or (3) the reporting entity—a special type of change in accounting principle.

Table 1

Effect of Accounting Changes and Corrections of Errors on Auditor's Report

Nature of Change (described in FASB No. 154)	**Recognize in Auditor's Report per AU sec. 420**
Accounting Change	
Change in accounting principle	Yes, represents material lack of comparability due to change in principle
Change in accounting estimate	No
Change in accounting estimate effected by change in accounting principle	Yes, represents material lack of comparability due to change in principle
Change in reporting entity— (1) presenting consolidated or combined statements in place of individual statements of companies, (2) changing subsidiaries comprising group of companies for consolidated statements, (3) changing companies included in combined financial statements	Yes, represents material lack of comparability due to change in principle
Error Correction	
Mathematical mistake	No
Mistake in application of GAAP (includes change from non-GAAP to GAAP)	Yes, represents material lack of comparability due to change in principle
Oversight or misuse of facts that existed at time financial statements were prepared	No

Accounting Guidance

According to APB Opinion No. 20, *Accounting Changes*—FASB No. 154's predecessor—most voluntary changes in accounting principle were recognized in the financial statements by including the cumulative effect, based on a retroactive computation of changing to a new accounting principle, in the net income of the period

of the change. APB Opinion No. 20, however, required a few changes in accounting principles to be reported by restating the financial statements of all prior periods.[18/]

FASB No. 154 carries forward, without change, accounting guidance contained in APB Opinion No. 20 for reporting a change in accounting estimate and for reporting the correction of errors in previously issued financial statements, which requires restatement of previously issued financial statements. For example, a change in accounting estimate is accounted for in "(a) the period of change if the change affects that period only or (b) in the period of change and future periods if the change affects both." FASB No. 154, however, identifies accounting for a change in depreciation, amortization, or depletion methods for long-lived non-financial assets as one example of a change in accounting estimate effected by a change in accounting principle rather than as a change in accounting principle, as it was defined in the previous guidance. The standard states, in paragraph 20, that –

> The new depreciation method is adopted in partial or complete recognition of a change in the estimated future benefits inherent in the asset, the pattern of consumption of those benefits, or the information available to the entity about those benefits. The effect of the change in accounting principle, or the method of applying it, may be inseparable from the effect of the change in accounting estimate.

FASB No. 154 provides new direction by requiring retrospective application of a new accounting principle, except in certain circumstances in which it is impracticable, for most voluntary changes in accounting principles and changes in accounting principles required as a result of the issuance of a new FASB pronouncement (when the pronouncement does not provide its own transition requirements).

- *Retrospective application* is the "application of a different accounting principle to prior accounting periods as if that principle had always been used." The term retrospective application replaces the term "restatement of prior-period financial statements" to harmonize wording with

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[18/] Changes requiring restatement included: (a) a change from the Last-in, First-out ("LIFO") method of inventory pricing to another method, (b) a change of accounting for long-term construction-type contracts, and (c) a change to or from the "full-cost" method of accounting (used in the extractive industries).

international standards.[19/] Retrospective application "shall include only the direct effects of a change in accounting principle, including any income tax effects." Retrospective application would not include the "indirect effects that would have been recognized if the newly adopted accounting principle had been followed in prior periods," e.g., the effect on a royalty payment that is based on a reported amount such as revenue or net income that has been subjected to retrospective application. If indirect effects are actually incurred and recognized, they are to be reported in the period in which the accounting change is made.

- *Impracticable circumstances* include several conditions, one of which is that "the entity is unable to apply the requirement to account for the change retrospectively after making every reasonable effort to do so."

FASB No. 154 states that when an entity restates it financial statements to correct an error, it should disclose that fact to distinguish corrections of errors from accounting changes. Accordingly, that standard limits use of the term *restatements* to "the process of revising previously issued financial statements to reflect the correction of errors in those financial statements."

Auditing Considerations

Current language in the auditor's report does not distinguish retrospective applications resulting from voluntary changes in accounting principles or adoption of a new accounting pronouncement from other restatements due to corrections of errors in previously issued financial statements. Rather, according to paragraphs .16-.17 of AU sec. 508, *Reports on Audited Financial Statements* –

> If . . . there has been a change in accounting principles or in the method of their application that has a material effect on the comparability of the company's financial statements, the auditor should refer to the change in an explanatory paragraph of the report. Such explanatory paragraph (following the opinion paragraph) should identify the nature of the change and refer the reader to the note in the financial statements that discusses the change in detail.

[19/] International Accounting Standard ("IAS") 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, is applicable for annual periods beginning on or after January 2005.

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Following is an example of a typical explanatory paragraph –

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 20X2.

Discussion Question—

C1. Should the wording in the auditor's report distinguish between changes due to retrospective application of a change in accounting principle and changes due to restatement to correct an error in the auditor's report?

As noted in Table 1 above, recognition in the auditor's report has been required, according to auditing direction in AU sec. 420, for a material lack of comparability between periods caused by changes in accounting principles, changes in estimates effected by a change in accounting principle, and error corrections involving GAAP.

Discussion Questions—

C2. Should the current requirement for recognition in the auditor's report for changes in accounting principles be expanded to include changes in accounting estimates and corrections of errors resulting from mathematical mistakes and omissions in previously reported financial statements?

C3. If it is recommended that only certain types of accounting changes and error corrections be recognized in the auditor's report, what should be the basic reporting principle? (Current requirements are to report principles-related error corrections or changes.)

C4. When the company indicates that it is impracticable to determine either the cumulative or the period-specific effects of an accounting change, should the auditor have a responsibility to substantiate the impracticability claim?

Auditor's Responsibility Regarding Justification for a Change in Accounting Principle

In FASB No. 154, the guidance requiring justification for a change in accounting principle on the basis of preferability is carried forward from APB Opinion No. 20. Therefore, once adopted, an accounting principle should not be changed for events and

transactions of a similar type. This requirement underscores the idea that using the same accounting principles consistently from one accounting period to another "enhances the usefulness of the financial information, especially by facilitating analysis and understanding of comparative accounting data." More importantly, justification for a change in accounting principle also requires that the entity proposing to make a change to another accounting principle shows that the basis for such a change—the alternative principle—is preferable. If justification was not required, companies could change accounting principles to affect the appearance of financial performance.

The auditor currently has some responsibilities regarding the justification for an accounting change. In addition to evaluating a change in accounting principle to determine whether the new principle is generally accepted and that the method of accounting for the change in principle is in conformity with GAAP, AU sec. 508.50 indicates that the auditor should evaluate whether "management's justification for the change is reasonable." This is short of a responsibility to be satisfied with preferability and relates only to whether the justification management discloses for preferability is reasonable.

On the other hand, the SEC has rules in place related to preferability requirements for auditors. SEC Rule 10-01(b)(6) of Regulation S-X[20/] requires that the auditor directly report on preferability. A company's independent auditor is required to issue a letter accompanying the first 10-Q subsequent to the date of an accounting change indicating whether the change is to an alternative principle which, in the circumstances, is preferable in the circumstances, unless the change is required by a pronouncement that the FASB adopts.

Discussion Questions—

C5. Should the auditor have a responsibility under PCAOB standards to substantiate that an accounting change in principle is preferable? (The Board's interim standards currently require the auditor to evaluate whether management's justification for the change is reasonable.)

C6. If the auditor has reporting responsibilities related to substantiating that an accounting change in principle is preferable, what criteria should the

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20/ Securities and Exchange Commission ("SEC") Rule 10-01(b)(6), 17 CFR 229.601.

auditor use to evaluate preferability? Should the auditor report his or her related conclusion and, if so, how?

Reporting on the Nature of Intentional Misstatements

Currently, accounting standards do not distinguish between *intentional* mistakes in the application of GAAP or the *intentional* oversight or misuse of facts and other errors from *unintentional* financial statement misstatements. However, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, makes this distinction in the context of an audit of financial statements. That pronouncement refers to "intentional misstatements and omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be presented, in all material respects, in conformity with GAAP" as relevant to the auditor's consideration of fraud (AU sec. 316.06). When the auditor has evidence that a misstatement was intentional, the auditor has certain communication responsibilities about possible fraud to management, the audit committee, and others, depending on the circumstances. The auditor is not required to identify intentional misstatements and omissions of amounts or disclosures in the auditor's report.

Discussion Question—

C7. Should restatements due to intentional misstatements in the application of GAAP or intentional oversight or misuse of facts require specific identification in the audit report?

Reporting on Changes That Are Likely To Be Material

Paragraph 17 of FASB 154 requires current-period disclosure when a change in accounting principle that is not material in the current period is "reasonably certain" to have a material effect in later periods. In these circumstances, the required disclosure is limited to identifying "the nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable." There is no requirement for recognition in the auditor's report, but such recognition is permitted.

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Discussion Questions—

C8. Should any direction be provided for the auditor regarding determining whether a change in principle in the current period is "reasonably certain" to have a material effect in later periods?

C9. Should the auditor be required to recognize in his or her report a change that is reasonably certain to be material in later periods?

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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.

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APPENDIX

Proposed GAAP Hierarchy Levels

Table A-1 is a summary of the generally accepted accounting principles ("GAAP") hierarchy levels included in the proposal by the Financial Accounting Standards Board ("FASB"), *The Hierarchy of Generally Accepted Accounting Principles* (April 28, 2005).

Table A-1
GAAP Levels of Authority (Proposed)

Level	Type of Literature
(a)	American Institute of Certified Public Accountants ("AICPA") Accounting Research Bulletins and Accounting Principles Board ("APB") Opinions that are not superseded by action of the FASB, FASB Statements of Financial Accounting Standards and Interpretations, FASB No. 133 Implementation Issues, and FASB Staff Positions[1/]
(b)	FASB Technical Bulletins, and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides and Statements of Position
(c)	AICPA Accounting Standards Executive Committee Practice Bulletins that have been cleared by the FASB and consensus positions of the FASB Emerging Issues Task Force
(d)	Implementation guides (Q&As) published by the FASB staff, AICPA accounting interpretations, and practices that are widely recognized and prevalent either generally or in the industry

The hierarchy helps the auditor evaluate the general acceptance of a company's selection of accounting principles from among the various principles developed by various rulemaking bodies over the years. According to the hierarchy, the following rules apply to the selection of accounting guidance –

- If the accounting treatment for a transaction or event is not specified by a pronouncement in category (a) (highest level of the hierarchy), the auditor should consider whether the accounting treatment is specified by another source of established accounting principles.

[1/] Rules and interpretive releases of the Securities and Exchange Commission ("SEC") are sources of category (a) accounting principles for SEC registrants.

- If an established accounting principle from one or more sources in category (b), (c), or (d) is relevant to the circumstances, the auditor should be prepared to justify a conclusion that another treatment is generally accepted.

- If there is a conflict between accounting principles relevant to the circumstances from one or more sources in category (b), (c), or (d), the auditor should follow the treatment specified by the source in the higher category—for example, follow category (b) treatment over category (c)—or be prepared to justify a conclusion that a treatment specified by a source in the lower category better presents the substance of the transaction in the circumstance.

The FASB proposal to remove the GAAP hierarchy from the auditing standards and to place it in the accounting standards[2/] also provides that –

> If the accounting treatment for a transaction or event is not specified by a pronouncement in categories (a) – (d), an entity shall consider accounting principles for similar transactions or events and other accounting literature. Other accounting literature includes, for example, FASB Concept Statements; AICPA Issues Papers; International Financial Reporting Standards of the International Accounting Standards Board; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles.

The proposal stipulates that –

> The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and general recognition of the issuer or author as an authority. For example, FASB Concepts Statements normally would be more influential than other sources in this category.

[2/] See FASB exposure draft, Proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles* (April 28, 2005).