

# 2007 Audit and Accounting Update

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# New Auditing Standards Related to Risk Assessment

- Includes SASs 104 through 111
- Primary objective is to enhance application of the audit risk model
  - More in-depth understanding of audit client and its environment, including its internal control
  - More rigorous assessment of the risk of material misstatement based on that understanding

# New Auditing Standards Related to Risk Assessment

- Primary objective is to enhance application of the audit risk model
  - Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks
- Effective for years beginning on or after 12/15/06, earlier application permitted.

# SAS 104 – Amendment to SAS 1

- Amendment to SAS 1
- Defines “reasonable assurance” as high but not absolute assurance. States that auditors should obtain evidence so that audit risk will be limited to a low level.

# SAS 105 – Amendment to SAS 95

- Expands the scope of understanding that the auditor must obtain from “internal control” to “the entity and its environment including its internal control”
- Emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures

# SAS 105 (cont)

- Revises some terminology
  - Replaces “internal control” with “the entity and its environment including its internal control”
  - Replaces “tests to be performed” with “further audit procedures”
  - Replaces “evidential matter” with “audit evidence”

# SAS 106 - Audit Evidence

- Supersedes SAS 31
- Defines audit evidence as “all the info used by the auditor in arriving at the conclusions on which the audit opinion is based.
- Defines relevant assertions as those that have a meaningful bearing on whether the account is fairly stated.

# SAS 106 (cont)

- Categorizes assertions by classes of transactions, account balances, and presentation and disclosure
- Introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risk of material misstatement

# SAS 106 (cont)

- Discusses qualitative aspects (relevance and reliability) that the auditor considers in determining sufficiency and appropriateness of audit evidence.

# SAS 106 (cont)

- Describes various audit procedures and discusses their purpose.
- Audit evidence is cumulative.
- Scanning is an analytical procedure.

# SAS 107 – Audit Risk and Materiality in Conducting an Audit

- The auditor must consider audit risk and must determine a materiality level for financial statements taken as a whole for the purpose of
  - Determining the extent and nature of risk assessment procedures
  - Identifying and assessing the risk of material misstatement
  - Determining the nature, timing, and extent of further audit procedures
  - Evaluating whether financial statements are presented fairly, in conformity with GAAP

# SAS 107 (cont)

- Combined assessment of inherent and control risks is termed the “risk of material misstatement”
- Auditor should have, and document, an appropriate basis for the audit approach
- Can no longer assess control risk at maximum unless you have a basis for that assessment

# SAS 107 (cont)

- Auditor should consider audit risk at both the overall financial statement level and assertion level
- Examples of financial statement level risk
  - Fraud
  - Incompetent management
  - Related party transactions

# SAS 107 (cont)

- Risk at the account balance, class of transaction, or disclosure level include
  - Combined risk
    - Inherent risk
    - Control risk
  - Detection risk

# SAS 107 (cont)

- Auditor must accumulate all known and likely misstatements and communicate them to management
- Provides guidance on determining the threshold below which misstatements do not need to be accumulated
- Provides guidance on appropriate responses to misstatements identified by the auditor

# SAS 108 – Planning and Supervision

- Provides guidance on
  - Appointment of the auditor
  - Establishing a written understanding with the client
  - Preliminary engagement activities
  - The overall audit strategy
  - The audit plan
  - Determining involvement of specialists, including IT professionals
  - Additional considerations in initial audits
  - Supervision of assistants

# SAS 109 - Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement

- Describes procedures for gaining an understanding of the entity and its environment
- Describes limitations of inquiries
- Requires an audit team brainstorming session to discuss risk
- Links understanding the entity with risk assessment and the design of further audit procedures

# SAS 109 (cont)

- More explicit guidance on assessing risk at both the financial statement and assertion level
- Requires evaluation of the design of internal controls and whether they have been implemented

# SAS 109 (cont)

- Introduces the concept of “significant risks”
- Increases documentation requirements

# SAS 110 - Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained

- Provides guidance on determining responses to address the risk of material misstatement
- Further audit procedures, which include tests of controls and substantive procedures, should be responsive to risk assessment

# SAS 110 (cont)

- Expands guidance on determining nature, timing, and extent of tests of controls and substantive tests
- Requires certain substantive tests on all audit engagements

# SAS 111 – Amendment to SAS 39, Audit Sampling

- Provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls

# SAS 113 - Omnibus Statement on Auditing Standards

- Amends seven SASs
- No major changes just clarifying or modifying language to conform with new terminology or concepts introduced by other new SASs.

# SAS 114 - The Auditor's Communication With Those Charged With Governance

- Supersedes SAS 61
- Establishes standards and provides guidance to auditors on matters to be communicated to those charged with governance
- Identifies specific matters to be communicated, many consistent with SAS 61, but some additional matters

# SAS 114 (cont)

- Those charged with governance includes the board of directors
- SAS 114 stresses two-way communication
- Matters to be communicated by the auditor are
  - Responsibilities of the auditor under generally accepted auditing standards
  - An overview of the scope and timing of the audit
  - Significant findings from the audit

# SAS 114 (cont)

- Significant findings includes
  - Accounting estimates
  - Corrected and uncorrected misstatements
  - Difficulties encountered in performing the audit
  - Disagreements with management
  - Management representations
  - Opinion shopping

# SAS 114 (cont)

- Requires that communication of significant findings be in writing when, in the auditor's professional judgment, oral communication would not be adequate
- Other communications can be oral or written

# SFAS 157 - Fair Value Measurements

- Provides guidance on measuring fair value when fair value is required or permitted by other accounting pronouncements
- 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.

# SFAS 157 (cont)

- Consider attributes specific to the asset or liability, for example, condition, location and restrictions.
- Consider if the asset or liability is standalone or part of a group
- Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

# SFAS 157 (cont)

- Independent of the reporting entity
- Knowledgeable about the asset or liability and the transaction
- Able to transact for the asset or liability
- Willing to transact for the asset or liability

# SFAS 157 (cont)

- Fair value (FV) shall be determined based on assumptions that market participants would use in pricing the asset or liability. In developing assumptions, the reporting entity need not identify specific market participants

# SFAS 157 (cont)

- Application to assets
  - FV measurement assumes the highest and best use of the asset considering what is physically possible, legally permissible and financially feasible
  - Highest and best use refers to the use of the asset that would maximize its value

# SFAS 157 (cont)

- Highest and best use establishes the valuation premise
  - In-use – asset would provide maximum value through its use in combination with other assets (ex: nonfinancial assets)
  - In-exchange – assets maximum value is principally on a standalone basis (ex: financial assets)

# SFAS 157 (cont)

- Application to Liabilities
  - FV measurement assumes that the liability is transferred to a market participant at the measurement date and that the nonperformance risk is the same before and after the transfer

# SFAS 157 (cont)

- The transaction price to acquire an asset may differ from the FV representing what would be received upon sale if:
  - The asset was acquired from a related party
  - The asset was acquired under duress or in a distress sale

# SFAS 157 (cont)

- The units or rights at acquisition differ from sale
- The sales market is different

# SFAS 157 (cont)

- Valuation techniques shall be used
  - Market approach – Uses prices and other information generated from market transactions
  - Income approach – Converts future amounts, such as cash flows or earnings, to discounted present value
  - Cost approach – Replacement cost

# SFAS 157 (cont)

- Prioritization of inputs for valuations
  - Level 1 – Quoted prices for identical assets or liabilities
  - Level 2 – Quoted prices for similar assets or liabilities or prices for identical assets or liabilities in markets that are not active (prices are not current)
  - Level 3 – Unobservable inputs based on the best information available

# SFAS 157 (cont)

- Disclosure requirements for assets and liabilities measured at FV on a recurring basis
  - The FV measurement at the reporting date
  - The input level used for the FV
  - For Level 3 inputs, a reconciliation of the beginning and ending balances
  - Change in unrealized gains and losses included in earnings
  - Valuation technique used

# SFAS 157 (cont)

- Disclosure requirements for assets and liabilities measured at FV on a nonrecurring basis
  - FV measures recorded and reasons for measurement
  - Level used for FV measurement
  - If Level 3 is used, description of inputs
  - Valuation technique

# SFAS 157 (cont)

- Quantitative disclosures shall be presented in a tabular format
- Encouraged to combine with FV disclosures required by other pronouncements

# SFAS 158 - Employers' Accounting for Defined Benefit Pension and Postretirement Plans

- Non-public companies are required to recognize the funded status and provide required disclosures as of the end of fiscal years ending after June 15, 2007
- Requirement to measure plan assets and benefit obligations as of the end of the year is effective for fiscal years ending after December, 15 2008

# SFAS 158 (cont)

- Requirements only relate to the asset or liability reported on the balance sheet and do not affect the calculation of the net periodic benefit cost.
- All of the information needed to implement SFAS 158 is currently provided
- Adjust liability or prepayment to funded status as of year end through accumulated other comprehensive income (AOCI)
- Remove any minimum pension liability adjustment

# SFAS 158 (cont)

## ■ Recognition Provisions

- Gains or losses, prior service cost (PSC) and transition obligation (TO) that have not yet been included in NPC as of the end of the year SFAS 158 is initially applied are recognized as components of the ending balance of AOCI, net of tax. Any required adjustment is reported as an adjustment of the ending balance of AOCI.

## SFAS 158 (cont)

- Subsequent changes to PSC, TO, and net gains and losses flow through AOCI
- These items are reclassified into current earnings as they are included in net periodic cost (NPC)
- Refer to illustration

## SFAS 158 (cont)

- The benefit obligation and plan assets must be measured as of year end. Estimates of the year end obligation by rolling forward prior year are acceptable. Assets should be as of year end
- If a company has not had an actuarial valuation of its benefit plan in several years, the impact of the transition adjustments will likely be substantial.

# SFAS 158 (cont)

- NTCA has added a new schedule with SFAS 158 disclosure info. Also, they will provide a worksheet that the company can use to remeasure the obligation.
- Actual year end assets will not be available until the earnings are allocated. Companies will receive a statement of those assets as in the past. Estimates may be required depending on the timing of the receipt of this statement.

# SFAS 158 (cont)

## ■ Disclosures

- Amounts recognized in OCI separated between net gain or loss and net PSC adjustment and between amounts arising during the year and reclassifications
- The TO reclassified to NPC
- Components of AOCI
- Amounts in AOCI expected to be recognized in NPC in the following year
- Plan assets expected to be returned to the business entity in the following year

# SFAS 159 - The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of SFAS 115

- Effective for years beginning after November 15, 2007
- Permits certain financial assets and liabilities to be measured at FV
- Objective is to mitigate volatility in reported earnings

# SFAS 159 (cont)

- The decision to elect the FV option
  - Is applied instrument by instrument
  - Is irrevocable
  - Is applied only to an entire instrument

# SFAS 159 (cont)

- Financial asset – Cash, evidence of an ownership interest in an entity, or a contract that conveys the right to receive cash or exchange financial instruments

# SFAS 159 (cont)

- Financial liability – Imposes obligation to deliver cash or another financial instrument or to exchange financial instruments on potentially favorable terms

# SFAS 159 (cont)

- All entities may elect the FV option for the following (eligible items)
  - Recognized financial assets or liabilities with some exceptions
  - Firm commitments involving only financial instruments
  - Rights and obligations under an insurance contract that are not financial instruments
  - Rights and obligations under a warranty contract that are not financial instruments
  - Host financial instruments resulting from derivatives

# SFAS 159 (cont)

- Cannot elect FV for the following
  - Investment in consolidated subsidiary
  - An interest in a variable interest entity
  - Pension, postretirement benefit and postemployment benefit obligations
  - Financial assets and liabilities recognized under leases
  - Deposit liabilities of banks
  - Components of equity

# FIN 48 - Accounting for Uncertainty in Income Taxes

- Effective for fiscal years beginning after December 15, 2006
- Upon applying FIN 48, companies must determine and assess all material positions taken in any income tax return as of the date they adopt FIN 48, including all significant uncertain positions, in all open tax years

# FIN 48 (cont)

- Addresses the recognition and measurement of income tax positions using a “more-likely-than-not” (MLTN) threshold
- A benefit related to an uncertain tax position (UTP) may be recognized in the financial statements if it is MLTN that the position will be sustained based on its technical merits
- Must be more than a 50% likelihood that the position would be sustained if challenged and considered by the highest court in the relevant jurisdiction

# FIN 48 (cont)

- The determination of what constitutes an individual tax position (unit of account) may directly affect the assessment and is a matter of professional judgment. Should consider:
  - The level at which the entity accumulates information to support the tax return
  - The level at which it expects tax authorities to address the issues during examination

## FIN 48 (cont)

- The tax benefit of a UTP is the largest amount of benefit that is more than 50% likely to be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information
- Refer to the table for an example of measuring the “cumulative probability of occurring”

# FIN 48 (cont)

- Two-step process
  - Step 1 is recognition by applying the MLTN threshold to the tax position. If less than 50%, record FIN 48 liability. If more than 50% perform Step 2
  - Step 2 is measurement. Even though it is MLTN that position will be sustained, should apply possible estimated outcome test if the company would be willing to negotiate a settlement upon examination

## FIN 48 (cont)

- As of each balance sheet date, unresolved UTPs must be reassessed, and management should determine whether
  - The factors underlying the sustainable assumption have changed
  - The amount of the recognized tax benefit is still appropriate

# FIN 48 (cont)

- A different assessment of the same information is not permitted. A different assessment must be supported by new developments

# FIN 48 (cont)

- New developments
  - Case law
  - Changes in tax law
  - New rulings or regulations
  - Settlement through negotiation or litigation
  - Interaction with taxing authority
  - Expiration of statute of limitations

# FIN 48 (cont)

- Judgments may change based on new information
- Unrecognized tax benefits should be recognized in the period in which the likelihood reaches the MLTN threshold
- Recognized benefits should be derecognized when the likelihood of a position falls below the MLTN threshold
- Using a valuation allowance is not permitted as a substitute for derecognition

# FIN 48 (cont)

- Differences between tax positions taken in tax returns and recognized in the financial statements will generally result in:
  - An increase in income taxes payable or a reduction of an income tax refund receivable
  - A reduction in a deferred tax asset or increase in a deferred tax liability
  - Both of above

## FIN 48 (cont)

- Recognition of FIN 48 liabilities for UTPs for which the uncertainty is strictly a timing issue do not affect overall expense but do reclassify the expense from deferred to current. The deferred tax liability for these UTPs is removed

# FIN 48 (cont)

- An income tax liability should not be classified as deferred unless it results from a taxable temporary difference
- Interest and penalties should be accrued on UTP liabilities in the period that they would first accrue under tax law
- Classification – Liabilities for UTPs, including, interest and penalties, must be classified separately from other tax liabilities and classified based on expected timing of payment

## FIN 48 (cont)

- Initial application – The cumulative effect of applying FIN 48 to all open years shall be reported as an adjustment of the opening balance of retained earnings
- Companies must disclose the cumulative effect of the change on retained earnings in the statement of financial position. This disclosure is required only in the year of adoption

# FIN 48 (cont)

## ■ Disclosures

- In tabular form, a reconciliation of the total amount of unrecognized tax benefits at the beginning of the period to those at the end of the period
- The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate
- Total amount of interest and penalties (1) recognized in the income statement, and (2) recognized in the balance sheet

# FIN 48 (cont)

- For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date
  - Nature of the uncertainty
  - Nature of the event that could occur that would cause the change

# FIN 48 (cont)

- An estimate of the range of possible change or a statement that it cannot be estimated
- Description of open tax years by major jurisdiction

# FSP No. FIN 48-1

- Amends FIN 48 to provide guidance on whether a tax position is effectively settled
- Replaces the term *ultimately settled* with *effectively settled* for recognition and *settled* for measurement
- In tax years under examination, a tax position does not need to be specifically reviewed by the taxing authority to be considered effectively settled

## FSP 48-1 (cont)

- If in the companies judgment, the year will not be reopened and there are no appeals, could conclude that all positions in that year are effectively settled
- Effective settlement of a positioned that was examined does not result in effective settlement for similar or identical positions in other years.

# SSARS Interpretation No. 28 of AR Section 100

- Special-Purpose Financial Statements to Comply With Contractual Agreements or Regulatory Provisions
  - Provides guidance and examples for reporting on such financial statements

# The End



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