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AUDIT RISK ALERTS

Audit Risk Alert — 2007/08

Strengthening Audit Integrity
Safeguarding Financial Reporting

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Notice to Readers

This Audit Risk Alert is intended to provide auditors with an overview of recent economic, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environment in which your clients operate. This alert is an important tool in helping you identify the significant risks that may result in the material misstatement of financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 To help auditors understand relevant industry, economic, and regulatory factors affecting their clients, the AICPA offers industry and topic-specific alerts to be used in conjunction with this alert. These alerts can be obtained by calling the AICPA at (888) 777-7077 or going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The client financial statements you audit will be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

Real Gross Domestic Product

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter final estimates, GDP increased at an annual rate of 3.8 percent.

.11 The increase in real GDP in the second quarter of 2007 reflects positive contributions for services, exports, nonresidential structures, federal and state and local government spending, and equipment and software sales. These positive contributions were partly offset by negative contributions for residential fixed investments. Imports decreased.

Unemployment

.12 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor (DOL), Bureau of Labor Statistics. Through the third quarter of 2007, the unemployment rate averaged 4.5 percent. These data further demonstrate the economic growth the United States has experienced since the beginning of 2006.

Interest Rates

.13 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent for 10 consecutive meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal fund rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting and in response to shaky financial market conditions, the Federal Reserve has taken several action steps. It announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25 percent target rate. On August 17, 2007, it announced that financial market conditions had deteriorated and tighter credit conditions and increased uncertainty have the potential to restrain economic growth. Then at its September and October meetings, the Federal Reserve decided to lower its target for the federal funds rate 50 and 25 basis points, respectively, to 4.50 percent citing increased uncertainty surrounding the economic outlook. The Federal Reserve also decided to decrease the discount rate 50 and 25 basis points, respectively, to 5.00 percent to consistently keep the spread between the primary credit rate and the target federal funds rate at 50 basis points. Auditors should remain alert to developments in the financial markets and how they may affect your audit engagements. Issues for auditors to consider include that the change in, and the volatility of, interest rates increase the inherent risk for the valuation of investments and derivatives whose value is significantly affected by interest rates. Auditors may need to determine that the recorded value of an investment or derivative uses reasonable interest rates in cases where the interest rate affects valuation.

Consumer Price Index Trends

.14 The U.S. DOL Bureau of Labor Statistics annually publishes its Consumer Price Index for all Urban Consumers (CPI-U). The CPI-U is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. The CPI-U is the most widely used measure of inflation and is sometimes viewed as an indicator of the effectiveness of government economic policy. It provides information about price changes in the nation's economy to government, business, labor, and private citizens and is used by them as a guide when making economic decisions. The table below shows the U.S. city annual average CPI-U for the past five years. The baseline years are: 1982–1984=100.

Year	*Annual Average CPI-U*	*Change From Prior Year*
2002	179.9	1.6%
2003	184.0	2.3%
2004	188.9	2.7%
2005	195.3	3.4%
2006	201.6	3.2%

Interest Rates for Below-Market Rate Loans

.15 The Internal Revenue Service (IRS) issues the blended annual Applicable Federal Rate each year to provide guidance in relation to Internal Revenue Code section 7872(e)(2), *Treatment of loans with below-market interest rates—Foregone interest* (U.S. Code, Title 26). The term *forgone interest* means, with respect to any period during which the loan is outstanding, the excess of—

a. the amount of interest, which would have been payable on the loan for the period, if interest accrued on the loan at the applicable federal rate and were payable annually on the day referred to in subsection (a)(2), over

b. any interest payable on the loan properly allocable to such period.

.16 This rate is a useful guide to auditors in evaluating interest rates and determining imputed interest for below-market-rate loans. The following table provides the blended annual rate for each of the previous five years as determined by the IRS.

Year	*Blended Annual Rate*
2003	1.52%
2004	1.98%
2005	3.11%
2006	4.71%
2007	4.92%

Housing Market

.17 The housing market continues to deteriorate and is not only slowing the economy directly, but rising concerns over falling home prices may encourage customers to cut back on their spending in the future. There is continued concern that inflation may begin to accelerate in our economy. After five years of record sales and growth, the residential real estate market slowed, and the outlook has since been bleak. The number of foreclosure filings reported in the United States in August 2007 more than doubled versus August 2006 and increased 36 percent from July 2007; a trend that signals homeowners are increasingly unable to make timely payments on their mortgages. The Mortgage Bankers Association reports that 550,000 homeowners with subprime loans began a foreclosure process over the last year and specialists say that number could double over the next couple of years.

Subprime Mortgages and the Liquidity Crisis

.18 In recent months, there has been a sharp rise in the rate of delinquency and default by subprime mortgage loan borrowers. This has occurred most frequently when the borrower on an adjustable-rate loan is unable to make the higher payments required after an interest-rate adjustment, and is unable to either refinance the loan or sell the home for an amount sufficient to pay off the mortgage. Moreover, several hundred billion dollars of adjustable-rate subprime mortgage loans are expected to "reprice" over the 15- to 18-month period beginning in October 2007. As a consequence, many industry observers expect that the rates of default—and foreclosure—will continue to increase sharply.

The difficulties arising from increasing defaults have been further compounded by declining real estate prices, especially in geographic areas that have a large volume of subprime mortgage loans. In many areas, rising foreclosures have contributed to the declining prices of residential real estate. The rising level of defaults, combined with the falling price of the related real estate collateral, has resulted in significant increases in credit losses and fear by investors that those losses will continue to grow for the foreseeable future.

Market Reaction

.19 Most subprime loans were ultimately financed by investors who purchased securities backed by the underlying subprime mortgage loans. These securities vary widely in terms of their exposure to loss from defaults on the underlying loans. The level of defaults has, in many cases, exceeded the model-based projections originally used to structure and assign ratings to securities backed by subprime mortgage loans, and has led to a significant number of downgrades. As a result of the uncertainty in the marketplace arising from current conditions, investors and lenders have largely retreated from investments in assets backed by subprime mortgage loans, creating a so called "liquidity crisis." With a sharply reduced number of investors in the marketplace willing to provide funding, many subprime mortgage lenders have been forced to cease originations of new mortgages, and holders of existing loans and mortgage-backed securities have experienced sharp declines in their value. Lenders that are still making new loans have significantly tightened their underwriting standards, making it more difficult for existing borrowers to refinance.

Contagion Effect—Spread of Illiquidity to Other Markets

.20 In recent weeks, the "liquidity crisis" has spread to other corners of the credit markets. Investors have pulled back from investments in collateralized bond obligations (many of which are backed by subordinated mortgage-backed securities backed by subprime mortgage loans), high-yield "junk" bonds, debt issued in leveraged buyout transactions, and even short-term, asset-backed commercial paper. It is not possible at this time to predict how long investors will stay on the sidelines or which markets will be most affected, but it is not unreasonable to expect—especially for subprime mortgage-related assets—that current conditions could persist for an extended period of time until the uncertainty is reduced, that is, when it becomes clear that defaults have peaked and real estate prices have bottomed out.

Valuation Issues

.21 Assets backed by subprime mortgage loans (and other assets affected by the market disruptions) are held by all types of entities—including, but not limited to, commercial and investment banks, insurance companies, investment companies such as mutual funds and hedge funds, pension and employee-benefit plans, and university endowment funds. In short, these assets can be found in investment portfolios across the spectrum. These assets may be held either directly, or indirectly, such as through an investment company such as a mutual fund or a hedge fund.

.22 Investors in a variety of assets have experienced severe price volatility as a result of the increased credit risk and the reduced liquidity in the marketplace. That volatility has given rise to questions about how to measure the fair value of subprime-mortgage-related assets, as well as other assets affected by the illiquidity in today's market. Fair value is an essential component of many accounting principles that underlie companies' financial reporting, not only when fair value is the primary basis of accounting—such as for trading accounts and held-for-sale portfolios—but also for purposes of measuring and reporting asset impairment, and for making disclosures about fair value.

Audit and Attestation Issues and Developments

.23 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. For information on auditing and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.24 The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the Securities and Exchange Commission (SEC) and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance

SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120)

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	• Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	The risk assessment standards are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier application permitted.
• SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")* (AICPA, *Professional Standards*, vol. 1, AU sec. 230)	• This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230A).

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• SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	• This statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A).
• SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	• This statement supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A).
• SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	• This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A).
• SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	• This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 310), and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A).
• SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	• This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
• SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1, AU sec. 318)	• This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
• SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	• This statement amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350A).

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SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) Issue date: December 2005 (Applicable to audits conducted in accordance with GAAS)	SAS No. 103 supersedes SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339A) and amends AU section 530, *Dating of the Independent Auditors Report* (AICPA, *Professional Standards*, vol. 1). Effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted, this SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency, significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.

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Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current years audit report.
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This PA responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.

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AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This PA provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditors report.
PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This standard replaces the PCAOB's previous internal control standard, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.
PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client's audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the SEC or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm's independence, and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524. This rule is effective for audits of fiscal years ending on or after November 15, 2007.

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PCAOB Conforming Amendments to the Interim Auditing Standards Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in Appendix 3 of PCAOB Release No. 2007-005A at www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.
PCAOB Report, *Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report is based on PCAOB inspections that looked at parts of approximately 275 audits of internal control over financial reporting by registered public accounting firms. Inspections focused on four areas: integrating the audits of financial statements and internal control, using a top-down approach, using the work of others, and assessing risk.
PCAOB Report, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, Select SEC-approved PCAOB Releases) Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report focuses on aspects of the PCAOB's interim auditing standards that address the auditor's responsibility with respect to fraud, specifically AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.
PCAOB Staff Questions and Answers, *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	Topics covered include the following: • The application of Rule 3522(a) when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm

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	• Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction • Whether a registered public accounting firms independence is affected by the IRS's subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b) • Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself • Clarification of the term *other change in employment event* as it relates to Rule 3522(c)
PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 100—PCAOB Staff Questions and Answers") Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards)	The guidance provides direction for auditing a company's estimation of the fair value of stock options granted to employees pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which became applicable for financial statements of companies with fiscal years ending on or after June 15, 2006.

The Auditor's Communication With Those Charged With Governance

.25 In December 2006, the Auditing Standards Board (ASB) issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to entities that either have an audit committee or have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. However, SAS No. 114 broadens the applicability of the

SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.26 SAS No. 114 recognizes the importance of effective two-way communication to the audit. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.27 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued.

.28 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.29 Because there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditors understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.30 In May 2006, the AICPA ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), the PCAOB redefined these terms, which now differ from SAS No. 112.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditors classification of the deficiency.
- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, and identifies indicators that control deficiencies should be regarded as a significant deficiency or a material weakness.
- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.
- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.
- Contains illustrative written communications to management and those charged with governance.

How Revisions of SAS No. 112 Affect Practice

.31 As auditors gain a better understanding of what needs to be communicated to management and those charged with governance, there may be more control deficiencies that are identified as significant deficiencies and material weaknesses and that are then communicated to management and those charged with governance. Auditors may emphasize and therefore spend more time evaluating identified control deficiencies than in the past.

Discussions With Management and Others

.32 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. Auditors may have to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor who does not provide attest services for the client can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving managements internal control objectives.

.33 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in written communication as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.34 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented, detected, and corrected by the client.

Issues for Audits of Smaller Entities

.35 One issue that has arisen in audits of smaller entities is the increase in costs as a result of the time the auditor spends documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.36 Another issue that has caused concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, detecting, or correcting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.[1] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.37 The requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing (ISA).

.38 The AICPA has published the AICPA Audit Risk Alert titled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS. That alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; that alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

AICPA Risk Assessment Standards

.39 In March 2006, the ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111). The SASs became effective for audits of financial statements for periods beginning on or after December 15, 2006. Although the SASs include many of the underlying concepts and detailed performance requirements contained in existing standards, they do create significant new requirements for the auditor. The primary objective of the SASs is to enhance your application of the audit risk model in practice by requiring, among other things:

- A more in-depth understanding of your audit client and its environment, including its internal control. This knowledge will be used to identify the risks of material misstatement in the financial statements (whether caused by error or fraud) and what the client is doing to mitigate them.
- A more rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

Key Provisions of the SASs and How They Differ From Previous Standards

.40 The following tables list the key provisions of the eight risk assessment standards and provide summaries of how these standards differ from previous AICPA generally accepted auditing standards (GAAS).

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[1] See Ethics Interpretation No. 101-3, "Performance of nonattest services," under Rule 101, *Independence* (AICPA, *Professional Standards,* vol. 2, ET sec. 101.05).

SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures (*"Due Professional Care in the Performance of Work"*)

Key Provisions	***How the SAS Differs From Current Standards***
• SAS No. 104 defines *reasonable assurance* as a "high level of assurance."	• SAS No. 104 clarifies the meaning of reasonable assurance.

SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards

Key Provisions	***How the SAS Differs From Current Standards***
• SAS No. 105 expands the scope of the understanding that the auditor must obtain in the second standard of field work from "internal control" to "the entity and its environment, including its internal control." • The quality and depth of the understanding to be obtained is emphasized by amending its purpose from "planning the audit" to "assessing the risk of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures."	• Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning. • By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risk of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements. • The new standard emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that "generic" audit programs will not be an appropriate response for all engagements because risks vary between entities. • The term *further audit procedures*, which consists of test of controls and substantive tests, replaces the term *tests to be performed* in recognition that risk assessment procedures are also performed. • The term *audit evidence* replaces the term *evidential matter*.

SAS No. 106, *Audit Evidence*

Key Provisions	How the SAS Differs From Current Standards
• SAS No. 106 defines *audit evidence* as "all the information used by the auditor in arriving at the conclusions on which the audit opinion is based."	• Previous guidance did not define audit evidence. • SAS No. 106 also describes basic concepts of audit evidence. • The term *sufficient, appropriate audit evidence*, defined in SAS No. 106, replaces the term *sufficient, competent evidence.*
• SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure; expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures.	• SAS No. 106 recategorizes assertions to add clarity. • *Assertion relating to presentation and disclosure* has been expanded and includes a new assertion that information in disclosures should be "expressed clearly" (understandability).
• SAS No. 106 defines *relevant assertions* as those assertions that have a meaningful bearing on whether the account is fairly stated.	• The term *relevant assertions* is new, and it is used repeatedly throughout SAS No. 106.
• SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence.	• The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance.
• SAS No. 106 identifies "risk assessment procedures" as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement at the financial statement and relevant assertion levels.	• SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risk of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately support the auditor's opinion on the financial statements.

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Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion.	
• SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor.	• Risk assessment procedures include: — Inquiries of management and others within the entity — Analytical procedures — Observation and inspection
• SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure.	• Inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented.

SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*

Key Provisions	*How the SAS Differs From Current Standards*
• The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of: 1. Determining the extent and nature of risk assessment procedures. 2. Identifying and assessing the risk of material misstatement. 3. Determining the nature, timing, and extent of further audit procedures. 4. Evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles.	• Previous guidance said that auditors "should consider" audit risk and materiality for certain specified purposes. SASs state that the auditor "must" consider. • New guidance explicitly states that audit risk and materiality are used to identify and assess the risk of material misstatement.

Key Provisions	***How the SAS Differs From Current Standards***
• Combined assessment of inherent and control *risks* is termed the *risk of material misstatement*.	• SAS No. 107 consistently uses the term *risks of material misstatement*, which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks.
• The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. • Assessed risks and the basis for those assessments should be documented.	• SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach. • These two provisions of the risk assessment standards effectively eliminate the ability of the auditor to assess control risk "at the maximum" without having a basis for that assessment. In other words, you can no longer "default" to maximum control risk.
• The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management.	• SAS No. 107 provides additional guidance on communicating misstatements to management. • The concept of not accumulating misstatements below a certain threshold is included in the previous standards, but SAS No. 107 provides additional, specific guidance on how to determine this threshold.
• The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit.	• SAS No. 107 provides specific guidance regarding the appropriate auditor's responses to the types of misstatements (known or likely) identified by the auditor.

SAS No. 108, *Planning and Supervision*

<table>
<tr><th>Key Provisions</th><th>How the SAS Differs From Current Standards</th></tr>
<tr><td>SAS No. 108 provides guidance on:

Appointment of the independent auditor.
Establishing an understanding with the client.
Preliminary engagement activities.
The overall audit strategy.
The audit plan.
Determining the extent of involvement of professionals possessing specialized skills.
Using a professional possessing information technology (IT) skills to understand the effect of IT on the audit.
Additional considerations in initial audit engagements.
Supervision of assistants.
</td><td>
Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards.
However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan.

— The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments.
— The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and extent of risk assessment and further audit procedures you perform in an audit.

SAS No. 108 states that you should obtain a written understanding with your client.
</td></tr>
</table>

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

Key Provisions	***How the SAS Differs From Current Standards***
• SAS No. 109 describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control.	• The auditor should perform "risk assessment procedures" to gather information and gain an understanding of the entity and its environment. These procedures include inquiries, observation, inspection, and analytical procedures. Previous standards did not describe the procedures that should be performed to gain an understanding of the client. • Information about the entity may be provided by a variety of sources, including knowledge about the entity gathered in previous audits (provided certain conditions are met), and the results of client acceptance and continuance procedures. • SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes the limitations of inquiry.
• The audit team should discuss the susceptibility of the entity's financial statements to material misstatement.	• Previous standards did not require a "brainstorming" session to discuss the risk of material misstatements. SAS No. 109 requires such a brainstorming session, which is similar (and may be performed together with) the brainstorming session to discuss fraud.
• The purpose of obtaining an understanding of the entity and its environment, including its internal control, is to identify and assess "the risk of material misstatement" and design and perform further audit procedures responsive to the assessed risk.	• SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of risk and design of further audit procedures. Thus, the understanding of the entity and its environment, including its internal control, provides the audit evidence necessary to support the auditor's assessment of risk.

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Key Provisions	***How the SAS Differs From Current Standards***
• SAS No. 109 states the auditor should assess the risk of material misstatement at both the financial statement and relevant assertion levels.	• The previous standard included the concept of assessing risk at the financial statement level, but SAS No. 109 provides expanded and more explicit guidance. • SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in risks at the assertion level.
• SAS No. 109 provides directions on how to evaluate the design of the entity's controls and determine whether the controls are adequate and have been implemented.	• Under the previous standard, the primary purpose of gaining an understanding of internal control was to plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the understanding of internal control provides audit evidence that ultimately supports the auditors opinion on the financial statements. • The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control.
• SAS No. 109 directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.	• Previous standard did not include the concept of "significant risks." • Significant risks exist on most engagements. • The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks.

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 109 provides extensive guidance on the matters that should be documented.	• The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards.

SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 110 provides guidance on determining overall responses to address the risk of material misstatement at the financial statement level and the nature of those responses.	• The concept of addressing the risk of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 "repositions" your consideration of risk at the financial statement level so you make this assessment as a result of and in conjunction with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning. • SAS No. 110 requires you to consider how your assessment of risks at the financial statement level affect individual financial statement assertions, so that you may design and perform tailored further audit procedures (substantive tests or tests of controls). • The list of possible overall responses to the risk of material misstatement at the financial statement level also has been expanded.
• Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risk of material misstatement at the relevant assertion level.	• Although the previous standards included the concept that audit procedures should be responsive to assessed risks, this idea was embedded in the discussion of the audit risk model. The SASs repeatedly emphasize the need to provide a clear linkage between your understanding of the entity, your risk assessments, and the design of further audit procedures. • SAS No. 110 requires you to document the linkage between assessed risks and further audit procedures, which was not a requirement under the previous standards.

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Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures.	• The new guidance on determining the nature, timing, and extent of tests of controls and substantive tests has been expanded greatly and addresses issues that previously were not included in the authoritative literature. • SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risk of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement. • SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include: — Performing substantive tests for all relevant assertion related to each material class of transactions, account balance, and disclosure regardless of the assessment of the risk of material misstatements. — Agreeing the financial statements, including their accompanying notes, to the underlying accounting records. — Examining material journal entries and other adjustments made during the course of preparing the financial statements.

SAS No. 111, *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 111 provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls.	• SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment. • SAS No. 111 revises AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1) to state that sample sizes determined using either statistical or nonstatistical methods would ordinarily be comparable in size.

.41 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the client's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations (COSO) of the Treadway Commission's framework at www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs will most likely result in significant changes to firm audit methodologies and the training of personnel. Therefore, it is recommended that auditors allow ample time in advance of the required implementation date. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Companion Audit Guide

.42 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Audit Documentation

.43 In December 2005, the ASB issued SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339). This SAS establishes standards and provides guidance to auditors of nonissuers on audit documentation; it supersedes SAS No. 96 of the same name. Audit documentation is an essential element of audit quality and although audit documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate audit documentation contributes to the quality of an audit.

.44 In developing this SAS, the ASB considered the documentation requirements of PCAOB Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"); the International Auditing and Assurance Standards Boards (IAASB) ISA No. 230 (Revised), *Audit Documentation*, issued in September 2005; *Government Auditing Standards* issued by the Comptroller General of the United States; and suggestions from the National Association of State Boards of Accountancy. Accordingly, the requirements of the SAS are similar, in most respects, to the requirements of PCAOB Auditing Standard No. 3 and ISA No. 230 (Revised).

.45 Among other things, this SAS:

- Requires the auditor to prepare audit documentation for each engagement in sufficient detail to provide an experienced auditor, having no previous connection to the audit, with a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached.

- Provides enhanced guidance on matters that should be documented. For example, in addition to the former requirements of SAS No. 96 that the auditor document audit findings or issues that in his or her judgment are significant, actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached, SAS No. 103 requires the auditor to document discussions of significant findings or issues with management and others, on a timely basis, including when and with whom the discussions took place.
- States that oral explanations on their own do not represent sufficient support for the work the auditor performed or conclusions the auditor reached, but may be used by the auditor to clarify or explain information contained in the audit documentation.
- Requires the auditor to document audit evidence that is identified as being contradictory or inconsistent with the final conclusions, and how the auditor addressed the contradiction or inconsistency.
- Requires the auditor to assemble the audit documentation to form the final audit engagement file within 60 days following the report release date. After that date, the statement requires the auditor not to delete or discard existing audit documentation and to appropriately document any subsequent additions.
- Specifies a minimum file retention period of five years from the report release date. (The terms of the engagement or state law or regulation may specify a longer retention period.)

.46 SAS No. 103 also amends paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1). See the section of this alert titled "Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*" for further discussion of this aspect of SAS No. 103. Also, see the following section of this alert titled "Audit Documentation Technical Practice Aids," which refers to two AICPA Technical Practice Aids (TPA). These TPAs address issues related to audit documentation. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2006.

Audit Documentation Technical Practice Aids

.47 In May 2007, the ASB issued two TPA Technical Questions and Answers (TIS) related to SAS No. 103.

.48 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.49 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), discusses whether the provisions of SAS No. 103 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current years audit report.

Practice Alert No. 07-1, *Dating of the Auditors Report and Related Practical Guidance*

.50 As mentioned previously in this alert, a key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530 to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms, an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.51 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.52 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf. Readers should also note the PITF is currently working on a practice alert that addresses auditing and other considerations related to electronic information that it plans to issue during the third quarter of 2007.

PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*

.53 On May 24, 2007, the PCAOB adopted Auditing Standard No. 5 that supersedes Auditing Standard No. 2, *An Audit of Internal Control Over Financial*

Reporting Performed in Conjunction With an Audit of Financial Statements, and an independence rule relating to the auditor's provision of internal-control-related, nonaudit services. It also adopted certain amendments to its interim standards. The SEC approved the standard on July 25, 2007.

.54 The PCAOB has closely monitored the implementation of Auditing Standard No. 2, and came to two conclusions:

1. The audit of internal control over financial reporting has produced significant benefits related to corporate processes and controls.
2. These benefits have come at a significant, higher than anticipated cost, and, at times, the effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

.55 The PCAOB adopted the new Auditing Standard No. 5 to replace Auditing Standard No. 2 with the primary objective of focusing the auditor on matters most important to internal control. Goals of this new standard are to eliminate unnecessary procedures, to simplify and shorten the standard by reducing detail and specificity, and to make the audit more scalable for smaller and less complex companies. Some examples of important differences between Auditing Standard No. 5 and Auditing Standard No. 2 follow:

- The new standard is less prescriptive, with fewer mandatory requirements and more reliance on auditor judgment.
- The new standard makes the audit scalable, so it can change to fit the size and complexity of any company.
- The new standard directs the auditor to focus on what matters most and eliminates unnecessary procedures from the audit.
- The new standard includes a principles-based approach to determining when and to what extent the auditor can use the work of others.

.56 The new standard will do the following, among other things:

- Direct the auditor to the most important controls and emphasize the importance of risk assessment using a top-down approach
- Emphasize fraud controls, with an emphasis on assessing fraud risk in the planning process and additional guidance on the types of controls that may address fraud risk
- Identify management fraud as an area of higher risk, directing the auditor to focus more attention in this area
- Recalibrate the walkthrough requirement
- Permit consideration of knowledge obtained during prior audits
- Revise the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness
- Adopt communication requirements, which require, among other things, that the auditor consider and communicate any identified significant deficiencies to the audit committee
- Direct the auditor to tailor the audit to reflect attributes of smaller and less complex companies

- Remove the requirement to evaluate management's process, which the PCAOB believes could contribute to a checklist approach to compliance by the auditors
- Provide auditors with further guidance regarding scoping decisions for multiple location audits

.57 Auditing Standard No. 5 is effective for audits of internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002 for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted at any point after SEC approval. Auditors who elect to comply with Auditing Standard No. 5 after July 25, 2007, but before its effective date, must also comply, at the same time, with newly adopted PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*), and other PCAOB standards as amended by Auditing Standard No. 5. Auditors who elect to comply with Auditing Standard No. 5 before its effective date should use the definition of *material weakness* contained in Auditing Standard No. 5. See www.pcaob.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.5.aspx for the full release document.

.58 Upon approval of the new standard by the SEC on July 25, 2007, the PCAOB announced that it is undertaking several initiatives to support the successful implementation of the standard. These initiatives include working closely with the audit firms, early in their process, as they evaluate how the new standard will affect their firms' audits of internal control. Other initiatives include continued outreach to public companies and smaller audit firms regarding the new standard. See full text of the press release at www.pcaob.org/News_and_Events/News/2007/07-25.aspx.

Considering and Using the Work of Others

.59 At the time the PCAOB proposed Auditing Standard No. 5 for public comment, the PCAOB also proposed an auditing standard titled *Considering and Using the Work of Others*, which would have superseded AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*). However, after considering all comments, the PCAOB decided to retain AU section 322 for both the financial statement audits and audits of internal control over financial reporting and incorporate language into Auditing Standard No. 5 that establishes integration concepts rather than adopting the proposed standard. Some of the key concepts in Auditing Standard No. 5 as they relate to using the work of others are as follows:

- Allows the auditor to use the work of others to obtain evidence about the design and operating effectiveness of controls for both the internal control audit and the financial statement audit, eliminating a barrier to integration of the two audits
- Eliminates the principal evidence provision
- Allows the auditor to use the work of company personnel, other than internal auditors, as well as third parties working under the direction of management or the audit committee
- Requires the auditor to use a risk-based approach to the extent that the auditor can use the work of others

.60 For additional information, see paragraphs 16–19 of Auditing Standard No. 5 at www.pcaob.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf.

PCAOB Rule 3525, Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

.61 The PCAOB also adopted a new rule related to the auditor's responsibilities when seeking audit committee preapproval of internal control-related nonaudit services. The rule is intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence. Specifically, the public accounting firm shall describe, in writing, the scope of the service and submit to the audit committee, as well as discuss with the audit committee, the potential effects of the service on the firms independence. Registered firms are also required to document the substance of such discussions in writing. This rule is effective for audits of fiscal years ending on or after November 15, 2007 (the same effective date as Auditing Standard No. 5). The full text of this rule can be found at www.pcaob.org/Rules/Rules_of_the_Board/Rule_3525.pdf.

Conforming Amendments to Interim Auditing Standards

.62 In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments due to the issuance of Auditing Standard No. 5 can be found at www.pcaob.org/Rules/Rules_of_the_Board/Conforming_Amendments_AS5.pdf.

Audit Considerations for Alternative Investments

.63 Over the past several years, certain not-for-profit organizations, healthcare entities, pension plans and investment companies—including hedge funds and funds of funds—have dramatically increased their investment in financial instruments that do not have a readily determinable market value. These investments are commonly referred to as alternative investments and, in many cases, have greater risk and volatility than other investments. For example, the value of investments related to subprime loans have reportedly declined significantly based on recent developments (discussed previously in this alert), including, but not limited to, decreased liquidity for such investments. Investments related to subprime loans may be in the form of direct holdings of subprime loans or ownership of entities or investment vehicles whose value is affected by the value of subprime loans, such as investments commonly referred to as tranches. In certain circumstances, the existence of investments related to subprime loans may not be obvious and may be identified only upon performing audit procedures designed to identify such investments.

.64 Generally, entities report alternative investments at fair value and developing valuations, as well as obtaining sufficient appropriate audit evidence in support of the valuation assertion, can present challenges because of the lack of readily determinable fair value and the limited investment information generally provided by the fund managers. For example, the value of investments related to subprime loans (which may be either direct holdings of subprime loans or ownership of entities or investment vehicles, such as tranches, whose value is affected by the value of subprime loans) have declined significantly based on recent developments, including, but not limited to decreased liquidity for such investments. However, the existence of investments related to subprime loans within an alternative investment portfolio and the basis for their valuation may not be obvious.

.65 To address the auditing challenges associated with alternative investments, the Alternative Investments Task Force developed and issued a practice aid for auditors in 2006, titled "Alternative Investments—Audit Considerations." The practice aid clarifies the responsibility of the client to have appropriate controls in place in order for management to adequately address valuation assertions and for the auditor to obtain comfort over the valuation of investments. Specifically, the practice aid includes guidance on:

- General considerations pertaining to auditing alternative investments
- Addressing management's financial statement existence assertion
- Addressing management's financial statement valuation assertion
- Management representations
- Disclosure of certain significant risks and uncertainties
- Reporting

.66 The practice aid also includes appendixes on confirmations for alternative investments and illustrative examples of due diligence, ongoing monitoring, and financial reporting controls. Many of the elements of the practice aid may assist auditors in addressing the audit issues related to recent subprime-related market developments. This practice aid may be downloaded at www.aicpa.org/members/div/auditstd/alternative_investments.htm

.67 In addition, auditors should consider AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), to determine the appropriate period in which to recognize any identified declines in value. Given the timing of some of the declines in investments related to subprime loans, this may be particularly relevant for entities with June 30 year ends and may be a continuing consideration going forward.

Accounting Issues and Developments

.68 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. For information on accounting standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*

(continued)

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*
TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss not-for-profit organizations fund-raising expenses.
TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
TIS sections 6300.25–.35 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various issues related to SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.69 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or go online at www.cpa2biz.com.

Fair Value Measurements

FASB Statement No. 157

.70 In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.71 Prior to this statement, there were different definitions of fair value, and guidance for applying those definitions was dispersed among many accounting pronouncements. Differences in the existing guidance created inconsistencies that added to the complexity in applying generally accepted accounting principles (GAAP). FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period.

.72 The following paragraphs summarize FASB Statement No. 157, but are not intended as a substitute for the reading the statement itself. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.[2] Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year.

Definition of Fair Value

.73 Paragraph 5 of FASB Statement No. 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." That definition retains the exchange price notion in earlier definitions of fair value, but clarifies that the exchange price is the price in a hypothetical transaction at the measurement date in the market in which the reporting entity would transact for the asset or liability. The hypothetical transaction to sell the asset or transfer the liability is considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition of fair value focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

.74 A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market—defined as the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability—or, in the absence of a principal market, the most advantageous market for the asset or liability.

.75 A fair value measurement of an asset assumes the highest and best use of the asset by market participants, considering the use of the asset that

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[2] FASB is considering a deferral of certain provisions of Statement No. 157. At the time of this writing no decision had been reached. See www.fasb.org for the latest developments.

is physically possible, legally permissible, and financially feasible at the measurement date. Highest and best use for an asset is established by one of two valuation premises: value in-use or value in-exchange. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, value in-use might be appropriate for certain nonfinancial assets. An asset's value in-use should be based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those other assets would be available to market participants. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, value in-exchange might be appropriate for a financial asset. An asset's value in-exchange is determined based on the price that would be received in a current transaction to sell the asset standalone.

.76 A fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value.

Valuation Techniques

.77 As described in FASB Statement No. 157, valuation techniques consistent with the market approach, income approach, cost approach or some combination of the approaches should be used to measure fair value, as follows:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.
- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multiperiod excess earnings method.
- The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

.78 Valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate and the respective indications of fair value should be evaluated and weighted, as appropriate.

Present Value Techniques

.79 Appendix B of FASB Statement No. 157 provides guidance on present value techniques. Present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique (also called the traditional present value technique) uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, expected present value techniques use the probability-weighted average of all possible cash flows (referred to as expected cash flows). The traditional present value technique and two methods of expected present value techniques are discussed more fully in the Appendix B of FASB Statement No. 157.

The Fair Value Hierarchy

.80 FASB Statement No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability (referred to in the statement as inputs). Paragraphs 21–31 establish a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

.81 The fair value hierarchy in FASB Statement No. 157 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The three levels are:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available, except as discussed in paragraphs 25–26 of FASB Statement No. 157.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall. Level 2 inputs include:
    - — Quoted prices for similar assets or liabilities in active markets
    - — Quoted prices for identical or similar assets or liabilities in markets that are not active
    - — Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield

curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)

— Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

- Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

Disclosures

.82 Paragraphs 32–35 of FASB Statement No. 157 expand the disclosures required for assets and liabilities measured at fair value. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, the statement requires the reporting entity to disclose certain information that enables users of its financial statements to assess the inputs used to develop those measurements. For recurring fair value measurements using significant unobservable inputs (Level 3), the reporting entity is required to disclose certain information to help users assess the effect of the measurements on earnings (or changes in net assets) for the period.

FASB Statement No. 159

.83 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with the FASBs long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.84 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157. The choice to adopt early should be made within 120 days of the beginning of the fiscal year of adoption (by April 2007 for calendar-year-end entities), provided the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption. The FASB and SEC have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA Center for Audit Quality (CAQ) issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically, the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans

.85 FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This statement also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

.86 This statement requires an employer that is a business entity and sponsors one or more single-employer defined benefit plans to:

- Recognize the funded status of a benefit plan—measured as the difference between plan assets at fair value (with limited exceptions) and the benefit obligation—in its statement of financial position. For a pension plan, the benefit obligation is the projected benefit obligation; for any other postretirement benefit plan, such as a retiree health care plan, the benefit obligation is the accumulated postretirement benefit obligation.
- Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FASB Statements No. 87, *Employers' Accounting for Pensions*, or No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Amounts recognized in accumulated other comprehensive income, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of FASB Statement Nos. 87 and 106, are adjusted as they are subsequently

recognized as components of net periodic benefit cost, pursuant to the recognition and amortization provisions of those statements.

- Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions).
- Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation.

.87 This statement also applies to a not-for-profit organization or other entity that does not report other comprehensive income. Reporting requirements have been tailored for those entities.

.88 This statement amends FASB Statement No. 87; No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*; No. 106; No. 132 (revised 2003), *Employers Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106*; and other related accounting literature. Upon initial application of this statement and subsequently, an employer should continue to apply the provisions in FASB Statement Nos. 87, 88, and 106 in measuring plan assets and benefit obligations as of the date of its statement of financial position and in determining the amount of net periodic benefit cost.

.89 The FASB believes that this statement provides financial statements that are more complete and easier to understand because information previously reported in the notes will be recognized in an employer's financial statements. Reporting the current funded status of a postretirement benefit plan as an asset or liability in an employer's statement of financial position allows users of those financial statements to assess an employer's financial position and its ability to satisfy the benefit obligations without referring to a reconciliation in the notes to financial statements. Likewise, recognizing transactions and events that affect the funded status in the financial statements in the year in which they occur enhances the timeliness and, therefore, the usefulness of the financial information.

.90 The required date of adoption of the recognition and disclosure provisions of this statement differs for an employer that is an issuer of publicly traded equity securities (as defined) and an employer that is not. For purposes of this statement, an employer is deemed to have publicly traded equity securities if any of the following conditions is met:

a. The employer has issued equity securities that trade in a public market, which may be either a stock exchange (domestic or foreign) or an over-the-counter market, including securities quoted only locally or regionally.

b. The employer has made a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market.

c. The employer is controlled by an entity covered by (*a*) or (*b*).

.91 An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006.

.92 An employer without publicly traded equity securities is required to recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after June 15, 2007.

.93 However, an employer without publicly traded equity securities is required to disclose the following information in the notes to financial statements for a fiscal year ending after December 15, 2006, but before June 16, 2007, unless it has applied the recognition provisions of this statement in preparing those financial statements:

a. A brief description of the provisions of this statement

b. The date that adoption is required

c. The date the employer plans to adopt the recognition provisions of this statement, if earlier.

.94 The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. If in the last quarter of the preceding fiscal year an employer enters into a transaction that results in a settlement or experiences an event that causes a curtailment of the plan, the related gain or loss pursuant to FASB Statement Nos. 88 or 106 is required to be recognized in earnings or changes in unrestricted net assets of that quarter.

.95 Earlier application of the recognition or measurement date provisions is encouraged; however, early application must be for all of an employer's benefit plans. Retrospective application of this statement is not permitted.

Income Tax Accruals and Deferred Income Taxes

FASB Interpretation No. 48

.96 FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109,* was issued in June 2006 and is effective for fiscal years beginning after December 15, 2006.[3] FIN 48 states that financial statement tax accrual may only contain positions that meet the *more-likely-than-not* standard and any variances must be disclosed in the financial statements. This translates to more work for accountants and auditors on the tax accrual, as you evaluate even garden-variety issues, such as unreasonable compensation or expensing versus capitalization. It also means that positions taken on the return (or that were taken in any open year) that do not meet the more-likely-than-not standard will be disclosed and will likely be subject to increased IRS scrutiny.

.97 The evaluation of a tax position in accordance with this interpretation is a two-step process. The first step is recognition: The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not

[3] FASB is currently considering a one-year deferral of the effective date of this interpretation for nonissuers who have not already implemented FIN 48. See www.fasb.org for more information.

recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

.98 Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in FASB Statement No. 109, *Accounting for Income Taxes*, is not an appropriate substitute for the derecognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on the sufficiency of future taxable income is unchanged by this interpretation.

.99 For calendar-year corporations, the new rules would seem to initially take effect with first quarter 2007 results. However, the new rules require calendar-year corporations to have a "clean" starting point for their tax accounts at January 1, 2007. In other words, the deferred tax asset and deferred tax liability accounts on that date must be determined in accordance with the standards of FIN 48.

.100 A practice guide for accountants, auditors, and tax advisers has been posted to the AICPA's Tax Center at www.aicpa.org/tax under the Resources tab. An AICPA CPE course on accounting for income taxes that has been updated for FIN 48 is now available and an AICPA webcast also is being presented. Go to www.cpa2biz.com for more information on these products.

Additional Implementation Guidance for FIN 48

FASB Staff Position FIN 48-1

.101 In May 2007, the FASB issued FASB Staff Position (FSP) FSP FIN 48-1, *Definition of Settlement in FASB Interpretation No. 48*. The purpose of this FSP is to amend FIN 48 to clarify that a tax position could be effectively settled upon examination by a taxing authority. Assessing whether a tax position is effectively settled is a matter of judgment because examinations occur in a variety of ways. In determining whether a tax position is effectively settled, an enterprise should make the assessment on a position-by-position basis, but an enterprise could conclude that all positions in a particular tax year are effectively settled. The FSP describes conditions for evaluating effective settlement of a tax position, provides guidance for determining effective settlement with respect to examination of tax positions by taxing authorities, and provides a number of conforming changes to FIN 48 with respect to the new settlement terminology discussed in the FSP. The full text of the FSP can be found at www.fasb.org/fasb_staff_positions/fsp_fin48-1.pdf.

Independence and FIN 48

.102 In August 2007, the staff of the Professional Ethics Division issued nonauthoritative guidance (a frequently-asked-question, or FAQ) on the question of whether under Ethics Interpretation 101-3, "Performance of nonattest services," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), members could assist an attest client in applying FIN 48 while maintaining independence. The staff of the Professional Ethics Division issued an FAQ that addresses whether independence is affected when a member helps an attest client apply FIN 48. The FAQ indicates that such services could be provided if the member met all of the requirements of Interpretation 101-3 and is satisfied that the client will be able to make informed judgments on the results of FIN 48 services (for example, understand why tax positions do or do not meet the more-likely-than-not threshold and the basis for any unrecognized tax benefit). In this way, the client may take responsibility for the amounts reported in the financial statements as a result of FIN 48.

.103 The FAQ was incorporated as question 23 into an existing FAQ document that is available on the Professional Ethics Divisions Web site at www.aicpa.org/download/ethics/nonattest_q_a.pdf.

SEC Regulations Committee Issues Revised Discussion Document on FIN 48

.104 On November 21, 2006, the SEC Regulations Committee issued a discussion document addressing specific questions regarding the implementation by public companies of FIN 48. Subsequently, the SEC staff has requested that the committee revise the discussion document to clarify the SEC staff's position regarding the financial statement presentation and disclosure when a registrant changes its accounting principle regarding the income statement classification of interest and penalties on uncertain income tax positions. Therefore, the committee amended the discussion document on February 6, 2007 to clarify the SEC staff's position, and is issuing a revised document that supersedes the previous *Appendix A—Disclosures under FASB Interpretation No. 48 in Form 10-Q in the Period of Adoption*, from the September 26, 2006 joint meeting between the SEC staff and the committee. The revised discussion document can be accessed at www.aicpa.org/caq/download/AppendixA_FIN48_092606_revised.pdf.

Recent AICPA Independence and Ethics Pronouncements

.105 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

On the Horizon

.106 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to auditors and accountants or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.107 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body	***Web Site***
AICPA Auditing Standards Board (ASB)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to service@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address, and, if known, your membership and subscriber number in the message. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.108 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of GAAS. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including:

- Establishing objectives for each of the standards, and the auditor's obligations related to the objectives
- Structural and drafting improvements to make the standards easier to read and understand

- Inclusion, in the explanatory material of the standards, of special considerations related to audits of public entities and small entities
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards

.109 The period to comment ended June 15, 2007. The discussion paper can be accessed at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.110 The ASB has created a number of task forces charged with monitoring specific activities of the IAASB and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of the ISA. Currently, the following ASB task forces exist:

- The Auditing Accounting Estimates Task Force is revising AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), with the objective of converging that section with the proposed, revised, and redrafted ISA No. 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.
- The Auditing Related Party Transactions Task Force plans to revise AU section 334, *Related Parties* (AICPA, *Professional Standards*, vol. 1), to achieve convergence with the related ISA, which the IAASB is developing.
- The Auditors' Reports Task Force is revising AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1). Simultaneously, the Auditor's Report Research Task Force is charged with performing research on the how the audit report might be revised to better address the existing expectation gap.
- The Going Concern Task Force is considering revisions to AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), based on proposed redrafted ISA No. 570, *Going Concern*. ISA No. 570 is predicated on International Accounting Standard (IAS) No. 1, *Presentation of Financial Statements*, which requires management to assess the entity's ability to continue as a going concern. While there is currently not a similar accounting requirement in U.S. GAAP, the FASB announced in May 2007 that it is adding a project to its agenda to address managements assessment of the entity's ability to continue as a going concern and the adoption of a liquidation basis of accounting.
- The Management Representations Task Force is considering revisions to AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), to achieve harmonization with a proposed revision of ISA No. 580, *Written Representations*.
- The Service Organizations Task Force will develop a new attestation standard that provides guidance to service auditors performing service auditors' engagements. Currently AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), pro-

vides guidance to both user auditors using service auditors' reports in an audit of financial statements and service auditors performing service auditors' engagements. When the new attestation standard is issued, AU section 324 will only contain guidance for user auditors. The task force will work to converge AU section 324 and the new attestation standard with ISA No. 402, *Audit Considerations Relating to an Entity Using a Service Organization*, and International Standard on Assurance Engagements (ISAE) No. 3402, *Assurance Reports on a Service Organization's Controls*, which the IAASB is currently developing.

- The Using the Work of a Specialist Task Force is revising AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), and replacing it with two new standards focusing on situations in which an auditor engages an outside (nonfirm) specialist to obtain the specialized skills or knowledge needed in the audit and situations in which an auditor uses as audit evidence the work product of a nonemployee specialist hired by management. The task force is monitoring the IAASB's progress to revise ISA No. 620, *Using the Work of an Expert*.

.111 The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.112 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1), the ASB decided to defer to issuance of a final revised AT section 501 until the PCAOB issued its amendments and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*

.113 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards*, vol. 1, AU sec. 411], as amended) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS concurrently with the FASB and PCAOB's issuance of their final standards.

Auditing Pipeline—Issuers

PCAOB Proposed Rules and Standards

Proposed Ethics and Independence Rule 3526, *Communication with Audit Committees Concerning Independence* and Proposed Amendment to Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*

.114 On July 24, 2007, the PCAOB proposed an ethics and independence rule, Rule 3526, *Communication with Audit Committees Concerning Independence*, that would supersede the PCAOB's interim independence requirement, Independence Standards Board (ISB) Standard No. 1, *Independence Discussions with Audit Committees*, and two related interpretations (ISB Interpretation No. 00-1, *Independence Discussions with Audit Committees* and No. 00-2, *The Applicability of ISB Standard No. 1: When "Secondary Auditors" Are Involved in the Audit of a Registrant—An Amendment of Interpretation 00-1*). As part of the proposal, the PCAOB also proposed an amendment to Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles* (AICPA, *PCAOB Standards and Related Rules*), and further adjusted the implementation schedule for PCAOB Rule 3523.

Proposed Auditing Standard *Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards*

.115 On April 3, 2007, the PCAOB proposed changes to its auditing standards in light of the issuance of FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3,* and the proposed FASB Statement, *The Hierarchy of Generally Accepted Accounting Principles*. This proposal, if adopted and approved by the SEC, would do the following:

- Supersede AU section 420, *Consistency of Application of Generally Accepted Accounting Principles* (AICPA, *PCAOB Standards and Related Rules*), with a new auditing standard
- Remove the GAAP hierarchy from the PCAOB's interim audit standards
- Make conforming amendments to the PCAOB's interim auditing standards

.116 For the full text of the proposal, see www.pcaob.org/Rules/Docket_023/2007-04-03_Release_No._2007-003.pdf.

.117 For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Internal Control Pipeline

.118 COSO has released a discussion document titled, *Guidance on Monitoring Internal Control Systems.* Comments received will be used in developing an exposure draft, which is expected to be issued by the end of 2007 with final guidance scheduled to be released early in 2008.

.119 The purpose of this guidance, which is appropriate for entities of any size or structure, is to enhance the application and assessment of the monitoring component of COSO's *Internal Control—Integrated Framework*. While applicable to all organizations, this guidance would be especially useful to those with reporting requirements under U.S. Sarbanes-Oxley Act of 2002, Section 404. The discussion document as well as the current status of this project can be found at www.coso.org.

Accounting Pipeline

.120 Presented below are accounting projects and pronouncements currently in progress. Some of the proposed pronouncements discussed in the prior year's alert have not been finalized as of the date of this writing, and are included again.

Business Combinations

.121 Phase 1 of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of Phase 2 of this project is to standardize business combination accounting through the convergence of the FASB and International Accounting Standards Board (IASB) accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are the following:

- All acquisitions of businesses should be measured at the fair value of the business acquired.
- Substantially all the assets acquired and liabilities assumed of the acquired business should be recognized and measured at their fair values at the acquisition date.
- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.122 In June 2005, the FASB and IASB issued a number of exposure drafts, for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. The FASB and IASB expect to issue final statements during the fourth quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and International Financial Reporting Standard (IFRS) No. 3(R), *Business Combinations*
- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- Proposed IAS Statement No. 27(R)

Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Fair Value

.123 During Phase 1 of the FASB's fair value option project, the FASB issued FASB Statement No. 159, which was previously discussed. In Phase 2 of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on Phase 2 are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.124 In December 2006, the FASB issued an exposure draft titled, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure ended in March 2007, and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133, including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entitys financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.125 The FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued an exposure draft, titled *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

Earnings Per Share

.126 The FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and IAS Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB statements. Currently the FASB and IASB are addressing significant differences that remain relating to instruments that can be settled in cash or shares and are classified as a liability on an entity's balance sheet. The FASB and IASB are considering modifications to the treasury stock method and several scoping issues in which either the FASB or IASB has issued or may issue more detailed implementation guidance on earnings per share that may create a convergence difference. The FASB and IASB are expected to issue an exposure draft for public comment during the third quarter of 2007. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

FASB Codification and Retrieval Project

.127 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, Emerging Issues Task Force (EITF), and the SEC). The codification will have a three layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track progress of the Codification and Retrieval Project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

Convergence With International Financial Reporting Standards

.128 Since their joint meeting in September 2002, the FASB and IASB have had a common goal—one set of accounting standards for international use. At that time, The Norwalk Agreement, a memorandum of understanding between the two rule-setting bodies, was signed. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. At that meeting, the FASB and the IASB pledged to use their best efforts to make their existing financial reporting standards fully compatible as soon as is practicable and to coordinate their future work programs to ensure that once achieved, compatibility is maintained. At their meetings in April and October 2005, the FASB and IASB reaffirmed their commitment to the convergence of U.S. GAAP and IFRS. A common set of high quality global standards remains the long-term strategic priority of both the FASB and the IASB.

.129 There has been progress towards this goal. FASB Standard Nos. 157 and 159 take U.S. GAAP in the direction of IFRS with respect to reporting at fair value. Also, in June 2007, the SEC announced that it was issuing for public comment a proposed rule that would eliminate the requirement to provide a reconciliation of IFRS-based financial statements to U.S. GAAP-based financial statements for foreign private issuers that file reports with the SEC.

.130 The goal of the FASB and the IASB is to reach a conclusion by 2008 about whether major differences in the a few focused areas should be eliminated through one or more short-term standard-setting projects and, if so, complete or substantially complete work in those areas. Those areas include impairment, income taxes, investment properties, government grants, research and development, joint ventures, subsequent events, and segment reporting. For more information on the status of this project go to www.fasb.org and www.iasb.org.

Private Company Financial Reporting

.131 The FASB and the AICPA are committed to exploring ways to enhance the value, transparency, and cost effectiveness of financial reporting for private companies. As a result, these two organizations have created a new committee, the Private Company Financial Reporting (PCFR) committee, whose primary objective will be to provide recommendations to the FASB as the FASB sets accounting standards for privately held enterprises.

.132 The PCFR has issued a proposal that recommends making certain improvements to the FASB's current processes for determining whether differences are needed in prospective and existing accounting standards for private company financial reporting and sponsoring a committee designed to increase private company constituent input in the standard-setting process. In assessing the need for differences for private companies in recognition, measurement, disclosure, and presentation, the FASB will consider the needs of users of financial statements as well as cost-benefit considerations. The full text of this proposal and additional information on this project is available at www.pcfr.org.

GAAP Hierarchy

.133 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, that is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.134 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.135 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/project/potential_fspd&other.shtml for complete information.

Resource Central

.136 The following are various resources that practitioners may find beneficial.

Publications

.137 Practitioners may find the following publications useful with respect to recent accounting and auditing developments:

- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)
- Audit Risk Alert *Compilation and Review Alert—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics Alert—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Checklist and Illustrative Financial Statements for Corporations* (product no. 008938kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.138 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firms needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, TPAs, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

.139 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

.140 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.141 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPAs flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics.

.142 To register or learn more, visit www.cpa2biz.com.

Webcasts

.143 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high quality, two-hour CPE programs that bring you the latest topics from the professions leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.144 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFOs personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.145 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the professions leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.146 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.147 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. You can reach the Technical Hotline at (877) 242-7212.

Ethics Hotline

.148 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

AICPA Governmental Audit Quality Center

.149 The Governmental Audit Quality Center (GAQC) is a firm-based voluntary membership Center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC's primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The GAQC also offers resources to enhance the quality of a firm's governmental audits.

.150 The mission of the GAQC is to do the following:

- Raise awareness about the importance of governmental audits.
- Serve as a comprehensive resource provider on governmental audits for member firms.
- Create a community of firms that demonstrates a commitment to governmental audit quality.
- Provide center members with an online forum tool for sharing best practices and discussing audit, accounting, and regulatory issues.
- List member firms to enable purchasers of governmental audit services to identify firms that are members.
- Provide information about the center's activities to other governmental audit stakeholders.

.151 For more information about the GAQC, visit http://gaqc.aicpa.org.

AICPA Center for Audit Quality

.152 The CAQ (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.153 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQis a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

AICPA Employee Benefit Plan Audit Quality Center

.154 The Center is a voluntary membership organization for firms that perform or are interested in performing Employee Retirement Income Security Act (ERISA) employee benefit plan audits. The Center was established to promote the quality of employee benefit plan audits.

.155 To achieve this goal, the Center has created a community of firms that demonstrate a commitment to employee benefit audit quality, and supports those firms by:

- Providing members with timely communication of regulatory developments, best practices guidance, and technical updates
- Providing members with an online community forum for sharing best practices as well as discussions on audit, accounting, and regulatory issues
- Maintaining relationships with, and acting as a liaison to, the DOL on behalf of member firms
- Providing Center members with a marketing toolkit to facilitate promotion of their membership in the Center
- Providing information about the Centers activities to other employee benefit plan stakeholders

.156 The increasing complexity of employee benefit plan auditing and increased scrutiny by the DOL have resulted in a significant number of changes and issues for auditing firms and CPAs in general. Firms and CPAs will benefit from the assistance of the Center as a resource for improving employee benefit plan audit quality.

.157 For more information about the Employee Benefit Plan Audit Quality Center, visit ebpaqc.aicpa.org.

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.158 This Audit Risk Alert replaces General *Audit Risk Alert—2006/07*.

.159 The General *Audit Risk Alert* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next years Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to ccole@aicpa.org or write to:

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Appendix—Additional Web Resources

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Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	***Content***	***Web Site***
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov

Web Site Name	***Content***	***Web Site***
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov