
EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 69, *THE MEANING OF PRESENT FAIRLY IN CONFORMITY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, FOR NONGOVERNMENTAL ENTITIES*

May 9, 2005

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues

Comments should be received by June 27, 2005, and should be addressed to
Sherry Boothe, Audit and Attest Standards,
AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775
or via the Internet to sboothe@aicpa.org.

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May 9, 2005

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board (ASB), of a proposed Statement on Auditing Standards (SAS) entitled *Amendment to Statement on Auditing Standards No. 69, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. The proposed SAS has been issued in response to the Financial Accounting Standards Board's (FASB's) proposed Statement of Financial Accounting Standards entitled *The Hierarchy of Generally Accepted Accounting Principles*. The ASB decided to coordinate the provisions and effective date of this exposure draft with the FASB proposed statement, which can be obtained at www.fasb.org.

A summary of the significant provisions of the proposed SAS accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. To facilitate the ASB's consideration of responses, comments should refer to specific paragraphs and include supporting reasons for each suggestion or comment.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after July 27, 2005, for one year. Responses should be sent to Sherry Boothe, Audit and Attest Standards, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 in time to be received by June 27, 2005. Responses may also be sent by electronic mail to sboothe@aicpa.org.

Sincerely,

John A. Fogarty

Chair

Auditing Standards Board

Charles E. Landes

Director

Audit and Attest Standards

Auditing Standards Board

(2004-2005)

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Audit and Attest Standards

SUMMARY

WHY ISSUED AND WHAT IT DOES

This exposure draft introduces a proposed Statement on Auditing Standards (SAS) that will amend SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 411). This proposed SAS applies to nongovernmental entities. It will have no impact on the generally accepted accounting principles (GAAP) hierarchy for state and local governments or for federal governmental entities.

In response to recommendations in the Security and Exchange Commission's (SEC's) July 2003 *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption of the United States Financial Reporting System of a Principles-Based Accounting System*, the Financial Accounting Standards Board (FASB) took on a number of initiatives aimed at improving the quality of accounting standards and the accounting standards-setting process. As a first step in its long-range plans to make such improvements, the FASB has issued a proposed Statement of Financial Accounting Standards on the GAAP hierarchy. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69) to the accounting literature. The GAAP hierarchy had been criticized for being directed at auditors rather than at the reporting entity, which is responsible for selecting accounting principles. Though the FASB proposal makes no substantive changes to the GAAP hierarchy existing in SAS No. 69, the FASB may change the GAAP hierarchy in the future. In fact, the FASB has projects underway that would (1) reduce the number of levels of accounting literature under the GAAP hierarchy to just two, authoritative and nonauthoritative, and (2) address the role of the FASB Concepts Statements in the GAAP hierarchy.

This exposure draft is issued in response to the FASB's proposed Statement. The proposed SAS clarifies that the FASB is responsible for identifying the sources of accounting principles and the framework for selecting such principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69.

The comment period for this exposure draft ends on June 27, 2005.

HOW IT AFFECTS EXISTING STANDARDS

The proposed SAS amends SAS No. 69. The ASB expects that this proposed SAS would not result in change in current practice.

Proposed Statement on Auditing Standards

Amendment to Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, for Nongovernmental Entities

1. The purpose of this Statement on Auditing Standard (SAS) is to amend SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 411) (the GAAP hierarchy) in response to the Financial Accounting Standards Board's (FASB) Proposed Statement of Financial Accounting 1XX, *The Hierarchy of Generally Accepted Accounting Principles*. This SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69.
2. SAS No. 69 would be amended as follows. New language is shown in ***boldface italics***; deleted language is shown by strikethrough.

Introduction

.01 An independent auditor's report contains an opinion as to whether the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. An identification of the country of origin of those generally accepted accounting principles also is required (see section 508.08h).

The purpose of this section is to explain the meaning of "present fairly . . . in conformity with generally accepted accounting principles."

.02 The first standard of reporting requires an auditor who has audited financial statements in accordance with generally accepted auditing standards to state in the auditor's report whether the statements are presented in conformity with generally accepted accounting principles. The phrase "generally accepted accounting principles" is a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. Those conventions, rules, and procedures provide a standard by which to measure financial presentations.

.03 The independent auditor's judgment concerning the "fairness" of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles. Without that framework, the auditor would have no uniform standard for judging the presentation of financial position, results of operations, and cash flows in financial statements.

.04 The auditor's opinion that financial statements present fairly an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles should be based on his or her judgment as to whether (a) the accounting principles selected and applied have general acceptance; (b) the accounting principles are appropriate in the circumstances; (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation (see section 431); (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed (see section 431); and (e) the financial statements reflect the underlying transactions and events in a manner that presents the 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.¹

~~.05 — Independent auditors agree on the existence of a body of generally accepted accounting principles, and they are knowledgeable about these principles and in the determination of their general acceptance. Nevertheless, the determination that a particular accounting principle is generally accepted may be difficult because no single reference source exists for all such principles. The sources of established accounting principles that are generally accepted in the United States of America are —~~

~~a. — Accounting principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to rule 203 of the AICPA Code of Professional Conduct. Rule 203 provides that an auditor should not express an unqualified opinion if the financial statements contain a material departure from such pronouncements unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. Rule 203 implies that application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows, in conformity with generally accepted accounting principles. Nevertheless, rule 203 provides for the possibility that literal application of~~

¹ The concept of materiality is inherent in the auditor's judgments. That concept involves qualitative as well as quantitative judgments (see sections 150.04, 312.10, and 508.36).

~~such a pronouncement might, in unusual circumstances, result in misleading financial statements. (See section 508, Reports on Audited Financial Statements, paragraphs .14 and .15.)~~

- ~~b. Pronouncements of bodies, composed of expert accountants, that deliberate accounting issues in public forums for the purpose of establishing accounting principles or describing existing accounting practices that are generally accepted, provided those pronouncements have been exposed for public comment and have been cleared by a body referred to in category (a).²~~
- ~~c. Pronouncements of bodies, organized by a body referred to in category (a) and composed of expert accountants, that deliberate accounting issues in public forums for the purpose of interpreting or establishing accounting principles or describing existing accounting practices that are generally accepted, or pronouncements referred to in category (b) that have been cleared by a body referred to in category (a) but have not been exposed for public comment.~~
- ~~d. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry, or the knowledgeable application to specific circumstances of pronouncements that are generally accepted.~~

~~.05 .06 Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance. The auditor should consider whether the substance of transactions or events differs materially from their form.~~

~~.07 If the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203, the auditor should consider whether the accounting treatment is specified by another source of established accounting principles. 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 circumstances.~~

²For purposes of this section, the word *cleared* means that a body referred to in subparagraphs (a) has indicated that it does not object to the issuance of the proposed pronouncement.

.06 .08 The auditor should be aware that the accounting requirements adopted by regulatory agencies for reports filed with them may differ from generally accepted accounting principles in certain respects. Section 544, *Lack of Conformity With Generally Accepted Accounting Principles*, paragraph .04 and section 623, *Special Reports* provide guidance if the auditor is reporting on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.

.07–.09 Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established accounting principles for reporting a specific transaction or event. In those instances, 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.

Sources of Generally Accepted Accounting Principles

.08 *For nongovernmental entities, the Financial Accounting Standards Board (FASB) is responsible for identifying the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles in the United States*² *For governmental entities, the sources of established accounting principles that are generally accepted in the United States of America are –*

- a.** *Accounting principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to rule 203 of the AICPA Code of Professional Conduct. Rule 203 provides that an auditor should not express an unqualified opinion if the financial statements contain a material departure from such pronouncements unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. Rule 203 implies that application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows, in conformity with generally accepted accounting principles. Nevertheless, rule 203 provides for the possibility that literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements. (See SAS No.*

² *The hierarchy of generally accepted accounting principles for nongovernmental entities is contained in FASB Statement No. 1XX.*

58, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 508.14 and .15.)

- b. Pronouncements of bodies, composed of expert accountants, that deliberate accounting issues in public forums for the purpose of establishing accounting principles or describing existing accounting practices that are generally accepted, provided those pronouncements have been exposed for public comment and have been cleared by a body referred to in category (a).³**
- c. Pronouncements of bodies, organized by a body referred to in category (a) and composed of expert accountants, that deliberate accounting issues in public forums for the purpose of interpreting or establishing accounting principles or describing existing accounting practices that are generally accepted, or pronouncements referred to in category (b) that have been cleared by a body referred to in category (a) but have not been exposed for public comment.**
- d. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry, or the knowledgeable application to specific circumstances of pronouncements that are generally accepted.**

~~.09-07~~ ***If the accounting treatment of a transaction or event for a governmental entity is not specified by a pronouncement covered by rule 203, the auditor should consider whether the accounting treatment is specified by another source of established accounting principles. 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 circumstances.***

³ *For purposes of this section, the word cleared means that a body referred to in subparagraphs (a) has indicated that it does not object to the issuance of the proposed pronouncement.*

Application to Nongovernmental Entities

~~10. For financial statements of entities other than governmental entities,³~~

~~a. Category (a), officially established accounting principles, consists of Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations, Accounting Principles Board (APB) Opinions, and AICPA Accounting Research Bulletins.~~

~~b. Category (b) consists of FASB Technical Bulletins and, if cleared⁴ by the FASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.~~

~~c. Category (c) consists of AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins that have been cleared⁴ by the FASB and consensus positions of the FASB Emerging Issues Task Force.~~

~~d. Category (d) includes implementation guides ("Qs and As") published by the FASB staff, AICPA accounting interpretations and practices that are widely recognized and prevalent either generally or in the industry.~~

~~11. In the absence of a pronouncement covered by rule 203 or another source of established accounting principles, the auditor of financial statements of entities other than governmental entities may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, FASB Statements of Financial Accounting Concepts; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; Governmental Accounting Standards Board (GASB) Statements, Interpretations, and Technical Bulletins; Federal Accounting Standards Advisory Board (FASAB) Statements,~~

³ Rules and interpretive releases of the Securities and Exchange Commission (SEC) have an authority similar to category (a) pronouncements for SEC registrants. In addition, the SEC staff issues Staff Accounting Bulletins that represent practices followed by the staff in administering SEC disclosure requirements. Also, the Introduction to the FASB's EITF Abstracts states that the Securities and Exchange Commission's Chief Accountant has said that the SEC staff would challenge any accounting that differs from a consensus of the FASB Emerging Issues Task Force, because the consensus position represents the best thinking on areas for which there are no specific standards.

⁴ For purposes of interpreting category (b) and category (c), the word "cleared" means that the FASB does not object to the pronouncements issuance.

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

[Subsequent paragraphs renumbered and the GAAP Hierarchy Summary currently in paragraph .18 will be modified, to remove the first column pertaining to nongovernmental entities.]

Effective Date

4. This Statement is effective for audits of financial statements with fiscal years beginning after September 15, 2005.