1990

Securities industry developments - 1990; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK
ALERTS

Securities Industry Developments—1990

Update to AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*

Includes *Audit Risk Alert—1990*

Issued by the
Auditing Standards Division

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This document, which contains *Securities Industry Developments—1990* and *Audit Risk Alert—1990*, is intended to provide auditors of financial statements of brokers and dealers in securities with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Securities Industry Developments—1990

Industry and Economic Developments

Soft Market Conditions

Nearly every sector of the securities industry is in the midst of a down cycle. Retail business, in both volume of transactions and commission rates, is off sharply, and competition for institutional business is growing more competitive. Securities firms are being displaced from their traditional role as intermediaries in capital and financial markets by discount brokers, banks, and others using financial and technological innovations (such as computerized trading networks that enable institutions to trade directly with one another) that are willing to provide the same service for a lower price. In addition, in recent months, the courts have ruled that banking institutions can enter the underwriting business that had been the private domain of the securities industry.

As a result of the decrease in the number of issues of high-yield "junk bonds" and new stock issues, the fees earned from underwriting by Wall Street firms were down 30 percent for the nine-month period ended September 30, 1990, as compared to the year-earlier period. Another result of the significant decrease in the issuance of high-yield debt is the decrease in large fees earned from mergers and acquisitions and the fact that other investment banking activities of the 1980s have fallen significantly. Only ten high-yield issues amounting to $17.5 million in fees were brought to market during the nine-month period ended September 30, 1990, as compared to 105 high-yield issues amounting to $636.1 million in fees for the year-earlier period.

As the decrease in volume and fees being earned by the securities firms continues, there is increasing pressure on individual departments and producers to develop new activities or products to increase profits. These pressures may cause such departments or producers to take additional, unauthorized risks to realize additional revenues.

Auditors should concentrate on assessing management's controls over the introduction of new activities and products and on the basic controls over the recording of fees and commissions.

Merchant Banking

Merchant banking refers to the use of a firm's own capital for a principal participation in a merger or acquisition. In many instances, firms take equity positions in leveraged buyouts or takeovers ultimately financed by high-yield bonds and provide debt in the form of bridge loans to facilitate the transactions. Although Wall Street firms have made modest equity investments in the past, certain bridge loans extended during the middle to late 1980s have represented significant portions of many firms' total capital. Firms have used bridge loans to facilitate their clients' financing needs, to generate fee income, and to earn investment returns significantly greater than returns of typical debt. However, bridge loans, as well as high-yield debt, expose the firms to significant credit risk. The majority of the companies that are financed by high-yield bonds are extremely leveraged and, therefore, have a greater probability of defaulting on their bonds than other companies have.

In audits of firms that hold high-yield bonds and bridge loans, auditors should consider whether controls are in place to monitor the collectibility of bridge loans, the financial strength and stability of each issuer, and the pricing of such bonds. Often, the value of bridge loans and high-yield bonds depends entirely on the creditworthiness of highly leveraged issuers. Further, many high-yield debt securities do not have a liquid market, and independent, accurate pricing sources are difficult to obtain.

Internationalization

The environment in which the securities industry operates has become more complex with the continuing internationalization of the industry. As a result, traditional geographic boundaries no longer limit the market potential for securities firms, nor do they limit the available markets for security issuers. The lowering of barriers to capital movement, the rise in international trade, the growth of volume in foreign markets, and the diversity in available financial instruments have all contributed to this globalization. As the trend continues, it is important that securities firms and their auditors recognize the changes and risks that are presented.

Trading international securities creates various operational and auditing difficulties. Many foreign securities are thinly traded. Consequently, the availability of sufficient pricing evidence may create significant pricing and mark-to-market issues. The clearing operations of international exchanges vary significantly. Few foreign exchanges have well-developed, central depository systems for security certificates. Thus, physical delivery of certificates may be required, creating additional costs and audit concerns.

International trading also creates significant foreign exchange, credit, and liquidity risks. All the risks inherent in the foreign exchange market (including timing of the purchase and sale of foreign exchange contracts, market volatility, and price fluctuations) add to the risks of brokerage operations. Credit and liquidity risks exist due to central banks' settlement practices and the lack of verifiable credit information. It is important that auditors carefully assess the controls that firms have in place.

The growing internationalization of the securities business has also highlighted the significant regulatory differences among countries. As is the case with accounting and auditing standards, each country's regulatory agency tends to take a domestic viewpoint to regulation-setting. Accordingly, each country's rules are different. Both management and auditors should generally be familiar with the rules in each country in which firms operate. Moreover, auditors should be cognizant of changes in U.S. domestic regulations to reflect this internationalization.

As investors continue to diversify their portfolios with foreign securities, the need for accessible and comparable financial information has grown. Today, accounting and auditing requirements are still determined on a nation-by-nation basis. Since standards are developed in response to the needs of the domestic market, they tend to differ, sometimes significantly, across national boundaries. The differences in accounting and auditing standards among countries may decrease the usefulness and comparability of financial statements. Additionally, the multiplicity of standards may also tend to decrease the flow of capital across borders. Additional expenses may be incurred to change foreign generally accepted accounting principles (GAAP) financial statements to U.S. GAAP to meet the applicable financial regulatory requirements. At least seven international standard-setting bodies seeking to establish worldwide standards for accounting and auditing exist.

SEC Rule 144A

In a move toward further globalization and integration of the U.S. securities markets, the Securities and Exchange Commission (SEC) adopted Rule 144A on April 19, 1990, permitting privately placed debt and equity issues to be traded freely by qualified institutional investors. The market is open to institutions that own or manage, under discretionary authority, $100 million in securities. Securities firms that own $10 million in securities can also participate. (Note that certain securities do not count toward the indicated levels.) Individual investors and small institutions are barred from this market, and securities traded on a public exchange cannot be traded in the 144A market. Sellers are obligated to evaluate the creditworthiness of the buyers and to inform them that the securities are being sold according to the provisions of Rule 144A.

The rule is also expected to have a significant impact on securities firms. The regulatory barriers that distinguish investors from underwriters could break down as a result of the rule. Since resales would not constitute an underwriting, other financial institutions could potentially originate loans or private placements and subsequently resell the obligations to other qualified buyers pursuant to the rule.

Risks to securities firms associated with 144A offerings are essentially the same as with any underwriting risk and fall into two categories: (1) market risk while securities are positioned for resale and (2) positions held for legal risk related to disclosure and due diligence for the period the securities are outstanding.

Securities firms also need to consider valuation risk associated with these securities. Essentially, these securities fall into two categories: (1) positions held in inventory (of particular importance with respect to establishing the existence of a ready market for 15c3-1 "haircut" purposes) and (2) positions held for margin purposes (impacting the extent that margin loans are extended to finance these securities).

Soft Dollars

"Soft dollar" arrangements arose on Wall Street as a vehicle to pay for research required by money managers by using part of the commissions paid by the money managers. Most soft-dollar arrangements are triangular in nature. In the first corner of the triangle is a money manager who wants to buy research data without writing a check. In the second corner, there is a broker with whom the money manager, or his or her client, trades. The broker uses a part of the commission (soft dollars) to pay the research firm on behalf of the money manager. In the third corner is the researcher, who is paid in "hard" cash by the broker and sends the data to the money manager. Since the 1970s, when soft dollars were first used, some brokers and money managers have used soft dollars to cover transactions not associated with research. The SEC allows money managers to purchase over 700 investment products with soft dollars. However, any such purchase must somehow enhance the investment process, and potential conflicts of interest must be monitored. Auditors should be alert to the possibility of inflated revenues, accelerated expense recognition, and the propriety of accruals associated with soft-dollar arrangements.

The Securities and Exchange Commission asserts that, in instances in which a product has a mixed use, money managers should make a reasonable allocation of the cost of the product according to its uses. The percentage of the service or specific component that provides assistance to money managers in the investment decision-making process may be paid in soft dollars, but services that provide administrative, or other non-research assistance to the money manager, are outside the safe harbor of Section 28(e) or the 1975 Securities Acts Amendments and must be paid for by the money managers using their own funds. The money managers must keep adequate books and records concerning allocations to make the required good-faith showing.

Program Trading

Several important index-related trading strategies (program trading) have developed over the past few years. The term *program trading* refers to the buying or selling of a large number of stocks simultaneously with or without related transactions in index futures or options. Thus, *program trading* is a generic term that encompasses several different index-related trading strategies (including hedging, index arbitrage, and portfolio insurance).

Computer systems and expertise have been developed to accommodate program trading. The ability to route equity orders through an automated system reduces the time required to execute a particular program and, therefore, increases an arbitrageur's probability of capturing the premium or discount to the index product. Moreover, the use of automated systems, as opposed to manual execution, lowers the costs associated with executing an arbitrage program.

Opponents to program trading have expressed the concern that program trading may be threatening the viability of the U.S. capital markets by creating extreme market volatility and thus alienating investors. Proponents have suggested that program trading has enhanced market liquidity.

The primary risks with program trading strategies are the following:

- Market circuit breakers prevent securities firms from completing strategies or unwinding large arbitrage positions.
- The ability to adequately monitor customer credit exposure is inhibited by the complicated nature of these strategies, as illustrated by the complex margin calculations.

Regulatory and Legislative Developments

The securities industry continues to be highly regulated in light of recent market conditions, the need to maintain integrity in the marketplace, and the need to maintain investor confidence. The following summarizes some of the recent key regulatory initiatives that may affect financial statement audits.

Foreign Securities

Due to the enormous, increased participation of U.S. brokers and dealers in foreign securities markets, various regulatory bodies have recently enacted rule changes with respect to foreign securities. Such changes include—

1. Permitting the margining of certain foreign equity and corporate debt securities and setting forth the time periods for payment of customer cash-account purchases of foreign securities made in foreign markets (see Federal Reserve Board Regulation T and New York Stock Exchange [NYSE] Information Memos 90–10 and 90–20).
2. Allowing alternative procedures for charges to net capital for aged fails-to-receive and fails-to-deliver of foreign-issued, foreign-settled securities (see NYSE Interpretation Memo 89–9).
3. Permitting the use of the customary settlement date in a foreign country for foreign fails-to-deliver for purposes of SEC Rules 15c3–3 and 17a–13 (see NYSE Interpretation Memo 90–7).

These changes were made due to the realization that there is sufficient liquidity in many foreign securities not originally comprehended by the U.S. rules and regulations. In addition, certain regulatory requirements had, in effect, previously required "aged" treatment for foreign items that were in fact current by standards set in established foreign markets.

Proposed SEC Initiatives

Minimum Net Capital Requirements, Haircuts, Aggregate-Indebtedness Method. The SEC has issued a proposal to amend Rule 15c3–1, the net capital rule for brokers and dealers (see SEC Release No. 34–27249, dated September 15, 1989). This proposal was made in consideration of, among other things—

- The decreased relative value of the dollar since the current minimum net capital requirements were adopted.
- The increase in the complexity of the securities markets and variety of activities in which brokers and dealers engage.
- The fact that holdings of customer funds and securities have increased greatly over the years.

Under the proposal, brokers and dealers that hold customer funds or securities would be required to maintain at least $250,000 in net capital. Those firms that clear customer transactions but do not hold customer funds or securities would be required to maintain at least $100,000. Brokers and dealers that introduce customer accounts to clearing firms would be required to maintain $50,000 or $100,000, depending on whether they occasionally or routinely receive customer funds and securities. Further, market-makers would be required to maintain greater net capital in proportion to the number of securities in which they make markets. Only brokers and dealers who carry customer accounts and hold customer funds or securities would be permitted to elect the alternative net capital computation. Finally, deductions for equity securities positions (haircuts) would be standardized under the basic and alternative methods of computing net capital, and some changes would be made to the computation of aggregate indebtedness. The increases would be phased in over a period of four years.

Withdrawal of Net Capital. The SEC has issued for comment another proposal to amend the net capital rule (see SEC release number 34-28347 dated August 15, 1990). The proposal would, under certain circumstances, prohibit registered brokers and dealers from withdrawing capital directly or indirectly to benefit certain persons related to the broker or dealer without first notifying the SEC at least two days prior to withdrawal. Such notice would be required when the projected withdrawal plus (a) withdrawals during the preceding thirty days would equal or exceed 20 percent of the broker's or dealer's excess net capital or (b) withdrawals during the preceding ninety days would be more than 30 percent of excess net capital (no notice would be required where the aggregate withdrawal is less than $50,000). The proposed amendments would also permit the SEC, by order, to restrict for a period of up to twenty days any of these withdrawals of capital if the SEC determined the withdrawal might be detrimental to the financial integrity of the broker or dealer or might affect the broker's or dealer's ability to repay its customer claims or other liabilities. Finally, the proposed amendments would prohibit any of these withdrawals of capital if such withdrawals would cause the broker's or dealer's net capital to be less than 30 percent of its haircuts, as required by the net capital rule affecting its readily marketable securities.

The proposed amendments are designed to address the issues arising from the withdrawal of capital from a broker or dealer by a parent or affiliate. They are intended to improve the SEC's ability to protect the customers and creditors of a broker or dealer when a financial problem in a holding company or other affiliate leads to withdrawals of capital from the broker or dealer.

While auditors are not required to specifically report on compliance with the following items, they are of general interest and provide information with respect to the current regulatory environment within which the brokers and dealers must operate.

Insider Trading. Congress has enacted the Insider Trading and Securities Fraud Enforcement Act of 1988, which requires every broker or dealer to establish, maintain, and enforce written policies and procedures to prevent the misuse of material, nonpublic information (see Section 15[f] of the Securities Exchange Act of 1934). The policies must take into consideration the nature of the broker's or dealer's business and be designed to prevent violations by the broker or dealer and anyone associated with it.

Initiatives to Minimize Excess Market Volatility. As described earlier, questions have been raised about whether certain sophisticated trading strategies related to program trading create excess volatility in the securities markets or whether, in fact, they enhance the efficiency of those markets. While this has been and continues to be researched by various legislative bodies and committees, certain interim regulations have been approved. New York Stock Exchange Rules 80A and 80B provide certain "circuit breakers" that take effect on days when the Dow Jones Industrial Average (DJIA) advances or declines by fifty points or more, the price of the Standard and Poor's 500 Stock Price Index futures contract reaches a value twelve points below its closing value on the previous trading day, or the DJIA reaches a value 250 or more points below its closing value on the previous trading day.

New Penny Stock Sales Requirements. Effective January 1, 1990, the SEC adopted Rule 15c2-6, which imposes sales practice requirements on brokers and dealers that recommend transactions in certain low-priced over-the-counter securities (generally referred to as "penny stocks") to customers who are not "established." The rule requires these brokers and dealers to document their determination of customer suitability and to obtain certain written agreements from such nonestablished customers.

Market Reform Act. Under a recently passed bill giving it expanded authority over the U.S. securities markets, the SEC may, after consulting with the President, shut those markets down during a "market disturbance." It may also suspend or restrict trading hours, set position limits, and take steps to ensure prompt clearance and settlement of stock transactions. Additionally, the bill provides the SEC with authority to obtain information concerning the financial and operational conditions of broker and dealer holding companies, and includes a provision that would give the SEC limited power to restrain program trading during periods of extreme market volatility.

Audit and Accounting Developments

Audit Issues

Internal Control Structure in Audits of Futures Commission Merchants. SOP 90-2, *Report on the Internal Control Structure in Audits of Futures Commission Merchants* amends the AICPA Audit and Accounting Guide *Audits* *of Brokers and Dealers in Securities* for changes required by Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit,* in connection with audits of futures commission merchants. This SOP provides an illustration of the independent auditor's report on the internal control structure required by the Commodity Futures Trading Commission Regulation 1.16. SOP 90–2 is effective for reports issued on or after March 1, 1990.

Internal Control Structure in Audits of Brokers and Dealers in Securities. SOP 89–4, *Reports on the Internal Control Structure in Audits of Brokers and Dealers in Securities,* amends the AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* in response to changes required by SAS No. 60. This SOP provides updated illustrations of the independent auditor's reports on the internal control structure required by Securities and Exchange Commission Rule 17a–5. The SOP contains a standard report on internal control structure that conforms to SAS No. 60 and a report that should be issued when the broker or dealer has not made the required notification of material weaknesses in the internal control structure to the SEC or when the auditor does not agree with the statements being filed. SOP 89–4 is effective for audits of financial statements for periods beginning on or after January 1, 1989.

Audited Financial Statements of Brokers and Dealers in Securities. SOP 89–1, *Reports on Audited Financial Statements of Brokers and Dealers in Securities,* amends the AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* for changes required by SAS No. 58, *Reports on Audited Financial Statements.* This SOP provides illustrations of the following four separate reports:

1. The independent auditor's standard report that expresses an unqualified opinion on the financial statements and on the supplementary schedules required by the SEC.
2. An example of a qualified opinion to be issued when the underlying entity has material securities and investments that are not readily marketable and valuation procedures are inadequate or unreasonable, or the underlying documentation does not support the valuation.
3. An example of an unqualified opinion with an added explanatory paragraph, to be issued when the underlying entity has material securities and investments that are not readily marketable but the auditors have determined that the underlying documentation and management valuation procedures appear reasonable. However, inherent uncertainty exists because the range of possible values is significant. The explanatory paragraph discusses this inherent valuation uncertainty.
4. A separate auditor's report on the supplementary schedules required under Rule 17a–5 of the SEC.

Accounting Issues

Definition of the Term Substantially the Same. SOP 90-3, *Definition of the Term* Substantially the Same *for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position,* is effective for transactions entered into after March 31, 1990, and provides guidance for determining whether two debt instruments that are exchanged are substantially the same for the purpose of determining whether a transaction involves a sale and purchase or a financing transaction. If the repurchased debt instrument is substantially the same as a sold debt instrument, it may be viewed as a financing transaction; however, if the repurchased debt instrument is not substantially the same as a sold debt instrument, the transaction may then be viewed as a sale with a commitment to buy another debt instrument. The issue of whether debt instruments are substantially the same is pertinent when considering the various types of repurchase and reverse repurchase arrangements used by brokers and dealers.

SOP 90-3 states that substantially the same debt instruments must meet the following six criteria:

1. The debt instruments must have the same primary obligor (an exception is made for debt instruments guaranteed by a sovereign government, central bank, or government-sponsored enterprise or agency), in which case the guarantor and terms of the guarantee must be the same.
2. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.
3. The instruments must bear the identical contractual interest rate.
4. Instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities, for which the mortgages collateralizing the securities must have similar weighted average maturities (WAMs) that result in approximately the same yield.
5. Mortgage-backed pass-through and pay-through securities must be collateralized by a similar pool of mortgages.
6. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, for which the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard.

Hedging Transactions. FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and*

Classification of Cash Flows From Hedging Transactions, which is effective for fiscal years ending after June 15, 1990, amends certain aspects of FASB Statement No. 95, *Statement of Cash Flows*, to permit cash flows resulting from futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedging transactions to be classified in the same category as the items being hedged, provided that accounting policy is disclosed.

Securities Acquired for Resale. FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, which is effective for financial statements issued after February 28, 1989, amends FASB Statement No. 95 to allow the cash flows from trading activity to be classified as operating cash flows.

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Copies of AICPA authoritative guidance may be obtained by calling the AICPA Order Department at (800) 334-6961 (USA) or (800) 248-0445 (NY). Copies of FASB authoritative guidance may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

Audit Risk Alert—1990*

General Update on Economic, Industry, Regulatory, and Accounting and Auditing Matters

Introduction

This alert is intended to help auditors in finalizing their planning for 1990 year-end audits. Successful audits are a result of a number of factors, including acceptance of clients with integrity, adequate partner involvement in planning and performing audits, an appropriate level of professional skepticism, and the allocation of sufficient audit resources to high-risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

It is important to make sure that written audit programs are *adequately tailored* to reflect *each client's circumstances,* including areas of greater *audit risk*. This alert identifies areas that, based on current information and trends, may be relevant to many 1990 year-end audits. Although it does not provide a complete list of risk factors to be considered, and the items discussed do not affect risk in every audit, this alert can be used as a planning tool for considering matters that may be especially significant for 1990 audits.

Economic Developments

The Current Economic Downturn

Dramatic events in the Persian Gulf and around the world have raised many questions and concerns for American companies. Rising oil prices, lower consumer demand, and reduced availability of capital are just *some* of the factors affecting companies in all industries. Auditors should take these economic factors into consideration and be aware of the ways in which clients have been affected by them as well as of the potential, if any, of a going-concern problem.

*This Audit Risk Alert was published in the December 1990 issue of the AICPA's *CPA Letter.*

Business Failures on the Rise

The current illiquidity in the junk-bond market, coupled with the continuing tightening of credit by lenders throughout the country, have made it substantially more difficult for prospective borrowers to obtain financing, particularly for highly leveraged companies. A recent article in the *Wall Street Journal* called attention to increases in bankruptcy filings, particularly in the real estate, apparel, retailing, and construction industries, due in large part to the weakening cash flow of many businesses as well as the more cautious credit environment. Some industries are becoming very risky undertakings. For example, in 1990, the number of restaurant closings exceeded the number of openings; increased competition has made it nearly impossible to raise menu prices, while costs have continued to increase, especially those for energy, insurance, and wages.

The effects of the economic slowdown will vary across geographic regions and industries, and among companies even within the same industry. Therefore, auditors need to focus specifically on the environment of each client and address each client's particular issues accordingly. Nevertheless, many companies will be unable to pass on increased costs (particularly increased oil prices and medical expenses) due, in part, to increasing competition and softening demand for their products. This could make it difficult for companies to report favorable operating results for the year. With this in mind, auditors should be even more sensitive this year to ongoing issues that affect operating results, such as the collectibility of receivables and the potential obsolescence and realizability of inventories.

Highly leveraged companies are particularly vulnerable to a downturn in business activity and the other factors discussed above. Auditors should consider these circumstances when evaluating the ability of highly leveraged clients to continue as going concerns.

Economic Considerations Relating to Debt

Adverse developments in the economy in general, or in a particular financial institution, may cause an institution to refuse to renew loans, to exercise demand clauses (such as the due-on-demand clause), or to decline to waive covenant violations. In addition, these developments may make it more difficult for companies to obtain alternate sources of financing than in the past. In these cases, the auditor should consider the borrower's classification of the liability, potential going-concern issues, management's plans (such as those for alternate financing or asset disposition), and the adequacy of disclosures in the borrower's financial statements. Securities and Exchange Commission (SEC) rules contain specific disclosure requirements in Management's Discussion and Analysis (MD & A) about liquidity and material uncertainties.

Regulatory and Legislative Developments

Environmental Liabilities

The Environmental Protection Agency is empowered by law (through the Superfund legislation) to seek recovery from anyone who ever owned or operated a particular contaminated site, or anyone who ever generated or transported hazardous materials to a site (these parties are commonly referred to as potentially responsible parties, or PRPs). Potentially, the liability can extend to subsequent owners or to the parent company of a PRP.

In connection with audit planning, the auditor should consider making inquiries of management about whether a client (or any of its subsidiaries) has been designated as a PRP or otherwise has a high risk of exposure to environmental liabilities. If a client has been designated as a PRP, the auditor should consider whether any amount should be accrued for cleanup costs and assess the need for disclosure and, possibly, for the inclusion of an explanatory fourth paragraph in the audit report citing the uncertainty, if management is unable to make reasonable estimates of the costs. In addition, for public entities, disclosure should be made in MD&A of estimates of cleanup costs or the reasons why the matter will not have a material effect.

Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*, and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provide guidance for the accounting and disclosure of loss contingencies, including those related to environmental issues. The FASB's Emerging Issues Task Force (EITF) reached a consensus in Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination*, that, generally, the costs incurred to treat environmental contamination should be expensed and may be capitalized only if specific criteria are met.

Notification of Termination of Auditor-Client Relationship

The SEC staff has observed instances in which CPA firms have not notified the SEC's Chief Accountant when an auditor-client relationship ends. Under a rule effective May 1, 1989, member firms of the SEC Practice Section of the AICPA Division for Firms must notify the SEC directly by letter *within five business days* after the auditor resigns, declines to stand for reelection, or is dismissed.

New Auditing Pronouncements

Implementing SAS No. 55 on Internal Control

AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, is effective for audit periods beginning on or after January 1, 1990. Auditors who did not apply its provisions early are faced with implementation for December 31, 1990, year-end audits.

To help auditors with questions that may arise, the Auditing Standards Board (ASB) issued the Audit Guide *Consideration of the Internal Control Structure in a Financial Statement Audit*. The guide presents two preliminary audit strategies for assessing control risk and uses three hypothetical companies ranging from a small, owner-managed business to a large public company to illustrate how the strategies affect the nature, timing, and extent of procedures. Particularly helpful is a series of exhibits that includes sample workpapers documenting the hypothetical companies' compliance with SAS No. 55. A copy of the guide (product number 012450) may be obtained by calling the AICPA Order Department at (800) 334-6961 (USA) or at (800) 248-0445 (NY).

New Financial Institutions Confirmation Form

The AICPA will replace the existing 1966 Standard Bank Confirmation Inquiry. The new form will provide only confirmation of *deposit* and *loan* balances. To confirm other transactions and arrangements, auditors will have to send a separate letter, signed by the client, to a financial institution official responsible for the financial institution's relationship with the client or knowledgeable about the transactions or arrangements. Anyone ordering the new standard form from the AICPA Order Department will receive a copy of a notice to practitioners, which describes the revisions to the process of confirming information with financial institutions, and illustrative letters for confirming some of these types of transactions or arrangements. The new form should be used for confirmations mailed on or after March 31, 1991. Practitioners should neither use the new form before March 31, 1991, nor use the old form on or after that date.

New SAS on Internal Auditing

In January 1991, the ASB will issue a new SAS, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, that will provide practitioners with expanded guidance when considering the work of internal auditors. Many internal audit activities are relevant to an audit of financial statements because they provide evidence about the design and effectiveness of internal control structure policies and procedures or provide direct evidence about misstatements of financial data contained in financial statements. The SAS is effective for audits of financial statements for periods beginning on or after January 1, 1991, and will include guidance to assist auditors in obtaining an understanding of the internal audit function, assessing the competence and objectivity of internal auditors, and determining the extent to which they may consider work performed by internal auditors. The SAS supersedes SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit,* and incorporates the terminology and concepts of more recent SASs, particularly SAS No. 55.

Forthcoming Guidance on Circular A-133

On March 8, 1990, the Office of Management and Budget (OMB) issued Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* The purpose of Circular A-133 is to establish audit requirements and to define federal responsibilities for implementing and monitoring audit requirements for institutions of higher education and other nonprofit institutions receiving federal awards. Institutions covered by Circular A-133 generally include colleges and universities (and their affiliated hospitals) and other not-for-profit organizations, such as voluntary health and welfare organizations and other civic organizations.

The circular applies to nonprofit institutions that receive $100,000 or more in federal awards. (Circular A-133's definition of *financial awards* is broader than the term *financial assistance* used in SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance.*) Nonprofit institutions that receive at least $25,000 but less than $100,000 in federal financial assistance have the option of applying either the requirements of Circular A-133 or separate program audit requirements. For institutions receiving less than $25,000, records must be kept and made available for review, if requested, but the provisions of the circular do not apply.

In the first quarter of 1991, the AICPA's Auditing Standards Division plans to expose a statement of position, prepared by a subcommittee of the AICPA Not-for-Profit Organizations Committee, that will provide guidance about compliance-auditing requirements in Circular A-133. Circular A-133 is effective for audits of fiscal years beginning on or after January 1, 1990. Since the circular permits biennial audits, some institutions may not be required to follow its requirements until the audit of their financial statements for the fiscal year ending June 30, 1992.

Audit Reporting and Communication Issues

Reporting on Uncertainties

Some auditors have issued an unqualified report with an additional paragraph about the existence of an uncertainty in situations when a qualified or adverse opinion should have been issued.

SAS No. 58, *Reports on Audited Financial Statements*, requires an auditor to add an explanatory paragraph (after the opinion paragraph) to the standard report when a matter is expected to be resolved at some future date, at which time sufficient evidence about its outcome is likely to be available. Examples of such uncertainties include lawsuits against the entity and tax claims by tax authorities when precedents are not clear. Because its resolution is prospective, sometimes management cannot estimate the effect of the uncertainty on the entity's financial statements. However, those uncertainties have, in some cases, been confused with other situations in which management asserts that it is unable to estimate certain financial statement elements, accounts, or items.

Generally, matters whose outcomes depend on the actions of management and relate to typical business operations are susceptible to reasonable estimation and, therefore, are estimates inherent in the accounting process, not uncertainties. Management's inability to estimate in these situations should raise concerns about the possible use of inappropriate accounting principles or scope limitations. If the auditor believes that financial statements are materially misstated because of the use of inappropriate accounting principles, a qualified or adverse opinion is required due to the GAAP departure. A scope limitation should result in a qualified opinion or a disclaimer of opinion.

Going-Concern Matters

When an auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern, SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires the auditor to include an explanatory paragraph (following the opinion paragraph) in the report to reflect that conclusion. Auditors have issued reports in which it is unclear whether they are expressing a conclusion that there is substantial doubt about an entity's ability to continue as a going concern.

For situations in which the auditor expresses such a conclusion, the ASB recently amended SAS No. 59 to require the use of the phrase "substantial doubt about the entity's ability to continue as a going concern" (or similar wording that includes the terms *substantial doubt* and *going concern*) in the required explanatory paragraph.

Required Communications to Audit Committees and Others Having Oversight Responsibility

Instances have been noted in which auditors have overlooked the communication requirements of SAS No. 61, *Communication With Audit Committees*. This statement requires auditors to ensure that certain matters are communicated to audit committees or other groups with responsibility for oversight of the financial reporting process. SAS No. 61 applies to—

- Entities that have an audit committee or a formally designated group having oversight responsibility for financial reporting (for example, a finance or budget committee).
- All SEC engagements as defined in note 1 of the statement.

In considering the communications required by SAS No. 61, the auditor should also not overlook the communications required by the following:

- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*
- SAS No. 54, *Illegal Acts by Clients* (see discussion below)
- SAS No. 60, *Communications of Internal Control Structure Related Matters Noted in an Audit*

Illegal Acts

SAS No. 54 provides guidance for communications with clients of possible illegal acts. The auditor has a responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on financial statement line-item amounts. Auditors may also become aware of other illegal acts that have, or are likely to have, occurred and that may not have a direct and material effect on financial statement amounts.

Auditors should assure themselves that all illegal acts that have come to their attention, unless clearly inconsequential, have been communicated to the audit committee or its equivalent (the board of trustees or an owner-manager) in accordance with SAS No. 54.

Recurring Audit Problems

Questionable Accounting Practices

Managements of companies—public or private—might feel pressure to report favorable results—for example, to maintain a trend of growth in earnings, support or improve the price of the company's stock, obtain or maintain essential financing, or comply with debt covenants. This pressure is most likely to affect public companies, but auditors should not underestimate the pressures on nonpublic companies to "stretch" earnings or report a favorable financial condition—particularly in light of the current credit crunch. In most cases, the actions taken are well-intentioned and believed to be appropriate by the company. However, in certain cases, the result is an inappropriate accounting practice.

The downturn in the economy may have an effect on the way a client conducts its business and carries out its revenue recognition policies. Auditors should be alert to facts and circumstances relating to revenue recognition policies that may not be appropriate, such as—

- Changes in standard sales contracts permitting, for example, continuation of cancellation privileges.
- Situations in which the seller has significant continuing involvement or the buyer has not made a sufficient financial commitment to demonstrate an intent or ability to pay.
- Certain sales with a "bill and hold" agreement.

Revenue should not be recorded until it is realized or clearly realizable, the earnings process is complete, and its collection is reasonably assured.

The following are some other accounting practices that distort operating results or financial position:

- Improperly deferring typical period costs and expenses (for example, personnel, training, and moving costs) or costs for which a specific quantifiable future benefit has not been determined
- Adjusting reserves without adequate support
- Nonaccrual of losses (for example, environmental liabilities) or inadequate disclosure in accordance with FASB Statement No. 5, *Accounting for Contingencies*
- Inadequate recognition of uninsured losses (for example, increased deductibles for workers' compensation or medical care)
- Using improper LIFO accounting practices, including inappropriate pools and intercompany transactions

Competent and sufficient audit evidence continues to be the foundation for the auditor's opinion. Insufficient professional skepticism, illustrated by "auditing by conversation," or failing to obtain solid evidence to back up management's representations, can lead to audit problems. In the final analysis, auditors need to step back and ask one of auditing's most fundamental questions: Does it make sense?

Problems also can occur due to errors in recording relatively straightforward transactions, particularly in those situations where cost-reduction and restructuring programs have reduced the number and quality of accounting personnel. The importance of principal audit procedures (for example, sales and inventory cut-off tests, searches for unrecorded liabilities, and follow-up on errors noted during tests) cannot be overemphasized. These types of procedures are fundamental and critical to the audit process.

Although clients may impose fee pressures or tight deadlines on auditors, these pressures do not change the professional responsibility to understand and audit the facts and situations carefully and to make professional, knowledgeable decisions.

Communications Between Predecessor and Successor Auditors

SAS No. 7, *Communications Between Predecessor and Successor Auditors*, establishes requirements for communications between predecessor and successor auditors when a change of auditors has taken place or is in process. It has been observed that the guidance provided by SAS No. 7 is sometimes not followed. It is essential that both predecessor and successor auditors are aware of, and adhere to, the requirements of SAS No. 7. For example, the predecessor auditor should respond promptly and fully to the successor's reasonable inquiries unless he or she indicates that the response is limited.

Part of Audit Performed by Other Independent Auditors

In accordance with SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 543), in no circumstances should an auditor state or imply that an audit report making reference to another auditor is inferior in professional standing to a report without such a reference. When a principal auditor decides not to make reference to the work of another auditor, the extent of additional procedures to be performed by the principal auditor may be affected by the other auditor's quality-control policies and procedures (see auditing interpretation "Part of Audit Performed by Other Auditors: Auditing Interpretations of AU Section 543" [AICPA, *Professional Standards*, vol. 1, AU sec. 9543.18]).

Attorney's Responses

A letter of audit inquiry to the client's lawyer is the auditor's primary means of corroborating information furnished by management concerning litigation, claims, and assessments. Auditors should carefully read all letters from attorneys and ensure that all matters discussed are understood. Ambiguous and incomplete responses should be appropriately resolved with client management and attorneys, and conclusions should be properly documented. An auditing interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, presented in the AICPA's *Professional Standards*, vol. 1, AU sec. 9337.18, discusses what constitutes an acceptable reply. Additional inquiries may be needed if replies are not dated sufficiently close to the date of the audit report.

Pitfalls for Auditors

Each year-end seems to abound with pitfalls for auditors. The following reminders are intended to alert auditors to some of these pitfalls.

- Watch out for large, unusual, one-time transactions, especially at or near year-end, that may be designed to ease short-term profit and cash flow pressures. Scrutinize each transaction to ensure validity of business purpose, timing of revenue or profit recognition, and adequacy of disclosure.
- In performing analytical procedures (for example, analyzing accounts, changes from period to period, and differences from expectations), maintain an attitude of objectivity and professional skepticism. Do not assume that the accounts or client explanations are right. Rather, question, challenge, and compare new information with what is already known about the client and of business in general.
- Make sure that receivables that are supported by real estate as collateral reflect the softening of the market. Increases in the allowance for uncollectibles may be needed. Recognize that assets acquired through foreclosure may be overvalued and difficult to sell.
- Pay special attention to the collectibility of significant receivables from debtors that have recently gone through a leveraged buyout (LBO). A company is not the same entity that it was before an LBO.

Accounting Developments

Financial Instruments Disclosure

In March 1990, the FASB issued Statement No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, effective for fiscal years ending after June 25, 1990. It applies to all entities, including small businesses (due to its requirement to disclose significant concentrations of credit risk arising from all financial instruments, including trade accounts receivable).

The statement applies to all financial instruments with off-balance-sheet risk of accounting loss and all financial instruments with concentrations of credit risk, with some exceptions that are detailed in paragraphs 14 and 15 of the statement. It requires all entities with financial instruments that have off-balance-sheet risk to disclose the face, contract, or underlying principal involved; the nature and terms of the financial instrument; the accounting loss that could occur; and the entity's policy regarding collateral or other security and a description of the collateral.

Postretirement Benefits Other Than Pensions

The FASB is expected to issue the final statement on postretirement benefits other than pensions in December 1990. The proposed statement would significantly change the prevalent current practice of accounting for postretirement benefits on the "pay as you go" (cash) basis by requiring accrual, during the years that employees render services, of the expected cost of providing those benefits to employees and their beneficiaries and covered dependents. This statement would be effective for calendar-year 1993 financial statements. An additional two-year delay would be provided for plans of non-U.S. companies and certain small employers.

In the SEC Staff Accounting Bulletin (SAB) No. 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period,* the SEC staff expressed its belief that disclosure of *impending* accounting changes is necessary to inform readers about expected effects on financial information to be reported in the future and should be made in accordance with existing MD&A requirements. The SEC staff provided supplemental guidance regarding SAB No. 74 in the November 1990 EITF minutes.

Reporting When in Bankruptcy

Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code,* provides guidance for entities that have filed petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11.

The SOP recommends that all such entities report the same way while reorganizing under Chapter 11, with the objective of reflecting their financial evolution. To do that, their financial statements should distinguish transactions and events that are directly associated with the reorganization from the operations of the ongoing business as it evolves.

The SOP generally becomes effective for financial statements of enterprises that have filed petitions under the Bankruptcy Code after December 31, 1990.

Audit Risk Alerts

The Auditing Standards Division is issuing Audit Risk Alerts to advise auditors of current economic, industry, regulatory, and professional developments that they should be aware of as they perform year-end audits. The following industries are covered:

- Airlines (022071)
- Agricultural producers and agricultural cooperatives (022073)
- Banking (022063)
- Casinos (022070)
- Construction contractors (022066)
- Credit unions (022061)
- Employee benefit plans (022055)
- Federal government contractors (022068)
- Finance companies (022060)
- Investment companies (022059)
- Life and health insurance companies (022058)
- Nonprofit organizations, including colleges and universities and voluntary health and welfare organizations (expected to be available in March 1991) (022074)
- Oil and gas producers (022069)
- Property and liability insurance companies (022072)
- Providers of health care services (022067)
- Savings and loan institutions (022076)
- Securities (022062)
- State and local governmental units (022056)

Copies of these industry updates may be purchased from the AICPA Order Department. They will also be included in the new loose-leaf service for audit and accounting guides.

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