2001

Audit risk alert - 2001/02; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Audit Risk Alert—2001/02

Current Risks

Accounting, Auditing, and Professional Developments

American Institute of Certified Public Accountants

AICPA

Notice to Readers

This Audit Risk Alert is intended to provide CPAs with an overview of recent economic, industry, regulatory, and other professional developments that may affect the engagements and audits they perform. The AICPA staff prepared this document. It has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA. The discussions presented in this publication do not represent the views, positions, or opinions of the AICPA.

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Audit Risk Alert—2001/02

How This Alert Helps You

This Audit Risk Alert helps you plan and perform your audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment your clients operate in. This Alert is an important tool in helping you identify the significant business risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and professional developments.

If you understand what is happening in the business environment and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that knowledge and understanding it.

The U.S. Business Environment

As of the fourth quarter of 2001, the U.S. economy is weak and its outlook is uncertain. Adding further agitation and uncertainty to that weak economic picture are the ramifications of the September 11 attacks upon America and subsequent related events. The effects of those events are likely to further unhinge consumer confidence, decrease corporate earnings, increase layoffs, and further depress the stock market. To be sure, the short-term economic picture looks grim.

Still, the financial underpinnings of the U.S. economy remain strong. Inflation is contained, interest rates have been cut, taxes have been lowered, energy prices have fallen, and the public debt has diminished. Additionally, in response to the September 11 attacks, government stimulus measures are likely to be enacted in the form of increased spending on defense, spending on recovery efforts, direct aid to certain industries, and further tax cuts. The seeds of economic recovery are sown. So while the health of the economy is grim and uncertain and will likely continue to worsen, the economic malaise may be short-lived and mild.

Business Risks and Audit Implications

The business environment is a factor affecting the accuracy of your client's financial statements, and affecting issues of fraud and going concern. Understanding the economic and business environment your client operates in should constitute a large part of your audit planning. You should understand your client's specific business environment and how the overall economic situation described in this Alert is affecting your client. The effect of the economic downturn varies across geographic regions and industries, and among companies even within the same industry. Therefore auditors need to focus specifically on the business environment of each client and address each client's particular risks accordingly.

Identifying Risks That May Result in Material Misstatements

As you plan your audits, you should obtain an understanding of each client's internal controls and its business environment sufficient to assess what significant risks give rise to problems that may cause misstatements in the financial statements.

The general economic and business environment and the business risks described in this Alert give rise to certain issues and concerns that could affect an entity's financial statements. Some of the more significant ones are presented in the following table and are discussed in this Alert.

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Causes Behind the Troubled Economic and Business Environment

Plunging Capital Spending, Tumbling Profits, Eroding Stock Market, Layoffs

The initial, primary cause of the economic slowdown was a breathtaking decline in business capital spending and investment. When the dot.com bubble burst, businesses took a more pessimistic view of the economic future and drastically curtailed their spending on equipment, software, real estate, inventories, and other business investments. One of the first sectors to suffer the effects of that reduction in capital spending was the high-tech industry, where earnings and share prices nose-dived.

As the drastic cutbacks in corporate spending rippled through the business environment, soaring energy prices took money out of consumers' pockets and ate into corporate earnings. Earnings throughout the business world sank, borrowing dwindled, office vacancies increased, economic growth slowed, and the stock market tumbled. Trillions of dollars of investor wealth vanished. Moreover, as earnings sank, layoffs followed. The unemployment rate rose sharply (although still historically low), undermining the economy's reliance on hardy consumer spending. As earnings worsen and the economic picture darkens, U.S. companies have initiated restructurings, inventory liquidations, and large write-offs.

11 September 2001

The September 11 attacks upon America were a shock to the business environment. However, evidence indicates that the economy may be more resilient to the terrorist attacks than was previously thought. Especially clobbered by the shock of September 11 are the tourism, hotel, airline, insurance, and restaurant industries. In addition, the terrorist attacks and the future threat of terrorism may unhinge the rapid pace of globalization that has been sweeping the world economy. A discussion of the ramifications of 11 September 2001 and subsequent events on the business environment is presented in a separate section of this Alert.

Weakening Consumer Spending

The pillars of consumer spending and a strong housing market have supported the battered economy. Throughout these difficult economic times, housing construction and purchases have soared, spurred on by low mortgage rates and poor investment alternatives. Despite layoffs and a deteriorating business environment, consumer spending remained robust, helped by plenty of refinancing loans. Now, however, consumer confidence has eroded and the attacks and aftermath of September 11 together with related subsequent events may send consumers into a full-blown retreat. Already auto sales and sales at large retail stores have slid. In addition, signs are appearing that the housing market may be slowing. The psychological effects of the terrorist attacks, continuing layoffs, and falling stock prices will most likely weaken consumer spending in the short term.

Positive Signs

While the short-term economic forecast looks grim, many economists are optimistic about the long-term outlook for the U.S. business environment. As stated above, interest rates have been lowered and taxes have been slashed. Furthermore, inflation remains low and the housing market, although exhibiting signs of slowing, appears sound. Businesses have shed excess inventories and the trade deficit is improving. Although the aftermath of the terrorist attacks could cause the price of energy to soar, the price of natural gas, crude oil, gasoline, and electricity have fallen from earlier highs. Spending less on energy frees up capital for consumers to spend and businesses to invest. Furthermore, the Bush administration is embarking upon an enormous stimulus package to help revive the economy. All of these factors form a favorable medium that can help the economy grow strongly.

Government Stimulus

As noted above, help to the business environment may also come in the form of government stimulus packages. As of the writing of this Alert, the Bush administration was considering additional individual tax cuts, business tax cuts, beefed-up spending on defense and intelligence, expanded unemployment benefits, and subsidies to certain industries. These packages could total 1.5 percent to 2 percent of gross domestic product and aid the economy's health. A number of economists, however, believe that the additional government spending will not have a substantial medicinal effect on the health of the economy. They fear that heightened government spending will lead to higher long-term interest rates and reduced private investment, thus damaging the economy.

Threats to Economic Recovery

Many economists expect the economic malaise to be short-lived. However, a risk exists that the ramifications of the terrorist attacks, the uncertainty of our war against terrorism, and the future threat of terrorist acts will severely deepen the black hole that business earnings are plummeting into. Although the economy is proving to be more resilient to the effects of the terrorist attacks than expected, another massive terrorist assault, a cut-off of oil supplies in the Persian Gulf, or other jarring news like a significant bioterrorism attack could send the U.S. economy tumbling deeper. In this scenario, earnings worsen, igniting more layoffs. Consumer spending grinds to a halt and the stock market erodes. If terrorism continues to threaten our nation and the world, the free flow of people and products could slow and the cost of capital could increase as investors demand a higher return to compensate for bigger risks. As the flow of people and goods slows due to the insecure environment, globalization proceeds at a reduced pace, productivity suffers, and investing decisions become much more cautious. Consequently, the nation's economic woes could linger on and grow worse. This could in turn drag down foreign economies and heighten the sense of unraveling.

Moreover, emerging weakness in some foreign economies, such as Asia, Europe, and Latin America (especially Argentina), as well as a failure for business capital spending to improve pose threats to the recovery of the U.S. economy.

For Better or Poorer; In Sickness and in Health—America and the Global Economy

The U.S. economy drives the world economy. The U.S buys one-fourth of the world's exports. Indeed, 28 cents out of every dollar spent in the U.S. is spent on imported goods. The economies of the United States and foreign nations are intertwined and dependent upon one another. As expected then, the deterioration in the U.S. business environment has struck foreign economies. Many of the layoffs announced by U.S. companies are cuts in overseas jobs since many U.S. firms have established and transferred manufacturing facilities and other operations abroad. Also, foreign companies, especially those that export technology equipment, have absorbed the harsh blow of reduced capital spending by American businesses.

As foreign economies weaken and suffer from the long reach of the anemic U.S. economy, global exports and imports have slackened. This in turn punishes many U.S. firms that rely on exporting their goods and services to foreign markets. U.S. multinational firms are deeply affected also, as their sales and earnings deteriorate in the weakening economies of foreign nations. As the U.S. economy goes so goes the world, and foreign economies will not improve until the U.S. business environment does.

Uncertain \ *adj:* not having certain knowledge: indefinite: not clearly identified or defined

The economic word of the day is "uncertain." Surely the outlook for the U.S. business environment remains uncertain. For the short term, the economy should remain troubled and deteriorate even further. The long-term does appear brighter however. Too many variables are in play to really be certain about what the economy will do. Will businesses finish liquidating inventories and resume capital spending? Will consumers start spending or will they retreat and extinguish businesses' incentive to invest? Will the stock market drift lower or turn up? Will energy prices remain stable or soar?

What impact will the government's stimulus packages have on the business environment? Will the aftermath of 11 September cripple the economy, have little ultimate effect, or provide fuel for growth? What effect will the threat of future terrorism and the reality of our war on terrorism have on businesses and the economy? Management, auditors, and many others will be seeking the answers to these questions as they assess the business environment they and their clients operate in.

Overview of Foreign Economies

Western Europe

Economic data from Europe has not been shining, although an imminent recession is doubtful. Experts and analysts report that the European communities continue to have moderate economic growth. In addition, these countries still have relatively low unemployment. Consumer spending is expected to increase because of slowing inflation throughout Europe. Germany, however, western Europe's largest economy, is perhaps in the worst shape. The German government initiated tax cuts, which could help spur the economy. The French economy has faired a little better than that of Germany and its other neighbors. France has modest economic growth, but its budget deficit continues to grow.

The Euro

January 1, 2002, is the date set for the final conversion of 12 European currencies into real euro notes and coins. January 1999 was the euro's first introduction to the market. Since that time the euro has been used in corporate accounts and stock and bond markets. Now, on January 1, 2002, Europeans will exchange all their lire, marks, and francs for the new Euro.

The effect of this new euro on the European economy remains to be seen. The hope is that with a single currency, trade between euro zone nations could grow dramatically, thereby improving the economy. There is also the hope that the value of the euro could climb back up toward that of the dollar. The euro has lost nearly 25 percent of its worth against the dollar since its introduction.

On the downside, analysts fear that the conversion could generate consumer and labor outrage over the inequities in prices and wages across the borders. Others fear that the mechanics of repricing might lead to inflation.

Steps in the Euro Conversion. The following steps remain in the euro conversion process:

- December 2001: Euro notes start arriving in banks, and stores. Consumers can buy small "starter packs" of euro currency from financial institutions.
- January 1, 2002: Euro introduced. ATMs and banks give only euro. Shops make change in euro only. Withdrawal of the national currencies starts.
- March 1, 2002: Old currencies will no longer be accepted and must be exchanged at banks.

Some Auditing Considerations. Consider these points when assessing the effect of the euro conversion on your clients.

- Emerging Issues Task Force (EITF) Abstract D-71, *Accounting Issues Relating to the Introduction of the European Economic and Monetary Union*, discusses accounting issues related to the euro, including comparative financial statements issuance.
- Securities and Exchange Commission (SEC) Staff Legal Bulletin No. 6 outlines the disclosure obligations related to the euro.
- Entities may now prepare their financial statements in either currency.
- Audit procedures may be necessary to assess the euro conversion's effects on your client's financial statements.
- Conversion costs could potentially exceed year 2000 compliance costs. Management will need to accrue any liability.
- Accounting systems will need to be flexible in order to handle all the varied functions necessary related to the euro.

Systems must be able to perform conversion functions that comply with the European Monetary Union (EMU) and they must minimize potential aggregate material conversion rounding differences.

- American financial operations in Europe will need to address implementation in a timely and appropriate manner.
- Management may need to review contracts and agreements with legal counsel and address potential issues as soon as possible. Currency values used in legal documents will be replaced by their euro equivalent at the fixed exchange rate.
- For most U.S. entities, there should be no income tax consequences from the conversion. However, companies with certain straddles or hedges should review tax issues.

Help Desk—Information about the euro conversion can be obtained at the European Federation of Accountants Web site at www.euro.fee.be.

Asia

With the exception of the Chinese economy, most of the Asian economies seem to be slumping. Many of the economies from Taiwan to South Korea to Malaysia are feeling the effects of the U.S. economic slowdown, which is causing lower demand for computers and other electronic goods.

Japan

Most of the major indicators from industrial production to consumer spending are flat or are declining. One of the most serious issues plaguing the Japanese is the bad debt carried at the nation's banks. Reports indicate that bad debts are accumulating in the construction, real estate, and manufacturing sectors. Unless there is a serious restructuring of the banking system, the Japanese may not realize growth in their economy for many years. The Japanese economy is also very dependent on exports and has suffered as a result of the downturn in the U.S. economy.

South Korea

Growth in South Korea has declined significantly in the last year. Economists predict the growth will slow even more in the coming months as the demand for technology-related products declines.

Indonesia

The Indonesian economy is suffering from a myriad of problems—a weakening currency, rising interest rates, inflation, and an increasing budget deficit. Although other Asian economies have similar woes, the Indonesians have less financial flexibility. The Indonesians are burdened by low international investor confidence and high government debt as well as a tenuous relationship with the International Monetary Fund. The new government, put in place in midsummer 2001, may bring reforms that will help the country find its way out of its financial crisis.

China

China's growth in the last several years has been impressive. Growth this year is expected to be between 7.5 percent and 8 percent. Both imports and exports continue to grow. Even more encouraging for the Chinese economy is that China has gained admission to the World Trade Organization (WTO). This event is expected to bring more foreign investment. In addition, the Olympic Games to be held in China in 2008 will stimulate various industries from construction to tourism. Not all of China's economic indicators are glowing. Unemployment is on the rise. The urban unemployment rate is at 3 percent, but some experts contend that rate is actually 8 percent. Rural unemployment is at a staggering 30 percent. In addition, the budget deficit is ballooning. A slight downturn in the economy could create employment problems with far-reaching implications.

The Americas

Latin America is showing signs of a slowdown like the rest of the global economy. The financial crisis in Argentina has raised fears that have spread throughout Latin America.

Brazil

The Brazilian economy is still growing but at a slower rate than in the beginning of 2001. Industrial production has been falling in part because of electricity shortages. Interest rates were increased in an attempt to stabilize the currency. This helped the currency situation, but did little to help the rest of the business environment. The government has introduced a number of reforms to improve the economy.

Argentina

Argentina, Latin America's third largest economy, continues to suffer from economic troubles. Argentina has been in a recession for the last three years. It is drifting towards insolvency and may default on its debt. Argentina's debt load represents approximately one-quarter of all emerging-market bonds. Should Argentina default on its debt, a ripple effect could send shudders throughout the markets in South America and the rest of the world. As of the writing of this Alert, Argentine officials and other parties are working on a debt restructuring program.

Mexico

In recent years Mexico has enjoyed a robust economy fueled mainly by strong exports to the United States as well as increased private investments and consumer spending. Analysts predict that economic growth will be about 2 percent, which is down from the 6.9 percent growth last year. Analysts cite three main issues daunting the country. The first is Mexico's dependence on the currently declining U.S. economy. The United States accounts for at least 80 percent of Mexico's exports. The September 11 attacks on the U.S. further soured Mexico's economic picture. The tourism industry, which brings in about $8 billion to $10 billion annually, is also suffering. Two major Mexican airlines have reported heavy losses because of cancelled flights. A second issue is possible further delays in fiscal reforms. The third factor is softening crude oil prices. Oil exports account for 30 percent of government revenues. The country has already suffered a shortfall in anticipated revenues because of the global decline in oil prices. The government has tried to expand trade agreements in Europe and Asia, but the United States remains Mexico's economic mainstay for now.

Canada

The Canadian economy is slowing down after a general strong performance in the late 1990s. The slowdown of the Canadian economy is for the most part due to the downturn in the U.S. economy. Since much of Canada's trade is with the United States, it is susceptible to changes in the American economy. The Canadian government feels it is better able to withstand external influences than in previous years because earlier economic imbalances have been eliminated. Their fiscal position is strong and they have been able to maintain a government financial surplus.

Russia

The Russian economy had been on an upswing largely due to the huge currency devaluation in 1998. However, recent statistics are mixed. Economic growth in 2000 was at 8.3 percent. But for 2001 the government is predicting that growth will be only half that. The inflation rate recently jumped to 25 percent. Owing to the economic boom of previous years, public finances are strong. In fact they boast a trade surplus of $60 billion. The government has put in place some sound economic reforms, but the banking system is still chaotic and corruption is rampant. While there are some positive signs, a serious concern exists that the Russian economy is still very weak. Without strong and quick economic growth and without substantial changes to the country's economic and financial infrastructure, predicting a positive outlook for the Russian economy is very difficult.

Audit Issues and Concerns Arising From Current Risks

Periods of economic decline and uncertainty lead to challenging conditions for companies due to potential deterioration of operating results, increased external scrutiny, and reduced access to capital. These conditions can result in increased incentives for companies to adopt practices that may be incorrect or inconsistently applied in an effort to address perceived expectations of the capital markets, creditors, or potential investors. In addition, a declining business environment can contribute towards the impairment of assets and deterioration in the value of assets. During such times, professional skepticism should be heightened and the status quo should be challenged.

Presented below is a discussion of audit issues and concerns arising from the current business and economic environment.

Going Concern

An entity's sensitivity to negative changes in economic conditions, such as reductions in consumer spending and business investment, layoffs, and a declining stock market, can often result in business failure. Accordingly, you should be alert to conditions and events which, when considered in the aggregate, indicate that there could be substantial doubt about your client's ability to continue as a going concern.

For example, such conditions and events could include (1) negative trends such as recurring operating losses or working capital deficiencies, (2) financial difficulties such as loan defaults or denial of trade credit from suppliers, (3) internal matters such as substantial dependence on the success of a particular product line, or (4) external matters such as legal proceedings or loss of a principal supplier. In such circumstances auditors will have to consider whether, based on such conditions and events, there is substantial doubt about the entity's ability to continue as a going concern.

Excessive and Unusual Reliance on External Financing

Another condition that may raise doubt about an entity's ability to continue as a going concern could be excessive and unusual reliance on external financing, rather than money generated from the company's own operations. This should be a lesson learned from the recent dot-com crash. The crucial consideration for those failing dot-coms was whether or not they would be able to raise enough cash or cut expenses sufficiently and quickly enough to stay in business. Auditors should remember that capital markets will not sustain unrealistic stock valuations for long and a company that maintains an excessive and unusual reliance on external financing may be a going concern risk.

Auditor's Responsibilities Related to a Going Concern Issue

You should be aware of your responsibilities pursuant to Statement on Auditing Standards (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). SAS No. 59 provides guidance to auditors in conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS) 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. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

If there is substantial doubt about the entity's ability to continue as a going concern, you 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 you obtain sufficient competent evidential matter to alleviate doubts about going concern issues, then consideration should be given to the possible effects on the financial statements and the adequacy of the related disclosures. In particular, the auditor should consider the adequacy of the disclosures of those circumstances and events that originally gave rise to the auditor's concern. If, however, after considering identified conditions and events, along with management's plans, you conclude 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, you should refer to the specific guidance set forth under SAS No. 59.

Impairment of Long-Lived Assets, Goodwill, and Other Intangibles

As the business environment deteriorates and companies face mounting economic difficulties, a need to make impairment and recoverability assessments of long-lived assets, business acquisitions, goodwill, and other intangibles will exist at many companies. With the economy sinking deeper into trouble, many companies will find themselves recording significant write-downs of businesses they had acquired over the past couple of years and which are now of less value. Similarly, goodwill and other intangibles, manufacturing facilities, mining or production facilities, property, divisions of the business, retail stores of a business, and other long-lived assets may need to be written down during this harsh business climate if their costs are not recoverable.

As you plan your audit, you may need to assess whether a risk exists that such long-lived assets and intangibles recorded on the books of your client may be impaired and need to be written down. You may also need to assess whether the disposal of long-lived assets is being properly accounted for and disclosed.

Accounting and Reporting Guidance

Old Guidance. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, provides accounting and reporting guidance for impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used. 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, provides guidance on accounting and reporting for the disposal of the segment of a business.

New Guidance. Issued in August 2001, FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* supersedes FASB Statement No. 121 and the accounting and reporting provisions of APB Opinion No. 30 for the disposal of a segment of a business. The provisions of FASB Statement No. 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early application encouraged.

Issued in June 2001, FASB Statement No. 142, *Goodwill and Other Intangible Assets,* provides guidance on the recognition and measurement of impairment losses for goodwill and intangible assets. The Statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, *Intangible Assets.* It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. The Statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. FASB Statement No. 142 is effective starting with fiscal years beginning after December 15, 2001. Early application is permitted for entities with fiscal years beginning after March 15, 2001, provided that the first interim financial statements have not previously been issued. The Statement is required to be applied at the beginning of an entity's fiscal year and to be applied to all goodwill and other intangible assets recognized in its financial statements at that date.

So, the accounting literature applicable to your client's financial statements will depend upon the date of your client's financial statements and upon whether they have early-adopted FASB Statements No. 144 and No. 142.

SEC Guidance. SEC Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges,* expresses views of the SEC staff regarding the accounting for and disclosure of certain expenses commonly reported in connection with exit activities and business combinations. This includes the recognition of impairment charges pursuant to APB Opinion No. 17 and FASB Statement No. 121. Given the issuance of the new accounting guidance by the FASB, SAB No. 100 will need to be reevaluated by the SEC staff.

Indications of Impairment

Certain events or changes in circumstances may indicate that a long-lived asset's carrying amount may not be recoverable. In those cases, a long-lived asset shall be tested for recoverability. The following are examples of such events or changes in circumstances:

- A significant decrease in the market price of a long-lived asset
- A significant adverse change in the extent or manner in which a long-lived asset is being used or in its physical condition
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset, including an adverse action or assessment by a regulator
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset
- A current expectation that, more likely than not (a level of likelihood that is more than 50 percent), a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life

Declines in the Value of Securities

The declining stock market and recession-like business environment raise issues about the valuation and impairment of securities. Various market indexes have fallen significantly and near-term recovery is uncertain. Securities need to be evaluated to determine if there has been a decline in value that is other than temporary. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, establishes accounting standards for both marketable equity and debt securities. Regardless of the valuation method used, generally accepted accounting principles (GAAP) might require recognizing in earnings an impairment loss for a decline in fair value that is other than temporary (note that in the case of trading securities, unrealized holding gains and losses are included in earnings).

Management should determine whether a decline in fair value below amortized cost basis is other than temporary. When the decline in fair value is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as a new cost basis and the amount of the write-down should be included in earnings. The new cost basis shall not be changed for subsequent recoveries in fair value.

Investigating Declines in Value

Management should investigate declines in the value of investments in marketable securities caused by general market conditions or specific information pertaining to an industry or an individual company. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the fair value of its investment. Therefore, in conducting its investigation, management should consider the possibility that each decline may be other than temporary and reach its determination only after consideration of all available evidence relating to the fair value of the security.

Other than temporary does not mean permanent. Thus, the point at which management deems the decline to no longer be temporary triggers the obligation to write down the investment. This point may precede a determination that an investment is permanently impaired.

Factors Indicating a Decline Is Other Than Temporary

Judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors:

- Fair value is significantly below cost and
  - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area
  - The decline has existed for an extended period of time
  - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value
- The security has been downgraded by a rating agency
- The financial condition of the issuer has deteriorated
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made
- The entity recorded losses from the security subsequent to the end of the reporting period

Determining Fair Value of a Security

Management's assessment of the fair value of a marketable security should begin with its contemporaneous market price because that price reflects the market's most recent evaluation of the total mix of available information. Objective evidence is required to support a fair value in excess of a contemporaneous market price. Such information may include:

- The issuer's financial performance including such factors as:
  - Earnings trends
  - Dividend payments
  - Asset quality
  - Specific events
- The near term prospects of the issuer

- The financial condition and prospects of the issuer's region and industry
- Management's investment intent

Management should employ a systematic methodology that includes documentation of the factors considered. Such methodology should ensure that all available evidence concerning declines in market values below cost will be identified and evaluated in a disciplined manner by responsible personnel.

Audit Implications

SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance on auditing investments in securities. The companion AICPA Audit Guide, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides essential guidance on how to apply SAS No. 92 to your audits. You should familiarize yourself with the guidance in these publications.

The auditor should evaluate (1) whether management has considered relevant information in determining whether factors such as those listed above exist and (2) management's conclusions about the need to recognize an impairment loss. That evaluation requires the auditor to obtain evidence about such factors that tend to corroborate or conflict with management's conclusions. When the entity has recognized an impairment loss, the auditor should gather evidence supporting the amount of the impairment adjustment recorded and determine whether the entity has appropriately followed GAAP.

The auditor is not responsible for designing procedures to detect the presence of these factors per se. Rather, the auditor should consider whether management has considered information that would be relevant in determining whether such factors exist. For example, the auditor would not be responsible for determining whether the financial condition of the issuer of a security has deteriorated, but instead, would ask management how it considered the issuer's financial condition. Once the auditor has determined that the entity considered relevant information, the auditor is responsible for evaluating management's conclusion about the need to recognize an impairment loss. To perform this evaluation the auditor should gather evidence about factors that tend to corroborate or conflict with management's conclusions.

If the entity has recognized an impairment loss, and the auditor agrees with that conclusion, the auditor should:

- Determine that the write-down of an investment to a new cost basis is accounted for as a realized loss
- Test the calculation of the loss recorded
- Determine that the new cost basis of investments previously written down is not changed for subsequent recoveries in fair value
- Review a summary of investments written down for completeness and unusual items
- Assess the credit rating of the counterparty
- Conclude on the adequacy of impairment adjustments recorded

Collectibility of Receivables

The client's estimate of the level of accounts receivable that may not be collectible as a result of bad debts is reflected in the allowance for doubtful accounts, which is one of the offsets used to bring accounts receivable to their net realizable value. (Other allowances include those for returns and rebates.) As the business environment worsens, as layoffs multiply, and as consumers and businesses become strapped for cash, the collectibility of your client's receivables may deteriorate. Accordingly, you may need to address that collectibility risk during your audit planning.

Audit Procedures You Can Perform

Testing the Aging. A review of the aging of the accounts receivable is often performed. This may include testing the reliability of the aging report, reviewing past due accounts on the report, including the number and amount of such accounts, reviewing past due balances, the client's prior history in collecting past due balances, customer correspondence files and credit reports, and so forth. This may be done with the assistance of the client in obtaining an understanding of how the allowance was developed and determining whether it is reasonable.

Testing the reasonability of the company's estimate of the collectibility of receivables may also be performed by using the following procedures: (1) obtaining publicly available information on major customers to determine their ability to honor outstanding obligations to the company, (2) investigating unusual credit limits or nonstandard payment terms granted to customers, and (3) testing subsequent collections of receivables.

Moreover, in performing your substantive tests, you may want to determine that the cash payments credited to an accounts receivable account actually came from the customer. Entities have been known to borrow cash offline and use the proceeds as evidence of subsequent collections. Entities have also been known to use another customer's payment and post it against a delinquent customer's account so that, to the auditor, it looks like the account was paid.

Analytical Procedures. Another very useful tool in evaluating the allowance for doubtful accounts is the application of analytical procedures. According to SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329.02), analytical procedures are an important part of the audit process and consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Often, the large number of customer accounts makes it difficult to determine the adequacy of the allowance only by reference to individual accounts, making analytical procedures helpful to the audit process. The following are examples of the ratios that auditors might use to evaluate collectibility of accounts receivable:

- *Accounts receivable turnover* indicates how well the company collects its receivables and is computed as net credit sales divided by average net accounts receivable.

- *Bad debts to net credit sales* indicates whether write-offs are adequate. It is computed as bad debt expense divided by net credit sales.
- *Doubtful accounts allowance to accounts receivable* indicates whether the allowance account is adequate. It is computed as allowance for doubtful accounts divided by accounts receivable.

The auditor may also review revenue and receivables transactions and fluctuations after the balance sheet date for items such as sales and write-offs. This may provide additional information about the collectibility of accounts receivable and the reasonableness of the allowance account on the balance sheet date.

An important tool in performing analytical procedures is the new AICPA Audit Guide *Analytical Procedures* (product no. 012551). This guide includes a discussion of SAS No. 56, concepts and definitions, a series of questions and answers, and a case study illustrating trend analysis, ratio analysis, reasonableness testing, and regression analysis.

Vendor Financing

Businesses will sometimes loan money to their customers as part of the normal course of doing business. It is an accepted and useful selling technique. However, a number of businesses have lent substantial sums of money to their customers in an effort to generate sales and prop up earnings. In effect, these companies were buying their own goods and services with their own money. Many customers were incapable of paying back the money loaned to them. As such, this selling technique, when used immoderately, can result in significant amounts of bad receivables. If your client engages in the practice of lending money to its customers, you may need to pay special attention to the collectibility of the related receivables.

Inventory Obsolescence and Valuation

The economic downturn has resulted in bulging warehouses full of inventory. Many companies have been reducing and liquidating inventory levels in response. As consumer spending and business investment slows, inventory sits and a risk exists that the inventory may become obsolete and not properly stated at the lower of cost or market value in the financial statements. A highly competitive environment and the rapid advancement of technological factors also can contribute to inventory obsolescence. Auditors may need to pay special attention to the risk of excess or obsolete inventory during these difficult economic times.

Accounting Considerations

Generally accepted accounting principles for accounting for the value of inventory are set forth in Statements 5, 6, and 7 of Chapter 4 of Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*. Chapter 4 of ARB 43 states that

> in keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories shall be stated at cost... A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. If the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes, a loss [*shall*] be reflected as a charge against the revenues of the period in which it occurs. The measurement of such losses shall be accomplished by applying the rule of pricing inventories at cost or market, whichever is lower.

In addition to ARB No. 43, SEC Regulation S-X, Article 5-02(6), requires disclosure of the major classes of inventory. SAB No. 100 provides additional guidance on how to account for and classify write-downs of inventory in the income statement. And finally, the SEC's Management's Discussion and Analysis (MD&A) rules will often require disclosure of what happened in the business that resulted in the reduction in sales values of inventories, as well as the effect of those factors on trends in operating results and liquidity.

Audit Considerations

When auditing inventory, consider the following issues when planning your audit procedures:

- An unusual increase in inventory balances, reduction in turnover, increased backlog, and a deterioration in the aging of inventories may be signs that the client has excessive inventory on hand.

- Declining prices and shrinking profit margins may cause inventory to be valued over market value.
- Reduced production at a manufacturing facility may lead to an overcapitalization of inventory overhead.

Factors that may affect inventory valuation include the following:

- Changes in a product's design may have an adverse effect on the entity's older products.
- A competitor's introduction of a more advanced version of a product may decrease salability of a client's products.
- Changes in the products promoted by the industry as a whole may affect salability.
- Downturns in foreign economies may result in slowdowns of export sales to that region and lower-priced imports from that region.

You may look at many factors in determining whether inventory is properly valued. Those factors include:

- Product sales trends and expected future demand
- Sales forecasts prepared by management as compared with industry statistics
- Anticipated technological advancements that could render existing inventories obsolete or that could significantly reduce their value
- Inventory valuation ratios, such as gross profit ratios, inventory turnover, obsolescence allowances as a percentage of inventory, and days' sales in inventory
- New product lines planned by management and their effects on current inventory
- New product announcements by competitors
- Economic conditions in markets where the products are sold

- Changes in the regulatory environment
- Unusual or unexpected movements, or lack thereof, of certain raw materials for use in work-in-process inventory
- Pricing trends for the kind of products sold by the client
- Changes in standards used by the industry

Furthermore, you might want to consider the following steps in identifying slow-moving, excess, defective, and obsolete items included in inventories:

1. Examine an analysis of inventory turnover
2. Review industry experience and trends
3. Analytically compare the relationship of inventory balances to anticipated sales volume
4. Tour the facility where inventory is kept
5. Inquire of sales and other relevant personnel concerning possible excess or obsolete items
6. Determine if material or unusual sales cancellations and returns occur after year end

When significant excess or obsolete inventories exist, it may be appropriate to include the matter in the management representation letter. SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333.17), provides the following illustrative example of such a representation: "Provision has been made to reduce excess or obsolete inventories to their estimated net realizable value."

Analytical Procedures. To evaluate the reasonableness of inventory valuation and to help identify the existence of obsolete inventory, the auditor may wish to consider using analytical procedures. Auditors should be aware of the need to have these procedures performed by staff with sufficient industry expertise to properly evaluate the results. In performing analytical procedures, auditors compare amounts or ratios to expected results developed from such sources as the following:

- Prior-period financial information
- Budgets or forecasts
- Relationships among elements of financial information in the same period
- Relationships among financial and nonfinancial data
- Industry data compiled by services (for example, Dun & Bradstreet, Robert Morris Associates, and Standard & Poor's)

Manipulation of Accounting Estimates and Accruals

The increased difficulty in reporting positive or improving financial results during an economic downturn may raise pressure on management to adopt aggressive accounting practices that may improve the financial statements. Accounting estimates and accruals, by their nature, are easily subject to aggressive accounting practices and can also be a means to manage earnings.

Preparers of financial statements should understand the economic substance of a transaction, and then reflect it properly in the books and records of the company. However, this is not always easy, as accounting rules are not simply black and white, and the nature of transactions is ever more complex.

While changes in estimates may be acceptable when supported by real economic facts, changing estimates when the underlying economics of the business do not support the change, and without any disclosure, is inappropriate. You may need to review changes in estimates to determine that they are appropriate, timely, and adequately supported with sufficient competent evidential matter. In addition, the company's disclosures need to comply with the requirements of APB Opinion No. 20, *Accounting Changes*, regarding the need to disclose material changes in accounting estimates. Paragraph 33 of APB Opinion No. 20 specifically requires companies to disclose the effect on income and per share amounts for a change that affects several future periods.

Similarly, as required by Item 303 of Regulation S-K, SEC registrants should also disclose in MD&A changes in accounting estimates that have a material effect on the financial condition or results of operations of the company, or trends in earnings, or would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

SAS No. 57 and Auditing Guidance

Accruals and other estimates are highly subjective and difficult for auditors to verify. When auditing accounting estimates, auditors should give close attention to the underlying assumptions used by management. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates used in a client's financial statements. The guidelines set by SAS No. 57 include:

- Identifying the circumstances that require accounting estimates
- Considering internal control related to developing accounting estimates
- Evaluating the reasonableness of management's estimate by reviewing and testing the process used and the assumptions made
- Developing an independent expectation about the estimate

As discussed in SAS No. 57, auditors should carefully consider the effects of postbalance sheet events on the estimation process. Auditors should refer to SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 560), which provides guidance on events or transactions that have a material effect on financial statements and that occur subsequent to the balance sheet date but before the issuance of the financial statements and the auditor's report. Such events or transactions may require adjustment or disclosure in the financial statements.

Evaluating the Support for Management's Assumptions

Management can easily manage and boost earnings by changing assumptions underlying key accounting estimates. For example, management can change the expected life of some long-term assets to reduce depreciation expense, or management can decide to become more optimistic about when customers will pay their debts and thus reduce bad debt expense on the company's books. When evaluating the support for the assumptions underlying an accounting estimate, you will probably have to rely on evidence that is persuasive, not convincing. Rarely will you be able to obtain enough evidence to be convinced beyond all reasonable doubt.

In order for you to be persuaded, there should be a preponderance of information to support each significant assumption. Preponderance does not mean that a statistical majority of available information points to a specific assumption. Rather a preponderance of information exists when the weight of available information tends to support the assumption.

Remember, as an auditor you are not trying to conclude that any one given outcome is expected. What you are trying to do is to determine whether certain assumptions are supportable and in turn provide a reasonable basis for the development of the soft accounting information.

When evaluating the support for assumptions you should consider whether:

- Sufficient pertinent sources of information about the assumptions have been considered
- The assumptions are consistent with the sources from which they were derived
- The assumptions are consistent with each other
- The assumptions are consistent with management's plans
- The information used to develop the assumptions is reliable
- The logical arguments or theory, considered with the data supporting the assumptions, are reasonable

Help Desk—Practical guidance on auditing estimates is available in the AICPA Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk). This publication includes information on how to plan effectively for the audit of soft accounting information, gather and assess relevant audit evidence, and present and disclose proper financial statements. Case examples and information sources necessary to conduct general business and industry research are also included.

Unrealistic Pension and Other Postretirement Plan Assumptions

The uncertainty of the current business environment, the falling market values of many investments, and the significant drops in interest rates could contribute to a risk that key assumptions used by management in recording accounting estimates related to their company's pension plan and other postretirement plans may be unrealistic and lead to material misstatement in the financial statements.

Management needs to continually monitor the key assumptions used in measuring pension benefit obligations, returns on plan assets, and periodic service cost. Principal actuarial assumptions include discount rates, participation rates, and factors affecting the amount and timing of future benefit payments. FASB Statements No. 87, *Employers' Accounting for Pensions*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, indicate that each assumption shall reflect the best estimate solely with respect to that individual assumption on the applicable measurement date.

Furthermore, if activity within an existing plan, such as earnings or returns on invested plan assets, has a material impact on the company's liquidity, capital resources, or results of operations, that activity should be discussed in MD&A.

Improper Revenue Recognition

As earnings at many companies deteriorate, management at those companies will be hard-pressed to generate profits and report favorable financial results. Accounting practices relating to revenue recognition may become more aggressive as a result. Also, the risk of fraudulent financial reporting may increase in the face of the declining business environment. If earnings and revenue are declining, management may help earnings by adopting aggressive or unusual accounting methods related to revenue recognition. Some of these methods may be improper and not in compliance with GAAP.

Such improper accounting treatment ranges from stretching the accounting rules (for example, recognizing revenues before they are earned) to falsifying sales in an effort to manage earnings. Therefore, auditors need to pay attention to warning signals that may indicate increased audit risk with respect to revenue recognition and respond with appropriate professional skepticism and additional audit procedures.

Accounting Considerations

The fundamental revenue recognition concept is that revenues should not be recognized by a company until realized or realizable and earned by the company. Revenue is defined in FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83, as follows:

> Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, sometimes one and sometimes the other being the more important consideration.

Additional guidance with respect to revenue recognition is found in the following pronouncements:

- Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*
- FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*
- SOP No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*
- SOP No. 97-2, *Software Revenue Recognition*, and SOP 98-9, *Modification of SOP 97-2,* Software Revenue Recognition, *With Respect to Certain Transactions*
- *Technical Practice Aids*, Section 5100, "Revenue Recognition"
- SOP 00-2, *Accounting by Producers or Distributors of Films*

- Numerous EITF Issues including EITF Issue No. 99-17, *Accounting for Advertising Barter Transactions*, EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, and EITF Issue No. 00-3, *Application of AICPA SOP No. 97-2*
- SEC SAB No. 101, *Revenue Recognition in Financial Statements*

Criteria for Revenue Recognition. Transactions should meet the following criteria before revenue is recognized:

- There is persuasive evidence of an arrangement
- Delivery has occurred or services have been rendered
- The seller's price to the buyer is fixed or determinable
- Collectibility is reasonably assured

While these criteria are general, they provide guidance for revenue recognition relating to most traditional business models. For companies that do not employ traditional business models, such as e-commerce companies, SAB No. 101 provides additional guidance on these revenue recognition issues:

- Timing of approval for sales agreements
- "Side" arrangements to the master contract
- Consignment or financing arrangements
- Criteria for delivery (bill and hold sale)
- Layaway programs
- Nonrefundable, up-front fees
- Cancellation or termination provisions
- Membership fees or services
- Contingent rental income
- Right of return

SAB No. 101 and the SEC's SAB No. 101 *Frequently Asked Questions (FAQ)* (www.sec.gov/info/accountants/sab101faq.htm) publication are valuable and comprehensive sources of guidance on revenue recognition.

Auditing Considerations

Given the current economic environment, where companies are struggling to achieve revenue forecasts, auditors need to conduct adequate and appropriate audit procedures on revenues. Be aware of certain factors or conditions that can be indicative of increased audit risk of improper, aggressive, or unusual revenue recognition practices. Management may be aware they are overstating revenue or may simply believe they are reflecting economic substance from their perspective. Be alert for significant unusual or complex transactions, especially those that occur at or near the end of a reporting period. Revenue recognition principles are sometimes difficult to apply and often vary by industry. A high level of care is always required in this area.

Factors and Conditions Indicative of Increased Audit Risk. Some of the factors or conditions that can be indicative of increased audit risk are presented below.

- Revenue transactions with related parties
- Partial shipment of goods with critical part of order not shipped
- Sales involving significant vendor involvement after delivery
- Sales in which payment is contingent on some event, for example, receipt of financing from another party
- Bill-and-hold transactions
- Existence of longer than usual payment terms or installment receivables
- Lack of involvement by the accounting or finance department in unusual or complex sales transactions
- Sales terms that do not comply with the company's normal policies
- Shipments of merchandise to customers without proper authorization from the customer

- Shipments made on canceled or duplicate orders
- Pre-invoicing of goods in process of being assembled or invoicing prior to or in the absence of actual shipment
- Aggressive accounting policies or practices
- Pressure from senior management to increase revenues and earnings
- A change in the company's revenue recognition policy
- Unusual volume of sales to distributors or resellers (that is, "channel stuffing")
- The use of nonstandard contracts or contract clauses
- The use of letters of authorization in lieu of signed contracts or agreements
- Barter transactions
- The existence of "side agreements"
- Shipments made after the end of the period
- Sales not based on actual (firm) orders to buy
- Shipments made to a warehouse or other intermediary location without the instruction of the customer
- Shipments that are sent to and held by freight forwarders pending return to the company for required customer modifications
- Altered dates on contracts or shipping documents

Planning. In planning the audit, you should obtain a sufficient understanding of the client's industry and business, its products, its marketing and sales policies and strategies, its internal control, and its accounting policies and procedures related to revenue recognition.

This understanding should include the procedures for receiving and accepting orders, shipping goods, relieving inventory, and billing and recording sales transactions. A sufficient understanding of a client's policies with respect to acceptable terms of sale and an evaluation of when revenue recognition is appropriate given those terms is essential. Also essential is for you to have an understanding of the computer applications and key documents (for example, purchase orders, shipping reports, bills of lading, invoices, credit memos) used during the processing of revenue transactions.

New Audit Guide. You can turn to the recently issued AICPA Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510) for excellent guidance on how to audit the area of revenue recognition. This publication provides guidance regarding auditing assertions about revenue and includes information about:

- The responsibilities of management, boards of directors, and audit committees for reliable financial reporting
- Key accounting guidance about whether and when to recognize revenue in accordance with GAAP
- Circumstances and transactions that may signal improper revenue recognition
- Key aspects of the auditor's responsibility to plan and perform an audit under GAAS
- Procedures to limit audit risk arising from improper revenue recognition
- Guidance on certain auditing revenue transactions in the computer software and high technology industries (additional industries will be featured in future editions)

Improper Recording of Restructuring Charges

Given the current economic situation, reading a newspaper without seeing a story about a company restructuring its business is rare. Entities undergoing restructurings and incurring related charges may be more inclined to record excessive liabilities and charges during periods of plunging earnings and business decline. While things are going poorly for everyone, and while the markets expect an entity to perform poorly, an entity could decide to take a big bath, clear the decks, clean the balance sheet, and throw as much as possible into its restructuring charges. This practice can help entities reduce expenses and enhance earnings in the future.

What Are Restructuring Charges?

The term "restructuring charge" is not defined in the existing authoritative literature. While the events or transactions triggering the recognition of what are often identified as restructuring charges vary, these charges typically result from the consolidation or relocation of operations, or the disposition or abandonment of operations or productive assets. Restructuring charges may be incurred in connection with a business combination, a change in an enterprise's strategic plan, or a managerial response to declines in demand, increasing costs, or other environmental factors.

When recording restructuring charges and liabilities, management needs to justify the amounts. A good deal of judgment is involved in recording these amounts.

EITF Issue No. 94-3 *Accounting Guidance*

You should consider whether management has appropriately accounted for restructuring costs. EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, provides guidance on whether certain costs (such as employee severance and termination costs) should be accrued and classified as part of restructuring charges, or whether such costs would be more appropriately considered a recurring operational cost of the organization. EITF Issue No. 94-3 provides guidance about the appropriate timing of recognition of restructuring charges and the related disclosures as well.

Management's Plan. To justify restructuring charges, an approved management plan as of the date of the financial statements should exist. Management's plan should be comprehensive, explicit, and adequately documented to provide objective evidence of management's intent.

Loss recognition that is based on management's intent must be supported by objective evidence of intent. To demonstrate management's intent, you may consider whether the plan is sufficiently developed to forecast its consequences and management's commitment to ultimately implement the plan as contemplated. A documented and appropriately approved management plan that is comprehensive and explicit is necessary to accrue a liability.

Practitioners should also evaluate whether the restructuring charges are in violation of loan covenant agreements.

Making Disclosures. When liabilities are accrued in accordance with the guidance in EITF Issue No. 94-3, certain disclosures are required. The thresholds for making the required disclosures are related to the materiality of the amounts accrued or the significance of the activities that will not be continued. Therefore, when the disclosure thresholds have been met, all the disclosures are required, not just those that are individually material.

Some of the disclosures are required until the plan of termination is completed or until all actions under a plan to exit an activity have been fully executed. For instance, under EITF Issue No. 94-3, the amount of actual termination benefits paid and charged against the liability and the number of employees actually terminated as a result of the plan to terminate the employees must be disclosed. The amount of any adjustments to the liability also must be disclosed.

Making Sure Accruals Are Not "Cushions." Sometimes, frequent reductions to restructuring liabilities may suggest that management has provided a cushion by overstating the accrual. When reviewing management's accruals, you should be aware of the kinds of charges that are allowed to be accrued for, pursuant to EITF Issue No. 94-3 and other relevant accounting literature, as appropriate. For example, FASB Statement No. 5 refers to "reserves for general contingencies." No accrual shall be made or disclosure required since general business risks do not meet the conditions for an accrual as stated in paragraph 8 of FASB Statement No. 5.

Other Accounting Guidance

***FASB Statement No. 88,* Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits.** FASB No. 88 establishes standards for accounting for curtailments and termination benefits, among other issues. Practitioners should refer to paragraphs 6 through 14 for guidance on curtailment and paragraphs 15 through 17 for guidance on termination benefits.

FASB Statement No. 106, **Employers' Accounting for Postretirement Benefits Other Than Pensions.** FASB Statement No. 106 requires recording the effect of curtailment, for example, termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a segment of a business, to be recorded as a loss. Refer to paragraphs 96 through 99 for guidance on how to account for plan curtailment. The Statement also provides guidance on how to measure the effects of termination benefits in paragraphs 101 and 102.

FASB Statement No. 112, **Employers' Accounting for Postemployment Benefits (an amendment of FASB Statements No. 5 and No. 43).** FASB Statement No. 112 requires that entities providing postemployment benefits to their former or inactive employees accrue the cost of such benefits. Accrual would occur in accordance with FASB Statement No. 5 when four conditions are met. Inactive employees include those who have been laid off, regardless of whether or not they are expected to return to work. Postemployement benefits that can be attributed to layoffs can include salary continuation, supplemental unemployment benefits, severance benefits, job training and counseling, and continuation of benefits, such as health care benefits and life insurance coverage.

FASB Statement No. 112 does not require that the amount of postemployment benefits be disclosed. The financial statement shall disclose if an obligation for postemployment benefits is not accrued because the amount cannot be reasonably estimated.

FASB Statement No. 132, **Employers' Disclosures about Pensions and Other Postretirement Benefits.** Among other disclosures, FASB Statement No. 132 requires the disclosure of the amount of any gain or loss recognized due to a settlement or curtailment. Additionally, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event are required to be disclosed.

SEC Guidance

SEC SAB No. 100, *Restructuring and Impairment Charges*, expresses views of the SEC staff regarding the accounting for and disclosure of certain expenses commonly reported in connection with exit activities and business combinations. This includes the accrual of exit and employee termination costs pursuant to EITF Issue No. 94-3.

Understatement of Expenses

Dramatically falling earnings and an increasingly dismal financial report may lead some members of management to improperly prop up earnings by understating or hiding expenses. Auditors should be aware that success in fraudulently understating expenses may be achieved by doing so in many small instances rather than by a few large understatements.

Management can use many techniques such as recording expenses as assets and writing their value down over time instead of immediately. Management could also stop booking accounts payable for some time to understate expenses.

Auditing Advice

Depending upon the circumstances and risks identified on your engagement, you may need to design specific audit steps to determine that expenses are not understated and amounts recorded as assets are in fact assets. Audit procedures may include:

- Searching for unrecorded liabilities by inquiry and examination of postbalance sheet transactions and confirmation as appropriate
- Confirming payable balances with major vendors, and identifying major vendors by reviewing voucher registers or subsidiary accounts payable records
- Obtaining an analysis for each significant classification of assets and examining supporting evidence for material change during the year.

Also, paragraphs 171 through 191 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, provide guidance about how to assess whether an item constitutes an asset.

Unusual and Nonstandard Accounting Entries

During periods of economic turmoil or business decline, more unusual and nonstandard accounting entries may be recorded in the client's books to handle unique transactions or circumstances that may arise. These entries may foster additional risk inasmuch as the entries may involve complicated transactions, subjective judgments, unclear application of GAAP, or the bypassing of regular internal control. Also, given the additional pressures that management may be subject to in this business environment, management may deliberately record fraudulent accounting entries with the intent of manipulating the financial results of the company.

Auditing Guidance

As part of your understanding of internal controls, you should gain an understanding of the procedures used to initiate, record, and process journal entries, including the use of nonstandard entries. That understanding should include what controls exist that are effective in ensuring that nonstandard entries are properly recorded, and to what extent adequate segregation of duties and supervision is present to deter management override.

Because research has indicated that many frauds are perpetrated through the use of fraudulent journal entries, you should consider selecting a sample of journal entries for testing. Such tests should be designed to determine that journal entries (whether standard or nonstandard) selected for testing are properly recorded.

Internal Control Concerns

The economic decline has been accompanied by major layoffs throughout many industries. Even healthy companies are using layoffs as a tool to reduce costs and accumulate earnings as they maneuver through this economic downturn.

Significant layoffs can have a serious effect on an entity's internal control and financial reporting and accounting systems. For instance, employees who remain at the company may feel overwhelmed by their workloads, may lack time to complete their tasks and to consider their decisions, and may be performing too many tasks and functions. The auditor may need to consider whether these situations exist and what their effect is on internal control.

Additionally, the auditor may need to consider the possible effects that key unfilled positions can have on internal control. Entities that have had strong financial reporting and accounting controls could see those controls deteriorate due to the lack of employees. Layoffs can also create additional exposure to possible internal fraudulent activities (for example, when an employee performs a job function that otherwise would be segregated).

You may want to consider these issues in planning and performing the audit and in assessing control risk. Remember that gaps in key positions may cause control weaknesses representing reportable conditions that should be communicated to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

Fraudulent Financial Reporting

The dismal economic and business environment can generate increased pressure on the management of many companies. The pressures to achieve earnings goals and to battle fierce competition within the industry become more intense during periods of economic decline. To be sure, many of the improper accounting and reporting practices discussed in this overall section can be, and frequently are, part of fraudulent financial reporting. Consequently, an increased risk of fraudulent financial reporting may exist at many entities.

Although fraud is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. As an auditor, you have a responsibility to obtain reasonable assurance that the financial statements are free of material misstatements, including material misstatements caused by fraud. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU secs. 110, 230, 312, and 316), requires you to consider the presence of fraud risk factors during all stages of the audit process. Therefore, audit techniques related to fraud should be incorporated throughout the entire audit process.

Risk Factors in a Deteriorating Business Environment

SAS No. 82 requires auditors to assess fraud risk factors on their engagements. Some factors that may heighten the risk of fraudulent financial reporting during these difficult economic times may include the following (remember that fraud risk factors will depend on the individual circumstances of every engagement, and therefore may not present an increased risk of fraud on your particular engagements):

- The company is undercapitalized, is relying heavily on bank loans and other credit, and is in danger of violating loan covenants
- The company appears to be dependent on an initial public offering (IPO) for future funding
- The company is having difficulty obtaining or maintaining financing
- The company is exhibiting liquidity problems
- The company is changing significant accounting policies and assumptions to less conservative ones
- The company is generating profits but not cash flow
- Management's compensation is largely tied to earnings or the appreciation of stock options
- There is a significant change in members of senior management or the board of directors

Key Audit Technique—Inquiries of Management

A powerful audit technique to identify fraud risk factors is quite straightforward—ASK. The best clues don't come from the books, but the people who work with them. In addition to helping you assess the risk of material misstatement due to fraud, inquiries of management help remind them of their responsibilities to prevent and detect fraud.

11 September 2001—Accounting and Auditing Implications

In addition to the obvious economic implications, a number of accounting and auditing issues are raised as a result of the September 11 terrorist attacks and related subsequent events. These issues affect those businesses and auditors directly affected by the attacks and those businesses and auditors who were not directly affected, but whose clients, vendors, suppliers, and others were directly affected.

CPA2biz.com Provides Accounting and Auditing Guidance

A thorough discussion of the ability of auditors to assist their clients in recovering accounting records, obtaining audit evidence, considering the risk of fraud, and other audit-related matters is offered at www.cpa2biz.com. In addition, www.cpa2biz.com offers extensive guidance on accounting, independence, tax, technology, and regulatory considerations. Presented below is brief information about some key issues.

EITF Issue No. 01-10 Provides Accounting Guidance

EITF Issue No. 01-10, *Accounting for the Impact of the September 11, 2001 Terrorist Acts*, addresses the proper accounting treatment for matters related to the terrorist attacks. EITF Issue No. 01-10 states that the economic effects of the events were so extensive and pervasive that it would be impossible to capture them in any one financial statement line item and decided against extraordinary treatment for any of the costs attributable to the terrorist attacks. Specifically, EITF Issue No. 01-10 addresses the following issues:

- How losses and costs incurred as a result of the September 11 attacks should be classified in the statement of operations

- When asset impairment losses incurred as a result of the September 11 attacks should be recognized
- When liabilities for other losses and costs incurred as a result of the September 11 attacks should be recognized
- How insurance recoveries of losses and costs incurred as the result of the September 11 attacks should be classified in the statement of operations and when those recoveries should be recognized
- How federal assistance provided to air carriers in the form of direct compensation should be classified in the statement of operations and when that assistance should be recognized
- What disclosures should be made in the notes to the financial statements regarding the losses and costs incurred as a result of the September 11 attacks, and related insurance or other recoveries

Audit Planning Considerations

As you prepare to conduct quarterly reviews and annual audits of firms affected by the events centered around the terrorist attacks, you need to realize that your clients may be working in a new business environment. You must gain an understanding of this new environment in order to adequately plan and perform the audit. Some industries have been affected directly, for example, the airline, financial services, and insurance industries. Other industries will experience more indirect effects, for example, the tourism, hospitality, and real estate industries. Many clients will experience effects related to shifts in demand for their products or services, collectibility of accounts receivable, or valuation of their investments.

Professional Ethics and Independence-Related Developments

This section of the Alert highlights some of the more important developments in the area of professional ethics and independence.

AICPA Independence Rule Modernization—Spotlight on the Engagement Team and Those Who Influence the Engagement Team

In light of fast-moving changes in society and business, the profession has responded by shifting from "firm based" independence rules toward an approach that is "engagement team based." In an effort to modernize the profession's rules on independence, the Professional Ethics Executive Committee (PEEC) of the AICPA approved new independence rules on August 9, 2001. The rules become effective May 31, 2002. These significant revisions to Rule 101, *Independence*, of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101) seek to modernize and harmonize independence rules with other governing bodies, most notably the SEC, while simplifying the rules at the same time.

Engagement Team Focus Approach

The rules are based on an approach to independence whereby the highest level of restrictions is limited to persons on the attest engagement team and to those who can generally influence the engagement team. The engagement team approach to independence significantly narrows the pool of staff who must follow the rules. The underlying concept is that the greatest risk to independence lies in the actions and judgments of those closest to the attest engagement. Prohibitions also extend to those who are able to influence the attest engagement or the attest engagement team. The Independence Standards Board (ISB) originated this "engagement team focus" concept which represents a dramatic departure from rules several decades old in which all firm partners were required to be independent of all a firm's attest clients. This approach is already supported by other independence standard-setters and regulators, such as the SEC, and the International Federation of Accountants (IFAC).

New Definition of "Covered Member"

The PEEC adopted new rules modifying Rule 101 that provide a new definition of "covered member" which replaces the term "member" which was formerly used. In addition, the rules identify a covered member's financial and other relationships, indicate that a covered member's family is also subject to the rules, and prohibit all partners and professional employees from having certain interests in attest clients and employment and other business associations.

In addition to modification of the independence rules, the PEEC also adopted revisions to an interpretation that permits a modified application of Rule 101 for certain engagements to issue restricted-use reports under the Statements on Standards for Attestation Engagements (SSAEs).

> **Help Desk**—You should familiarize yourself with the new independence rules. Final rules are available at www.aicpa.org/members/div/ethics/adopt.htm. Also look for publication of the final rules in the November 2001 issue of the *Journal of Accountancy*.

Benefits of the Engagement Team Approach

The engagement team-based approach offers advantages for all constituencies.

The Public. Financial statement users (such as creditors, analysts, investors, audit committees, and boards of directors) will benefit from independence rules that are easier to apply because they are more logical and intuitive. Audit committees and boards of directors in particular will be better able to make informed decisions about the independence of their company's auditors.

The Client. Clients will realize the same benefits as the public, and straightforward independence rules should reduce disruptions due to inadvertent violations. Such violations, which often are the result of a professional's confusion about the rules, could also surface after the completion of an attest engagement. Any move, therefore, to simplify the rules could also help to prevent situations in which a firm has to consider withdrawing its previously issued report. The lower likelihood of these events, which come at great cost to both attest firms and their clients, should decrease costs for attest services.

The Attest Firm. When the public and the client benefit, so does the attest firm. Simplification may also reduce costs of identifying staff independence issues and monitoring compliance with the rules, which, in turn, could translate to lower costs for clients and the public for attest engagements. In addition, less burdensome rules should help accounting firms attract and retain professionals, a serious problem that has left many firms struggling to compete for the best available talent.

SEC Revises Independence Rules

In November 2000, the SEC adopted its final rule: *Revision of the Commission's Auditor Independence Requirements.* Among other matters, the rule addresses:

- Investments by auditors or their family members in audit clients
- Employment relationships between auditors or their family members and audit clients
- The scope of services provided by audit firms to their audit clients

In addition, the rule:

- Significantly reduces the number of audit firm employees and their families whose investments in audit clients would impair auditor independence
- Identifies certain nonaudit services that could impair the auditor's independence (note: such proscriptions do not extend to services provided to clients for which no attest services are performed)
- Creates, for accounting firms, a limited exception for certain inadvertent independence impairments if they have quality controls in place and can satisfy other conditions
- Creates a requirement for public companies to disclose in their statements certain information related to, among other things, nonaudit services provided by the auditor during the most recent fiscal year

The effective date of the SEC rule was February 5, 2001, with different transition dates for firms providing certain nonaudit services, for example, valuation services. You can download a copy of the SEC's final rule at the SEC Web site: www.sec.gov/rules/final/33-7918.htm.

Independence Standards Board—Mission Accomplished

Effective July 31, 2001, the Independence Standards Board (ISB) discontinued its operations. Created in 1997 by the SEC and AICPA to address auditor independence-related issues, the ISB initiated research and helped develop standards to improve communications between auditors and audit committees related to independence. The ISB's mandate was limited to setting standards for auditors required to meet SEC independence requirements.

In addition to interpretations and other independence-related information, the following standards were issued by the ISB:

- ISB Standard No. 1, *Independence Discussions with Audit Committees*
- ISB Standard No. 2, amended, *Audits of Mutual Funds and Related Entities*
- ISB Standard No. 3, *Employment with Audit Clients*

The SEC considers ISB standards and interpretations to be authoritative to the extent they do not conflict with the SEC's rules and interpretations.

You can obtain additional information related to the past activities of the ISB at www.cpaindependence.org.

General Accounting Office Proposes Changes to Independence-Related Government Auditing Standards

The U.S. General Accounting Office (GAO) issued an exposure draft, *GAGAS ED 4: Government Auditing Standards: Independence Standards*, on May 4, 2001, proposing revisions to the general standards on auditor independence in Government Auditing Standards (also known as the "Yellow Book"). The exposure draft proposes independence standards that:

- Expand the definition of personal impairments to include restrictions on the scope of services auditors provide
- Highlight the distinction between external and internal reporting
- Prescribe the ways that certain governmental organizations can be free from organizational impairments to independence

The most significant departures from the AICPA's independence standards included in the GAO's proposed changes relate to the performance of bookkeeping or similar services and human resource services.

In general, the AICPA supports many of the GAO's proposed changes to independence standards. However, the AICPA recommends that the GAO incorporate the AICPA's independence standards as a base foundation into Government Auditing Standards for nongovernment auditors, with the GAO then making adjustments to that foundation to accommodate needs of the government auditors subject to the Yellow Book. Among other items, the AICPA recommends working with the GAO through a formal mechanism to address any concerns and resolve them within the framework of AICPA standards or some other form of communication to the audit community.

For the latest information related to the proposed standard on independence, you can visit the following Web site: www.gao.org.

Recent AICPA Ethics Interpretations and Rulings

In November 2001, the PEEC revised the following rulings and interpretations of the AICPA Code of Professional Conduct. See the November 2001 issue of the *Journal of Accountancy* for the revisions.

- ET section 92, *Definitions*
- Interpretation 101-1 under Rule of Conduct 101
- Interpretation 101-11: *Modified application of rule 101 for certain engagements to issue restricted-use reports under the Statements on Standards for Attestation Engagements*

- Ethics Ruling No. 60: *Employee Benefit Plans—Member's Relationships With Participating Employer*

Professional Issues

The Gramm-Leach-Bliley Act and the Independent Auditor

The Gramm-Leach-Bliley Act (the Act) requires financial institutions to maintain the privacy of their customers' nonpublic personal information and disclose to customers its policies regarding that information. Full compliance with the regulations was required as of July 1, 2001.

The objective of these requirements is to prevent financial institutions from disclosing to a nonaffiliated third party any nonpublic personal information unless the financial institution provides the customer with an appropriate notice or offers the customer the ability to opt out of having the disclosure made. The law provides several general exceptions to this prohibition, including disclosure of nonpublic personal information to the institution's accountants and auditors. Thus the law does not preclude an independent auditor from obtaining the information necessary to conduct the audit (Section 502(e)(4) of the Act).

Other exemptions in the law include:

- Disclosure to self-regulatory organizations, which would appear to include the AICPA or state CPA societies that administer peer reviews (Section 502(e)(5) of the Act)
- Disclosure to comply with laws and other applicable legal requirements, which would appear to include mandatory peer reviews required under state accountancy laws and regulations (Section 502(e)(8) of the Act)

Remember Your Duty

Auditors are reminded of their duties under state laws and professional standards to maintain the confidentiality of client information, including nonpublic personal information obtained in conducting an audit. Other services provided by CPA firms such as consulting and advisory services are not covered by the general exception for audit and accounting services. The law also contains exemptions for certain other services; however, if a firm provides these services to a financial institution, it may be asked to sign a confidentiality agreement concerning the nondisclosure of nonpublic personal information. Although the Act does not require a financial institution to obtain a confidentiality agreement from its auditors, many financial institutions are asking all third parties that have access to nonpublic personal information of its customers to sign such agreements. If a practitioner is asked to sign such an agreement, he should ensure that the agreement allows for the disclosure of information received for purposes of peer review.

Help Desk—The Gramm-Leach-Bliley Act (Public Law 106-102) can be accessed at http://thomas.loc.gov and additional information about the effect of the Act on CPAs can be found on the AICPA's Web site at http://www.aicpa.org/index.htm under the section "News for CPAs" and the title "Practice Guide on FTC Privacy/Disclosure Rules." Also, the AICPA's SEC Practice Section has included guidance addressing the effect of the Act on peer review at http://www.aicpa.org/members/div/secps/glbact.htm. Readers who have additional questions about the Act and related regulations should consult their attorneys.

Peer Review Changes for Small Firms

New AICPA rules became effective as of January 1, 2001, that are intended to enhance financial reporting quality for firms that do not audit SEC registrants. Of the 30,000 firms enrolled in the AICPA's peer review program, the new rules primarily affect approximately 18,000 small firms that perform only review or compilation engagements. In addition, the rules affect regulators (such as state boards of accountancy, which require peer review for licensure), CPAs performing peer reviews, and state CPA societies.

The most significant change is that there are three types of peer reviews instead of two (on-site and off-site). The engagements in a firm's accounting and auditing practice previously covered under peer review still are covered under the revised standards. Briefly, the three types of peer review are as follows:

- *System reviews*—For firms performing engagements under SASs, Yellow Book examinations, or examinations of prospective financial statements under SSAEs. The reviewer expresses an opinion on the firm's system of quality control in this type of review.
- *Engagement reviews*—For firms that aren't required to have system reviews and aren't eligible for report reviews (explained next). The reviewer provides limited assurance of the firm's conformity with Statements on Standards for Accounting and Review Services (SSARSs) and SSAEs in this type of review. No documentation is required other than that required by SSARSs and SSAEs, which includes, for example, management representation letters, documentation of matters covered in the accountant's inquiry, and analytical procedures on a financial statement review.
- *Report reviews*—Firms performing only compilations that omit substantially all disclosures will have report reviews. However, a firm must have an engagement review if it performs, as its highest level of service, compilations referred to in the SSARSs as "Selected information—substantially all disclosures required are not included."

Step-Up in Peer Review

A firm that is required to have only a report review may elect to have an engagement or system review; a firm that's required to have an engagement review may elect to have a system review. Remember that, although approximately 18,000 of the 30,000 firms being peer-reviewed are not required to have a system review, all CPA firms must have a quality control system in place. Additionally, AICPA Statement on Quality Control Standards (SQCS) No. 2 (AICPA, *Professional Standards*, vol. 2, QC sec. 20.25) requires that your firm prepare appropriate documentation to demonstrate compliance with your system of quality control. Some of those firms, therefore, may find it useful to have peer reviews covering that system.

AICPA Bylaw Change

The AICPA recently amended its bylaws to require public accounting members in entities not eligible to enroll in a practice monitoring program (non-CPA-owned entity) to enroll as individuals if their reports issued and services offered are peer reviewed. Currently, the only services covered by this situation are compilations performed under SSARSs. Those individual members will be subject to engagement or report reviews.

> **Help Desk**—Much more detailed information about the three types of peer review and the revised standards can be obtained on the AICPA peer review Web site at www.aicpa.org/members/div/practmon/index.htm. If you have questions about peer review, call the state CPA society that administers your reviews or the AICPA peer review program staff at (201) 938-3030.

Money Laundering[1]

Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national, or international jurisdiction.

Money launderers tend to use the business entity more as a conduit than as a means of directly expropriating assets. For this reason, money laundering is far less likely to affect financial statements than such types of fraud as misappropriations and consequently is unlikely to be detected in a financial statement audit. In addition, other forms of fraudulent activity usually result in the loss or disappearance of assets or revenue, whereas money laundering involves the manipulation of large quantities of illicit proceeds to distance them from their source quickly and in as undetectable a manner as possible. However, money laundering activities may have indirect effects on an entity's financial statements.

1. This section of the Alert was drafted after consultation with the U.S. Department of Treasury. As such, it provides auditors with a unique insight into how federal regulators view this important area of concern.

In June 2000, the Organization for Economic Cooperation and Development's (OECD) Paris-based Financial Action Task Force (FATF), the world's anti-money laundering watchdog intergovernmental organization, issued *Review to Identify Non-Cooperative Countries or Territories*, expressly identifying 15 governments as noncooperative with other countries and jurisdictions in combating money laundering. Subsequently, in July 2000 the U.S. Treasury Department followed suit with a series of Financial Crimes Enforcement Network (FinCEN) country advisories, which asked U.S. businesses to pay closer attention to transactions linked to these countries. During 2001, several of these jurisdictions were removed from the noncooperative lists and new ones added.

Audit Implications

Independent auditors have a responsibility under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), to be aware of the possibility that illegal acts may have occurred, indirectly affecting amounts recorded in an entity's financial statements. In addition, if specific information comes to the auditor's attention indicating possible illegal acts that could have a material indirect effect on the entity's financial statements (for example, the entity's contingent liability resulting from illegal acts committed as part of the money laundering process), the auditor must apply auditing procedures specifically designed to ascertain whether such activity has occurred.

Possible Indicators of Money Laundering

Possible indications of money laundering include the following:

- Transactions that appear inconsistent with a customer's known legitimate business or personal activities or means; unusual deviations from normal account and transaction patterns
- Situations in which it is difficult to confirm a person's identity
- Unauthorized or improperly recorded transactions; inadequate audit trails

- Unconventionally large currency transactions, particularly in exchange for negotiable instruments or for the direct purchase of funds transfer services
- Apparent structuring of currency transactions to avoid regulatory recordkeeping and reporting thresholds (such as transactions in amounts less than $10,000)
- Businesses seeking investment management services when the source of funds is difficult to pinpoint or appears inconsistent with the customer's means or expected behavior
- Uncharacteristically premature redemption of investment vehicles, particularly with requests to remit proceeds to apparently unrelated third parties
- The purchase of large cash value investments, soon followed by heavy borrowing against them
- Large lump-sum payments from abroad
- Purchases of goods and currency at prices significantly below or above market
- Use of many different firms of auditors and advisers for associated entities and businesses
- Forming companies or trusts that appear to have no reasonable business purpose

Under SAS No. 54, money laundering is considered to be an illegal act with an *indirect* effect on financial statement amounts under SAS No. 54 and the auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

Auditors should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

Help Desk—Descriptions of federal regulations pertaining to money laundering, by industry, appear in the following AICPA Industry Audit Risk Alerts: *Auto Dealerships*; *Banks, Credit Unions, and Other Lenders and Depository Institutions*; *Insurance*; *Investment Companies*; *Real Estate*; and *Securities.*

New Auditing and Attestation Pronouncements and Other Guidance

Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 94	*The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*
SOP 01-3	*Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*
SOP 01-4	*Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards*
SSAE No. 10	*Attestation Standards: Revision and Recodification*
Audit Guide	*Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*
Audit Guide	*Auditing Revenue in Certain Industries*
Audit Guide	*Audit Sampling*
Audit Guide	*Analytical Procedures*
Audit Interpretation No. 1 of SAS No. 73	"The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation

	Criterion in Paragraph 9(a) of Financial Accounting Standards Board No. 140"
Practice Alert No. 01-1	*Common Peer Review Recommendations*
Practice Alert No. 01-2	*Audit Considerations in Times of Economic Uncertainty*

The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*

SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance to auditors about the effect of information technology (IT) on internal control, and on the auditor's understanding of internal control and assessment of control risk. Entities of all sizes increasingly are using IT in ways that affect their internal control and the auditor's consideration of internal control in a financial statement audit. Consequently, in some circumstances, auditors may need to perform tests of controls to perform an effective audit.

SAS No. 94 amends SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), and is effective for audits of financial statements for periods beginning on or after June 1, 2001 (earlier application is permissible).

SOP 01-3, *Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*

This SOP represents the recommendations of the AICPA's Reporting on Internal Control Over Derivative Transactions at Insurance Entities Task Force regarding the application of SSAEs to agreed-upon procedures engagements performed to comply with the requirements of Section 1410(b)(5) of the New York State Insurance Law, as amended (the Law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401(a) of the Law, and Section 178.6(b) of Regulation No. 163. This SOP is effective upon issuance and is applicable only to agreed-upon procedures engagements that address internal control over derivative transactions required by the Law.

SOP 01-4, *Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards*

This SOP represents the recommendations of the AICPA's Investment Performance Statistics Task Force regarding the application of SSAEs to engagements to report pursuant to the Association for Investment Management and Research Performance Presentation Standards.

SSAE No. 10, *Attestation Standards: Revision and Recodification*

SSAE No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 2, AT secs. 101-701), supersedes SSAE Nos. 1 through 9 and renumbers the AT sections. SSAE No. 10 eliminates the requirement for the practitioner to obtain a written assertion in an agreed-upon procedures attest engagement. It also incorporates changes needed as a result of the withdrawal of 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).

In addition, SSAE No. 10:

- Changes the title of AT section 101 to "Attest Engagements"
- Changes the definition of an attest engagement into a statement of applicability of the standard
- Revises the third general standard to focus on the essential elements of criteria
- Enables true direct reporting on subject matter by eliminating the requirement to make reference to the assertion in the practitioner's report

- Provides expanded guidance on the circumstances in which the use of attest reports should be restricted to specified parties

SSAE No. 10 is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001.

Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

This Guide (product no. 012520kk) provides practical guidance for implementing SAS No. 92 on all types of audit engagements. The Guide includes an overview of derivatives and securities and how they are used by various entities, a summary of accounting guidance, and a discussion of the three elements of the auditing framework: inherent risk, control risk, and substantive procedures. Additionally, practical illustrations and case studies are included in the Guide.

Audit Guide *Auditing Revenue in Certain Industries*

The Guide (product no. 012510kk) is intended to help auditors fulfill their professional responsibilities with regard to auditing assertions about revenue, and includes guidance on selected industries that are not covered by any AICPA Audit and Accounting Guides. The Guide:

- Discusses the responsibilities of management, boards of directors, and audit committees for reliable financial reporting
- Summarizes key accounting guidance regarding whether and when revenue should be recognized in accordance with generally accepted accounting principles
- Identifies circumstances and transactions that may signal improper revenue recognition
- Summarizes key aspects of the auditor's responsibility to plan and perform an audit under generally accepted auditing standards
- Describes procedures that the auditor may find effective in limiting audit risk arising from improper revenue recognition

- Provides guidance on auditing revenue transactions in the computer software and high-technology manufacturing industries

Audit Guide *Audit Sampling*

This Guide (product no. 012530kk) provides guidance to help auditors apply audit sampling in accordance with SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, sec. AU 350). It serves as a user-friendly reference that reflects SASs issued since the Guide was originally published in 1983, provides practical assistance on the use of nonstatistical and sampling auditing, includes increased coverage of nonstatistical audit sampling, and offers procedures useful in performing attestation engagements that involve sampling.

Audit Guide *Analytical Procedures*

This Audit Guide (product no. 012551kk) provides practical guidance to auditors on the effective use of analytical procedures. Specifically, this Guide includes a discussion of SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329); concepts and definitions; a series of questions and answers; and a case study illustrating trend analysis, ratio analysis, reasonableness testing, and regression analysis.

Auditing Interpretation No. 1 of SAS No. 73, *Using the Work of a Specialist*

In November 2001, the Auditing Standards Board (ASB) issued auditing Interpretation No. 1, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board No. 140" of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 9336). This Interpretation supersedes the Interpretation, "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 125," issued in February 1998 and amended in October 1998. This new Interpretation is effective for auditing procedures related to transfers of financial assets that are required to be accounted for under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as amended by FASB Technical Bulletin (FTB) No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*. The new Interpretation addresses the use of legal interpretations as evidential matter to support management's assertion that a transfer of financial assets has met the isolation criterion in paragraph 9(a) of FASB Statement No. 140.

Practice Alert No. 01-1, *Common Peer Review Recommendations*

The AICPA Securities and Exchange Commission Practice Section (SECPS) Executive Committee established a Professional Issues Task Force (PITF) which formulates guidance based on issues arising in peer reviews, firm inspections, and litigation to facilitate the resolution of emerging audit practice issues. This guidance takes the form of Practice Alerts. The information contained in these Practice Alerts is nonauthoritative. It represents the views of the members of the PITF and does not represent official positions of the AICPA.

Practice Alert No. 01-1 provides a summary of common peer review findings that will be helpful to professionals as they consider critical and significant issues in planning and performing audits. The common peer review recommendations presented in the Practice Alert are grouped into five categories: (1) implementation of new professional standards or pronouncements, (2) application of GAAP pertaining to equity transactions, (3) application of GAAP pertaining to revenue recognition considerations, (4) documenting audit procedures or audit findings, and (5) miscellaneous findings.

Practice Alert No. 01-2, *Audit Considerations in Times of Economic Uncertainty*

Periods of economic uncertainty lead to challenging conditions for companies due to potential deterioration of operating results, increased external scrutiny, and reduced access to capital. These conditions can result in increased incentives for companies to adopt practices that may be incorrect or inconsistently applied in an effort to address perceived expectations of the capital markets, creditors, or potential investors. During such times, professional skepticism should be heightened and the status quo should be challenged. Practice Alert No. 01-2 is designed to remind auditors of issues to consider during these times.

New Accounting Pronouncements and Other Guidance

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 141	*Business Combinations*
FASB Statement No. 142	*Goodwill and Other Intangible Assets*
FASB Statement No. 143	*Accounting for Asset Retirement Obligations*
FASB Statement No. 144	*Accounting for the Impairment or Disposal of Long-Lived Assets*
FASB Technical Bulletin No. 01-1	*Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
SOP 00-3	*Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*
SOP 01-1	*Amendment to Scope of Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*
SOP 01-2	*Accounting and Reporting by Health and Welfare Benefit Plans*
AICPA Audit and Accounting Guide	*Audits of Investment Companies*
Questions and Answers	*FASB Statement No. 140*

AICPA Practice Aid	*Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus* on Software, Electronic Devices, and Pharmaceutical Industries (expected to be issued in December 2001)

The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org.

FASB Statement No. 141, *Business Combinations*

This Statement addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16, *Business Combinations*, and FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*. All business combinations in the scope of this Statement are to be accounted for using one method—the purchase method. Use of the pooling-of-interests method is no longer permitted. The provisions of this Statement apply to all business combinations initiated after June 30, 2001. This Statement also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. This Statement does not apply, however, to combinations of two or more not-for-profit organizations, the acquisition of a not-for-profit business entity by a not-for-profit organization, and combinations of two or more mutual enterprises.

FASB Statement No. 142, *Goodwill and Other Intangible Assets*

Issued concurrently with FASB Statement No. 141, this Statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, *Intangible Assets*. It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. This Statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements.

FASB Statement No. 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Thus, amortization of goodwill, including goodwill recorded in past business combinations, will cease upon adoption of this Statement.

The provisions of this Statement are required to be applied starting with fiscal years beginning after December 15, 2001. Early application is permitted for entities with fiscal years beginning after March 15, 2001, provided that the first interim financial statements have not previously been issued.

FASB Statement No. 143, *Accounting for Asset Retirement Obligations*

This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This Statement applies to all entities. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, or the normal operation of a long-lived asset, except for certain obligations of lessees. As used in FASB Statement No. 143, a legal obligation is an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel. This Statement amends FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*. This Statement does not apply to obligations that arise solely from a plan to dispose of a long-lived asset as that phrase is used in paragraph 15 of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* An obligation that results from the improper operation of an asset also is not within the scope of this Statement.

FASB Statement No. 143 requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the entity capitalizes a cost by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss upon settlement.

This Statement is effective for financial statements issued for fiscal years beginning after June 15, 2002. Earlier application is encouraged.

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*

FASB Statement No. 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This Statement supersedes FASB Statement No. 121 and the accounting and reporting provisions of APB Opinion No. 30 for the disposal of a segment of a business (as previously defined in that Opinion). This Statement also amends ARB No. 51, *Consolidated Financial Statements*, to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. The provisions of this Statement are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early application encouraged.

FASB Technical Bulletin No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*

FASB Technical Bulletin No. 01-1 defers until 2002 application of the isolation standards of FASB Statement No. 140, as clarified in FASB staff guidance published in April 2001 (see below), to banks and certain other financial institutions. Those institutions also will be allowed up to five years of additional transition time for transfers of assets to certain securitization master trusts. That additional transition time applies only if all beneficial interests issued to investors after July 23, 2001, permit the changes in structure necessary to comply with those isolation standards.

SOP 00-3, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*

This SOP provides guidance on accounting by insurance enterprises for demutualizations and the formation of mutual insurance holding companies. The SOP also applies to stock insurance enterprises that apply SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, to account for participating policies that meet the criteria of paragraph 5 of SOP 95-1. See the SOP for information about its effective date.

SOP 01-1, *Amendment to Scope of Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*

This SOP amends SOP 95-2 to include within the scope of SOP 95-2 investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974. This SOP is effective for financial statements issued for periods ending after December 15, 2001. Earlier application is encouraged.

SOP 01-2, *Accounting and Reporting by Health and Welfare Benefit Plans*

This SOP amends Chapter 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* and SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, to provide accounting and reporting guidance for health and welfare benefit plans in a number of areas. SOP 01-2 specifies the presentation requirements for benefit obligation information and revises the standards for disclosing information about the postretirement benefit obligations that are to be funded by plan participants. The SOP also establishes standards of financial accounting and reporting for postemployment benefits provided by health and welfare plans.

This SOP is effective for financial statements for plan years beginning after December 15, 2000, with earlier application encouraged.

Audit and Accounting Guide *Audits of Investment Companies*

Covering those aspects of accounting and auditing unique to investment companies, this Guide provides new guidance on accounting for offering costs, amortization of premium or discount bonds, liabilities for excess expense plans, reporting complex capital structures, payments by affiliates, financial statement presentation and disclosures for investment companies, and nonpublic investment partnerships.

Questions and Answers About FASB Statement No. 140

The FASB published a Special Report on February 15, 2001, which addresses the most frequently asked questions about FASB Statement No. 140. On April 19, 2001, the FASB staff published a set of questions and answers about isolation of financial assets transferred by banks and other entities, focusing on rights of redemption. Finally, on August 7, 2001, the FASB staff published a set of questions and answers about the limitations on the activities of a qualifying special-purpose entity set forth in paragraphs 35 through 44 of FASB Statement No. 140.

Practice Aid *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*

This publication, to be issued December 2001, identifies best practices related to defining and accounting for, disclosing, valuing, and auditing assets acquired to be used in research and development (R&D) activities, including specific in-process R&D (IPR&D) projects. The Practice Aid is also a useful tool for entities in all industries dealing with other kinds of intangible assets acquired in a business combination.

EITF Consensus Positions

The following table contains a summary of EITF issues that consensuses were reached on from November 2000 through the September 2001 meeting.[2]

EITF Issue No.	*Description*	*Date of Consensus/Status*
00-11	*Lessors' Evaluation of Whether Leases of Certain Integral Equipment Meet the Ownership Transfer Requirements of FASB Statement No. 13,* Accounting for Leases, *for Leases of Real Estate*	Originally discussed May 17-18, 2000. Consensuses reached July 19, 2001.
00-18	*Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees*	Originally discussed July 19-20, 2000. At the July 19, 2001, meeting the EITF agreed to discontinue further consideration of issue 1. Consensus reached on issue 2. Further discussion is planned.
00-19	*Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*	Originally discussed July 19-20, 2000. Consensuses reached on certain issues September 20-21, 2000, and November 15-16, 2000. Revisions to abstracts made January 17-18, 2001. (EITF Issues No. 96-13 and No. 00-7 have been codified in this Issue.)
00-22	*Accounting for "Points" and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future*	Originally discussed September 20-21, 2000. Consensuses reached on issue 3 January 17-18, 2001. Further discussion is planned.
00-23	*Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25,* Accounting for Stock Issues to Employees, *and FASB Interpretation No. 44,* Accounting for Certain Transactions involving Stock Compensation	Originally discussed September 20-21, 2000. Consensuses reached on certain issues September 20-21, 2000, November 15-16, 2000, January 17-18, 2001, April 18-19, 2001, and July 19, 2001. No further discussion of Issue No. 10 is planned. Further discussion of additional issues expected at future meetings.

2. This table reflects information contained in the minutes to the September 2001 Emerging Issues Task Force (EITF) meeting. Look to the EITF Abstracts for final language. The Abstracts can be ordered directly from the Financial Accounting Standards Board (www.fasb.org).

EITF Issue No.	*Description*	*Date of Consensus/Status*
00-25	*Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor's Products*	Originally discussed September 20-21, 2000. Consensuses reached April 18-19, 2001. Illustration added July 19, 2001.
00-27	*Application of EITF Issue No. 98-5, 'Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios,' to Certain Convertible Instruments*	Originally discussed November 15-16, 2000. Consensuses reached on certain issues January 17-18, 2001. Further discussion is planned.
01-1	*Accounting for a Convertible Instrument Granted or Issued to a Nonemployee for Goods or Services or a Combination of Goods or Services and Cash*	Originally discussed and consensuses reached January 17-18, 2001.
01-2	*Issues Related to the Accounting for Nonmonetary Transactions*	Originally discussed and consensuses reached April 18-19, 2001.
01-5	*Application of FASB Statement No. 52,* Foreign Currency Translation, *to an Investment Being Evaluated for Impairment That Will Be Disposed Of*	Originally discussed and consensuses reached July 19, 2001.
01-10	*Accounting for the Impact of the Terrorist Attacks of September 11, 2001*	Originally discussed and consensuses reached September 20 and 28, 2001.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that may be relevant to your engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	http:/www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft email list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Auditing Pipeline

New Framework for the Audit Process

The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB expects to issue a series of exposure drafts in late 2001 and 2002. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

Some of the more important changes to the standards that are expected to be proposed are:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to assessment of the risk of material misstatement of the financial statements. Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.

- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

In connection with this major initiative, the ASB and the International Auditing Practices Committee (IAPC) have agreed to form a joint task force to develop a joint standard addressing the risk assessment process. This standard will represent a significant step towards converging U.S. and international auditing standards. The standard produced by this joint task force will form the basis for the ASB's overall project.

You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Exposure Draft on Audit Documentation

The ASB has issued an exposure draft of a proposed SAS and SSAE titled Audit Documentation which would replace SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), amend several other SASs, and amend the attestation standards to reflect the concepts and terminology in the proposed SAS-SSAE. A final standard is expected to be issued during the first quarter of 2001.

Exposure Draft on GAAS Hierarchy

The ASB has issued an exposure draft of a proposed SAS that would create a hierarchy of generally accepted auditing standards. A final standard is expected to be issued during the first quarter of 2002. The proposed SAS is expected to:

- Identify the body of auditing literature
- Clarify the authority of auditing publications issued by the AICPA and others
- Specify which auditing publications the auditor must comply with and which ones the auditor must consider when conducting an audit in accordance with GAAS
- Identify specific AICPA auditing publications and provide information on how to obtain them

New Fraud Standard to Be Proposed

The ASB is revising SAS No. 82 to address recommendations and findings of:

- The Public Oversight Board's (POB's) Panel on Audit Effectiveness regarding earnings management and fraud
- The ASB's Fraud Standard Steering Task Force
- Academic research on the effectiveness of SAS No. 82
- Other financial reporting stakeholders

The following areas have been identified for possible proposals for standard-setting changes and enhancements. Remember that these areas are only early considerations in the process. The guidance on fraud that the ASB eventually issues may not address these areas or may address other areas.

- *Fraud risk factors.* A consideration of whether additional risk factors should be added (or any deleted) from SAS No. 82, whether the risk factors should be re-categorized, and whether the risk factors should be weighted in some manner.
- *Additional substantive procedures.* A consideration of the POB Panel recommendation to require the performance of "forensic" procedures.

- *Other POB Panel recommendations.* A consideration of recommendations dealing with supervisory discussions, nonstandard journal entries, retrospective procedures, and interim procedures.
- *Corporate governance.* An exploration of requirements that would help assure an auditor understanding of the extent of focus by management and the audit committee on the risk of fraud, including added auditor communication with management and the audit committee.
- *Incorporating a technology focus.* Responding to recommendations of the ASB's Computer Audit Subcommittee related to SAS No. 82 and otherwise incorporating into the standard more focus on the current technological environment.

An exposure draft of a new fraud SAS is expected to be issued in the Spring of 2002.

Accounting Pipeline

Exposure Draft on Lending Activities and Upcoming New Guide

AcSEC has issued an exposure draft of a proposed SOP titled *Accounting by Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others.* In addition to banks, savings institutions, credit unions, finance companies, corporate credit unions, and mortgage companies, the proposed SOP would also apply to manufacturers, retailers, wholesalers, and other business enterprises that provide financing for products and services. AcSEC expects to issue a final SOP during the fourth quarter of 2001 or the first quarter of 2002.

New Combined Audit and Accounting Guide to Be Issued. A proposed Audit and Accounting Guide Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others reconciles the specialized accounting and financial reporting guidance established in the existing AICPA Audit and Accounting Guides *Banks and Savings Institutions, Audits of Credit Unions,* and *Audits of Finance Companies.* The final provisions would be incorporated in a final combined Audit and Accounting Guide, applicable to all entities that lend to or finance the activities of others. The final combined Guide is expected to be issued in May 2002.

Exposure Draft on Purchased Loans and Securities

AcSEC has issued an exposure draft of a proposed SOP titled *Accounting for Certain Purchased Loans and Debt Securities.* This proposed SOP considers whether Practice Bulletin (PB) No. 6, *Amortization of Discounts on Certain Acquired Loans,* continues to be relevant given a number of FASB pronouncements issued subsequent to PB No. 6. The proposed SOP excludes originated loans from its scope. AcSEC expects to issue a final standard during the fourth quarter of 2001 or the first quarter of 2002.

Exposure Draft Related to NAIC Codification

AcSEC has issued an exposure draft of a proposed SOP titled *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification.* This proposed SOP makes necessary changes to insurance industry-related SOPs as a result of the completion of the National Association of Insurance Commissioners (NAIC) codification of statutory accounting practices. AcSEC expects to issue a final standard during the fourth quarter of 2001 or the first quarter of 2002.

Exposure Draft on Liabilities and Equity

The FASB has issued an exposure draft of a proposed Statement, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both,* and an exposure draft of a proposed amendment to Concepts Statement No. 6 titled *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities.* The objective of the project is to improve the transparency of the accounting for financial instruments that contain characteristics of liabilities, equity, or both. The FASB expects to issue final standards during the second quarter of 2002.

Planned Rescission of FASB Statement No. 4

The FASB has issued an exposure draft that rescinds FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt,* and an amendment of that Statement, FASB Statement No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements.* In addition, this proposed Statement would rescind FASB Statement No. 44, *Accounting for Intangible Assets of Motor Carriers,* as well as amend other existing authoritative pronouncements to make various technical corrections. When FASB Statement No. 4 was issued in 1975 the FASB indicated that the accounting it would require represented a practical solution and was intended to be temporary. Recently constituents expressed concern that automatically classifying gains and losses associated with the extinguishment of debt as extraordinary items could be misleading to users of financial statements because debt extinguishment is part of their strategy for managing interest rate risk in their debt portfolio. The FASB expects to issue a final standard during the first quarter of 2002.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- Audit Guide *Auditing Derivative Instruments, Hedging Activities and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012551kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2001* (product no. 009893kk)

- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (product no.008883kk)
- Audit Risk Alert *E-Business Industry Developments—2001/02* (product no. 022277kk)

Audit and Accounting Manual

The *Audit and Accounting Manual* (product no. 005131kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditor's reports; checklists; engagement letters, and management representation letters, and confirmation letters.

CD-ROM

The AICPA is currently offering a CD-ROM product titled Resource: *AICPA's Accounting and Auditing Literature.* This CD-ROM enables subscription access to the following AICPA Professional Literature products in a Windows format: *Professional Standards*, *Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set that includes all Guides and the related Audit Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products.

Educational Courses

The AICPA has developed a number of continuing professional education courses that are valuable to CPAs working in public practice and industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (product no. 737061kk (text) and 187078kk (video)). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.

- *SFAS 133: Derivative and Hedge Accounting* (product no. 735180kk). This course helps you understand GAAP for derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.
- *Independence* (product no. 739035kk). This interactive CD-ROM course will review the AICPA authoritative literature covering independence standards (including the newly issued SECPS independence requirements), SEC regulations on independence, and ISB standards.
- *SEC Reporting* (product no. 736745kk). This course will help the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *Internal Control Implications in a Computer Environment* (product no. 730617kk). This practical course analyzes the effects of electronic technology on internal controls and provides a comprehensive examination of selected computer environments, from traditional mainframes to popular personal computer set-ups.
- *E-Commerce: Controls and Audit* (product no. 731550kk). This course is a comprehensive overview of the world of e-commerce. Topics covered include internal control evaluation and audit procedures necessary for evaluating business-to-consumer and business-to-business transactions.

Online CPE

The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee ($95 for members and $295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

CPE CD-ROM

The Practitioner's Update (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

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 (888) 777-7077.

Web Sites

AICPA Online

AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, AICPA Online offers information about AICPA products and services, career resources, and online publications.

CPA2Biz.Com

This new Web entity is the product of an independently incorporated joint venture between the AICPA and state societies. It currently offers a broad array of traditional and new products, services, communities, and capabilities so CPAs can better serve their clients and employers. Because it functions as a gateway to various professional and commercial online resources, cpa2biz.com is considered a Web "portal."

Some features cpa2biz provides or will provide include:

- Online access to AICPA products including Audit and Accounting Guides, and Audit Risk Alerts
- News feeds each user can customize
- CPA "communities"
- Online CPE
- Web site development and hosting
- Electronic procurement tools to buy goods and services online
- Electronic recruitment tools to attract potential employees online
- Links to a wider variety of professional literature
- Advanced professional research tools

Other Helpful Web Sites

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of the Alert.

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This Audit Risk Alert replaces the AICPA *Audit Risk Alert—2000/01*. The general *Audit Risk Alert* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may email these comments to rdurak@aicpa.org, or write to:

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INFORMATION SOURCES

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center, 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	www.aicpa.org	*AcSec Telephone Line* (212) 596-6008
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800	*Information Line* (202) 512-2250	www.gpo.gov	

Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8078	*Information Line* (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	*Information Line* (202) 942-8090 (202) 942-8092 (tty)

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