2004

Insurance industry developments - 2004/05; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Insurance Industry Developments — 2004/05

Strengthening Audit Integrity
Safeguarding Financial Reporting

American Institute of Certified Public Accountants

AICPA

AUDIT RISK ALERTS

Insurance Industry Developments — 2004/05

Strengthening Audit Integrity
Safeguarding Financial Reporting

American Institute of Certified Public Accountants

AICPA

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of the high-technology industry with an overview of recent economic, technical, and professional developments that may affect the audits they perform.

This publication is an Other Auditing Publication as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Written by J. Russell Madray, CPA
Edited by Lori L. Pombo, CPA
Technical Manager
Accounting and Auditing Publications

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

Table of Contents

High-Technology Industry Developments—2004/05

How This Alert Can Help You

This Audit Risk Alert can help you plan and perform your high-technology industry audits. The knowledge delivered by this Alert can assist you in achieving a more robust understanding of the high-technology business environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues and about current accounting, auditing, and regulatory developments.

If you understand what is happening in the high-technology industry and if 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 industry knowledge and understanding it.

This Alert is intended to be read in conjunction with the AICPA general *Audit Risk Alert—2004/05* (product no. 022335kk).

Current Economic and Industry Developments

For a complete overview of the current economic environment in the United States, see the AICPA general *Audit Risk Alert—2004/05* (product no. 022335kk).

General Industry Trends and Conditions

Although 2004 started off with a bang, spending on technology began to decrease in the second half of the year, according to the Gartner Technology Demand Index (TDI), an index included in IT Watch, a monthly economic indicator service of Gartner, Inc. (Gartner).

Gartner attributes the trend to lowered business confidence. However, respondent projections for 2005 technology budgets moved upward slightly in August. Total external technology spending budgets for the United States and Canada will increase by 3 percent in 2005, according to IT Watch respondents.

While reported 2005 budgets for hardware will be largely unchanged from 2004, Gartner predicts budgets will grow by 2 percent for software, by 4 percent for external information technology services, and by 7 percent for networking and telecommunications. Small businesses are driving the reported rebound in technology spending for 2005. Budgets reported by respondents with technology spending authority in manufacturing, communication, and services industries are growing, as are government technology budgets.

According to industry indexes and surveys, U.S. enterprises have been spending below their budgeted levels. Gartner regards these results as a powerful indicator of a lack of business confidence causing enterprises to continue to defer discretionary spending. Caution remains the norm for technology investment and expense.

Current TDIs show underbudget spending is consistent throughout the sectors tracked by IT Watch. Spending lags budgets in hardware, software, networking/telecommunications, and external services alike. Recent data suggests that spending on technology staffing is increasing, although still falling short of budgeted amounts. Staffing budget increases for next year are reported for most large organizations.

What Is High Technology and What Are Its Industry Segment Conditions?

It is difficult to find common ground on the precise definition of the high-technology industry. According to the AEA (formerly known as the American Electronics Association), the high-technology industry is made up of 45 Standard Industrial Classification (SIC) codes. These sectors fall into three broad categories—high-technology manufacturing, communications services, and software and computer-related services.

High technology is a lot like quality—people know it when they see it—but it is not easy to define. This means the definition of the high-technology industry varies greatly depending on the combination of products and services selected to define the industry. For the purposes of this Alert, we will use a definition that segments the industry into five classifications—personal computers (PCs); semiconductors; mainframes, servers, and storage; networking and telecommunications equipment; and software and services.

Personal Computers

Consistent gains in commercial PC demand have led IDC, a global market research firm based in Framingham, Mass., to raise expectations for 2004 PC shipments to 176.5 million on growth of 14.2 percent. Commercial PC shipment growth of 17.2 percent in the second quarter was the highest since mid-1999, and the fourth consecutive quarter over 13 percent, according to IDC's Worldwide Quarterly PC Tracker. Replacement PC purchases remained the key engine of growth for the industry, as worldwide PC shipments totaled 43 million units in the second quarter of 2004, a 13.3 percent increase over the same period last year, according to preliminary results by Gartner. Although worldwide consumer growth met expectations in the second quarter, growth is expected to slow from near 20 percent in the second half of 2003 to only 9 percent in the second half of 2004. Even with the slowdown in consumer activity, commercial growth has led IDC to increase projections for total 2004 shipment growth from a June estimate of 13.5 percent to a current projection of 14.2 percent.

Despite the increase, second quarter growth accounted for 58 percent of the total change to 2004 shipment volumes, with only 42 percent falling into the second half of the year. In addition, growth estimates for 2005 were lowered 0.2 percent to 10.5 percent, and projections for growth in future years remain in the single digits. Also, it is important to be aware of regional variations in consumer and commercial growth.

According to IDC analysts, strong growth in Western Europe and the rest of the world played a significant role in boosting second-quarter results, while growth in the United States missed forecasts and slipped into single digits. Similarly, it's important to note that IDC lowered growth expectations for the consumer and portable markets even though projections for overall growth have increased slightly in the short term.

High growth in recent quarters is partially the result of a depressed market in prior years. As the market recovery matures, year-on-year comparisons will become more difficult, and growth is expected to subside.

The tempered forecast of the U.S. market is somewhat in contrast to higher growth elsewhere, particularly in Europe. Overall market maturity in the United States and uncertainty in both political and economic spheres led IDC to revise its forecast modestly downward.

Short product life cycles are a fundamental characteristic of this industry sector. For example, the life cycle of a desktop PC is thought to be two years or less, and it is estimated that up to 50 percent of profits for PCs and related products are generated in the first three to six months of sales. As a result, computer makers face the risk of inventory obsolescence. (See the "Inventory Valuation" section later in this Alert for a discussion of this issue.)

Semiconductors

Worldwide semiconductor revenue is forecast to reach $226 billion in 2004, a 27.4 percent increase from 2003 revenue, according to the latest quarterly update by Gartner.

While the market will experience strong growth this year, there are concerns among vendors about the industry outlook. At the end of the second quarter of 2004, semiconductor vendors and distributors reported a notable increase in inventory days on their balance sheets. This brought a wave of concerns about excess supply.

However, the Gartner Dataquest Semiconductor Inventory Index showed inventories in the supply chain at the low end of the "caution" zone. Had the increased inventory been accompanied by a flat or even falling semiconductor market, it would have been of grave concern. In a rising market, increasing inventory levels are normal.

Despite the improving market conditions that semiconductor vendors have enjoyed over the past several quarters and the expectation that revenue growth this year will be close to 30 percent, this industry upcycle is notable in that few in the industry have felt able to acknowledge it as a boom. According to Gartner analysts, the hangover from the severe market downturn endured in 2001 still lingers, just as concerns about the next downturn have begun to worry semiconductor industry executives. The classic signs of an approaching peak in the market—such as increased channel inventory, increased capital spending forecasts, and reduced device pricing—and lead times—which in the past would have been treated lightly at this stage in the cycle—are causing executives to be nervous.

Mainframes, Servers, and Storage

According to IDC's Worldwide Quarterly Server Forecast, the resurgence in demand for enterprise server solutions that began late last year is expected to continue throughout 2004, expanding worldwide spending for servers by 5 percent to $53 billion. IDC expects the server market will achieve a compound annual growth rate (CAGR) of 3.8 percent over the next five years, representing a $60.8 billion opportunity in 2008.

A good environment for hardware and software replacement and migration is helping fuel new enterprise spending for information technology (IT) infrastructure, according to IDC analysts. IDC anticipates growing demand in emerging markets, such as Eastern Europe and Asia, as well as mature markets like the United States and Western Europe.

While vendors continue to compete very aggressively on price for these customer dollars, demand has driven the number of servers sold above the 20 percent year-on-year growth mark for the past three quarters. There continues to be very strong growth in the x86 industry standard server market—particularly for Windows and Linux-based solutions. Growth has been strong for everything from stand-alone systems in small offices to several hundred node clusters in enterprise data centers.

From a regional perspective, the United States will continue to hold the greatest share of the worldwide server market through the end of the forecast period, followed by Western Europe and Asia/Pacific (excluding Japan). IDC expects the strongest growth over the next five years to be in Central and Eastern Europe, as well as the Asia/Pacific region, which are both expected to witness a CAGR in excess of 6.5 percent.

In terms of products, a key growth area will be the server blade market, which is expected to reach $9 billion by 2008. Server blades will represent nearly 29 percent of server unit shipments by the end of the five-year forecast period. IDC believes the blade or modular computing market is a new area of opportunity for server vendors and will bring dramatic changes to the server landscape while creating new areas of demand for server management, virtualization, network equipment, and clustering.

Servers based on the Linux operating system will have comparable market share numbers in 2008, representing approximately 29 percent of all server unit shipments and about $9.7 billion in revenues. Microsoft Windows-based servers are expected to capture 60 percent of all server unit shipments in 2008 and represent the largest server operating environment in terms of revenues with $22.7 billion. IDC anticipates Windows and Linux servers combined to total more than 50 percent of server market revenues in 2008—up from just 37 percent in 2003.

As with other segments of the high-technology industry, there is the potential for rapid inventory obsolescence. As demand for new types of servers and storage systems increases, older types may become obsolete. As a result, you may need to consider an increased level of risk associated with inventory valuations. (For a further discussion, see the section titled "Inventory Valuation" later in this Alert.)

Networking and Telecommunications Equipment

While segments of the U.S. telecom industry have faced intense economic challenges, total spending in the U.S. telecommunications industry rose 4.7 percent in 2003, to an estimated $720.5 billion, according to the *2004 Telecommunications Market Review* *and Forecast*, an annual study published by the Telecommunications Industry Association (TIA).

Double-digit increases in wireless services, services in support of equipment, specialized services (unified communications, video- and audioconferencing, and high-speed Internet access) offset decreases in equipment spending and local- and toll-service revenues. The U.S. telecommunications industry is predicted to grow at a projected 9.2 percent compound annual rate between 2004 and 2007, reaching $1 trillion.

And a turnaround is in sight for U.S. telecommunications equipment spending. The network equipment market bottomed out in 2003 at $14 billion, and a 2.3 percent increase to $14.4 billion is predicted for 2004. Service providers are looking to voice over Internet protocol (VoIP), bundled services, data transport, and TV to generate additional revenue, which will require new investment in equipment. By 2007, network equipment spending will total $18.5 billion, climbing at a 7.0 percent compound annual rate from 2003.

The enterprise equipment market expanded 3.9 percent to $94 billion in 2003. In the enterprise, the shift to Internet protocol (IP) is boosting most segments of equipment spending. For instance, after declining in the previous three years, the private branch exchange (PBX) market bounced back in 2003 with a 12.0 percent increase, reaching $4.2 billion on the strength of growing IP-PBX sales. Videoconferencing was the fastest-growing segment, jumping 28.6 percent and reaching $900 million.

Spending on transport services was essentially flat in 2003 at $285 billion. Local exchange revenues went down 2.9 percent to $118 billion, following a 3.3 percent decrease in 2002. Toll-service spending fell 8.2 percent to $78 billion, its third consecutive decrease as the shift from wireline to wireless in long-distance traffic continued. Offsetting these declines in 2003 was a 14.3 percent increase in wireless services to $89 billion, surpassing toll services for the first time. The services market is undergoing a transformation as more consumers are relying exclusively on wireless, VoIP is growing, and the distinction between local and long distance is disappearing.

Broadband services continue to gain traction. Spending on high-speed Internet access services (including cable modems, digital subscriber line [DSL], fixed wireless, satellite, and fiber-to-the-home) reached $13 billion in 2003, and TIA expects growth to increase to $25 billion by 2007. The overall specialized services category, defined above, is a rapidly growing segment of the industry, predicted to grow from $18.2 billion in 2003 to $34.7 billion in 2007.

The U.S. wireless market consists of transport services, handsets, infrastructure (including Wireless Fidelity (Wi-Fi) equipment), and professional services in support of the wireless infrastructure. Spending in 2003 totaled $134.5 billion, up 7.9 percent from 2002. The 2003 performance represents the first single-digit gain in the wireless market following years of double-digit growth, indicating that the market is approaching maturity. Wireless spending will grow at a compound annual rate of 9.1 percent between 2004 and 2007, reaching an estimated $190.8 billion. New applications, such as wireless Internet access, text messaging, instant messaging, ring tones, wireless games, multimedia messaging services, and Wi-Fi, will drive the market. Wi-Fi represents a small but rapidly growing component of the wireless communications services, and spending on Wi-Fi services is predicted to increase from $21 million in 2003 to $270 million by 2007.

International telecommunications spending (not including U.S. figures) is predicted to total an estimated $1.5 trillion in 2004, up 10.3 percent over 2003. TIA expects high-speed Internet access to be the principal driver of equipment spending. International spending on telecommunications equipment is predicted to increase by 5.4 percent in 2004 to $260.1 billion and then to grow at high single-digit rates through 2007. Overall international telecom spending is expected to reach $2 trillion in 2007, growing at a compound annual rate of 10.5 percent between 2004 and 2007.

Software and Services

Forrester Research, Inc. (Forrester) recently projected that U.S. business and government spending on purchased software will grow by 10 percent in 2004.

Spending on information enablers (business intelligence, portals, and so on), systems management, security, and desktop PC applications will outpace spending on enterprise applications and, to a lesser degree, spending on middleware. Custom software built to order by IT services companies will grow 13 percent, thanks to low-cost offshore options, while software built internally by corporate IT staff will increase only 4 percent as companies focus on minor enhancements to existing deployments.

Forrester breaks the U.S. software market into three broad segments: (1) purchases of commercial software, whether in prepackaged or in customizable forms; (2) purchases of custom-developed software by IT services companies; and (3) the value of internally developed software. In total, U.S. enterprises will invest $234 billion in 2004 to buy or build software, with commercial software representing 56 percent of this spending, custom-built software equaling 7 percent, and internally built software being 37 percent.

When people think about software today, they primarily think of commercial software from leading software vendors, such as Microsoft, IBM, Oracle, SAP, Computer Associates International, Symantec, Veritas, BMC Software, and Adobe Systems, to name just a few of the largest of thousands of software vendors. With commercial software becoming more capable, more adaptable, and more available for a wider range of specialized needs, it is no surprise that total U.S. enterprise spending in this category reached $119 billion in 2003 and will grow by 10 percent to $131 billion in 2004. Commercial software includes both packaged off-the-shelf software and component-based software that can be configured and customized by the purchaser.

Twenty years ago, custom-developed software still dominated the commercial software segment, especially for enterprise operations and applications. However, the role of custom-developed software has steadily diminished as commercial packaged and semi-packaged software has grown in sophistication and scope. Spending on custom-developed software, according to Forrester calculations, equaled $15 billion in 2003—one-eighth of the spending in commercial software overall. Governments—especially the federal government—have a disproportionate share of this market, due to their very specialized needs and limited resources for internal software development. However, the availability of low-cost, offshore development resources, which is being used increasingly by many businesses, especially in financial services and in high-technology, has recently reversed this trend. Forrester projects that spending on custom-developed software will equal $17 billion in 2004, up 13 percent from 2003.

Enterprises will continue to develop their own software to meet unique needs and requirements, and to adapt and customize packaged applications. However, investment in internally built software has been steadily declining year over year as commercial software has become more capable and customizable, and has been developed to support more business processes and adapted for different vertical industries. The Commerce Department calculates that investment in internally built software was $83 billion in 2003, and Forrester projects that it will grow by 4 percent to $86 billion in 2004. Governments, insurance companies, banks, utilities, retail and wholesale firms, health care companies, telecom companies, and manufacturers will make about half of these investments during 2004, while the other half comes from software vendors and other technology companies developing software for sales to others. Investment in internal software will continue to shrink as development needs of IT buying enterprises narrow to the creation of specific functions not available in commercial software or to extensions and adaptations, but investment in internally built software by IT vendors will grow as the market shifts to commercial software.

Audit Issues and Developments

Assessing Audit Risks in the Current Environment

The proper planning and execution of an audit has always required you to have an understanding of the high-technology industry and the nature of your client's business. Auditors of high-technology companies will need to obtain an understanding of the client's products, services, and distribution processes, and the terms and conditions of sales arrangements. Such an understanding will enhance your ability to plan and perform auditing procedures. For most audit firms, this understanding means that the most experienced partners and managers must become involved early and often in the audit process.

You should keep the following points in mind as you plan and perform audits of high-technology clients:

- Understand how your client is affected by changes in the current business environment.
- Understand the stresses on your client's internal control over financial reporting, and how they may affect its effectiveness.
- Identify key risk areas, particularly those involving significant estimates and judgments.
- Approach the audit with objectivity and skepticism, setting aside prior experiences with or belief in management's integrity.
- Pay special attention to complex transactions, especially those presenting difficult issues of form versus substance.
- Consider whether additional specialized knowledge is needed on the audit team.
- Make management aware of identified audit differences on a timely basis.
- Question the unusual and challenge anything that doesn't make sense.
- Foster open, ongoing communications with management and the audit committee, including discussions about the quality of financial reporting and any pressure to accept less than high-quality financial reporting.
- When faced with a "gray" area, perform appropriate procedures to test and corroborate management's explanations and representations, and consult with others as needed.

Specific points to keep in mind with respect to high-technology clients include:

- Consider the inappropriate use of "bill and hold" accounting, for example, in circumstances where the customer has not requested the delay in shipment or provided a ship date that is unreasonably long in the circumstances.
- Identify "round trip" transactions (see the "Accounting Issues and Developments" section later in this Alert for a detailed discussion of these transactions).
- Consider nonmonetary transactions.
- Pay attention to whether persuasive evidence of the arrangement exists at the time revenue is recognized and whether legal title to the goods has been transferred and the customer has all the risks and rewards of ownership at that time.
- Consider customers' rights of return, particularly those of distributors, and whether all the requirements of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists*, have been satisfied for revenue recognition.

Audit Planning

Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), among other matters, provides guidance for auditors regarding the specific procedures that should be considered in planning an audit in accordance with generally accepted auditing standards (GAAS). SAS No. 22 states that the auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics, and consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions as they relate to the specific audit. For audits of high-technology companies, you should consider obtaining information relating to:

- The types of products being developed and marketed as well as their corresponding life cycles.
- Whether those products are relatively standard or require significant customization.
- Whether the company has a practice of allowing customers to return products for new or upgraded models.
- Whether the company sells standalone products or a bundle of products and services (that is, multiple-element arrangements).
- The company's current marketing programs, for example, pricing incentives and the nature of any incentives that may affect the timing of revenue recognition.
- Whether the company uses a standard form of sales agreement; if standard sales agreements are not used, the processes by which sales agreements are evaluated for propriety of revenue recognition.
- Compensation plans for management and sales personnel that may provide an incentive to misstate revenue.
- Factors used by stock analysts to value the entity.
- The general terms of the company's arrangements with distributors and value-added resellers (VARs), if the company uses them.
- The types of arrangements and warranty provisions the company typically enters into with its end-user customers.
- If sales are made internationally, the laws of the local jurisdiction relating to billing, transfer of title, or other items that may affect revenue recognition.
- The competitive environment.

The Competitive Environment

The high-technology industry is extremely competitive. Industry participants use a variety of pricing mechanisms and other product offerings to gain market share and increase their customer base. Some segments of the industry—most notably, the PC segment—sell what is considered a commodity. When a product is considered a commodity, the primary means of differentiation is price, and it is not unusual for participants in the industry to engage in aggressive pricing practices or offer generous sales concessions to gain or retain market share.

Rapid innovation and substantial technological change also characterize the industry. New industry players and products continuously emerge, and companies are under constant pressure to enhance the capabilities and quality of their products and services. Clients whose products become technologically inferior become vulnerable to customer demands for price or other concessions.

The pressure to meet quarterly or annual earnings targets creates a strong incentive for entities to complete transactions by the end of the reporting period. Customers can take advantage of this desire to meet revenue expectations by forcing companies to lower prices or provide more liberal sales terms in contracts negotiated near the end of a reporting period. For this reason, it is not uncommon for high-technology companies to report a proportionately higher number of sales near the end of a reporting period. This situation generally leads to a greater risk of material misstatement to the financial statements.

Revenue Recognition

Revenue recognition continues to pose significant audit risk to auditors. The high-technology industry represents one of the more challenging industries when it comes to the topic of revenue recognition.

The Securities and Exchange Commission (SEC) sought to fill the gap in the accounting literature with Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, which was issued in December 1999, and the companion document, *Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers*, which was issued in October 2000. SAB No. 101 was superseded by SAB No. 104, *Revenue Recognition*, in December 2003. SAB No. 104 states that if a transaction falls within the scope of specific authoritative literature on revenue recognition, that guidance should be followed; in the absence of such guidance, the revenue recognition criteria in FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (namely, that revenue should not be recognized until it is (1) *realized or realizable* and (2) *earned*), should be followed. However, SAB No. 104 is more specific, stating additional requirements for meeting those criteria, and reflects the SEC staff's view that the four basic criteria for revenue recognition in AICPA Statement of Position (SOP) 97-2, *Software Revenue Recognition*, should be a foundation for all basic revenue recognition principles. Those criteria are:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred.
- The vendor's fee is fixed or determinable.
- Collectibility is probable.

The SEC continues to see instances of questionable and inappropriate revenue recognition practices. Significant issues encountered recently include:

- Complex arrangements that provide for separate, multiple deliverables (for example, multiple products and/or services), at different points in time, during the contract term.
- Nonmonetary (for example, barter) transactions where fair values are not readily determinable with a sufficient degree of reliability.

The SEC has requested that the Emerging Issues Task Force (EITF) address certain of these issues to clarify the application of GAAP in these transactions. However, the SEC staff generally believes that the existing accounting literature provides analogous guidance for a number of these issues, including SOP 97-2, *Software Revenue Recognition*; Accounting Principles Board (APB) Opinion No. 29, *Accounting for Nonmonetary Transactions*; SOP 81-1, *Accounting for Performance of Construction-Type* *and Certain Production-Type Contracts*; FASB Concept Statement No. 5; and FASB Concept Statement No. 6, *Elements of Financial Statements*.

In an industry as varied as high technology, invariably there will be significant differences among companies regarding the types of products and services sold, and how they are sold. Characteristics of high-technology revenue transactions that may affect revenue recognition include the following.

- *Bundled sales*. The bundling of installation or other services with product sales can complicate the revenue recognition process.
- *Indirect versus direct selling*. Many high-technology companies use a combination of direct sales with a network of VARs and distributors to sell their products to end users. Sales made through distributors, as well as significant single sales, often can have unique, nonstandard terms. It is common for high-technology companies to provide incentives or sales concessions to their VARs and distributors that go beyond the rights of return granted to end users. Many of the incentives and concessions raise revenue recognition issues.
- *Bill and hold sales*. It is not uncommon for high-technology companies to enter into bill and hold transactions. In a bill and hold transaction, a customer agrees to purchase the goods but the seller retains physical possession until the customer requests shipment. Normally, such an arrangement does not qualify as a sale because delivery has not occurred.
- *International sales*. High-technology companies may make sales in non-U.S. legal jurisdictions. The laws in these jurisdictions relating to product sales can vary significantly from U.S. laws. For example, some countries may prohibit the billing for goods until delivery occurs or may have rules regarding transfer of title that may be significantly different from U.S. rules.

AICPA's Audit Guide on Revenue Recognition

The AICPA Audit Guide *Auditing Revenue in Certain Industries* assists auditors in auditing assertions about revenue in selected industries not covered by other AICPA Audit and Accounting Guides. You can look to this Guide for descriptions and explanations of auditing standards, procedures, and practices as they relate to auditing assertions about revenue in both the computer software and high-technology manufacturing industries.

This 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 GAAP.
- 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 GAAS.
- Describes procedures that the auditor may find effective in limiting audit risk arising from improper revenue recognition.

You can order the AICPA Audit Guide *Auditing Revenue in Certain Industries* (product no. 012514kk) from the AICPA at (888) 777-7077 or go online at www.cpa2biz.com.

Consideration of Fraud

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit.

Considering Fraud Risk Factors

You may identify events or conditions that indicate incentives or pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes and rationalizations to justify a fraudulent action. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

SAS No. 99 provides fraud risk factor examples that have been written to apply to most enterprises. Remember that fraud risk factors are only one of several sources of information you consider when identifying and assessing risk of material misstatement due to fraud. Some examples of fraud risk factors that may exist in the high-technology industry include the following:

- Management's excessive interest in maintaining sales or earnings without regard to proper accounting or to the company's established revenue recognition policies.
- Significant amounts of executive compensation tied to stock performance.
- Excessive involvement of nonfinancial management, such as sales personnel in financial reporting.
- A failure by management to display and communicate an appropriate attitude regarding internal control and financial reporting. Specific indicators might include—
  - Poor or no coordination between sales, accounting, and legal personnel regarding the terms of sales agreements that affect revenue recognition.
  - Lack of control over contract documentation, and insufficient review and understanding of the sales agreements by finance personnel.
  - Lack of communication throughout the organization regarding acceptable revenue recognition practices.
  - The existence of side agreements.
- A highly competitive environment.
- High vulnerability to technological changes and product obsolescence.

- Significant volumes of product sold into a distribution channel without a corresponding increase in end-user demand.
- Continuing sales to resellers coupled with a lack of enforcement of payment terms on previously outstanding balances.
- Frequent changes in marketing or distribution methods or strategies.
- Existence of an unusual number of contract amendments, late changes, or both.
- The use by management of unusually aggressive accounting practices in recognizing revenue.
- Complicated criteria for recognizing sales transactions, making it difficult to assess the completion of the earnings process. (For additional information about revenue-recognition-related issues, see the "Revenue Recognition" section of this Alert.)
- Inadequate responses or an unwillingness to respond to inquiries about known regulatory or legal issues.
- Significant related-party transactions.
- A significant portion of management compensation represented by bonuses, stock options, or other incentives.
- Excessive interest by management in maintaining or increasing an entity's stock price.
- Existence of nonmonetary transactions.

SAS No. 99 also identifies risk factors related to misstatements arising from fraudulent financial reporting, such as a high degree of competition or market saturation and rapidly changing technology or rapid product obsolescence. All of these factors are present in the high-technology industry, implying potential audit concerns.

Identifying Risks That May Result in a Material Misstatement Due to Fraud

In identifying risks of material misstatement due to fraud, it is helpful to consider the information that has been gathered in accordance with the requirements of SAS No. 99 (AU sec. 316.19-.34). Your identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, you should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.

Practical Guidance

The AICPA has developed a Practice Aid titled *Fraud Detection in a GAAS Audit, Revised Edition* (product no. 006615kk), which provides practical help on considering fraud in a financial statement audit. Also see the AICPA's Antifraud & Corporate Responsibility Resource Center at www.aicpa.org/antifraud, an online resource providing comprehensive tools, information, and resources devoted to the prevention, detection, and investigation of fraud.

Evaluating Going Concern

A number of high-technology industry sectors have experienced intense competition, recurring operating losses, negative cash flows, and the inability to obtain debt or equity financing.

Certain conditions, considered in the aggregate, may lead you to question the entity's ability to continue as a going concern. In general, conditions and events that might indicate caution about going-concern issues could include (1) negative trends, such as recurring operating losses; (2) financial difficulties, such as loan defaults or denial of trade credit from suppliers; (3) internal challenges, such as substantial dependence on the success of a particular product line or service; or (4) external matters, for example, pending legal proceedings or loss of a principal supplier. Also consider the case of an entity's excessive and unusual reliance on external financing, rather than on money generated from the company's own operations as a going-concern issue.

Key in evaluating these risk factors is whether:

- Existing conditions and events can be mitigated by management's plans and their effective implementation.
- The company has the ability to control the implementation of mitigating plans rather than depending on actions of others.
- The company's assumption about its ability to continue as a going concern is based on realistic, rather than overly optimistic, assessments of its access to needed debt or equity capital or its ability to sell assets in a timely manner.
- Liquidity challenges have been appropriately satisfied and disclosed.

When evaluating management's plans to continue as a going concern, an appropriate level of professional skepticism is important. For example, you may want to scrutinize the company's assumptions to continue as a going concern to assess whether those assumptions are based on overly optimistic or "once-in-a-lifetime" occurrences.

Key factors in your evaluation of the ability to continue as a going concern are part of the guidance provided in 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), as amended.

Auditor's Responsibilities Related to a Going-Concern Issue

Auditors should be aware of their responsibilities pursuant to SAS No. 59 (AU sec. 341.02 and .03(b)). That Statement provides guidance about conducting an audit of financial statements in accordance with GAAS to evaluate whether there is substantial doubt about a client's ability to continue as a going concern for a reasonable period of time.

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, or the ability to remain a going concern, 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 you 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 management plans can mitigate existing conditions and events and whether those plans can be effectively implemented. If you obtain sufficient competent evidential matter to alleviate doubts about going-concern issues, you should give consideration to the possible effects on the financial statements and the adequacy of the related disclosures. 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, refer to the specific guidance set forth under SAS No. 59.

Inventory Valuation

The primary literature on inventory accounting is Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, as amended, chapters 3A and 4, which provide the following summary:

> Inventory shall be stated at the lower of cost or market, except in certain exceptional cases when it may be stated above cost. Cost is defined as the sum of the applicable expenditures and charges directly or indirectly incurred in bringing inventories

to their existing condition and location. Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as first-in, first-out; average; and last-in, last-out).

Whether inventory is properly stated at lower of cost or market can be a very significant issue for high-technology audit clients because of the rapid changes that can occur in many areas of the industry, and the need for entities to keep up with the newest technology. Examples of factors that may affect inventory pricing include:

- Changes in a product's design that may have an adverse impact on the entity's older products, with older products not as salable as the newer versions.
- A competitor's introduction of a technologically advanced version of the product that may decrease salability of a client's products.
- Changes in the products promoted by the industry as a whole, such as a shift from analog to digital technology, that may affect salability.
- Changes in foreign economies that could result in such situations as slowdown of sales to that region or lower-priced imports from that region.
- Changes in technology to produce high-technology products that can give competitors a selling-price advantage.
- Changes in regulations that could affect the competitive environment.
- The entity's own product changes that may not be well researched due to the pressure to introduce new products quickly, resulting in poor sales or high returns.

The highly competitive environment and the rapid advancement of technological factors contribute to the common problem of rapid inventory obsolescence in the high-technology industry. As such, you should consider whether the carrying amount of inventories is appropriate.

You can look at many factors in determining the proper valuation of inventories. A few examples of factors that may be useful include the following:

- 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 reserves 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 product is sold
- Economic conditions in areas where competitive products are produced
- Changes in the regulatory environment
- Unusual or unexpected movements, or lack thereof, of certain raw materials for use in work-in-process inventory
- Levels of product returns
- Pricing trends for the type of products sold by the client
- Changes in standards used by the industry

These are not the only issues of importance to consider. You may need to address many other issues, including the client's taking of physical inventories in high-technology entities. Consider guidance set forth in SAS No. 1 (AU sec. 331.09-.13). Among the issues for your consideration are the following:

- When dealing with some difficult types of inventory, such as chemicals used in the process, you may need to take samples for outside analysis. The work of a specialist may also be needed, and in this case you should follow the guidance set forth in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).

- The extent to which raw materials have been converted to work-in-process will need to be determined to assess the value of the work-in-process.
- Indications of old or neglected materials or finished goods need to be considered in the valuation of the inventory.
- The client's inventory held by others, as well as field service inventories for use in servicing the client's products, will need to be considered.

In addition, the SEC staff believes that inventory reserves create a new cost basis and thus cannot be subsequently reversed into income as a change in estimate if, for example, demand were forecasted to pick up and thereby a previously established excess and obsolete inventory reserve were deemed no longer necessary.

There are also risks posed by the use of contract manufacturers. In many of those circumstances the hardware vendor will provide the contract manufacturer with a guarantee against its loss due to excess raw material inventory (and, possibly, against the value added in the manufacturing or assembly process) that would occur if the vendor were to reduce purchases beyond a certain point. Such a guarantee may represent a contingent loss that needs to be recognized or disclosed under FASB Statement No. 5, *Accounting for Contingencies*. The disclosure requirements of FASB Statement No. 47, *Disclosure of Long-Term Obligations,* also need to be considered.

Accounting Issues and Developments

Revenue Recognition

Income Statement Classification

The appropriate classification of amounts within the income statement or balance sheet can be as important as the appropriate measurement or recognition of such amounts. In the current environment where revenue growth may not be as robust as originally projected, you need to be particularly concerned about income statement misclassifications designed to increase reported revenue (for example, reporting agency transactions on a gross basis and showing sales discounts as a marketing expense rather than a revenue reduction). Several EITF consensus provisions provide guidance on the proper classification of certain revenue and expense items. For example, consider EITF Issues No. 99-17, "Accounting for Advertising Barter Transactions"; No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent"; No. 00-10, "Accounting for Shipping and Handling Fees and Costs"; and No. 00-14, "Accounting for Certain Sales Incentives." SEC registrants should apply the guidance provided in SEC Regulation S-X regarding classification of amounts in financial statements.

Round Tripping

Round tripping is another technique used to artificially inflate revenues and has appeared in several restatement scenarios. It involves transactions in which the company sells products and services to the same entity from which it buys products and services. Often the transactions happen in close temporal proximity and completing one transaction is dependent on completing the other. The fair value of both transactions may be overstated such that the company can report higher revenue at the "cost" of increased expenses. In addition, the products and services purchased back may not be used in the same period the revenue is recognized, resulting in more than a basic incorrect grossing-up of the income statement.

Vendor Financing

The reduced liquidity of many customers is resulting in an increased use of vendor financing that goes well beyond normal trade terms. That requires consideration of whether the fee is fixed or determinable and/or collectible. In addition, provisions of APB Opinion No. 21, *Interest on Receivables and Payables*, need to be considered.

Nonmonetary or Barter Transactions

Abuses in the area of nonmonetary or barter transactions have also been a focus of several recent restatements. The principle issues are whether there is a legitimate business purpose for the transaction and whether there is sufficient objective evidence of fair values. Also of concern are "disguised" barter transactions that are not analyzed as such due to the presence of "boot" or separation in time of transactions that are, in fact, negotiated together. Abuses are seen most often in situations where there is little hard inventoriable cost associated with the deliverables.

The FASB has issued a proposed FASB Statement, *Exchanges of Productive Assets—an amendment of APB Opinion No. 29*, that would affect the accounting for nonmonetary exchanges. A final Statement is expected to be issued in late 2004. Readers should be alert for any final guidance.

Price Protection Agreements

A price protection clause requires a high-technology company to rebate or credit a portion of the sales price if the company subsequently reduces its price for a product and the distributors and VARs are entitled to the benefits of the price concession for past sales or for software or products in inventory. High-technology companies should provide appropriate allowances at the date of revenue recognition for price concessions; however, revenue should not be recognized until reasonable and reliable estimates of the effects of price concessions can be made.

Guaranteed Minimum Resale Value

EITF Issue No. 95-1, "Revenue Recognition on Sales with a Guaranteed Minimum Resale Value," provides guidance when a manufacturer sells equipment to a purchaser and guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of. The seller may agree to (1) reacquire equipment at a guaranteed price at specified time periods as a means to facilitate its resale or (2) pay the purchaser for the deficiency. According to the EITF, the manufacturer is precluded from recognizing a sale if the manufacturer guarantees the resale value of the equipment. Rather, the manufacturer should account for the transaction as a lease, using the guidance in FASB Statement No. 13, *Accounting for Leases*.

Inventory Costs

In November 2004, the FASB issued Statement No. 151, *Inventory Costs—an amendment of ARB No. 43, Chapter 4*, which clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities.

This standard will most likely affect the high-technology industry in the computer segment where in the past there has been confusion about whether companies should capitalize or expense unusual amounts of costs associated with production below normal levels.

The standard is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after November 23, 2004. The provisions of FASB Statement No. 151 should be applied prospectively. The final standard can be obtained on the FASB Web site at www.fasb.org.

Employee Stock Options

Knowledgeable workers are the prime assets of high-technology businesses and are the key to wealth creation. Accounting for their compensation sometimes raises difficult accounting issues if high-technology companies include stock options in employee compensation packages. High-technology companies grant stock options to essential employees to attract, motivate, and retain them, in addition to granting stock options, awards of stock, or warrants to consultants, contractors, vendors, lawyers, finders, lessors, and others. Issuing equity instruments makes a lot of sense, partly because of the favorable accounting treatment and partly because the use of equity conserves cash and generates capital.

Due to increased scrutiny from the press, Congress, regulators, and others, the FASB issued an exposure draft in March 2004, *Share-Based Payment*. The proposed Statement addresses the accounting for employee stock options. It also addresses the accounting for transactions in which a company incurs liabilities that are based on the fair value of the company's equity instruments or that may be settled by issuing equity instruments in exchange for employee services. The proposed Statement only affects employee stock options (and related liabilities); it does not affect the accounting for similar transactions involving parties other than employees. It also does not affect the accounting for employee stock ownership plans, which are subject to SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans*. Generally, the approach in the proposed Statement is similar to the approach described in FASB Statement No. 123, *Accounting for Stock-Based Compensation.* However, the proposed Statement would require all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values.

The main purpose of this proposed Statement is to recognize the cost of employee services received in exchange for equity instruments and related liabilities in an entity's financial statements. Key provisions of the proposed Statement are as follows:

- For public entities, the cost of employee services received in exchange for equity instruments would be measured using the fair value of those instruments on the grant date. The compensation cost would then be recognized over the requisite service period (usually the vesting period). Generally, no cost would be recognized if the equity instruments do not vest.
- For public entities, the cost of employee services received in exchange for liabilities would be measured at the fair value of the liabilities initially, then remeasured at each reporting date through the settlement date. The pro rata change in the fair value of the liability during the requisite service period would be recognized over that period. After the requisite service period is complete, the change in fair

value would be recognized in the financial statements in the period of the change.

- On the grant date, the estimated fair value of employee stock options and similar instruments would be determined using options pricing models (unless observable market prices are available).
- If an equity award is modified after the grant date, incremental compensation cost will be recognized. This amount will be the difference between the fair value of the modified award and the fair value of the original award immediately before the modification.
- If the terms of employee share purchase plans were no more favorable than those available to all holders of the same class of shares, and substantially all employees could participate on an equitable basis, those plans would not be considered compensatory.
- Excess tax benefits, as defined by the proposed Statement, would be treated as additional paid-in capital. Cash retained as a result of those benefits would be reported in the statement of cash flows as cash from financial activities. The write-off of deferred tax assets as a result of unrealized tax benefits associated with recognized compensation would be reported as income tax expense.
- The proposed Statement allows nonpublic companies to elect to use the intrinsic method to measure the cost of employee stock options and similar instruments, as well as liability instruments. Public companies may also use the intrinsic method if it is not reasonably possible to estimate grant-date fair value.
- The notes to the financial statements of all entities should include information that users need to understand the nature of employee stock options and similar instruments and the effect those instruments have on the financial statements.

However, the proposed Statement has developed into a political issue. In July 2004, the U.S. House of Representatives (the

House) voted to block the proposed Statement. The House-passed measure would limit required expensing of options to those owned by a corporation's top five executives. It also would allow newly public companies to delay expensing for top executives in the first three years. In the House debate, supporters of the legislation insisted that a mandate to expense options complicate income statements, discourage startup companies, and hurt the economy by stifling future innovation. Backers also said it was impossible to determine the value of options.

The FASB recently announced a delay in the effective date of the proposed Statement because corporations already are facing deadlines to implement other new regulations enacted in 2002 in response to the Sarbanes-Oxley Act. The proposed Statement will be effective for awards that are granted, modified, or settled in fiscal years beginning after (1) June 15, 2005, for public entities and nonpublic entities that used the fair-value-based method of accounting under the original provisions of FASB Statement No. 123 for recognition or pro forma disclosure purposes and (2) December 15, 2005, for all other nonpublic entities.

You should continue to follow the developments of this proposed Statement and discuss its implications with your high-technology clients. For information on this exposure draft and other accounting standards issued subsequent to this Alert, please refer to 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.*

Research and Development Costs

As noted in last year's Alert, ongoing innovation is the heart of competition in the high-technology industry and is required for survival. Consequently, most high-technology companies devote a substantial portion of their resources to research and development (R&D) activity. According to paragraphs 8(a) and 8(b) of FASB Statement No. 2, *Accounting for Research and Development Costs*:

> Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service…

> *Development* is the translation of research findings or other knowledge into a plan or design for a new product or process…whether intended for sale or use.

High-technology management may reduce net loss or increase earnings by capitalizing R&D costs, which are significant for many companies in the high-technology industry. However, FASB Statement No. 2, as interpreted by FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, prohibits capitalization and requires R&D to be expensed when incurred, except for acquired R&D with alternative future uses purchased from others. In addition to the requirement to expense internal R&D, FASB Statement No. 2 requires disclosure in the financial statements regarding the total amount of R&D costs charged to expense.

Some high-technology companies acquire their assets through mergers and acquisitions. One purpose of these business combinations is to acquire in-process R&D. You may need to hire a technology specialist to determine which acquired technology objects have alternative future uses. For clients with technology with alternative future uses, you should verify that they are properly valued and capitalized.

The 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* (product no. 006609kk) may be helpful in valuing these intangible assets. The Practice Aid can be obtained by calling AICPA Service Center Operations at (888) 777-7077 or by going online at www.cpa2biz.com.

New Auditing, Attestation, and Quality Control Pronouncements, and Other Guidance

Presented below is a list of auditing, attestation, and quality control pronouncements and other guidance issued since the publication of last year's Alert. The AICPA general *Audit Risk Alert—2004/05* (product no. 022335kk) contains a summary explanation of most of these issuances. For information on auditing, attestation, and other standards and guidance issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org and the Public Company Accounting Oversight Board (PCAOB) Web site at www.pcaobus.org. The PCAOB sets auditing standards of public companies and other SEC registrants only. 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's Auditing Standards team and available at www.aicpa.org/members/div/auditstd/opinion/index.htm.

SOP 04-1 (November 2004) (Not applicable to audits conducted in accordance with PCAOB standards)	*Auditing the Statement of Social Insurance*
AICPA Audit Interpretation No. 17 of SAS No. 58 (June 2004) (Not applicable to audits conducted in accordance with PCAOB standards)	"Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance with Generally Accepted Auditing Standards"
AICPA Audit Interpretation No. 18 of SAS No. 58 (June 2004) (Not applicable to audits conducted in accordance with PCAOB standards)	"Reference to PCAOB Standards in an Audit Report of a Nonissuer"
PCAOB Auditing Standard No. 1 (May 2004) (Applicable to audits conducted in accordance with PCAOB standards)	*References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*
PCAOB Auditing Standard No. 2 (June 2004) (Applicable to audits conducted in accordance with PCAOB standards)	*An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*
PCAOB Auditing Standard No. 3 (August 2004) (Applicable to audits conducted in accordance with PCAOB standards)	*Audit Documentation and Amendment to Interim Auditing Standards*
PCAOB Rules (Various dates) (Applicable to audits conducted in accordance with PCAOB standards)	In the past year the PCAOB has issued numerous rules to be used by registered public accounting firms in the preparation and issuance of audit reports. For a complete listing of PCAOB rules, go to www.pcaobus.org.

(*continued*)

PCAOB Staff Questions and Answers (Various dates) (Applicable to audits conducted in accordance with PCAOB standards only)	1. *Auditing Internal Control Over Financial Reporting* 2. *Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the PCAOB*
Suggested Framework for Internal Controls Related to PCAOB Auditing Standard No. 2	*A Framework for Evaluating Process/ Transaction-Level Exceptions and Deficiencies*
Revised AICPA Ethics Interpretation No. 101-3 (September 2003 and July 2004)	"Performance of Nonattest Services"
AICPA Ethics Ruling No. 12 under Rule 102 (November 2004)	"Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services"
AICPA Ethics Ruling No. 12 under Rules 201 and 202 (November 2004)	"Applicability of General and Technical Standards When Using a Third-Party Service Provider"
Revised AICPA Ethics Ruling No. 1 under Rule 301 (November 2004)	"Computer Processing of Clients' Returns"
AICPA Toolkit (December 2003) (Nonauthoritative)	*The AICPA Audit Committee Toolkit*
AICPA Practice Alert No. 2003-03 (June 2004) (Nonauthoritative)	*Acceptance and Continuance of Clients and Engagements*
AICPA Practice Alert No. 2004-01 (November 2004) (Nonauthoritative)	*Illegal Acts*
AICPA Practice Aid (June 2004) (Nonauthoritative)	*Auditing Governmental Financial Statements: Programs and Other Practice Aids*
AICPA Technical Practice Aid 9110.15 (September 2004) (Nonauthoritative)	*Reporting on Medicaid/Medicare Cost Reports*
AICPA Practice Aid (November 2004) (Nonauthoritative)	*Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*
New COSO Framework (September 2004)	*Enterprise Risk Management—Integrated Framework*

For summaries of the above standards and other guidance, visit the applicable Web site. The standards and interpretations promulgated by the AICPA Auditing Standards Board are now available free of charge by visiting the AICPA's Audit and Attest Standards Team's page at www.aicpa.org/members/div/auditstd/Auth_Lit_for_NonIssuers.htm. Members and nonmembers alike can download the auditing, attestation, and quality control standards by either choosing a section of the codification or an individual statement number. You can also obtain copies of AICPA standards and other guidance by contacting Service Center Operations at (888) 777-7077 or going online at www.cpa2biz.com.

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. The AICPA general *Audit Risk Alert—2004/05* (product no. 022335kk) contains a summary explanation of most of these issuances. 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. 132(R) (revised 2003) (December 2003)	*Employers' Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106*
FASB Statement No. 151 (November 2004)	*Inventory Costs—an amendment of ARB No. 43, Chapter 4*
FASB Interpretation No. 46(R) (revised December 2003) (December 2003)	*Consolidation of Variable Interest Entities—an interpretation of Accounting Research Bulletin No. 51*
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/ for a complete list of EITF Issues.
FASB Staff Positions (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FASB Staff Positions (FSPs). Some of the recently issued FSPs address issues relating to FASB Statements

(*continued*)

	No. 141, No. 142, No. 144, and No. 150, among others; FASB Interpretations No. 45 and 46(R); and EITF Issue No. 03-1.
SEC Rules, Regulations, Accounting Bulletins, etc. (Various dates)	Go to www.sec.gov for a complete list of all SEC Guidance.
AICPA Audit and Accounting Guide (January 2004)	*Audits of Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies*
SOP 03-3 (December 2003)	*Accounting for Certain Loans or Debt Securities Acquired in a Transfer*
SOP 03-4 (December 2003)	*Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships
SOP 03-5 (December 2003)	*Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies
SOP 04-2 (December 2004)	*Accounting for Real Estate Time-Sharing Transactions*
AICPA Practice Aid (May 2004) (Nonauthoritative)	*Valuation of Privately-Held Company Equity Securities Issued as Compensation*
AICPA Technical Practice Aid 6930.05 (July 2004) (Nonauthoritative)	*Sale of Real Estate Investments Held by Employee Benefit Plans and Discontinued Operations*
AICPA Technical Practice Aid 6400.45 (August 2004) (Nonauthoritative)	*Applicability of FASB Interpretation No. 45—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—Physician Loans*
AICPA Technical Practice Aid 6400.46 (August 2004) (Nonauthoritative)	*Applicability of FASB Interpretation No. 45—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—Mortgage Guarantees*
AICPA Technical Practice Aids 6300.05-.08 (October 2004) (Nonauthoritative)	Related to SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*

For summaries of the above standards and other guidance, visit the applicable Web site. To obtain copies of AICPA standards and other guidance, contact Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. You should check the appropriate standard-setting Web sites (listed below) for a complete picture of all accounting and auditing projects in process. Presented below is brief information about some ongoing projects that may be relevant to your high-technology engagements. Refer to the AICPA general *Audit Risk Alert—2004/05* (product no. 022335kk) for additional summaries of some of the more significant ongoing projects and exposure drafts outstanding. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP, GAAS, or PCAOB standards.

The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts and where copies of exposure drafts may be downloaded. 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) (Note that for audits of public companies, the Public Company Accounting Oversight Board sets auditing standards.)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.fasb.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org

Help Desk—The AICPA's standard-setting committees publish 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 service@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to expedite your submission. Include your full name, mailing address and, if available, your membership and subscriber number in the message.

Auditing Pipeline—Nonpublic Companies

The proposed standards discussed in this section do not apply to the audits of public companies and other audits conducted under the standards of the PCAOB. Readers should keep abreast of the status of the following 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.

Proposed SAS, *Communication of Internal Control Related Matters Noted in an Audit*

This proposed SAS will supersede SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), and significantly strengthen the quality of auditor communications of such matters in audits of nonpublic companies. Readers should be alert for the issuance of a final standard.

Seven SASs Related to Audit Risk Proposed

In December 2002, the AICPA's Auditing Standards Board (ASB) issued an exposure draft proposing seven new SASs relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*
- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. Readers should be alert for the issuance of final standards in the first half of 2005.

Proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Over Financial Reporting*

This proposed Statement on Standards for Attestation Engagements (SSAE) establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). Specifically, guidance is provided regarding the following:

- Conditions that must be met for a practitioner to accept an engagement to examine the effectiveness of an entity's internal control and the prohibition of acceptance of an engagement to review such subject matter
- Engagements to examine the design and operating effectiveness of an entity's internal control
- Engagements to examine the design and operating effectiveness of a portion of an entity's internal control (for example, internal control over financial reporting of an entity's operating division or its accounts receivable)
- Engagements to examine only the suitability of design of an entity's internal control (no assertion is made about the operating effectiveness of internal control)
- Engagements to examine the design and operating effectiveness of an entity's internal control based on criteria established by a regulatory agency

Readers should be alert for the issuance of a final standard.

Accounting Pipeline

Proposed FASB Statement *Share-Based Payment—an amendment of FASB Statements No. 123 and 95*

This proposed Statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally would require instead that such transactions be accounted for using a fair-value-based method. A final Statement is expected to be issued during the fourth quarter of 2004. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement *Fair Value Measurements*

In June 2004, the FASB published an exposure draft of a proposed Statement, *Fair Value Measurements*, which seeks to establish a framework for measuring fair value that would apply broadly to financial and nonfinancial assets and liabilities, improving the consistency, comparability, and reliability of the measurements. The fair value framework would clarify the fair value measurement objective and its application under authoritative pronouncements that require fair value measurements. The exposure draft would replace any current guidance for measuring fair value in those pronouncements and would expand current disclosures. Readers should be alert for the issuance of a final Statement, which is expected in the first quarter of 2005. Refer to the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statements Resulting From Short-Term International Convergence Project

In an effort to reduce or eliminate certain differences between U.S. GAAP and international financial reporting standards (IFRS), the FASB issued exposure drafts on the proposed FASB Statements listed below. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement *Accounting Changes and Error Correction—a replacement of APB Opinion No. 20 and FASB Statement No. 3*	This proposed Statement would change the reporting of certain accounting changes specified in APB Opinion No. 20, *Accounting Changes*, by requiring retrospective application of a newly adopted accounting policy for most changes in accounting principle, including changes in accounting principle required by issuance of new pronouncements. It would also require reporting of a change in depreciation, amortization, or depletion method as a change in accounting estimate. Readers should be alert for the issuance of a final Statement, expected in the first quarter of 2005.

(*continued*)

Proposed FASB Statement *Exchanges of Productive Assets—an amendment of APB Opinion No. 29*	This proposed Statement would eliminate paragraph 21(b) of APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, which establishes an exception to the general principle that exchanges of nonmonetary assets should be recorded at the fair value of the assets exchanged. This proposed Statement would require that exchanges of productive assets be accounted for based on the fair values of the assets involved, unless the exchange transaction does not have commercial substance. Readers should be alert for the issuance of a final Statement, expected in the fourth quarter of 2004.
Proposed FASB Statement *Earnings per Share—an amendment of FASB Statement No. 128*	This proposed Statement would amend the computations guidance in FASB Statement No. 128, *Earnings per Share*, for calculating the number of incremental shares included in diluted shares when applying the Treasury stock method. Also, this proposed Statement would eliminate the provisions of Statement No. 128 that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in stock. In addition, this proposed Statement would require that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted-average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory. Readers should be alert for the issuance of a final Statement, which is expected to be released in the fourth quarter of 2004.

Proposed FASB Interpretation *Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143*

This proposed Interpretation would clarify that a legal obligation to perform an asset retirement activity that is conditional on a future event is within the scope of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*. Readers should be alert for the issuance of a final Statement, which is expected to occur in the fourth quarter of 2004. Refer to the FASB Web site at www.fasb.org for complete information.

Proposed FASB EITF Issues

Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

Proposed FASB Staff Positions

A number of proposed FASB Staff Positions are in progress addressing issues related to FASB Statements No. 140, No. 142, No. 109 and EITF No. 03-1. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

Resource Central

Presented below are various resources that practitioners engaged in the high-technology industry may find beneficial.

Publications

The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements (product numbers appear in parentheses):

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2001) (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2004) (product no. 012514kk)
- Audit Guide *Audit Sampling* (2001) (product no. 012530kk)
- Audit Guide *Analytical Procedures* (2004) (product no. 012554kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended (2004)* (product no. 012774kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (1998) (product no. 010010kk)

- *Accounting Trends & Techniques—2004* (product no. 009896kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (1998) (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit, Revised Edition (2004)* (006615kk)
- General *Audit Risk Alert—2004/05* (product no. 022335kk)

Audit and Accounting Manual

The *Audit and Accounting Manual* (revised as of July 1, 2004) (product no. 005134kk) 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, and engagement letters; management representation letters; and confirmation letters.

Educational Courses

The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Visit www.cpa2biz.com for a complete list of CPE courses.

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

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 following table.

Name of Site	*Content*	*Internet Address*
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com/
Accountants World	Online community of independent accountants providing resources and tools	www.accountantsworld.com
AccountingWeb	Online community for the accounting profession	www.accountingweb.com
American Institute of CPAs	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org
CPAnet	Online community and resource center for the accounting profession	www.cpanet.com/
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org/index.html
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
FirstGov	Portal through which all government agencies can be accessed	www.firstgov.gov
Government Accountability Office (formerly General Accounting Office)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org

(*continued*)

Name of Site	*Content*	*Internet Address*
Hoovers Online	Online information on various companies and industries	www.hoovers.com
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board	Information on accounting and auditing, the activities of the PCAOB, and other matters	www.pcaobus.org
Securities and Exchange Commission	The SEC Digest and Statements, EDGAR database, current SEC rulemaking	www.sec.gov
Tax Analysts Online	Information on current tax developments	www.tax.org
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ ustax/ustax.html
Vision Project	Information on the profession's Vision Project	www.cpavision.org
WebCPA	Provides online business news for the tax and accounting community	www.webcpa.com/

....

This Audit Risk Alert replaces *High-Technology Industry Developments—2003/04*. *High-Technology Industry Developments* 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 them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to lpombo@aicpa.org or write to:

Lori L. Pombo
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

tionally, the Act repeals the Section 809 differential earnings adjustment for mutual life insurance companies. Separate portions of the Act have multiple effective dates, starting with tax years beginning after December 31, 2003.

Defining a Property Casualty (Liability) Insurance Company

Prior to the Act. The definition of a *property casualty insurance company* was based on the company's "primary and predominant business activity," that is, a company was considered to be a property casualty insurance company if its primary and predominant business was insurance. A separate definition of an *insurance company* applied to life insurance companies as defined in Section 816(a) of the Internal Revenue Code, which stated that an "insurance company" is any company for which "more than half of its business during the tax year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies."

Subsequent to the Act. The Act created a uniform definition of an *insurance company* for property casualty and life insurance companies by amending the definition of a *property casualty insurance company* in Section 831 to include the definition stated in Section 816(a). The new definition of a property casualty insurance company may affect companies that have substantial amounts of other business activity, such as investment income relative to their insurance income. The classification of an entity as an insurance company for federal tax purposes has potentially broad implications, including classification as a corporation for federal tax purposes, eligibility for certain favorable accounting methods, and the avoidance of classification as a passive foreign investment company. The change is effective for tax years beginning after December 31, 2003, for most property casualty insurance companies.

Tax-Exempt Status of a Property Casualty Insurance Company (Section 501(c)(15))

The effective date for changes is for tax years beginning after December 31, 2003, with special transition provisions with respect to certain companies. The summary below is for informational purposes only and should not be relied upon as a substitute for a complete reading of the code.

Existing Law in 2003	*Pension Funding Equity Act of 2004 Amendments*
Non-life insurance company qualifies for tax-exempt status if the greater of net or direct written premiums, determined on a controlled group basis, does not exceed $350K.	1. For companies other than mutual property casualty companies, annual gross receipts, determined on a controlled group basis, must not exceed $600K and premiums received must be greater than 50% of gross receipts. 2. For a mutual property casualty company, annual gross receipts must not exceed $150K and annual premiums must be greater than 35% of gross receipts, provided that certain code requirements are met.
There is no limitation on the amount of "nonpremium" (e.g., investment) income that a tax-exempt non-life insurance company may receive in a tax year. However, the amount of nonpremium income may affect whether the entity is an insurance company for federal tax purposes and therefore determines its tax-exempt status.	1. The premium requirement determines that nonpremium (e.g., investment) income must be $300K or less. 2. For a mutual property casualty company, the aforementioned premium requirement determines that the most nonpremium (e.g., investment) income a company can have is $97,499 (less than 65% of $150K)
Control group definition: The premium test is determined by including all members of a controlled group, which is defined by Section 1563(a) (50% ownership requirement, with life insurance companies included).	Control group definition: The Act adds the requirement to include the receipts of foreign and tax-exempt corporations to the control group.

The changes to tax-exempt status under Section 501(c)(15) will cause many companies that were tax-exempt in 2003 to become taxable in 2004. These companies should evaluate the implications of a transition from tax-exempt to taxable status. Consideration should be given to the effect of any change on accounting methods, accounting periods, carryover of tax attributes, filing requirements, and personal holding company taxes. Consideration should also be given to any financial statement implications, including annual statements for 2003 that may be filed with state insurance commissioners.

Section 831(b) Election

The Act also made a small change to the definition of an insurance company that may elect to be taxed only on investment income.

Existing Law in 2003	*Pension Funding Equity Act of 2004 Amendments*
The choice to be taxed only on investment income (831(b) election): • Is available if the greater of net or direct written premiums exceeds $350K but does not exceed $1.2 million.	The choice to be taxed only on investment income (831(b) election): • Is available if the greater of net or direct written premiums does not exceed $1.2 million (floor is eliminated).

SEC Guidance About Non-GAAP Financial Measures

In January 2003, the SEC published its final rule to implement Section 401(b) of the Sarbanes-Oxley Act. Section 401(b) required the SEC to issue a rule about the disclosure of pro forma financial information in any reports filed with the SEC, or in any public disclosures or press releases. The SEC rule adopts the term *non-GAAP financial measures* rather than *pro forma financial information* to eliminate confusion with pro forma disclosures that are required under existing SEC rules and regulations.

As required by the Act, whenever a company presents a non-GAAP financial measure, Regulation G will require presentation of a numerical reconciliation to the most directly comparable measurement calculated using GAAP. Regulation G also explicitly prohibits the presentation of inaccurate or misleading non-GAAP financial measures.

The final SEC rule defines a *non-GAAP financial measure* as a numerical measure of a company's historical or future financial performance, financial position, or cash flows that excludes (includes) amounts or is subject to adjustments that have the effect of excluding (including) amounts, that are included (excluded) in the most directly comparable measure calculated in accordance with GAAP.

The definition of *non-GAAP financial measures* specifically excludes measures that are required to be disclosed by GAAP, SEC rules, or an applicable system of regulation imposed by a government, governmental authority, or self-regulatory organization. Therefore, statutory-basis financial ratios (for example, combined ratios) used by insurance registrants in SEC filings to describe the results of operations are considered outside the scope of the non-GAAP rules as long as those ratios are identical (in terms of both formula and result) to those presented in required filings with insurance regulators.

In addition to the newly adopted Regulation G, the SEC also amended Regulations S-K and S-B to impose additional requirements and restrictions on the disclosure of non-GAAP financial measures in SEC filings. Among other things, the amendments to Regulations S-K and S-B prohibit the presentation of performance measures that exclude charges or gains identified as "nonrecurring, infrequent or unusual," unless the excluded items meet certain conditions. Many insurance companies use the term *operating earnings* (or similar non-GAAP terms) in discussing financial results within SEC filings. Insurance companies have defined *operating earnings* in a variety of different ways; however, the most common definition is net income excluding after-tax realized investment gains and losses. Under the new non-GAAP rules, the term *operating earnings* is prohibited from being used in SEC filings because it is considered a performance measure that is adjusted to eliminate or smooth items (such as realized investment gains and losses), which have either occurred in the prior two years or are likely to recur within two years from the balance-sheet date. The SEC staff has occasionally required several insurance companies to restate Form 10-Q filings because the registrants originally used the term *operating earnings* or a similar term in discussing results of operations. The SEC staff also has required insurance companies to discontinue using *operating earnings* in press releases.

NAIC—Actuarial Data Integrity

Effective for 2004 year-end audits, the NAIC *Property and Casualty Annual Statement Instructions* were revised to require additional coordination among the auditor, the appointed actuary, and management and may potentially require additional procedures for the auditor related to claim loss and loss adjustment expense data. Section 9 of the instructions, *Scope of Examination and Report of Independent Certified Public Accountant*, states:

> The insurer shall also require that the independent certified public accountant subject the data used by the appointed actuary to testing procedures. The auditor is required to determine what historical data and methods have been used by management in developing the loss reserve estimate and whether he or she will rely on the same data or other statistical data in evaluating the reasonableness of the loss reserve estimate. After identifying the relevant data, the auditor should obtain an understanding of the controls related to the completeness, accuracy, and classification of loss data and perform testing as the auditor deems appropriate. Through inquiry of the appointed actuary, the auditor should obtain an understanding of the data identified by the appointed actuary as significant. It is recognized that there will be instances when data identified by the appointed actuary as significant to his or her reserve projections would not otherwise have been tested as part of the audit, and separate testing would be required. Unless otherwise agreed among the appointed actuary, management and the auditor, the scope of the work performed by the auditor in testing the claims data in the course of the audit would be sufficient to determine whether the data tested is fairly stated in all material respects in relation to the statutory financial statements taken as a whole. The auditing procedures should be applied to the claim loss and defense and cost containment expense data used by the appointed actuary and would be applied to activity that occurred in the current calendar year (e.g., tests of payments on claims paid during the current calendar year).

There may be circumstances in which data deemed significant by the appointed actuary is not included as part of the statutory financial statement audit. This may result in a need for additional testing outside the scope of the statutory audit to comply with the NAIC data integrity requirements. The conclusion regarding the need for the auditor to perform additional procedures should be agreed with management, after discussion with the appointed actuary. Additional procedures needed to fulfill the NAIC requirement for data integrity could be accomplished through an Agreed-Upon Procedures report, performed in accordance with AICPA professional standards.

Consideration of the Examiner's Handbook

The Model Audit Rule states that auditors "shall" consider the procedures in the NAIC *Financial Condition Examiner's Handbook* (the Examiner's Handbook) in the conduct of the audit as the independent certified public accountant deems necessary. Although the AICPA supports increased communication with regulators and a better understanding of the financial examination process and procedures, it does not require auditors to perform procedures from the Examiner's Handbook that they would not have otherwise performed as part of a generally accepted auditing standards (GAAS) audit. This revision of the Model Audit Rule places emphasis on giving consideration to the procedures contained in the Examiner's Handbook. In planning the audit, auditors may consider incorporating into their planning documentation that they have given consideration to the Examiner's Handbook procedures as they deemed necessary. In the conduct of financial examinations, examiners review, use, and/or rely upon the auditor's working papers.

Reminder—Access to CPA Audit Documentation

An external auditor is required by the NAIC Model Audit Rule to provide timely access to or copies of audit documentation when requested by regulators.

Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," of SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 9339.01–.15), addresses the responsibilities of an auditor when a regulator requests access to audit documentation. Auditors should note that PCAOB Auditing Standard No. 3 (AICPA, *Professional Stan-*

dards, vol. 1, PC sec. 150), supersedes SAS No. 96 for audits of public companies and other issuers.

The AICPA's task force on NAIC matters has worked actively with subgroups consisting of designated regulators and NAIC representatives during 2003 and 2004 to pursue ways to increase the examiners' reliance upon the statutory audit and use of underlying audit documentation. Suggested protocols were forwarded to the Financial Examiners Handbook Technical Group for consideration of possible revisions to the Examiner's Handbook, and letters were sent to chief examiners in the states apprising them of the new process.

The AICPA NAIC Task Force helped to establish the four-step process to provide a protocol for financial examiners that are having difficulty in pursuing a resolution of (1) questions with respect to a firm's individual engagement to perform a statutory audit, (2) difficulties in gaining access to working papers, or (3) the regulator concerns about the work performed by the CPA. If a financial examiner determines that additional response is required, after informing appropriate management, the financial examiner would contact the following individuals in this suggested order, as needed:

1. The engagement partner
2. The designated national firm representative
3. Chair of the insurer's audit committee
4. State board of accountancy, ethics (or quality review) committee, or other regulatory bodies deemed appropriate

Firms or individual practitioners performing statutory audits of regulated insurance entities that wish to designate a national firm representative and have not already done so should contact NAIC representatives at (816) 783-8006 or (816) 783-8132.

NAIC—Sarbanes-Oxley Initiative Update

During late 2003 and into 2004, the NAIC has been reviewing the requirements of the Sarbanes-Oxley Act of 2002. The NAIC is considering proposed revisions to the Model Audit Rule to incorporate certain aspects of Sarbanes-Oxley, which would be applicable to all insurers, both public and nonpublic. Of the 11 titles of Sarbanes-Oxley, the key titles of interest to the NAIC are Titles II, III, and IV. These Titles relate to auditor independence (Title II), corporate responsibility (including audit committees) (Title III), and enhanced financial disclosures (Title IV). Enhanced financial disclosures include management's assertion relative to the effectiveness of its internal control over financial reporting and the auditor's attestation report on management's assertion.

At the July 2004 interim NAIC meeting, subgroups were formed to address Titles II and III. The subgroups consist of regulators, industry representatives, and members of the public accounting profession drawn from the AICPA's NAIC Task Force. Title IV will be addressed after Titles II and III have been completed. Both Title II and III Subgroups expect to present recommendations for changes to the Model Audit Rule to the NAIC/AICPA Working Group, the sponsor of the initiative, at the December 2004 Quarterly NAIC meeting. December 31, 2006, is the earliest potential date for new guidance relating to Title IV.

Relative to any Sarbanes-Oxley-related modifications to the Model Audit Rule, substantive changes to the Rule must go through the NAIC's due process because the Model Audit Rule is an Accreditation Standard. Auditors should monitor the progress of this initiative.

Terrorism Risk Insurance Act of 2002

The market for terrorism risk insurance was severely disrupted by the events of September 11, 2001. Those events resulted in reinsurers choosing to no longer cover terrorism risk, or if they do, to make coverage extremely expensive. On November 26, 2002, the President signed into law the Terrorism Risk Insurance Act (TRIA) of 2002. TRIA, which became effective immediately, established a temporary federal program of shared public and private compensation for insured commercial property and casualty losses resulting from acts of terrorism.

Accordingly, terrorism exclusions on existing insurance policies were removed and all policyholders had the ability to secure coverage for terrorism risk through mandatory offer requirements placed on insurers. The TRIA places the federal government only temporarily in the terrorism risk reinsurance business because the program was written to sunset on December 31, 2005.

Under the program, once an insurer has suffered a loss equal to its deductible, the United States Treasury will cover 90 percent of the losses above the deductible. The insurer's deductible increases over the life of the program. In 2004, the deductible was equal to 10 percent and increases to 15 percent in 2005, the last year of the program under the original Act. New legislation will need to be passed to extend the TRIA subsequent to 2005. The TRIA also provides the Treasury with the authority to recoup federal payments via policyholder surcharges. The maximum amount of any potential policyholder surcharge that can be imposed is 3 percent per year.

The NAIC members have adopted model disclosure forms to assist insurers in complying with the TRIA. The model disclosure forms may be used by insurers to meet their obligation under the rules, provide policyholders with the status of current coverage, and, in some cases, make a selection regarding future insurance coverage for acts of terrorism. Insurers must comply with state law and the Act, and are encouraged to review the disclosure forms in light of their current policy language, state legal requirements, and the provisions of the TRIA.

New Auditing and Attestation Pronouncements, Quality Control, 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, attestation and related standards and guidance issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. The Public Company Accounting Oversight Board (PCAOB) sets auditing and attestation standards for audits of public companies. See the

PCAOB Web site at www.pcaobus.org for information about its activities and any recently issued standards. You may also look for announcements of newly issued standards in *The CPA Letter, Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SOP 04-1 *(Not applicable to audits conducted in accordance with PCAOB standards)*	*Auditing the Statement of Social Insurance*
Revision of Ethics Interpretation No. 101-3	"Performance of Nonattest Services" (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05)
Interpretation No. 5 of Chapter 1, "Attest Engagements," of SSAE No. 10, *Attestation Standards: Revision and Recodification* (AICPA *Professional Standards*, vol. 1, AT sec. 101), as amended	"Attest Engagements on Financial Information Included in XBRL Instance Documents" (AICPA, *Professional Standards*, vol. 1, 9101.47-.54)
Interpretation No. 17 of SAS No 58 *(Not applicable to audits conducted in accordance with PCAOB standards)*	"Clarification in the Audit Report of the Extent of Testing of Internal Control over Financial Reporting in Accordance with Generally Accepted Auditing Standards" (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.85-.88)
Interpretation No. 18 of SAS No. 58 *(Not applicable to audits conducted in accordance with PCAOB standards)*	"Reference to PCAOB Standards in an Audit Report of a Nonissuer"(AICPA, *Professional Standards*, vol. 1, AU sec. 9508.89-.92)
AICPA Audit and Accounting Guide	*Depository and Lending Institutions; Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies*
PCAOB Auditing Standard No. 1 *(Applicable to audits conducted in accordance with PCAOB standards only)*	*References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *Professional Standards*, vol. 1, PC sec. 130)
PCAOB Auditing Standard No. 2 *(Applicable to audits conducted in accordance with PCAOB standards only)*	*An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, PC sec. 140)
PCAOB Auditing Standard No. 3 *(Applicable to audits conducted in accordance with PCAOB standards only)*	*Audit Documentation* (AICPA, *Professional Standards*, vol. 1, PC sec. 150)

Amendment to Interim Auditing Standards *(Applicable to audits conducted in accordance with PCAOB standards only)*	*Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, PC sec. 150)
Amendment to Interim Auditing Standards *(Applicable to audits conducted in accordance with PCAOB standards only)*	*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB No. 2*, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements
PCAOB Rules *(Applicable to audits conducted in accordance with PCAOB standards only)*	In the past year the PCAOB has passed numerous rules (not standards) relating to the implementation of the Sarbanes-Oxley Act of 2002. For a complete listing of PCAOB rules go to www.pcaobus.org.
PCAOB Implementation Guidance	The PCAOB issues Q&As and other practice materials. For a complete listing of PCAOB aids, go to www.pcaobus.org.
Statements on Standards for Accounting and Review Services	For information on compilations and reviews, see the *Compilation and Review Alert—2004-05* as well as the link www.aicpa.org/members/div/auditstd/index.htm.
AICPA Practice Alert No. 2003-3 (Nonauthoritative)	*Acceptance and Continuance of Clients and Engagements*
AICPA Practice Alert No. 2004-01 (Nonauthoritative)	*Illegal Acts*
AICPA Technical Practice Aid 9110.15 (Nonauthoritative)	*Reporting on Medicaid/Medicare Cost Reports*
AICPA Practice Aid (Nonauthoritative)	*Audit Committee Toolkit*
AICPA Practice Aid (Nonauthoritative)	*Valuation of Privately-Held Company Equity Securities Issued as Compensation*
AICPA Practice Aid (Nonauthoritative)	*Auditing Governmental Financial Statements: Programs and Other Practice Aids*
AICPA Practice Aid (Nonauthoritative)	*Applying OCBOA in State and Local Governmental Financial Statements*
AICPA Practice Aid (Nonauthoritative)	*Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*

Items having particular significance to the insurance industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable guidance. To obtain copies of AICPA standards and Guides, contact AICPA Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

AICPA Attest Interpretation No. 5, "Attest Engagements on Financial Information Included in XBRL Instance Documents," of Chapter 1 of SSAE No. 10

In September 2003, the AICPA issued attest Interpretation No. 5, "Attest Engagements on Financial Information Included in XBRL Instance Documents," of Chapter 1, "Attest Engagements," of SSAE No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 9101.47-.54). Interpretation No. 5 explains the terms *XBRL* and *XBRL instance document,* and the practitioner's considerations when engaged to examine and report on whether an XBRL instance document accurately reflects the financial information it includes. For more information on XBRL, see the section "XBRL Technology" in the "Industry and Economic Developments" section of this Alert.

PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*

Effective for audits subsequent to November 15, 2004 for accelerated filers[2], and July 15, 2005 for nonaccelerated filers (market capitalization less than $75 million) and foreign private issuers,

2. On November 30, 2004, the SEC delayed the filing deadline for the first internal control report over financial reporting for some accelerated filers. Accelerated filers with a market capitalization of less than $700 million and a fiscal year ending between and including November 15, 2004, and February 29, 2005 now have an additional 45 days to file management's first report on internal control over financial reporting and the related reports of their auditors as long as the company meets certain conditions. To facilitate the SEC's objectives and subject to SEC approval, on November 30, 2004, the PCAOB adopted a temporary transitional rule, which expires July 15, 2005. The temporary rule relieves auditors from two Auditing Standard No. 2 requirements. The rule permits auditors to (1) date their reports on management's assessment of the effectiveness of internal control over financial reporting, later than the date of their reports on the financial statements (for applicable companies), and (2) not include a paragraph referencing the separate report on internal control over financial reporting in the auditor's separate report on the financial statements (for applicable companies).

this standard establishes requirements that apply when an auditor of an issuer is engaged to audit both an issuer's financial statements and management's assessment of the effectiveness of internal control over financial reporting, requirements referred to in Section 404(b) of the Sarbanes-Oxley Act of 2002 and described in the following paragraph. The PCAOB has published staff guidance, *Staff Questions and Answers: Auditing Internal Control Over Financial Reporting*, issued in tandem with SEC guidance for issuers, on audits of internal control. The document can be found at www.pcaobus.org/Standards/Staff_Questions_and_Answers/index.asp. The guidance consists of questions and answers dealing with such issues as independence, scope and extent of testing, evaluating deficiencies, multiple location issues, using the work of others, and service organizations. Registered public accounting firms must comply with the standards of the PCAOB in connection with the preparation or issuance of any audit report on the financial statements of an issuer.

A Related SEC Rule—Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports

As directed by Section 404 of the Sarbanes-Oxley Act of 2002, the SEC adopted rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting. The internal control report must include a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company; management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting, and a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

Under the new rules, a company is required to file the registered public accounting firm's attestation report as part of the annual report. Furthermore, there is a requirement that management evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. Finally, there are amendments to the rules and forms under the Securities Exchange Act of 1934 and the Investment Company Act of 1940 to revise the Section 302 certification requirements and to require issuers to provide the certifications required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 as exhibits to certain periodic reports. The rule was effective August 14, 2003, with certain exceptions. See the SEC Web site at www.sec.gov for more information.

Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*

This standard conforms the PCAOB interim auditing standards as a result of the issuance of PCAOB Auditing Standard No. 2. The standard amends and supersedes certain sections of the PCAOB interim auditing standards. You can check the PCAOB Web site for the list of interim standards that are affected.

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, the FASB Web site at www.fasb.org, and the PCAOB Web site at www.pcaobus.org. You may also look for announcements of newly issued standards in *The CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 151	*Inventory Costs, An Amendment of ARB No. 43, Chapter 4*
FASB Statement No. 132 (R) (revised 2003)	*Employers' Disclosures about Pensions and Other Postretirement Benefits*
FASB Interpretation No. 46 (R) (revised December 2003)	*Consolidation of Variable Interest Entities*
FASB EITF Issues	Go to www.fasb.org for a complete list of EITF issues.
FASB Staff Positions	Go to www.fasb.org for a list of any FASB Staff Positions related to FASB Statements, FASB Interpretations, and EITFs.
SEC Rules, Regulations, Staff Accounting Bulletins, etc.	Go to www.sec.gov for a complete list of all SEC Guidance.
SOP 03-3	*Accounting for Certain Loans or Debt Securities Acquired in a Transfer*
SOP 03-4	*Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies *and AICPA SOP 95-2,* Financial Reporting by Nonpublic Investment Partnerships
SOP 03-5	*Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies
SOP 04-2	*Accounting for Real Estate Time-Sharing Transactions*
AICPA Audit and Accounting Guide	*Depository and Lending Institutions; Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies*
Technical Practice Aids—Questions and Answers	*Q&As Related to the Implementation of SOP 03-1,* Accounting and Reporting by Insurance Enterprises for Certain Non-Traditional Long-Duration Contracts and Separate Accounts
Technical Practice Aid—Questions and Answers	*Sale of Real Estate Investments Held by Employee Benefit Plans and Discontinued Operations*
Technical Practice Aid—Questions and Answers	*Applicability of FASB Interpretation No. 45—*Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—Mortgage Guarantees

(*continued*)

Technical Practice Aid—Questions and Answers	*Applicability of FASB Interpretation No. 45*—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—Physician Loans
Technical Practice Aid—Questions and Answers	*Other-Than-Temporary Impairment Losses on Investments by Not-for-Profit Health Care Organizations*
Technical Practice Aids—Questions and Answers	*Not For Profit Technical Practice Aids (Excluding Certain TPAs Pertaining to FASB Statement No. 136 (Section IT 6140)*
Technical Practice Aids—Questions and Answers	*Not For Profit Technical Practice Aids pertaining to FASB Statement No. 136 (including those applicable to Not-For-Profit Health Care Organizations) (Section IT 6400)*
Practice Aid	*Valuation of Privately-Held Company Equity Securities Issued as Compensation*
Practice Aid	*Accounting Trends and Techniques—Employee Benefit Plans*
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*
Practice Aid	*Auditing Governmental Financial Statements: Programs and Other Practice Aids*

Of the pronouncements and other guidance listed in the previous table, those having particular significance to the insurance industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA literature, contact the Service Center Operations at (888) 777-7077, or go online at www.cpa2biz.com.

FASB Statement No. 132 (Revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*

This new standard improves financial statement disclosures for defined benefit plans. The project addresses transparency concerns of investors and other financial statement users. The standard requires that companies provide more details about their plan assets, benefit obligations, cash flows, benefit costs, and other relevant information. For the first time, companies are required to provide financial statement users with a breakdown of plan assets by category, such as equity, debt, and real estate. A description of investment policies and strategies and target allocation percentages, or target ranges, for these asset categories also are required in financial statements. In addition to expanded annual disclosures, the FASB is improving interim financial statements as certain disclosures are required on a quarterly basis. The guidance is effective for fiscal years ending after December 15, 2003, and for quarters beginning after December 15, 2003.

FASB Interpretation No. 46(R) (Revised December 2003), *Consolidation of Variable Interest Entities*

This interpretation was issued in December 2003 to incorporate and alter practice issues identified during the implementation of the original interpretation. The interpretation may present a wide range of implications for insurance and reinsurance companies based on the various types of activities and investments companies have entered into with entities that likely fall under the definition of a VIE. Companies might have a variety of involvements with VIEs that require consideration regarding the potential for the company to be a primary beneficiary, and therefore, the consolidator of a VIE.

For insurance companies consolidating their GAAP statements, FASB Interpretation No. 46(R) addresses consolidation by business enterprises of entities to which the usual condition of consolidation described in ARB No. 51, *Consolidated Financial Statements*, does not apply because either the equity investors in an entity (1) do not have the characteristics of a controlling financial interest or (2) do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. An entity lacking one of these characteristics is referred to as a variable interest entity. FASB Interpretation No. 46(R) governs how businesses should assess interests in other entities in determining whether to consolidate (or deconsolidate) that entity. For further information on this standard see the section "What's New With Variable Interest Entities?" in the "Accounting and Auditing" section of this Alert.

SOP 03-5, *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies

In December 2003, the AICPA Accounting Standards Executive Committee (AcSEC) issued SOP 03-5, *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies. The SOP provides guidance on reporting financial highlights by separate accounts of insurance enterprises. The SOP is effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis is permitted, but not required. The provisions of this SOP should be applied prospectively from the beginning of the year of adoption. However, if adopting this SOP results in presentation different from prior periods, companies should explain the effects of adoption on their financial highlights calculations.

The AICPA Audit and Accounting Guide for Financial Institutions

Many insurance companies have associations with, or are part of, financial institutions. A new combined financial institution Audit and Accounting Guide entitled *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* was published in April 2004. The Guide reconciles guidance in the former three Audit and Accounting Guides *Banks and Savings Institutions, Audits of Credit Unions,* and *Audits of Finance Companies*, which was accomplished through the issuance of SOP 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others.* More specifically, the new Guide reconciles the specialized accounting and financial reporting guidance established in the former Guides, eliminates differences in accounting and disclosure, and carries forward accounting guidance for transactions determined to be unique to certain financial institutions. The Guide contains topics such as investments, loans, mortgage banking activities, real estate and foreclosed assets, deposits, repurchase agreements, equity, trust services, insurance activities, and other areas. The Guide also incorporates recent regulatory issuances from the FDIC, Office of Thrift Supervisor, OCC, FRB, and the National Credit Union Administration. Finally, the Guide has a special chapter on insurance activities. To order a copy, go to www.cpa2biz.com.

Technical Practice Aid—*Q&As Related to the Implementation of SOP 03-1,* Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and Separate Accounts

In September 2004, the AICPA released a set of technical questions and answers (Q&As) on financial accounting and reporting issues related to SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and Separate Accounts.* The guidance includes the following TPAs:

TPA 6300.05 Definition of an Insurance Benefit Feature

TPA 6300.06 Definition of an Assessment

TPA 6300.07 Level of Aggregation of Additional Liabilities Determined Under SOP 03-1

TPA 6300.08 Losses Followed by Losses

TPA 6300.09 Reinsurance

TPA 6300.10 Accounting for Contracts That Provide Annuitization Benefits

Adoption of this guidance that results in changes to previously reported information should be recorded in accordance with APB Opinion No. 20, *Accounting Changes.* For more specific information see the section "Life and Health Spotlight—Guarantees and Other Developments" in the "Industry and Economic Developments" section of this Alert.

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 have particular significance to the insurance industry or that may result in very significant changes. 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. Many more accounting and auditing projects exist beyond those discussed below. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
AICPA Accounting and Review Services Committee (ARSC)	www.aicpa.org/members/div/auditstd/index.htm
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Auditing Pipeline—AICPA

(Note that this discussion of literature does not apply to audits of public companies.)

New Framework for the Audit Process

The Auditing Standards Board has issued an exposure draft proposing seven new SASs relating to the auditor's risk assessment process for audits of nonissuers.

The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- A more in-depth understanding of the entity and its environment, including its internal control, that would better enable the auditor to identify the risks of material misstatement in the financial statements and any steps the entity is taking to mitigate them.
- A more rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks of material misstatement and the nature, timing, and extent of audit procedures performed in response to those risks.

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.

Revisions—Interpretation No. 12 of SAS No. 62

The AICPA Audit Issues Task Force (AITF) is discussing possible revisions to Interpretation 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis", of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), for issues surrounding the applicability of new GAAP disclosures to be included in statutory financial statements prior to consideration by the National Association of Insurance Commissioners (NAIC). Auditors and insurance companies should monitor this issue as the AITF plans to have this resolved for year end 2004 reporting.

Auditing Pipeline—PCAOB

The PCAOB is continuing to develop new rules and standards. For a complete listing of upcoming and finalized PCAOB rules and standards, go to www.pcaobus.org/rulemaking_docket.asp.

Some areas the PCAOB will be concentrating on in the future include, but are not limited to, fraud, conflicts of interest, and auditor communications.

Accounting Pipeline—Deferred Acquisition Costs on Internal Replacements

Under GAAP, commissions, allowances, and other costs that vary with and are primarily related to the acquisition of new and renewal business are generally deferred and amortized. These deferred amounts, referred to as deferred acquisition costs (DAC), are recorded as an asset on the balance sheet and amortized to income in a systematic manner based on related contract revenues or gross profits or gross margins. GAAP concerning the treatment of existing DAC related to internal replacements is unclear. FASB Statement No. 97 requires the writeoff of existing DAC when a FASB Statement No. 97 universal life contract replaces a FASB Statement No. 60 traditional life insurance contract. However, GAAP is silent about whether to write off or maintain DAC if a policy is replaced with a comparable product (for example, if a FASB Statement No. 97 deferred annuity replaces another FASB Statement No. 97 deferred annuity). To the extent an insurer follows a policy of maintaining DAC for policies replaced by another similar contract, management should document the rationale for its position and that such rollover DAC continues to be recoverable.

In the fourth quarter of 2004, AcSEC issued, for comment, a second exposure draft of a draft originally issued in March 2003, *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements.* After receiving comment letters and discussion among AcSEC members and FASB, certain significant conclusions on the first draft were altered. The purpose of the exposure draft is to provide guidance on determination of the proper accounting by insurance enterprises for DAC on internal replacements other than those specifically described in FASB Statement No. 97. Areas covered include the following:

- The definition of an internal replacement
- Nonintegrated and integrated contract features

- Determining whether contracts or modifications involved in an internal replacement result in "substantially unchanged" or "substantially changed" contracts
- Accounting for internal replacements that are substantially unchanged or substantially changed sales inducements offered in conjunction with an internal replacement
- The costs and assessments related to an internal replacement

The provisions of the proposed SOP would be effective for internal replacements occurring in fiscal years beginning after December 15, 2005, with earlier adoption encouraged. The effect of initially adopting this SOP would be reported prospectively, with restatement of prior issued financial statements prohibited.

Accounting Pipeline—FASB No. 140 Amendment Projects, Including Mortgage Servicing Rights

The FASB expects to issue an exposure draft for an amendment to Statement No. 140 in the second quarter of 2005 concurrently with exposure drafts for projects on beneficial interests in securitized financial assets and qualifying special purpose entities (QSPEs) and isolation of transferred assets. The separately issued exposure drafts will include a presentation of the proposed revisions to FASB Statement No. 140 reflecting the collective decisions of all three projects. Because so many other issues came to the fore during deliberations on FASB Statement No. 140, such as accounting for loan participations and the right of set off as well as the valuation of mortgage servicing rights, the structure of the project has evolved to the above described scope.

The original project was initiated because by allowing QSPEs to be an exception to consolidation, FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, created an incentive for people to convert certain entities to QSPEs. The project originally specified conditions under which a QSPE is permitted to issue beneficial interest with maturities that are shorter than the QSPE assets and roll over those beneficial interests at maturity. The original project also clarified or amended other requirements of the statement related to commitments by transferors, their affiliates, and their agents to provide additional assets to fulfill obligations to beneficial interest holders.

Mortgage-Servicing Rights

Some insurance entities have been significantly increasing their real estate loan portfolios, as well as enhancing their servicing portfolios of loans sold in the secondary market with servicing retained by the entity. Entities in recent years have been much more likely than in the past to retain servicing for loans sold to secondary market investors. Not only has the number of companies that are servicing portfolios grown considerably, but the size and dollar amount of entities' servicing have also increased. Conversely, the recent refinancing boom has adversely affected certain entities, as borrowers have moved to other entities in the highly competitive market.

Current FASB Statement No. 140 guidance notes that mortgage-servicing rights (MSRs) are recorded at the lower of cost or market. The FASB has noted difficulties related to the hedging of MSRs since the fair value of MSRs does not change in a linear fashion due to the nature of prepayment estimates. This causes MSRs to lose value at a faster rate when interest rates decline than the rate at which MSRs gain value when interest rates increase. By reporting MSRs at fair value, relief will be provided from the substantial recordkeeping requirements needed to obtain hedge accounting treatment. Check the FASB Web site at www.fasb.org for the most recent deliberation decisions on this project. An exposure draft is expected in the second quarter of 2005.

Accounting Pipeline—Other Projects

FASB Project on Business Combinations: Purchase Methods Procedures

This FASB project addresses the accounting and reporting for certain business acquisitions. There will be two exposure drafts issued because this project is being developed with the International Accounting Standards Board. One project objective is to require that the acquiring entity in a business combination account for the business acquired at its fair value at the acquisition date. The project encompasses financial reporting by all acquiring business enterprises, including mutual enterprises (such as mutual insurance companies). The project will not apply to the formations of joint ventures, transactions or events between entities under common control, combinations between not-for-profit organizations, or acquisitions of a for-profit business by a not-for-profit organization. To allow sufficient time for the development, the exposure draft issuance is planned for the fourth quarter of 2004. For further insurance specific information see the section "Insurance Purchase Accounting News" in the "Accounting and Auditing" section of this Alert.

Exposure Draft on Fair Value Measurements

The FASB has issued an exposure draft entitled *Fair Value Measurements,* which seeks to establish a framework for measuring fair value that would apply broadly to financial and nonfinancial assets and liabilities, improving the consistency, comparability, and reliability of measurements. The exposure draft would replace any current guidance for measuring fair value and would also expand the disclosure requirements. The proposed effective date for this standard would be for financial statements issued for fiscal years beginning after June 15, 2005, and all interim periods within those fiscal years.

Equity (Stock) Based Compensation

On March 31, 2004, the FASB issued an exposure draft, *Share-Based Payment, an Amendment of FASB Statements No. 123 and 95.* The exposure draft seeks to improve existing accounting rules and provides more complete, higher quality information for investors. The proposed change in accounting would replace existing requirements under FASB Statement No. 123, *Accounting for Stock-Based Compensation,* and ABP Opinion No. 25, *Accounting for Stock Issued to Employees.* You can keep abreast of current developments at www.fasb.org/project/equity-based_comp.shtml.

Resource Central

Presented below are various resources that practitioners engaged in the insurance industry may find beneficial.

On the Bookshelf

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

- Audit and Accounting Guide *Life and Health Insurance Entities* (product no. 012634kk)
- Audit and Accounting Guide *Property and Liability Insurance Companies* (product no. 012674kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012514kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012554kk)
- Checklists and Illustrative Financial Statements *Life and Health Insurance Entities* (product no. 008954kk)
- Checklists and Illustrative Financial Statements *Property & Liability Insurance Companies* (product no. 008964kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- Practice Aid F*raud Detection in a GAAS Audit: Revised Edition* (product no. 006615kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- *Accounting Trends & Techniques—2004* (product no. 009896kk)

- *Audit and Accounting Manual* (product no. 005134) (The manual 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, and engagement letters; management representation letters; and confirmation letters.)

AICPA reSOURCE On-line

Get access—any time, anywhere—to the AICPA's latest *Professional Standards, Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, and *Accounting Trends & Techniques*. To subscribe to this essential service, go to www.cpa2biz.com.

CD-ROMS

The AICPA is currently offering a CD-ROM product entitled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access to AICPA Professional Literature products in a Windows format, including *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.

Continuing Professional Education

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the insurance industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Update Workshop* (product no. 736180kk [text] and 187188 [DVD] or 187088 [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.
- *SEC Reporting* (product no. 736770kk (text) and 186751kk (video)). This course will help the practicing CPA and cor-

porate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.

Online CPE

AICPA InfoBytes, offered exclusively through CPA2biz.com, is the AICPA's flagship online learning product. Selected as one of *Accounting Today*'s top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two- credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

AICPA Practice Pro is an annual online subscription program designed for accountants in public practice. The subscription delivers hottest topics to your desktop—each month six new courses arrive, covering tax, auditing, and accounting. Courses feature streaming video, course outlines, online transcripts, and quizzes. Choose from courses in financial reporting, auditing, financial planning, estate planning, individual and business tax, and ethics. (product no. SP1-XXkk)

AICPA Financial Pro is an annual online subscription program designed for accountants in business and industry. The subscription delivers hottest topics to your desktop—each month four new courses arrive covering current topics of interest to corporate accountants and financial managers. Courses feature streamlining video, course outlines, online transcripts, and quizzes. Choose from courses in audit, economics, e-commerce, financial reporting, information systems, managerial accounting, security and control, tax, and more. (product no. SP2-XXkk)

AICPA Online and CPA2Biz

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, CPA2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, *Professional Standards*, and CPE courses. To learn more, visit www.aicpa.org.

AICPA Service Center Operations

To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Service Center Operations at (888) 777-7077. The best times to call are 8:30 a.m. to 11:30 a.m. and 2:00 p.m. to 7:30 p.m., Eastern Standard Time. You can also order AICPA products from Service Center Operations by facsimile at (800) 362-5066 or visit www.cpa2biz.com to obtain product information and place online orders.

AICPA's Antifraud and Corporate Responsibility Resource Center

The AICPA's Antifraud and Corporate Responsibility Resource Center (www.aicpa.org/antifraud/) allows you to select optional ways to learn about fraud. The Center spotlights the new Web-based fraud and ethics case studies and commentaries recently issued; the AICPA antifraud Webcast series; the interactive CPA course *Fraud and the CPA*, and a competency model that allows you to assess your overall skills and proficiencies as they relate to fraud prevention, detection, and investigation, among other topics. In addition, the site offers press releases and newsworthy items on other AICPA courses related to prevention and detection and an overview of the AICPA Antifraud and Corporate Responsibility Program.

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.

The AICPA Sarbanes-Oxley Act Hotline

If you have questions regarding the Sarbanes-Oxley Act of 2002 call (866) 265-1977.

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.

Fax Hotline

The AICPA has a 24-hour fax system that enables interested persons to obtain information that includes, for example, current AICPA comment letters, conference brochures and registration forms, CPE information, actions of the Accounting Standards Executive committee (AcSEC), and legislative news. To access the hotline, dial (201) 938-3787 from a fax machine and follow the voice cues.

Webcasts

When planning your engagements, you can join the many practitioners who have participated in AICPA Webcasts. Webcasts are an exceptional way to stay current on today's professional issues. Led by recognized experts, Webcasts provide complete briefings on a variety of pertinent practice topics. During a two-hour live Webcast, participants have the opportunity to e-mail and ask questions of expert panelists.

Additionally, past archived Webcasts are available in CD format and can be accessed at www.cpa2biz.com/CS2000/Products/Product+Detail.htm?cs_id={97573D6D-56D1-426C-84E1-56DBF55E42DE}&cs_catalog=CPA2Biz&cs_category=accounting_auditing. CPE credit is earned for both live and CD version participation.

Additional Information Sources

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 at the end of this Alert.

••••••••

This Audit Risk Alert replaces the *Insurance Industry Developments—2003/2004* Audit Risk Alert. The *Insurance Industry Developments 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 them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to jgould@aicpa.org, or write to:

Julie Gould, CPA
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2004/05*. We also suggest that you review the annual AICPA Audit Risk Alerts *Securities Industry Developments—2004/05, Bank, Credit Union, and Other Depository and Lending Institution Industry Developments—2004/05,* and *Investment Companies Industry Developments—2004/05,* if you have clients or business lines that encompass related activities.

INFORMATION SOURCES

Organization	*General Information*	*Fax Services*	*Internet*
American Institute of Certified Public Accountants (AICPA)	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 www.cpa2biz.com
Financial Accounting Standards Board (FASB)	Order Department P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org
Financial Crimes Enforcement Network (FinCEN)	2070 Chain Bridge Road Vienna, VA 22182 (703) 905-3770	(703) 905-3885	www.ustreas.gov/fincen
National Association of Insurance Commissioners (NAIC)	2301 McGee Street, Suite 800 Kansas City, MO 64108-2662 816-842-3600	(816) 783-8175	www.naic.org

Public Company Accounting Oversight Board (PCAOB)	1666 K Street N.W. Washington, DC 20006 (202) 207-9100	Fax (202) 862-8430	www.pcaobus.org
U.S. General Accounting Office (GAO)	Superintendent of Documents U.S. Government Printing Office Washington, D.C. 20401-0001 (202) 512-1800	Information Line (202) 512-2250	www.gpo.gov
U.S. Securities and Exchange Commission (SEC)	Publications Unit 450 Fifth Street, NW Washington, D.C. 20549-0001 (202) 942-4046 (212) 942-4150 *Information Line* 202-942-8090	(202) 942-9517	www.sec.gov

022355