1-1-2008

Comprehensive audit risk alert - 2008; Audit risk alerts

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Comprehensive Audit Risk Alert – 2008

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AUDIT RISK ALERT

2008

Comprehensive Audit Risk Alert

Strengthening Audit Integrity
Safeguarding Financial Reporting

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Comprehensive Audit Risk Alert

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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1776-341

1 2 3 4 5 6 7 8 9 0 AAP 0 9 8

ISBN 978-0-87051-765-5

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements with an overview of recent economic, industry, 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 environments 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 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.

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

.03 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

.04 The client financial statements that 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).

.05 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.

.06 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.

.07 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

.08 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 effect on the entity's financial statements being audited.

.09 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, real GDP increased at an annual rate of 2.2 percent in 2007. According to 2008 second quarter preliminary estimates, real GDP increased at an annual rate of 3.3 percent, which is up significantly from the 0.9 percent rate in the first quarter of 2008.

.10 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. However, during 2008, the unemployment rate has risen. As of July 2008, the unemployment rate was 5.7 percent, representing approximately 8.8 million people.

.11 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates a total of 3.25 percentage points to 2.00 percent as of the end of July 2008. The Federal Reserve noted in its July press release that overall economic activity continues to expand. However, labor markets have softened further and financial markets remain under considerable stress. Tight credit conditions, the ongoing housing contraction, and the rise in energy prices are likely to weigh on economic growth over the next few quarters. Inflation has been high, spurred by the earlier increases in the prices of energy and some other commodities, and some indicators of inflation expectations have been elevated. The Federal Open Market Committee expects inflation to moderate later this year and next year, but the inflation outlook remains highly uncertain.

Consumer Price Index Trends

.12 The U.S. Department of Labor 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 as a guide when making economic decisions. The following table 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*
2003	184.3	1.9%
2004	190.3	3.3%
2005	196.8	3.4%
2006	201.8	2.5%
2007	210.0	4.1%

Interest Rates for Below-Market Rate Loans

.13 The 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 was payable annually on the day referred to in Subsection (a)(2), over

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

.14 This rate is a useful guide to auditors 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*
2004	1.98%
2005	3.11%
2006	4.71%
2007	4.92%
2008	2.80%

Housing Market

.15 The housing market has continued to deteriorate and contribute to a slowing economy. There are significant concerns that falling home prices may cause consumers to cut back on spending. The number of foreclosure filings continues to rise at an unprecedented rate. According to RealtyTrac, a company which specializes in foreclosed properties, 739,714 foreclosure filings were made in the second quarter of 2008. That number represents an increase of 121 percent from the second quarter of 2007. To compound the problem, according to the Mortgage Bankers Association, reluctance on the part of homebuyers has resulted in historically high unsold home inventories. These conditions have caused home prices to level off and decline in many areas of the United States, which, in turn, contributes to an increase in foreclosures.

The Liquidity Crisis

.16 Recently, the increase in foreclosures and the sinking value of investor portfolios have led to a number of bailouts and even some failures of large U.S. mortgage banking and financial institutions. In an effort to solve the liquidity crisis, on July 30, 2008, the president signed the Housing and Economic Recovery Act of 2008. The major provisions of this legislation include the following:

- An increase in the loan limits for government sponsored enterprises and Federal Housing Administration (FHA) backed mortgages to shore up investor confidence
- An allowance for additional credit to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to ease liquidity concerns
- The reduction and refinancing of troubled mortgages through the FHA to make them affordable to homeowners
- Promotion of a nationwide licensing and registration system for residential loan originators
- Authorization of $100 million for foreclosure mitigation activities and the creation of tax credits and incentives for certain homeowners

.17 The purpose of this legislation is to reduce the number of foreclosures, encourage new buyers to enter the housing market to absorb excess housing inventory, and guarantee the stability of mortgage lenders to boost investor confidence.

Valuation Issues

.18 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. These assets can be found in investment portfolios across the spectrum, affecting many different types of audits. These assets may be held either directly or indirectly (for example, through an investment company such as a money market fund, a mutual fund, or a hedge fund).

.19 Again this year, 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 raises 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 an organization's 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

Audit Risks Arising From Current Economic Conditions

.20 Rising food and oil prices, a weak housing market, and a weak U.S. dollar have ripple effects throughout the U.S. economy. Whether the audit client transports goods, applies for a line of credit, or simply buys office supplies, costs are increasing, which may result in higher inventory costs. The client may struggle with how to compensate for rising costs and how much its business will be affected by passing those costs onto the customer. Your client's profit margins are likely to be affected as well. You may find that your clients have renegotiated supplier contracts to seek better payment terms. The client's customers may be scaling back purchases in an effort to control costs or may not be able to pay promptly, which may cause inventory levels to rise and accounts receivable collection rates to decrease. Recent economic conditions may cause additional risk factors that had not existed or did not have a material effect on audit clients in prior years. When obtaining an understanding of the external factors that affect the entity and the risks associated with those factors, the auditor may consider whether conditions exist that indicate risks of material misstatement. Some examples that relate to economic conditions are as follows:

- Operations that are exposed to volatile markets, which may include oil, agriculture, or currency markets
- Changes in the entity's supply chain, including surcharges on transportation
- Constraints on the availability of capital and credit
- Operations in regions with economic volatility, including employment and housing issues
- Going concern and liquidity issues

.21 Although many of these risks are not new to business, consideration of the many ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks.

Common Audit and Review Engagement Deficiencies

.22 The AICPA Peer Review Program is dedicated to continually enhancing the quality of accounting, auditing, and attestation services performed by AICPA members in public practice. To protect the public interest, the programs are driven by adherence to the highest professional standards and understanding the changing business and regulatory environments.

.23 Each year, the AICPA Peer Review team compiles a list of deficiencies that are most commonly found during the examinations of engagements performed by firms that participate in the program. The purpose of this list is to raise awareness with the goal of improving the quality of audit, review, and compilation engagements. The deficiencies are categorized by materiality, engagement performance area, and type of engagement. Also included is a section on issues related to the implementation of new standards. The list is available at www.aicpa.org/download/members/Div/practmon/Revised_Deficiency_Guidance_for_2008_FINAL.doc.

.24 Additional information about the AICPA Peer Review Program or Peer Review Standards can be found at www.aicpa.org/members/div/practmon/index.htm.

Summary of Recent Auditing and Attestation Pronouncements and Related Guidance

.25 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 Accounting and Auditing 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.

.26 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 AICPA Audit Risk Alert *SEC and PCAOB Developments—2008* (product no. 022499kk), 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 visiting www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Auditing Standards (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])	Replacing SAS No. 61, *Communication With Audit Committees*, this 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, to whom they should be communicated, 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 AU section 150, *Generally Accepted Auditing Standards*, to reflect terminology in AU section 120, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1).

Recent Auditing and Attestation Pronouncements and Related Guidance	
	• Adds a footnote to the headings before paragraphs .35 and .46 in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), 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)	See the "AICPA Risk Assessment Standards" section in this alert.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This standard 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 AT section 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA,

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
	Professional Standards, vol. 1). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.
Auditing Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .56–.59) Issue Date: March 2002 Revised Date: May 2008 (Interpretive publication)	This auditing interpretation interprets AU section 508 and addresses the application of AU section 508 in reporting on financial statements prepared in conformity with International Financial Reporting Standards (IFRS).
Auditing Interpretation No. 19, "Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board," of AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .93–.97) Issue Date: May 2008 (Interpretive publication)	This auditing interpretation interprets AU section 508 and addresses the application of AU section 508 in reporting on financial statements prepared in conformity with IFRS.
Auditing Interpretation No. 2, "Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board," of AU section 534, *Reporting on Financial Statements Prepared for Use in Other Countries* (AICPA, *Professional Standards*, vol. 1, AU sec. 9534 par. .05–.08) Issue Date: May 2008 (Interpretive publication)	This auditing interpretation interprets AU section 534 and addresses the application of AU section 534 in reporting on financial statements prepared in conformity with IFRS.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Auditing Interpretation No. 3, "Financial Statements Audited in Accordance With International Standards on Auditing," of AU section 534 (AICPA, *Professional Standards*, vol. 1, AU sec. 9534 par. .09–.11) Issue Date: May 2008 (Interpretive publication)	This auditing interpretation interprets AU section 534 and addresses the application of AU section 534 in audits of financial statements prepared for use outside the United States.
Statement of Position (SOP) 07-2, *Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers* (AICPA, *Technical Practice Aids*, AUD sec. 14,430) Issue Date: October 2007 (Interpretive publication)	This statement addresses the application of SSAEs primarily to examination engagements in which a practitioner reports on the suitability of the design and operating effectiveness of a service provider's controls in achieving specified compliance control objectives. Examples of the service providers addressed by this SOP are investment advisers, custodians, transfer agents, administrators, and principal underwriters that provide services to investment companies, investment advisers, or other service providers.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) sections 8200.05–.16. (AICPA, *Technical Practice Aids*) Issue Date: April and May 2008 (Nonauthoritative)	These questions and answers in TIS section 8200, *Internal Control*, were developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111.
TIS section 9120.08, "Part of an Audit Performed in Accordance With International Standards on Auditing" (AICPA, *Technical Practice Aids*) Issue Date: April 2008 (Nonauthoritative)	This question and answer discusses the implications to the principal auditor's report when part of an audit is conducted by other independent auditors in accordance with International Standards on Auditing or another country's auditing standards.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
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 management 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 AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that AU section 339 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 year's 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 practice alert is a response 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.
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 practice alert provides guidance regarding application of certain provisions of AU section 339, primarily related to dating the auditor's report.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Public Company Accounting Oversight Board (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") 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 Preapproval of Non-audit Services Related to Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Rules") 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 Securities and Exchange Commission (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, *Audit Committee Pre-approval of Certain Tax Services* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Rules"). This rule is effective for audits of fiscal years ending on or after November 15, 2007.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Conforming Amendments to the Interim Auditing Standards (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "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 Release No. 2007-001, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, "Selected SEC-Approved PCAOB Releases") Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This release 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*, PCAOB Standards, As Amended). 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* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100 par. .05) Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	Topics covered include the following: • The application of PCAOB Rule 3522(a), *Tax transactions* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Rules"), when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm • Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction • Whether a registered public accounting firm's 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 PCAOB Rule 3522(b)

Recent Auditing and Attestation Pronouncements and Related Guidance	
	• 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 PCAOB Rule 3522(c)
PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .02) Issue Date: December 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles that are particularly relevant to the current economic environment.

The Auditor's Communication With Those Charged With Governance

.27 In December 2006, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (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*. This 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 became effective for audits of financial statements for periods beginning on or after December 15, 2006.

Identifying Those Charged With Governance

.28 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.

.29 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.

.30 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 auditor's understanding of the entity's governance structure and processes obtained in accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), 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

.31 The ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which became effective for audits of financial statements for periods ending on or after December 15, 2006. 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. This SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion). Among other things, SAS No. 112

- requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. 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 auditor's 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 at least a significant deficiency and a strong indicator of 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.

.32 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 a discussion of the benefits of training programs for client personnel to become more knowledgeable about internal control. Auditors can also teach clients how to develop a risk assessment approach to designing a system of internal control. Readers should note 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 (ISAs).

.33 The AICPA published Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to help readers understand the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

AICPA Risk Assessment Standards

.34 The 8 SASs referred to as the risk assessment standards (SAS Nos. 104–111) became effective for audits of financial statements for periods beginning on or after December 15, 2006 (earlier application was permitted). Although the SASs include many of the underlying concepts and detailed performance requirements contained in the standards they amend or supersede, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risks of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between risks, controls, audit procedures, and conclusions.

Key Provisions of the Risk Assessment Standards

.35 The risk assessment standards require the auditor to understand and respond to the risks of material misstatement, whether due to error or fraud. 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 of the Treadway Commission's [COSO] *Internal Control—Integrated Framework* at www.coso.org/IC-IntegratedFramework-summary.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 should have already been completed and has likely resulted in significant changes to firm audit methodologies and personnel training.

Risk Assessment Standards Technical Practice Aids

.36 To assist auditors in implementing the risk assessment standards in their audits, the AICPA has issued a series of nonauthoritative Technical Practice Aid (TPA) Technical Questions and Answers (TIS) sections relating to internal control. TIS sections 8200.05–.16 (AICPA, *Technical Practice Aids*) have been developed in response to common questions received from auditors. Topics include the following:

- Consideration of controls that are less formal or not documented by the client
- Whether the auditor may suggest improvements to a client's internal control system
- Assessing inherent risk in relation to the consideration of control risk
- The frequency of walkthroughs that are used as the basis for the auditor's understanding of internal control
- Considerations in obtaining an understanding of, evaluating, and documenting controls that the auditor believes are nonexistent or ineffective
- Assessing control risk at the maximum level
- Considerations for developing a substantive audit strategy

Risk Assessment Audit Guide and Audit Risk Alert

.37 The AICPA published Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk) and Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk). These resources help auditors further understand the risk assessment standards. The resources include practical guidance, examples, and an in-depth case study. These publications can be ordered by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

PCAOB Auditing Standard No. 5

.38 The SEC approved PCAOB Auditing Standard No. 5 on July 25, 2007. This standard replaces PCAOB Auditing Standard No. 2. Auditing Standard No. 5 is principles based and presents a risk-based, top-down approach designed to increase the likelihood that material weaknesses will be found before resulting in a material misstatement of a company's financial statements, while eliminating unnecessary procedures. The standard was also designed to make audits more scalable for smaller or less complex companies. The PCAOB worked closely with the SEC to coordinate Auditing Standard No. 5 with the guidance to public company management that was approved by the SEC in May 2007. The PCAOB chairman, stated, "The new standard is more risk-based and scalable, which will better meet the needs of investors, public companies, and auditors alike."

.39 This standard is required for all audits of internal control for fiscal years ending on or after November 15, 2007. For more information, readers may refer to Audit Risk Alert *SEC and PCAOB Developments—2008* (product no. 022499kk).

Accounting Issues and Developments

Convergence With International Financial Reporting Standards

.40 Since the signing of the Norwalk Agreement by Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) the bodies have had a common goal—one set of accounting standards for international use. 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. In 2005 meetings, FASB and the IASB reaffirmed their commitment to the convergence of U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS). A common set of high quality, globally accepted standards remains the long-term strategic priority of both FASB and the IASB.

.41 FASB and the IASB have untaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S .GAAP and IFRS. These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. For more information on the status of this project go to www.fasb.org and www.iasb.org.

SEC Eases Acceptance of IFRS Financial Statements

.42 On December 21, 2007, the SEC took a major step towards easing the acceptance of IFRS financial statements by adopting rules to accept from foreign private issuers financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP. This rule marks an important step in the process toward the development of a single set of high quality, globally accepted accounting standards. This rule became effective March 4, 2008. Readers can access this rule at www.sec.gov/rules/final/2007/33-8879.pdf.

.43 More than 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and additional countries are moving to do the same. This recent movement to IFRS outside the United States has resulted in an increase of filings with the SEC of foreign private issuers that represent in the footnotes to their financial statements that their financial statements comply with IFRS as published by the IASB—from a relative few in 2005 to approximately 110 in 2006. The SEC expects this number will continue to increase in the future, particularly pursuant to Canada's announced move to IFRS, as there currently are approximately 500 foreign private issuers from Canada.

.44 This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies report under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries' financial statements in IFRS for purposes of local regulatory or statutory filings. Readers should remain alert to developments regarding convergence.

IFRS "Roadmap"

.45 The SEC has outlined several initiatives concerning the possible use of IFRS in the United States in the spotlight section of its Web site. This section provides the following information on the following topics and groups:

- SEC roundtable on IFRS held on August 4, 2008
- SEC roundtable on practical issues surrounding the use of IFRS in the United States in recent years, and the potential expanded use of IFRS in future years
- SEC roundtable on IFRS in the U.S. markets held on December 13, 2007
- Proposed rulemaking and request for public comments
- SEC staff roundtable on IFRS roadmap
- SEC press releases
- Staff review of financial statements prepared in accordance with IFRS
- Speeches and public statements

.46 This information can be accessed at www.sec.gov/spotlight/ifrsroadmap.htm.

AICPA Launches IFRS.com Web Site

.47 The AICPA is calling for an orderly transition and reasonable time frame of three to five years for the U.S. accounting profession to adopt IFRS. During a June 16, 2008 FASB forum, held to facilitate an open dialogue about whether and how to move the U.S. financial reporting system to IFRS and to define the next steps in that process, it was noted that awareness of IFRS is growing, but most believe it will take three to five years for the United States to prepare for IFRS implementation.

.48 The AICPA launched a new Web site www.ifrs.com, in May 2008, to provide current information about developments in international convergence. The growing acceptance of IFRS as a basis for U.S. financial reporting represents a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years.

.49 Developed by the AICPA, in partnership with its marketing and technology subsidiary, CPA2Biz, IFRS.com provides a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.

.50 The Web site features tools and resources to help CPAs get acquainted with IFRS, the surrounding issues, and available support. Resources include a history of convergence, a high-level overview of the differences between IFRS and U.S. GAAP, frequently asked questions, articles, textbooks, CPE courses and live conference training, helpful links, and assistance for audit committee members.

FASB *Accounting Standards Codification*™

.51 On January 15, 2008, FASB launched the one-year verification period of the FASB *Accounting Standards Codification*™ (codification). The codification is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. The codification includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature. The codification also includes relevant authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance.

.52 The purpose of the codification is not to change GAAP, but rather to reorganize thousands of GAAP pronouncements into approximately 90 topics. Therefore, the one-year verification period is not to debate the underlying requirements of GAAP, but rather to verify that the codification appropriately captures those requirements and accurately reflects existing U.S. GAAP for nongovernmental entities. The verification period is also a period for constituents to acquaint themselves with the new structure and submit feedback regarding any issues before the codification content becomes authoritative. At the end of the one-year verification period, FASB is expected to formally approve the codification as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. At that time, FASB will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the codification will become nonauthoritative. FASB expects to approve the codification in April 2009.

.53 The codification uses a topical structure in which topics, subtopics, and sections are numerically referenced. This effectively organizes the content without regard to the original standard-setter or standard from which the content was derived. The topics of the codification reside in eight main areas: presentation, assets, liabilities, equity, revenue, expenses, broad transactions, and industry guidance. The overall presentation area addresses presentation of financial information, but does not address items such as recognition, measurement, or derecognition. For example, topics in this area include income statement, balance sheet, and earnings per share. The broad transactions area includes topics related to multiple financial statement accounts that are transaction oriented, such as derivatives and business combinations. The industry area includes guidance unique to an industry or type of activity such as airlines, software, and real estate.

.54 Constituents are encouraged to use FASB's online Codification Research System free of charge and provide feedback to FASB on the codification. The Codification Research System includes general information on how to use the online research system and special features such as cross reference reports that show where current standards reside in the codification. Readers are encouraged to register and access the codification at http://asc.fasb.org/home. Special attention should be paid to where FASB reconciled conflicts in existing GAAP and to identify any unintentional changes to GAAP.

.55 The AICPA has published the Financial Reporting Alert *FASB Codification Developments—2008* (product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of the codification, outline the structure of the codification, as well as provide case studies on how to navigate the FASB *Accounting Standards Codification*™ Research System and perform accounting research.

Changes to the Financial Accounting Foundation, FASB, and Governmental Accounting Standards Board

.56 In February 2008, the Board of Trustees of the Financial Accounting Foundation (FAF) voted to approve major changes to the oversight, structure, and operations of the FAF and its two standard-setting boards, FASB and the Governmental Accounting Standards Board (GASB).

.57 Specifically, the FAF Board of Trustees approved the following key changes:

- FAF changes include
  - expanding the number and breadth of investors, accounting, business, financial, and government organizations and entities invited to nominate FAF trustees with the understanding that the final authority for all appointments rests solely with the discretion of the board of trustees;
  - changing the current term of trustees from one three-year term with a possible second three-year term to one five-year term;
  - changing the size of the board of trustees from a fixed 16 trustees to a flexible range of 14–18 trustees; and
  - increasing the trustee governance activities, including its level of formal review, analysis, and oversight of the data and materials regularly provided by FASB, Financial Accounting Standards Advisory Council (FASAC), GASB, and Governmental Accounting Standards Advisory Council (GASAC).
- FASB changes include
  - reducing the size of FASB from seven members to five, effective July 1, 2008;
  - retaining FASB simple majority voting requirements;
  - affirming the need for investor participation on FASB by broadening the current bylaw requirement that FASB members possess investment experience; and
  - changing FASB's agenda-setting process whereby the FASB chair is vested with the authority, following appropriate consultation, to set FASB project plans, agenda, and priority of projects.
- GASB changes include
  - securing a stable and permanent funding source for GASB;
  - retaining the current size, term length, and composition of GASB; and

— changing GASB's agenda-setting process whereby the GASB chair is vested with the authority, following appropriate consultation, to set GASB project plans, agenda, and priority of projects.

XBRL Initiative

.58 eXtensible Business Reporting Language (XBRL) is an extensible markup language (XML)-based language used to communicate financial and business data electronically. XBRL is being developed by an international not-for-profit consortium with more than 450 member organizations, including accounting firms, software providers, financial intermediaries, academics, and technologists.

.59 XBRL is used to "tag" financial statements so that the information in those statements is machine readable, thereby allowing users to analyze financial information more easily and quickly. To assist with the tagging process, XBRL US, Inc. has currently developed more than 11,000 financial concepts that essentially represent a dictionary of U.S. GAAP and other financial reporting requirements.

.60 On January 11, 2008, the SEC Advisory Committee on Improvement to Financial Reporting proposed that the SEC adopt a mandatory phase-in of XBRL for a specified time period, starting with the largest 500 domestic public reporting companies. On May 14, 2008, the SEC proposed amendments to require companies to provide their financial statements to the SEC in interactive data format using XBRL with a proposed three year phase-in schedule. The proposed rules would apply to both domestic and foreign companies using U.S. GAAP and eventually to foreign private issuers using IFRS. Be sure to check the SEC's Interactive Data link at www.sec.gov to view the current status of the project.

.61 For more information on XBRL, visit the XBRL site at www.xbrl.org.

Summary of Recent Accounting Pronouncements and Related Guidance

.62 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. 163 (May 2008)	*Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60*
FASB Statement No. 162 (May 2008)	*The Hierarchy of Generally Accepted Accounting Principles*

(continued)

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 161 (March 2008)	*Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*
FASB Statement No. 160 (December 2007)	*Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*
FASB Statement No. 141 (revised 2007) (December 2007)	*Business Combinations*
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
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. (FIN) 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* FASB Staff Position (FSP) FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, issued in February 2008, defers the effective date of FIN 48 for certain nonpublic enterprises, as defined in the FSP, to the annual financial statements for fiscal years beginning after December 15, 2007.
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 (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.

Recent Accounting Pronouncements and Related Guidance	
AICPA 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* In February 2008, FASB issued FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*, which indefinitely defers the effective date of SOP 07-1. Entities that early adopted SOP 07-1 before December 15, 2007 are permitted, but not required, to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the exception in the following sentence: if a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by the parent entity that is formed or acquired after that parent entity's adoption of the SOP must apply the provisions of the SOP in its stand-alone financial statements.
TIS sections 6910.25–.28 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss financial statement presentation considerations for investment companies.
TIS sections 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.
AICPA Practice Guide (Nonauthoritative)	*Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48*

.63 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 as they relate to specific industries that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

Accounting for Financial Guarantee Insurance Contracts

.64 In May 2008, FASB issued FASB Statement No. 163, *Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60*, to address diversity in practice in accounting for financial guarantee insurance contracts by insurance enterprises under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. This standard is discussed in detail in Audit Risk Alert *Insurance Industry Developments—2008* (product no. 022359kk).

The Hierarchy of Generally Accepted Accounting Principles

.65 In May 2008, FASB issued FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. The GAAP hierarchy existed in the auditing literature in SAS No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1, AU sec. 411). However, FASB decided the hierarchy should reside in the accounting literature and thus issued this statement. FASB Statement No. 162 carries forward the existing GAAP hierarchy in SAS No. 69 with certain modifications that FASB does not expect will result in changes to current practice. FASB Statement No. 162 does not carry forward the exception permitted in ET section 203, *Accounting Principles*, of the AICPA's Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2), that allows departures from the GAAP hierarchy if the member can demonstrate that, due to unusual circumstances, the financial statements would otherwise have been misleading. Therefore, an entity cannot represent that its financial statements are presented in accordance with GAAP if its selection of accounting principles departs from the GAAP hierarchy set forth in FASB Statement No. 162, and that departure has a material effect on its financial statements. This statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP in the United States (the GAAP hierarchy).

.66 The sources of accounting principles[1] that are generally accepted are categorized in descending order of authority as follows:

a. FASB Statements of Financial Accounting Standards and Interpretations, FASB Statement No. 133 Implementation Issues, FASB Staff Positions (FSPs), and AICPA Accounting Research Bulletins (ARBs), and Accounting Principles Board (APB) Opinions that are not superseded by actions of FASB

b. FASB Technical Bulletins (TBs) and, if cleared by FASB, AICPA Industry Audit and Accounting Guides and Statements of Position (SOPs)

c. AICPA Accounting Standards Executive Committee Practice Bulletins that have been cleared by FASB, consensus positions of the FASB EITF, and the topics discussed in appendix D of EITF Abstracts (EITF D-Topics)

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[1] Rules and interpretive releases of the Securities and Exchange Commission (SEC) are sources of category (a) accounting principles for SEC registrants. In addition, the SEC staff issues Staff Accounting Bulletins that represent practices followed by the staff in administering SEC disclosure requirements and utilizes Emerging Issues Task Force (EITF) D-Topics and Observer Comments in EITF Issues to publicly announce its views on certain accounting issues for SEC registrants.

d. Implementation guides (Q&As) published by FASB staff, AICPA Accounting Interpretations, AICPA Industry Audit and Accounting Guides and SOPs not cleared by the FASB, and practices that are widely recognized and prevalent either generally or in the industry.

.67 This statement applies to financial statements of nongovernmental entities that are presented in conformity with GAAP and will be effective 60 days following the SEC approval of the PCAOB amendments to AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended).

.68 During its May 2008 meeting, the ASB voted to ballot for final issuance a SAS that will delete the hierarchy of GAAP for nongovernmental entities from AICPA AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1). The effective dates of the AICPA, PCAOB, and FASB standards will coincide.

.69 Additionally, in August 2008, GASB issued a similar exposure draft, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. The provisions of this statement would incorporate the GAAP hierarchy for state and local governments into GASB authoritative literature. The comment period ends October 30, 2008. See www.gasb.org/exp/index.html for access to the exposure draft.

.70 The Federal Accounting Standards Advisory Board, which is the standard setting body for federal government entities, is also working on a project to incorporate the GAAP hierarchy as it applies to federal entities into its standards. See www.fasab.gov/projectsgaap.html for more information.

Disclosures About Derivative Instruments and Hedging Activities

.71 In March 2008, FASB issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows.

.72 The new standard improves transparency about the location and amounts of derivative instruments in an entity's financial statements; how derivative instruments and related hedged items are accounted for under FASB Statement No.133, *Accounting for Derivative Instruments and Hedging Activities*; and how derivative instruments and related hedged items affect financial position, financial performance, and cash flows.

.73 FASB Statement No. 161 achieves these improvements by requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity's liquidity by requiring disclosure of derivative features that are credit risk related. Finally, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments.

.74 It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged.

Business Combinations

.75 In December 2007, FASB issued FASB Statement No. 141 (revised 2007), *Business Combinations*, and FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*. These standards strive not only to improve and simplify the accounting for business combinations and the reporting of noncontrolling interests in consolidated financial statements, but also to converge with international standards. The issuance of these standards marks the completion of FASB's first major joint project with the IASB.

.76 FASB Statement No. 141(R) requires the acquiring entity in a business combination to recognize all the assets acquired and liability assumed in the transaction, establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed, and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. FASB states that FASB Statement No. 141(R) will also decrease the complexity of existing GAAP because the new standard includes both core principles and application guidance, eliminating the need for other interpretive guidance. FASB Statement No. 141(R) shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply the standard before this date.

.77 FASB Statement No. 160 improves the relevance, comparability, and transparency of financial information by requiring all entities to report noncontrolling (minority) interests in subsidiaries in the same way—as equity in the consolidated financial statements. FASB Statement No. 160 also eliminates the diversity in accounting for transactions between an entity and noncontrolling interests by requiring they be treated as equity transactions. FASB Statement No. 160 is effective for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2008 (for calendar year end companies the effective date is January 1, 2009). Earlier adoption is prohibited. The standard is applied prospectively as of the beginning of the fiscal year in which the statement is initially applied, except for the presentation and disclosure requirements. Presentation and disclosure requirements shall be applied retrospectively for all periods presented.

Fair Value Measurements

FASB Statement No. 157

.78 In September 2006, FASB issued Statement No. 157, *Fair Value Measurements*, to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines 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.

.79 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 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.

.80 In February 2008, FASB issued FSP FAS 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13*, which amends FASB Statement No. 157, to exclude FASB Statement No. 13, *Accounting for Leases*, and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under FASB Statement No. 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB Statement No. 141, *Business Combinations*, or FASB Statement No. 141(R), regardless of whether those assets and liabilities are related to leases. This FSP is effective upon the initial adoption of FASB Statement No. 157.

.81 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. Early adoption is permitted. However, in February 2008, FASB also issued FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, which became effective upon issuance. This FSP delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow FASB and its constituents the time to consider the various implementation issues associated with FASB Statement No. 157. Readers can access the full text of FASB Statement No. 157 on the FASB Web site at www.fasb.org.

.82 The following paragraphs summarize FASB Statement No. 157, but are not intended as a substitute for the reading of the statement itself.

Definition of Fair Value

.83 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).

.84 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.

.85 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 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.

.86 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

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

- 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.

.88 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

.89 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 appendix B of FASB Statement No. 157.

The Fair Value Hierarchy

.90 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 when pricing the asset or liability (referred to in the statement as inputs). Paragraphs 21–31 establish a fair value hierarchy that distinguishes between (*a*) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (*observable inputs*) and (*b*) 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.

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

- 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 the following:
  - — 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

.92 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

.93 Subsequent to the issuance of FASB Statement No. 157, FASB issued 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 FASB's 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.

.94 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. FASB and the SEC expressed concern in the way some early adopters applied the transition provisions of the standard. The Center for Audit Quality (CAQ), which is affiliated with the AICPA, 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 FASB Statement No. 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.

Deferral of FASB Interpretation No. 48 for Certain Nonpublic Entities

.95 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. However, subsequent to its issuance, FASB issued FSP FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, which defers the effective date of FIN 48 for nonpublic enterprises included in the FSP's scope to the annual financial statements for fiscal years beginning after December 15, 2007. For the full text of FIN 48 and its associated FSPs, visit the FASB Web site.

Internal Control Issues and Developments

COSO Internal Control Guidance for Small Companies

.96 In 2006, COSO issued *Internal Control over Financial Reporting—Guidance for Small Public Companies* to provide guidance on how small companies can become more knowledgeable about internal control, ultimately leading to more effective control systems and greater proficiency in reporting on internal control for regulatory compliance purposes. COSO's 1992 *Internal Control—Integrated Framework* has served as the internal control standard for organizations implementing and evaluating internal control in compliance with the U.S. Sarbanes-Oxley Act of 2002 and PCAOB Auditing Standard No. 2, which has since been replaced by PCAOB Auditing Standard No. 5. This small business guidance takes the concepts of *Internal Control—Integrated Framework* and demonstrates their applicability for achieving financial reporting objectives of smaller public companies. COSO's primary goal is that these smaller businesses will use the guidance to design and implement processes that will help their businesses operate more effectively and to evaluate the effectiveness of their internal controls for regulatory purposes. Although the document was created for use with small publicly traded companies, the guidance is equally applicable to private entities, including not-for-profit organizations, and governments. More information is available at www.coso.org.

Recent AICPA Independence and Ethics Pronouncements

.97 AICPA *Independence and Ethics Alert—2008* (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

On the Horizon

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

.99 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 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/
Financial Accounting Standards Board (FASB)	www.fasb.org
Governmental Accounting Standards Board (GASB)	www.gasb.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

Auditing Pipeline—Nonissuers

ASB Clarity Project

.100 The ASB formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In

March 2007, the ASB approved for exposure the discussion paper *Improving the Clarity of ASB Standards*. In response to the feedback received on the discussion paper and subsequent discussions with interested parties, the ASB has established clarity drafting conventions. The clarity drafting conventions include the following:

- Establishing objectives for each of the standards
- Including a definitions section, where relevant, in each standard
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an *A*-prefix and presenting them in a separate section that follows the requirement section
- Using formatting techniques, such as bullet lists, to enhance readability
- Including, where appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the standard
- Including, where appropriate, special considerations relevant to audits of governmental entities within the text of the standard

.101 The drafting conventions previously listed will be applied to all standards issued by the ASB after January 2008, with limited exceptions. In addition, over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of AICPA *Professional Standards*), to apply the clarity drafting conventions and to converge with the ISAs issued by the International Auditing and Assurance Standards Board (IAASB). The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made, and will be amended should that prove necessary. Read the *Clarity Project Explanatory Memorandum* and the discussion paper at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.

Proposed SASs Redrafted for Clarity

.102 In April 2008, the ASB issued exposure drafts of the first two proposed SASs to be redrafted under the ASB's Clarity Project. Proposed SAS No. 103, *Audit Documentation*, and No. 114, *The Auditor's Communication With Those Charged With Governance*, demonstrate the project's goals to make the standards easier to read and understand while converging the language and requirements with international standards. The comment period for these exposure drafts ended June 30, 2008.

Convergence With International Standards

.103 In addition to the clarity project, the ASB is working toward convergence with ISAs by developing projects concurrently with those of the IAASB. The ASB has created a number of task forces charged with monitoring specific activities of the IAASB, assisting the ASB in commenting on exposure drafts of ISAs, and drafting proposed SASs using the ISAs, including the international convention for wording, as the base standard. The status of ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

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

.104 The ASB has issued an exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would replace AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1). Unlike extant AT section 501, the proposed standard would be applicable only to integrated audits (engagements consisting of an audit of an entity's financial statements and an examination of its internal control over financial reporting). Currently, AT section 501 permits a practitioner to perform an examination of an entity's internal control even if the financial statements have not been audited. The term *integrated audit* and much of proposed AT section 501 is based on PCAOB Auditing Standard No. 5.

.105 As standard setters adopt a global, rather than a national, perspective, it becomes essential to avoid unnecessary differences between standards of the AICPA, PCAOB, and IAASB. Accordingly, for the most part, the proposed standard diverges from PCAOB Auditing Standard No. 5 primarily in the terminology used for nonissuers. With respect to international standards, proposed AT section 501 conforms the definition of the term *significant deficiency* with the definition of that term in the IAASB's July 2008 exposure draft of ISA 265, *Communicating Deficiencies in Internal Control*.

.106 Additionally, the ASB issued a proposed SAS to conform the definitions in AU section 325 of the various kinds of deficiencies in internal control and the related guidance for evaluating such deficiencies with the definitions and guidance in the proposed SSAE, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*. The proposed SSAE and SAS are being exposed for comment concurrently. Readers may view the exposure drafts on the AICPA Web site at www.aicpa.org.

Auditing Pipeline—Issuers

PCAOB Auditing Standard No. 6

.107 In January 2008, the PCAOB adopted PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, which will become effective 60 days after SEC approval. This standard and its related amendments update the auditor's responsibilities to evaluate and report on the consistency of a company's financial statements and align the auditor's responsibilities with FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*. This standard also improves the auditor reporting requirements by clarifying that the auditor's report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principle or the correction of a misstatement.

.108 In the same release, the PCAOB adopted several amendments to its interim standards relating to standards and interpretations of AU section 328, *Auditing Fair Value Measurements and Disclosures*; AU section 400, *The First, Second, and Third Standards of Reporting*; AU section 508, *Reports on Audited Financial Statements*; and AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended). In these amendments, the PCAOB removed the GAAP hierarchy from its standards as it believes the hierarchy is more appropriately located in the accounting standards. FASB intends to incorporate the hierarchy into the accounting standards. For more information on the status of this adopted standard and its associated amendments, please visit www.pcaob.org.

.109 For more information about recent developments at both the SEC and PCAOB, readers may refer to AICPA Audit Risk Alert *SEC and PCAOB Developments—2008* (product no. 022499kk).

Accounting Pipeline

.110 Presented in the following sections are accounting projects and pronouncements currently in progress. Some of the proposed pronouncements discussed in last year's alert have not been finalized as of the date of this writing, and, thus, are included again.

Joint FASB and IASB Project on Conceptual Framework

.111 In May 2008, FASB and the IASB published consultative documents that seek public comment on two of the eight phases of their joint project to develop an improved conceptual framework. The objective of the project is to develop an improved conceptual framework that provides a sound foundation for developing future accounting standards.

.112 The first of the two documents is an exposure draft of chapters 1 and 2 of the framework. It seeks views on an improved objective of financial reporting, the qualitative characteristics of information provided by financial reporting, and constraints on the provision of that information. The draft reflects the two boards' updated proposals in light of the comments received on an initial consultation document published in July 2006. The exposure draft now proposes that the objective of financial reporting is to provide financial information that is useful to present and potential equity investors, lenders, and other creditors who are making decisions in their capacity as capital providers.

.113 The second document sets out the two boards' preliminary views on the reporting entity concept and related issues. Although the reporting entity concept determines some important aspects of financial reporting, the boards' existing frameworks do not address it specifically.

.114 The comment period for these documents ended on September 29, 2008.

Accounting for Hedging Activities

.115 In June 2008, FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities—an amendment of FASB Statement No. 133*. This proposed statement is intended to simplify hedge accounting resulting in increased comparability of financial results for entities that apply hedge accounting. Specifically, the proposed statement would eliminate the multiple methods of hedge accounting currently being used for the same transaction. It also would require an entity to designate all risks as the hedged risk (with certain exceptions) in the hedged item or transaction, better reflecting the economics of such items and transactions in the financial statements. The proposed statement would require application of the amended hedging requirements for financial statements issued for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years. The comment period ended August 15, 2008.

Accounting for Contingencies

.116 In June 2008, FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Disclosure of Certain Loss Contingencies—an amendment of FASB Statements No. 5 and 141(R)*. This proposed statement is intended to improve the quality of financial reporting by expanding disclosures required about certain loss contingencies. Investors and other users of financial information have expressed concerns that current disclosures required in FASB Statement No. 5, *Accounting for Contingencies*, do not provide sufficient information in a timely manner to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies. This proposed statement would expand disclosures about certain loss contingencies in the scope of FASB Statement No. 5 or FASB Statement No. 141(R). The proposed statement would be effective for fiscal years ending after December 15, 2008, and interim and annual periods in subsequent fiscal years. The comment period ended August 8, 2008.

Fair Value

.117 During phase one of FASB's fair value option project, FASB issued FASB Statement No. 159, which was previously discussed. In phase two of the project, 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. Readers should remain alert to developments by visiting the FASB Web site.

Transfers of Financial Assets

.118 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 simplify the guidance on accounting for transfers of financial assets for the purpose of improving consistency and transparency in financial reporting. This project is being performed largely in conjunction with the separate project on the reconsideration of FIN 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*. In August 2005, FASB issued the exposure draft *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. At the July 30, 2008 meeting, FASB discussed the transition and effective date for the proposed amendments to FASB Statement No. 140 and FIN 46(R). The board unanimously decided to change its tentative decisions, reached at the June 11, 2008 board meeting, about transition and effective date to a single effective date for fiscal years beginning after November 15, 2009.

.119 However, the board also decided to separately issue an FSP that would require additional disclosures as soon as possible. The board decided that the proposed FSP will be effective no later than the first interim reporting period in 2009. The purpose of a disclosure-only FSP is to meet financial statement user needs for greater transparency for off-balance sheet transactions and to permit preparers, regulators, auditors, and users with adequate time to consider and implement the other proposed amendments to FASB Statement No. 140 and FIN 46(R).

.120 The board also decided that the proposed FSP will only be applicable to public companies and that the exposure period will be 30 days. The exposure draft is expected to be released during the third quarter of 2008. See the FASB Web site for complete information.

Earnings Per Share

.121 In August 2008, FASB issued a revised exposure draft of a proposed Statement of Financial Accounting Standards, *Earnings per Share—an amendment of FASB Statement No. 128*. The proposed statement seeks to improve financial reporting by clarifying and simplifying the method of calculating earnings per share (EPS), and promote the international convergence of accounting standards by eliminating major differences that currently exist between FASB Statement No. 128, *Earnings per Share*, and International Accounting Standard (IAS) Statement No. 33, *Earnings per Share*. As proposed, an entity would be required to apply the requirements of this proposed statement as of the beginning of a fiscal year, and interim periods within those fiscal years, generally through retrospective application to prior periods. Earlier application is prohibited. The proposed exposure draft does not include a specific effective date for a final statement. FASB will determine the effective date when it approves the final amendments to FASB Statement No. 128.

.122 The proposed exposure draft invites individuals and organizations to submit comments on the proposed guidance. Responses must be received in writing by December 5, 2008.

Income Taxes

.123 The objective of this project is to improve the accounting for income taxes and reduce the application differences between FASB Statement No. 109, *Accounting for Income Taxes*, and IAS Statement No. 12, *Income Taxes*. FASB plans to issue an exposure draft during the fourth quarter of 2008. Readers can track the project's progress on the FASB Web site.

Proposed FASB EITFs and FSPs

.124 ***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.

.125 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Internal Control Pipeline

COSO Guidance on Monitoring Internal Control

.126 In June 2008, COSO released the exposure draft *Guidance on Monitoring Internal Control Systems*. This document is designed to help organizations monitor the quality of their internal control systems and includes practical application guidance and case studies, as well as clarification of the concept of monitoring internal control. The comment period on this exposure draft ended August 15, 2008. The full text of the exposure draft can be found at www.coso.org/guidance.htm.

Resource Central

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

Publications

.128 Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

- Audit Guide *Analytical Procedures* (2008) (product no. 012558kk [paperback], WAN-XX [online], or DAN-XX [CD-ROM])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2008) (product no. 012528kk [paperback], WDI-XX [online], or DDI-XX [CD-ROM])
- Audit Guide *Auditing Revenue in Certain Industries* (2008) (product no. 012518kk [paperback], WAR-XX [online], or DAR-XX [CD-ROM])
- Audit Guide *Audit Sampling* (2008) (product no. 012538kk [paperback], WAS-XX [online], or DAS-XX [CD-ROM])
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2008) (product no. 012778kk [paperback], WSV-XX [online], or DSV-XX [CD-ROM])
- Audit Risk Alert *Compilation and Review Developments—2008* (product no. 022309kk [paperback], WCR-XX [online], or DCR-XX [CD-ROM])
- Audit Risk Alert *Independence and Ethics—2008* (product no. 022479kk [paperback], WIA-XX [online], or DIA-XX [CD-ROM])
- Audit Risk Alert *SEC and PCAOB Developments—2008* (product no. 022499kk [paperback])
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk [paperback])
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk [paperback] or 022536PDF [downloadable PDF])

- *Audit and Accounting Manual* (2008) (product no. 005138kk [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- *Accounting Trends & Techniques, 62nd Edition* (product no. 009900kk [paperback] or WAT-XX [online])

.129 Additional resources for accountants in business and industry are the *Financial Reporting Alert* series, designed to be used by members of an entity's financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity's financial reporting.

- Financial Reporting Alert *Current Accounting Issues and Risks—2008* (product no. 029208kk)
- Financial Reporting Alert *Not-for-Profit Organizations—Accounting Issues and Risks 2008* (product no. 029207kk)
- Financial Reporting Alert *FASB Codification Developments—2008* (product no. 029209kk)

AICPA reSOURCE: Accounting and Auditing Literature

.130 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, 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

.131 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 (2008–2009 Edition)* (product no. 736184kk [text] or 187192kk [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. 736775kk [text] or 186756kk [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.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731666 [text]). With the fast pace of the convergence project, understanding the differences between IFRS and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and U.S. GAAP.
- *The International Financial Reporting Standards: An Overview* (product no. 157220 [online] or 739750HS [DVD]). This course captures a live presentation on IFRS given to the AICPA Board of Directors.

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

Online CPE

.133 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz, is AICPA's 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. To register or learn more, visit www.cpa2biz.com.

Webcasts

.134 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 profession's 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

.135 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting, 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

.136 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's 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

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

Hotlines

Accounting and Auditing Technical Hotline

.138 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. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

.139 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

.140 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.

.141 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

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

The Center for Audit Quality

.143 The CAQ, which is affiliated with the AICPA, 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.

.144 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 CAQ is 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

.145 The AICPA Employee Benefit Plan Audit Quality Center is a firm-based, voluntary membership center created in March 2003 with the goal of promoting quality employee benefit plan audits. The center now has more than 1,500 members in all 50 states, the District of Columbia, the U.S. Virgin Islands, and Puerto Rico.

.146 Reviews performed by the U.S. Department of Labor's Employee Benefits Security Administration continue to show a difference in the quality of Employee Retirement Income Security Act audits performed by center member firms compared with those performed by nonmember firms. As members of the center, firms have tools and resources that are not available from any other source. In addition to providing periodic e-alerts with information about recent developments affecting employee benefit plan audits, the center has recently made available to its members

- accounting and auditing resource centers about Section 403(b) plan audits, SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), SAS No. 112, the risk assessment standards, stable value investments, and the Pension Protection Act of 2006.
- "Live Forum" and "Roundtable Discussion" conference calls to share important information and answer participant questions on a wide range of technical and practice topics. As an added benefit, the center now offers a CPE option for most calls.
- two new "Topix" primers on cash balance plans and Section 403(b) plans to help members gain a general understanding of these types of plans.
- three new "Plan Advisories" for members to share with plan stakeholders about issues of importance for plan auditors, including the plan sponsor and trustees' responsibility for monitoring their TPAs, the importance of internal controls, and the plan sponsor's responsibility for valuing plan investments.

.147 Visit the center Web site at www.aicpa.org/ebpaqc to see a complete list of center members and to preview center benefits. For more information, contact the center at ebpaqc@aicpa.org.

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.148 This Audit Risk Alert replaces *Audit Risk Alert—2007/08*.

.149 This Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's 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

.150 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 www.ifrs.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues guides, technical questions and answers, and 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 analyses, 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

(continued)

Web Site Name	*Content*	*Web Site*
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials and 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 Auditing and Assurance Standards Board (IAASB)	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants (IFAC)	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee (PCFRC)	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting.	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing 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