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Audit Risk Alerts

Retail Industry Developments—1996/97

American Institute of
Certified Public Accountants

NOTICE TO READERS

This Audit Risk Alert is intended to provide auditors of financial statements of retail businesses with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Technical Manager,
Accounting and Auditing Publications

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

Table of Contents

Page

Retail Industry Developments—1996/97 5

Industry and Economic Developments 5
Industry Profile 5
Economic Developments 7

Audit Issues and Developments 10
Going-Concern Issues 10
Merchandise Inventory 12
Revenue and Purchasing Cycles 13
Impairment of Long-Lived Assets 15
Control Environment 17
New Pronouncements 18
Ethics Ruling—Indemnification of a Client 20
AICPA Exposure Drafts: Proposed SASs 21

Accounting Issues and Developments 22
Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities 22
Revenue Recognition When Right of Return Exists 24
Product Warranties, Extended Warranty, and Product Maintenance Contracts 25
Advertising Costs 27
Preopening expenses 29
Delayed Effective Dates—Accounting Pronouncements 29

Exhibit 31

Information Sources 32

Retail Industry Developments—1996/97

Industry and Economic Developments

Industry Profile

The retail industry is broadly defined as being comprised of those businesses engaged in the distribution of products and services directly to the consumer market. Retailing is one of the largest and most diversified of domestic industries, consisting of two million firms that generate more than $2 trillion in annual sales while employing over 18 million people. Individual retail establishments are generally classified by the following: (1) the type of merchandise carried, (2) the level of specialization, that is, the variety of merchandise offered, and (3) in-store versus nonstore sales format. The United States Department of Commerce classifies retailing activities into the following general categories:

- Food stores
- General merchandise
- Apparel and Accessory stores
- Furniture, Home furnishings, and Equipment stores
- Equipment stores
- Automotive dealers
- Gasoline service stations
- Eating and Drinking establishments
- Supply and Mobile home dealers
- Drug and Proprietary stores
- Miscellaneous Retail stores
- Building materials, Hardware, Garden

The ownership of a retail business can take a variety of forms including the independent or single-store retailer, chain stores, or franchises.

Independent Retailer. By far the most common form of retail ownership is the small, owner-operated firm. Such entities comprise approximately 80 percent of all retail establishments, while accounting for

more than 50 percent of all retail sales. This form of ownership is characterized by ease of entry, comparatively low initial capital outlays and few legal obstacles (such as the general absence of rigorous licensing requirements). These minimal barriers explain the prevalence of this form of ownership, as well as the industry's intense competition. A high rate of business failure is also a hallmark of the independent retail ownership form in that it tends to attract a disproportionate number of relatively unsophisticated entrepreneurs. Auditors should therefore be alert to the possibility that in these circumstances accounting records and internal control may be inadequate (this matter is discussed in greater detail in the "Audit Issues and Developments" section of this Audit Risk Alert under "Control Environment").

Chain Stores. Chain stores are characterized by common ownership of multiple retail units and centralized management. Regional and national retail outlets typically adopt this form of organization.

Franchises. Franchises involve a contractual relationship whereby, for an initial fee and, typically, a percentage of future gross sales, an individual entrepreneur (franchisee) is granted the right by a sponsoring organization (franchisor) to operate an established business. The rights and obligations of both parties to the arrangement are set forth in a legal document known as the franchise agreement. Auditors of entities adopting this form of ownership should become familiar with the franchise agreement so they can identify those matters that may have accounting or disclosure implications for the franchisee.

For analytical purposes, retail establishments are often categorized on the basis of financial attributes such as gross margin and inventory turnover. For example, retail establishments with otherwise diverse activities such as supermarkets, pharmacies, discount stores, and building material outlets are sometimes grouped into a single category based on their tendency to generate low gross margins and high inventory turnover. Retail establishments such as jewelry stores, men's clothing stores, and furniture stores may also be viewed as a particular retail category in that they tend to generate, conversely, high gross margins and low inventory turnover. Comparing a retail client's results with overall performance in these categories can provide auditors with useful insight into the reasonableness of certain financial statement assertions. Auditors may therefore wish to consider the value of analytical tools such as a retailer's gross profit margin and inventory turnover ratio when addressing the guidance set forth under AICPA Statement on Auditing Standards (SAS) No. 56, *Analytical Procedures,* (AICPA, *Professional Standards,* vol. 1, AU sec. 329). SAS No. 56 requires the use of analytical procedures in the planning and overall review stages of all audits.

Retail enterprises range in size and age from well established multinational corporations to small development-stage enterprises. See Financial Accounting Standards Board (FASB) Statement No. 7, *Accounting and Reporting by Development Stage Enterprises* (FASB, *Current Text,* vol. 2, sec. De4), for relevant accounting guidance. Development-stage enterprises present auditors with unique risks. In developing an audit strategy, assessing risk, and designing substantive procedures, auditors should consider characteristics of the entity such as the following:

- Dependence on a limited product line or service
- Dependence on a limited number of suppliers, customers, or financing sources
- Credit arrangements imposing restrictive financial covenants or requirements to achieve "target" operating results
- Related-party sales or purchase or leasing transactions

See further discussion under "Control Environment" in the "Audit Issues and Developments" section of this Audit Risk Alert.

Although retail sales are generally consummated through store operations, electronically conducted sales transactions are becoming more prevalent as the necessary technology becomes available to both retailers and consumers. The consensus among industry observers is that the allure of so-called on-line commerce will, in the foreseeable future, become overwhelming because, on the Internet, no store ever closes, and no location is isolated from the rest of the planet. Sales transactions consummated through electronic means, such as the Internet, will present unique challenges to the auditor, particularly in the areas of internal control and evidential matter. In recognition of this developing trend the Auditing Standards Board (ASB) has issued an exposure draft amending SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards,* vol. 1, AU sec. 326). The amendment would provide guidance to auditors relating to electronic information and the testing of related controls. See "New Pronouncements" under the "Audit Issues and Developments" section of this Audit Risk Alert for further discussion.

Economic Developments

The Christmas shopping season, of crucial importance to retailers, netted dismal results for 1995, the worst holiday sales figures since 1990. As a result, annual retail sales for 1995 rose only 4.5 percent over the previous year, which is significantly lower than the 7 percent annual growth rate common during the benchmark 1980s. The poor holiday season showing led to reduced profits in early 1996 as retailers

were forced to offer steep discounts to move unsold inventories. Although many larger retailers recovered from the holiday "fire-sales," smaller stores that were unable to match such price reductions have been driven out of business.

The industry rebounded later in the first quarter of 1996 on the basis of a surge in consumer spending. A stronger than expected economy in the second quarter lifted retail sales through May, though they declined slightly in June. Despite these favorable results, industry analysts estimate that 1996 sales growth will be limited to a disappointing 4 percent to 5 percent annual increase (with the nation's major retailers expected to reap the largest gains). The low expectations for 1996 retail performance are primarily based on current economic and demographic conditions such as the following:

- Stagnant family incomes (as evidenced by government statistics showing that real average hourly wages grew by approximately one percent annually between 1990 and 1995)
- An aging population that is curtailing in spending
- A current downward trend in the consumer confidence index
- An all-time high nonmortgage debt-to-income ratio of 19 percent for consumers, along with sharply rising credit card delinquencies

The modest level of expected growth is likely to be mitigated in many retail segments by the heavy discounting that has become common practice throughout much of the industry. This is expected to hold true even for industry segments such as consumer electronics, which performed well in 1995. Despite expectations of continued sales growth, market segments such as this one will be operating on extremely narrow gross margins largely due to intense competitive pressures. These retailers have attempted to offset the impact of discounting by offering customers separately priced extended warranty and product maintenance contracts. This strategy has been successful for some in recouping the profits lost through discounting. In these circumstances, auditors should become familiar with the terms of such agreements and consider whether management has applied the appropriate accounting treatment to these transactions. This topic is explored further in the "Accounting Issues and Developments" section of this Audit Risk Alert under "Product Warranties, Extended Warranties and Product Maintenance Contracts."

High levels of promotional activity have accompanied the aforementioned product discount programs. Accordingly, auditors should consider whether their clients have properly addressed the accounting and disclosure issues relating to advertising expenses. The accounting

treatment for advertising costs is addressed in the "Accounting Issues and Developments" section of this Audit Risk Alert under "Advertising Costs."

On Wall Street, retail stocks mirrored the industry's poor performance in the early part of the year. Although the Standard and Poor's Composite Index of 500 Stocks Index rose nearly 38 percent in 1995, the retail stores index was up just 12 percent. Early in the year some investment advisors forecast that retail stocks, beaten down by liquidations and cost-conscious consumers, had nowhere to go but up. And indeed, retail stocks did rebound by midyear. However, the general consensus is that this recovery will be short-lived and that 1996 will be a disappointing year for retail stocks. Auditors may wish to consider the impact of stock performance on the control environment of publicly held retail clients. Management's philosophy and operating style may be adversely affected by pressure from stockholders stemming from poor stock performance. This situation could, for example, manifest itself in overly aggressive positions on accounting issues adopted by management to more extreme instances of intentional material misstatement of the financial statements. The ASB has considered the issue of management fraud as detailed in its recently issued exposure draft of a proposed SAS, "Consideration of Fraud in a Financial Statement Audit." See the "Audit Issues and Developments" section of this Audit Risk Alert under "AICPA Exposure Drafts: Proposed SASs", for further information.

During 1995, approximately 15,000 retail establishments sought protection from their creditors by filing for bankruptcy under Chapter 11. These filings, which include several prominent national and regional chains, represented a 20 percent increase over 1994 bankruptcy activity. The consensus of industry analysts is that the retail trade is currently "overstored," that is, there are too many stores chasing too few consumer dollars. Accordingly, future growth for retailers can only come from taking market share away from the competition. Such competitive pressures will continue to have an impact on bankruptcy filings. For example, established retailers will face increasing threats from nontraditional retailers. These include direct consumer sales being carried out by manufacturers and wholesalers, who sell their products directly to the consumer through outlets such as "superstores" or warehouse clubs. Based on these circumstances, retail economists are predicting an even greater increase in bankruptcies for 1996. In these circumstances, auditors should be aware of their responsibilities pursuant to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards,* vol. 1, AU sec. 341). The "Audit Issues and Developments" section of this Audit Risk Alert includes further discussion of this matter.

In addition to bankruptcies, cost cutting, restructurings, and downsizing undertaken by local, regional and national retailers have led to an increased number of store closings. During the first quarter of 1996, approximately 3,500 retail stores outlets closed down operations. In these circumstances, auditors should consider whether management has addressed relevant accounting guidance such as the FASB's Emerging Issues Task Force (EITF) Issue 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring),* EITF Issue No. 96-9, *Classification of Inventory Markdowns and Other Costs Associated with a Restructuring* (guidance provided by the Securities and Exchange Commission), and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text,* vol. 1, sec. IO8). Additionally, auditors should consider whether the store closing constitutes the disposal of a business segment. If it is determined that the store(s) is a component of the retail enterprise whose activities represent a separate major line of business or class of customer, auditors should consider whether management has properly applied the accounting treatment specified under Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text,* vol. 1, sec. I13).

The highly competitive environment has resulted in a "consolidation fever" spreading throughout retailing. According to industry analysts, it is becoming increasingly difficult for regional chains to succeed in metropolitan markets. Larger companies who benefit from economies of scale and enhanced purchasing power have targeted weaker retailers seeking bargain basement sales while weaker firms are seeking buyers to avoid bankruptcy. Industry analysts predict a developing trend whereby, through acquisition and consolidation, "the strong will get stronger" at the expense of weaker retailers. Auditors should consider whether management has appropriately accounted for an acquisition or consolidation in accordance with relevant accounting literature such as APB Opinion No. 16, *Business Combinations* (FASB, *Current Text,* vol. 1, sec. B50).

Audit Issues and Developments

Going-Concern Issues

Economic and demographic factors coupled with the retail industry's intensely competitive environment contributed to record bankruptcies for 1995. This trend is expected to continue in 1996. Accordingly, auditors should be alert to conditions and events which,

when considered in the aggregate, indicate that there could be substantial doubt about a retailer's ability to continue as a going concern. For example, such conditions and events could include the following:

1. negative trends such as recurring operating losses or working capital deficiencies
2. financial difficulties such as working capital loan defaults or denial of trade credit from suppliers
3. internal matters such as uneconomic long-term commitments
4. external matters such as legal proceedings that could jeopardize the entity's ability to operate.

In such circumstances auditors may conclude that, based upon such conditions and events, there is substantial doubt about the retailer's ability to continue as a going concern.

Accordingly, auditors should be aware of their responsibilities pursuant to SAS No. 59. SAS No. 59 provides guidance to auditors in conducting an audit of financial statements in accordance with generally accepted auditing standards for evaluating whether there is substantial doubt about a client's ability to continue as a going concern for a period not to exceed one year from the date of the financial statements being audited.

Continuation of an entity as a going concern is generally assumed in the absence of significant information to the contrary. Information that significantly contradicts the going-concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions. SAS No. 59 does not require the auditor to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statements being audited. However, the results of auditing procedures designed and performed to achieve other audit objectives may bring such contrary information to the auditor's attention.

If, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the entity's ability to continue as a going concern, the auditor should consider whether it is likely that existing conditions and events can be mitigated by management plans and whether those plans can be effectively implemented. If the auditor obtains sufficient competent evidential matter to alleviate doubts about going-concern issues then consideration should be given to the need for disclosure of the princi-

pal conditions and events that initially caused the auditor to believe there was substantial doubt. If, however, after considering identified conditions and events, along with management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern remains, the audit report should include an explanatory paragraph to reflect that conclusion. In these circumstances, auditors should refer to the specific guidance set forth under SAS No. 59.

For those retailers emerging from bankruptcy reorganization pursuant to chapter 11 of the Bankruptcy Code, the auditor should consider whether the retailer is following the accounting guidance of SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code.*

Merchandise Inventory

Merchandise inventory is generally the most significant asset on the balance sheet of a retailing enterprise. Given the current industry and economic environment, auditors should be alert to the potential for a high level of audit risk associated with this area.

Many retail businesses are now confronted with problems such as declining sales, narrow profit margins, and intense competition. These conditions may increase the likelihood that management will adopt overly aggressive positions in accounting for particular inventory transactions. For example, the failure to adequately assess inventory obsolescence might be used as a means of overstating ending inventory in order to inflate solvency ratios. Accordingly, when auditing inventory in these circumstances, auditors should adopt an approach of heightened professional skepticism.

Audit risk relating to merchandise inventory generally involves issues such as the following:

- *The proper cutoff of sales and purchase transactions.* Transactions occurring near year-end should be examined to ensure that they are recorded in the period in which the related revenue has been earned or the expense has been incurred. Procedures that may be performed by the auditor to assess the proper cutoff of sales and purchase transactions (completeness assertion AU sec. 326.03) could include the observation of physical inventory counts, analytical procedures comparing the relationship of inventory balances to recent purchasing and sales activities, along with testing the client's cutoff procedures for shipping, receiving, sales, sales returns, purchases, and purchase returns.

- *Inventory valuation.* Current industry and economic conditions suggest increased significance in assessing the net realizable value of inventory; the proper application of inventory cost flow assumptions; and the consideration of obsolescence, shrinkage, and changes in demand on inventory valuation. Procedures that may be performed by the auditor to assess the valuation of the client's merchandise inventory (see the valuation assertion in AU sec. 326.03) might include examining paid vendors' invoices and current market value quotations, assessing inventory obsolescence by analyzing inventory turnover, comparisons with industry experience and trends, and for highly specialized merchandise (for example, jewels) the guidance set forth in SAS No. 73, *Using the Work of a Specialist*, (AICPA, Professional Standards, AU sec. 336) should be considered.
- *Inventory ownership.* Failure to determine ownership can result in the overstatement of inventory through, for example, improper sales or purchase cutoff, incorrect assessment of when title passes in sales or purchase transactions (FOB shipping point or FOB destination). Procedures that may be performed by the auditor to assess whether the inventory balance shown on the client's balance sheet is actually owned by the client (see the rights and obligations assertion in AU sec. 326.03) might include observing physical inventory counts, obtaining confirmation of inventories at locations outside the entity, testing cutoff procedures relating to sales, sales returns, purchases, and purchase returns, as well as examining paid vendors' invoices, shipping terms, consignment agreements, and bill and hold arrangements.
- *The physical existence of merchandise inventory.* A key audit objective is to establish the existence of inventory. Procedures that may be performed by the auditor to make this assessment (see the existence assertion, in AU sec. 326.03) might include observation of the client's physical inventory count, obtaining confirmation of inventories at locations outside the entity, along with the testing of inventory transactions between a preliminary physical inventory date and the balance sheet date.

Revenue and Purchasing Cycles

Accounts Receivable. A retailer's accounts receivable may include, among other items, customer accounts, installment or layaway plans, as well as amounts due from third-party charge companies that are not included in cash. Some of the major issues facing the auditor in this

area include the collectibility of the account balance, the validity of receivables, along with evaluating the client's procedures for safeguarding cash receipts, and the collections of accounts receivable.

Given the current economic difficulties faced by many retailers, there is likely to be a high level of audit risk associated with credit sales. In order to address the problems of a diminishing customer base, the potential exists for management to relax restrictions on granting credit to the point where collectibility may be called into question. Accordingly, auditors should consider the client's procedures for granting credit to new customers as well as authorizing credit for established customers. This should also factor into the auditor's evaluation of the adequacy of the allowance for doubtful accounts.

In the current environment, auditors should be alert to the potential for the overstatement of assets, such as accounts receivable. Given the inordinately high rate of retail business failures, lenders, in an effort to protect their investments, may establish restrictive loan covenant provisions specifying minimum levels of liquidity to be maintained by the debtor. As such, auditors should be alert to the potential manipulation of solvency ratios through the overstatement of current assets such as accounts receivable.

Procedures that may be performed by the auditor to assess the validity of accounts receivable include various analytical reviews and, principally, direct confirmation by the auditor with customers. In this regard, auditors may wish to refer to the AICPA publication, Auditing Procedure Study (APS), *Confirmation of Accounts Receivable,* (Product Code No. 021064). This APS discusses the relationship of financial statement assertions to accounts receivable audit objectives and how those objectives may be achieved by using confirmations. The APS illustrates and discusses four different kinds of confirmation forms (positive, negative, blank, and expanded-field forms) and presents guidance on selecting an appropriate confirmation form for various client situations. Finally, the APS identifies practical suggestions for improving the quality and quantity of accounts receivable confirmation responses. The APS includes a copy of SAS No. 67, *The Confirmation Process* (AICPA, Professional Standards, vol. 1, AU sec. 330).

Sales. Declining sales revenues in the current environment suggest an increased level of audit risk in this area. Auditors may wish to place special emphasis on evaluating the adequacy of client procedures relating to the proper cutoff of sales, returns and allowances, and shipping. Auditors may wish to pay particular attention to specialized credit transactions, large, end-of-year transactions including consignment and bill-and-hold arrangements. Management must be in a posi-

tion to establish that the earnings process is complete before revenue related to these transactions can be recognized.

Additionally, in connection with credit sales, auditors should assess management's consideration of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), which requires the disclosure of information about significant concentrations of credit risk.

Accounts Payable. Retailers typically have a significant number of vendors to whom they are liable for merchandise and expense items. Accounts payable is generally the most significant current liability on the retailer's balance sheet. Given the current economic circumstances, auditors should be alert to the potential for the understatement of liabilities and the related expense. To accomplish specified audit objectives, auditors may wish to utilize procedures such as the following:

- Analytical procedures to test the reasonableness of payables
- Search for unrecorded liabilities
- Reviews of cutoff procedures relating to purchases and purchase returns
- Direct confirmation with vendors (in certain extreme circumstances)

Impairment of Long-Lived Assets

In March 1995, the FASB issued Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. I08) which requires that long-lived assets and certain identifiable intangibles and goodwill related to those assets to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Statement also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less costs to sell, except for assets covered by APB Opinion No. 30, *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text*, vol. 1, sec. I13). Assets covered by APB Opinion No. 30 will continue to be reported at the lower of the carrying amount or the net realizable value. The Statement is effective for financial statements for fiscal years beginning after De-

cember 15, 1995. Accordingly, this is the first year that auditors will evaluate management's implementation of the Statement.

In evaluating management's implementation of FASB Statement No. 121, major issues to be considered by auditors include the following:

- *The appropriate classification of long-lived assets as either those being held and used or those to be disposed of.* Auditors should obtain an understanding of the policies and procedures used by management to classify long-lived assets pursuant to FASB Statement No. 121 as well as evaluating whether those classifications are proper.
- *The identification of events or circumstances indicating that the carrying amounts of assets to be held and used may not be recoverable.* Auditors should obtain an understanding of the policies and procedures used by management to identify such events and circumstances. Examples of such events and circumstances could include the following:
  - — A dramatic change in the manner in which an asset is used
  - — A reduction in the extent to which an asset is used
  - — Forecasts showing lack of long-term profitability
  - — A change in the law or business environment
  - — A substantial drop in the market value of an asset
- *The assumptions used in the underlying calculation of estimated future cash flows when testing for asset impairment used in management's impairment test, and assumptions used in estimating the fair value of assets for which an impairment loss is to be recognized.* Management's estimates of future cash flows from asset use and the fair value of assets used in calculating impairment losses should be evaluated pursuant to the guidelines set forth in SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards,* vol. 1, AU sec. 342). Procedures to be employed should include one or a combination of the following: (1) reviewing and testing the process used by management to develop the estimates, (2) developing an independent expectation to corroborate the reasonableness of the estimates, or (3) reviewing subsequent events or transactions occurring before the completion of fieldwork.
- *The recording of assets to be disposed of at the lower of carrying amount or fair value less cost to sell.* Auditors should verify that management has appropriately classified and valued long-lived assets to be disposed of.

- *The disclosure requirements of FASB Statement No. 121.* Auditors should verify that all disclosure requirements of FASB Statement No. 121 have been included in the client's financial statements.

Control Environment

Minimal barriers to enter the retail trade guarantee that a sizable number of entities will be young, development-stage enterprises. Internal control in these companies often include unique characteristics that may affect an auditor's assessment of control risk. Characteristics that may increase control risk include the following:

- Many retail entities are relatively small and frequently closely held. In such entities, the entire accounting function may be the responsibility of one or a few employees and thus lacking in adequate segregation of duties. In addition, owners or managers often have the authority to override prescribed control procedures.
- Owners and managers of retail entities frequently are entrepreneurs who may be more likely to give priority to the business of selling over accounting systems and related control activities. As a result, internal control, accounting, and financial reporting functions may receive less support and attention than might be warranted.
- Owners and managers of small retail entities may not be as well versed in matters of accounting, finance, and administration.
- The limited resources of some start-up retail enterprises may engender informal accounting systems with inadequate internal control.

If internal control of a retail entity includes the preceding characteristics, control risk might be assessed as high. Auditors should adjust the scope of their audits accordingly, and should document the understanding of the entity's internal control as required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).[1] If that understanding reveals that the oversight function is weak, there is increased risk that material errors and irregularities will result in misstatements

[1] SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. SAS No. 78 was issued in November 1995 and is effective for audits of financial statements for periods beginning on or after January 1, 1997. See the "New Pronouncements" section for further discussion of this matter.

in the financial statements, and reportable conditions, as defined in SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 325), may exist.

New Pronouncements

Auditing Standards

SAS No. 75. In September 1995, the ASB issued SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards,* vol. 1, AU sec. 622), which provides guidance to an accountant concerning performance and reporting in all engagements to apply agreed-upon procedures to specified elements, accounts, or items of a financial statement, except in certain circumstances, as discussed in the SAS. The Statement is effective for reports on engagements to apply agreed-upon procedures dated after April 30, 1996, with earlier application encouraged.

SAS No. 76. In September 1995, the ASB issued SAS No. 76, *Amendments to SAS No. 72,* Letters for Underwriters and Certain Other Requesting Parties (AICPA, *Professional Standards,* vol. 1, AU sec. 634). The SAS provides reporting guidance and an example of a letter, actually a form of agreed-upon procedures report, that the accountant can provide in response to a request to provide a comfort letter in circumstances in which the party requesting the letter does not provide the accountant with the representations required in paragraphs 6 and 7 of SAS No. 72. The Statement is effective for letters issued pursuant to paragraph 9 of SAS No. 72 after April 30, 1996.

SAS No. 77. In November 1995, the ASB issued SAS No. 77, *Amendments to SAS No. 22,* Planning and Supervision, No. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, and No. 62, Special Reports (AICPA, *Professional Standards,* vol. 1, AU secs. 311, 341, and 623), which, among other things, clarifies that a written audit program should be prepared in every audit and precludes the use of conditional language in the auditor's explanatory paragraph to indicate that there is substantial doubt about the entity's ability to continue as a going concern. SAS No. 77 is effective for engagements beginning after December 15, 1995.

SAS No. 78. In December 1995, the ASB issued SAS No. 78, which revises the definition and description of internal control contained in the Statements on Auditing Standards to recognize the definition and description contained in *Internal Control—Integrated Framework* (the

COSO Report), published by the Committee of Sponsoring Organizations of the Treadway Commission. This Statement is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

SAS No. 79. In December 1995, the ASB issued SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements (AICPA, *Professional Standards,* vol. 1, AU sec. 508), which eliminates the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report. SAS No. 79 also clarifies and reorganizes the guidance in SAS No. 58 concerning emphasis paragraphs, matters involving uncertainties, and disclaimers of opinion. This SAS does not affect SAS No. 59 nor preclude the auditor from adding a paragraph to the auditor's report to emphasize a matter disclosed in the financial statements. This Statement is effective for reports issued or reissued on or after February 29, 1996, with earlier application permitted.
A table outlining the significant provisions of the newly issued auditing standards is set forth in the "Exhibits" section of this Audit Risk Alert.

Attestation Standards

SSAE No. 4. In September 1995, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards,* vol. 1, AT sec. 600). SSAE No. 4 sets forth attestation standards and provides guidance on the performance and reporting in all agreed-upon procedures engagements, except in certain circumstances, and is effective for reports on agreed-upon procedures engagements dated after April 30, 1996. SSAE No. 4 generally should be used when applying agreed-upon procedures to nonfinancial statement subject matter. In addition, SSAE No. 4 requires a written assertion from management as a condition of engagement performance.

SSAE No. 5. In November 1995, the ASB issued SSAE No. 5, *Amendment to Statement on Standards for Attestation Engagements No. 1,* Attestation Standards (AICPA, *Professional Standards,* vol. 1, AT sec. 100). This amendment provides guidance on the quantity, type, and content of working papers for attestation engagements and is effective for engagements beginning after December 15, 1995.

SSAE No. 6. In December 1996, the ASB issued SSAE No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards,* vol. 1, AT sec. 400). This amendment conforms

the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 (see the discussion in the preceding section) and *Internal Control—Integrated Framework*. The amendment is effective for an examination of management's assertion when the assertion is as of or for the period ending December 15, 1996, or thereafter. Early application of the provisions of this Statement is permitted.

Quality Control Standards. In May 1996, the ASB issued Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards,* QC sec. 20) and No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards,* QC section). SQCS No. 2 supersedes SQCS No. 1, *System of Quality Control for a CPA Firm: Interpretation of QC Section 10* (AICPA, *Professional Standards,* vol. 2, QC sec. 10 and 10-1). The provisions of these Statements are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997.

SQCS No. 2 redefines a firm's accounting and auditing practice to include all audit, attest, and accounting and review services for which professional standards have been established by the ASB or the Accounting and Review Services Committee under Rules 201, *General Standards,* and 202, *Compliance With Standards,* of the AICPA *Code of Professional Conduct* (AICPA, *Professional Standards,* vol. 2, ET sec. 201 and 202). The definition of a firm's accounting and auditing practice has been revised to include engagements performed under SSAEs issued by the ASB. These standards had not been issued when SQCS No. 1 was promulgated. Also, the new standard replaces the nine specific elements discussed in SQCS No. 1 with the following five broad elements: (1) independence, integrity, and objectivity; (2) personnel management; (3) acceptance and continuance of clients and engagements; (4) engagement performance; (5) monitoring. SQCS No. 3 provides guidance on how a firm can implement the new monitoring element of a quality control system in its accounting and auditing practice.

Ethics Ruling—Indemnification of a Client

Recently, the AICPA Professional Ethics Executive Committee issued Ethics Ruling No. 102, *Member's Indemnification of a Client,* as published in the January 1996 Journal of Accountancy. This ruling states that auditors should not enter into agreements that would require them to indemnify their client for damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to client acts, or their independence will be impaired. In assessing their

independence, auditors of retail enterprises should consider the implication of indemnification arrangements requested by their clients, in light of this new ethics ruling.

AICPA Exposure Drafts: Proposed SASs

Consideration of Fraud in a Financial Statement Audit. In May 1996, the AICPA issued an exposure draft of a Proposed Statement on Auditing Standards - *Consideration of Fraud in a Financial Statement Audit and Amendments to Statements on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures, and No. 47, Audit Risk and Materiality in Conducting and Audit. The proposed Statement would provide expanded operational guidance on the consideration of fraud in conducting a financial statement audit. The proposed changes in auditing standards also clarify the auditor's present responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud. In addition, the proposed changes provide added guidance on the standard of due professional care in the performance of work, including the need to exercise professional skepticism, and the concept of reasonable assurance. In addition to amending SAS Nos. 1 and 47, the proposed statement would:

- Describe fraud and its characteristics.
- Require the auditor to specifically assess the risk of material misstatement due to fraud and provide categories of fraud risk factors that should be considered in the auditor's assessment.
- Provide guidance on how the auditor should respond to the results of the assessment.
- Provide guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud.
- Describe related documentation requirements.
- Provide guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

Amendment to SAS No. 31, Evidential Matter. In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Amendment to SAS No. 31,* Evidential Matter. This proposed Statement would provide guidance for a practitioner who has been engaged to audit an entity's financial statements where significant information is transmitted, processed, maintained, or accessed electronically. The proposed Statement would include examples of evidential matter in electronic form and provide that an auditor should consider the time during which

such evidential matter exists or is available in determining the nature, timing, and extent of substantive tests. In addition, the proposed Statement would indicate that an auditor may determine that, in certain engagement environments where evidential matter is in electronic form, it would not be practical or possible to reduce detection risk to an acceptable level by performing only substantive tests. The proposed Statement would provide that in such circumstances, an auditor should consider performing tests of controls to support an assessed level of control risk below the maximum for affected assertions.

Investments in Debt and Equity. In May 1996, the AICPA issued an exposure draft of a proposed SAS, *Investments in Debt and Equity.* This proposed Statement would revise the guidance on auditing investments to make that guidance consistent with recently issued accounting standards, particularly FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*

Accounting Issues and Developments

Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities

In June 1996, the FASB issued FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.* This Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishment of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interest in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
2. Either (*a*) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right—to pledge or ex-

change the transferred assets or (*b*) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.

3. The transferor does not maintain effective control over the transferred assets through (*a*) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (*b*) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

FASB Statement No. 125 requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interest in transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

FASB Statement No. 125 requires that servicing assets and liabilities be subsequently measured by (*a*) amortization in proportion to and over the period of estimated net servicing income or loss and (*b*) assessment for asset impairment or increased obligation based on their fair values.

FASB Statement No. 125 requires that debtors reclassify financial assets pledged as collateral and that secured parties recognize those assets and their obligation to return them in certain circumstances in which the secured party has taken control of those assets.

FASB Statement No. 125 requires that a liability be derecognized if and only if either (*a*) the debtor pays the creditor and is relieved of its obligation for the liability or (*b*) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

FASB Statement No. 125 provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interest, servicing of financial assets, securitizations, transfers of sales-type and direct financial lease receivables, securities lending transactions, repurchase agreements including "dollars rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishment of liabilities.

FASB Statement No. 125 supersedes FASB Statements No. 76, *Extinguishment of Debt*, and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. This Statement amends FASB Statement No. 115 to clarify that a debt security may not be classified as held-to-ma-

turity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. This Statement amends and extends to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* and supersedes FASB Statement No. 122, *Accounting for Mortgage Servicing Rights.* This Statement also supersedes Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt,* No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)* and No. 87-3, *Accounting for Mortgage Servicing Fees and Rights.*

FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishment of liabilities occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted.

Revenue Recognition When Right of Return Exists

In the normal course of business, many retail entities offer their customers the option to return purchased merchandise. This policy may be a matter of contract or simply a matter of existing practice. Typically, the product may be returned for a refund of the purchase price, for a credit applied to amounts owed or to be owed for other purchases, or in exchange for other products. FASB Statement No. 48, *Revenue Recognition When Right of Return Exists* (FASB, *Current Text,* vol. 1, sec. R75), specifies how an enterprise should account for sales of its product in which the buyer has a right to return the product. FASB Statement No. 48 provides that revenue from such sales transactions shall be recognized at the time of sale only if all of the following conditions are met:

1. The seller's price to the buyer is substantially fixed or determinable at the date of sale.
2. The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product.
3. The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
4. The buyer acquiring the product for resale has economic substance apart from that provided by the seller[2]

[2] This condition relates primarily to buyers that exist "on paper," that is, buyers that have little or no physical facilities or employees. It prevents enterprises from recognizing sales revenue on transactions with parties that the sellers have established primarily for the purpose of recognizing such sales revenue.

5. The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
6. The amount of future returns[3] can be reasonably estimated.

If these conditions are not met, revenue recognition is postponed; if they are met, sales revenue and cost of sales reported in the income statement must be reduced to reflect estimated returns, and expected costs or losses must be accrued.

The ability to make a reasonable estimate of the amount of future returns as specified in item 6 above depends on many factors and circumstances that vary from one case to the next. FASB Statement No. 48 outlines examples of factors that may impair the ability to make a reasonable estimate, such as the following:

- Technological obsolescence or changes in demand
- Relatively long periods in which a product may be returned
- The absence of historical experience with similar type of sales of similar products
- The absence of a large volume of relatively homogeneous transactions

In circumstances where the right of return exists, the auditor should assess the client's application of FASB Statement No. 48 by referring to the full text of the statement.

For publicly held companies, the activity in the allowance for sales returns and allowances should be disclosed consistent with the requirements of Article 5.04 (c), Schedule II of Regulation S-X.

Product Warranties, Extended Warranty, and Product Maintenance Contracts

Typically, sales to retail consumers are typically made subject to a product warranty. Such an arrangement will generally provide for repair services or replacement parts during a specified warranty period. The warranty represents an obligation incurred by the retailer in connection with the sale of products or services that may require further performance by the seller after the sale has taken place. Because of the uncertainty surrounding claims that may be made under warranties, warranty obligations fall within the definition of a contingency as set

[3] Exchanges by ultimate customers of one item for another of the same kind, quality, and price (for example, one color or size for another) are not considered returns for the purposes of FASB Statement No. 48.

forth under FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current text*, vol. 1, C59). FASB No. 5 provides that losses from warranty obligations shall be accrued when both of the following conditions are met:

1. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
2. The amount of loss can be reasonably estimated.

The loss accrued is commonly based on previous experience with regard to the same product line, or absent that, related products or the experience of other enterprises in the same business may be appropriate. If there is no basis to calculate a reasonable estimate of the loss accrual, the possibility of material future warranty costs may suggest that a sale should not be recorded before the expiration of the warranty period or until sufficient experience allows for the calculation of a reasonable estimate. If no accrual is made, the nature of the contingency and the range of potential loss or the fact that such an estimate cannot be made should be disclosed in the financial statements. In accordance with FASB Statement No. 5, if no accrual is made for warranty costs because one or both of the conditions for accrual are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

Auditors may wish to read relevant sales agreements and examine historical trends to determine the existence of warranty obligations along with the nature and extent of any warranty liability. Where applicable, the auditor should assess the valuation of the estimated liability recorded by the client.

It is common practice for many retail establishments, particularly those selling consumer electronics, household appliances, and automobiles, to offer extended warranty and product maintenance contracts to provide warranty protection or product services not included in the product sales price. The losses incurred due to heavy discounting are often recouped through the sale of either or both the separately priced warranty and maintenance contracts.

An extended warranty is an agreement to provide warranty protection in addition to the scope of coverage of the manufacturer's original warranty, if any, or to extend the period of coverage provided by the manufacturer's original warranty. A product maintenance contract is an agreement to perform certain agreed-upon services to maintain a

product for a specified period of time. A contract is separately priced if the customer has the option of purchasing the services provided under the contract for an expressly stated amount separate from the price of the product.

FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts* (FASB, *Current Text,* vol. 1, sec. R75), addresses how revenue and costs from a separately priced extended warranty or product maintenance contract be recognized. The bulletin provides the following:

1. Revenue from separately priced extended warranty and product maintenance contracts should be deferred and recognized in income on a straight-line basis over the contract period except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. In those circumstances, revenue should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.
2. Costs that are directly related to the acquisition of a contract and that would have not been incurred but for the acquisition of that contract (incremental direct acquisition costs) should be deferred and charged to expense in proportion to the revenue recognized. All other costs, such as costs of services performed under the contract, general and administrative expenses, advertising expenses, and costs associated with the negotiation of a contract that is not consummated, should be charged to expense as incurred.
3. A loss should be recognized on extended warranty or product maintenance contracts if the sum of expected costs of providing services under the contracts and unamortized acquisition costs exceeds related unearned revenue. Extended warranty or product maintenance contracts should be grouped in a consistent manner to determine if a loss exists. A loss should be recognized first by charging any unamortized acquisition costs to expense. If the loss is greater than the unamortized acquisition costs, a liability should be recognized for the excess.

Advertising Costs

An increased level of product promotion occurred during 1995. Industry analysts expect that level to increase during 1996 as retailers advertise in an attempt to develop a competitive edge. Additionally, many retail chains, unable to sustain heavy discounting, have been forced to abandon the "every day low pricing" strategy. In turn, they

have increasingly begun to rely on advertising to promote special sales.

Statement of Position (SOP) 93-7, *Reporting on Advertising Costs,* defines advertising as a customer acquisition activity involving the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image, or to create or stimulate a desire to buy the entity's products or services. SOP 93-7 provides guidance on accounting for advertising costs in annual financial statements for the following:

1. Reporting the costs of advertising, which should be expensed either as incurred or the first time the advertising takes place, except for direct-response advertising:
   a. The primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and
   b. that results in probable future economic benefits.
2. For direct-response advertising that may result in reported assets (that is, capitalized pursuant to the criteria set forth in items *a.* and *b.* above) as follows:
   a. How such assets should be measured initially
   b. How the amounts ascribed to such assets should be amortized
   c. How the realizability of such assets should be assessed

Additionally, SOP 93-7 requires that the notes to the financial statements should disclose the following:

1. The accounting policy for reporting advertising, indicating whether such costs are expensed as incurred or the first time the advertising takes place
2. A description of the direct-response advertising reported as assets (if any), the accounting policy for it, and the amortization period
3. The total amount charged to advertising expense for each income statement presented, with separate disclosure of amounts, if any, representing a write down to net realizable value
4. The total amount of advertising reported as assets in each balance sheet presented

The following is an example of the disclosures required by the SOP:

Note X. Advertising

The Company expenses the production costs of advertising the first time the advertising takes place, except for direct-response

advertising, which is capitalized and amortized over its expected period of future benefits.

Direct-response advertising consists primarily of magazine advertisements that include order coupons for the Company's products. The capitalized costs of the advertising are amortized over the three-month period following the publication of the magazine in which it appears.

At December 31, 19XX, $1,000,000 of advertising was reported as assets. Advertising expense was $10,000,000 in 19XX, including $500,000 for amounts written down to net realizable value.

Preopening Expenses

Selling space expansion grew at an annual rate of approximately 5 percent in 1995 and is expected to grow at the same rate during the current year. The construction of new retail facilities includes supercenters and huge specialty outlets such as home improvement and consumer electronics stores. Costs related to the planning and preparation for the opening of new retail store locations such as these are generally considered to be period costs and industry practice has been to expense these costs as they are incurred. However, costs that are directly related to a store opening and that are expected to benefit future periods may be deferred and amortized if there is objective evidence that probable future net operating results will be sufficient to recover such costs. The deferral of costs would be discontinued upon the store's opening. In practice, the amortization period for preopening expenses rarely extends beyond one year.

Delayed Effective Dates—Accounting Pronouncements

Disclosures about Fair Value of Financial Instruments. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* issued in December 1991, was effective for financial statements issued for fiscal years ending after December 15, 1992. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995. In that a sizable portion of retail entities may be smaller, development state enterprises, financial statements for years ended during 1996 will be subject to the provisions contained therein. In such circumstances, auditors should consider whether management has made all disclosures required by FASB Statement No. 107.

FASB Statement No. 107 requires disclosure of the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable

to estimate fair value. If estimating fair value is not practicable, the Statement requires disclosure of descriptive information pertinent to estimating the value of a financial instrument. Certain financial instruments (for example, lease contract, deferred-compensation arrangements, and insurance contracts) are excluded from the scope of the Statement.

Disclosures about Derivative Financial Instruments. FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments,* issued in October 1994, was effective for financial statements issued for fiscal years ending after December 15, 1994. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995.

FASB Statement No. 119 requires disclosures about derivative financial instruments such as futures; forward, swap, and option contracts; and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* to require disaggregation of information about financial instruments with off-balance-sheet risk of accounting loss by class, business activity, risk, or other category that is consistent with the entity's management of those instruments. The Statement also amends FASB Statement No. 107 to require that fair value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with the fair value of nonderivative financial instruments and be presented together with the related carrying amounts in the body of the financial statements, a single footnote, or a summary table in a form that makes it clear whether the amounts represent assets or liabilities.

Auditors should consider whether the provisions of FASB Statement No. 119 apply to their retail clients, and if so, evaluate whether the client's financial statement disclosures are adequate and appropriate in view of the requirements set forth therein.

Exhibit

Significant Provisions of Newly Issued SASs

Pronouncement	*Pronouncements Affected*	*Key Provisions*
SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*	SAS No. 35	Prohibits negative assurance. Provides guidance concerning the conditions for performing agreed-upon procedures engagements; the nature, timing, and extent of the procedures; the responsibilities of practitioners and specified users; and reporting on agreed-upon procedures.
SAS No. 76, *Amendments to SAS No. 72,* Letters for Underwriters and Certain Other Requesting Parties	SAS No. 72	Specifies the form of letter to be provided by the accountant in circumstances in which a comfort letter is requested but the requesting party has not provided a representation letter.
SAS No. 77, *Amendments to SAS No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports	SAS Nos. 22, 59, and 62	Clarifies that a written audit program should be prepared. Precludes the use of conditional language in a going concern report.
SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*	SAS No. 55	Recognizes the COSO definition of internal control.
SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements	SAS No. 58	Eliminates the requirement to add an uncertainties paragraph to the auditor's report (does not affect SAS No. 59).

Information Sources

Further information on matters addressed in this Audit Risk Alert is available through various publications and services listed in the table at the end of this document. Many nongovernment and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow users to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed data lines.

* * * *

Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1996/97* and *Compilation and Review Alert—1996/97*, which may be obtained by calling the AICPA Order Department at the number below.

Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (extension 1) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
United States Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4040 *SEC Public Reference Room* (202) 942-8090	Information Line (202) 942-8088 (ext. 3)	SEC's Homepage www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)
United States Department of Commerce	Herbert C. Hoover Building 14th Street between Pennsylvania and Constitution Avenue Washington, D.C. 20230	*General Information* (202) 482-2000 Bureau of Economic Analysis 1441 L Street, Washington D.C. 20230 (202) 606-9600		

(continued)

Information Sources *(cont'd)*

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
National Association of Retail Dealers of America	10 E. 22nd Street Lombard, Il 60148	*General Information* (708) 953-8950		
National Retail Federation	325 7th St. NW, Ste. 1000 Washington, DC 20004-2802	*General Information* (202) 783-7971		
International Mass Retail Association, Inc.	1700 North Moore Street, Suite 2250 Arlington, VA 22209	*General Information* (703) 841-2300 *Fax* (703) 841-1184		

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