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Public Company Accounting Oversight Board

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STAFF QUESTIONS AND ANSWERS

ADJUSTMENTS TO PRIOR-PERIOD FINANCIAL STATEMENTS AUDITED BY A PREDECESSOR AUDITOR

June 9, 2006

Summary: Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to adjustments to prior-period financial statements audited by a predecessor auditor were prepared by the Office of the Chief Auditor. Additional questions should be directed to Greg Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org) or Sam Guzman, Assistant Chief Auditor (202/207-9117; guzmans@pcaobus.org).

General

Q1. Circumstances arise that require a company to make adjustments to prior-period financial statements. Such circumstances include, for example, the reporting of discontinued operations, and the retrospective application of a change in accounting principle or the correction of an error in prior-period financial statements pursuant to Financial Accounting Standards Board Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("FASB Statement 154").[1/]

[1/] Pursuant to Financial Accounting Standards Board Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("FASB Statement 154"), the retrospective application of a change in accounting principle also is

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If the prior-period financial statements that require adjustments were audited by a predecessor auditor, which auditor, the predecessor or the successor, may audit the adjustments to prior-period financial statements?[2/]

> **A1.** Either the successor auditor or the predecessor auditor may audit the adjustments made to prior-period financial statements so long as the auditor is independent and registered with the PCAOB. Issuers sometimes select the predecessor auditor to audit the adjustments because that auditor has performed the audit of the prior-period financial statements and has knowledge of the transactions that occurred during that period. In addition, the use of the predecessor auditor sometimes can be more cost-effective for performing this work. However, the successor auditor also may audit the adjustments.

Predecessor Auditor Audits the Adjustments to Prior-Period Financial Statements

Q2. If the predecessor auditor audits the adjustments to the prior-period financial statements, how should the predecessor auditor date his or her report on the reissued financial statements?

> **A2.** The predecessor auditor should dual-date his or her reissued report in connection with the audit of the adjustments made to the prior-period financial statements. Paragraph .73 of AU section ("sec.") 508, *Reports on Audited Financial Statements,* states that, "A predecessor auditor's knowledge of the current affairs of his or her former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing the report on prior-period

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appropriate when there are no transition requirements specific to a particular accounting pronouncement.

[2/] The term "adjustments to prior-period financial statements" should be understood for purposes of this set of questions and answers to include, among other things, the reporting of discontinued operations, as well as, restatements to correct errors and retrospective applications of changes in accounting principles, as described in FASB Statement 154.

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financial statements, a predecessor auditor should use the date of his or her previous report to avoid any implication that he or she has examined any records, transactions, or events after that date. If the predecessor auditor revises the report or if the financial statements are restated, he or she should dual-date the report."

Q3. If the predecessor auditor audits the adjustments made to the prior-period financial statements, what is the successor auditor's responsibility with regard to those adjustments?

A3. If the predecessor auditor audits the adjustments made to the prior-period financial statements, he or she is responsible for the audit conclusions reached with respect to those adjustments. However, because corrections of errors and the retrospective application of a change in accounting often have the effect of changing the periods in which transactions and events are recognized in the financial statements, the successor auditor should obtain an understanding of the adjustments made to the prior-period financial statements and their effects, if any, on the current-period financial statements.[3/]

In addition, the successor auditor should evaluate the consistency of the application of accounting principles from period to period. Paragraph .24 of AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, states:

> When the independent auditor has not audited the financial statements of a company for the preceding year, he should adopt procedures that are practicable and reasonable in the circumstances to assure himself that the accounting principles employed are consistent between the current and the preceding year.

[3/] See the requirement for the auditor to plan and perform his or her work with due professional care in paragraph .02 of AU section ("AU sec.") 230, *Due Professional Care in the Performance of Work*.

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Successor Auditor Audits the Adjustments to Prior-Period Financial Statements

Q4. What factors are relevant to a successor auditor's determination as to whether he or she is able to audit only the adjustments to prior-period financial statements or whether a reaudit of those financial statements is necessary?[4/]

A4. To audit only the adjustments to prior-period financial statements that were audited by a predecessor auditor,[5/] a successor auditor must be able to form an opinion that the adjustments are appropriate and have been properly applied.[6/] In determining whether he or she is able to form such an opinion without performing a reaudit of the prior-period financial statements, the successor auditor should consider:

- *The extent of the adjustments.* The less extensive and pervasive the adjustments to prior-period financial statements are, the more likely it is that a successor auditor can form an opinion that the adjustments are appropriate and have been properly applied without performing a reaudit of those financial statements. More extensive and pervasive adjustments make it more likely that a reaudit is necessary.

4/ This staff question and answer assumes that the predecessor auditor reissues his or her report on the prior-period financial statements before the effects of the adjustments.

5/ This series of staff questions and answers assumes that the predecessor auditor has not ceased operations as the term "ceased operations" has been defined in footnote 2 of AU sec. 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*. In cases in which the predecessor auditor has ceased operations, the successor auditor should refer to AU sec. 9508.60-.75.

6/ See paragraph .74 of AU sec. 508, *Reports on Audited Financial Statements*.

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- *The reason for the adjustments.* A successor auditor is ordinarily more likely to be able to form an opinion that adjustments to prior-period financial statements are appropriate and have been properly applied when those adjustments are due to the retrospective application of an accounting principle rather than when the adjustments are necessary to correct an error.[7/] In the latter situation, the auditor should consider the risk that there may be other undetected misstatements in the prior-period financial statements. In particular, if the adjustments correct an intentional misstatement,[8/] it is more likely that a reaudit is necessary.

- *Cooperation of predecessor auditor*. A successor auditor is more likely to be able to form an opinion that adjustments to prior-period financial statements are appropriate and have been properly applied if he or she has the cooperation of the predecessor auditor. For example, a successor auditor may determine that he or she is able to audit adjustments to prior-period financial statements if he or she has access to the audit documentation relating to the prior periods and if the predecessor auditor is responsive to questions relating to those periods.

After a successor auditor has determined that he or she is likely to be able to form an opinion that adjustments to prior-period financial statements are

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[7/] FASB Statement 154 defines an error in previously issued financial statements as an error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared. Errors, also referred to as misstatements, include those that are intentional or unintentional.

[8/] See paragraph .05 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

appropriate and have been properly applied, the auditor might obtain evidence indicating, or otherwise might determine, that the prior-period financial statements are materially misstated in other respects. In this circumstance, the successor auditor should reevaluate whether auditing only the adjustments is appropriate or whether a reaudit of the prior-period financial statements is necessary.[9/]

Q5. If the successor auditor audits adjustments to the prior-period financial statements audited by a predecessor auditor, how should the successor auditor report on the results of the audit of those adjustments?

A5. AU sec. 508.74 describes how a successor auditor should report when he or she audits adjustments and the predecessor auditor's report is not presented. The successor auditor may use a similar form of reporting if he or she has audited the adjustments made to prior-period financial statements in connection with his or her audit of a subsequent period and if the predecessor auditor also reissues his or her report on the prior-period financial statements. It also is appropriate for the successor auditor to emphasize in the report that he or she was not engaged to audit, review, or apply any procedures to the prior-period financial statements other than with respect to the adjustments.

The following are examples of a paragraph the successor auditor may include in his or her report on the audit of the financial statements of a subsequent period:

Example for retrospective application of a change in accounting

We also have audited the adjustments to the 20X4 financial statements to retrospectively apply the change in accounting

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[9/] In addition, the successor auditor has responsibilities under paragraphs .21-.22 of AU sec. 315, *Communications Between Predecessor and Successor Auditors*, when the successor auditor becomes aware of information that leads him or her to believe that the prior-period financial statements reported on by the predecessor auditor may require revision.

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> [*describe accounting change*], as described in Note X. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X4 financial statements of the Company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X4 financial statements taken as a whole.
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> ***Example for correction of an error***
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> We also have audited the adjustments described in Note X that were applied to restate the 20X4 financial statements to correct an error. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X4 financial statements of the Company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X4 financial statements taken as a whole.

Q6. When a successor auditor audits and reports on adjustments made to prior-period financial statements due to the correction of an error, may the predecessor auditor reissue his or her report on the prior-period financial statements?

A6. Yes. A predecessor auditor may reissue 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-period 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.[10/] When determining whether the report is still appropriate, the predecessor auditor may consider factors such as:

[10/] See AU sec. 508.71. The predecessor auditor also may decide to withdraw his or her report on those financial statements. See AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

- The nature and extent of the adjustments pertaining to the error correction,
- Whether management has withdrawn the prior-period financial statements, and
- Whether the errors were intentional.

Q7. If the predecessor auditor does not reissue his or her report on the prior-period financial statements, may the successor auditor reaudit and report on those financial statements as adjusted?

> **A7.** Yes. A successor auditor or another independent auditor may reaudit and report on prior-period financial statements as adjusted.

Q8. In circumstances in which a successor auditor audits and reports on adjustments made to prior-period financial statements audited by a predecessor auditor, what procedures should the predecessor auditor perform prior to reissuing his or her report on those financial statements prior to adjustment?

> **A8.** AU sec. 508.71 states that, "a predecessor auditor should (a) read the financial statements of the current period, (b) compare the prior-period financial statements that he or she reported on with the financial statements to be presented for comparative purposes, and (c) obtain representation letters from management of the former client and from the successor auditor. The representation letter from management of the former client should state (a) whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (b) whether any events have occurred subsequent to the balance-sheet date of the latest prior-period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements [except for the adjustments]. The representation letter from the successor auditor should state whether the successor's audit revealed any matters that, in the successor's opinion, might have a material effect on, or

require disclosure in, the financial statements reported on by the predecessor auditor [other than the adjustments disclosed to the predecessor auditor]."

Q9. In circumstances in which a successor auditor audits and reports on adjustments made to prior-period financial statements audited by a predecessor auditor, are there any modifications the predecessor auditor should make to his or her reissued report on the prior-period financial statements?

A9. Yes. If the predecessor auditor was not engaged to audit the adjustments to the prior-period financial statements, the predecessor auditor should modify his or her reissued report to indicate that (a) the reissued opinion relates to the prior-period financial statements before the effects of the adjustments, and (b) he or she was not engaged to audit, review, or apply any procedures to the adjustments.

The following are examples of how the predecessor auditor may modify his or her report:[11/]

Example for retrospective application of a change in accounting

Report of Independent Registered Public Accounting Firm

We have audited, before the effects of the adjustments to retrospectively apply the change in accounting described in Note X, the balance sheet of ABC Company as of December 31, 20X4, and the related statements of income, changes in shareholders' equity, and cash flows for the year then ended (the 20X4 financial statements before the effects of the adjustments discussed in Note X are not presented herein). The 20X4 financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

11/ See PCAOB staff question no. 6.

[*Same second paragraph as the standard report*]

In our opinion, the 20X4 financial statements, before the effects of the adjustments to retrospectively apply the change in accounting described in Note X, present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X4, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

We were not engaged to audit, review, or apply any procedures to the adjustments to retrospectively apply the change in accounting described in Note X and, accordingly, we do not express an opinion or any other form of assurance about whether such adjustments are appropriate and have been properly applied. Those adjustments were audited by [*name of successor auditor*].

[*Signature*]

[*City and State or Country*]

[*Original Date*]

Example for correction of an error

Report of Independent Registered Public Accounting Firm

We have audited, before the effects of the adjustments for the correction of the error described in Note X, the balance sheet of ABC Company as of December 31, 20X4, and the related statements of income, changes in shareholders' equity, and cash flows for the year then ended (the 20X4 financial statements before the effects of the adjustments discussed in Note X [*have been withdrawn and*] are not presented herein). The 20X4 financial statements are the responsibility of the company's management.

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Our responsibility is to express an opinion on these financial statements based on our audit.

[*Same second paragraph as the standard report*]

In our opinion, except for the error described in Note X, the 20X4 financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X4, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

We were not engaged to audit, review, or apply any procedures to the adjustments for the correction of the error described in Note X and, accordingly, we do not express an opinion or any other form of assurance about whether such adjustments are appropriate and have been properly applied. Those adjustments were audited by [*name of successor auditor*].

[*Signature*]

[*City and State or Country*]

[*Original Date*]

Q10. When a successor auditor audits and reports on adjustments made to prior-period financial statements audited by a predecessor auditor, how should the predecessor auditor date his or her report on the reissued financial statements?

A10. When the successor auditor has audited and reported on the adjustments made to the prior-period financial statements and the predecessor auditor is reissuing the report on the prior-period financial statements, the predecessor auditor should use the date of the previous report to avoid any implication that he or she has examined any records, transactions, or events after that date.[12/]

Successor Auditor Has Not Completed an Audit

Q11. Can a successor auditor audit and report on the adjustments made to the prior-period financial statements if he or she has not yet completed an audit of the current-period financial statements?

A11. No. If the prior-period financial statements have been adjusted, the successor auditor may audit and report on the adjustments made to the prior-period financial statements in connection with the successor auditor's audit of the financial statements of the company for a subsequent period.[13/] Unless the successor auditor has completed an audit of the financial statements of the company, he or she will not have sufficient knowledge of the company and its financial reporting to adequately plan and perform an audit of the adjustments to conclude on whether they are appropriate and have been properly applied. If the successor auditor has not completed an audit of a subsequent period, the successor auditor, or another independent auditor, may be engaged to reaudit the prior-period financial statements and audit the adjustments to those financial statements.

[12/] See AU sec. 508.73.

[13/] See AU sec. 508.74.