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ASB meeting minutes, 1997, September 16-18

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ASB Meeting Minutes, September 16-18, 1997

Meeting: Auditing Standards Board

Date: September 16-18, 1997

Location: Oak Brook Hills Hotel & Resort
3500 Midwest Road
Oak Brook, IL 60522

Meeting Attendance: Edmund R. Noonan, Chair
John L. Archambault
Luther E. Birdzell
John A. Fogarty, Jr.
James S. Gerson
Stephen D. Holton
J. Michael Inzina
Norwood J. Jackson, Jr.
John J. Kilkeary
Charles E. Landes
Stephen McEachern
Kurt Pany
Edward F. Rockman
Alan Rosenthal

W. Ronald Walton

Other Participants

Beth Schneider, Deloitte & Touche LLP

Dan M. Guy, Vice President, Professional Standards and Services

Thomas Ray, Director, Audit and Attest Standards

Julie Anne Dilley, Technical Manager, Audit and Attest Standards

Kim M. Gibson, Technical Manager, Audit and Attest Standards

Gretchen Fischbach, Technical Manager, Audit and Attest Standards

Jane M. Mancino, Technical Manager, Audit and Attest Standards

Judith M. Sherinsky, Technical Manager, Audit and Attest Standards

I. CHAIRS REPORT (FILE 1220)

Edmund R. (Randy) Noonan, Chair, presented to the Auditing Standards Board the highlights of the Audit Issues Task Forces September 4, 1997 meeting (See attached report).

II. DIRECTORS REPORT (File 1221)

Thomas Ray, AICPA Director, Audit and Attest Standards, reported the following matters to the ASB.

- A. On August 5, 1997, AICPA staff and committee members representing Practice Monitoring, Accounting Standards and Audit and Attest Standards, met with representatives of the Financial Executives Institutes Committee on Corporate Reporting (CCR). The CCR representatives were interested in discussing the ASBs project on managements discussion and analysis. John Fogarty participated in that discussion.
- B. R. Noonan and T. Ray met with the ASB Liaison Committee of the American Accounting Association to discuss ways in which academe could more fully participate and contribute to the standards setting

process. One specific area of discussion was the ASBs commitment to perform a retrospective review of the fraud standard after a two-year period. Research may play a significant role in that review. T. Ray agreed to explore with Ray Whittington, ASB Liaison Committee chair, means to better communicate ASB activities to elicit timely input from academe, and to begin the process of planning for the fraud retrospective.

- C. Elizabeth Fender recently joined the AICPA as Director, Accounting Standards. Liz replaced Jane Adams, who joined the Office of the Chief Accountant at the Securities and Exchange Commission as Deputy Chief Accountant.
- D. The AICPA and the National Association of State Boards of Accountancy are pursuing amendment to the Uniform Accountancy Act (UAA). One aspect of the amendment would require the AICPAs professional standards to include an experience requirement as a condition for supervising or taking responsibility for an attest engagement, as defined in the UAA. Experience requirements, if any, currently are established by each jurisdiction. This may require the ASB to consider establishing such a requirement in the Statements on Quality Control Standards. T. Ray will monitor the situation, and advise the ASB chair as it develops.
- E. Nominations for ASB chair, vice chair and vacancies were submitted to the AICPAs Board of Directors for approval. Deborah D. Lambert, a recent former ASB member, was nominated as ASB chair, and James Gerson was nominated as vice chair. T. Ray will advise the ASB on the outcome of the nominations.

RESTRICTED-USE (File Ref. No. 4275)

The Restricted-Use Task Force (task force) is considering areas of the auditing and attestation standards that prescribe restrictions on the use or distribution of accountants reports to determine whether standards should be developed that describe the characteristics of the subject matter, nature of the engagement, or other factors that might necessitate a restriction on the use of an accountants report.

John J. Kilkeary, Chair of the task force, led the ASB in a discussion of a revised draft of a proposed Statement on Auditing Standards (SAS) titled, Restricting the Use of an Auditors Report, that would provide guidance for engagements performed under the SASS. The ASB recommended that the

task force —

- Exclude reports issued under SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties, from the applicability of the proposed standard
- Replace the term "specified users" with the term "specified parties"
- Not expand footnote 3 of the SAS to include an example of how an auditor could restrict a report that ordinarily is not restricted. (See Board Preference Vote)
- Delete the following sentence from paragraph 10, "The presumption is that these specified parties are able to properly use these reports because they understand the context in which the reports were issued."
- Replace the words "ordinarily should" with the words "may wish to" in the first sentence of paragraph 16 so that the revised sentence would read, "The auditor may wish to advise his or her client that restricted-use reports are not intended for distribution by the client to non-specified users."
- Not revise paragraph 11, which addresses combined reports, to conform with paragraph 47 of SAS No. 75, Agreed Upon Procedures, which addresses combined and included reports.

Summary of ASB Preference Vote

Restricted-Use Task Force (File Ref. No. 4275)	For	Against	Abstain	Absent
Should footnote 3 of the proposed SAS be expanded to include an example of how an auditor could restrict a report that ordinarily is not restricted?	3	9	1	2
Should paragraph 11 of the proposed SAS, which addresses combined reports, be revised to conform with paragraph 47 of SAS	2	11	0	2

No. 75, Agreed Upon Procedures, which addresses combined and included reports?

OWNERSHIP, EXISTENCE, AND VALUATION (File Ref. No. 2405)

The Ownership, Existence, and Valuation Task Force (task force) is considering the auditors responsibility for auditing financial-statement assertions about the ownership, existence, and valuation of financial instruments, commodity contracts, and similar instruments.

Tom Birdzell, Chair of the task force, led the ASB in a discussion of a draft of a proposed SAS titled Auditing Financial Instruments. The proposed SAS revises the scope of SAS No. 81, Auditing Investments, to include all financial instruments. The current scope of SAS No. 81 includes (1) debt and equity securities, as that term is defined in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, and (2) investments accounted for under APB Opinion No. 18, The Equity Method of Accounting. The ASB reviewed the draft and recommended that the task force —

- Revise paragraph 1 to more clearly indicate which financial instruments are included in the scope of the Statement.
- Clarify paragraph 7 to indicate which audit procedures are applicable to receivables, payables, and cash
- Provide additional guidance concerning the procedures an auditor should perform to address the completeness assertion
- Reorder paragraphs 2 through 4 so that the section begins with guidance about internal control considerations.
- Delete the references to the various SASs in paragraphs 2 through 4.
- Provide examples of the types of intervening events that might cause the fair value of a financial instrument to change.
- Indicate in paragraph 32 that evidential matter to support an assertion about the fair value of a financial instrument must be reasonably current. (See ASB Preference Vote)
- Enhance the disclosure section of the document by identifying the GAAP disclosures about financial instruments that may be required.

The ASB also recommended that the proposed interpretations of SAS No. 70, Reports on the Processing of Transactions by Service Organizations, that will provide guidance on whether an auditor needs to obtain information about a custodian's controls if an entity uses a service organization to maintain custody of its financial instruments, should be exposed for comment in conjunction with the proposed revision of SAS No. 81.

Summary of ASB Preference Vote

Ownership, Existence, and Valuation Task Force (File Ref. No. 2405)	For	Against	Abstain	Absent
Should the guidance in paragraph 32 of the proposed SAS indicate that evidential matter to support a financial statement assertion about the fair value of a financial instrument must be reasonably current?	12	1		2

ATTESTATION RECODIFICATION (File Ref. No. 2155)

Ronald Walton, chair of the Attestation Recodification Task Force, led the Board's discussion of the project.

The Board:

- Discussed the International Auditing Practice Committees exposure draft, Reporting on the Credibility of Information, issued in August 1997.
- Directed the task force to incorporate the line of reasoning on restricting reports from the proposed SAS, Restricting the Use of an Auditors Report.
- Discussed footnote 8 of SAS No. 62, Special Reports, which refers the reader to AT section 100 of the Attestation Standards for guidance when reporting on a review of one or more specified elements,

accounts or items of a financial statement.

Various Board members had extensive comments that, if addressed, would require a significant rewrite of the Attestation Standards. This led to a discussion of the task forces charge, which is to recodify the Attestation Standards, not to rewrite them. The task force will discuss the issues raised by the Board at its next task force meeting.

MANAGEMENT REPRESENTATIONS TASK FORCE (File Ref. No. 4308)

James Gerson, Chair of the Management Representations Task Force (task force), led the Board in a discussion of the proposed Statement on Auditing Standards (SAS) Management Representations. The Board discussed the proposed statement which included revisions to reflect comments received during the exposure period.

In addition to the above, the task force prepared a paper which highlighted some of the revisions made to the proposed statement. The following were discussed by the Board:

- Revising the proposed statement to indicate that all of the specific representations listed should be obtained from management when performing an audit in accordance with generally accepted auditing standards.
- The American Bar Association (ABA) provided suggested wording regarding management representations with respect to unasserted claims or assessments. The Board reviewed the suggested wording, however agreed to leave the language in the proposed statement as is.
- Revising the proposed statement to include guidance regarding obtaining a representation letter when an audit report has been dual dated. The guidance included in the proposed statement states that the auditor should consider obtaining additional representations relating to the subsequent event and then refers the auditor to AU section 530.05, Dating of the Independent Auditors Report.
- Revising the proposed SAS to include circumstances in which the auditor should obtain an updated representation letter.
 1. One of the circumstances is when a predecessor auditor is requested by a former client to reissue the audit report of a

prior period reflecting the amendment to AU section 508.71 in Appendix D. Wording has been added to clarify that this situation applies only when prior period financial statements are to be presented on a comparative basis with the audited financial statement of a subsequent period. Appendix D - Amendment to SAS No. 58, Reports on Audited Financial Statements, has been revised accordingly.

2. Paragraph 10 of the proposed SAS has been revised to expand the matters that should be included in an updating management representation letter. The letter should state (i) whether any information has come to managements attention that would cause them to believe that any of the previous representations should be modified, and (ii) whether any events have occurred subsequent to the balance-sheet date of the latest financial statements reported on by the auditor that would require adjustment to or disclosure in those financial statements.

Appendix C, "Illustrative Updating Management Representation Letter" and Appendix D, Amendment to SAS No. 58, Reports on Audit Financial Statements, have both been revised to reflect (i) and (ii) above. Appendix C has also been revised to remove reference to the predecessor auditor and now is an example of an updating letter that can be used for various circumstances.

- Revising the proposed SAS to state that if management refuses to provide the letter, this refusal would ordinarily be sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause the auditor to disclaim an opinion or withdraw from the engagement. The guidance continues to state that based on the circumstances, the auditor may conclude that a qualified opinion would be appropriate.

After review of the proposed statements and discussion of the above, the Board agreed to vote to ballot the statements for final issuance. (See Summary of Board Preference Vote)

Summary of ASB Preference Vote

Management Representations Task Force (File Ref. No. 4308)	For	Against	Abstain	Absent
Should the proposed statement, Management Representations be balloted for final issuance?	15			

MANAGEMENTS DISCUSSION AND ANALYSIS (File Ref. No. 3507)

John A. Fogarty, chair of the Management's Discussion and Analysis (MD&A) Task Force, led the Boards discussion of issues relating to the proposed SSAE, Managements Discussion and Analysis.

The Board discussed:

- Restrictions on the distribution of reports on reviews of MD&A. The Board debated whether (1) all reports on review of MD&A should be restricted, (2) the MD&A review report restriction should be left to the practitioners discretion, or (3) a certain subset of review reports on MD&A should be restricted. The Board ultimately decided that review reports applying to public companies, as defined, should be restricted. (See Summary of Board Preference Vote.)
- The effect of the proposed SSAE on MD&A on SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties. The Board decided to clarify the fact that the accountant, under SAS No. 72, is permitted to apply agreed-upon procedures to items in MD&A that are subject to internal control over financial reporting, as long as the underwriter or other requesting party has not been provided with the assurance included in either a review or an examination report on MD&A.
- The applicability of the Private Securities Litigation Reform Act of 1995. The Board added to the proposed SSAE a new paragraph 26A regarding the safe harbor, provided by the Act, from liability in private litigation with respect to forward-looking statements that include, or make reference to, cautionary language.

To facilitate discussion of the proposed SSAE at the next Board meeting, J. Fogarty urged the Board members to send any comments to the task force as soon as possible and proposed that the Board review the proposed SSAE in large tranches at the November meeting. The Board hopes to vote to ballot for issuance of the proposed SSAE as a final SSAE at the next meeting.

Summary of ASB Preference Vote

Managements Discussion and Analysis (File Ref. No. 3507)	For	Against	Abstain	Absent
Should some review reports on MD&A be restricted (specific language to be worked out)?	9	6	-	-

ASB HORIZONS PLANNING DOCUMENT (File Ref. No. 4430)

James S. Gerson, Chair of the ASB Horizons Task Force (task force), led the Boards discussion of the planning document that the task force had drafted. The Board agreed with the four major initiatives proposed in the document, as follows:

- Initiative A: Improve the core audit service to serve the public, the preparers, and the profession.
- Initiative B: Broaden the utility of the attestation standards to facilitate new assurance services that respond to emerging user needs.
- Initiative C: Significantly strengthen its leadership role in developing international auditing standards and quality control processes that meet the needs of a global marketplace.
- Initiative D: Enhance the utility of audit and attest guidance by implementing process improvements in ASB operations.

The Board suggested editorial changes to consolidate and reorder some of

the actions under Initiatives A and D but generally approved the proposed actions to implement the initiatives. The Board directed the task force to make the recommended changes and complete the resource needs section and the bibliography of the document. The revised draft will be brought back for the Boards approval at its December meeting.

Highlights of the Audit Issues Task Forces September 4, 1997 Meeting

A. The Audit Issues Task Force (AITF) met on September 4, 1997 in Greenwich, CT.

The Year 2000 Proposed Interpretations

Luther E. (Tom) Birdzell, AITF member, and Thomas Ray, Director, Audit and Attest Standards, presented draft interpretations of AU section 311, Planning and Supervision, that address the year 2000 issue. Specifically, the draft interpretations clarify auditor responsibility regarding the year 2000 issue, planning considerations, and internal control deficiencies (reportable conditions) related to the Year 2000 issue. AITF members discussed the proposed interpretations and recommended some changes in wording and organization. The interpretations will be redrafted to incorporate these changes and distributed to the full ASB membership at the ASBs September meeting, with a comment deadline of September 25 for fatal flaw review.

The interpretations will be a major part of an AICPA practice aid that is being developed for issuance in October 1997. The practice aid also will include a description of the year 2000 issue and its ramifications, a summary of accounting guidance, best practices guidance, and discussion of the year 2000 issue as it relates to MD&A, impairment, internal use software, and other matters. The AITF discussed possible communication vehicles for the practice aid, and how to draw attention to the final product via The CPA Letter and other AICPA newsletters and alerts.

FASB 125 Audit Issues Task Force (Task Force)

Tracey Barber, Task Force Chair, presented an update on the Task Forces first meeting on August 21, 1997. The Task Force membership includes an attorney and a preparer in order to obtain their perspective on the

guidance that the task force is drafting. FASB staff are attending the meetings as well. The guidance probably will be issued in the form of an interpretation that addresses what is sufficient competent evidential matter to provide reasonable assurance that the legal isolation criteria in SAS 125 paragraph 9 (a) have been met to account for a transfer of financial assets as a sale. In developing the standard, the FASB concluded that legal isolation was the key characteristic distinguishing sales from secured borrowings.

Issues to be addressed in the interpretation include when a legal letter is required, what other evidence may be used, what language is required in a legal letter, and how various kinds of restrictive language in a legal letter might affect its use as audit evidence. The interpretation will address the kind of evidential matter appropriate for different scenarios, for example, depending on whether the entity being audited is an FDIC-insured bank, or a broker-dealer subject to the U.S. Bankruptcy Code.

Since SAS 125 was effective for transfers of financial assets after December 31, 1996, the AITF urged the Task Force to submit draft guidance for AITF consideration at its October and December meetings with the objective of issuing an interpretation by the end of the year.

FASB 130/131 Reporting Issues Update

T. Ray noted that ASB members Charles Landes and Stephen McEachern had agreed to review SAS 130, Reporting Comprehensive Income, and John Fogarty and Alan Rosenthal had agreed to review SAS 131, Disclosures about Segments of an Enterprise and Related Information, for possible audit issues that may arise pursuant to those standards. J. Fogarty has reported that AU section 435, Segment Information, will need to be updated for conforming changes, and may require additional reconsideration under the new SAS. More detailed reports on the need for additional audit guidance as a result of these new accounting standards will be provided at the October AITF meeting.

Electronic Commerce Draft Reports

Everett Johnson, Chair, Electronic Commerce Assurance Services Task Force, joined the AITF by conference call to discuss proposed drafts of the

attestation reports on the WebAssure™ project in the context of the criteria and assertions presented in the draft WebAssure™ Manual. AITF members generally agreed that the report language should track the language of the assertions as expressed in the Handbook. Also, if no assurance is to be provided regarding whether an entity follows its disclosed policies, AITF members felt the report should have some sort of disclaimer to that effect. It also was suggested that inherent limitations language similar to that in AT sec 400.46 would be preferable to the last sentence of the report as currently phrased.

Edmund R. (Randy) Noonan agreed to discuss with E. Johnson during the following week how to resolve certain other issues.

B. Liaison Meeting with the Governmental Accounting Standards Board (GASB)

The AITF met with GASB representatives and staff on September 5, 1997 in Norwalk, CT. The following matters were discussed:

Management's Discussion and Analysis (MD&A)

James S. Gerson, AITF member, provided an update on the status of the ASBs MD&A exposure draft that is expected to be voted out by the end of the year. David R. Bean, Director of Research, and Thomas L. Allen, Chairperson, of the GASB summarized major comments received on the exposure of Basic Financial Statements--and Management's Discussion and Analysis--for State and Local Governments. Subsequent discussion focused on difficulties that may arise due to governments lack of experience in preparing MD&A, as distinct from that of public entities, and the perceived subjectivity of the criteria used to prepare it. George Scott, member of the AICPA Government Accounting and Auditing Committee (GAAC) who participated via conference call, noted that because auditors frequently are involved in the preparation of the financial statements of governmental entities, auditors are likely to become embroiled in political controversy related to the content of MD&A.

Materiality

Participants discussed materiality as it relates to financial statements and

particularly to the notes to financial statements. Some AITF members felt that accounting standards setters could facilitate the consideration of materiality by being more specific with regard to the purpose for which a disclosure is required, and by relating disclosures to base measures in the financial statements. Participants also discussed the checklist mentality that encourages the recurrence of every disclosure once made, whether relevant or not. In terms of the proposed government reporting model, G. Scott noted that GAAC is reassessing the criteria for determining materiality in the AICPA Audit and Accounting Guide, Audits of State and Local Governmental Units, to see where it may need to be changed to conform with the broader perspectives contemplated in the reporting model, for example, with governmental, proprietary, and fiduciary fund summary levels.

Differential Reporting

D. Bean and T. Allen noted that respondents to the exposure draft on the reporting model were concerned about the complexity of the "dual perspective" presentation of financial statements with a single report. A possible way to address this concern would be to have "differential reporting," that is, separate reports on the financial statements prepared under each perspective. AITF members generally did not feel that there was any impediment to separate reports, given the flexibility in audit reporting that presently is enabled in AU sec 623, Special Reports. The GASBs final standard, however, may guide how these matters ultimately are addressed.

Other Matters

Other matters discussed included the retroactive capitalization of infrastructure assets that the new reporting model requires, and electronic reporting issues.

Finally, the AITF suggested a more continuous liaison between the GASB and the AICPA's GAAC on issues of mutual concern, and offered AITF involvement as needed.

C. Liaison Meeting with the Financial Accounting Standards Board (FASB)

The AITF met with FASB representatives and staff on September 5, 1997 in Norwalk, CT. The following matters were discussed:

Financial Instruments

An updated draft of the proposed standard, Accounting for Derivative and Similar Financial Instruments and for Hedging Activities, was distributed to AITF members. The revised draft is available on the Internet and the comment deadline is October 14, 1997. The FASB expects to issue the new standard by the end of the year. The standard lists the required criteria that must be met to qualify for fair value hedge accounting. Among the criteria are that management must formally document the hedging relationship and the risk management objective and strategy at the inception of the hedge, including documentation of the entity's plans to assess the hedging instruments effectiveness. Gains and losses on a qualified fair value hedge will be recognized currently in earnings.

The proposed standard uses the SAS 125 definition of fair value. T. Birdzell noted that the definition of fair value under SAS 35 differs from that of the recent standards on financial instruments. SAS 35 requires use of a market price for fair value measurement only if there is an active market for the investment, and if not, other means by which to determine fair value are described. AITF members stated that the definition of fair value in SAS 125 (and SAS 107) is ambiguous in that it appears to require quoted market prices even when there is not an active market. The FASB will consider clarifying the definition. Participants discussed situations where quoted market prices, even in active markets, may not be a "real" price, for example, because of the impact of the transaction on the market.

SAS 125 Issues

Scott Marcello of the FASB staff discussed the conditions in paragraph 9 of the standard that must be met to account for the transfer of financial assets as a sale. Kurt Pany, AITF member and member of the FASB 125 Audit Issues Task Force (Task Force), summarized the Task Force objectives and noted that FASB staff persons Halsey Bullen and Victoria Lusniak have agreed to participate in the Task Force meetings. One outcome of the first meeting is that H. Bullen will bring to the FASB's attention the implications for broker-dealers of the nature of SIPC, as

compared to FDIC, receivership, a matter that had not been discussed when the standard was being developed.

International Standards Process and Projects

Edmund L. Jenkins, the new FASB Chairman, commented that international standards are inevitable. Timothy Lucas, FASB staff member, described FASB international initiatives which include observing IASC meetings, participating in working groups, keeping current the recently-completed two-way comparison of FASB and international standards, and commenting on exposure drafts. Dan M. Guy, AICPA Vice President, Professional Standards & Services, and R. Noonan, both members of an AICPA International Strategies Committee, noted that the AICPA similarly will be taking a greater leadership role in international standard setting, a fact that is recognized in the ASBs planning document that currently is being drafted.

Other Matters

T. Ray noted that ASB members are reviewing SAS 130 and SAS 131 for potential audit issues that may arise pursuant to the issuance of those standards. J. Gerson stated that the MD&A Task Force is in the process of considering comments received on the exposure draft and the new attestation standard is expected to be voted out by the end of the year. He noted that the project had been undertaken partially in response to recommendations of the AICPA's Special Committee on Financial Reporting for an expanded reporting model and for auditor involvement to provide assurance on the elements of that model.

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