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

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

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

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

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

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

<u>Proposed Auditing Standard on Evaluating Consistency of Financial Statements</u>

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

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

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

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

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

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

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

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

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

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

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

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

Reconsider whether changes in the reporting entity impact consistency.
Paragraph 6 of the proposed standards states the following: "the auditor should report on a change in the reporting entity as if it were a change in accounting principle." As a result,

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

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

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

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

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

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

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

Retain certain guidance currently in AU Section 9420.
Currently AU Section 9420.11-20 discusses *The Effect of APB Opinion 28 on Consistency* and the *Impact on the Auditor's Report of FIFO to LIFO Change in Comparative Financial Statements*. We believe this guidance is still relevant and useful, and we believe it should be retained in the PCAOB auditing standards.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Retain AU Section 9411 paragraphs 11 and 12.
These paragraphs provide important audit guidance with respect to evaluating the application of accounting principles when there are no established sources of accounting principles. Because these paragraphs provide guidance on the audit procedures to perform (and not accounting guidance), we believe they should be retained in the PCAOB auditing standards. We recognize that some modifications to paragraph 12 may be appropriate; however, the guidance to the auditor on the procedures to perform should be retained.

Other Comments on Proposed Changes to Interim Standards

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

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

Retain current language in AU Section 508.73-.74.
The proposed modifications to paragraphs 73 and 74 of AU 508 would remove the word "restated" and replace it with the word "adjusted." It appears, however, that using the word "adjusted" would incorporate all reclassifications, which under paragraph 11 of the proposed standard may not, in all cases, be considered restatements. Therefore, we recommend that the word "restated" be retained in both paragraphs 73 and 74.

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

Sincerely,

/s/ Deloitte & Touche LLP

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