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Audit Risk Alerts

Audit Risk Alert—1996/97

General Update on Auditing and Accounting Matters

Issued by the Professional Standards and Services Group

AICPA

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NOTICE TO READERS

This Audit Risk Alert is intended to provide auditors with an overview of recent technical 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 any senior technical committee of the AICPA.

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Audit Risk Alert—1996/97

Introduction

This Alert is intended to help auditors plan their 1996 year-end audits. Successful audits are a result of a number of factors, including the acceptance of clients with integrity; adequate partner involvement in planning, supervising, and performing audits; an appropriate level of professional skepticism; and the allocation of sufficient audit resources to high risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

Throughout the audit process, from the initial consideration of whether to accept a client to the issuance of the audit report, auditors should consider overall engagement risk. Engagement risk consists of the following three components:

1. *Client's business risk*—The risk associated with the entity's survival and profitability
2. *Audit risk*—The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated
3. *Auditor's business risk*—The risk of potential litigation costs from an alleged audit failure and the risk of other costs (whether an audit failure is alleged or not) such as fee realization and the effect on the auditor's reputation resulting from association with the client

Although this Audit Risk Alert does not provide a complete list of the risk factors to be considered, and the items discussed do not affect risk in every audit, it can be used as a planning tool for considering matters that may be especially significant for a specific audit. During the conduct of all engagements, auditors must remember that their paramount responsibilities are to boards of directors, shareholders, creditors, and the public. This requires traits that are the hallmarks of auditors: independence, objectivity, and integrity.

New Auditing and Attestation Pronouncements

SAS No. 78, Consideration of the Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55

In December 1995, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 78, *Consideration of the Internal*

Control in a Financial Statement Audit: An Amendment to SAS No. 55 (AICPA, *Professional Standards,* vol. 1, AU sec. 319A). SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997.

This amendment revises the definition and description of internal control contained in SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 319A), to recognize the definition and description contained in *Internal Control—Integrated Framework,* published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Report).

Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

1. Reliability of financial reporting
2. Effectiveness and efficiency of operations
3. Compliance with applicable laws and regulations

Internal control consists of the following five interrelated components:

1. Control environment
2. Risk assessment (the entity's, not the auditor's)
3. Control activities
4. Information and communication (including the accounting system)
5. Monitoring

There is a direct relationship between objectives (what an entity strives to achieve), and components (what is needed to achieve the objectives). Not all of the objectives and components listed above are relevant to an audit of financial statements. Internal control, no matter how well designed and operated, can provide only reasonable assurance regarding the achievement of an entity's objectives.

Changes in terminology introduced by the amendment to SAS No. 55 are presented in the following table.

Old Terminology	*New Terminology*
Elements (In SAS No. 55, the elements of internal control were the control environment, accounting system, and control procedures.)	Components (The five components are listed above.)
Control procedures	Control activities

Old Terminology	*New Terminology*
Internal control structure	Internal control
Policies and procedures	Controls (other than those for control activities)

At the same time that SAS No. 78 was published, the ASB also issued Statement on Standards for Attestation Engagements (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). Like SAS No. 78, the amendment conforms the description of the elements of an entity's internal control to the components of internal control contained in COSO. SSAE No. 6 is effective for examinations of management's assertion if the assertion is as of or for the period ending on December 15, 1996, or thereafter. Earlier application is encouraged.

SAS No. 79, Reporting on Uncertainties

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 eliminated the requirement that, if certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report. The Statement is effective for reports issued or reissued on or after February 29, 1996.

Before the issuance of this Statement, if the chance of a material loss resulting from the resolution of an uncertainty was at least reasonably possible, the auditor was required to consider adding an explanatory paragraph to an unqualified report describing the matter giving rise to the uncertainty and indicating that the outcome of the uncertainty could not be determined at the time. Now, if such a matter is presented and disclosed in the financial statements in accordance with generally accepted accounting principles (GAAP), the auditor should issue a standard report.

In addition to eliminating uncertainties paragraphs, SAS No. 79—

- Clarifies the guidance concerning emphasis paragraphs to indicate that such paragraphs are never required and are always optional. Emphasis paragraphs may be added to an auditor's report to emphasize a matter disclosed in the financial statements. They point to information already disclosed in the financial statements rather than introducing new information.
- Continues to allow an auditor to disclaim an opinion on financial statements because of a matter involving an uncertainty.

- Indicates that an unresolved uncertainty in the current year that gave rise to an uncertainties paragraph in the prior year does not require the addition of such a paragraph in the current year's report or retention of the paragraph in a reissued report on the prior year's financial statements.
- Does not affect the provisions of 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), which requires that an auditor add an explanatory paragraph to the auditor's report if there is substantial doubt about an entity's ability to continue as a going concern.

SAS No. 80, Amendment to Statement on Auditing Standards No. 31, *Evidential Matter*

In December 1996, the ASB issued SAS No. 80 entitled *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter. The Statement provides guidance to auditors engaged to audit the financial statements of entities for which significant information is transmitted, processed, maintained, or accessed electronically. The Statement includes examples of evidential matter in electronic form and provides that an auditor should consider the period during which electronic evidential matter will be in existence or be available in determining the nature, timing, and extent of substantive tests. In addition, the Statement indicates that an auditor may determine that in certain engagements for which 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 Statement provides that, in such circumstances, the auditor should consider performing tests of controls to support an assessed level of control risk below the maximum for affected assertions. SAS No. 80 is effective for engagements beginning on or after January 1, 1997.

In the first quarter of 1997, an Auditing Procedure Study (APS) entitled *The Information Technology Age: Evidential Matter in the Electronic Environment* will be issued. The APS provides guidance to auditors in applying SAS No. 80 by describing electronic evidence and illustrating the implications of electronic evidence on the audit and possible audit approaches. The APS includes two case studies that present approaches an auditor might use to audit the financial statements of entities for which the electronic environment and the use of information technology significantly affect information and transactions.

SAS No. 81, Auditing Investments

In December 1996, the ASB issued SAS No. 81, *Auditing Investments,* which revises the guidance on auditing investments to make that guid-

ance consistent with recently issued accounting standards, particularly Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* SAS No. 81 supersedes "Long-Term Investments" (AICPA, *Professional Standards,* vol. 1, AU sec. 332), which required updating because it is based on FASB Statement No. 12, *Accounting for Certain Marketable Securities,* an accounting standard that was superseded by FASB Statement No. 115. The new Statement also deletes interpretation no. 1, "Evidential Matter for the Carrying Amount of Marketable Securities," in "Long-Term Investments: Auditing Interpretations of Section 332" (AICPA, *Professional Standards,* vol. 1, AU sec. 9332).

SAS No. 81 is applicable to audits of financial statements that contain assertions about investments in debt securities and equity securities (as those terms are defined in FASB Statement No. 115) and investments accounted for under Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.* It also is applicable to audits of presentations covered by SAS No. 62, *Special Reports* (AICPA, *Professional Standards,* vol. 1, AU sec. 623) that contain such assertions.

The new Statement provides guidance to auditors on evaluating management's intent related to an investment and an entity's ability to hold a debt security to maturity. Such guidance is important because the intent and ability to hold a security to maturity affect the accounting for investments under FASB Statement No. 115. The Statement also contains guidance on auditing assertions about the valuation of investments, including guidance on auditing investments carried at cost and fair value.

Finally, the Statement contains guidance on evaluating other-than-temporary impairment conditions related to an investment. The auditor considers whether evidence related to factors about other-than-temporary impairment conditions corroborates or conflicts with management's conclusions. The guidance in SAS No. 81 regarding investments accounted for using the equity method of accounting is generally unchanged from the guidance contained in the previous standard.

SAS No. 81 is effective for audits of financial statements for periods ending on or after December 15, 1997, with early application permitted.

SAS No. 82, Fraud in a Financial Statement Audit

In November 1996, the AICPA's ASB voted to ballot the proposed Statement on Auditing Standards, *Consideration of Fraud in a Financial Statement Audit,* for issuance as a final Statement. The new standard

will supersede SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). The standard will provide auditors with expanded guidance on the consideration of fraud in conducting a financial statement audit. It will strengthen the auditor's ability to fulfill his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.

The standard describes the types of fraud and requires the auditor to specifically assess the risk of material fraud in every audit. It also provides separate categories of risk factors for fraudulent financial reporting (management fraud) and misappropriation of assets (theft) that require auditor consideration.

In addition, the new standard provides procedural guidance and examples of how the auditor can respond to the presence of fraud risk factors. The standard reaffirms the requirement that the auditor communicate known instances of fraud to appropriate levels of management and the audit committee and, under certain circumstances, appropriate regulators.

The AICPA's current effort regarding the detection of fraud in financial statements began in 1993. The standard is responsive to both the AICPA Board of Directors' 1993 policy statement, *Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession*, and the Public Oversight Board's recommendations in its 1993 report, *In the Public Interest*.

The ASB expects to issue the standard in the first quarter of 1997. The Statement is effective for audits of financial statements for periods ending on or after December 15, 1997. The following are some questions and answers that will assist in explaining the need for the new standard, and highlighting some of the significant changes.

1. *Q* Why is the ASB issuing a new standard on fraud?

   A The ASB is issuing the new standard to enhance auditor performance. The standard will provide auditors with expanded operational guidance on the consideration of material fraud in conducting a financial statement audit. It will aid the auditor in fulfilling his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether financial statements are free of material misstatement, whether caused by error or fraud. The standard is thus expected to drive auditor performance.

2. *Q* What does the standard require?

   A The standard requires the auditor to—

- Specifically assess the risk of material misstatement due to fraud. (The standard provides categories of fraud risk factors that the auditor should consider.)
- Respond to the results of the assessment.
- Document the fraud risk factors identified and the responses to those risk factors.

The standard also reaffirms the auditor's responsibility to communicate fraud to management, the audit committee, and, under some circumstances, appropriate regulators.

3. *Q* How will the independent auditor's responsibility for the detection of material fraud (fraud that would result in a material misstatement in an entity's financial statements) change with the new standard?

   A The auditor's responsibility will not change. The standard reaffirms the independent auditor's current responsibility, that is, to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. However, the ASB concluded that performance standards are needed to support the auditor in executing that responsibility.

4. *Q* How will the new standard affect audit fees?

   A The effect will vary. Some organizations have very strong internal control. In these organizations, management is concerned about fraud and its effects on the entity, and there are controls that are designed to prevent and detect fraud. For these organizations, the effect on audit fees will not be significant. For organizations with fraud risk factors that are not effectively addressed by management, the costs will be greater. The profession believes that the public interest benefits will outweigh the additional cost. Also, organizations concerned about such costs can take active measures to reduce them by, for example, implementing controls designed to prevent and detect fraud.

5. *Q* In what other ways will the new standard affect entities under audit?

   A The new standard will require the auditor to ask management about the risk of fraud and whether management has knowledge of fraud that has been perpetrated on or within the entity. The auditor also will be expected to communicate to manage-

ment any risk factors that the auditor identifies. This is expected to have the salutary effect of encouraging management to improve fraud prevention and detection techniques.

6. *Q* How will the new standard help the auditor?

   A The new standard describes fraud and its characteristics. It also provides examples of fraud risk factors that, when present, might indicate the existence of fraud. The standard also explains how the auditor should respond to the risk of material misstatement due to fraud.

7. *Q* How does the standard serve the public interest?

   A This new procedural guidance on fraud detection will help auditors better serve the public interest by increasing their ability to detect material misstatements in financial statements caused by fraud. The public interest is served by adding independent assurance to the credibility of financial statements upon which our capital and credit markets depend.

8. *Q* Is there a connection between this standard and the securities litigation reform legislation passed in 1995?

   A Although the new standard is not directly related to the 1995 legislation, it reminds auditors of the legislative requirements. Title III of the Private Securities Litigation Reform Act of 1995 (P.L.104-67) incorporates the auditor's present responsibility for the detection of material fraud, and shortens the time frame for reporting findings to the Securities and Exchange Commission (SEC), if such reporting is required.

The AICPA recognizes its responsibility to help auditors understand and implement this standard and is undertaking a major initiative to assist auditors in attaining that objective. This initiative will include the following.

- *Communication*—These initiatives will include a coordinated effort to inform the public and the business community about the new Statement on fraud and a series of presentations, given by members of the ASB and the Fraud Task Force, discussing the new Statement (to be held in several major United States cities in May 1997). The AICPA is also developing a video presentation of a panel of representatives from both large and small firms discussing implementation issues.
- *Implementation Guidance*—A nonauthoritative guide, to be available upon issuance of the final Statement or shortly thereafter, will provide practical guidance on implementing the new Statement. A

case study and sample nonauthoritative documentation, such as audit engagement letters and client representation letters, will be included. The guide will also identify risk factors that may be considered in assessing the risk of fraud for specific industries.

- *Training and Education*—Group and self-study courses on the auditor's consideration of fraud in a financial statement audit will be developed.
- *Additional Interpretative Guidance*—Questions and answers on issues that practitioners may face in implementing the new Statement will be developed.

A complete list of AICPA implementation efforts will be published when the new Statement is issued in the first quarter of 1997.

Auditing and Attestation Interpretations Issued in 1996

In 1996, the AITF of the ASB issued two Interpretations and an additional Interpretation will be issued in January 1997, and all three are discussed below. Interpretations are issued by the AITF to provide timely guidance on the application of ASB pronouncements and are reviewed by the ASB. An Interpretation is not as authoritative as a pronouncement of the ASB; however, practitioners should be aware that they may have to justify departures from an Interpretation if the quality of their work is questioned.

Financial Statements for General Use Only Outside of the United States in Accordance With International Accounting Standards and International Standards on Auditing. In May 1996, the AITF issued an auditing Interpretation of SAS No. 51, *Reporting on Financial Statements Prepared for Use in Other Countries* (AICPA, *Professional Standards,* vol. 1, AU sec. 534), entitled "Financial Statements for General Use Only Outside of the United States in Accordance with International Accounting Standards and International Standards on Auditing" (AICPA, *Professional Standards,* vol. 1, AU sec. 9534). The Interpretation indicates that an auditor practicing in the United States may report on the financial statements of a United States entity in conformity with the International Accounting Standards (IAS) for general use only outside of the United States. In addition, the Interpretation states that an auditor may perform an audit in accordance with the International Standards on Auditing (ISA) if the financial statements are presented in conformity with the IAS provided that the general and fieldwork standards of United States generally accepted auditing standards (GAAS) and any additional requirements of the ISA are followed.

Providing Regulators Access to Or Photocopies of Working Papers. In May 1996, the AITF issued an attestation Interpretation of SSAE No. 1, *Attestation Engagements* (AICPA, *Professional Standards,* vol. 1, AT sec. 100). The Interpretation states that Interpretation No. 1 of SAS No. 41, *Working Papers* (AICPA, *Professional Standards,* vol. 1, AU sec. 339,) entitled "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards,* vol. 1, AT sec. 9100.56–.59) applies to attestation engagements if a regulator requests access to or photocopies of working papers. Illustrative letters to a regulator for an examination and agreed-upon procedures engagements are included in the Interpretation.

Lawyers' Responses to Audit Inquiry Letters. The AITF will issue an auditing Interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards,* vol. 1, AU sec. 337) in January 1997, entitled "Use of Explanatory Language Concerning Unasserted Possible Claims or Assessments in Lawyers' Responses to Audit Inquiry Letters" (AICPA, *Professional Standards,* vol. 1, AU sec. 9337). The Interpretation indicates that the inclusion of certain explanatory comments to emphasize the preservation of the attorney-client privilege, in responses by lawyers to audit inquiry letters, does not result in an audit scope limitation. The Interpretation also reminds auditors of the requirement in SAS No. 12 to obtain the lawyer's acknowledgment of his or her responsibility to advise and consult with the client concerning financial statement disclosure obligations for unasserted possible claims or assessments.

Developments in Quality Control and Peer Review

New Statements on Quality Control Standards

In May 1996, the ASB issued two new Statements on Quality Control Standards (SQCS), Nos. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards,* vol. 1, QC sec. 20), and 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards,* vol. 2, QC sec. 30). The new Statements supersede SQCS No. 1, *System of Quality Control for a CPA Firm* (AICPA, *Professional Standards,* vol. 2, QC sec. 10), and provide guidance for developing a system of quality control for a firm's accounting and auditing practice.

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 Ac-

counting and Review Services Committee (ARSC) under Rules 201 and 202 of the AICPA *Code of Professional Conduct,* and any other professional standards that may be issued by the aforementioned standard setters in the future. Before the issuance of SQCS No. 2, attestation services were not specifically addressed in the quality control standards because the SSAEs had not been issued when SQCS No. 1 was promulgated. The revised definition now makes it clear that attestation services must be included in a firm's quality control system.

SQCS No. 2 replaces the nine elements of quality control presented in SQCS No. 1 with five broad elements of quality control. It does not establish any new elements but instead combines and renames the previous elements as shown in the following table.

Old *Nine Elements of SQCS No. 1*	*Change*	*New* *Five Elements of SQCS No. 2*
Independence	The independence element is expanded to include integrity and objectivity. Firms are now required to establish policies and procedures assuring that personnel perform all professional responsibilities with integrity and maintain objectivity while performing those responsibilities.	Independence, integrity, and objectivity
• Hiring • Advancement • Assigning personnel to engagements • Professional development	Four elements are combined into a single element. This element also adds a requirement that firms establish policies and procedures to meet the continuing professional education requirements of the AICPA and regulatory agencies.	Personnel management
Acceptance and continuance of clients	The name of this element is modified because SQCS No. 2 requires that firms consider the acceptance of client engagements in addition to considering client relationships. SQCS No. 2 also requires a firm to establish policies and procedures that	Acceptance and continuance of clients and engagements

(continued)

Old Nine Elements of SQCS No. 1	*Change*	*New Five Elements of SQCS No. 2*
	provide reasonable assurance that a firm will accept only those engagements it can complete with due professional competence. Firms also must have policies and procedures in place requiring them to obtain an understanding with their client of the nature, scope, and limitations of the services they will perform.	
• Supervision • Consultation	These two elements are combined and referred to as activities within the new element of engagement performance.	Engagement performance
Inspection	*Monitoring* is defined as an ongoing consideration and evaluation relating to the design and application of each of the other elements of quality control. Inspection becomes subsumed under the new element of monitoring. SQCS No. 3 provides guidance on how a CPA firm can monitor its accounting and auditing practice.	Monitoring

SQCS Nos. 2 and 3 are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997. Firms with well-established quality control systems should not have to make significant modifications to their policies and procedures as a result of the issuance of these new standards.

To help firms implement the new standards, a booklet entitled *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* has been issued. The guide includes illustrative examples of four hypothetical firms and the suggested policies and procedures for the design and maintenance of a quality control system that is appropriate for each firm's accounting and auditing practice. A firm's policies and procedures should be sufficient for it to obtain reasonable assurance of complying with the requirements of SQCS Nos. 2 and 3, and the illustrative examples depict

various types of policies and procedures that a firm may consider for each of the elements of quality control.

Standards for Performing and Reporting on Peer Reviews

The AICPA Peer Review Board (the Board) has voted to ballot for final issuance a proposed standard that updates the "Standards for Performing and Reporting on Peer Review" (AICPA, *Professional Standards*, vol. 2, PR sec. 100) to reflect the recently issued SQCS Nos. 2 and 3 discussed on page 14 of this Audit Risk Alert. In addition, the Board believes there was a need to reevaluate the overall guidance provided in the standards.

The following are some of the significant provisions of the new standard.

- The new standard expands the definition of an accounting and auditing practice for the purposes of performing and reporting on a peer review to include attest services on financial information if the firm audits, reviews, or compiles the historical financial statements of the client.
- A firm that performs any engagement covered by the Statement on Auditing Standards must have an on-site peer review. This means that if the only engagements performed by a firm are engagements to apply agreed-upon procedures under 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), the firm would be required to have an onsite peer review. SAS No. 75 is applicable if a practitioner applies agreed-upon procedures to specified elements, accounts, or items of a financial statement, such as accounts receivable aged over thirty days, average monthly sales, or the amounts included in the property and equipment account.
- The restriction prohibiting a team captain from serving in that capacity for more than two successive reviews of the same firm is eliminated. The responsibility for determining when and whether it is appropriate to rotate reviewers is placed in the hands of the reviewed firm. As a result, the new standard does not restrict the number of successive reviews a firm or individual may perform.
- The peer review is to be planned and performed using a risk-based approach in the same way that an audit is planned and performed using a risk-based approach. Examples of factors to consider in a risk-based approach include the size of the entity, the industry in which the entity operates, the level of service being performed, entity personnel, litigation in the industry in which the entity operates, and whether the engagement is an initial engagement.

The effective date of the proposed standard is for peer reviews with year ends beginning on or after January 1, 1997.[1]

Responding to Peer Review Letters of Comments

During fieldwork in a peer review, the reviewer will inform the reviewed firm of any deficiencies noted during the peer review, and generally will note those deficiencies on a form entitled "Matter for Further Consideration" (MFC). The reviewed firm will have the opportunity to discuss the identified deficiencies during the peer review and to respond in writing concerning the deficiencies on the response section of the MFC form. Because peer review is a subjective process, there may be differences of opinion between the reviewer and the reviewed firm as to whether a deficiency exists that is not resolved to the reviewed firm's satisfaction. In such circumstances, the reviewed firm should ask the reviewer to cite the applicable section of the professional standards or the reviewed firm's policies that support the reviewer's conclusion that a deficiency exists. Ordinarily, such matters are resolved before the exit conference. If the reviewed firm is still dissatisfied with the reviewer's conclusions, the reviewer or reviewed firm should consult with the entity administering the peer review or the AICPA Peer Review Program at (201) 938-3030. If the matter is not resolved through consultation, the reviewed firm should respond to the reviewer's letter of comments by addressing each deficiency noted and citing the section of the professional standards that supports the reviewed firm's view. The state CPA society peer review committee, or the SEC Practice Section Peer Review Committee, if applicable, will then attempt to resolve the disagreement.

Many professional standards require the use of professional judgment; accordingly, a reviewed firm should not assume that the reviewer's interpretation is always the correct one. If a reviewer identifies deficiencies in an engagement, it is in the reviewed firm's best interest to read the applicable section of the standards to broaden his or her knowledge of the subject and to verify that the comment is applicable to that particular situation.

Audit Issues and Audit Problems to Watch For

Revenue Recognition

Improper revenue recognition continues to be a primary cause of misstated financial statements, and sometimes these misstatements are intentional. This problem continues to arise in litigation involving high

[1] This is a revised effective date. The effective date in the exposure draft of the proposed standard was for peer reviews beginning on or after January 1, 1997.

technology clients. The use of side agreements that relieve the customer of some of the customary risks and rewards of ownership is frequently associated with improper revenue recognition. Examples of such practices are shipping merchandise to customers without proper authorization from the customer, shipping merchandise to company-owned warehouses and billing fictitious customers, and making sales arrangements that obligate the customer to pay only upon resale.

Because very few individuals within the client organization may be aware of side agreements, it is often difficult to discover their existence. If accounting and financial personnel are not aware of side agreements, management representations and standard audit procedures in the revenue and accounts receivable areas will not be an adequate audit response to this problem.

If there is a significant risk of undisclosed side agreements, in addition to confirming account balances and material revenue transactions, the auditor should confirm relevant contract terms with customers to obtain assurance that side agreements do not exist. Such confirmations should be addressed to the contract signer and not to the accounts payable department.

Updating Legal Letters

SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* requires the auditor to ask his or her client to send a letter of audit inquiry to the client's lawyer to corroborate information furnished by management concerning litigation, claims, and assessments. The latest date of the period covered by legal counsel's response should be as close to the completion of fieldwork as is practicable in the circumstances. The timing of the auditor's request should be carefully planned to assure that this is accomplished. However, if completion of the fieldwork has been delayed, or for other reasons the attorney's response date is significantly earlier than the date of the completion of fieldwork, the auditor should request that the attorney update his or her response. An oral update, documented in the audit working papers, may be acceptable if there have been no changes from the previously received letter, or if any changes that have occurred are relatively simple and straightforward (the lawsuit was dismissed or settled at no cost to the client). However, for important matters discovered in oral updates, including new litigation or significant additional matters relating to prior litigation, it is good practice to confirm these in writing.

Undisclosed Related Parties and Related-Party Transactions

Auditors should be alert to indicators of undisclosed related-party transactions that may be a source for fraudulent financial reporting. Indicators of possible undisclosed related parties include the following:

- A complex corporate structure with restrictions on the disclosure of ownership or the identity of shareholders
- Entities that conduct material intercompany transactions with each other and that are audited by different firms
- Highly complex business practices that facilitate management's ability to mask their economic substance
- The existence of unique, highly complex, and material transactions that pose difficult questions relating to their business purpose

Examples of transactions that might indicate previously undisclosed related parties include the following:

- Significant and unusual transactions at or near year end, particularly those for which significant income is recognized, even if the full sales proceeds have been remitted
- Significant purchases from new suppliers or sales to new customers during the course of the year that seem unusual as to location, quantity, price, or terms
- Borrowings from unusual sources at below-market interest rates
- Sales or nonmonetary exchanges of recently acquired noncurrent assets such as wine or works of art at significant gains (Such assets, if they appreciate in value at all, tend to do so over a long period.)

The AICPA's Division for CPA Firms—Professional Issues Task Force has issued Practice Alert No. 95-3 entitled *Auditing Related Parties and Related-Party Transactions*. This Practice Alert describes how related parties may be used to commit and conceal fraud, provides guidance on identifying related parties and related-party transactions that are not voluntarily disclosed by management, and provides guidance on how to respond to a heightened risk of the use of related parties to commit fraud. The Practice Alert appears in the November 1995 issue of *The CPA Letter*.

Discontinued Operations

Accounting for discontinued operations with a measurement date after the balance-sheet date but before the issuance of the financial statements is controversial. Emerging Issues Task Force (EITF) Consensus Position No. 95-18 describes the appropriate GAAP accounting. In summary, the EITF concluded that the following presumptions exist if a loss is expected from the planned disposal of a segment.

1. The estimated loss, as determined in accordance with APB Opinion 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,* should be recognized in the not-yet-issued financial statements for the period prior to the measurement date.
2. The segment should be presented as a discontinued operation in the income statement of the not-yet-issued financial statements.

If a gain is expected, or if the loss presumption is overcome, the segment's operating results should be shown as discontinued operations.

Management Reports on Internal Control Over Financial Reporting

As in the past, annual reports to shareholders this year may include comments by management about its responsibility for the financial statements and internal control over financial reporting. Interpretation No. 3, "Other References by Management to the Internal Control Structure Over Financial Reporting, Including References to the Independent Auditor," of SAS No. 8, "Other Information in Documents Containing Audited Financial Statements" (AICPA, *Professional Standards,* vol. 1, AU sec. 9550), generally prohibits management from stating in its management report or elsewhere in the document that the auditor has not identified any material weaknesses in internal control in connection with the audit unless a separate, full examination of internal control has been performed and a report has been issued in accordance with SSAE No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards,* vol. 1, AT sec. 400).

If the annual report contains an assertion by management about the effectiveness of the entity's internal control over financial reporting that implies the auditor's endorsement of the assertion, and the auditor has not been engaged to examine that assertion, the auditor should request that management revise the wording of the assertion. In the rare instances in which the client does not agree to revise the wording, the auditor should follow the guidance in paragraph 6 of SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 550), which indicates that the auditor should notify the client in writing about his or her concerns, and consult with legal counsel about additional actions.

Predecessor/Successor Auditor—Access to Working Papers

SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards,* vol. 1, AU sec. 315), indicates that a

predecessor auditor ordinarily should permit a successor auditor to review working papers relating to matters of continuing accounting significance. Frequently, predecessor auditors request that the successor auditor agree, in writing, to certain conditions concerning the use of the predecessor's working papers. Such agreements are designed to protect the predecessor auditor from litigation that may result from information obtained from the predecessor's working papers.

Although the ASB has not reached a conclusion on this matter, several public accounting firms believe that the use of this type of written agreement better serves the public interest and the profession. The use of a written agreement in practice has provided successor auditors with greater access to the predecessor auditor's working papers. Greater access can assist a successor auditor in identifying and evaluating audit risk when planning a first-time audit. Also, broader access to working papers could have a favorable effect on the profession's litigation experience, particularly in light of the fact that many claims are related to audits performed in the first or second year of a client relationship.

Following are examples of items that a predecessor auditor might request a successor auditor to agree to in writing concerning the use of the predecessor's working papers.

- The review of the predecessor's working papers is undertaken solely for the purpose of obtaining an understanding about the client and certain information about the predecessor's audit.
- Due to the successor's limited access to the predecessor's working papers, the successor will not comment orally or in writing to anyone as a result of the review as to whether the engagement was performed in accordance with GAAS.
- The successor will not provide expert testimony or litigation support services, or accept an engagement to comment on issues relating to the quality of the predecessor's audit, and will not use the audit procedures or results thereof documented in the predecessor's working papers as evidential matter in rendering his or her opinion except as contemplated in SAS No. 7.
- The successor understands the purpose for which the working papers were prepared, and does not intend to rely upon the audit results documented therein as part of the audit evidence in rendering an opinion on the current-year financial statements.
- The successor agrees to subject any copies of the working papers obtained from the predecessor to his or her working paper retention policy.

- The successor will obtain permission before voluntarily allowing any third-party access to the working papers and information otherwise derived from them and will obtain on behalf of the predecessor any releases that the successor may have obtained by such third parties.
- The successor will provide the predecessor with copies of any subpoena, summons, or other court order for access to the working papers that include copies of the working papers provided by the predecessor auditor or information otherwise derived therefrom.

The Wrong "Tone at the Top" Can Lead to Fraudulent Financial Reporting

Here is an example of how one company's pursuit of double-digit sales and earnings growth got out of hand.

The company, a manufacturer and distributor, enjoyed over a decade of double-digit growth in sales and earnings. However, insistence by top management on maintaining that growth rate resulted in practices by certain divisions that appeared to have led to falsified financial statements.

Apparently, the message from the top was to achieve the numbers at all costs. The pressure to achieve management's sales forecasts was fueled by unrelenting criticism of those who failed to achieve the targets, and a bonus plan that punished those who fell even slightly below budget while generously rewarding those who exceeded the budget. Bonus computations gave little weight to controlling assets such as receivables and inventories. Further, in some instances, the failure to meet the targeted goals may have resulted in dismissal. Top management and its auditors ultimately were alerted to these activities by the soaring receivables in the various divisions. Some of the alleged practices that led to inflated sales are highlighted in the following.

- In December 1993, a meeting was held with a number of the company's wholesale distributors at which they were allegedly instructed to take huge stocks of old inventory (up to two years' worth) or lose their exclusive distributorships. However, at the same time many of the distributors were told verbally that they would not have to pay for the merchandise until they in turn had sold it (a form of *side agreement*). The result—millions of dollars of sales booked in the final days of 1993, with much of the merchandise returned in 1994.
- In addition to offering extended payment terms and rebates for large orders, one division would ship merchandise that was not

even ordered (there were no purchase orders) and book the shipments as sales.

- In one of the foreign locations, to achieve sales targets, the manager prepared invoices showing false sales to distributors and shipped millions of dollars of merchandise to a warehouse. This scheme unraveled when the accounts receivable jumped so significantly that the company had to investigate. The company's auditors later discovered that the goods were still on hand.

A careful assessment of the control environment, particularly the emphasis that top management places on the bottom line and how management motivates lower level executives and employees to meet targeted results, coupled with a careful analysis of the financial statements, may identify a heightened risk of fraud.

Audit Communication and Reporting Issues

Going Concern

As required by GAAS, auditors should assess in every audit, the entity's ability to continue as a going concern for one year from the date of the audited balance sheet. Examples of conditions or events that might raise doubts about an entity's ability to continue as a going concern include the following:

- Negative cash flow from either current operations or forecasted results for the coming year
- Declining revenues accompanied by losses from continuing operations
- Adverse key financial rations such as negative net worth or negative working capital
- Loss of or significant declines in orders from major customers
- Noncompliance with statutory capital requirements
- Lawsuits or other significant loss contingencies such as those related to environmental or uninsured catastrophic events
- Loan defaults
- Preferred dividend arrearages
- Denial of the usual trade credit from suppliers

- Departures of key personnel, for example, the departure of a top research scientist from a biotech firm.

If the auditor believes that the presence of one or more conditions or events raises a question as to the validity of the going-concern assumption, ordinarily the key audit issue is whether management's plans, if any, for addressing the problem are appropriate and achievable. If management's plans relate primarily to the success of future normal operations for the coming year, the auditor should review the assumptions underlying management's forecast and become satisfied that the forecasted results are reasonable in light of past experience and that any significant differences are suitably supported. If management's plans relate primarily to the disposition of assets, or another single event (for example, signing up a major new customer), the auditor should consider whether sufficient evidence currently exists (for example, the existence of an identified financially capable and committed buyer or customer) to enable the auditor to conclude that it is more likely than not that management will be successful.

If the auditor still has substantial doubt about the entity's ability to continue as a going concern, the report language should be unequivocal. Auditors should not use conditional language in expressing substantial doubt about an entity's ability to continue as a going concern. Examples of inappropriate conditional language include, "If the company continues to incur operating losses, there may be substantial doubt . . ." or "The company has been unable to renegotiate its expiring credit agreements; unless the company is able to obtain financial support there is substantial doubt . . ." Guidance on the appropriate language for a going-concern explanatory paragraph is provided in paragraphs 13 and 14 of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.*

Lessons from Litigation

Not every financial disaster befalling a client is the result of an audit failure, even though all too frequently the auditor is sued because the audit firm is perceived to have failed to properly perform its work diligently and because the investors or creditors want to "bail out" of a bad decision. On the other hand, there are audit failures.

Audit failures continue to be uncovered with startling regularity. In many cases, the presumed audit failure relates to situations in which management has decided to account for certain transactions incorrectly and to withhold that decision from the auditors. In other cases,

management initiates and perpetrates a fraud for its own benefit. Auditors need to increase their diligence to uncover situations in which management is deliberately misstating the books and records.

The following are some of the more common audit issues identified in litigation and audit failures:

- Willingness to accept management's representations without corroboration
- Allowing the client to unduly influence the scope of the auditing procedures
- Accepting the accounting for transactions, especially revenue recognition, without thoroughly understanding relevant GAAP or all the facts surrounding the transactions
- Failure to obtain and read contracts
- Failure to identify risky situations, or ignoring identified audit risks, by not applying professional skepticism and revising auditing procedures appropriately
- Not examining year-end transactions critically
- Ignoring or failing to understand the client's business, including its distribution channels and the environment in which it operates
- Misusing the summary of unadjusted differences to justify accounting that is wrong and should be corrected
- Not using specialists in such fields as insurance, pensions, and derivatives
- Accepting accounting estimates at the low (but acceptable) end of a range without extending auditing procedures or communicating the matter to the audit committee

A number of these cases involve either management fraud or deliberate deceit by management in working with auditors. Nevertheless, there may be signs of material errors or fraud that under GAAS should lead the auditors to perform additional procedures. Perhaps, if the auditor extends the auditing procedures or takes a firmer stance earlier, many of the failures would be avoided.

Analysis of International Standards on Auditing

An auditor practicing in the United States may be engaged to audit financial statements in accordance with International Standards on Auditing (ISAs) (AICPA, *Professional Standards*, vol. 2, AU sec. 8100–10,090). In such circumstances, the U.S. auditor should comply with

both the ISA and the SASs. An engagement of this nature is ordinarily conducted by performing an audit in accordance with U.S. auditing standards and then performing any additional procedures required by the ISAs. To help auditors perform such engagements, an analysis has been prepared that identifies the sections and paragraphs of the ISAs that contain procedural or documentation requirements that go beyond the requirements of U.S. auditing standards or that conflict with U.S. standards. A brief description of how the international standard differs from the U.S. standard is also provided. The analysis is entitled *Analysis of International Standards on Auditing* and is appendix B of the "Statements on Auditing Standards" (AICPA, *Professional Standards*, vol. 1, appendix B).

Recent GAAP Pronouncements

Authoritative Pronouncements Becoming Effective in 1996

A number of authoritative accounting pronouncements, issued before 1996, have delayed effective dates for certain reporting entities and will be implemented for the first time in 1996 by those entities. Following is a brief overview of a number of the pronouncements becoming effective in 1996 that auditors should be aware of. When applying these pronouncements, auditors should refer to the complete professional standard.

FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, extends existing fair-value disclosure practices for some instruments by requiring all entities to disclose 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 the disclosure of descriptive information pertinent to estimating the value of a financial instrument. Appendix A of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, provides examples of instruments that are included in and excluded from the definition of a financial instrument. Statement No. 107 is effective for financial statements issued for fiscal years ending after December 15, 1992, except for entities with less than $150 million in total assets. For those entities, the effective date is for fiscal years ending after December 15, 1995.

FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, and FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, are both effective for fiscal years beginning after December 15, 1994, except for not-for-profit organizations with

less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. Statement No. 116 establishes accounting standards for contributions and applies to all entities that receive or make contributions. Generally, contributions received, including unconditional promises to give, are recognized as revenues in the period received at their fair values. Contributions made, including unconditional promises to give, are recognized as expenses in the period made at their fair values. Conditional promises to give, whether received or made, are recognized when they become unconditional, that is, when the conditions are substantially met. The Statement allows certain exceptions for contributions of services and works of art, historical treasures, and similar assets.

FASB Statement No. 117 establishes standards for general-purpose external financial statements provided by not-for-profit organizations. It requires that those statements include a statement of financial position, a statement of activities, and a statement of cash flows. It also requires the classification of an organization's net assets and its revenues, expenses, gains, and losses based on the existence or absence of donor-imposed restrictions. For implementation guidance on FASB Statement Nos. 116 and 117, refer to the article entitled "Implementing FASB 116 and 117," that recently appeared in the *Journal of Accountancy*.[2]

FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, requires disclosures about the amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. It also amends FASB Statement Nos. 105 and 107 to require that distinction in certain disclosures required by those Statements. FASB Statement No. 119 is effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets. For those entities, the Statement is effective for financial statements issued for fiscal years ending after December 15, 1995. For additional guidance on derivatives and FASB Statement No. 119, refer to the following:

[2] Benson, Martha L , Alan S. Glazer, Henry R. Jaenicke, and Kenneth D. Williams,"Implementing FASB 116 and 117," *Journal of Accountancy* (New York: AICPA, September 1995).

- Winograd, Barry N., and Robert H. Herz. "Derivatives: What's an Auditor to Do?" *Journal of Accountancy* (New York: AICPA, June 1995).
- Molvar, Roger H.D., and James F. Green. "The Question of Derivatives." *Journal of Accountancy* (New York: AICPA, March 1995).
- *Derivatives—Current Accounting and Auditing Literature,* A Report Prepared by the Financial Instruments Task Force of the Accounting Standards Executive Committee, AICPA.

FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* requires that long-lived assets and certain identifiable intangibles (including goodwill) to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. In performing the review for recoverability, the entity should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset. The Statement 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 cost to sell, except for assets that are covered by APB Opinion 30. Assets that are covered by APB Opinion 30 will continue to be reported at the lower of carrying amount or net realizable value. FASB Statement No. 121 is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is not permitted. Impairment losses resulting from the application of the Statement should be reported in the period in which the recognition criteria are first applied and met. The initial application of the Statement to assets that are being held for disposal at the date of adoption should be reported as the cumulative effect of a change in accounting principle.

FASB Statement No. 122, *Accounting for Mortgage Servicing Rights,* was issued in May 1995 and amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* to require that mortgage banking enterprises capitalize the cost of purchased and originated mortgage servicing rights as part of the cost of a mortgage loan and, for mortgage loans sold with servicing rights retained, allocate the cost of the loan between the servicing rights and the loan without the servicing rights based on the relative fair values of each of the components.

The gain or loss on the sale of the loan is equal to the sales proceeds less the allocated cost of the mortgage loan; any cost allocated to the mortgage servicing rights is recognized as a separate asset. The Statement also includes guidance on estimating the fair values of the components and accounting for the impairment of the capitalized mortgage serving rights and expands the disclosure requirements of FASB Statement No. 65. The provisions of the Statement are to be applied prospectively in fiscal years beginning after December 15, 1995; special transition provisions apply.

FASB Statement No. 123, *Accounting for Stock-Based Compensation,* applies to all transactions in which an entity acquires goods or services by issuing equity instruments or by incurring liabilities to a supplier (an employee or nonemployee) in amounts based on the price of the entity's common stock or other equity instruments. The Statement provides a choice of accounting methods for transactions with employees that are within the scope of APB Opinion 25, *Accounting for Stock Issued to Employees.* It presents a fair-value based method of accounting for employee stock options or similar equity instruments and encourages all entities to adopt that accounting method for all their employee stock compensation plans. Under the fair-value method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. Entities having transactions with employees that are within the scope of APB Opinion 25 may continue to measure compensation cost under that standard. However, if they choose that measurement option, they must make pro forma disclosures of net income and, if presented, earnings per share, as if the fair-value based method of accounting presented in FASB Statement No. 123 had been applied. The fair-value method is preferable to the method presented in APB Opinion 25 for purposes of justifying a change in accounting principle under APB Opinion 20, *Accounting Changes.* Equity instruments issued to acquire goods and services from nonemployees should be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. The Statement is generally effective for fiscal years beginning after December 15, 1995; special transition provisions apply.

FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations,* establishes standards for accounting for certain investments held by not-for-profit organizations. It requires that investments in equity securities with readily determinable fair values and all investments in debt securities be reported at fair value with gains and losses included in a statement of activities. The Statement requires disclosures about investments held by not-for-profit organizations and the return on those investments. The Statement also estab-

lishes standards for reporting losses on investments held because of a donor's stipulation to invest a gift in perpetuity or for a specified term. The Statement is effective for annual financial statements issued for fiscal years beginning after December 15, 1995. Earlier application is encouraged. The Statement is applied either by restating the financial statements of all prior years presented or by recognizing the cumulative effect of the change in the year of the change. The expiration of restrictions on previously unrecognized net gains may be recognized prospectively.

FASB Interpretation No. 42, "Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power," interprets paragraph 4 of FASB Statement No. 116. Paragraph 4 of FASB Statement No. 116 states, "This Statement does not apply to transfers of assets in which the reporting entity acts as an agent, trustee, or intermediary, rather than as a donor or donee." FASB Interpretation No. 42 clarifies that an organization that receives assets acts as a donee and a donor, rather than as an agent, trustee, or intermediary, if a resource provider specifies a third-party beneficiary or beneficiaries and explicitly grants the recipient organization the unilateral power to redirect the use of the assets away from the specified beneficiary or beneficiaries (variance power). The Interpretation is effective for financial statements issued for fiscal years ending after September 15, 1996. Earlier application is encouraged. The Interpretation may be applied either retroactively or by reporting the cumulative effect of the change in the year of the change.

Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations,* amends and makes uniform the guidance on reporting of related entities in the AICPA Audit and Accounting Guides *Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations,* and in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations.* SOP 94-3 provides that the decision as to whether the financial statements of a reporting not-for-profit organization and those of one or several other entities (either not-for-profit organizations or business entities) are to be consolidated should be based on the nature of the relationship between the entities. That relationship also affects the disclosures that the reporting organization is required to make. The guidance in SOP 94-3 focuses on investments in majority-owned for-profit subsidiaries and financially interrelated not-for-profit organizations. SOP 94-3 is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. Earlier application is permitted.

For organizations that adopt FASB Statement No. 117 before its effective date, earlier application of the SOP is encouraged.

Practice Bulletin No. 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships,* provides guidance on applying existing accounting literature to limited liability companies (LLCs) and limited liability partnerships (hereinafter referred to as limited liabilities companies or LLCs).[3] LLCs combine the limited liability aspect of corporations with the flow-through tax attributes of partnerships. Because an LLC is formed under state law, its characteristics may vary depending on the state in which it is organized. However, LLCs generally have the following characteristics:

- An LLC is an unincorporated association of two or more "persons."
- Its members have limited personal liability for the debts and obligations of the entity.
- It is classified as a partnership for federal income tax purposes and thus lacks at least two of the four corporate characteristics which include limited liability, free transferability of interests, centralized management, and continuity of life.

Practice Bulletin No. 14 is effective for financial statements issued after May 31, 1995.

Authoritative Accounting Pronouncements Issued in 1996

The following tables list various authoritative accounting pronouncements issued from January 1, 1996, to November 1, 1996, and their effective dates.[4] To order copies, call the FASB at (203) 847-0700, ext. 10.

FASB Statements of Financial Accounting Standards and Interpretations

Description		*Effective Date*
FASB Statement No. 125	*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*	For transfers and servicing of financial assets and extinguishments of liabilities occurring after

[3] SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards,* vol. 1, AU sec. 411), identifies AICPA practice bulletins as authoritative ("must know") accounting principles.

[4] See the Audit Risk Alert *State and Local Governmental Industry Developments—1996* for recently issued Statements of the Governmental Accounting Standards Board.

Description		Effective Date
		December 31, 1996; should be applied prospectively
FASB Interpretation No. 42	*Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power*	For financial statements issued for fiscal years ending after September 15, 1996; earlier application is encouraged

EITF Consensus Positions

EITF Issue No.	Description	Date of Consensus
96-1	*Sale of Put Options on Issuer's Stock That Require or Permit Cash Settlement*	January 18, 1996
96-3	*Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services under FASB Statement No. 123*	March 21, 1996
96-4	*Accounting for Reorganizations Involving Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners*	May 23, 1996
96-5	*Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination*	March 21, 1996
96-7	*Accounting for Deferred Taxes on In-Process Research and Development Activities Acquired in a Purchase Business Combination*	May 23, 1996
96-8	*Accounting for a Business Combination When the Issuing Company Has Targeted Stock*	May 23, 1996

(continued)

EITF Issue No.	Description	Date of Consensus
96-10	*Impact of Certain Transactions on the Held- to-Maturity Classification under FASB Statement No. 115*	May 23, 1996
96-11	*Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115*	May 23, 1996
96-14	*Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*	July 18, 1996
96-17	*Revenue Recognition under Long-Term Power Sales Contracts That Contain both Fixed and Variable Pricing Terms*	September 18–19, 1996
96-21	*Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*	September 18–19, 1996
96-22	*Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan is Restructured in a Troubled Debt Restructuring into Two (or More) Loans*	September 18–19, 1996

SOP 96-1, Environmental Remediation Liabilities

In October 1996, the AcSEC issued SOP 96-1, *Environmental Remediation Liabilities,* which provides accounting guidance for the recognition, measurement, display, and disclosure of environmental remediation liabilities. The Statement of Position requires that environmental remediation liabilities be accrued when the criteria in FASB Statement No. 5, *Accounting for Contingencies,* are met. The Statement of Position includes benchmarks to aid in the determination of when environmental remediation liabilities should be recognized in accordance with FASB Statement No. 5. Examples of such benchmarks are when an entity is identified as a potentially responsible party (PRP) and when a feasibility study is completed. The Statement of Position also requires that the

accrual for environmental remediation liabilities include the incremental direct costs of the remediation effort and the costs of compensation and benefits for employees who are expected to devote a significant amount of time directly to the remediation effort, to the extent of the time expected to be spent directly on the remediation effort. The measurement of the liability should—

- Include the entity's allocable share of the liability for a specific site, and the entity's share of amounts that will not be paid by other PRPs or the government.
- Be based on enacted laws and existing regulations and policies, and on the remediation technology that is expected to be approved to complete the remediation effort.
- Be based on the entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed. The measurement may be discounted to reflect the time value of money if the aggregate amount of the liability or component of the liability and the amount and timing of the cash payments for the liability or component are fixed or reliably determinable.

The Statement of Position also provides guidance on the display of environmental remediation liabilities in financial statements and on the disclosures about environmental-cost-related accounting principles, environmental loss contingencies, and other loss contingency considerations. In addition to the accounting guidance, the document also contains a nonauthoritative section describing major federal legislation dealing with pollution control (responsibility) laws and environmental remediation (cleanup) laws and the need to consider various state and non-U.S. government requirements. The provisions of the Statement of Position are effective for fiscal years beginning after December 15, 1996. Earlier application is encouraged. The effect of initially applying the Statement of Position should be reported as a change in accounting estimate. Restatement of previously issued financial statements is not permitted.

The Environmental Issues Task Force of the ASB has drafted auditing guidance on planning, performing, and reporting on an audit of financial statements as it relates to auditing environmental remediation liabilities. The guidance is included in an appendix of the SOP 96-1 that is entitled "Auditing Environmental Remediation Liabilities." The following are some of the topics included in that appendix.

- Environmental-related matters the auditor should obtain knowledge of when planning an audit, including knowledge about the industry the entity operates in, the types of products or services

the entity provides, the number and characteristics of the entity's locations, applicable governmental regulations, and the entity's production and distribution processes.

- Questions an auditor might ask of entity personnel to obtain an understanding of potential environmental remediation liabilities to which an entity might be exposed. Examples follow. What controls are in place to identify potential environmental remediation liabilities or related contingencies affecting the entity? Are landfills or underground storage tanks used to store or dispose of environmentally hazardous waste?
- Substantive audit procedures the auditor might perform to audit management's estimate of environmental remediation liabilities, such as, reviewing and testing the process used by management to develop the estimate, developing an independent expectation, using the work of a specialist, making inquiries of a client's lawyer, and obtaining client representations.
- The effects of various audit findings on the auditor's report.

Standards Overload Report

Managing the information overload that results from the large number of standards in existence, the continuous development of new standards, and the amendment of existing standards makes the work of a CPA extremely difficult. In August 1996, the AICPA's Private Companies Practice Section Special Task Force on Standards Overload completed its report containing recommendations as to the actions that should be taken to address the problem of standards overload. The task force was composed of CPAs from small firms who provide financial-statement services primarily to small nonpublic entities. The following are some of the recommendations that were made by the task force.

1. *Increase small-firm input in the standard-setting process.* Standard-setters should be made aware of the unique problems certain standards pose for small entities, such as the high cost of capturing and generating certain financial information, and the irrelevancy of certain required financial-statement disclosures to the users of the financial statements of small entities. Small CPA firms are less likely than large firms to be able to allocate resources to the formal consideration of proposed standards and may require assistance in expressing their views on proposed standards. One way to assist small firms in expressing their views is to increase the effectiveness and visibility of the AICPA's Technical Issues

Committee (TIC), which has primary responsibility for communicating the views of small CPA firms and their clients to standard setters. The task force recommends that the TIC be assigned an additional staff person to serve as a liaison between the TIC and the standard-setting bodies and to assist the TIC in expressing its views on the potential effects of specified standards on small businesses.

The Financial Accounting Foundation should make a concerted effort to recruit and select trustees, FASB members, and FASB staff persons who have experience with and understanding of the needs of small nonpublic entities.

2. *Facilitate access to the professional literature and improve the understandability of that literature.* To help CPAs keep abreast of new standards as they are issued, and understand and apply those standards, the AICPA should—

   - Provide members with all of the relevant codified professional and accounting standards and other important literature, such as Emerging Issues Task Force (EITF) consensuses, and Audit and Accounting Guides, in a single CD-ROM format. The product should be reasonably priced, easy to learn, well-indexed, and contain an effective search capability so that it serves as an effective research tool.[5]

   - Provide members with the option of ordering a minimum library package of professional standards, in soft cover, at the time they renew their annual AICPA memberships. This could be implemented by providing a checkoff option on the annual dues statement.

   - Expand the staff and hours of the AICPA Technical Information Hotline, which provides answers to accounting, auditing, and attestation questions, as well as to questions related to compilation and review engagements. The Technical Informa-

[5] Practitioners Publishing Company (PPC) and the AICPA are currently offering on one CD-ROM disk, entitled *The Practitioner's Library—Accounting and Auditing,* publications issued by PPC, the AICPA, and the FASB. The disk contains the following publications issued by the FASB: *Original Pronouncements, Current Text, Emerging Issues Task Force Abstracts,* and *FASB Implementation Guides;* and the following publications issued by the AICPA: *Professional Standards, Technical Practice Aids, Audit and Accounting Guides* (available April 1997), and *Peer Review Program Manual* (available January 1997). The disk also contains eighteen PPC engagement manuals. The disk may be customized so that purchasers pay for and receive only selected segments of the material. For more information about this product call (800) 323-8724.

tion Hotline provides important technical consultation services to CPAs in small firms, and, for many CPAs, serves as the only contact with the AICPA.

- Publish articles in the *Journal of Accountancy* that present new accounting standards in a succinct and understandable format and that contain examples and journal entries elucidating the application of the standard to situations that are relevant to small entities. Each article should be followed by a self-study examination on the new standard that may be submitted to the AICPA for CPE credit at a nominal cost.
- Enable CPAs to obtain copies of professional standards and other technical pronouncements for a fee through the AICPA 24-Hour Fax Hotline or via the computer.
- Draft standards using language that is unambiguous and easy to understand, and when accounting matters require a high degree of subjectivity, provide examples of appropriate options. Pivotal terms should always be defined and terminology should be used consistently in all standards.

3. *Sensitize peer reviewers and reviewed firms to standards-overload concerns.* The implementation of peer review has significantly improved the quality of practice. However, in some cases, peer reviewers are more demanding than the standards require and thereby become de facto standard setters. The task force believes that representatives of the AICPA's Practice Monitoring Division (Peer Review) should continue to be involved in the examination of the standards-overload problem by ensuring that peer reviewers are well qualified and do not expect firms to exceed professional standards. In addition, reviewed firms should be encouraged to request that peer reviewers cite the applicable section of the professional standards or firm policy that supports peer-reviewer recommendations for changes to the financial statements or accountant's report, or recommendations that additional procedures be performed or provided for in the firm's quality control procedures.
4. *Provide guidance on disclosure in OCBOA presentations.* Because of the complexities of GAAP, many entities elect to present their financial statements using an other comprehensive bases of accounting (OCBOA). Paragraph 9 of SAS No. 62, *Special Reports,* indicates that OCBOA financial statements should include "all informative disclosures that are appropriate for the basis of accounting used." However, the guidance in SAS No. 62 is extremely broad and practitioners find they need more specific

guidance concerning disclosures in OCBOA presentations. The task force recommends that standard setters issue such guidance.

5. *Provide guidance concerning materiality and financial-statement disclosures.* A problematic area of practice is the consideration of materiality in determining whether specified financial-statement disclosures are required. Many CPAs believe that the materiality threshold is relatively low for small nonpublic entities. The task force believes that CPAs who make this assumption are overlooking the fact that materiality has a qualitative aspect in addition to a quantitative aspect. Both aspects should be considered in making decisions about the disclosures that should be included in financial statements. The AICPA should provide implementation guidance on the consideration of materiality in applying accounting standards and in making judgments about financial-statement disclosures for small nonpublic entities.

6. *Provide practice guidance concerning compilation engagements.* There is a need to provide CPAs with high-quality, practical CPE in modules that address problematic areas of practice. For example, comments from focus groups and responses to questionnaires indicate that CPAs need additional information about how to perform cost-effective compilation engagements tailored to their clients' financial-information needs. Statement on Standards for Accounting and Review Services (SSARS) 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards,* vol. 2, AR sec. 100) provides for alternatives to full-disclosure GAAP financial statements, such as financial statements that omit substantially all disclosures, and financial statements prepared in accordance with an OCBOA. These engagements should enable CPAs to provide clients with a timely and cost-effective service; however, many practitioners are unaware of effective ways to use these alternatives. The task force recommends that the AICPA develop a four-hour CPE course to alert CPAs to these options and that the course be designed, coordinated, and staffed by the AICPA to ensure that the course content is technically correct, that there is consistency in the information presented, and that instructors are knowledgeable and effective communicators. This course should be offered in locations nationwide and should be reasonably priced to encourage attendance by as many practitioners as possible. It should also be available in video and, perhaps, CD-ROM format to maximize exposure.

7. *Continue to evaluate the effectiveness and relevance of financial-statement disclosures.* The task force reviewed the FASB Prospectus, *Disclosure Effectiveness,* and is aware that the FASB is currently

considering modification of the disclosure requirements in certain specified standards. The task force strongly supports the FASB's project to reevaluate the information needs of financial statement users.[6]

Guides and Risk Alerts

AICPA Audit and Accounting Guides

Audit and Accounting Guides summarize the practices applicable to specific industries and describe relevant matters, conditions, and procedures unique to these industries. The accounting guidance included in AICPA Audit and Accounting Guides is in the GAAP hierarchy as authoritative GAAP. Guides are available from the AICPA for the following industries (product numbers are shown in parentheses):

Agricultural producers and cooperatives (012351)
Airlines (013181)
Banks and savings institutions (011175)
Brokers and dealers in securities (012177)
Casinos (013148)
Certain nonprofit organizations (013165TA)
Colleges and universities (013323TA)
Common interest realty associations (012089)
Construction contractors (012094)
Credit unions (012044)
Employee benefit plans (012335)
Entities with oil and gas producing activities (012089)
Federal government contractors (012436)
Finance companies (012464)
Health care organizations (012429)
Investment companies (012360)

[6] On September 20, 1996, the FASB issued an exposure draft of a proposed Statement entitled *Elimination of Certain Disclosures about Financial Instruments by Small Nonpublic Entities.* The proposed Statement would amend FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* to make the disclosures about the fair value of financial instruments prescribed in FASB Statement No. 107 optional for nonpublic entities that (1) have total assets of less than $10 million on the date of the financial statements, and (2) have not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, *Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments,* during the reporting period.

Not-for-profit organizations (013166)
Property and liability insurance companies (011919)
State and local governmental units (012056)
Stock life insurance companies (012035)
Voluntary health and welfare organizations (012158TA)

The following general Audit and Accounting Guides also may be of interest to CPAs performing audit and attest engagements:

Consideration of Internal Control in a Financial Statement Audit (012451)
Personal Financial Statements (011133)
Prospective Financial Information (011140)
Use of Real Estate Appraisal Information (013158)

AICPA Annual Industry Audit Risk Alerts

AICPA annual Industry Audit Risk Alerts provide information about current economic, regulatory, and professional developments in specified industries. They assist CPAs in planning and performing engagements by highlighting reporting issues, recurring peer review problems, and lessons learned from litigation. 1996/97 Audit Risk Alerts are available from the AICPA for the following industries (product numbers are shown in parentheses):

Banks and savings institutions (022190CLA10)
Construction contractors (022185CLA10)
Credit unions (022198CLA10)
Employee benefit plans (022177CLA10)
Health care (022186CLA10)
High technology (022187CLA10)
Insurance (022188CLA10)
Investment companies (022184CLA10)
Not-for-profit organizations (022178CLA10)
Real estate (022197CLA10)
Retail enterprises (022195CLA10)
Securities (022196CLA10)
State and local governmental developments (022179CLA10)

Publications from the Audit and Attest Standards Group

The following publications are available from the AICPA. Product numbers and prices are shown in parentheses.

- *Codification of Statements on Auditing Standards* includes SAS Nos. 1 to 79 as well as SSAEs (059026, $52.00 members, $57.25 nonmembers)
- Recently published Auditing Procedures Studies are the following:
  - *Implementing SAS No. 70,* Reports on the Processing of Transactions by Service Organizations (0210566A, $28.50 members, $31.50 nonmembers)
  - *Audit Implications of Electronic Data Intercharge* (0210606A, $19.50 members, $21.50 nonmembers)
  - *Auditing in a Client/Server Environment* (available end of first quarter of 1997)
  - *Audit Implications of Electronic Document Management* (available end of first quarter of 1997)
  - *Revised Confirmation of Accounts Receivable* (0210646A, $28.50 members, $31.50 nonmembers)
- *Codification of Statements for Accounting and Review Services* includes SSARS Nos. 1 to 7 (0571676A, $13.00 members, $14.25 nonmembers)

Recently Published Practice Alerts

The Professional Issues Task Force of the AICPA's Division for CPA Firms issued Practice Alert 95-2 entitled *Complex Derivatives.* The Practice Alert explores factors auditors should be aware of that might indicate the presence of a complex derivative structure and the risks associated with such a structure through a discussion of complex swap derivatives. This Practice Alert appears in the October 1995 issue of *The CPA Letter.*

In addition, the Division for CPA Firms—Professional Issues Task Force of the AICPA recently issued Practice Alert 96-1 entitled *The Private Securities Litigation Reform Act of 1995* (the Act). The Practice Alert addresses two sections of the Act—fraud detection and disclosure and the safe harbor for forward-looking statements—and how they affect auditors in performing audits and other services. This Practice Alert appears in the May 1996 issue of *The CPA Letter.*

AICPA Services

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07303-2209; fax (800) 362-5066. Prices do not include shipping and handling. The best times to call are 8:30 to 11:30 A.M. and 2:00 to 7:30 P.M., EST.

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (800) 862-4272 (menu selection #2).

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (800) 862-4272 (menu selection #4).

World Wide Web Site

The AICPA recently established a home page on the World Wide Web. "AICPA Online," the Web site (URL or uniform resource locator: http://www.aicpa.org), offers CPAs the unique opportunity to stay abreast of developments in accounting and auditing, including exposure drafts. The home page is updated daily.

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This Audit Risk Alert replaces *Audit Risk Alert—1995/96*.