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Retail industry developments - 1999/2000; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Retail Industry Developments—1999/2000

American Institute of Certified Public Accountants

Notice to Readers

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

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Retail Industry Developments—1999/2000

Economic and Industry Developments

What are the current economic and industry conditions facing retailers this year?

The U.S. economic expansion is now in its ninth year. In 1999, gross domestic product (GDP) grew at an annual rate of 4.3 percent in the first quarter, 1.9 percent in the second quarter, and 4.8 percent in the third quarter.

Consumer confidence remains high as a result of such factors as job creation, low interest rates, and high stock valuations. Personal income and personal spending surged in August and the savings rate was negative for the ninth straight month.

Consumer spending, a key determinant of retail sales, rose at a 6.7 percent annual rate in the first quarter and a 4.6 percent annual rate in the second. This increase in consumer spending has benefited retailers, as retail sales are a significant component of consumer spending. Consumer spending on retail sales, excluding autos, has increased every month in 1999 through September. And consumers are buying a lot on credit, adding $5.8 billion to revolving credit cards in July—the largest increase in almost three years.

Risks for Retailers

Of course, the success of a retail business is still dependent on many factors, not just the economy as a whole. The robust economy and strong consumer spending do not insulate retailers from problems. According to the American Bankruptcy Institute, bankruptcies among discount, home-improvement, catalog, and other stores have been growing. Therefore, auditors should be aware of other risk factors for the retail industry, such as the proportionally greater number of bankruptcies in the retail industry as compared to many other industries. Most retailers do not have the capital base or cost structure to effectively compete against the retail giants. This may result in negative trends, or other 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. Auditors should be aware of their responsibility to evaluate whether there is a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provides guidance to auditors on this issue. Also, see the "Store Closings" section of this Audit Risk Alert for a discussion of some of the accounting and auditing issues that result when a retail entity closes store locations.

Among the factors that appear to determine which retailers are successful is the type of retail establishment. For example, department stores continue to lose market share to discount chains and high-end retailers. And the big retailers have various advantages, such as the ability to demand better terms, higher discounts, and exclusive merchandise from suppliers, as well as the ability to import directly from overseas suppliers.

To compete successfully, some larger retailers are using new technologies to better manage inventory levels. Some retailers are also implementing computerized ordering systems that integrate with those of suppliers (using a type of electronic commerce often referred to as *electronic data interchange* or *EDI*). EDI may also be used in shipping, record maintenance, invoicing, and other functions. The AICPA's Auditing Procedure Study *Audit Implications of EDI* (Product no. 021066kk) addresses the opportunities and challenges that EDI presents, including issues such as the internal controls that are important in EDI systems.

Also, when using EDI, retailers may use the services of an outside service organization to standardize the computer communications among entities. For a discussion of some of the relevant audit issues that may arise when a client uses such an organization, see the "Service Organizations" section in this Audit Risk Alert.

Electronic Commerce

Electronic commerce (e-commerce) is big news this year, particularly with respect to consumers buying products on the Internet. The 1998 holiday shopping season resulted in $3.5 billion in sales over the Internet—45 percent of total 1998 online sales. And one survey predicts that consumers will make 35 percent of their 1999 holiday purchases on the Internet, up from 12 percent in 1998. Another survey predicts that U.S. online retail sales will reach $20 billion this year (with seven million people making their first online purchase) and $185 billion by 2004. However, to keep these numbers in perspective, consider that $185 billion will be only 7 percent of total U.S. retail sales.

How this overall trend will affect an individual retailer is a bigger question because shoppers are not just using a different means of buying from the same company. One consumer survey found that many shoppers will go to new e-commerce businesses rather than merely going to the Web sites of department stores or catalogs they know. Another factor is the demographics of online purchasers. Because most of the online purchases are being done by higher-income individuals, some types of businesses may be more affected by this trend than others.

To compete with online retailers, some stores are developing their own Internet sites, and a few are acquiring companies that already have the necessary resources. The costs of starting a new e-commerce Web site are often much greater than anticipated. One study found the cost to average $1 million and that companies often do not budget enough for the project. Retailers may also fail to anticipate the high cost of processing orders received on the Internet, plus the significant marketing expenses involved.

Even when retailers have made the leap to e-commerce, they may not get orders over the Internet if customers do not feel that the transaction processing is secure. In one recent survey, 97 percent of customers who revealed why they did not buy on the Internet said that they felt uncomfortable putting credit card information online. This may indicate an opportunity for CPAs to provide a needed service to their retail clients by providing WebTrust℠

services. When providing WebTrust^{SM} services, the CPA places the WebTrust^{SM} Seal of assurance directly on the retailer's Web site after it has been shown to be in compliance with the CPA WebTrust^{SM} Principles and Criteria. Online customers can click on the Seal and gain access to the CPA-issued report about the site. For more information, see the section "Beyond the Audit—CPA WebTrust^{SM}" in this Audit Risk Alert.

Retailers may face increased price competition as a result of e-commerce, as consumers can comparison shop with the click of a mouse. High shipping costs may also alter the price equation substantially, and it may be less expensive to buy from a bricks-and-mortar store. Finally, for some products, such as computers, consumers are increasingly buying directly from the manufacturer.

Another significant aspect of the e-commerce boom is consumer credit card fraud. According to an article in *Stores Magazine*,[1] "Some experts now estimate that nearly 10 percent of on-line sales involve the fraudulent use of either credit cards or off-line debit cards." Additionally, retailers, rather than the credit card companies, foot the bill for these transactions, even when they have been authorized. As a result, auditors may see some changes in the amounts of receivables that need to be written off or at least looked at more closely. For a discussion of some audit issues regarding bad debts, see the section "Collectibility of Receivables (Allowance for Doubtful Accounts)."

Finally, another unknown is how taxation of Internet purchases will affect e-commerce. The Internet Tax Freedom Act (the Act) went into effect beginning October 1, 1998. One aspect of the Act was a three-year moratorium on new taxes on Internet commerce while a special commission studies the issue. A possible outcome is a federal law allowing states to tax Internet commerce. (See a detailed discussion of this issue in the June 1999 *Journal of Accountancy*.)

1. *Taking Aim at Internet Fraud*, by Patricia A. Murphy, in the October 1999 issue of *Stores* magazine.

A further discussion of some of the audit and accounting implications of e-commerce is included under the heading "Electronic Commerce" in the "Audit Issues and Developments" section of this Audit Risk Alert.

Earnings Management and Revenue Recognition

In this quickly changing and competitive environment, there may be greater pressures on retailers to manage earnings—for example, by making entries that, although not rising to the level of quantitative materiality, give a more favorable impression of the company. One issue recently reported in the news is the tendency for some large retailers to claim large deductions on bills from manufacturers for damaged or otherwise unusable goods. If these adjustments are booked close to the end of a reporting period, but later paid after agreeing with the manufacturer that the deduction was an error, it could indicate an attempt to manage earnings. This type of scenario shows that auditors must continue to be on the alert for transactions that are out of the ordinary. In some cases, this may be the type of item being addressed by the SEC's recent Staff Accounting Bulletin (SAB) No. 99 on materiality. See a discussion of this SAB in the section "Materiality—SEC Staff Accounting Bulletin" in this Audit Risk Alert. Additionally, see the section "Analytical Procedures" for a discussion of some of the ratios that auditors can use to help determine if reported results are in line with anticipated results.

Fraud

Some retailers may be facing a high degree of competition or market saturation, accompanied by declining margins. This is a fraud risk factor that the auditor may need to consider in accessing the risk of material misstatement due to fraud, as discussed in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). Auditors may also find some relevant information about fraud, such as who commits it and how, in the recently issued fraud report of the Committee of Sponsoring Organizations of the Treadway

Commission (COSO), *Fraudulent Financial Reporting: 1987-1997: An Analysis of U.S. Public Companies* ("COSO Fraud Report"). According to this report, most of the public companies found to be committing fraud were relatively small, with well below $100 million in total assets. This may be of particular significance to auditors of small retail entities. A further discussion of this report and fraud in a financial statement audit is included in the section "Fraud—A Closer Look" in this Audit Risk Alert, and in *Audit Risk Alert—1999/2000.*

January Firsts

On January 1, 1999, the European Economic and Monetary Union (EMU) went into effect. Under the EMU, only one reporting currency exists—the euro. Every entity that trades with or has subsidiaries in Europe will be affected by the change to a common currency. This may affect entities with foreign-currency transactions or foreign operations involving the euro. A discussion of this issue was included in *Audit Risk Alert—1998/99* and the June 1999 *Journal of Accountancy.*

Also, we are now closer to another significant date—January 1, 2000—and to the Year 2000 Issue. Problems resulting from the millennium bug may have significant effects on your retail client and implications for the audit. See the section "The Year 2000 Issue" in this Audit Risk Alert for a further discussion.

Executive Summary—Economic and Industry Developments

- The U.S. economic expansion is continuing, and many, but not all, retailers are benefiting from it.
- Retailers may be facing significant changes as a result of e-commerce, including increased competition and the need to have a presence on the World Wide Web.
- Retailers may face increasing pressures to meet earnings expectations, resulting in earnings management or fraudulent behavior.
- The year 2000 will be here soon, and auditors need to consider relevant accounting and auditing issues.

Audit Issues and Developments

Electronic Commerce

How will the increased use of e-commerce affect auditors of retail entities?

Before discussing the effect of e-commerce on the auditor, it may be helpful to provide a definition: The term *electronic commerce (e-commerce)* simply refers to those business transactions that are conducted in an electronic environment. There are many aspects of e-commerce, including direct sales to consumers over the Internet, Web sites that provide only product information, and computer interfaces between retailers and suppliers that allow the retailers' computer systems to place orders with the suppliers. Many of these have audit and accounting implications, including the following.

- E-commerce will result in the increased use by retailers of electronic data to transact business, and to record, update, and maintain records. As a result, auditors of retail companies increasingly will be confronted with evaluating evidential matter that may exist only in electronic format. SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326), provides guidance to auditors who have been engaged to audit the financial statements of an entity that transmits, processes, maintains, or accesses significant information electronically. The AICPA Auditing Procedure Study *The Information Technology Age: Evidential Matter in the Electronic Environment* (Product no. 021068kk) is designed to provide nonauthoritative guidance to auditors in applying SAS No. 80.

- The auditor also may be more likely to see prepackaged or customized computer systems used by retail clients. In such circumstances, the auditor should evaluate management's consideration of Statement of Position (SOP) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

- Such factors as lack of a paper trail, possible poor controls, and unauthorized persons initiating transactions may increase the potential for disputes. Among the possible results is that disputes leading to legal action may arise with customers and suppliers over such matters. Information regarding such issues may point to the existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments, pursuant to SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337).

- The use of e-commerce may result in a greater number of risks and uncertainties for the retail entity. Auditors should consider whether management has evaluated all such risks and uncertainties appropriately and made any necessary disclosures pursuant to SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. In addition, auditors should also evaluate management's consideration of related contingencies arising from e-commerce, pursuant to FASB Statement No. 5, *Accounting for Contingencies*.

- The retail entity may decide to purchase another entity that already has some or all or the infrastructure to support its e-commerce goals. In such cases, auditors should refer to appropriate accounting standards, such as Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*.

- Changes in the way the client does business (such as a first-time venture into e-commerce) of course need to be considered by the auditor when planning the engagement, as discussed in SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311). As noted in SAS No. 22, in planning the audit, the auditor should consider, among other matters, matters relating to the entity's business and the industry in which it operates, planned assessed level of control risk, and the methods used by the entity to process significant accounting information, including the use of service organizations, such as outside service centers.

- Some retailers are outsourcing the entire fulfillment function, becoming "virtual" stores. Auditors of entities that use such services should be familiar with the requirements of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). See the "Service Organization" section of this Audit Risk Alert for a further discussion.

- E-commerce may result in rapid changes in the way transactions are processed, possibly without adequate consideration of the effect on internal control. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit,* as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).

- Retailers may organize their e-commerce operations as a separate business segment. For a public business enterprise, this may result in an operating segment subject to the disclosure requirements of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information.* In such circumstances, auditors should consider the guidance set forth under auditing Interpretation No. 4, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.22).

- EDI is also a type of electronic commerce that is often used by retailers to interact via computer with suppliers and customers. The Auditing Procedure Study *Audit Implications of EDI* addresses the opportunities and challenges that EDI presents, including issues such as the internal controls that are important in EDI systems, and the audit and business risks associated with using the technology.

Auditors should also note that the Emerging Issues Task Force (EITF) of the FASB recently added several accounting issues related to Internet activities to its agenda. For retailers, some of these issues arise because of the different business models used by retailers in their e-commerce operations vis-à-vis their traditional operations, whereas other issues also exist outside of the e-commerce realm but have become more common because of e-commerce. When auditing the financial statements of retailers that engage in e-commerce, auditors should gain an understanding of the retailers' accounting policies used for their e-commerce activities, and should ensure that transactions that retailers enter into through their e-commerce operations are accounted for using the established accounting models for similar transactions entered into through the retailers' traditional business operations, when such models exist. Auditors of retailers with e-commerce operations are also encouraged to monitor the activities of the EITF in this area, as consensus guidance on certain issues will be forthcoming.

Executive Summary—Electronic Commerce

- The growth of the Internet has led many retailers to make an initial venture into electronic commerce. Auditors need to consider how these ventures will affect the audit.
- Increasingly, auditors are faced with auditing in an environment where a significant amount of business is transacted electronically.
- Among the many accounting and auditing implications of the retailer's use of e-commerce are accounting for software developed or purchased for internal use, use of service organizations, and the effect of e-commerce on internal control.
- Auditors should monitor the activities of the EITF in the area of e-commerce and Internet activities.

Collectibility of Receivables (Allowance for Doubtful Accounts)

What are some of the audit issues that may arise when considering the collectibility of receivables?

Because more people are ordering over the Internet, retailers may experience an increased number of fraudulent transactions. (As mentioned before, some experts estimate that nearly 10 percent of these sales involve the fraudulent use of credit or debit cards.) As a result, retailers may experience an increase in uncollectible receivables. Additionally, because this is a rapidly evolving area, the retailer may not have an adequate history of bad debts resulting from Internet sales on which to estimate the level of uncollectible accounts, making the determination more difficult.

The client's estimate of the level of accounts receivable that may not be collectible as a result of bad debts is reflected in the allowance for doubtful accounts, which is one of the offsets used to bring accounts receivable to their net realizable value. (Other allowances include those for returns and rebates.) An audit of the allowance for doubtful accounts is an audit of an accounting estimate. When auditing estimates, auditors should be familiar with SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), which provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates used in a client's financial statements. The guidelines set forth by SAS No. 57 include the following:

- Identifying the circumstances that require accounting estimates
- Considering internal control relating to developing accounting estimates
- Evaluating the reasonableness of management's estimate

As part of evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate for the allowance for doubtful accounts and, based on that understanding, use one or a combination of the following approaches listed in SAS No. 57.

1. Review and test the process used by management to develop the estimate.
2. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.

3. Review subsequent events or transactions occurring prior to completion of fieldwork.

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

Another very useful tool in evaluating the allowance for doubtful accounts is the application of analytical procedures. Often, the large number of customer accounts makes it difficult to determine the adequacy of the allowance only by reference to individual accounts, making analytical procedures helpful to the audit process. See the "Analytical Procedures" section of this Audit Risk Alert for a further discussion of this issue.

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

The auditor will, of course, use his or her professional judgment to determine which of these and other procedures to perform to obtain the evidence needed to judge whether the allowance is reasonable.

Also, auditors of retail entities that have transferred receivables should evaluate whether management has properly implemented FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, an amendment of FASB Statement No. 125, and any related pronouncement.

Fraud—A Closer Look

What information do recent events provide regarding the possibility of fraud in a retail environment? What is the auditor's responsibility to detect fraud in a financial statement audit?

The recently issued COSO Fraud Report, along with recent highly publicized instances of fraudulent financial reporting, serve as reminders to auditors of the need to remain alert to possible instances of fraudulent activity, and to maintain an appropriate attitude of professional skepticism.

The COSO Fraud Report highlights some factors that may be of particular interest to auditors of retail entities. The report, which resulted from the examination of all of the financial statement fraud cases brought by the Securities and Exchange Commission (SEC) from 1987 to 1997, examines financial reporting fraud cases the SEC brought against U.S. public companies.[2] Among the findings that may be of interest to auditors of retail entities are the following:

- Most of the companies found to be committing fraud were relatively small, as are many retail entities.
- Fifty percent of the companies used improper revenue recognition to commit fraud, including sham sales, recognizing revenue before all the terms of the sale were complete, conditional sales, improper sales cutoff, and other methods.
- Inventory and accounts receivable were the most frequently misstated asset accounts.

In addition to the information in the COSO Fraud Report, auditors can also note that a number of prominent fraud cases reported have involved either management fraud or deliberate deceit by management in working with their auditors. Some of the more common audit issues identified in recent litigation related to fraudulent financial reporting included the following:

2. Additional information on the COSO Fraud Report can be found in *Audit Risk Alert—1999/2000*.

- A willingness by the auditor to accept management's representations without corroboration
- Allowing the client to unduly influence the scope of auditing procedures
- Failing to identify risky situations, or ignoring identified audit risks by not applying professional skepticism and revising auditing procedures appropriately

Auditors are not responsible for detecting fraud *per se*; however, auditors do have a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. The issuance of SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol.1, AU sec. 316), did not change the auditor's responsibility with respect to fraud, but was designed to help auditors to fulfill their responsibility to detect material misstatements of financial statements caused by fraud.

Among other things, the Standard—

- Describes the characteristics of fraud. The more the auditor knows about the nature of fraud, the better he or she will be equipped to identify risk factors, assess the risk of material misstatement due to fraud, and develop an appropriate audit response.
- Requires the auditor to make an assessment as to the risk of material misstatement due to fraud, from the perspective of the broad categories listed in the SAS. The assessment is separate from, but may be performed in conjunction with, other risk assessments made during the audit. The SAS also requires the auditor to reevaluate the assessment if other conditions are identified during the fieldwork.
- Provides examples of fraud risk factors that, when present, might indicate the presence of fraud.
- Requires the auditor to document evidence of the performance of the fraud risk assessment, including risk factors identified as being present and the auditor's response to those risk factors.

- Requires the auditor to communicate to management at the appropriate level and, in certain circumstances, directly with the audit committee.

The presence of a fraud risk factor, or even many fraud risk factors, does not always mean that there has been a fraud. But it may indicate the presence of a fraud. The examples of fraud risk factors in the SAS were developed from research on known frauds, and have often been observed in circumstances involving fraud.

Consider the example where an auditor, in the planning phase of the audit, becomes aware that the client was having cash flow problems in spite of reported profits and earnings growth, and was operating in a declining industry with increasing business failures and significant declines in customer demand. The auditor ordinarily would use this information to identify high-risk audit areas while planning the audit. The auditor also should be aware that these items are fraud risk factors. Because of this, the auditor should consider this information as an indicator of possible fraud and plan and perform the auditing procedures accordingly.

The assessment of the risk of a material misstatement due to fraud is a cumulative process. Over the course of the audit, the auditor may become aware of the presence of additional risk factors. For example, the auditor may learn that—

- Management is dominated by a small group of individuals who could probably override any internal controls.
- There are significant pressures to obtain additional capital to remain competitive.
- Management has committed to analysts to achieve what appear to be unduly aggressive or unrealistic financial targets.

The auditor may also uncover, during the audit, unusual journal entries to the accounts receivable ledger or sales journal that significantly affect reported earnings, or a significant number of pre- or post-dated transactions.

Regardless of when the auditor discovers fraud risk factors or other conditions related to the fraud risk assessment, the auditor should consider their effect on auditing procedures. The auditor should document the risk factors identified, as well as the auditor's response to the risk factors. The fraud risk factors and other conditions identified may cause the auditor to believe that the planned audit procedures are not sufficient to provide reasonable assurance that the financial statements are free from material misstatement. Accordingly, auditing procedures should be planned and performed to specifically address the identified risks.

In certain situations, management may have the motive (pressure to obtain additional capital) and opportunity (ability to override internal controls) to improperly recognize revenue, perhaps by recording fictitious sales or recognizing revenue in the improper period. In such circumstances, the auditor may consider expanding audit procedures in this area by—

- Thoroughly examining original (not copies) source documents.
- Analyzing credit memos and other accounts receivable adjustments.
- As part of the confirmation process, confirming the terms of sale with customers, including the existence of side-agreements.
- Analyzing large or unusual sales made prior to the period end.
- Scanning the general ledger, sales journal, and accounts receivable subledger for unusual activity.
- Comparing operating cash flows to sales by sales person, location, or product.

Above all, auditors must maintain an appropriate attitude of professional skepticism. This means neither assuming that management is dishonest nor assuming unquestioned honesty; obtaining corroborating evidence for management representations; considering whether misstatements may be the result of fraud; and appropriately designing and performing auditing procedures to address fraud risk factors. The application of professional skepticism in response to the auditor's assessment of the risk of material misstatement due to fraud might include (1) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (2) increased recognition of the need to corroborate management explanations or representations concerning material matters – such as further analytical procedures, examination of documentation, or discussions with others within or outside the entity.

> **Help Desk**—For further information on fraud refer to the self-study course *Consideration of Fraud in a Financial Statement Audit: The Auditor's Responsibilities under SAS No. 82* (Product no. 732045kk) and the AICPA Practice Aid, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product no. 008883kk), which walks the practitioner through the issues likely to be encountered in applying the SAS to audits and provides valuable tools, such as sample documentation.

Executive Summary—Fraud

- The COSO Fraud Report and recent publicized cases serve as reminders to remain alert to possible instances of fraudulent activity, and to maintain an appropriate attitude of professional skepticism.
- The COSO Fraud Report highlights some factors that may be of particular interest to auditors of retail entities.
- Auditors should be familiar with the requirements of SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, which provides, among other things, that auditors specifically assess the risk of material misstatement due to fraud in every audit.

Analytical Procedures

How can analytical procedures be applied in a retail environment, and what practical guidance has the AICPA issued recently to assist auditors in using analytical procedures?

Analytical procedures are required in the planning and overall review stages of the audit according to SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329). In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives. They may be particularly helpful in a retail setting, where some trends tend to remain relatively constant and where the large number of small transactions make it difficult to test a significant portion of the period's transactions. Auditors should be aware of the need to have these procedures performed by staff with the sufficient industry expertise to properly evaluate the results, particularly when analytical procedures are being performed in lieu of other substantive auditing procedures.

In performing analytical procedures, the auditor compares amounts or ratios to expected results developed from such sources as the following:

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

A brief description of some of the ratios commonly used in a retail environment is given in the following sections.

Liquidity Ratios

The *acid test ratio (quick ratio)* indicates the retailer's ability to pay current debts using cash and assets that can be quickly converted to cash. It is computed as the total of cash, marketable securities, and net receivables, divided by current liabilities.

The *current ratio (working capital ratio)* indicates the company's ability to pay current debts with current assets and is computed as current assets divided by current liabilities.

Financial Leverage Ratios

The *debt to equity ratio* indicates the extent that the retailer's assets, such as new store locations, are financed with debt rather than equity. It is computed as long-term debt divided by stockholders' equity.

Times interest earned is a ratio that indicates the company's ability to meet its debt obligations. It is computed as net income before taxes and interest expense divided by interest expense.

Inventory Valuation Ratios

The *gross profit ratio* indicates whether profit goals will be met and whether there are unusual variances in cost of sales and inventory, and is computed as gross margin divided by net sales.

The *inventory turnover ratio* indicates how well merchandise inventory is managed and whether sales problems exist. It is computed as cost of goods sold divided by average inventory.

The *stock to sales ratio* indicates the projected time (usually in months) to sell the merchandise. It is computed as beginning merchandise inventory divided by sales for the period. A similar ratio is days of sales in inventory.

Inventory shrinkage to inventory indicates the percentage of inventory loss resulting from shrinkage. This ratio is calculated as the inventory shrinkage amount divided by the book value of inventory.

Net markdowns to inventory available for sale at retail provides information about trends in marking down inventory. This ratio is calculated as net markdowns divided by total inventory available for sale at retail.

Inventory by location provides a check on whether the amount of inventory at each location is reasonable (or even possible). Various calculations are possible, such as using total by location, square foot by location, using dollar values, or using quantities of inventory.

Accounts Receivable Collectibility Ratios

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

Bad debts to net credit sales indicates whether write-offs are adequate. It is computed as bad debt expense divided by net credit sales.

Doubtful accounts allowance to accounts receivable indicates whether the allowance account is adequate. It is computed as allowance for doubtful accounts divided by accounts receivable.

Overall Operating Efficiency Ratios

The *gross margin return on investment* is a ratio that indicates the profitability of assets and can be calculated at various levels, such as a stock-keeping unit (SKU) or a merchandise department. It is computed as the annual inventory turnover rate multiplied by the mark on percentage.

The *return on assets ratio* indicates how well the retailer used assets to generate profits. This ratio is computed as net income divided by average assets.

Return on equity ratio indicates the profitability of the capital investment in the company. This ratio is computed as net income divided by average stockholders' equity.

The *return on net sales ratio* indicates the amount of profit generated by each dollar of sales, and is computed as net income divided by net sales.

The *sales per square footage ratio* indicates how well the retailer used selling space, and can be calculated for various levels, such as for the entire company or for a particular store. This ratio is computed as net sales divided by square footage.

The *sales per associate ratio* indicates productivity of sales associates. This ratio is calculated as net sales divided by average number of associates. Similar ratios are sales per employee hour and payroll as a percentage of sales.

The *comparable store sales change ratio* indicates the change in sales for stores that have been open during both the periods being compared and is calculated as the percentage increase in sales from one period to the next only using stores open during both periods.

One area that the auditor may want to consider when reviewing ratios is whether particular ratios must be maintained at a certain level in order to comply with loan agreements. There may be an increased risk of misstatement of accounts that affect those ratios if the company is experiencing financial difficulty.

Also, when reviewing ratios, the auditor may want to compare client-generated information with industry statistics to assess the reasonableness of these financial statement assertions. The auditor may also consider the extent to which a retailer's operations do not match the industry norm. For example, the return on assets ratio will be affected by the extent to which assets are owned or leased, and whether the leases are capital or operating leases. Also, current economic and business environment trends may cause certain historical relationships to no longer be applicable, or they may lag in reflecting current events.

> **Help Desk**—Industry statistics are available from services such as Robert Morris Associates, Standard & Poor's, and Dunn & Bradstreet. Appendix A, "The Internet—An Auditor's Research Tool," of this Audit Risk Alert contains the names of several industry associations that may be helpful in obtaining such statistics. Also, the AICPA has recently issued the Auditing Practice Release (APR) *Analytical Procedures* (Product no. 021069kk), which is designed to help practitioners effectively use analytical procedures. It includes a description of how analytical procedures are used in audit engagements, relevant questions and answers, and case studies, including a case study using regression analysis.

Audit Sampling

Why is audit sampling significant in a retail environment, and what practical guidance has the AICPA issued recently to assist auditors in using audit sampling?

GAAS does not require auditors to use sampling. Yet it goes without saying that few audits involve the examination of every transaction that occurred within the period under consideration. Examples of audit sampling for a retail client could include the following.

- Substantive tests of balance sheet accounts, such as confirming accounts receivable and observing inventory counts
- Testing controls, such as controls over retail inventory records or the sales audit function
- Substantive testing of transactions, such as inspecting the detail supporting recorded purchase transactions

Indeed, in most situations testing every item that could possibly be selected for examination would make a timely and reasonably priced audit virtually impossible. Instead it is far more common for auditors to examine something less than an entire population or class of items. But is "something less than the entire population" always considered to be a sample for the purposes of SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350)?

SAS No. 39 defines sampling as "...the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class..." It is important to keep in mind, therefore, that merely testing less than 100 percent of a given population does not constitute sampling as defined by SAS No. 39. The audit test must be performed for the purpose of evaluating some characteristic of the entire balance or class in order to meet that definition.

Let's assume that you have decided to test less than 100 percent of a particular account. You have chosen to audit only those items above a predetermined dollar amount, and to do nothing more. In this situation, SAS No. 39 would not apply. Yes, you have audited less than 100 percent of the population, but you have not projected test results to the population as a whole. Instead, you have tested 100 percent of the items in a particular subpopulation—those above the predetermined dollar amount. In this circumstance, it is not appropriate to project the results of that test to the remaining balances, because those remaining balances had no opportunity to be selected for testing. Examples of other procedures that, in general, do not involve sampling include inquiry and observation, analytical procedures, and procedures applied to every item in a population.

Sampling is a complex area. The issue of what does or does not constitute sampling is just one of a number of matters for auditors to consider. Some of the key requirements of SAS No. 39 to keep in mind are as follows:

- *Sample selection*—Select sample items in such a way that they can be expected to be representative of the population from which they are drawn. All items in the population should have an opportunity to be selected.
- *Evaluation*—Misstatements detected in a sample for a substantive test of details should be projected to the population, thus yielding an estimate of the total projected misstatement in the population. Be sure to consider the nature and cause of the misstatements and their possible relationship to other phases of the audit as well.
- *Sampling risk*—Consider the risk that the conclusions reached on the basis of tests applied to a sample might be different from those that would have been reached if the test were applied in the same way to the entire population. In other words, a sample may contain more, or less, monetary misstatements, or deviations from prescribed controls, than exist in the balance or class as a whole. Note that sampling risk is inversely related to sample size. With all other factors remaining the same, the larger the sample, the lower the sampling risk.
- *Tolerable misstatement*—When using sampling in substantive tests of details, this is how much monetary misstatement in the related account balance or class of transactions may exist without causing the financial statements to be materially misstated. When using sampling in tests of controls, this is the maximum rate of deviation from the prescribed control that you would be willing to accept without altering your planned assessed level of control risk.

The AICPA has recently issued an Auditing Practice Release (APR) titled *Audit Sampling* (Product no. 021061kk). This APR, which supersedes the Audit Guide *Audit Sampling*, provides guidance to help auditors apply audit sampling in accordance with SAS No. 39.

It provides practical guidance on the use of both nonstatistical and statistical sampling in auditing. You can use the APR as a reference source if you are knowledgeable about audit sampling. Or, if you are new to this area, you can use the APR as an initial introduction to sampling. Some of the topics that the APR addresses include sampling vs. nonsampling techniques, statistical and nonstatistical sampling, determining sampling size, controlling sample risk, evaluating sample results, sampling in tests of controls, and sampling in substantive tests of details.

Service Organizations

Why is the use of service organizations significant in a retail environment, and what practical guidance has the AICPA issued recently to assist auditors of clients using service organizations?

Many smaller retail entities may not have the personnel to handle all of the tasks necessary to run a business. As a result, they may use an outside service organization to accomplish tasks that affect the retailer's financial statements. There are many types of service organizations. One type of service organization is a data processing service organization, which may provide services such as entering a client's manually recorded data and processing it with software that produces computer-generated journals, a general ledger, and financial statements, handling payroll or inventory functions, and so forth. Value-added networks (VANs) are another type of service organization of relevance to retailers. These may be of more relevance to large retailers that are using EDI to process transactions, such as purchasing inventory from manufacturers. VANs function like mailboxes, where the trading partners send or receive transactions. The VANs provide protocol conversion to assist trading partners with different communication standards, as well as a level of security by validating trading partners' user identification numbers and passwords.

Auditors of retailers that use service organizations should be familiar with the requirements of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). SAS No. 70 provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. SAS No. 70 also provides guidance for independent auditors who issue reports on the processing of transactions by a service organization for use by other auditors. Also, an interpretation of SAS No. 70 is currently under consideration. See the "Other Matters" section of this Audit Risk Alert.

Help Desk—The AICPA has recently issued the Auditing Practice Release *Service Organizations: Applying SAS No. 70* (Product no. 060457kk), which supersedes the Auditing Procedure Study *Implementing SAS No. 70* and provides guidance to user auditors engaged to audit the financial statements of entities that use service organizations. It also provides guidance to service auditors engaged to issue reports on a service organization's controls that may affect a user organization's internal control as it relates to an audit of financial statements.

Materiality—SEC Staff Accounting Bulletin

What does the new SEC Staff Accounting Bulletin have to say about materiality? What effect will it have on financial statement preparation and audits for retail entities?

The SEC staff has recently released SAB No. 99.[3] This SAB addresses the application of materiality thresholds to the preparation and audit of financial statements filed with the SEC. The SAB states that it does not create new standards or definitions for materiality, but reaffirms the concepts of materiality as expressed in the accounting and auditing literature as well as in long-standing case law.

Indeed, the SAB draws heavily on the existing auditing and accounting literature on materiality, and makes some important statements. These statements include the following:

- Registrants and auditors may not rely solely on a numerical threshold to determine what is material.

3. SABs are not rules or interpretations of the SEC; they represent interpretations and practices followed by staff of the Office of the Chief Accountant and the Division of Corporation Finance in administering the disclosure requirements of the federal securities laws.

- The materiality of misstatements discovered in the financial reporting and auditing processes must be considered both individually and in the aggregate.
- Intentional misstatements, even if not quantitatively material, are inappropriate and may be unlawful.

The SAB addresses the evaluation of misstatements discovered in the financial reporting and auditing processes, and does not affect the auditor's consideration of materiality in planning the audit.

Qualitative Characteristics of Materiality

Registrants and the auditors of their financial statements should not rely exclusively on quantitative benchmarks, or rules of thumb, to determine whether an item is material to the financial statements. A numerical threshold may provide the basis for a preliminary assumption that an amount is unlikely to be material; however, it is not a substitute for a full analysis. The accounting literature reminds us that an amount is material if the "magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the [financial] report would have been changed or influenced by the inclusion or correction of the item."[4] Thus, management and auditors must consider both quantitative and qualitative aspects of unadjusted differences and omissions.

SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), provides auditors with guidance on evaluating audit findings (see AU sec. 312.35 – .40). SAS No. 58, *Reports on Audited Financial Statements*, also provides guidance on evaluating the materiality of departures from generally accepted accounting principles (see AICPA, *Professional Standards*, vol.1, AU sec. 508.36). SAB No. 99 provides some additional qualitative factors to consider and states that among the considerations that may well render material a quantitatively small misstatement of a financial statement item are whether the misstatement—

4. FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information.*

- Arises from an item capable of precise measurement or whether it arises from an estimate and, if the latter, the degree of imprecision inherent in the estimate.
- Masks a change in earnings or other trends.
- Hides a failure to meet analysts' consensus expectations for the enterprise.
- Changes a loss into income or vice versa.
- Concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability.
- Affects the registrant's compliance with regulatory requirements.
- Affects the registrant's compliance with loan covenants or other contractual requirements.
- Has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation.
- Involves concealment of an unlawful transaction.

SAB No. 99 also emphasizes the possible effect of misstatements on segment disclosures. For example, it states that a misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important.

Auditors and management may wish to consider expanding their documentation of the reasons for concluding that unadjusted misstatements are not material to include salient qualitative considerations.

Aggregation of Unadjusted Differences

SAB No. 99 reminds auditors that, when evaluating the materiality of unadjusted differences, the differences should be considered both individually and in the aggregate. An individually material misstatement should not be aggregated with offsetting immaterial amounts as part of an analysis that justifies that, as a whole, the misstatements are not material. In addition, SAS No. 47 states that "the auditor should aggregate misstatements that the entity has not corrected in a way that enables him or her to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole." (See SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312.34) Also, the SEC staff believes that, in considering the aggregate effect of multiple misstatements on a subtotal or total, registrants and the auditors of their financial statements should exercise particular care when considering whether to offset (or the appropriateness of offsetting) a misstatement of an estimated amount with a misstatement of an item capable of precise measurement.

Intentional Misstatements

SAB No. 99 states that management should not make intentional immaterial misstatements in a registrant's financial statements to "manage" earnings, and that, in certain circumstances, intentional immaterial misstatements are unlawful. The SAB makes some subtle observations about management's intent and the legality of intentional misstatements, some of which are discussed below. It further reminds registrants of their legal responsibility to keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect transactions and the disposition of assets. The SAB also reminds auditors of their obligation to inform management and, in some cases, the audit committee of illegal acts that come to the auditor's attention.

The SEC staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements are immaterial. Although the intent of management does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to "manage" reported earnings. In that instance, management presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant's financial statements. The SEC staff believes that investors generally would regard such a practice as significant.

In discussing the legality of misstatements, SAB No. 99 focuses on intent. The SAB states that it is unlikely that it is ever "reasonable" for registrants to record immaterial misstatements *or not to correct known immaterial misstatements* as part of an ongoing effort directed by or known to senior management for the purposes of "managing" earnings. Therefore, when evaluating the materiality of unadjusted misstatements, it becomes important to consider factors such as analysts' consensus estimates and other factors that might be motivating management.

The SAB reminds auditors of their responsibilities under GAAS and the securities laws to report illegal acts to management and, under certain circumstances, to the audit committee. However, it does not provide any definitive conclusions about when an immaterial misstatement is an illegal act. If the auditor identifies otherwise immaterial misstatements that he or she suspects are either intentional or were not corrected "as part of an ongoing effort directed by or known to senior management for the purposes of managing earnings," he or she may need to consider consulting with legal counsel.

Registrants and their auditors are urged to read the SAB fully and carefully. The ASB has established a task force to consider whether the auditing standards should be amended or interpreted, or whether additional guidance is needed.

> **Help Desk**—The full text of the SAB can be viewed at the SEC Web site http://www.sec.gov/rules/acctreps/sab99.htm. Additional sources of guidance on materiality evaluation include Practice Alert 94-1, *Dealing With Audit Differences*, issued by the Professional Issues Task Force (PITF) of the AICPA SEC Practice Section Executive Committee (the Alert is available on the AICPA's Web site at http://www.aicpa.org) and a "White Paper" on materiality developed by a task force of the five largest accounting firms (this paper also is available on the AICPA's Web site).

The Year 2000 Issue

What is the Year 2000 Issue, and how does it affect retail clients and their auditors?

By now you are aware that there are many potential problems that retailers can face as a result of the Year 2000 Issue. Many types of computer systems could be affected, from the retailer's point-of-sale inventory system to the electronic data interchange system with suppliers. Potential problems include the possibility that inventory control systems might treat new items as obsolete, receivables may be erroneously identified as past due, and interest calculations may be incorrect. Additionally, systems that have embedded chips with date information could be affected, such as elevators and escalators or time-delay safes. Additionally, interactions with other businesses, such as credit card companies or banks, may cause problems. And retailers may sell consumer electronics or other products that are not year-2000-ready.

Regarding the significance of this issue to auditors of retail clients, it must first be understood that it is the responsibility of an entity's management to assess and remedy the effects of the Year 2000 Issue on an entity's systems. The Year 2000 Issue does not create additional responsibilities for the auditor. Under GAAS, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, regardless of whether the cause is a Year 2000 Issue or something else.

However, auditors should be aware of the many auditing and accounting issues that arise from the Year 2000 Issue, including audit planning, going-concern issues, establishing an understanding with the client, valuation, impairment, revenue and expense recognition, and disclosure. A few of these are listed below. A more comprehensive list and discussion of this topic can be found in *Audit Risk Alert—1999/2000.*

- As we approach the end of 1999, some organizations may intend to modify their normal business practices (for example, suspending operations around December 31, 1999) or financial accounting procedures (for example, modifying previous procedures for closing the general ledger and preparing quarterly or annual financial statements as of December 31, 1999.) Organizations also may experience significant changes in historical patterns of sales or purchases because of uncertainties about the year 2000 readiness among trading partners. As part of the audit planning process, auditors may wish to specifically inquire about any changes their client anticipates in such items that might have an effect on the audit (for example, timing of sales cut-off procedures, timing of inventory observations), and consider the possible effect such items may have on the nature, timing, and extent of planned audit procedures (for example, historical analytical relationships may be different because of changes in normal business practices). Auditors also should anticipate that changes in normal business practices may represent additional accounting or disclosure issues that may not be identified until year end, such as considering whether an unusually high level of December 1999 sales will be accompanied by an unusually high level of January returns, and consequently whether the reserve for returns is adequate.

- Auditors also should consider whether any year-2000-related events have occurred subsequent to the balance-sheet date but prior to the issuance of the financial statements and the auditor's report that require adjustment or disclosure in the financial statements. Examples of such events and how companies should account for them are discussed in EITF Issue No. 99-11, *Subsequent Events Caused by Year 2000.* As this Alert went to press, the EITF was discussing, but had not reached a consensus on, Issue No. 99-11, *Subsequent Events Caused by Year 2000.* The issue is in which accounting period costs or losses associated with Y2K failures that are detected subsequent to the balance sheet date but prior to the issuance of financial statements should be recognized. The Issue provides several cases to illustrate how various transactions could be affected by Y2K failures. The types of transactions include warranty, receivables from product sales, loans, inventory, capitalized software costs, long-lived assets, contracts to provide services, litigation for lost profit or loss of business, insurance policies, and sales with the right of return. Auditors may check the FASB Web site to monitor the status of this guidance.

- Auditors should consider whether the costs associated with their clients' modifications of computer systems pursuant to the Year 2000 Issue have been properly accounted for. The FASB's EITF has considered this matter in EITF Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*, which addresses accounting for the external and internal costs specifically associated with the modification of internal use computer software for the year 2000.

- The Year 2000 Issue may render certain client assets (such as computer hardware and software) obsolete or inoperable. Accordingly, auditors may wish to consider whether the client has properly accounted for such events by appropriately adjusting useful lives, residual values, or both; or recognizing impairment losses pursuant to the guidelines set forth under FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.*

- The Year 2000 Issue may create product warranty, product defect liability, and product returns issues for software and hardware vendors. These vendors should consider FASB Statement No. 5, *Accounting for Contingencies*, paragraphs 24 to 26, if there are product warranty or product defect liability issues, and FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, for product return issues.

- Inventories of hardware devices that are not year–2000-ready would be subject to the lower of cost or market test described in ARB 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 4, paragraph 8.

- In addition to the disclosure requirements under the pronouncements previously mentioned, practitioners should be aware of the requirements of SOP 94-6, *Disclosure of*

Certain Significant Risks and Uncertainties. Although the need for disclosure by an entity depends on facts and circumstances, disclosure may be required in areas such as impairment, inventory valuation, or litigation if it is reasonably possible that the amounts reported in the financial statements could change by a material amount within one year from the date of the financial statements. Disclosures also may be required of current vulnerability due to certain concentrations if, for example, a significant vendor has not satisfactorily addressed the Year 2000 Issue.

- Auditors of publicly held companies should consider the guidance set forth by the SEC in its Interpretation "Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers" (the Interpretation). The Interpretation, which supersedes the guidance previously set forth in the revised Staff Legal Bulletin No. 5, can be viewed on the SEC Web site, http://www.sec.gov.

Auditors should also be aware of the risk of litigation relating to the Year 2000 Issue, as some litigation consultants have indicated that lawsuits against corporate officers, directors, and perhaps auditors will begin before the year 2000 over their failure to recognize and remedy the problem.

A more complete discussion of the implications of the Year 2000 Issue, along with a list of published guidance in this area, can be found in *Audit Risk Alert—1999/2000.* Also the AICPA's web site, http://www.aicpa.org, provides a year 2000 resource page with additional information and links with other sites, and with the AICPA publication *The Year 2000 Issue—Current Accounting and Auditing Guidance.*[5]

5. With regard to this publication, the SEC Interpretation on year 2000 issues (referred to above) states that "Although the term *may* is used throughout the AICPA's guidance, perhaps suggesting that the guidance is discretionary, we believe that the procedures outlined by the AICPA should be considered appropriate practice at this time and we expect companies and their auditors to comply with that guidance. If they do not, they should be prepared to justify why the procedures were not followed."

Executive Summary—The Year 2000 Issue

- By now you are aware of the Year 2000 Issue and the potential problems that can result if corrective action is not taken.
- The Year 2000 Issue can result in audit implications, client accounting issues, and litigation threats.
- Additional information on accounting and auditing pronouncements related to the Year 2000 Issue and how the Year 2000 Issue can affect entities and their auditors can be found in the publication *Audit Risk Alert—1999/2000.*

Beyond the Audit—CPA WebTrust℠

What is CPA WebTrust℠? Why should CPAs provide this service to their retail clients?

According to polling data, a significant number of consumers will not shop online. Many are concerned with the privacy of their personal information. For example, consumers are concerned about sending their credit card and Social Security numbers over the Internet. Others question the authenticity of the company behind the Web site. In an attempt to develop greater credibility for electronic commerce conducted on the Internet and expand the base of assurance services that CPAs can offer, the CPA WebTrust℠ Seal of assurance was developed. The WebTrust℠ Seal provides assurance to online customers that the business entity behind the Web site is legitimate and adheres to a standard set of business practices and controls. In doing so, CPA WebTrust℠ builds consumer trust and confidence in conducting electronic commerce over the Internet.

CPA WebTrust℠ is an electronic commerce assurance service. It was developed jointly by the AICPA and the Canadian Institute of Chartered Accountants. The CPA WebTrust℠ Seal, which is placed directly onto the online business' Web site, is issued to those sites that have been shown to be in compliance with the CPA WebTrust℠ Principles and Criteria.[6] Online customers can click on the

6. Further information on the WebTrust℠ Principles and Criteria can be found in the Assurance Services Alert *CPA WebTrust℠—1999* (Product no. 022232kk).

Seal and gain access to a CPA-issued report about the site. The WebTrust℠ Seal can be issued only by CPAs certified to conduct WebTrust℠ engagements. That certification is obtained by completing specialized training and entering into a licensing arrangement with the AICPA. The training, certification, and licensing process that CPAs undergo, along with a mandatory WebTrust℠ quality review program, ensure the consistent application of the CPA WebTrust℠ Principles and Criteria.

Given the rapid pace with which many Web sites change, each Web site that displays the CPA WebTrust℠ Seal of assurance must undergo a review process with the CPA to renew the Seal at least every three months. This renewal period may be shorter for some businesses, depending on the nature of their operations. CPA WebTrust℠ Seals are not reissued to online businesses that do not pass the review process. The digital certificate associated with the CPA WebTrust℠ Seal of assurance is difficult to counterfeit and can be revoked if the online business does not continuously meet the prescribed business practices and control criteria.

The potential abuses and concerns associated with electronic commerce clearly demonstrate the need for assurance. But why are CPAs best suited to provide this? The answer is equally clear. CPAs bring to this environment the necessary objectivity and integrity, along with many other vital skills. Although other professionals may be able to provide the technological skills, when independent assurance is needed, the CPA's ethical standards and traditions are valuable assets. In addition, access to existing clients and knowledge of client systems and client integrity create an initial competitive advantage.

The CPA's focus on internal control in financial statement audits also provides a competitive advantage because most non-CPA competitors lack the CPA's knowledge and experience of internal control and assessment techniques. The competencies required for control assessment relative to historical financial statements are very similar to those required for assurance services. There is a natural extension of these into electronic commerce assurance services such as WebTrust℠.

Most of the skills required to perform WebTrust℠ engagements build on the existing expertise of CPAs who provide attest services in a computerized environment. However, CPAs must also acquire new competencies. These additional skills include, among others, a working knowledge of Internet technologies, protocols, and security techniques, and specific controls and best practices a company should implement. This can be accomplished by training a staff person in the required skills or contracting with or hiring an individual who has the requisite skills.

A new competency model for WebTrust℠ practitioners is currently being developed by the AICPA's Electronic Commerce Task Force. This model—which will define core competencies and proficiencies and tie the competencies as defined to a training curriculum, activities, tools, research, and information—as well as other information regarding the CPA WebTrust℠ service are discussed further in the Assurance Services Alert *CPA WebTrust℠—1999* (Product no. 022232kk).

> **Help Desk**—The AICPA is currently developing a nonauthoritative guide to assist practitioners in performing WebTrust℠ services. It will include guidance on all of the steps a practitioner takes in carrying out the WebTrust℠ engagement, from the marketing stage all the way through to the ninety-day examination updates. Look for notices regarding this upcoming publication in the *CPA Letter.*

New Auditing and Attestation Pronouncements

What new auditing and attestation pronouncements have been issued recently?

In this section we present brief summaries of recently issued auditing pronouncements. The summaries are for informational purposes only, and should not be relied on as a substitute for a complete reading of the applicable standard.

New Auditing Standards

At the time this Alert went to press, no new SASs had been issued during 1999. For proposed SASs that are in the pipeline, see the

"Recent Exposure Drafts" section of the publication *Audit Risk Alert—1999/2000.*[7]

Reminder—Don't forget that SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards,* vol. 1, AU sec. 532), became effective for reports issued after December 31, 1998. As detailed in last year's Alert, SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, what elements to include in that report.

New Attestation Standard

SSAE No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3,* was issued early in 1999.[8] The SSAE—

- Enables a practitioner to directly report on specified subject matter, such as an entity's internal control over financial reporting, rather than on management's assertion about the internal control. In either case, the practitioner is required to obtain management's assertion as a condition of engagement performance.
- Eliminates, in certain cases, the requirement for a separate presentation of management's assertion if the assertion is included in the introductory paragraph of the practitioner's report.
- Revises the reporting guidance on the SSAEs so that SSAE reports contain elements that are similar to those included in auditor's reports on historical financial statements, as prescribed in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 508).
- States that the practitioner ordinarily should express his or her conclusion directly on the subject matter, rather than on management's assertion, when conditions exist that re-

7. *Audit Risk Alert—1999/2000* (Product No. 022250kk) provides a general update on economic, auditing, and accounting matters.

8. SSAE No. 9 has been integrated within AT sections 100, 400, and 500 of AICPA, *Professional Standards,* vol. 1.

sult in one or more deviations from the criteria used to present the subject matter.

- Provides guidance on the relationship between the SSAEs and the Statements on Quality Control Standards (SQCSs).

Other Matters

AITF Advisory: *Reporting the Adoption of SOP 98-2*[9]

See the summary of this AICPA Advisory in the publication *Audit Risk Alert—1999/2000.*

Year 2000 Interpretation on SAS No. 70 Being Considered

The Auditing Standards Board is reviewing an Interpretation of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* which provides guidance on a service auditor's reporting responsibility when he or she becomes aware that a service organization's computer programs, which correctly processed data during the period covered by the service auditor's examination, did not correctly process data subsequent to the period covered by the service auditor's examination and prior to the date of the service auditor's report (the subsequent events period) because of the Year 2000 Issue. The proposed Interpretation states that since SAS No. 70 does not apply to design deficiencies that potentially could affect processing in future periods, the service auditor would not be required to report such design deficiencies in his or her report. However, potential processing problems differ from processing problems that have actually occurred and come to the service auditor's attention during the subsequent events period. Therefore, if a service auditor becomes aware of such problems, the service auditor should determine whether management has disclosed that information in section 4 of the service auditor's report, "Other Information Provided by the Service Organization." If management has not disclosed that information, the service auditor should include that information

9. From time to time the AITF issues Advisories to provide nonauthoritative guidance on current developments or recently issued authoritative literature.

in section 3 of the service auditor's report, "Information Provided by the Service Auditor," and should consider adding a paragraph to his or her report highlighting the disclosure. If management has disclosed that information in section 4 of the service auditor's report, the service auditor should disclaim an opinion on that information because it is not covered by the service auditor's report. Auditors should be alert to the issuance of a final Interpretation.

Accounting Issues and Developments

Revenue Recognition

What significant factors should the auditor consider with respect to revenue recognition for retail audit clients?

Although issues of improper revenue recognition reported in the media often are mentioned in the context of fraud, improper revenue recognition could also result from misapplication of the various revenue recognition concepts, or from errors in accounting for complex transactions. In dealing with revenue recognition questions, it may be useful to understand the principles set forth in the FASB's Statements of Financial Accounting Concepts. For example, Concept Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, includes a list of fundamental recognition criteria. Guidance of a more specific nature may be found in FASB and AICPA accounting pronouncements, such as those discussed in the following sections, and, for SEC registrants, literature such as the SEC's Accounting and Auditing Enforcement Releases (for example, Release No. 108, which addresses bill and hold situations). Generally, auditors should ensure that the following criteria have been met prior to the recognition of revenue by retailers:

1. Persuasive evidence of an agreement between the customer and retailer must exist.
2. Delivery of the product to the customer must have occurred.
3. Collectibility of the receivable from the customer must be reasonably assured.

4. If the terms of the product sale provide for customer returns, the retailer must be able to make reasonable and reliable estimates of such returns.

Some accounting pronouncements that may be of significance to retail entities are discussed below.

FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*

As with most entities that sell products, customers of retailers often have certain return rights. FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, specifies criteria for recognizing revenue on a sale in which a product may be returned, whether as a matter of contract or as a matter of existing practice, either by the ultimate customer or by a party who resells the product to others. FASB Statement No. 48 provides that revenue from such sales transactions shall be recognized at the time of sale only if all the following conditions are met:

1. The seller's price to the buyer is substantially fixed or determinable at the date of sale.
2. The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product.
3. The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
4. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.[10]
5. The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.

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

6. The amount of future returns[11] can be reasonably estimated.

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

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

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

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

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

FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*

The retail entity may also have revenue from the sale of separately priced extended warranty and product maintenance contracts to customers. FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts,*

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

addresses how revenue and costs from a separately priced extended warranty or product maintenance contract should be recognized. The bulletin provides the following:

1. Revenue from separately priced extended warranty and product maintenance contracts should be deferred and recognized in income on a straight-line basis over the contract period except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. In those circumstances, revenue should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.

2. Costs that are directly related to the acquisition of a contract and that would have not been incurred but for the acquisition of that contract (incremental direct acquisition costs) should be deferred and charged to expense in proportion to the revenue recognized. All other costs, such as costs of services performed under the contract, general and administrative expenses, advertising expenses, and costs associated with the negotiation of a contract that is not consummated, should be charged to expense as incurred.

3. A loss should be recognized on extended warranty or product maintenance contracts if the sum of expected costs of providing services under the contracts and unamortized acquisition costs exceeds related unearned revenue. Extended warranty or product maintenance contracts should be grouped in a consistent manner to determine if a loss exists. A loss should be recognized first by charging any unamortized acquisition costs to expense. If the loss is greater than the unamortized acquisition costs, a liability should be recognized for the excess.

Help Desk—In addition to the pronouncements mentioned in this section, information on other accounting guidance on revenue recognition can be found in the AICPA's *recently* published Audit Issues in Revenue Recognition, a nonauthoritative guide developed in response to concerns expressed by the SEC about improper revenue recognition. This publication brings together in one source important auditing and accounting guidance on revenue recognition. You may obtain this publication from the AICPA Web site at http://www.aicpa.org/members/div/auditstd/pubaud.htm.

Leasing Transactions

How does the use of leasing transactions in retail businesses affect the auditor?

Retailers often operate from multiple locations, including stores and warehouses, and these locations can change in response to economic conditions. Retailers often choose to lease a significant portion of their space, one reason being that leasing, as opposed to owning, frees up capital that can be used in inventory financing. As a result, lease expense is usually one of the larger expense items for retailers. The following discussion highlights some of the variety of leasing issues that the auditor should be alert to when auditing retail clients.

To begin with, the auditor will need to determine the leases that the client has entered into. This may be accomplished with procedures such as talking to company personnel, reviewing minutes, analyzing rent expense (analytical procedures may prove effective for this purpose), and reviewing lease agreements. The auditor should also review the terms of each lease to determine if it has been properly accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*, and the related Interpretations and pronouncements, which provide, in part, that a lease is categorized as a capital lease if it meets one of the following criteria.

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease contains an option to purchase the leased property at a bargain price.
3. The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
4. The present value of rental and other minimum lease payments equals or exceeds 90 percent of the fair value of the

leased property less any investment tax credit retained by the lessor.

Some of the issues the auditor may encounter when evaluating the lease under these standards are that the lease may apply only to a portion of a building, equipment may be included in the rental, the fair market value of the leased property may not be easily determinable, and the economic life of the leased property may not be easily determinable.

The auditor will need to determine whether the client has properly accounted for the leases in the financial statements and that appropriate disclosures have been included in the financial statements. A detailed discussion of the accounting for lease terms is beyond the scope of this Audit Risk Alert, but in general, for operating leases (which tend to be more prevalent among retail store space), FASB Statement No. 13 provides, in part, the following.

Normally, rental on an operating lease shall be charged to expense over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expense nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used.

In addition to base rents, the lease may provide for various other kinds of lease terms, such as the following:

- Scheduled rent increases
- Rent holidays
- Contingent rents (such as percentage rents)
- Common area maintenance (CAM) charges
- Pass-through charges, such as property taxes and insurance
- Reimbursements by the landlord to the lessee for certain expenses, such as moving and leasehold improvements
- Key money

- Sublease income
- Construction allowances from the landlord for construction or remodeling costs

The auditor will need to determine that these arrangements have also been recorded in accordance with FASB Statement No. 13, and the related Interpretations and pronouncements, including consensus positions reached by the EITF relating to leasing transactions. See the section entitled "EITF Consensus Positions" in *Audit Risk Alert—1999/2000* for a listing of recent EITF issues, including EITF Issue No. 98-9, *Accounting for Contingent Rent.* EITF Issue No. 98-9 addresses how lessees should account during annual and interim periods for contingent rental expense that is based on future specified targets.

The auditor should also review leases for upcoming lease expiration dates, penalties for early terminations, requirements that the client make changes to the premises, and other terms.

Lease terms often call for contingent rents to be calculated as the greater of a specified minimum or a percentage of sales over a set dollar amount. Various categories of sales or receipts may be excluded, such as sales to employees, sales taxes collected, and delivery charges. Landlords often require a report from the accountants with respect to the sales amounts. The level of service used in this report can be an audit, a review, a compilation, or agreed-upon procedures. However, the first question to be answered is whether the information will be reported on as supplementary information to the basic financial statements or reported on separately as a separate specified element. Assuming that the landlord requires an audit service, and sales are being reported on as supplementary information, the auditor would follow SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), in addition to other applicable GAAS. However, if the audit service is to report on sales as a separate element, the auditor would follow SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), in addition to other applicable GAAS. If a different level of service is required, the auditor would follow the applicable standards.

Numerous other issues can also arise when addressing leases. For example, if the owner of the retail business also owns the building being leased in a separate entity (more often seen with freestanding sites), the auditor should refer to "Related Parties" in SAS No. 45, *Omnibus Statement on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 334), FASB Statement No.13, and the related Interpretations and pronouncements. Another example of a situation the auditor may encounter occurs if the retailer subleases a portion of the stores to independent entities; such arrangements may affect sublease income, payroll, and so forth.

The auditor needs to be aware of various situations that can affect the accounting treatment for the client's leases. For example, because of the nature of the transaction, such as the use of a special-purpose entity as the lessor or the client's involvement in asset construction, the retail client may be required to consolidate the other entity or record additional assets. Among the applicable literature are EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*, EITF Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction.*

Store Closings

What accounting issues arise with respect to store closings?

Closing particular stores is often a normal part of a retailer's operations. Among the issues to be considered by the auditor are—

- Whether a store closing constitutes an event or a change in circumstances indicating that the carrying amount of an asset in question may not be recoverable. Auditors should evaluate management's consideration of FASB Statement 121, which requires that long-lived assets and certain identifiable intangibles and goodwill related to those assets to be held and used by an entity be reviewed for impairment in such circumstances. This Statement also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less costs to sell, except for assets covered by APB Opinion 30, *Reporting the Results of Operations–Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.* Assets covered by APB Opinion 30 will continue to be reported at the lower of the carrying amount or the net realizable value.

- Whether management has properly addressed the requirements of EITF Issue 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring).* This has been an area of concern by SEC staff. Auditors of SEC registrants should, therefore, pay particular attention to the accrual of estimated liabilities, the criteria necessary to accrue for the costs of the exit plan, and the disclosures that should be provided. In particular, the reasons for such accruals, and the incurrence of the costs which are subsequently charged against such reserves, or the reversals of excess amounts of such liability reserves, should be clearly disclosed. When evaluating the criteria necessary to accrue for the costs of an exit plan, auditors should be aware of the requirement in EITF Issue 94-3 that the exit plan identify specifically all significant actions to be taken to complete the exit plan. In determining the specificity of a retailer's exit plan, SEC staff suggests that auditors may wish to consider whether the exit plan is sufficiently detailed such that the retailer can and will use it to (1) evaluate the performance of those responsible for executing the plan and (2) identify and react to plan versus actual performance. That is, auditors should consider whether the exit plan is at least comparable to other operating and capital budgets the retailer prepares in terms of the level of detail and reliability of estimates. Furthermore, auditors should consider whether it is more likely than not that either the exit plan itself, or significant actions identified within the exit plan, will be materially revised in response to events or circumstances that are likely to occur. If so, the exit plan may not be sufficiently detailed and, thus, not meet the criteria for accrual of related costs under EITF Issue 94-3. Finally, auditors should be aware that EITF Issue 94-3 permits accruals to be made only for those costs associated with specifically identified significant actions that can be reasonably estimated at the exit plan's commitment date.

- Whether the client has properly addressed the requirements of EITF Issue No. 96-9, *Classification of Inventory Markdowns and Other Costs Associated with a Restructuring*, and, for publicly held companies, whether the position of the SEC staff, as provided in Staff Accounting Bulletin No. 67, has been followed regarding the classification as a component of costs of good sold for markdowns associated with a restructuring.
- Whether, as a result of the decision to close a store, the client has entered into a lease modification agreement with the landlord, and whether the client has properly addressed the requirements of EITF Issue 95-17, *Accounting for Modification to an Operating Lease.*

New FASB Pronouncements

What new accounting pronouncements have been issued this year by the FASB?

FASB Statement No. 134

See the summary of FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, an amendment of FASB Statement No. 65, in *Audit Risk Alert—1999/2000.*

FASB Statement No. 135

See the summary of FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*, in *Audit Risk Alert—1999/2000.*

FASB Statement No. 136

See the summary of FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, in *Audit Risk Alert—1999/2000.*

FASB Statement No. 137

FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, an amendment of FASB Statement No. 133, amends Statement 133 as follows: (1) the first sentence of paragraph 48 is replaced by the following: "This Statement shall be effective for all fiscal quarters of all fiscal years beginning after June 15, 2000." (2) Paragraph 50 is replaced by the following : "At the date of initial application, an entity shall choose to either (a) recognize as an asset or liability in the statement of financial position all embedded derivative instruments that are required pursuant to paragraphs 12-16 to be separated from their host contracts or (b) select either January 1, 1998 or January 1, 1999 as a transition date for embedded derivatives. If the entity chooses to select a transition date, it shall recognize as separate assets and liabilities (pursuant to paragraphs 12-16) only those derivatives embedded in hybrid instruments issued, acquired, or substantively modified by the entity on or after the selected transition date. That choice is not permitted to be applied to only some of an entity's individual hybrid instruments and must be applied on an all-or-none basis." The Statement became effective upon its issuance in June 1999.

FASB Interpretation 43

See the summary of FASB Interpretation 43, *Real Estate Sales,* of FASB Statement No. 66, *Accounting for Sales of Real Estate* in *Audit Risk Alert—1999/2000.*

EITF Consensus Positions

The status of issues considered recently by the EITF of the FASB can be found in *Audit Risk Alert—1999/2000.*

Executive Summary—New FASB Pronouncements

- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise,* an amendment of FASB Statement No. 65
- FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*

- FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*
- FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, an amendment of FASB Statement No. 133
- FASB Interpretation 43, *Real Estate Sales*
- The status of issues considered recently by the EITF of the FASB can be found in *Audit Risk Alert—1999/2000* or on the FASB Web site.

New AICPA Accounting and Auditing Statements of Position

What new AICPA accounting and auditing SOPs have been issued this year?

SOP 98-9

See the summary of SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, *With Respect to Certain Transactions*, in *Audit Risk Alert 1999/2000.*

SOP 99-1

See the summary of SOP 99-1, *Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program*, in *Audit Risk Alert—1999/2000.*

SOP 99-2

See the summary of SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, in *Audit Risk Alert—1999/2000.*

SOP 99-3

See the summary of SOP 99-3, *Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters*, in *Audit Risk Alert—1999/2000.*

AcSEC Pronouncements Effective in 1999

The following are AcSEC pronouncements with effective dates in 1999:

- SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk,* effective for financial statements for fiscal years beginning after June 15, 1999, with earlier application encouraged
- Reminder—SOP 98-5, *Reporting on the Costs of Start-Up Activities,* is effective for fiscal years beginning after December 15, 1998

Executive Summary—New AICPA Statements of Position

- SOP 98-9, *Modification of SOP 97-2,* Software Revenue Recognition, *With Respect to Certain Transactions*
- SOP 99-1, *Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program*
- SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans: Amendment to the AICPA Audit and Accounting Guide* Audits of Employee Benefit Plans
- SOP 99-3, *Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters*
- Reminder—SOP 98-7 is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier application encouraged. SOP 98-5 is effective for fiscal years beginning after December 15, 1998.

Independence and Other Ethics Standards

The Independence Standards Board's First Standard

What is the Independence Standards Board? Has it issued any standards that you must follow?

The Independence Standards Board (ISB) was established in May 1997 as part of an agreement between the AICPA and the SEC. Its charge is to establish, maintain, and improve independence standards for external auditors of SEC registrants. Although the SEC retains its statutory authority to define independence, it recognizes the responsibility of the ISB in establishing independence standards and interpretations for auditors of public entities. The SEC also considers principles, standards, interpretations, and practices issued by the ISB as having substantial authoritative support.

The pronouncements of the ISB apply to auditors of publicly held entities only. The functioning of the ISB does not affect the authority of state licensing or disciplinary authorities regarding auditor independence. Also, it does not affect the AICPA rules on independence as they relate to audits of nonpublic entities.

The ISB adopted its first standard this year. ISB Standard No. 1, *Independence Discussions with Audit Committees*, requires auditors of public companies, at least annually, to—

1. Disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgement may reasonably be thought to bear on independence.
2. Confirm in the letter that, in its professional judgement, it is independent of the company within the meaning of the Securities Acts.
3. Discuss its independence with the audit committee.

This Standard is effective for audits of companies with fiscal years ending after July 15, 1999, with earlier application encouraged.[12]

The Professional Issues Task Force (PITF) has issued Practice Alert 99-1, *Guidance for Independence Discussions with Audit Committees*,

12. The *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (see *Audit Risk Alert—1999/2000*) includes a recommendation that the listing rules for both the New York Stock Exchange and the National Association of Securities Dealers require audit committees to ensure the receipt of a formal written statement from the outside auditors consistent with ISB Standard No.1.

to assist firms in evaluating and enhancing their policies and procedures for identifying and communicating with audit committees those judgmental matters that may reasonably be thought to bear on the auditor's independence. The Practice Alert provides examples of certain relationships that may be thought to bear on the auditor's independence, safeguards to ensure independence, a sample letter to an audit committee, and other implementation guidance.

Help Desk—EITF Practice Alert 99-1 can be found on the AICPA Web site at http://www.aicpa.org/pubs/cpaltr/may99/supp/public.htm

In addition to its first standard, the ISB also issued Interpretation 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives).* This Interpretation provides guidance on the auditor independence implications of likely areas of requested assistance, solely with respect to the implementation of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

The Interpretation concludes that the auditor may provide consulting services on the proper application of FASB Statement No. 133, including assisting a client in gaining a general understanding of the methods, models, assumptions, and inputs used in computing a derivative's value. To ensure, however, that the auditor's independence is not threatened, as discussed in paragraph 4 of the Interpretation, the auditor may not prepare accounting entries, compute derivative values, or be responsible for key assumptions or inputs used by the client in computing derivative values. The Interpretation includes illustrative lists of permitted and prohibited services.

Help Desk—The full text of the Standard and the Interpretation, along with information about all other activities of the ISB, are posted on the ISB's Web site at http://www.cpaindependence.org

AICPA Professional Ethics Rulings and Interpretations

Ethics Interpretations and rulings are promulgated by the executive committee of the professional ethics division of the AICPA to provide guidelines on the scope and application of ethics rules but are not intended to limit such scope or application. Publication of an Interpretation or ethics ruling in the *Journal of Accountancy* constitutes notice to members. A member who departs from Interpretations or rulings shall have the burden of justifying such departure in any disciplinary hearing. A listing of recent ethics ruling and interpretations is included in *Audit Risk Alert—1999/2000.*

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This Audit Risk Alert replaces *Retail Industry Developments—1998/99.*

Practitioners should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—1999/2000* (Product no. 022250kk) and *Compilation and Review Alert—1999/2000* (Product no. 022240kk) which may be obtained by calling the AICPA Order Department at 1-888-777-7077.

The *Retail Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be greatly appreciated. You may send these comments to:

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APPENDIX A
The Internet—An Auditor's Research Tool

If used properly, the Internet can be a valuable tool for auditors. Through the Internet, auditors can access a wide variety of global business information. For example, information is available relating to SEC filings, professional news, state CPA society information, Internal Revenue Service information, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are such materials accessible from the computer, but they are available at any time, and are generally free of charge.

A number of resources provide direct information, whereas others may simply point to information inside and outside of the Internet. Auditors can use the Internet to—

- Obtain audit and accounting research information.
- Obtain texts such as audit programs.
- Discuss audit issues with peers.
- Communicate with audit clients.
- Obtain information from a client's Web site.
- Obtain information on professional associations.

There are caveats to keep in mind when using the Internet. Reliability of information obtained via the Internet varies considerably. Some information on the Internet has not been reviewed or checked for accuracy; caution is advised when accessing data from unknown or questionable sources. Although a vast amount of information is available on the Internet, much of it may be of little or no value to auditors. Accordingly, auditors should learn to use search engines effectively to minimize the amount of time browsing through useless information. The Internet is best used in tandem with other research tools, because it is unlikely that all desired research can be conducted solely from Internet sources.

Some Web sites that may provide valuable information to auditors are listed in the following table.

Name of Site	*Content*	*Internet Address*
American Institute of CPAs	Summaries of recent auditing and other professional standards as well as other AICPA activities	http://www.aicpa.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	http://www.fasb.org
Securities and Exchange Commission	SEC Digest and Statements, EDGAR database, current SEC rulemaking	http://www.sec.gov
Independence Standards Board	Information on the activities of the Independence Standards Board	http://www.cpaindependence.org
The Electronic Accountant	World Wide Web magazine that features up-to-the-minute news for accountants	http://www.electronic accountant.com
CPAnet	Links to other Web sites of interest to CPAs	http://www.cpalinks.com/
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	http://www.tetranet.net/users/ gaostl/guide.htm
Accountants Home Page	Resources for accountants and financial and business professionals	http://www.computercpa.com/
United States Department of Commerce	Various economic statistics about the U.S. economy	http://www.doc.gov http://www.bea.doc.gov
U.S. Tax Code Online	A complete text of the U.S. Tax Code	http://www.fourmilab.ch/ ustax/ustax.html
Federal Reserve Bank of New York	Key interest rates	http://www.ny.frb.org/pihome/ statistics/dlyrates
Cybersolve	Online financial calculators such as ratio and breakeven analysis	http://www.cybersolve.com/ tools1.html
XFRML—the digital language of business	Information on the development of a standards-based method to prepare, publish in a variety of formats, exchange and analyze financial reports and the information they contain.	http://www.xfrml.org
Hoovers Online	Online information on various companies and industries	http://www.hoovers.com

Name of Site	*Content*	*Internet Address*
Ask Jeeves	Search engine that utilizes a user-friendly question format. Provides simultaneous search results from other search engines as well (e.g., Excite, Yahoo, AltaVista)	http://www.askjeeves.com
Vision Project	Information on the profession's vision project	http://www.cpavision.org/horizon
Chain Store Age	Industry periodical with retail news headlines	http://www.chainstoreage.com
MRI Retail Search	Executive search firm that provides links to many industry web sites	http://www.mrisearch.com
Today's Retail News	Current events in the retail industry	http://biz.yahoo.com/news/retail.html